ScottishPower

energy management

Sonia Brown
Director, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

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0141 568 3113

Dear Sonia,

National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08 – Invitation to Submit Views
July 2006

Thank you for the opportunity to submit our views on the incentive schemes to apply to the System Operator (SO) businesses of National Grid Electricity Transmission (NGET) and National Grid Gas (NGG) from 1 April 2007. This response is submitted on behalf of the UK energy businesses of ScottishPower, namely ScottishPower Energy Management Ltd, ScottishPower Generation Ltd and ScottishPower Energy Retail Ltd.

We believe that it is important that NGET and NGG have financial incentives to reduce the costs associated with their monopoly roles as system operators and that SO incentive schemes are in place for 2007/08.

Electricity System Operator Incentive Scheme

The annual incentive schemes that NGET has faced for its external balancing costs since the introduction of NETA in 2001 have had the desired effect of incentivising NGET to efficiently manage the system and reduce operating costs with NGET able to outturn costs below target for each of the first 4 years even although the target level was reduced in each of these years. It is not surprising that there was a step change in balancing costs in 2005/06 with the widening of NGET's role as SO to the whole of GB following the introduction of BETTA and also the volatility introduced by the higher energy prices seen during 2005/06.

However, we believe that with the experience to date of operating the GB system under BETTA that it should be possible to agree a fair incentive scheme for 2007/08 encompassing the full scope of the scheme proposed for 2006/07 but with some form of adjustment to ensure that NGET will continue to have appropriate incentives even if power prices remain volatile.

A longer term incentive scheme would be beneficial for both market participants and NGET as it would incentivise contracting for services on a longer term basis and evaluating measures with a longer pay back period. However, we believe that in the short term in view of the market volatility, and particularly if some form of power indexation is introduced into the scheme, then it

will be necessary to review some of the components of the scheme on an annual basis. Nevertheless the aim should be to move to longer term schemes.

Our responses to the detailed questions set out in Annex A are set out below.

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

We believe that the previous form remains appropriate with NGET keeping a proportion of any cost reduction below target and only paying a proportion of any cost excess over target but with its profits under the scheme limited by a cap and its losses limited by a floor. This however only remains an appropriate incentive if the true outturn costs are within the cap-collar range. In the first year of the scheme under NETA NGET was able to reduce costs to the level where it was making the maximum possible return on the scheme and was not incentivised to reduce costs further. In 2005/06 although NGET sustained a loss of £10m under the scheme the outturn was still within the collar and thus NGET was still incentivised to keep costs as low as possible.

In terms of scope there are significant benefits in having a scheme with wide scope as it is likely that increases in costs in one area can be offset by reductions in another. We therefore support a scheme that incorporates energy balancing, constraint management and system management costs incurred through the balancing mechanism and also through balancing services contracts. In particular NGET should be incentivised to negotiate balancing services contracts which reduce the overall balancing costs.

We also believe it is appropriate for NGET to be incentivised to reduce transmission losses through the scheme.

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

We support the proposed process of an initial consultation, Ofgem publishing its initial proposals and a workshop giving NGET the opportunity to present its views and interested parties the opportunity to respond. Ofgem should ensure that this process allows final proposals to be put to NGET by the end of December 2006 to ensure sufficient notice is available to NGET and the market. The process this year with final proposals only published at the end of February 2006 did not allow sufficient time.

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?

It is not surprising that there was a step change in balancing costs in 2005/06 with the widening of NGET's role as SO to the whole of GB following the introduction of BETTA and also the volatility introduced by the higher energy prices seen during 2005/06. Volatility in energy prices has continued to impact on balancing costs throughout 2006/07 to date and may be expected to continue to do so in 2007/08 and perhaps for a number of years. However there is no change envisaged in 2007/08 which would have such an impact on balancing costs as the introduction of BETTA did in 2005/06 and thus overall volatility in balancing costs in 2007/08 should be less than in 2005/06.

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

There are significant benefits in having a bundled incentive scheme as it is likely that increases in costs in one area can be offset by reductions in another. Costs incurred in constraint management

could reduce the costs of energy balancing. It is important that costs incurred through balancing services contracts are included along with those incurred through the balancing mechanism to ensure NGET has the incentive to reduce overall balancing costs.

Question A.5: What prospects are there for reducing ancillary services costs?

Ancillary services costs are experiencing increased competitive pressures from the expansion in the market to GB wide in April 2005 and also from the introduction of a competitive mechanism for mandatory frequency response in November 2005. They are also however experiencing upward pressure from the impact of high and volatile energy prices. If energy prices fall there will be scope for reducing ancillary services costs but in the short term, and particularly for 2007/08, the prospects for reduced costs are limited.

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

The recent introduction of a competitive mechanism for mandatory frequency response is allowing the true costs of providing this service to be realised. There is sufficient liquidity in the provision of frequency response to ensure that the revised market arrangements are delivering more efficient costs of providing response.

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

We believe it is important for NGET to be incentivised to reduce transmission losses through the scheme and this has served to reduce losses under the current transmission losses scheme where losses are averaged across all GB generators. Actions that NGET takes can significantly impact losses and we thus believe that it is the most important body to be incentivised to reduce losses.

