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9th January 2009

Dear Malcolm

NATIONAL GRID ELECTRICITY SYSTEM OPERATOR INCENTIVES – INITIAL PROPOSALS CONSULTATION

Thank you for the opportunity to comment on the issues raised in your consultation on the above as published on 27th November 2008.

Headlines:

- **We are minded to support the adoption of either Scheme Option 1 or 3 on the grounds that these appear to strike the right balance between risk and reward. However, we do consider that Option 3 has the advantage of being simpler and allows comparisons to be made to previous schemes.**
- **We have yet to be convinced of the merits of a new reactive power index and consider there to be too much uncertainty in the costs, driver interactions, and the effect of such a change to be able to support the proposal at this time.**
- **Given the improved transparency of the distinct cost components that make up incentivised balancing costs, we continue to support the use of a fully bundled scheme.**
- **Given the uncertainty over future costs and drivers we consider a one year scheme remains appropriate.**
- **We support in principle the implementation of a new adjustment ‘New NIA’.**

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Our response to the specific questions set out in the consultation can be found below:

1	<p>Do you agree with the areas identified as the main cost drivers for 2008/09? Yes Are there any other drivers not explicitly identified? None that are immediately apparent.</p>
2	<p>Do you agree with the high level assumptions outlined: - utilisation of forward power prices and the 60% - 160% range? Yes. Though we are comfortable with this approach for the next year, it should be acknowledged that (a) historic price behaviour/evolution is not necessarily an indicator of future behaviour, (b) the range selected is to some extent arbitrary. - market length central and ranges? Yes. Though we are comfortable with this approach for the next year, it should be acknowledged that (a) historic length is not necessarily an indicator of future behaviour, (b) the lower and upper values used are to some extent arbitrary. - generation availability and utilisation of OC2 data? Yes. We have no source of better information.</p>
3	<p>Do you agree with the assumptions (described in detail in the appendix) used to forecast the various elements that make up underlying balancing costs?</p>
4	<p>Do you agree with the areas identified as the main cost drivers for 2009/10? Please explain your rationale. Are there any other drivers not explicitly identified? Yes. The main cost drivers have been identified and considered. In particular, do you agree with the assumptions used to forecast margin (reserve, STOR and BM start up) and constraint costs? We have no additional information to inform a view on this.</p>
5	<p>Do you have any comments on the assumptions used in determining the increase in costs associated with the revised operation of the England / France interconnector known as Use it or lose it? We have limited information on which to express a view.</p>
6	<p>Do you believe that we should include some provision for a volume of additional generation connecting as a result of the interim connect and manage arrangements? If not, how do you believe we should manage the risk of additional generation connecting? Given uncertainty over the exact arrangements, the relevant capacity which might connect during the year, and the impact of that capacity, we accept the practicality of considering significant materiality as an income adjusting event.</p>
7	<p>Do you agree with the implementation of a new adjustment as described as new NIA? Yes, in principle. Are the values of MLM and VO described based on a straightforward best-fit with all historic data? Correlation level? If there is any element of judgement made in determining the proposed values of values MLM and VO, what is its basis? Use of values of MLM and VO closer to the existing 'simple NIA' values would reduce any tendency to over-correct for energy imbalance, and leave the SO with firmer incentives to reduce costs. If not, please outline your rationale?</p>
8	<p>Do you agree with the implementation of a new reactive power index? Not on the basis of evidence provided. . If not, please outline your rationale? Although we can see the appeal of a simple market price indexation for reactive payments made on default terms, we think more evidence should be provided of the benefits to system users of such an arrangement. Reactive costs can depend on and interact with other drivers and their costs (eg. constraints, outages, market contracts). The previous consultation showed relatively poor correlation between market prices and</p>

