SCOTTISHPOWER
Energy Wholesale

SO Incentives
National Grid House
Warwick Technology Park
Gallows Hill
Warwick
CV34 6DA

22 December 2010

Dear Sirs,

Electricity SO Incentives
Initial Proposals for 1st April 2011

Thank you for the opportunity to respond to this Consultation Document. This response is submitted on behalf of ScottishPower Energy Management Ltd, ScottishPower Generation Ltd and ScottishPower Renewable Energy Ltd.

We agree that it is useful to review the incentive scheme and its increase its flexibility. The market for balancing services has been developing rapidly in recent years and it is desirable for NGET to have incentives to procure these services effectively in that market, while avoiding windfall gains or losses if the market does not develop as expected.

ScottishPower welcomes the new approach to developing a multi-year incentive mechanism which will encourage National Grid to take a longer term view of the economic costs of managing the GB transmission system. In addition we welcome the development of robust models for forecasting the various elements of SO costs which should reduce the uncertainty in forecasting BSUoS costs.

In principle, we support the adoption of the ex-ante ex-post approach to model inputs which should focus the incentive element of the scheme upon those areas where National Grid's expertise should be able to derive benefits for the industry and consumers through lower costs. However, it is essential that National Grid remain incentivised to reduce costs in all areas even where their direct control may be weaker.

While a considerable amount of work has been completed on development of the various costs models and defining the relationships between the input variables and the resultant costs, it is important, particularly in the early years, that these relationships are re-visited and back-tested to avoid windfall gains or losses arising from inherent errors in the models.

Our detailed responses to the questions raised in the consultation are attached below.

I hope you find these comments useful. Should you have any queries on the points raised, please feel free to contact us.

Yours sincerely,

James Anderson
Commercial and Regulation Manager

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Question 1: To what extent do you think that the proposed approach to incentivisation, with the use of Ex-Post data for volatile, difficult to forecast parameters, will result in more appropriate incentivisation of National Grid's system operator incentives?

In principle, we support the adoption of the ex-ante ex-post approach for some model inputs. This should focus the incentive element of the scheme upon those areas where National Grid's expertise should be able to derive benefits for the industry and consumers through lower costs.

However, simply because a parameter is difficult to forecast, it should not be excluded from rigorous cost control and perhaps there should remain an element of overall cost incentivisation to ensure continued minimisation of costs.

Question 2: Do you agree with the criteria used by National grid to assess the extent to which it can forecast or control BSIS drivers? Are there other criteria that you think National Grid should consider?

ScottishPower agrees that tools which are assessed as having No or Low influence on model inputs should be treated on an ex-post basis. However, the methodology for assessing the level of influence should be robust and re-visited on a regular basis to ensure that treatment is consistent with prevailing market conditions.

Question 3: What are your views on National Grid's conclusions regarding the treatment of Generation Availability in BSIS models?

Generators provide comprehensive availability data through the OC2 process prescribed in the Grid Code. This data can therefore be used as an ex-ante input to the model. However, neither National Grid nor Generators can forecast unplanned unavailability other than as an annual failure rate which would not specify the timing. Therefore, actual unplanned generation outages should be an ex-post model input.

Question 4: What are your views on National Grid's conclusions regarding the treatment of Generation Running in BSIS models?

We agree in principle with National Grid's proposed treatment of Generation Running in the models. However, as the proportion of renewable generation on the system increases, it is increasingly important that National Grid develops reliable forecasting tools to determine the impact of system stability and security of changes in renewable output and we believe that in the near future, a measure of National Grid's forecasting ability should be included in the SO incentive scheme.

Question 5: What are your views on National Grid's conclusions regarding the treatment of Demand Volatility in BSIS models?

We agree that National Grid has developed a significant demand forecasting capability and that this should be an ex-ante model input. Although the demand contribution to NIV is not directly controllable by National Grid, we would expect that historical analysis would provide a good indicator of supplier performance and that this could also be an ex-ante input.

Question 6: What are your views on National Grid's conclusions regarding the treatment of Transmission Availability in BSIS models?

We agree with the treatment of planned outages on an ex-ante basis and unplanned outages on an ex-post basis.

Question 7: What are your views on National Grid's conclusions regarding the treatment of Transmission Capability in BSIS models?

We agree that transmission capability should be treated on an ex-ante basis.

Question 8: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Energy Imbalance will act as an appropriate incentive to deliver cost efficiencies?

The proposed approach to modelling Energy Imbalance will be a measure of how the cost of National Grid's procurement of Balancing Services versus a proxy for market price compares to a predetermined ratio for the same relationship. This should incentivise National Grid to improve upon historical performance. However, to provide continuous year on year improvement, the ex-ante regression should be recalculated at the start of each incentive scheme.

