British Energy

31st October 2006

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Dear Sonia

NATIONAL GRID ELECTRICITY TRANSMISSION AND NATIONAL GRID GAS SYSTEM OPERATOR INCENTIVES FROM 1 APRIL 2007

British Energy welcomes the opportunity to comment on the issues raised by your consultation paper on the above as published in October 2006. Please note that our comments primarily relate to the electricity external balancing – system operator incentive scheme.

As a principle British Energy supports the adoption of a transparent incentive regime as the most appropriate means through which to ensure that NGET are incentivised to operate the transmission system in an efficient and economic manner. We do not consider the current backstop approach where NGET's costs are regulated under its licence to be the most effective way of protecting the interests of system users and ultimately customers.

Detailed Comments:

Duration:

We note that there are calls for a multi-year scheme for external system operator costs. In principle, we are not opposed to the idea of a scheme with a longer duration than twelve months. However, we agree with Ofgem that a fundamental review of the external SO scheme may now be beneficial and that any proposal to extend the duration of the scheme should form part of this review. Consequently, we support the proposal for a one year scheme commencing in April 2007 and we would urge Ofgem to publish draft terms of reference for the fundamental review as part of its final proposals for the 2007/8 scheme.

Bundled Scheme:

We have previously advocated the separation of the various incentive pots on the basis that this would improve the overall transparency of any incentive scheme. Whilst we continue to believe that an unbundled scheme has merits and would not lead to the creation of perverse incentives on NGET we note that Ofgem's preliminary view is that a single incentivised balancing cost (IBC) target should be retained. With this in mind we consider that the fundamental review which is to be conducted next year should consider ways in which to improve the transparency of the overall scheme and the various incentive pots.

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Indexation to wholesale electricity prices

Whereas we believe it is undesirable for NGET's outturn profit or loss under its incentive scheme to be dominated by market prices any proposal for some form of price indexation needs to be carefully assessed as it would not be appropriate to remove the SO completely from any form of price exposure given that this risk can be managed to some extent. Furthermore, the incentives on NGET to manage balancing costs efficiently should not be in any way diluted by such a proposal to the detriment of consumer interests. One such proposal that may address these concerns is the adoption of a price risk band whereby incentives on the SO are maintained but the risk of windfall loss or gains resulting from significant price fluctuations is reduced.

Consequently, we support moves to give this issue further consideration, be it during the development of the scheme for 2007 or as part of the fundamental review to be commenced next year. Clearly, consideration needs to be given as to what is the appropriate price index, which components are to be covered by the indexation and whether the implementation of price indexation should lead to a change in the sharing factors under such a scheme.

IAE Provisions

We do not currently have any particular concerns with the licence provisions in respect of income adjusting events (IAEs). However, we are concerned with the fact that we have experienced three system operator incentive IAEs in as many years. In particular, we were opposed to the recent IAEs that were raised by NGET earlier this year on the basis that the increase in costs were neither unforeseen or unexpected and further that NGET accepted the targets set by Ofgem in respect of the relevant IBC components. This raises concerns regarding the incentive arrangements and in particular the setting and agreeing of targets by Ofgem and NGET.

NGET's Forecast & Assessment Drivers

It would appear that the assessment drivers related to external SO costs used by NGET in its forecast are appropriate. We currently do not see any new significant change to market operations that would need to be factored in for the 2007/8 incentive scheme.

However, it is clear that a number of factors have changed since the production of NGET's forecast which will need careful consideration. Most noticeably there has been a marked reduction in the forward wholesale electricity price which will clearly need to be factored in. In addition, the impact of Ofgem's decision on P205 will also need to be considered. With this in mind we note that NGET had forecast that P194 would have had the effect of reducing IBC by approximately £3 million.

Ancillary Service Costs

As we have indicated previously we were concerned with the fact that frequency response costs have risen significantly as a consequence of the introduction of CAP047. We note that Ofgem has commented in this consultation that following the introduction of CAP047 it expected costs to rise and then stabilise and the fact that this did not happen (due to the REP arrangements) has now been addressed by CAP107B. We support proposals that enhance market transparency and competition, however, there will be a need to monitor the impact of implementing CAP107B later this year in order to ascertain whether these perceived benefits are materialised and costs are ultimately reduced.

We note that NGET are forecasting an increase in standing reserve costs. We are somewhat surprised by this given the new arrangements being implemented in April 2007 which allow for more frequent and transparent procurement of reserve. We would expect this development to ultimately improve competition in reserve provision and thus better facilitate the provision of economic and efficient reserve services. Consequently, we would welcome some explanation as to why NGET is forecasting an increase in reserve costs.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely

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