National Grid Electricity Transmission and National Grid Gas System Operator Incentives – Preliminary Views Consultation
Response by Association of Electricity Producers

30 October 2006

Introduction The Association welcomes the opportunity to comment on Ofgem's preliminary views consultation for National Grid's SO incentives. The Association of Electricity Producers (AEP) is the UK trade association representing electricity generators. It has some 90 members ranging from small firms to large, well-known PLCs. Between them they represent at least 90 per cent of the transmission connected generating capacity and they embrace nearly every generating technology used in the UK. Many member companies have interests in the production and development of renewable energy where the government has set ambitious targets for development over the next decades.

Our response to the consultation document falls into two parts: general comments and then detailed comments that follow the layout of the questions posed within the document. The questions are posed in italics and our responses are in normal font.

GENERAL COMMENTS

We welcome Ofgem's early involvement of parties in the development of the SO Incentive scheme proposals for 2007 and beyond. It is inevitably the case that early involvement means that we can only comment in general terms about some of the proposals and that the detail will be revealed later. Additionally, the commercially sensitive nature of some of the information being considered means that only Ofgem and NGET will have full enough access to draw conclusions as to the robustness and accuracy of proposed target figures. Therefore, our responses will tend to focus on principles, not figures.

DETAILED COMMENTS

Chapter 3: Electricity SO cost forecasts

Duration: We note that Ofgem intend to set an external scheme for one year and to undertake a review of incentive scheme structures during 2007. We look forward to participating in this review and suggest that the draft terms of reference are published together with the detailed proposals for 2007/08 in December.

Scope: We agree with Ofgem's conclusion that the interaction between constraints, energy balancing and system management, mean that a bundled IBC-type target is appropriate.

Information Asymmetry: This year (2006/07) the lack of an SO Incentive scheme has led to an unprecedented provision of detailed operational information from NGET to Ofgem. We would expect this to inform the detailed provisions that are promised in December.

***Question 1**: Do you consider that it is appropriate to have a form of indexation for external costs to wholesale electricity prices? If so, do you consider that the merits of this approach outweigh the additional complexity?*

We suggest this approach is worthy of further thought, particularly given the IAEs following 2005/06. Using such an approach would impose further complexity, but is likely to mean NGET's SO actions such as trading may be less likely to impact the operation of the market.

***Question 2**: If you consider that a form of indexation to wholesale electricity prices is appropriate, please give your views on the components of NGET's external costs that should be covered by indexation?*

Table 3.3 indicates those areas that are particularly affected by movements in summer and winter energy prices and the variation between them. In the event of a price indexation, the commercial risk to which NGET would be exposed would be reduced and we would expect sharing factors to be consequentially reduced.

***Question 3**: Do you have any views on a possible approach of indexing through the use of a 'price risk band', which would adjust the IBC target only if wholesale electricity prices moved outside the price risk band, and any comments on the appropriate size of such price risk band?*

We recognise Ofgem's aspiration to ensure NGET still have an incentive to choose cost-efficiently between trading ahead and on the day. Nevertheless, a 'price-risk band' seems likely to become an IAE by another name. We await details of such a proposal.

***Question 4**: Do you have any comments on whether the current IAE licence provisions are appropriate, or whether they should be amended, and if so, how?*

In principle the revisions to the IAE process implemented recently by Ofgem have led to a more transparent process. Therefore, the licence provisions probably don't need amendment. However, Ofgem will be aware of Association members' disappointment at the recent IAE submissions and the outcome, given that NGET and Ofgem had freely negotiated the SO Incentive scheme for 2005/06, and that the position finally accepted by NGET explicitly included components of the incentive covering Scottish constraints and frequency response. In these circumstances, we find it difficult to understand what commercial risk NGET are agreeing to take and hence what is the incentive delivering.

***Question 5**: Do you have any comments on NGET's overall forecast of, and assessment of drivers related to, external SO costs it expects to incur in 2007/08?*

Ofgem and NGET are the only parties who have full access to commercially sensitive information and can therefore judge the validity of the forecasts. The choice of primary drivers seems appropriate and we do not anticipate any radical change to market operations in the coming year. Therefore these drivers are likely to remain primary. Ofgem's recent decision on P205 will need to be factored into the detailed proposals.

Question 6*: Do you have any comments on NGET's forecast increases in Ancillary Services costs in 2007/08?*

We agree that the revised arrangements for REP provide a better structure for frequency response prices and hence should lead to a more market-based outcome. NGET's replacement for warming contracts will start to affect costs this winter and Ofgem should try to take account of this in their final proposals (although there is little time to see the effect).

