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Dear Sonia,

National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 – Invitation to submit views

Thank you for the opportunity to comment on your initial consultation on the System Operator incentive schemes to apply to NGET and NGG in 2007-08.

General Observations

Although we are supportive of the application of incentive schemes to encourage improvements in performance, we are mindful that these need to be carefully designed in order to avoid unforeseen and unwanted effects. The activity of the System Operator (SO) is one such area where their performance will have an impact upon the wider industry.

From reviewing the details of past periods contained within Annex A & B, we believe that there is scope to make the incentive regime more challenging as the rewards appear to have been attained without great effort on the part of the SO in many cases.

Specific Questions - Gas

B1 – Are the form and scope of the incentives schemes still appropriate?

In general we believe that the form of the incentives is appropriate in that there is potential for gain and loss to be experienced by the SO. We also agree that there should be caps and collars to provide an absolute limit to the gain or loss. These figures need to be set with considerable care in order to incentivise without creating unwelcome consequences.

We have some views about the scope of the incentives and these are included within the response to questions B4 and B5 below.

B2 – Should future incentives continue to last for two years or should they be shorter or longer?

We are of the view that the incentives should be set over a longer period. This provides consistency of approach and certainty for the subject of the incentive and to the wider industry. With a longer term approach, the period over which the incentives applied could be co-incident with the Price Control.

However, we recognise that it would be difficult to set both the structure and all parameters of an incentive scheme that would remain relevant over a longer period of say five years. In order to address this variation through the period we would suggest that a defined structure of incentive would apply throughout but that other measures were related to the activity contemporaneously. For example, gas price could be set with reference to an index and volume could be set as a percentage of throughput.

It would be necessary to configure the package to be testing but attainable and sufficiently attractive to gain the buy-in of the SO without being seen as reward for little or no effort.

This approach would also avoid to potential for the incentive package to be switched on and off in the shorter term were it to be insufficiently attractive to the SO as has been the case with the incentives for the Electricity SO.

B3 – Are daily incentive payments subject to annual cap and floor still appropriate?

We believe that this element of the form of the incentives is still appropriate. There should be scope for the SO to gain reward for additional effort each day. In this respect the application of an annual cap could serve to curtail the daily incentive when the cap is reached. In the event that the incentives were more challenging the industry may be more relaxed about the need for an annual cap but until there is greater certainty about the ease with which the incentives could be attained, the annual cap does provide a limit to these costs.

B4 – Are both residual balancing incentive schemes still required?

We are of the view that the price incentive is still required but could be amended. The setting of the intersect at 10% may not serve the best interest of Users. Where this limit is set to 10% it may be the case that the SO will not be able to effect a small action early in the day because the price is unattractive. We believe that this has in the past led to the need to take much bigger actions later in the day and in extreme cases it is then necessary to take a large action at a high price for the SO to reach residual balance, thereby breaching the 10% threshold in any event. It this threshold were raised to 15% or 20%, it would allow the SO to give the appropriate signal to the market much earlier in the day, resulting in less balancing actions required and therefore increased efficiency.

Should a higher intersect be applied then it would be necessary to adjust the gradient. By retaining the £5,000 daily maximum the upside gradient would become more shallow. We would also suggest that consideration be given to making the downside gradient steeper where maximum exposure would be reached at say 60%. This would serve the make the price incentive much sharper.

We have reservations about the need for the linepack incentive. We believe that there is a very strong incentive of operational need to preserve linepack. Experience has shown, as demonstrated in Figure B6 (Annex B), that the linepack incentive is usually achieved. Our view is that the incentive is being paid for something which is in the interest of the SO for operational reasons and therefore the incentive itself does not influence behaviour. Our concern about the removal of this completely would be the potential to “shift” imbalance from one day to the next by manipulation of linepack. This could be incentivised by other means.

A further concern on the application of the linepack incentive is related to the release of flexibility (or linepack depletion) currently under consideration in the Enduring Offtake Workgroup. We believe that this incentive may serve to restrict the amount of “flexibility” that the SO is content to be utilised by customers. This may be artificially constraining the true capabilities of the system.

B5 – Are both system balancing incentive schemes still required?

We believe that the system balancing incentives upon gas costs for shrinkage and gas reserves are both still required. However it is particularly in this area where we are of the view that the incentives should be much more challenging. The figures provided in Tables B3 and B4 (Annex B) demonstrate that the cost incurred have been within target by some considerable margin. With reference to our comments above under the duration of the incentive package, we believe that these areas are those where index gas cost and %age throughput should continue to be applied but the evidence shows that the target figures are not sufficiently challenging.

B6 – Is NGG's 100% exposure under these incentives still appropriate?

As these incentives are clearly designed and focussed upon the activity and performance of the SO we believe that it remains appropriate for them to be 100% exposed to the incentives.

Specific Questions – Electricity

A1 – Is the form and scope of the previous incentive schemes still appropriate?

In our view an incentive regime can be an effective way of encouraging NGET to manage the transmission system in an efficient and economic manner and to reduce the cost of operating the transmission system.

