International Power comments on 2006/07 SO Incentive Scheme (External costs)

International Power considers that the two alternative proposals made to NGET for the 2006/07 scheme were manifestly unrepresentative of the costs that the SO will likely incur in balancing the system. Cost increases observed beyond the date of NGET's initial forecasts should have been taken into account more fully through final negotiations.

For 2005/06, the provisional outturn incentivised cost was £414m, £37m in excess of the incentivised target. A significant driver of balancing costs has been increases in gas costs and EU emissions allowances, neither of which are in NGET's control, and both of which have had the effect of driving up offer prices from gas plant. This resulted in average accepted offer prices in the BM increasing rapidly to over £100/MWh for most of the winter. There is no indication in forward markets that either gas or EU allowance prices will be lower for the coming winter or indeed summer 2006 than they were in 2005/06. Taking account of other, more certain, cost increases, the proposed range of £390 to £410m for 2006/07 is clearly not reflective of latest expectations.

Given the above it seems that NGET were left with little choice but to reject both of OFGEM's proposals, as acceptance of either would in all probability have led to a material loss from the incentive scheme.

It is International Power's view that both of the options now available for managing NGETs 2006/07 external balancing costs are undesirable, in that both will lead to considerable uncertainty. Referral to the Competition Commission will take at least 8 months with the possibility of a target being introduced retrospectively. In the meantime, NGET will have its costs regulated by Ofgem with no certainty of the incentive scheme it will be working to. In the context of a 12 month scheme, the referral option looks both unnecessary and excessive.

If Ofgem does not refer NGET, Ofgem will regulate NGET's costs for the full year. It is not clear that Ofgem has the necessary resource to carry out this highly complex task, and using consultants to perform this role will likely be very expensive. It is also unclear to the wider market exactly how Ofgem would intend to manage this situation. What action would Ofgem take, for example, if NGET is complying with its licence obligations but its balancing costs for the year are projected to outturn in excess of Ofgem's final proposals (£390-£410m)?

International Power believes that to minimise the cost and extent of intervention, a much better option would be for Ofgem and NGET to promptly renegotiate the 2006/07 incentive scheme to a level that may reflect recent market changes. The scheme could have an explicit linkage to gas price such that the incentivised cost is varied to reflect the impact that gas prices have on balancing costs. We firmly believe that this will deliver better value to the consumer, and will provide certainty to National Grid and the industry.

Libby Glazebrook
Manager, Market Development
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