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4 August 2006

Dear Sonia

National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 Consultation

EDF Energy welcomes the opportunity to comment to Ofgem on the possible form and duration of the next SO Incentives Schemes.

We would like to register our concern that there is no SO incentives scheme in place for NGET in respect of the current year. We do not have confidence that "monitoring" of NGET's costs will be effective in limiting costs, which are ultimately reflected in prices to customers.

We also do not agree with NGET's rather belated call, made at the last possible moment, for an "income-adjusting event" in respect of the SO incentives scheme that was in place for NGET in respect of 2005-06. An "income-adjusting event" should be a rare and very specific event outside anything that NGET might have expected when, on the basis of the range of possible outcomes, it negotiated with Ofgem the parameters for a balanced and reasonable scheme. NGET should not enter into SO incentives schemes on the basis that it has the right to make a profit in every single year (we note that NGET made £135m profit from its electricity SO incentives schemes during the period 2001-04). The specific and unusual "event" trigger in respect of 2005-06 is in fact that costs were higher than it expected across the whole year. It was entirely predictable that constraint compensation costs would go up following BETTA, because of the increase in constraint compensation rights to Scottish generators. This was at the very heart of BETTA, which NGET was, or should have been, more aware of than any other party.

Income-adjusting events are called only by NGET. This is due to information asymmetry that exists in the market with regard to NGET's actions. It is important to bear in mind that, when an IAE is "approved" by Ofgem, suppliers are faced with an ex-post charge which may not be recoverable through competitive tariffs, as it relates to past costs. For the future, there should be a clear ex-ante definition of what does, and what does not, constitute an income-adjusting event (IAE). Certainly an income-adjusting event should be a genuine, specific and quite exceptional event and not simply based on "it was a bad year overall".

We will be responding separately in more detail to Ofgem's consultation about the claim made by NGET for an income-adjusting event in respect of the 2005-06 SO incentives scheme.

We also wish to reaffirm our support for longer-term incentives than those arsing from a scheme of a single year's duration. We played a direct and leading part in the Supplier Negotiating Team for the first SO incentives schemes, UMIS and TSS1, TSS2, and on each occasion there was a clear intent expressed, accepted by both supplier and NGC teams, that future years' schemes would move to being multi-year at the very earliest opportunity. In a single year scheme, even with a sharing factor of 50%, any capital spent on reducing SO costs has to have a pay-back of 1 year, meaning that it must have better than a 200% return in respect of the annual saving in SO costs compared to the capital investment. This is because, from NGET's point of view, any gain in the next-following year may be taken into account in its entirety in setting the SO incentives scheme target. It is essential to aim for a multi-year scheme from 2007/8. Without such a longer timescale, savings will continue to remain unrealised.

Our understanding is that NGET is not yet managing the system on an integrated and holistic basis post-BETTA. The main control room at Wokingham is despatching one half of England-and-Wales, the "back up" control room near Wokingham (no longer a back-up site) is despatching the other half of England-and-Wales, and the two Scottish control rooms are despatching Scotland, based on very broad parameters given to them from time to time by Wokingham. We believe that the synergies that are clearly available can be achieved only by a challenging, multi-year SO incentives scheme.

With regard to gas, we believe that Ofgem should publish more information relating to how well NG has performed against its incentives every year, and even within the year. The impact of NGG's performance feeds through into transportation costs and other charges and it is important that there is transparency.

Finally, NGG's "residual balancing role" is not a defined term anywhere in the Uniform Network Code or in its licence. The interpretation of this role has created confusion recently with the removal of Top-up and with UNC modification 086. We believe that Ofgem should formally define this role in order to provide clarity to the industry on what NGG should doing, and should not be doing, as System Operator.

In the attachment to this letter, we provide answers to the questions raised in Annexes A and B.

Yours sincerely

Denis Linford
Director of Regulation

Attachment

National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 Consultation

EDF Energy's responses to questions raised in Annexes A and B

A1 – Form and scope of the incentive scheme
Schemes should have the following attributes:

- Multiyear
- Symmetrical sharing factors
- Wide incentivised cost range
- Ex-ante definition of income adjusting events that excludes underestimation of general costs throughout the year and includes specific, discrete events.

