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Dear Sonia,

National Grid System Operator Incentive schemes 2007-08

International Power is responding to your Open Letter on behalf of First Hydro Company, Saltend Cogeneration Company Ltd, Rugeley Power Ltd, and Deeside Power Development Company Ltd. Our comments are restricted to discussion of the electricity SO incentive arrangements.

We support the continuation of an NGET SO incentive scheme – it remains a more efficient approach than the alternatives. Applying regulatory scrutiny to monitor costs purely using licence and statutory obligations is, we believe, inefficient and resource intensive.

We provide below specific answers to some of the questions listed in your open letter appendix:

Question A.1: Is the form and scope of the previous incentive schemes still appropriate?

We support the continued use of an SO incentive scheme. The use of licence obligations and the attendant monitoring and reporting required for 2006/7 is resource intensive for both NGET and the regulator. However, it is clear from recent events that NGET will not accept an incentive scheme where there is no prospect of making a profit. Therefore, in future it is more appropriate to adopt a shallower scheme (with symmetrical sharing factors). This would also be consistent with the increased reliance on market arrangements for the procurement of balancing services.

Question A.3: 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?

Given the increase in forward gas prices over winter 2005/06 it seems that NGET were left with little choice but to reject both of Ofgem's proposals for the 2006/07 scheme, as acceptance of either would in all probability have led to a material loss from the incentive scheme.

As noted in Annex A to this consultation, there continues to be a clear seasonal trend in NGET's balancing costs with the first half of the year facing lower costs than the second. We note that spend to the end of June 2006 on balancing the system was £96m. This compares to £64m over the same period in 2005. This suggests that outturn costs may well be above the targets proposed by Ofgem.

It is likely therefore that the change in 2005/06 was not a one-off event. Costs in both years have been driven by higher gas prices. Indexation to market prices could be used in future to dampen their impact on incentive arrangements.

Question A.4: Is a bundled incentive scheme still appropriate, or would there be merit in separating constraint costs into a separate incentive?

We do not see the need for a separate constraint incentive going forward. There is sufficient interaction with other services to suggest that the most efficient solution is to keep a single general incentive. There are in any case difficulties in identifying the costs of actions taken purely to relieve constraints (as demonstrated in NGET's IAE claim for 2005/6).

For 2007/08 we do not believe there is a need to earmark amounts for the management of constraints and CAP 47 costs within the incentive scheme. By 2007/08, NGET will have 2 years experience of managing these costs and more accurate assessments of future costs should be possible.

Question A.8: Should a dynamic reference price be used?

Question A.9: Does industry believe any price uncertainty should be reflected in the 2007/08 incentive scheme?

Question A.10: Would price indexation be a desirable mechanism to manage these risks, if so can different options for price indexation be identified?

Indexing the incentive scheme to power prices or some other measure such as gas/oil prices should be developed further. As noted in the consultation, this would remove windfall gains and losses and will also limit the need for IAEs. We think this is a sensible proposal which should help Ofgem and NGET in reaching agreement on future incentive schemes.

Other comments

Beyond 2007/8, future incentive schemes should continue to be of a year's duration. This will allow baselines to be reset annually in the light of outturn costs. We also have concerns that both NGET and Ofgem might be expected to build risk premiums into longer term scheme discussions, which would provide a barrier to reaching agreement.

We trust you will find these comments helpful.

Yours sincerely

Kevin Dibble
Regulation