Sonia Brown
Director, Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

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Your Ref: Ofgem doc 112/06

Dear Sonia

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

energywatch welcomes the opportunity to respond to the issues raised by the consultation letter and accompanying documents. This response is non-confidential and we are happy for it to be published on the Ofgem website.

Past performance – National Grid Electricity Transmission (NGET)

Ofgem has highlighted the reasons why NGET has been subject to an incentive scheme relating to its role as System Operator (SO) in previous years. In particular, we note that NGET is to "efficiently manage the system and reduce operating costs". Ofgem rightly points out that consumers bear the costs of system operation but they rely fully on NGET to manage the system efficiently and mitigate the costs involved on their behalf. NGET therefore has a significant responsibility to consumers which we believe has been undertaken poorly in previous years.

The facts as stated in the letter and in the relevant annex indicate two things:

- that NGET has been able to profit considerably from the SO incentive schemes in the past, which is undoubtedly against the interests of consumers, by reducing costs but mainly for its own benefit rather than sharing these benefits with consumers

- that Ofgem has been weak in its analysis of NGET's SO costs year-on-year, and has failed to implement rigorously both effective, and stretching, targets for incentivised costs for NGET to meet which has allowed NGET to profit.

We have previously argued that NGET has consistently overstated its forecast of the year-end SO costs which it believed would be incurred, and which Ofgem has used as a guide to setting the following year's target value. It seems to us that Ofgem has tended to largely accept NGET's view and set a more generous target than was necessary. This can be the only rational explanation for why NGET has been able to profit from the incentive scheme since NETA go-live, until 2005/06, to the tune of £135 million. Even though the level of profit fell in 2003/04 and 2004/05, this can only be due to belated recognition by Ofgem of the arguments of the industry that NGET had been overstating its forecasts.

Consumers have failed to see the benefits of the reduction in operating costs and the evidence instead points to considerable benefit to NGET. We believe that, only when presenting its proposals for the 2006/07 SO incentive scheme, did Ofgem recognise the concerns of consumers, amongst others, and set a much more testing and realistic target. As we now know, however, NGET rejected these proposals.

In 2005/06, NGET made a loss on the incentive scheme for the first time. We believe that this is because the incentivised target value was based on a much more realistic assessment of the likely outurn operating costs for the previous year. However, NGET appears now to seek to reduce the size of its loss by raising income adjusting event (IAE) claims, which we believe are unjustified. We argued that this was the case when NGET first raised the issue in response to the proposed 2006/07 incentive scheme proposals. We believe that NGET should have been able to manage the additional constraint costs and the higher balancing costs associated with the wholesale prices seen in the market last winter as there was sufficient warning, if not complete certainty, about the need to manage these events. We do not believe that NGET should be able to successfully claim on these grounds. We will make further comment on these matters when Ofgem issues its formal consultation on the IAEs.

Past performance – National Grid Gas (NGG)

We note that NGG has also been able to profit in the past from its SO incentive schemes to the tune of £16 million. While the amount is lower than in the electricity market, we have concerns that NGG still has the ability to profit when balancing of gas should be easier over the period of the gas day as opposed to the second-to-second balancing required in electricity.

Future SO incentives – electricity

We believe that the scope and form of the SO incentives scheme, if not necessarily its application to NGET in previous years, remains appropriate and that there should continue to be a target level set for SO costs with upside and downside sharing factors, caps and collars for the coming year's (2007-08) scheme. Based on our comments above, however, we believe that Ofgem should be rigorous in scrutinising the true value of balancing costs and set a target accordingly, rather than relying to a large extent on NGET's own assessment. We hope that the lack of an incentive scheme for 2006-07 has not prevented Ofgem from undertaking careful monitoring of NGET's SO actions, particularly the efficiency of those actions. We would prefer to see regular reporting of Ofgem's assessment of NGET's current performance as SO during this year. This will be of particular importance as we move into the winter period when there may be more pro-active management of the system.

In the longer term, we agree with Ofgem that the whole area of SO incentives need more detailed examination as the nature of balancing costs and incentives will change over time as the market develops and that there will need to be increased flexibility to the incentives scheme as a result. We do not have any preference regarding how the longer term scheme may operate. However, it should be based around the need to not just keep the costs of balancing low, but provide adequate sharing of benefits between NGET and consumers who have seen NGET gain financially from previous schemes with only marginal benefits being passed through to them.

Future SO incentives – gas

We have no particular comments on the scope and form of the existing SO incentives scheme in gas. We would reiterate that consumers must see adequate sharing of benefits from these schemes which are openly and transparently highlighted when price controls are set. The SO incentive scheme appears to have worked well in the past and we consider that a two-year scheme is appropriate as a shorter scheme would not reflect the different nature of the gas scheme (the longer (daily) period over which NGG is able to balance), while a longer scheme may create uncertainties over, and dampen rather than sharpen, incentives to balance.

We are disappointed with Ofgem's intention to create SO quality of information incentive schemes for NGG, as we believe that NGG has an existing duty to improve the level of transparency of market data as the SO and does not need additional monies to ensure its systems and processes are geared up to deliver effectively. Improved transparency is a hallmark of open, competitive and efficient markets and there should be no need for NGG to have additional funding. We would request Ofgem to re-think whether schemes of these kinds are appropriate, and, at the very least, to review the schemes after the coming winter to judge whether the need to incentivise has a rational basis.

Going forward, we will continue to keep these issues under review as and when they are raised, always considering the possible impact on consumers.

We would appreciate being kept informed of the progress of the consultation and any related issues to enable us to comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs