

Appendix A – Response to specific questions

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

We believe the form and scope of the previous incentives schemes provides a useful starting point for developing an SO incentives scheme for 2007/8. The form of incentive within the previous Balancing Services Incentive Schemes has a number of favourable attributes. Sharing factors have facilitated a balance of risk and reward to the System Operator whilst delivering value to consumers against an agreed target. The flexibility inherent in the mechanism provides an ongoing capability to maintain a meaningful incentive on the System Operator while addressing annual variations in:

1. energy input prices impacting on Balancing Services costs
2. energy market arrangements impacting on Balancing Services Costs
3. Balancing Services provision
4. network and generation disposition led impacts on transmission constraints

Arrangements have focussed appropriately on those elements within the control of NGET, whilst removing those elements that are outside the control of NGET, such as market length (through the Net Imbalance Adjustment). Where significant uncertainties have existed regarding the expected level of costs, at the time of setting allowances, additional provisions have been incorporated into the form of control, such as the use of IAE provisions for Scottish Constraints and CAP047 in the 2005/6 incentive scheme. We believe the ability to adapt the basic form of the incentive scheme to be a useful mechanism in the process of reaching a mutually acceptable scheme.

Given the uncertainties that exist in estimating the costs going forward, consideration should be given to the underlying cost drivers and National Grid's ability to influence those cost drivers. In this regard we are pleased that Ofgem's open letter is seeking to consult upon the primary cost drivers and seek views on the potential mechanisms to deal with uncertainties. This is covered further in the section below.

Question A.2: Are there ways in which the process of setting incentive scheme proposals could be improved?

Our experience in developing and operating under incentive schemes shows that it has been possible to set meaningful incentive targets which deliver value to consumers based on a shared understanding of high level drivers and trends in Balancing Services Costs.

However, it is clear that the process can be developed further. In this regard we believe there are two main areas for consideration, which are set out below.

Increased transparency

Over recent years we have increased the level of information provided to the market on our procurement and use of balancing services, supplementing information already available on the Balancing Mechanism via the BMRS. This has been done to broaden knowledge and experience in Balancing Services and understanding of our System Operator role across the industry as a whole. This increased transparency is

aimed at increasing liquidity and competitiveness for the provision of services we procure and facilitating better balancing by the market as a whole.

Having said this, the BSIS forecasting process is still seen by many industry participants as not being sufficiently transparent. We believe a key aspect of the perceived lack of transparency is the complexity associated with the modelling process. We are therefore keen to explore ways in which the articulation of the forecasting process can be made simpler as we believe this will enhance the ability of Ofgem and the industry to:

- understand our forecasts and the forecasting uncertainties in today's environment;
- debate and challenge the underlying assumptions behind the forecasts; and
- propose solutions/alternative approaches to address areas of significant uncertainties (particularly the areas substantially outside National Grid's control).

In relation to the points raised above we believe there is merit in considering:

- a simplified display/explanation of the key forecast elements;
- greater transparency of the calculation of numbers, particularly the link to the main cost drivers; and
- a clearer link between the forecasts and other publicly available data.

In parallel with discussions on the elements described above, some consideration will need to be given in relation to any areas where increased transparency of the underlying cost drivers may lead to additional balancing services costs. For example, where a transmission constraint can be managed using a limited number of parties (and on occasions a single party), full disclosure of the transmission constraint could lead to an elevation in prices and hence costs.

Scheme options

We support a process whereby Ofgem offer National Grid a range of options which explore National Grid's appetite for risk and reward. As part of this process, however, we believe that it is important that options are internally consistent (ie options cover high risk/high reward or low risk/low reward). As detailed in our discussions on the 2006/7 scheme, we believe the asymmetric downward sharing factor of 60% in the higher target option last year removed the ability for National Grid to accept a low risk/low reward option.

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?

We are continuing to analyse the events and balancing costs of winter 2005/06 to fully understand the root causes and resultant effects on our costs.

Our analysis to date identifies that Balancing Costs in 2005/06 increased significantly above our original expectations with respect to three discrete elements of cost (alongside a number of smaller effects):

These were:

- 1) The expansion of the Balancing Services Scheme under BETTA to cover the GB Electricity Market, with respect to transmission constraints in Scotland and between Scotland and E&W
- 2) The commencement, in November 2005, of pricing freedom in the provision of mandatory frequency response services
- 3) An increase in winter 2006 Electricity wholesale prices from November 2005 onwards. The same driver that caused the increase in wholesale prices also lead to an increase in the prices paid within the Balancing Mechanism and for contracted Balancing Services with prices rising with wholesale electricity and gas prices.

Overall, increases in these cost elements led to the majority of the increase in costs from our original forecast of annual costs for 2005/06 from £360m (in October 2005), to an outturn cost of £427m.

The additional costs relating to items 1 and 2, Scottish constraints and CAP047 have been widely discussed within our IAE submission notices. These two elements resulted in an increase above expected costs of approximately £35m and will persist to greater or lesser degree over the coming years.

