RWE npower

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

Your ref
Our ref
Name Terry Ballard
Phone 01793 892715
Fax
E-Mail Terry.Ballard@rwenpower.com

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112/06: National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 – Invitation to Submit Views

Dear Sonia,

Thank you for the opportunity to respond to the above consultation. The first part of our response makes some general comments about the nature and scope of incentive arrangements. This is followed by observations on a number of specific points relating to electricity and gas separately.

General

Although previous incentive schemes may have gone some way to reducing the cost of system actions, we are not convinced that they are necessarily required for the future. Incentive schemes introduce the risks of double counting any benefit; if for example, NGET undertakes investments to reduce cost, such as additional transmission assets to relieve constraints, or the installation of reactive compensation, it benefits from both the reduction in operating costs and the return it then makes on the capital investment. At the same time, incentive schemes may also tend to militate against the introduction of market arrangements that would pass some balancing responsibilities from the SO to market participants as this would diminish the scope and hence the value of the incentive arrangement to the SO.

During the consultation process for the 2004 scheme, NGET acknowledged that there was little further action that can be taken to reduce costs. Therefore, in the future, there may be a case for using NGET's licence obligations to ensure that system actions are taken in an efficient and economic manner. We note that NGET rejected the proposed scheme for 2006/7, resulting in Ofgem monitoring their actions. It would be useful if Ofgem could provide some observations on NGET's performance to date at the proposed SO seminar.

In the event that Ofgem remain of the view that incentive schemes are the most effective means to ensure NGET and NGG operate in an efficient and economic manner, we favour schemes that have relatively narrow (say +/- 10%) but symmetrical

RWE npower
Trigonos
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

T +44(0)1793/87 77 77
F +44(0)1793/89 25 25
I www.rwenpower.com

sharing factors. In the event that costs vary significantly the Income Adjusting Provisions are available to address unforeseen events.

Electricity

Ofgem note that NGET have received payments of £135m during the four years from 2001/02 to 2004/5. For the year 2005/06 a relatively small loss of £10m has been made. This is consistent with the normal distribution of forecasts and should not in itself be an argument in favour of any IAEs.

We do not favour the separation of elements of cost such as constraints into separate schemes as we believe that this may result in their discretionary allocation. Where costs are to be part of an incentive scheme, the better option is to provide an incentive to reduce overall costs.

It is not clear how the actions that the System Operator takes influence the overall level of transmission losses and consequently why the balancing incentive scheme includes a losses target. Unless greater transparency is provided as to the reason for this incentive, it should be discontinued.

Currently the incentive scheme covers all system balancing costs that are within the SO's control. It is our view that incentive schemes remain a poor substitute for competition and that there is merit in developing a reserve market mechanism to provide a transparent assessment of different reserve products.

Gas

We believe that there should be a residual balancing incentive on National Grid Gas (NGG) as the residual balancing costs are recovered from all shippers through neutrality. We support the principle of NGG undertaking its gas balancing trades at prices close to the system average price and the Price Performance Measure incentive should be retained.

The effectiveness of the linepack incentive is less clear. Its initial purpose was to avoid targeting imbalances to the incorrect day by restricting the movement of linepack between days. It would appear that while NGG can set opening and closing linepack targets, these are influenced by actual flows on the system. Furthermore, there may be a conflict between the price and linepack incentives where NGG need to trade-off taking a relatively high/low priced action to move linepack to hit the incentive range at the expense of foregoing incentive revenue under the price performance measure. Clearly operational necessity will be a key driver rather than the prospect of incentive revenues, as noted by NGG themselves. For this reason, we would support removing the linepack incentive.

For both components of the System Balancing Incentive, it is correct to retain 100% sharing factors, as these are costs related to how NGG manages its system. The activities covered by the gas cost incentive are those where NGG can directly influence the volume of gas that it requires, but has less influence over the price that it has to pay for that gas. We agree that forward looking gas prices should be used, but believe that more work is required into how that reference price is determined and how to avoid windfall gains or losses that are unrelated to efficiency improvements. As future patterns of gas supply change and the volume of gas moved north-south reduces this should also have an effect on the volumes of gas required as they will need to be moved over shorter distances.

NGG's OM obligations are related to its Safety Case and the requirement should be reasonably predictable. This is borne out by the historic performance under the incentive scheme. On this basis, modest incentives should be retained.

If you wish to discuss any aspect of our response, please do not hesitate to contact me or my colleague Charles Ruffell (01793-893983).

Yours Sincerely

Terry Ballard
Economic Regulation