

Sonia Brown
Director, Wholesale Markets
Ofgem
9, Millbank
London
SW1P 3GE



30 October 2006

Dear Sonia

**National Grid Electricity Transmission and National Grid Gas System Operator
Incentives from 1 April 2007 – Consultation**

EDF Energy welcomes the opportunity to comment on the next SO incentive schemes.

We welcome the fact that there will be SO incentive schemes in place for the coming year.

We would have preferred to have seen proposals for multi-year SO incentives schemes, including for 2007/8, and therefore welcome the commitment to this for the future that is made in section 3.2. This has been acknowledged as a strongly-desirable aim ever since the first "UMIS" SO incentives scheme in 1995/6, in the negotiation of which we played a part for the Suppliers. However, there has always been a reason why it was not possible in practice – for example, the splitting of energy and transport "uplift" in April 1997; plant divestments and the associated wholesale price collapse; preparations for NETA; NETA; BETTA, and now, perhaps, renewables investment and changes to the access regime may be raised.

The time to move to a multi-year SO incentives scheme can always be argued to be "wrong", but such a move would have the enduring benefits of enabling far "deeper" investments to be made. Within a one year scheme, even with symmetrical 50% sharing and no deadband, any capital investment has to have an infeasible 6-month payback for the scheme to incentivise it. Thus, many desirable improvements will never be made until the move to a multi-year scheme is made.

We welcome the proposal that at least SO internal costs be incentivised over 5 years from April, 2007 (para 3.41) – and that the form of this element of incentivisation remain aligned with TPCR.

We believe that a SO incentive schemes should have only a very "tight" definition of an income adjusting event (IAE). The use of IAEs is in practice an option that, owing to informational and resource asymmetries, is most likely to be exercised by NG rather than by Ofgem on behalf of system users. Moreover IAEs have sometimes been raised for fairly general reasons that did not relate to specific events, in years when NG did not make the profit it

had hoped for (and which it generally has made through SO incentives schemes over time).

It should be made clear that an IAE is to be a rare, very specific event beyond anything that NG could possibly have expected, in negotiating a scheme with Ofgem. It might be helpful if the text on IAEs could specifically exclude certain events that are not appropriate re-openers, so as to further restrict the range of possible IAEs and the frequency of IAE requests.

Ofgem should itself be mindful of any rare, very specific events that may reduce costs dramatically, and itself trigger an IAE to ensure that the windfall in this rare instance is shared between NG and market participants – an IAE should not be a one-way option for NG.

In terms of general form, we would support a scheme with symmetrical sharing factors and a wide incentivised cost range to ensure that costs continue to be minimised on an ongoing basis.

You will find attached our responses to the questions raised in Chapters 3 and 4.

I hope you will find this is helpful. If you have any queries, please do not hesitate to contact Paul Mott on 020 7752 2517 or myself.

Yours sincerely

A handwritten signature in black ink, appearing to read "D. Linford".

Denis Linford
Director of Regulation

Attachment

National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007

EDF Energy's responses to the questions in Chapters 3 and 4

Chapter 3

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?*

Yes, we do consider it desirable to index-link external costs to wholesale electricity prices, as there is a correlation in reality, and such a linkage could assist in minimising the need for IAEs. It should also facilitate the negotiation of a many-year SO incentive scheme as it would take out some of the risk for NGT (and for BSUoS payees). Complexity should be avoided in this linkage.

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

Our own analysis showed that when, on past data, half-hourly BSUoS was regressed against half-hourly wholesale market forward prices (both as expressed in £/MWh), the gradient of BSUoS against forward prices appeared to be around 0.025, with a high confidence level (from F- and T-tests) that this relationship was a genuine result which was actually explaining about a third of the movement in BSUoS (£/MWh) as a whole. This relationship could inform the negotiation / creation of an indexation relationship between wholesale market forward prices, as averaged over a year, and the incentivised costs. The reason for the relationship is assumed to be that as forward market prices go up, BSUoS does so too, because for example when NGT is having to select offer prices and pay at offer, the offer prices are themselves inevitably higher in such an environment.

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 note that some respondents to the previous consultation saw merit in the use of a deadband. The need for the use of a deadband is not clear to us, given the clear relationship (correlation) that exists.

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?*

We believe that an ideal system operator incentives scheme should not have any concept of income adjusting events. We have commented on this at greater length in the covering letter.

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

The increase in ancillary services costs, both in terms of the 2006/7 forecast outturn and of 2007/8 forecast, looks particularly high; NGT always over-forecasts the back end of the current year by a large margin in these negotiations. The 2005/6 data should be used as a base-line.