However, if a zonal transmission losses scheme were to be introduced in April 2008, with generators paying differential losses dependent on their location within GB, then it would no longer be appropriate for NGET to be incentivised through the SO incentive scheme to reduce losses. Generators would be including the costs of locational losses in their bids and offers and thus it would be inappropriate for NGET to have an additional incentive to reduce losses over and above its incentive to reduce the costs of procuring the necessary services from generators which already have the costs of losses incorporated. We believe it is more appropriate to retain the current average transmission losses scheme and also to continue to incentivise NGET to reduce transmission losses through the SO incentive scheme.

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

We agree that a dynamic reference price should be introduced to transform the difference between actual and target losses into a financial incentive. While this was not necessary in previous years the current volatility in energy prices makes it essential to now use a dynamic rather than an ex ante reference price to ensure the incentive to reduce physical losses translates into a meaningful financial incentive to reduce overall costs.

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

We believe that price uncertainty should be reflected in the 2007/08 scheme. While this was not required in previous schemes the current volatility in energy prices, which may be expected to continue into 2007/08, makes it essential to correct the scheme for price uncertainty to maintain a meaningful incentive.

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

We believe a form of price indexation would be desirable. It will however be necessary to agree an appropriate indexation factor. The energy balancing, constraint management and system management costs incurred by NGET through the balancing mechanism and also through balancing services contracts are not directly proportional to the wholesale electricity price in that if the wholesale price doubles NGET's overall balancing costs would not be expected to double.

The indexation factor would need to be two-way with target costs reduced if wholesale prices fall. It could also be beneficial to have a deadband such that target costs would only be adjusted if wholesale prices varied above a specified level.

The inclusion of price indexation could remove the need for NGET to raise income adjusting events at a later stage.

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

The objective of an SO incentive scheme is to reduce the costs that eventually get passed on to customers by incentivising NGET to reduce overall balancing costs. If the scheme is such that NGET do not have any incentive to reduce costs then customers lose out not only in having to pay higher balancing costs but also in having to pay the costs of implementing the scheme. Thus it is preferable not to have a scheme at all rather than to have a scheme which is not delivering. Provided a cap and collar is put on the profits and losses that NGET can make on the scheme then the potential adverse impact on customers should be limited with the proviso that experience in operating a scheme will enable Ofgem to tighten targets on a yearly basis to the long term benefit of customers.

Gas System Operator Incentive Scheme

Gas balancing incentives have been in effect against a backdrop of a changing gas market with a greater import dependency level which has led to the requirement for massive pipeline investment in the next few years and record high gas prices in winter periods. These high prices have had an impact on domestic gas prices and this underlines the importance of putting adequate incentives on the SO to avoid excessive costs to the industry and customers.

Our responses to the detailed questions set out in Annex B are set out below.

Question B.1: Are the form and scope of the incentive schemes still appropriate?

NGG has used its incentives to deliver the system balancing performance required. It has performed consistently well on its basket of incentives covering entry capacity buy-backs, system balancing and residual gas balancing, suggesting that the targets set might need to be modified. We favour targets set based on historical evidence, but with appropriate review so that NGG does not earn incentive revenue without an improvement in performance.

Other incentives have been suggested, but we believe that the existing ones need to be retained as well rather than be replaced by the new incentives which have been proposed e.g. on information and innovation.

Question B.2: Should future incentives continue to last for two years or should they be shorter or longer?

A longer term incentive scheme would incentivise NGG to contract for services on a longer term basis and evaluate measures with a longer payback period. However due to the changing nature of the gas market and the predicted changes to the infrastructure and regime over the next few years it would be appropriate to at present set the incentives on a short-term basis.

Also the attempt to apply the entry model to the exit regime will possibly give rise to the need for additional and or different incentives. The regime may look very different from now in the medium term and within the period of the price control. Incentives need to be set presently on a short-term basis until we have some stability in the regime and markets.

There is also an overlap between the price control period and when these new enduring arrangements are due to be implemented.

We would prefer greater certainty and stability offered by enduring incentives over the entire price control period. This would require more stable market conditions than at present, however existing incentives have been subject to significant change during the current price control period.

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

These incentives are relatively small, but important. It is appropriate that they are set on a daily basis reflecting the balancing period.

We believe new incentives which are being proposed, e.g. regarding information provision, should also be applied on a daily basis, and capped.

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

We believe that both the price performance measure and the linepack target are appropriate incentives. Hopefully, these help to increase efficiency and reduce system imbalance costs.

As noted above, these are relatively small and may possibly be supplemented by other incentives set on a daily basis.

Question B.5: Are both system balancing incentive schemes still required?

Appropriate incentives for system balancing are key to the success of new arrangements within the forthcoming price control period.

The mixed level of performance of both these indices suggests that they are appropriate and realistic. However, we note that maximum incentive revenue for the gas cost incentive has been achieved in the last 3 years, suggesting a more realistic target might need to be set (or an adjustment to the gas cost reference price).

Performance on the system reserve incentive has been much more mixed. This area is also a focus for change. Any changes to the regime affecting how NGG procures its system gas reserves will mean that this incentive will need to be changed.

Question B.6: Is NGG's 100% exposure under these incentives still appropriate?

In theory, as long as NGG is being economically efficient in its procurement of gas and services, this should not be a problem. These incentives encourage it to operate in this way. NGG's performance to date on the gas cost element has been good, and neutral on procuring the system reserve.

Also, given the possibility of using the provisions associated with an income adjusting event and the fact that the incentives are set using historical information as a basis, the 100% exposure is appropriate particularly when the incentives are set on a short-term basis. Longer-term incentives should be set where there is greater stability.

I hope you find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

Alex MacKinnon
Regulation and Trading Arrangements Manager