	<p>reactive costs. Further justification is needed before such an arrangement can be considered</p> <p>Are there any other indices that we should consider?</p>
9	<p>Do you have any comments on the forecast range of incentivised balancing costs and BSUoS costs for 2009/10?</p> <p>Given skew, how does mean compare with median?</p> <p>Specifically do you believe that the range is too wide or narrow or do you believe it represents the full range of costs?</p> <p>Given the input assumptions, the range seems reasonable.</p>
10	<p>Do you have any comments on option 1? In particular:</p> <ul style="list-style-type: none"> - sharing profile - benefits / drawbacks of such a scheme - do you support implementation of such a scheme in April 2009 <p>The approach has a theoretical appeal, and we support the widening of the range of costs which are incentivised. Our main concern is that it lacks the simplicity of a single sharing factor(s).</p>
11	<p>Should we consider a change to the incentive period to ensure that an incentive remains on National Grid over the year?</p> <p>Would you support the implementation of such an incentive?</p> <p>The purpose of indexing is to reduce the impact of market price changes on a significant part of the SO balancing cost incentive, regardless of the incentive period. Although not ruling out shorter incentive periods for the future, we prefer to continue with a one year period for now, and see how well revised indexing works.</p>
12	<p>What could such an incentive scheme look like?</p> <ul style="list-style-type: none"> - incentive period (e.g. monthly, quarterly) - caps and collars - sharing factors <p>No comment.</p>
13	<p>Do you agree with the implementation of reactive power indexation?</p> <p>No. Market price is only one of the drivers of reactive costs, and we are concerned that use of an index on market price could mask or exaggerate the effect of other drivers.</p>
14	<p>Do you agree with the unbundling of reactive power? Should the bundled scheme caps and collars be changed from £20m?</p> <p>No. In principle, unbundling provides transparency and allows individual elements to be separately incentivised. However, the interaction and overlap between different balancing costs could create perverse incentives to effectively transfer costs between different 'incentive pots'. In practice, given the uncertainties in costs and the interaction between reactive and other costs; the additional work which would be required and the improved reporting transparency by the SO within the overall scheme, we do not support unbundling of reactive power. If unbundling were to occur, the scheme incentive parameters would need to be revised.</p>
15	<p>Do you agree with the unbundling of transmission losses? Please give your rationale.</p> <p>No. In principle, unbundling provides transparency and allows individual elements to be separately incentivised. However, the interaction and overlap between different balancing costs could create perverse incentives to effectively transfer costs between different 'incentive pots'. In practice, the current adjustment of losses costs using a reference price as part of a wider incentive scheme is simple and is probably adequate, given other uncertainties in the scheme and the reporting transparency now provided by the SO.</p>
16	<p>The transmission losses reference price is currently calculated on an annual basis. Do you believe there are any benefits in changing this to a more frequently calculated transmission losses reference price, such as daily? Please give your rationale.</p> <p>It would not be unreasonable in principle to use a more frequent determination of reference price, more reflective of outturn price, for the transmission loss incentive</p>

	<p>adjustments. We do not believe transmission losses volumes are closely correlated with market prices, so the benefit of more frequent reference pricing would be to avoid an incentive payment associated with the difference between initial forecast and annual outturn prices. If such a change were made, a corresponding change in the main incentive target should be made. However the cost of such a change should be weighed against the benefit.</p> <p>It is not clear from the consultation document why the shadow cost of carbon is added to the forward market price to give the reference price for transmission loss incentive adjustments.</p>
17	<p>Are there any other components that you believe should be unbundled?</p> <p>No.</p>
18	<p>Do you agree with multi-year reactive power scheme? Please give your rationale.</p> <p>No. We are not convinced that future reactive power costs, and longer term behaviour of drivers, are sufficiently well known to make a longer term scheme appropriate.</p>
19	<p>Do you agree with multi-year transmission losses scheme? Please give your rationale.</p> <p>In principle, a multi-year scheme either as a longer term cost adjustment methodology, or an unbundled scheme, could reduce the work and uncertainty associated with annual re-assessment. In practice, we think this benefit is relatively small and we are content with the current annual review process within a bundled scheme.</p>
20	<p>Are there any other components that you believe should have a multi-year scheme?</p> <p>None at this time.</p>
21	<p>Which is (are) your preferred incentive scheme(s)? Please provide reasons and your views on caps, collars and sharing factors.</p> <p>'Option 1 – Bundled Scheme with variable sharing factors' has the benefit of providing a wider range of incentivisation and a theoretical basis for sharing scheme risk and benefit.</p> <p>'Option 3 – Bundled Scheme with linear sharing factors' (parameters as proposed) has the advantage of simplicity.</p> <p>We do not support the other options.</p>
22	<p>Do you have any comments on the forecast range of BSUoS costs for 2009/10?</p> <p>We are surprised at the forecast increase in constraint costs. For example, in Section 77 of the consultation there is an increase in forecast Cheviot constraint volume of just 0.11 TWh but an increase in forecast constraint cost of £36m (equivalent to 327 £/MWh). We look forward to timely revision of these forecasts as information becomes available.</p>
23	<p>Did you find the level of information within this consultation, and associated documentation and workshop, on our balancing and BSUoS costs forecasts for the current year and 2008/09 informative.</p> <p>Yes. We welcome the provision of clear information on total costs and BSUoS prices as well as information on the incentivised costs for the incentive scheme. We assume BSUoS prices are system demand weighted resulting from division of total costs by total chargeable volumes.</p> <ul style="list-style-type: none"> - What additional information should National Grid provide to explain better the costs and cost drivers?
24	<p>Do you have any further comments on the analysis and information provided within the appendices to this consultation or in the further documentation available on our website?</p> <p>We welcome the transparency in methodologies and data provided by National Grid in the consultation(s).</p>
25	<p>Do you have any further comments on any aspect of this consultation in relation to the Electricity SO?</p> <p>None at this time.</p>

If you have any questions regarding the above please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'David Love', with a stylized flourish at the end.

David Love
Head of Regulation

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