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30 October, 2006

Dear Sonia,

NG SO Incentive Scheme 2007/08

Thank you for the opportunity to respond to the above consultation document. We believe that it is very difficult for participants to comment on specific cost forecasts as we are not party to the same amount of market data as National Grid. At this stage therefore we would like reiterate our views on the structure that the scheme should take for 2007/08. We understand that this will be the subject of the next consultation document. However, we thought it would be more helpful to set our views prior to this rather than simply reacting to the initial proposals when they are published.

1. As we have stated in our responses to consultations on previous years' schemes, we believe that the sharing factors could be set more modestly and still achieve the aim of the scheme. At present, this incentive means that National Grid is able to earn large sums of money simply by performing in accordance with its licence obligations. Whilst we accept the scheme is a useful addition to the licence requirements, it does not need to be of such an extreme nature. A maximum payment, or charge, of one or two million pounds would be sufficient reason for National Grid to seek to minimise its balancing costs. Therefore, we believe that the sharing factors can be reduced significantly.

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2. This would have an additional effect of reducing the need for Income Adjusting Events (IAEs). If smaller amounts of money are being exchanged within the scheme, the pressure to raise IAEs will reduce. We believe that the IAE provisions should be removed for reasons we have stated previously. Firstly, IAEs usually represent a one way bet in that users do not have the same information to raise them for events which would have reduced the outturn costs. Additionally, we believe that once a scheme has been set it should be adhered to. National Grid accepts a single target covering a number of different cost drivers, some of which interact with each other. As has been shown in respect of the scheme for 2006/07, National Grid is not compelled to accept the scheme. If it does so, however, it should be held to the terms of that scheme and not be able to opt out of certain elements which do not outturn as well as hoped whilst retaining the benefits associated with those areas which performed better than expected.

3. We note in the document that Ofgem proposes to introduce a one year scheme for external costs. We agree with this approach as we believe that it allows the targets to more accurately reflect changing circumstances year on year. This reduces the requirement and likelihood of income adjusting events. It should be borne in mind that income adjusting events introduce financial uncertainty for participants as they result in a significant retrospective adjustment to their balancing charges.

4. We are uncertain whether or not it is necessary to introduce a target for constraint costs which is indexed to wholesale prices. This would appear to be problematic unless there is a clear and proven correlation between balancing costs and wholesale prices. In the absence of such a correlation, such a move could introduce unnecessary complexity into the arrangements.

I hope the above points prove helpful.

Yours sincerely

Paul Jones
Trading Arrangements