The additional costs related to item 3, Electricity Forward price, are estimated to have totalled between £35m and £50m, and the increase in costs is predominantly as a result of increases in the prices paid within the Balancing Mechanism and, to a lesser extent in the year concerned, increases in the prices paid for other Balancing Services. The Balancing Mechanism prices observed in 2005/06 are also likely to set a new baseline not only for future Balancing Mechanism prices, but also for services for which value can be measured by comparing them with Balancing Mechanism prices, such as Standing Reserve for example.

Together, these effects have introduced a paradigm shift in Balancing Services Costs which we have no reason to believe will not be sustained.

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

The procurement of Balancing Services is driven by the need to achieve balance within physical parameters on a minute by minute basis. As such, an optimal balancing process requires an integrated approach to satisfying all the technical criteria required to achieve a balanced system within statutory operating requirements.

Often this means that the efficient procurement of a Balancing Service meets a number of different requirements (eg solve an importing Transmission Constraint and provide Operating Margin at the same time). This integrated approach suggests that a bundled incentive remains appropriate in order to support efficiency.

The bundled scheme also allows a range of risks to be contained within the single scheme. If these risks are contained within separate incentives, the cumulative risk range will be wider.

Separate schemes would lead to a need to apportion costs, which is inherently difficult and could be an expensive exercise in itself. More fundamentally it could

lead to perverse incentives on the system operator to arbitrage between incentive schemes.

Therefore, it is our view that a single incentive scheme provides the most appropriate overall approach. However, it is clear that if a significant level of cost volatility or uncertainty exists within one particular cost element, then there is a risk the incentive on other areas of operation might be reduced. In these cases it may be appropriate to consider revenue drivers or target adjustments, including IAE mechanisms, to allow the single scheme target to be adjusted and preserve an appropriate incentive on the SO.

Question A.5: What prospects are there for reducing Ancillary Services costs?

National Grid as System Operator has continually refined and improved its derivation of physical requirements and optimal satisfaction of those requirements for Balancing Services. This has led to a reduction of the volume of Ancillary Services such as frequency response and reactive power procured against a background of rising prices.

At the present time, a real reduction in these costs is reliant on a reduction in prices as the prospect for further volume reductions is limited in the short term. These volumes will come under further upward pressures in the future as new intermittent generation sources impact on the requirement for frequency control and operating margin services.

Question A.6: Has there been any underlying trends in NGET's procurement of ancillary services that merit consideration?

As discussed above, we have worked hard to manage the volume of Ancillary Services procured. In conjunction, we have continued to develop procurement mechanisms to, as far as is possible, promote competition and present a downward pressure on prices. We have been pleased to contribute to industry development of market based approaches and will continue to procure through these mechanisms. It should be recognised, however, that market prices can move up as well as down and in many cases NGET is a price-taker.

We have previously highlighted the savings delivered through tender rounds for services such as Fast Reserve.

Question A.7: Is a transmission losses incentive appropriate?

Historically, the economic assessment of costs driven by transmission network configuration has been dominated by constraint effects rather than the costs of transmission losses. However, the expansion of the Balancing Mechanism to a GB wide coverage means that transmission losses will become more significant. We believe therefore that the continuance of a transmission losses incentive is appropriate.

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

A dynamic reference price could be used to represent the costs of Transmission Losses more precisely within the incentive. Further assessment will be needed to quantify its value in improving the incentive to manage transmission losses in the context of the overall incentive arrangements.

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

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

Our response to question A.3 outlines how energy prices (amongst other drivers) influenced Balancing Services costs in 2005/06. We also suggest that the combination of the effects described have, to some extent, resulted in a fundamental shift in Balancing Services prices.

In general, we consider that indexation or similar mechanisms reduce the incentive on the SO. However, if a particular cost element is very volatile then there is a risk that performance of a single volatile element may dominate the SO's incentive performance. In these cases, where such volatility is outside the control of the SO, it may be appropriate to consider some form of indexation in order to preserve the financial incentive on the SO to manage costs.

Overall it is our view that NGET should be incentivised to manage costs that are controllable. In general, National Grid can exert cost control through either:

- management of price, or price exposure, through efficient and economic procurement; or
- through management of volume exposure, i.e. by innovation and/or efficient dispatch that minimise the volume of a service required.

Therefore, where current forward prices and/or possible volume are appropriately reflected within the calculation of the incentive target then we consider that indexation or similar measures may not be necessary.

Where such prices are not appropriately represented with the scheme target, then NGET loses the ability to control cost exposure through efficient procurement. For example, if NGET were given a cost allowance at 80% of the current prevailing price, then NGET would be exposed to any costs between 80% and the current prevailing price because NGET would only be able to limit its exposure by procuring at current forward prices.

Thus it is essential that the impact of energy prices is reflected in any incentive mechanisms. In summary we believe, in the first instance, it should be explored whether the impact of energy prices can be incorporated into the setting of an appropriate bundled scheme target. If agreement cannot be reached, through the established process, then options such as indexation can and should be considered. The form of these should reflect the specific parameters concerned and we would be happy to work through them with Ofgem and the industry, if they become necessary.

Question A.11: What is the potential impact on NGET's incentives and risks to customers?

As discussed above, we believe that setting appropriate incentive parameters from an informed and shared understanding of Balancing Services costs and their place in the energy markets can deliver an appropriate level of risk and reward to the system operator and deliver value to consumers.