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

Yes, they are particularly extreme. 2005/6 would make the best baseline. Moreover, the continuing contract innovation by NG that is occurring (for example the replacement now in hand of the old "warming contracts") should cause costs to generally fall from those levels. The introduction of more cost-reflective frequency response energy payments (REPs) may well cause a reduction in the costs to NG of reimbursing generators for holding frequency response.

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

Yes, this is almost certain to be correct – all NGT's "forecasts" in all of these negotiations, including the three earliest ones (UMIS1, UMIS2 and TSS1) in which we represented Supplier interests, were very high, which can be regarded as a negotiating ploy.

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?*

2005/6 remains a valid baseline for future forecasting. NGT's dispatch efficiency in respect of these services should become greater over time, reducing costs from this level. NG could usefully provide more commentary

than it has on page 70 on how frequency response markets are operating and especially on the reason for a rise in costs when a fall might have been expected, and when volumes have remained unchanged. NG could also improve market transparency more generally via full disaggregation of the BSAD data that feeds into cashout prices – market participants have generally supported full disaggregation of BSAD data whenever the topic has been discussed.

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?*

Companies' bidding behaviour north of the border should be closely monitored to ensure that it does not represent abuse of a dominant position. More adequate tagging mechanisms in the BM should be considered to identify system actions.

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?*

Please see our reply to question 4, above.

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

No.

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?*

The Ofgem preliminary view does not seem unreasonable.

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?*

Again, the Ofgem preliminary view does not seem unreasonable.

Chapter 4

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

It is how these provisions are-applied that is of more concern than their content. We believe the IAE should only be applied in the event of truly unexpected costs and events, not when NGG has not done as well as expected.

We believe that a system operator incentives scheme should have only a very “tight” definition of an income adjusting event (IAE). The use of IAEs is in practice an option that, due to informational and resource asymmetries, is most likely to be exercised by NG rather than by Ofgem on behalf of system users. The definition of an IAE should be made clearer as a rare and very specific event beyond anything that NG could possibly have expected, even as an outside chance, in negotiating a scheme with Ofgem. In respect of general variations to outturn costs, it would be just for all sides involved to “take the rough with the smooth”. It might be helpful if the text on IAEs could perhaps specifically exclude certain events that are not appropriate re-openers, so as to further restrict the range of possible IAEs and the frequency of IAE requests.

Ofgem should itself be mindful of any rare, very specific events that may reduce costs dramatically, and itself trigger an IAE to ensure that the windfall in this rare instance is shared between NG and market participants – an IAE should not be a one-way option for NG.

Question 2: *Do you have any comments on NGG’s shrinkage volume forecast for 2007/08?*

Whilst it is useful to have NGG’s target for 2006/07 for shrinkage volumes, and their forecasts for 2007/08, it is hard to provide any comments without being able to identify what their historic targets and outturn shrinkage volumes were. We are aware that in the 2002-2007 Transmission Price Control Period, NGG managed to beat their shrinkage target and “hit their cap” every year, and are on target to do so again this year.

Question 3: *Do you have any comments on our preliminary view on the appropriate shrinkage volume for 2007/08?*

As stated above, whilst the analysis and commentary provided by Ofgem and its consultants, TPA, is very useful, it is very hard to form a view as to whether the shrinkage volume represents an adequate target without having sight of the historical targets and outturn shrinkage volume.

Question 4: *Do you have any comment on which of the low, central and high case forecasts presented by NGG and in our preliminary views is the most appropriate basis for the system balancing gas cost incentive scheme target?*

NGG’s classification of volumes into “Own Use Gas”, “Unaccounted for Gas” and “Unbilled energy” is also very useful. We would therefore welcome historical information on NGG’s shrinkage volume targets, and outturn performance, broken down into the above categories in order to inform our response. Going forward, as NGG can effectively only manage its “Own Use Gas”, it may be worth focusing the incentive on this element of the shrinkage account, whilst incentivising reduction, or economic minimisation, of “Unaccounted for Gas”.

In terms of NGG's Quality of information performance we believe Ofgem should be implementing the first option in section 4.15 - the two-sided incentive, but the target benchmark should be changed to the Enhanced Performance scheme where NGG would have to improve based on current performance. This is because we note that the quality of data and NTS demand forecasts have worsened slightly since the incentive was implemented - see the extract below from NGG's Operational Data website. We believe that simply maintaining the current level of performance would not be efficient.

"A discrepancy has been identified with the calculation of NTS Throughput within SISR04 since early October 2006. We are in the process of correcting this discrepancy, but in the meantime, please refer to the NORD01 report for D+1 actual demand."

Question 5: *Do you have any comment on NGG's gas reserve volume forecast for 2007/08?*

Comments on question 3 of chapter 4 above also apply to this question.

Question 6: *Do you have any comments on our preliminary view on the appropriate gas reserve volume for 2007/08?*

Comments on question 3 of chapter 4 above also apply to this question.

EDF Energy
October 2006