



Industry Participants, Customers
and other interested parties

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Direct Dial: 0207 901 7437
Email: mark.feather@ofgem.gov.uk

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Dear Colleague

Proposed Guidance - Environmental Issues and the Code Objectives

This letter sets out Ofgem's proposed guidance to code panels, administrators and industry participants on the treatment of carbon costs within the existing code governance framework, and in particular, in relation to the code objective governing economic and efficient network operation within the industry codes.

The energy sector is a significant contributor to the production of greenhouse gases and has a key role to play in tackling climate change and delivering more sustainable and secure energy markets. Member States have committed to targets to reduce significantly the overall level of greenhouse gas emissions and to increase significantly the contribution of renewable energy, both by 2020.

Ofgem clearly has a key role to play in this rapidly changing policy environment. It operates within a statutory framework within which it makes complex judgements balancing social, economic, environmental and other considerations. Recent examples of where environmental considerations have been at the heart of Ofgem's policy include:

- *setting new incentives for National Grid to reduce emissions of greenhouse gases associated with its networks;*
- *proposing new incentives on the gas distribution networks to cut their emissions of greenhouse gases through gas that is lost in the process of transportation;*
- *possible extension of gas networks; and*
- *revision of the guidelines on Green Supply Offerings which are deals offered by most major energy suppliers to customers who want to use energy generated from renewables.*

However, it is not only for regulators and governments to tackle the challenges posed by climate change and moving to a low carbon energy system. Industry and market participants also have a critical role to play and will need to evolve their commercial thinking to embrace these challenges.

One of the fundamental aspects of the energy market, and in which industry has a crucial role, are the codes¹ governing key commercial relationships between market participants.

¹ The term codes includes the Balancing and Settlement Code, the Connection and Use of System Code, the Uniform Network Code, the Distribution Use of System and Connection Agreement, the System Operator Transmission Owner Code, the Uniform Network Code for Independent Gas Transporters, Supply Point Administration Agreement, Master Registration Agreement, the Grid Code, and the Distribution Code.

Industry has an important role in overseeing and conducting the process of analysis for modifications to these codes. In this context, we have been considering the role of the industry in the codes process and how this fits in with the climate change and sustainable development agenda.

We touched upon these issues in our open letter to the CUSC Panel Chairman, on 17 April 2007². This letter was also forwarded to the panel chairs of all the other industry codes, since the issue is relevant across all of the codes that govern the industry.

Codes Governance Review

Since publishing our 17 April 2007 letter, we have initiated the Industry Codes Governance Review ('the governance review') which is considering, amongst other things, whether the current objectives for the industry codes need to be aligned with the statutory duties of the Gas and Electricity Markets Authority and, as part of this, whether additional objectives are needed to supplement the existing code objectives.³ For example, we may consider it appropriate to add additional objectives to address issues such as the environment.

Our recent consultation on the scope of the governance review concluded in late January. Since then we have held a Powering the Energy Debate (PED) event on the governance review which addressed, amongst other things, sustainability and the code governance arrangements. We are now giving consideration to the scope of the governance review, including whether to address issues relating to the scope of the code objectives.

On 17 March we issued a letter to industry participants and customers which provided an update on the governance review.⁴

Guidance on carbon costs

Having given more thought to the issues raised in our letter of 17 April 2007, we consider that it would be appropriate to issue further guidance to industry participants, code panels and code administrators on the treatment of greenhouse gas emissions within the existing code objectives. Further clarification of the interpretation of the code objectives, which we set out below, could assist in providing increased certainty to the industry and should aid in ensuring that the greenhouse gas impacts of code modification proposals are fully assessed.

This clarification is intended to assist industry participants under the current code arrangements. However, it does not prejudice the outcome of any further discussions and consultation on this issue that may arise out of the governance review.

Some modifications to the codes will have an impact on the level of greenhouse gases that are released into the environment and we consider it is important that when assessing whether a code modification is more economic and efficient than the status quo and any other modification proposal against which it is being assessed, the financial impacts of greenhouse gas emissions are factored into the analysis.

Going forward therefore, we consider industry needs to assess, where relevant, the financial impact a code modification may have in terms of its ability to increase or reduce the levels of greenhouse gases emitted into the environment.

