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Dear Sonia,

Re: National Grid Electricity Transmission and National Grid Gas System Operator Incentives 2007-08

Scottish and Southern Energy plc (SSE) welcomes the opportunity to comment on the design and effectiveness of system operator incentives beyond 2006/07. We agree that the correct incentives are key to ensuring that the UK's power and gas systems are managed and operated as efficiently and as cost-effectively as possible. Importantly, any incentive scheme needs to be suitably transparent and capable of providing a sufficiently strong signal to continually improve the performance and efficiency of system operators.

We were disappointed that NGET felt unable to accept Ofgem's 2005/06 incentive proposals, but we welcome Ofgem's early efforts to consult with the marketplace with a view to establishing incentive mechanisms for both NGET and NGG in 2007/08. We consider the mechanisms already in place for NGG and those outlined in Ofgem's consultation document for NGET to be largely consistent with the above objectives, but have taken this opportunity to input some additional and specific comments.

I hope the attached response proves to be useful feedback. Should you require any additional information or explanation, please do not hesitate to get in contact.

Yours sincerely,

Rob McDonald
Director of Regulation.

Electricity External Balancing

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

Yes. With the exception of 2005/06, NGET has performed well against its targets since 2001. Year-on-year (again with the exception of 2005/06) Ofgem has been able to reduce NGET's target costs and, whilst NGET's profits have reduced, NGET has successfully exceeded its target value.

We do not believe that NGET's financial loss under the scheme in 2005/06 reflects badly on Ofgem's incentive mechanism. It is unrealistic of NGET to expect to always gain under the incentive mechanism. However, having now had the experience of 2005/06, NGET should be in a better position to manage their costs and ensure that this does not happen again.

In terms of the incentive scheme's structure, we believe the form and scope of the previous scheme to still be appropriate.

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

We believe Ofgem's current process to be sufficiently thorough, but are concerned that in the past, Ofgem has had insufficient time to get the necessary sign-on to the incentive from NGET. We therefore welcome Ofgem's efforts to consult earlier on the setting of 2007/08 system operator incentives.

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 believe that in 2007/08, NGET's efficiency of operating the system since BETTA will undoubtedly have improved, and similarly their contracting arrangements, which should put downward pressure on costs. The new gas infrastructure should also put downward pressure on gas prices. Nevertheless, these factors may be offset by other issues such as the risk premium generators may include for balancing under P194 and the effect of environmental regulations. On balance therefore we would expect little change in the level of SO costs, but that the split of these costs between longer-term and shorter–term balancing actions may change.

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

There may be merits in terms of transparency for the market and increasing competitiveness if constraint costs are separated out. However, given NGET's experience of operating the system, greater use of longer-term contracts, network reinforcements, and the potential for increased intertrip services, it is not clear whether there will be the need in future for such a dis-aggregated scheme. In addition, under dis-aggregated schemes, NGET will be less able to optimise their costs of operating the system, given the interaction between energy balancing and system balancing. Also, greater transparency of constraints in such a small market as exists in GB may allow inappropriate balancing offers to be made. Overall, we would suggest continuing with a bundled incentive.

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

Given NGET's extensive experience of contracting for ancillary services, it is not clear that there is room for significant improvement. There may be the vestiges of contracts remaining to be put in place with Scottish generation following BETTA, e.g. for intertrip services, but other than this, improvement may only result from institutional changes of introducing market based arrangements such as that for frequency response.

A.6. Have there been any underlying trends in NGET's procurement of ancillary services that merit consideration?
Not that we are aware of.

A.7. Is a transmission losses incentive appropriate?
Yes. Various industry responses to the current 'suite' of zonal transmission losses modification consultations in the BSC recognise that the SO directly affects transmission losses in the short-term. Given the likely lack of stable long-term signals from these zonal loss proposals we believe that only NGET should continue to be incentivised on losses in the future.

A.8. Should a dynamic reference price be used?
We believe that a reference price reflecting market pries would be more appropriate and that the form of this should be developed for consultation.

A.9. Does industry believe any price uncertainty should be reflected in the 2007/08 incentive scheme?
We continue to believe that price uncertainty should be addressed through the setting of appropriate caps and collars and the Income Adjusting Event provisions in NGET's licence, though as noted below, the use of price indexation may be worth considering.

A.10. Would price indexation be a desirable mechanism to manage these risks? If so, can different options for price indexation be identified?
Given price indexation is already being deployed in NGG's gas cost incentive it is worth investigating its use in electricity. The identification of an appropriate price index would require full industry consultation and an impact assessment, and we would suggest that this is carried out as part of the consultation on the 2007/08 incentive.

A.11. What is the potential impact on NGET's incentives and risks to customers?
If an appropriate indexation can be found, this might reduce risks to NGET and potentially lower costs to customers.

Gas External Balancing

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

Yes. We do not believe that any substantial revision to the existing schemes is necessary, but we support Ofgem in carrying out this review process.

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

We believe that an annually-derived incentive regime would offer the most responsive approach to system operator incentives. It certainly should not apply to periods greater than two years.

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

Again, we believe that the existing mechanisms are still valid and appropriate. We would, however, question the effectiveness of the cap and floor applied to the price incentive payment. They seem to be largely redundant.

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

Given the limited impact of the linepack incentive, it is questionable whether this is indeed effective. In deciding whether or not this incentive is still necessary, it would be useful to have a better understanding of NGG's likely behaviour in the absence of this mechanism.

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

Since 2003/04, NGG has annually received its maximum £4 million incentive payment as a result of exceeding its gas cost target. This could imply that this target is too achievable. Nevertheless, we believe that a gas cost incentive is necessary. This is supported by the considerable improvements that have been made since NGG suffered a loss under the mechanism in 2002/03. A possible revision to guard against over-rewarding NGG and complacency may be to reduce the cap. Alternatively, Ofgem could reduce the sharing factor from 100% to, for example, 75%.

Without seeing a reduction in target or change in over- or under-performance, it is very difficult to comment on how effective the system reserve incentive is at keeping NGG costs down.

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

See response to B.5. Given the sizeable payments being routinely made to NGG under the Gas Cost Incentive, we propose that the 100% sharing factor could be revised downwards to avoid the risk of over-payment. It may be that this provides a more appropriate solution to the one suggested above, i.e. modifying the cap.