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Dear Chris

National Grid Gas & Electricity System Operator Incentives – Initial Proposals

British Energy welcomes the opportunity to comment on the issues raised in your consultation on the above dated 7th December 2007. Please note that our comments primarily relate to the electricity external balancing – system operator incentive scheme. As a principle British Energy supports the continued adoption of an incentive regime as the most appropriate means through which to ensure that NGET are incentivised to operate the transmission system in an efficient and economic manner.

Process

On the whole we welcome the revised arrangements for developing an incentive scheme for 2008 whereby National Grid has taken the lead on developing initial proposals and has consulted and fully engaged the industry within this process. However, we are concerned that the timetable for finalising the proposals appears to be extremely short. In fact Ofgem will only have one month to produce final proposals and a statutory licence consultation. Not only does this appear to be an ambitious timetable but it also does not allow for any further consultation with the industry on the final proposals. Any review of the new process undertaken by National Grid and Ofgem should explore the opportunity for commencing the process at an earlier stage.

Scheme Duration

We note that Ofgem has in the past been advocating longer duration incentive schemes. In principle, we are not opposed to the idea of a scheme with a longer duration than twelve months together with the possibility of aligning such a scheme with transmission price controls periods. However, we are concerned that, depending on the actual design of such a scheme, year on year variations within a longer duration scheme may become more volatile and increase the uncertainties faced by system users managing costs over shorter periods.

Furthermore, as highlighted in the document, there are a number of significant market developments for 2008/9 which need serious consideration and which would make setting an incentive scheme longer than one year problematic. In particular, we note that proposed modifications to the cash-out arrangements are currently proceeding through the BSC modification process and other potential fundamental changes to cashout are being discussed. Given this and the uncertainties surrounding

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the implementation of LCPD, investment in renewable generation and the Cheviot constraints, we support the proposals for the continuation of a one year scheme.

Indexation

We believe it is undesirable for National Grid's outturn profit or loss under its incentive scheme to be dominated by market prices. However, any proposal for some form of price indexation needs to be carefully assessed as it would not be appropriate to remove the SO completely from any form of price exposure given that this risk can be managed to some extent. Furthermore, the incentives to manage balancing costs efficiently should not be in any way diluted to the detriment of consumer interests by such a proposal. We note that some of the scheme proposals include price indexation. We are currently not convinced that a case has been made for the price indexation suggested. It is clear from the document that the relationship between wholesale price variances and incentivised balancing costs variances is not clear or stable and therefore we do not support the use of indexation as outlined.

One proposal that may address the concerns of significant price fluctuations is the adoption of a price risk band whereby incentives on the SO are maintained yet possibly reducing the risk of windfall loss or gains resulting from significant price fluctuations. We would support moves to give this issue further consideration possibly as part of the 2009 incentive scheme development.

Cost Drivers

We believe that the significant cost drivers over and above the baseline costs for 2008/9 have been appropriately identified, namely, introduction of LCPD, increased in wind generation and the significant increase in network outages. We note that Ofgem predicted significant savings in SO balancing costs would have arisen from sharper balancing signals under BSC cashout modification P194, but approved modification P205 considerably diluted the effect of P194. Ofgem have recently indicated they are minded to approve BSC modification P211, which would have the opposite effect of diluting balancing signals and thus increasing SO balancing costs. No material consideration appears to have been given to this eventuality. We appreciate the difficulties and uncertainties faced in assessing the impact of these drivers on incentivised balancing costs. Undoubtedly, National Grid are in the best position to assess these cost drivers and forecast the potential impact. With that in mind, we note National Grid's assumptions and analysis and consider these to be an appropriate assessment of the potential impact of these specific cost drivers. Clearly, experience and the outturn costs of these drivers for 2008 will be factored into any 2009 scheme where these drivers will remain and more transparent information will be available to National Grid and the industry.

Scheme Options

As mentioned above, we have yet to be convinced of the benefits of price indexation. We also at this stage are not minded to support an index on the Cheviot outage weeks as we consider that these costs are not completely outside the control of National Grid. With this in mind, we are minded to support the adoption of either Scheme 3 or 4 on the grounds that these appear to strike the right balance between risk and reward and continue to maintain an appropriate incentive on National Grid in the event that costs rise above the target level.

Net Imbalance Adjustment

The methodology for determining the net imbalance adjustment has not been seriously reviewed for several years. This has a significant effect on the incentivised amounts. There may be better ways of estimating the idealised cost of meeting the Net Imbalance Volume. For example, comparison of actual Balancing Mechanism costs with those achievable from a theoretical 'constrained schedule' and an 'unconstrained schedule' could give an indication of the costs of non-optimal balancing and transmission constraints respectively. We think it would be sensible to draw the methodology into the incentive scheme arrangements explicitly, thereby consolidating the incentive arrangements under a single licence condition.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

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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