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Wednesday, 28<sup>th</sup> May, 2008

Dear John,

**RE: National Grid Gas (NTS) SO Environmental Incentive - Initial Proposals Consultation**

E.ON UK supports the intention behind this proposed new environmental SO incentive, which is to reduce the level of methane emissions from the NTS. Although compared to Gas Distribution Networks, the volume of methane vented from the NTS is small; nonetheless we believe that there are clear environmental benefits to be gained by reducing overall emissions. This initial consultation paper, however, raises more questions than it answers and we believe there is more detailed analysis that needs to be carried out - particularly on potential unintended consequences - before this incentive can be implemented into National Grid's licence.

***Question 1: Is it appropriate for National Grid to have an Environmental Incentive relating the natural gas vented from NTS compressors?***

**Nature and Purpose of the Incentive**

Under its current licence arrangements, National Grid NTS is cost-neutral to the methane it releases from the NTS. It is neither penalised<sup>1</sup> nor rewarded for varying the volume of methane emitted. As a result, it has little reason to vent compressors other than for routine maintenance or operational reasons.

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<sup>1</sup> But is subject to primary legislation imposing environmental limits.

Under the proposed incentive, however, National Grid will be forced to consider the environmental impact of its actions. The reward for doing so is additional revenue where the emissions are reduced, even if this is only by a small amount. If National Grid achieves only a modest reduction in emissions each year, it will receive more revenue than is currently the case, but will continue to pollute by releasing methane from its compressors. At a high-level, it could be argued that this concept does not sit particularly comfortably with the “polluter pays” principle and perhaps brings into question the suitability of a financial incentive for this particular issue.

The incentive appears to do little to motivate National Grid NTS to find better or more innovative ways of managing the problem and thereby reducing the cost both to industry and the environment. For instance, venting pure methane is significantly more damaging to the environment than burning methane, so could it be more environmentally sound in certain circumstances to burn-off the gas rather than release it directly into the atmosphere? This has not been explored in the consultation paper but may merit further analysis.

The fact that the proposed incentive is neither particularly harsh nor rewarding for National Grid NTS may suggest that improvements could be made by NGG through relatively simple changes, rather than requiring significant investment in the system. It would clearly not be appropriate for National Grid NTS to receive additional remuneration for doing something which it is perfectly capable of doing already, as this would not provide value for money for the industry. A strong incentive is one that accomplishes the stated goal; but we are concerned that that this particular incentive could easily turn into a ‘steady earner’ for National Grid NTS if they achieve modest improvement in performance each year, without really making any significant steps to reduce methane emissions.

In summary, although the intention behind the proposal is to be welcomed, the proposed incentive seems likely to reward a simple change in operational policy rather than, for instance, the use of innovative technology to abate methane emissions. A more challenging incentive may have a greater effect on NGG NTS’s behaviour, but this must be proportionate to the benefits gained and must take account of the potential for unintended consequences. Some of these are explored from our perspective as a User of the NTS in more detail, below.

### **Timing of the Incentive**

As this proposal is being raised between industry consultations on current and future SO incentive schemes, it is impossible to assess how this incentive would work with the other SO incentives. More detail is required on the interaction between the various SO incentives to ensure that there are no windfall gains to be made.

We also have a concern that this new incentive is proposed to apply from April 2008. We have no visibility on NGG's performance over the last few months, so there is the potential for currently hidden windfall gains to be made if this incentive is implemented retrospectively. We would prefer to see this incentive implemented from October 2008 as a minimum, which of course does not prevent National Grid from taking action in the meantime to actively reduce its methane emissions from the NTS.

### **Impact of the incentive on Users of the NTS**

As National Grid acknowledges, any environmental costs incurred under this future incentive would feed into their operational decision making for the system. However, it is not clear from the consultation to what *extent* this proposal will influence the operation of compressors on the network.

As a User of the NTS, our concern is the possible negative impact on the rights of Users: Specifically that our rights may be reduced or adversely affected by this proposal. In addition, it is not clear whether a change in operational policy for compressors to take account of this proposed incentive, will affect the available capacity of the network. If it were to reduce available capacity then this is something about which we would have very significant concerns. More clarification or explanation on this point from National Grid would be appreciated.

A significant sharpening of the incentive may motivate NGG NTS to perform better in reducing methane emissions, but would this necessarily mean environmental concerns play a greater role in System Operator decision making, thereby pushing the interests of Users further down the ranks? It is not clear in the consultation what the effects on Users would be and so we would welcome more detail (or reassurance that there will be no adverse effects) from National Grid NTS.

***Question 2: Is the approach taken to setting the target volume of vented natural gas (2086 tonnes) appropriate?***

Although National Grid NTS has provided evidence of historic performance for the last seven years, we have no feel for whether this was "good" or "bad", since there is no other benchmark to use. As such, it is difficult for us to say whether it is the best, or indeed most challenging, starting point for National Grid, but it would seem like a reasonable place to begin.

***Question 3: Is it correct to use an 80% conversion factor to apply from natural gas to methane?***

Based on the evidence put forward by National Grid in paragraph 24, we broadly agree with this approach.

***Question 4: Is £546/tonne of methane and therefore £437/tonne of natural gas vented, the correct price to apply to the incentive.***

It is sensible to be consistent with the DEFRA guidance on the use of the shadow price of carbon in policy appraisal.

***Question 5: Is it appropriate that the incentive has no sharing factor, cap or floor?***

Without access to the full data set for the distribution of expected costs it is not possible to ascertain whether or not it is appropriate to have sharing factors.

***Question 6: Is it appropriate that the scheme should have a dead band? & Question 7: If there was a dead band what size should it be?***

As a Shipper we have little feel for how hard or easy it will be for National Grid NTS to achieve the objective behind this proposed incentive. The lack of a consistent pattern to past performance does not help and the deviation between volumes of methane released in the last seven years has been significant - e.g. 564 tonnes more methane released in 2003

than in 2002. If National Grid was to repeat its performance in 2002 or 2007<sup>2</sup>, it would potentially earn c. £100,000 - £150,000<sup>3</sup> apparently without even changing its behaviour, since both years out-turned well below the seven-year average. Therefore, the significant year-on-year fluctuations would suggest the need for a dead band to rule-out excessive windfall gains for National Grid NTS. However, it is difficult to say at this point exactly what size the dead band should be, but we would certainly welcome more analysis on this point.

I hope you find these comments useful in informing the way forward on this issue, but if you wish to discuss them in any more detail, please do not hesitate to contact me on T: 02476 181421.

Yours sincerely

**Richard Fairholme (by email)**  
Trading Arrangements  
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<sup>2</sup> 1819 and 1887 tonnes, respectively.

<sup>3</sup> Based on Figure 2, page 10 of the consultation document.