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Dear Chris

National Grid Gas (NGG) and Electricity (NGET) System Operator (SO) Incentives: Initial Proposals consultation

energywatch welcomes the opportunity to respond to the issues raised in this consultation. This response is non-confidential and we are happy for it to be published on the National Grid website.

Consumers expect the delivery of safe, secure and reliable supplies of gas and electricity in an efficient and economic manner. NGG and NGET, as the System Operators of the National Transmission System (NTS) and the electricity transmission grid respectively, are under licence obligations to meet consumers' expectations.

The outcomes of the last transmission price control reviews and the additional investment in the electricity grid which has been agreed to support the connection of renewable generation are welcome developments for consumers if they improve long-term security of supply. However, projects must be delivered with minimal risk of stranding assets, ensuring that consumers are not unnecessarily burdened with inefficiently incurred costs. In operating transmission networks, NGG and NGET must only receive rewards reflecting an appropriate balance against the risks incurred.

We have considered NGG and NGET's initial proposals for the next SO incentive schemes in light of the expectations noted above and have a number of comments.

Process

Ofgem's decision to trial a different process for setting the SO incentives for 2008/09, asking NG to set out initial proposals, consult with users and other stakeholders, and present conclusions to Ofgem before it sets out final proposals, has worked well so far. NG has run an effective process, seeking to be open and maximise engagement with stakeholders despite a shortened timetable.

There will be lessons to learn but we would endorse a similar approach going forward so long as NG is given longer to develop and consult on its initial proposals.

We would particularly welcome the use by NG of an open forum session to report back on any bilateral discussions it has had (which may not have been possible this time as timescales were short). This would allow a much rounder picture to emerge of the key arguments and issues raised and which may be influencing NG's thinking.

Electricity SO incentives

- we agree that the duration of the electricity SO incentive scheme ought to remain at one year. We also agree that the form of the incentive scheme, with the use of a target cost, sharing factors, caps and collars should be retained. NGET has highlighted significant issues which may impact on its ability to balance the system, from forward wholesale electricity prices to the impact of the Large Combustion Plant Directive (LCPD). The effects of these factors vary from year to year and so will their impact on NGET's forecast of incentivised balancing costs. SO incentives are therefore better determined every year;
- we understand that the current volatility in wholesale electricity prices will affect NGET's SO actions and also its forecast of 2008/09 SO costs. However, NGET must always seek to minimise the impact of such fluctuations to ensure that only efficient actions are taken and that balancing services are purchased which provide economic value. We have been sceptical in the past about NGET's tendency to provide high forecasts for year end incentivised balancing costs only to surpass its target comfortably and obtain a reward under the incentive scheme. We intend to judge the NGET SO incentives target for 2008/09 based on efficient investment which seeks to minimise the risks to system operation highlighted in these proposals while making appropriate savings;
- we note that the LCPD will have an effect on SO costs. As 2008 progresses, the picture regarding how affected generating plant intends to run may become clearer. There may be something to be learned about plant running and availability for next winter from early experience during the remainder of this winter, as well as progress into the main outage season in the summer. Recently, NG has indicated that baseload running has switched from coal to gas since the Directive came into force. We believe that there may be scope for NGET to develop and improve its current scenarios as more is discovered about swings in plant operation to utilise the hours available under the Directive, and in response to wholesale price movements. NGET should update Ofgem in time for some judgements to be made before publication of the final proposals;
- we also note the additional network constraint costs associated with progress on works to upgrade the transmission grid for renewable generation, as well as the impact on system operation and balancing costs of increased deployment of wind generation. While we recognise that the intermittent nature of wind generation makes availability more difficult to forecast, increased connection of wind farms is part of the delivery of sustainable and more diverse generation sources. Consumers need assurance that both constraints and the intermittency of wind output will be carefully managed by NGET. Where efficiencies allow completion of reinforcement works in a timely manner, constraint costs should be minimised. NGET must liaise effectively with all transmission owners on a coordinated timetable that limits the impact of outages during this work;

- we have no particular insight into the appropriate level of SO forecast costs for 2008/09 and the experience of the previous two full years does suggest that short-term volatility can increase SO costs. We agree that the 'base' forecast of £530 million may provide a starting point for setting a SO incentives target. NGET should continue to pursue savings through achieving increased efficiency. We find the 'staggering' of sharing factors around a mean target to be attractive – in other words, NGET will be increasingly rewarded (or penalised) the more that it is saves (or spends) below (or above) target. However, we remain concerned about the asymmetric nature of sharing factors, particularly on the downside. NGET must have effective incentives to minimise costs above target;
- we are unclear above the purpose of having indexes for specific factors which may affect incentivised costs. We believe that if circumstances arise which adversely impact on NGET's ability to meet its targets, NGET, if it believes that those factors were outside its control, should submit an income adjusting event claim providing proper justification for why there was an increase in costs and whether those additional costs were incurred efficiently. Indexation could provide NGET with additional leeway without proper justification for the change in target.

Gas SO incentives

- we note that the proposed gas SO incentives scheme incorporates a mix of one-year and long-term incentives and the unbundling of certain incentive elements. We agree that this is an appropriate approach. Levels of shrinkage ought to be assessed over a longer period, especially in the context of long-term goals on the environment and sustainability. Incentives on NGG to reduce shrinkage should be set accordingly. Losses on the NTS must be minimised as consumers pay for the associated costs once they are passed through;
- many of the issues and impacts on SO incentives created by variations in the wholesale gas price are similar to those around the wholesale electricity price. We believe that NGG must manage system operation as effectively and efficiently to minimise these impacts even through volatile periods;
- we remain opposed to the need for quality of information incentives for demand forecasting and data publication. We believe that NGG ought to provide as accurate demand forecasts as possible on a timely basis through a platform accessible to all market participants. It is the interaction between these forecasts and the commercial activity by market participants which will determine NGG's short-term balancing actions and costs. If NGG does need an additional financial incentive with regard to quality of information, there should be some downside risk incorporated into the data publication element of the incentive. We do not accept NGG's argument that any investment in systems and processes to improve data publication timeliness and availability which then fails to produce a reward for NGG in itself amounts to sufficient downside risk. We do welcome NGG's intention to expand the scope of data provided as, the more accessible and timely this data becomes, the more that market efficiency will increase.

We will continue to assess the possible impact on consumers once Ofgem issues the final proposals and comment further as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs