



First Hydro Company is part of a joint venture between
International Power plc and Mitsui & Co., Ltd.

First Hydro Company
Bala House
Lakeside Business Village
St David's Park
Deeside
Flintshire
CH5 3XJ

Tel + 44 (0)1244 504 600
Fax + 44 (0)1244 504 613
www.ipplc.com
www.mitsui.co.jp

Ian Pashley
National Grid plc
National Grid House
Gallows Hill
Warwick
CV34 6DA

22nd December 2010

Dear Ian,

Electricity SO Incentives: Initial Proposals for 1st April 2011

These comments are provided on behalf of all of the International Power/ Mitsui assets in the UK.

Below are our principal thoughts on the Initial Proposals for 2011.

Success of the new method

It is clear that NG has made a significant attempt to improve the incentive scheme mechanism. In many ways the increased use of ex post variables represents a step forward in the methodology. There is substantial uncertainty surrounding key drivers of costs which the increased use of ex post variables can mitigate to a certain degree. However, whilst a step forward, this modelling exercise also demonstrates the difficulty in this general approach to incentives. The proposed method is highly complex and whilst it might achieve more accurate incentive targets, it does not follow that it delivers sufficiently accurate incentive targets. It is not clear that the proposed method can support multi-year schemes.

Robustness of relationships

The success of the new methodology depends on the ability to establish robust ex ante relationships between the variables; we are not convinced that the relationships established are sufficiently robust (particularly in the margin and the constraints models). This leaves open the potential for windfall profits/losses as the relationships may or may not hold for the duration of the scheme. Further, future system requirements may cause these historic relationships to break down. This is not necessarily the ideal incentive in a market that is changing in some significant ways.

The proposed approach demonstrates the limitations of such historic relationship based methodologies: despite extensive analysis, the interactions between all the variables which determine

First Hydro Company
Registered in England: 02444277
Registered Office: Senator House
85 Queen Victoria Street
London EC4V 4DP

out-turn costs are simply too complex to accurately capture in a model. There is a risk that too much weight is placed on the models in the push to establish longer term schemes.

Deadband, caps/ collars and sharing factors

Given the limitations of the ex ante relationships it is clear that windfall profits/ losses are still possible; for this reason we believe a deadband is still required. Further, using the new methodology to apply sharper incentives (e.g. higher sharing factors) may not be justified. The Initial Proposals document fails to make a strong case for higher caps/collars than those seen in recent years; +/- £50m over two years is a substantial increase from the current cap/collar levels. It is not clear that the drivers of costs can be modelled successfully enough to justify such an increase.

More targeted incentives

The extent of the modelling exercise undertaken and the limitations it reveals demonstrate the complexity and difficulty in establishing a robust incentive scheme. An alternate method to encourage NG to take a longer term view, and reduce consumers' costs, would be to establish specific, targeted incentives for those projects which the current one year bundled scheme fails to encourage (due to its relatively short timeframe). This approach does not seem to have been considered in the evaluation of the incentive scheme.

Consultation timescales

The timeline for agreeing the new methodology is quite compressed. The proposals do not indicate what would happen if the consultation process reveals flaws in the proposed methodology such that it could not be implemented; intuitively, there is insufficient time to implement a scheme using the 2010/11 methodology. We must question whether this review process is being squeezed into too short a timeframe.

Conclusion

Whilst the proposed methodology increases the sophistication of the model the interaction of variables is so complex that we doubt that it can be modelled sufficiently accurately to justify substantially increasing the caps and collars or eliminating the deadband. Further, the modelling may not be robust enough to support longer term schemes. For these reasons it may be more appropriate to apply the proposed methodology to a one-year scheme with similar caps/collars and sharing factors as can be found under the 2010/11 Incentive Scheme.

If you have any questions on our response then please do not hesitate to contact me.

Yours sincerely,

Andy Rimmer
Trading Analyst