Question 9: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Margin will act as an appropriate incentive to deliver cost efficiencies?

Including the percentage of forecast wind output to be held as reserve as an ex-ante input may result in excessive volumes of reserve being procured as there will be no incentive on National Grid to optimise / minimise the level of reserve held for this purpose once the percentage is set. There is also a danger that in setting high reserve requirements for wind output, National Grid "double-counts" the overall reserve requirement by determining the volume of each type of reserve requirement in isolation rather than holistically.

Question 10: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Fast Reserve will act as an appropriate incentive to deliver cost efficiencies? Are there any areas where you think improvements to the models can be made?

Examination of Figures 19 and 20 would appear to show that National Grid should be able to procure BM Fast Reserve Bids and Offers below their respective target prices of £22 and £90/MWh on the majority of occasions thus earning a contribution from the incentive scheme. Setting of tighter targets would incentivise National Grid to find better procurement methods and thus deliver savings.

Question 11: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Frequency Response will act as an appropriate incentive to deliver cost efficiencies?

Any concerns we have with the model for Frequency Response costs relate to the concerns already outlined above that there is no incentive on National Grid to improve on wind output forecasting and that the relationship between BM price and SPNIRP (the proxy for market price) should be set to achieve year on year improvement.

Question 12: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Footroom will act as an appropriate incentive to deliver cost efficiencies?

Basing the forecast footroom price upon historic footroom prices would not appear to incentivise National Grid to seek year on year improvements in service procurement unless the target price is adjusted on a regular basis.

Question 13: To what extent do you think that National Grid's approach to delivering a modelled target cost for reactive power will act as an appropriate incentive to deliver cost efficiencies?

The proposed modelling of reactive power costs would appear to be appropriate.

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Question 14: To what extent do you consider that there exists the potential for windfall profit or loss under the scheme if a single snapshot of the generation outage plan were to be taken prior to the start (and used in the models for the duration of the scheme)?

Question 15: To what extent do you consider that a rolling Ex-Ante approach to modelling planned generation outages, as notified via Grid Code OC2 processes, is an appropriate mechanism to ensure the modelled outage plan remains representative (and suitable for incentivisation)? What other mechanisms could be considered?

We agree with National Grid's proposal that the ex-ante generation outage programme data should be updated on a rolling annual basis i.e. the most recent OC2 data should be used for the forthcoming incentive year. This should reduce the scope for windfall gains and losses as any subsequent changes to the outage programme should be agreed between National Grid and the generator on an economic basis.

Question 16: To what extent do you consider that there exists the potential for windfall profit or loss under the scheme if unplanned generator availability is not considered when calculating target costs for constraint management incentivisation?

Question 17: Do you agree that treating generation faults as an Ex-Post input to [constraint] models is an appropriate mechanism to ensure the modelled target cost remains representative (and suitable for incentivisation)?

We agree with National Grid's proposal that unplanned generator outage should be treated as an ex-post model input. This should reduce the scope for windfall gains and losses. However, we would expect National Grid to use its best endeavours in estimating unplanned outage rates when providing its forecast of BSIS (and BSUoS) costs.

Question 18: To what extent do you consider that there exists the potential for windfall profit or loss under the scheme if a single snapshot of the transmission outage plan were to be taken prior to scheme start (and used in the models for the duration of the scheme)?

We agree with National Grid's proposal that the ex-ante transmission outage programme data should be updated on a rolling annual basis i.e. the most recent data should be used for the forthcoming incentive year. This should reduce the scope for windfall gains and losses as any subsequent changes to the outage programme should be agreed between National Grid (as SO) and the relevant TO's on an economic basis. This also provides a balance with the update of generator outage data which may have affected transmission outage plans (Questions 14 & 15).

Question 19: To what extent do you think that BM price submissions can reasonably be forecast?

Question 20: What are your views on the use of submitted BM prices Ex-Post as means of determining target costs for constraint management?

Generators' submission of BM bids and offers is a complex process influenced by a range of factors beyond the "fundamentals" identified by National Grid. Due to the lack of published forward information on transmission outages, it is unlikely that there are "localised constraints markets". In addition, we see a danger in modelling constraint costs simply upon BM prices as this may remove any incentive on National Grid to look at alternative, economic and competitive methods of resolving constraint issues. In conclusion, while the use of Ex-Post BM prices in the BSIS model would resolve the issue of forecasting generator behaviour, such prices should have an "adjuster" to incentivise National Grid to beat BM prices.

Question 21: What are your views on the use of a 'pseudo BM' price to apply to contracted BM Units when calculating target constraint costs? To what extent do you agree that the options outlined in paragraph 355 might be suitable?