The introduction of policy instruments such as the EU Emissions Trading Scheme (ETS) in 2005 has meant that a market value can now be placed on the cost of greenhouse gas emissions including carbon and that this value can be used to assess the environmental

² The letter can be viewed at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=43&refer=Licensing/ElecCodes/CUSC/Amend>

³ *Review of industry code governance*, Ofgem, 28 November 2007

⁴ This update can be viewed at: <http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx>

costs of code modification proposals. In addition, the Government has issued guidance on the shadow price of carbon which can also be used to assess environmental costs.⁵ The shadow price of carbon is intended to represent society's willingness to pay for carbon abatement. It is noted that in its March 2008 Revised Guidance for Impact Assessments, Ofgem indicated that it will use the new guidance on the shadow price of carbon wherever appropriate⁶. In view of these developments, we consider that code panels should also take these measurable costs into account in assessing code modification proposals.

Proposed guidance

"In practical terms, all code panels should take the following steps in considering the impact of a code modification proposal on greenhouse gas emissions, and in particular, the costs of these emissions:

1. *The panel should consider whether a code modification is likely to have an impact on the efficient and economic operation of the network (in accordance with the relevant objective as set out in the code under which the modification has been raised).*
2. *If the panel reaches the view that the code modification will have such an impact, then the panel should consider whether the modification, in so far as it impacts upon efficient and economic network operation, is likely to have an impact in either reducing or increasing greenhouse gases.*
3. *If the panel reaches a view that such an impact will occur or is likely to occur, the financial consequences of this impact should be quantified in terms of greenhouse gas costs. This may require the panel to employ the relevant expertise to undertake such measurements.*
4. *Any measurement should assess the economic costs and benefits of greenhouse gas increases or reductions associated with the modification proposal. In undertaking these measurements we consider that the code panels should:*
 - a. *quantify the impact on greenhouse gas emissions in terms of tonnes of carbon equivalent⁷; and*
 - b. *develop a range of cost scenarios using both the price of carbon under the EU ETS, as well as the shadow price of carbon. We recognise that going forward, other mechanisms to measure the commercial costs of greenhouse gases may be developed and this letter should not be interpreted as precluding the use of any such mechanisms.*
5. *Having measured the economic costs of greenhouse gas emissions, the code panel should use the results of this analysis to inform its assessment of the relevant modification against the efficient and economic network operation objective of the relevant industry codes."*

By taking these steps, we consider that the code panels can take the costs of greenhouse gas emissions into account within the existing code objectives.

In proposing this guidance, we recognise that there are potentially wider impacts on the environment beyond the cost of greenhouse gas emissions that may need to be assessed

⁵ This guidance has been issued by DEFRA and is available on <http://www.defra.gov.uk/Environment/climatechange/research/carboncost/index.htm>

⁶ *Guidance on Impact Assessments*, Ofgem, March 2008 at paragraph 6.25.

⁷ Quantification of greenhouse gas emissions in terms of tonnes of carbon equivalent can be undertaken using the guidance provided by DEFRA at <http://www.defra.gov.uk/Environment/climatechange/research/carboncost/index.htm>

by code panels⁸. Further, we recognise that the Authority has wider statutory duties governing sustainability and the environment that it needs to consider in assessing code modification proposals. Whilst this letter does not offer guidance on any other assessments that need to be made by code panels or the Authority's interpretation of its statutory duties, we nevertheless consider that the proposed guidance set out above would increase the degree of alignment between panel assessments of code modifications and the Authority's own analysis.

In order to take account of the views of interested parties in introducing the guidance, we welcome written submissions. We request that any such responses are provided by 30 April 2008. Subject to those, we propose that panels should take account of the guidance from 19 May 2008.

If you have any questions regarding this letter, please contact me on the above number.

Yours sincerely



Mark Feather
Director, Industry Codes and Licensing

⁸ For example, the relevant objectives of the CUSC refer to the "efficient discharge by the licensee of its obligations...under the [Electricity Act]". Schedule 9 of the Electricity Act contains certain duties relating to the environment which are applicable to National Grid Electricity Transmission. Therefore, the CUSC panel may need to assess other impacts on the environment when considering CUSC modification proposals.