Question 7*: Do you have any comments on our preliminary view that there are good prospects for external SO costs incurred by NGET in 2007/08 to be less than its initial forecast?*

The recent transient effect on prices of the commissioning of the Langeled pipeline is one of a number of effects on the structure of supply and hence price that will be manifesting over the course of the coming winter. We do not know the price outcome of these effects, yet.

Question 8*: Do you have any comments on whether there are any further potential Rule amendments that might assist in placing further downward pressure on prices For Ancillary Services?*

None as yet, although we may be able to offer further comments on sight of the detailed proposals.

Question 9*: Do you have any comments on how internal Scotland constraint costs might be best minimised during the 2007/08 external SO incentive scheme?*

None as yet, although we may be able to offer further comments on sight of the detailed proposals.

Question 10*: Do you have any comments on whether the current IAE licence provisions are appropriate, or whether they should be amended, and if so, how?*

See comments in response to question 4.

Question 11*: Do you have any comments on NGET's overall forecast of internal operating and capital SO costs it expects to incur between 2007/08 and 2011/12?*

It may prove to be the case that increased renewable and offshore generation will impact the SO's internal cost-base. However, this needs to be demonstrated, and we look forward to seeing this demonstration.

Question 12*: Do you have any comments on our preliminary view that the efficient level of opex over the duration of the incentive scheme is £251.5 million?*

See response to question 11.

Question 13*: Do you have any comments on our preliminary view that the efficient level of capex over the duration of the incentive scheme is £47 million?*

We do not have access to the information that allows Ofgem to produce its detailed analysis of previous under-spends and minor inefficiencies. Hence we have no detailed comment on the level of capex. We presume that the impact of expected staff reductions and new hiring costs are factored into the pension costs.

Chapter 3: Gas SO cost and volume forecasts

Question 1&8*: Do you have any comments on whether the current IAE licence provisions are appropriate, or whether they should be amended, and if so, how?*

We consider that the arrangements for electricity and gas transmission should remain consistent, with an IAE being subject to consultation on each occasion.

Question 2&3: *Do you have any comments on NGG's forecast or Ofgem's views on shrinkage volumes for 2007/8?*

NGG has routinely received the capped incentive payment under this scheme in the past three years. However we recognise that from the information provided it is not possible to determine how much of this out performance related to volume or price. If lower volumes have been achieved then it would seem reasonable to set more challenging targets.

We support a lower target than NGG's central case for own use gas as we believe that less compression will be required as increased flows arrive via Langeled and Milford Haven.

Unaccounted for gas has routinely out-turned below the target level, therefore setting the central case target at the level of the expected 06/07 outturn seems reasonable.

We acknowledge that changing gas flows and associated qualities may increase the unbilled energy volumes but NGG's high case seems extreme and even its low and central case is twice that expected this current year.

Question 4: *Do you have any comment on which of NGG's forecasts is the most appropriate basis for the system balancing gas cost incentive scheme target?*

The system balancing incentive includes both the gas cost incentive and system reserve incentive, please see comments under the individual elements. Overall, something lower than NGG's central case would seem appropriate.

Question 5&6: *Do you have any comments on NGG's forecast or Ofgem's view on the gas reserve volume for 2007/8?*

We understand that supply /demand forecasts impact the anticipated reserve requirements and that NGG's central case is based on the winter 06/07 base case and demand that does not include recently observed demand side response. It seems reasonable to exclude the extensive demand side response seen last year as the circumstances were perhaps exceptional. Clearly if such demand side response becomes a regular feature of winter operation as import dependency grows then this can be reviewed in the future.

We agree that adjustments should be made for the potential double counting effects.

Question 7: *Do you have any comment on which of NGG's forecasts is the most appropriate basis for the system balancing gas reserve incentive scheme target?*

The central case adjusted for double counting seems reasonable.

Question 9: *Do you have any comments on NGG's overall forecast of internal operating and capital SO costs it expects to incur between 2007/8 and 2011/12?*

Similarities between NGG's forecast and Ofgem's views are encouraging.

Question 10: *Do you have any comments on our preliminary view that the efficient level of opex over the duration of the incentive scheme is £122.1 M?*

We note this is at a similar level to the NGG forecast and have no further information to comment on whether Ofgem's proposed reduction is reasonable.

Question 11: *Do you have any comments on our preliminary view that the efficient level of capex over the duration of the incentive scheme is £45.1 M?*

We note the overspend in the current price control period and expect operational efficiencies to flow from these. We consider Ofgem's proposals to be reasonable.