The proposal outlined for a 'pseudo BM Price' appear too complex and subjective to form the basis of a robust incentive scheme.

Question 22: Do you agree that National Grid should be incentivised to beat historic constraint contracting performance?

Question 23: If yes, what in your view is the most appropriate way to achieve this in practice?

Yes, National Grid should be incentivised to beat historic constraint contracting performance. As constraint management contracts are only a single element in the range of options available for management of constraints, historic improvement should be based upon the overall cost of resolving constraints rather than setting individual incentives which may encourage National Grid to adopt a particular, though less economic, strategy.

Question 24: To what extent do you agree with National Grid's views on the need for a cost 'dead band' under the proposed approach to incentivisation?

Question 25: To what extent do you agree with National Grid's views on the magnitude of the profit cap and loss floor under the proposed approach to incentivisation?

Question 26: To what extent do you agree with National Grid's views on the magnitude of sharing factors under the proposed approach to incentivisation? What do you consider to be an appropriate level of sharing factor?

The current proposals represent a major shift from previous years' incentive schemes and it is not entirely clear to market participants how accurately the BSIS model will reflect actual costs and how the use of ex-ante and ex-post data will incentivise National Grid's performance.

To protect market participants from windfall profits and losses, ScottishPower would like to see a gradual transition from the existing structure with a dead band, caps and floor to a "sharper" incentive scheme without a dead band and with higher cap and floor as the performance of the new scheme is measured and refined.

We consider that a dead band of £20m would be appropriate to allow for inherent unpredictability in the new model and support the cap/floor of +/- £50m over 2 years suggested by National Grid. Similarly, the use of a higher sharing factor in the first scheme utilising the new model may expose market participants to greater volatility under the new scheme due to the use of ex-post inputs and we would suggest that for the first scheme a 25% sharing factor would be appropriate until the volatility of the scheme results are better understood.

Question 27: Do you agree that National Grid should be concerned about the potential for parties to influence its performance under the incentive scheme by using information that it makes available to the wider industry?

No. Due to the continued development of innovative products and competitive markets for the provision of constraint management services, ScottishPower does not believe that parties would have the ability to influence its performance under the incentive scheme.

Question 28: Do you agree that the creation of an open, transparent statement describing National Grid's methodology for determining whether model inputs should be treated on an Ex-Ante or Ex-Post basis is appropriate?

Yes. The introduction of a complex scheme such as the one proposed could increase uncertainty and volatility in participant BSUoS charges and the methodology statement should be made available on an open and transparent basis To minimise uncertainty, participants require access to the full model to enable them to use their own model inputs to forecast BSUoS charges.

Question 29: What are your expectations of National Grid when it comes to the production of an Incentivised Balancing Cost/BSUoS charge forecast?

We would expect National Grid to produce a central case forecast of IBC/BSUoS together with upper and lower ranges. This forecast should be broken down into the major cost elements as at present including National Grid's expected profit/loss under the scheme. It would be helpful to have details of the major assumptions used for the ex-post model inputs to enable participants to compare these with their own assumptions.

Question 30: What are your views on the timing of such forecasts? For example, do you have processes that will be impacted by the timing of publication of an IBC/BSUoS forecast?

Such forecasts should be produced and discussed at the monthly Operational Forum meetings as at present. Changes to the publication of this data would impact participants' own market forecasting systems which are updated in line with the current publication of IBC forecasts.

Question 31: Do you agree with the concept of (and need for) a Scheme Adjusting event? If so, what sort of events do you consider it appropriate to adjust for?

Question 32: To what extent do you consider that the scheme needs to be able to cope with the 'known unknowns' listed in section 4.4.2? How might the impact of these events be managed?

Scheme Adjusting Events should only be applied in exceptional circumstances such as those outlined in section 429 (a) and (c). With a two year scheme being proposed it is unlikely that there should be any material shift in policy or regulation that could not have been reflected at the commencement of the scheme.

National Grid should be able to forecast the potential impact of three 'known unknowns' listed with a reasonable degree of accuracy. The inclusion of a dead band (Question 24) would allow for any reasonable variation in these elements.

Question 33: Do you consider that your systems will be impacted by the proposed change to scheme structure outlined in these Initial Proposals? If so, what information will you require (and in what timescales) in order to accommodate the change?

Existing systems will not be impacted provided that the data (Question 29) and timing (Question 30) are provided as detailed above. In order to enable participants to develop their own independent BSIS/BSUoS forecasts, the model together with the Ex-Post inputs should be provided as soon as agreed with Ofgem and no later than the start of the scheme year.