We believe that target based incentive payments which are subject to a caps and collars are appropriate. However, this is provided that targets are sufficiently testing and that sharing factors reflect the right balance between risks and rewards. NGET should not be (overly) rewarded for running its business in a way which is already a requirement under its licence.

As mentioned in previous responses, we believe that rather than setting a single target, a so-called deep SO incentive regime should be considered for 2007/08. This would provide NGET with more specific targets, it would increase transparency for market participants and it would better enable them to comment meaningfully on the scheme and raise Income Adjusting Events (IAEs), if necessary.

A2 – Are there ways in which the process of setting incentive scheme proposals could be improved?

<u>Consultation process</u>

We believe that market participants should have the opportunity to participate actively in the development of the SO incentive regime. Therefore a consultation document setting out NGET's forecast cost and Ofgem's view on the NGET proposal should be an integral part of the process, especially since only Ofgem can review figures that are considered confidential by NGET.

In addition, we believe that market participants should have sufficient time to consider NGET's proposals. In our view Ofgem should not consider revised forecasts from NGET after a specific date in the process when revised forecasts can no longer be consulted on.

<u>Incentive regime</u>

Considering the data in Annex A, we believe that NGET face a high degree of upside with little risk. We have seen in respect of 2006/07 an unwillingness by NGET to accept more challenging targets. This needs to be addressed in setting a new regime for 2007/08.

We believe that this regime should be appropriate such that NGET can be required to accept the proposed incentives without Ofgem having to shift the risks and rewards at the expense of market participants. In our view this can only be achieved by changing NGET's licence so that it <u>will</u> be subject to an incentive regime.

In our view monitoring of NGET's costs is not an effective way of incentivising NGET to manage the transmission system in an efficient and economic manner and to reduce the cost of operating the transmission system. In addition, this approach does not provide market participants with sufficient data to review NGET's actions and arrangements and to raise and consider IAEs.

A3 – Has there been a permanent change in the distribution of BM costs or is the apparent change in 2005/06 likely to have been due to one-off factors?

We believe a number of factors may have contributed to the broader distribution of daily balancing mechanism costs, including spikes in gas prices and the increase in Scottish constraint management costs. In our view these are not one-off factors, although they may not be permanent changes either. We believe that gas spikes and constraints will have a significant impact for at least another 2 years of the annual incentive scheme. As also discussed below, in setting any incentive the anticipated resolution to the underlying problem should be understood.

A4 – Is a bundled incentive scheme still appropriate or would there be merit in separating constraint costs into a separate incentive?

As mentioned under question A1, we believe that a deep SO incentive regime should be considered. Given the magnitude of the constraint issue, this regime should include a separate incentive for constraint costs. At the same time, the issue of transparency need to be addressed, in particular with regards to commercial arrangements between NGET and third parties. Market participants should have sufficient information to review the effectiveness of the incentive. However, it should be noted that any actions or arrangements by NGET do not treat the root cause of the problem. In our view, it should be a high priority for NGET to resolve the underlying reason for the Scottish constraints. In addition, we believe that Ofgem should be focussing on this issue in other ways than just monitoring NGET's costs in this area.

A5 – What prospects are there for reducing ancillary services costs?

Figure A.8 (Annex A) shows that there has been a sharp increase in frequency reserve costs which seems to be related the introduction of CAP047 in November 2005. For the same reason as for constraint costs, we believe a separate incentive should be considered for frequency reserve costs.

A6 – Has there been any underlying trends in NGET's procurement of ancillary services that merit consideration?

With only limited information available to us, this question is difficult to answer. Therefore NGET and Ofgem should provide greater transparency to allow the industry to respond.

A7 – Is a transmission losses incentive appropriate?

Figure A.9 (Annex A) shows that the level of transmission losses have remained relatively stable and that NGET has generally beaten its transmission losses volume target. We are therefore of the view that the existing incentive may no longer be appropriate going forward and should be revisited.

A8 – Should dynamic reference price be used?

See question A7.

A9 – Does industry believe any price uncertainty should be reflected in the 2007/08 incentive scheme?

Volatile prices are a fact in the current market and the incentive scheme has to strike the right balance with regard to sharing risks and rewards between NGET and market participants. A mechanism such as indexation should not be overly generous to NGET and not introduce a high level of complexity and uncertainty for the rest of the industry. If indexation were to be introduced, it should be ensured that the risk of volatile prices is not shifted onto market participants and that it does not create perverse incentives on NGET.

A10 – Would price indexation be a desirable mechanism to manage these risks, if so can different options for price indexation be identified?

See question A9.

A11 – What is the potential impact on NGET's incentives and risks to customers?

See question A9.

<u>Summary</u>

We are supportive of incentive schemes, but we believe that both the gas and the electricity SO should be set more challenging targets. The SOs should not be rewarded for doing what is already a requirement under their licence. We agree in principal that incentives should be set over a longer period, but this may not be possible in all areas. Finally, although the underlying principles should be the same, for it to be appropriate the actual application of incentives may have to be different for each market.

Please contact me if you require any further information.

Yours sincerely,

Mike Young

Commercial Manager