The key objective of the incentive scheme is to measure the efficiency of NGET's actions. The present approach calculates this on a cost basis. There are other approaches that could be considered, for example by using a scoring based approach that rewarded NGET for accepting the most efficient action available to it and penalised it for using an action out of cost order. This might be possible to measure on an automated basis with regard to balancing mechanism actions.

A2 – The process for setting incentive scheme proposals
Ofgem should consider initiating the process earlier in the year to avoid the unacceptable position in which no incentive scheme is placed on NGET. The consultations for the 2006-07 scheme contained comments to the effect that "insufficient resource is available to do this thoroughly" which must have strengthened NGET's hand when rejecting the final proposals. Regulation of monopoly activities should be the primary focus of Ofgem and the necessary resources should be devoted to it.

A3 – Has there been a permanent change in distribution of BM costs or is the change in BM costs likely to have been due to one-off factors?
The recent increase in Balancing Mechanism costs is unlikely to persist in the longer-term as:

- new gas infrastructure capacity comes on-stream and additional gas supplies become available;
- NGET improves its skill in managing transmission line outage programmes, and therefore constraints, in Scotland;
- transmission line upgrades are delivered in the longer-term (e.g. reinforcing the England – Scotland interconnector); and
- the introduction of P194.

New challenges will arise, e.g. managing high levels of penetration of intermittent generation, but a significant impact from this on costs may still be some years away.

A4 – Is a bundled incentive scheme still appropriate or is there merit in separating constraint costs into a separate incentive?
Acceptances in the Balancing Mechanism for system actions to resolve constraints are currently untagged and also deliver an energy volume. Until system constraint costs can be separately distinguished (which we would

welcome as it would also enable their removal from energy imbalance cashout prices) it seems impractical to have a separate incentive.

A5 – What prospects are there for reducing ancillary service costs?
A6 – Has there been any underlying trends in NGET's procurement of ancillary services that merit consideration?
We are starting to see changes proposed arising from NGET's reserve review conducted last year. These may provide opportunities for cost reductions, for example by allowing a wider range of units to access warming / start-up contracts.

A7 – Is a transmission losses incentive appropriate?
A8 – Should a dynamic reference price be used?
Yes. The losses incentive should target the efficiency of NGET's actions with respect to losses. A dynamic reference price would seem appropriate.

A9 – A11 price indexation and its impacts
Looking forward price indexation may be appropriate. NGET should be targeted on costs that are within its control and on the efficiency of its actions. However there are a number of complexities. For example, NGET contracts for balancing services over a range of timescales (seasonal for standing reserve through to within the Balancing Mechanism). Selecting an appropriate price indexation method may prove difficult and may encourage speculative behaviour from NGET to try and outperform the index. Risks to customers are likely to be limited – they are already exposed in 2006-07 to market price for the energy component of balancing actions in the absence of an external SO cost incentive scheme.

B:1 Are the form and scope of the incentive schemes still appropriate?
We believe that the general form of the incentives is still appropriate but that it might be appropriate to review the relationship between the two balancing incentives (system and residual) to assess whether they are working well together. This type of comparative analysis has not been presented in this consultation but was done previously, when industry spent 6 months in 2002-03 looking at this under modification 0513. However, we also believe that the Price Performance Measure (PPM) should apply only on days when NGG takes balancing action. This is because there are already penal incentives on shippers to balance on every gas day and NGG has little influence on days when no balancing actions are needed. Therefore, it is questionable whether NGG should be rewarded on these days. The fact that NGG achieved the maximum level of payments on over 40% these days could reflect the fact that frequently the market was well balanced rather than that NGG was necessarily efficient in its actions.

B:2: Should future incentives continue to last for two years or should they be shorter or longer?
EDF Energy supports multi-year incentive schemes to provide opportunities for investment to reduce the long-term costs of system management. Using price indexation (either ex-ante or retrospectively) or scoring mechanisms to determine efficiency provide methods for removing exposure to general market price movements which are outside the control of the SO and which could be significant during a multi-year scheme.

B:3: Are daily incentive payments, subject to annual cap and floor still appropriate?
Yes.

B:4: Are both residual balancing incentive schemes still required?

We believe the two residual balancing schemes are still relevant, as they create an appropriate balance between maintaining system linepack and incurring economic and efficient costs.

EDF Energy
August 2006