British Energy

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Dear Sonia

NATIONAL GRID ELECTRICITY TRANSMISSION AND NATIONAL GRID GAS SYSTEM OPERATOR INCENTIVES 2007-08

British Energy welcomes the opportunity to comment on the issues raised by your consultation paper on the above as published in July 2006. Please note that our comments primarily relate to the electricity external balancing system operator incentive scheme.

As a principle, British Energy supports the 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. We do not consider the current backstop approach where NGET's costs are regulated under its licence, effectively as or after they are incurred, to be the most effective way of protecting the interests of system users and ultimately customers.

Form and scope of incentive scheme

It would appear that the form and scope of the previous incentive schemes has generally worked well and we currently see no reason why any significant change to the structure of the incentive scheme should be developed. However, NGET has enjoyed significant rewards under the incentive scheme in most years since NETA was introduced. Consequently, in designing a scheme for 2007/8 we would urge Ofgem to consider a scheme with a sliding scale design based on shallower sharing factors and the possibility of removing the associated caps and collars.

Process of setting incentive scheme proposals

As indicated above we consider the adoption of an incentive scheme, rather than simply relying on NGET's licence obligations, would be the most effective way of protecting the interests of consumers. Consequently, it is vital that the process of designing an appropriate scheme is commenced early enough to permit a suitable analysis and an appropriate consultation process to be undertaken which ultimately should result in a scheme that is acceptable to all relevant parties. Consequently, we welcome Ofgem undertaking this current consultation and commencing the process of setting a scheme for 2007/8 well in advance of its implementation.

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Distribution of BM costs

It would appear that the main factors that raised costs above incentive targets in 2005/6 were high energy prices and the tight gas margins during the winter; the effects of CAP047 and Scottish constraint costs. Ofgem itself has reported that there is still a great deal of uncertainty about gas supplies this winter and that supplies could be tighter this winter if pipes and terminals are not used to expected capacity. Consequently, concern about gas supply margins remain and energy prices may well continue to be volatile.

We are concerned at the level of cost increase associated with the introduction of CAP047. We were opposed to its introduction due to concerns over the concentration of market power in a limited number of service providers. This concern seems to have been well founded as ancillary service contract costs have increased significantly since the introduction of CAP047. In light of this Ofgem need to look closely at the workings of this mechanism and need to be mindful of this when reaching a decision on CAP107.

Again it was widely expected that constraint management costs would increase following the introduction of BETTA primarily because of the Scotland-England interconnector. However, we also consider that in setting a target Ofgem needs to be mindful of the ability of the Scottish incumbents to manage local Scottish constraints.

Consequently, it would appear that none of these events are unique to 2005/6 and all need to be suitably factored in, along with the impact of P194 when it is introduced later this year, when setting an appropriate target for future incentive schemes.

Bundled incentive scheme

We have always advocated the separation of the various incentive pots on the basis that this would improve the overall transparency of any incentive scheme. We have yet to be convinced that separate incentive pots would create perverse incentives on NGET that may not be in the interests of system users and customers.

Prospects of reducing ancillary services costs

As highlighted above we are concerned with the fact that frequency response costs have risen significantly as a consequence of the introduction of CAP047. Furthermore, we consider that CAP107, if implemented, would have the effect of pushing these costs up further and as consequence we oppose this modification proposal. We would urge Ofgem to seriously consider the effects CAP047 had on NGET’s costs when arriving at a decision on CAP107.

We support proposals for more frequent and transparent procurement of reserve. We expect that it would improve visibility of the requirement for, the value and the cost of reserve; increase the flexibility available to parties in offering reserve services; improve competition in reserve provision, and thus better facilitate the provision of economic and efficient reserve services.

Transmission losses incentive

The GBSO influences transmission losses through it's BM actions and through its choice of system configuration during intact running and transmission outages. In the long term, its transmission investments also influence the level of transmission losses: the main reason for having a high voltage system is to avoid losses! Therefore, we consider it appropriate for there to be a well designed transmission losses incentive. With this is mind we support in principle the adoption of a dynamic reference price that is linked to market prices as opposed to a price that is a fixed ex-ante reference price. A dynamic reference price is likely to maintain appropriate incentives on NGET even with the existence of price volatility.

Price uncertainty

Whereas we believe it is undesirable for NGET's outturn profit or loss under its incentive scheme to be dominated by market prices any proposal for some form of price indexation needs to be carefully assessed in order to ensure that the incentives on NGET to manage balancing costs are not in any way diluted to the detriment of consumer interests. Clearly, windfall loss or gains resulting directly from price fluctuations needs to be addressed and further analysis of the potential for price indexation, including the calculation of a suitable market reference price, should be conducted. Ideally, the cost of balancing services would reflect the market view of energy prices at the time of procurement. However, balancing services are procured at different times, and different balancing services have different proportions of energy price in their total cost. Therefore, choice of appropriate index price(s) will not be simple.

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

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