energywatch
your gas and electricity watchdog

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Dear Sonia

National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007: preliminary view consultation

energywatch welcomes the opportunity to respond to the issues raised by this consultation. This response is non-confidential and we are happy for it to be published on the Ofgem website.

Our starting point in considering all incentive schemes applicable to the transmission network operators is that consumer expectations are met. These expectations are that regulated networks are operated safely and reliably, ensuring security of supply to all consumers but particularly the vulnerable. The networks should be operated in an efficient and economic manner, with the costs incurred kept as low to consumers as possible. These expectations are reflected in transmission licensees' obligations.

National Grid (NG), as System Operator (SO) for both gas and electricity networks, has a particular licence responsibility to consumers to operate and balance networks efficiently and economically. We note the proposed levels of external and internal SO costs which NG considers it will need to recover in 2007/08 in both markets.

National Grid Electricity Transmission (NGET)'s SO incentives

In our response to Ofgem's previous letter on SO incentives in July 2006, we highlighted our view that the scope and form of previous SO incentives schemes applied to NGET are appropriate. We maintain this view and also agree that the external cost scheme should last for one year. The benefits of an integrated scheme are to allow NGET's balancing actions to be assessed in the round rather than broken into constituent parts. Some actions may have more than one purpose and it seems sensible to adopt a holistic approach to balancing costs.

Any long-term scheme applicable to external costs should be deferred until NGET's offshore SO role is better defined and assessed. We welcome Ofgem's commitment to review the external SO scheme in 2007. In any case, without a more flexible approach which allows incentivisation to respond to movements in external costs and the appropriate and timely adjustment of the scheme to manage those changes, a long-term scheme may be ineffective and limit the adequate scrutiny of costs.

In our view, a one-year scheme for 2007/08 using a target value based on rigorous analysis of NGET's own forecasts is required to ensure that the external costs scheme is robust. We agree that appropriate sharing factors, caps and collars should apply, preferably on a symmetrical basis unless there is strong evidence favouring asymmetric sharing factors on the upside or downside. We view future schemes in the context of our concern that past schemes have allowed NGET to keep a large share of benefits by setting easily attainable targets which NGET has comfortably out-performed. Consumers should see a greater share of benefits of efficient operation as NGET is able to manage those risks and not them.

We understand the difficulties that arise in setting a target value for 2007/08 as there is an ongoing volatility to wholesale energy prices which has a knock-on effect on NGET's ability to manage and balance the networks. NGET's use of the forecast forward wholesale electricity prices for 2007/08 seasonal periods makes certain assumptions about balancing costs, but, as is also highlighted, recent trends indicate that these forward prices are falling. This volatility will not disappear so long as uncertainties remain about not just the availability, but deliverability, of gas to Great Britain, with the significant impact it has on gas and electricity network management.

In principle, we believe it is worth exploring some form of price band around a central forecast of seasonal wholesale electricity prices going forward upon which to base the target value for the incentives scheme. The difficulty lies in determining which period to use to determine the central forecast and the tolerance level applied within which movements in prices will be accepted for the purposes of the target value. However, the adoption of a flexible mechanism should allow NGET to develop strategies to manage price risk and limit the impact of some volatility in prices.

We are curious as to why NGET's analysis suggests that there will be limited impact on balancing costs from a more marginal Balancing Mechanism (BM) main price arising from the decision on BSC modification P205 (replacing the earlier P194 decision). NGET justified support for P194 by arguing that it would meet BSC Applicable Objective b, allowing it to operate the network more efficiently and economically. The Impact Assessment for P194 suggested considerable benefits, ultimately to consumers, of lower balancing costs. This may not be borne out if there are other counterbalancing BM costs. Ofgem must clarify whether lower balancing costs, to the extent claimed, are actually achievable. We do not consider Ofgem's decision to approve P205 to have had a material effect on the Impact Assessment analysis presented for P194.

We are also concerned that there are other aspects of balancing costs, including ancillary service costs, being overstated by NGET and that these costs could be lower. We look forward to a more updated assessment of these costs which provide a realistic picture of the level of costs which NGET may incur in 2007/08. Our concern is that a higher target value will fall out of these forecasts, which allows NGET to obtain a greater share of the benefits under the incentives scheme.

We have no comments on the NGET SO internal cost incentives schemes, which appear appropriate. We look forward to seeing Ofgem's proposed approach to the form of the scheme in due course. We would underline that NGET has an obligation to undertake efficient capital investment to reduce the costs of operation.

National Grid Gas (NGG)'s SO incentives

As with NGET's external costs incentive scheme, we agree that NGG's scheme should last for one year. We have no specific views on the scope and form of the scheme but the objective must be to operate the gas network efficiently and economically on behalf of consumers.

We have indicated before that NGG should not need a quality of information incentive, as information transparency and timely provision of data to the market should be integral to efficient network operation. Given Ofgem's intention to carry forward this scheme, we expect to see a much tighter incentive on NGG in the 2007/08 scheme. This should ensure that appropriate and timely data is available to allow market participants to make rational commercial judgements and, in turn, allow NGG to lower the costs of balancing. We agree that a two-sided incentive scheme and standard of performance obligations are more appropriate, to provide NGG with downside risk if it performs poorly in providing up-to-date information on its website. We recognise that setting the target level may be difficult when insufficient data is available but consider that winter 2006/07 performance data could be extrapolated to set enhanced performance targets for NGG to attain in 2007/08. The incentive should be based on the most recent data.

We note that NGG's forecasts for shrinkage and gas reserve volumes in 2007/08 are significantly higher than those assessed independently on Ofgem's behalf. While there is some analysis in support of Ofgem's preliminary view, it would be helpful to understand further why there is a discrepancy between the figures. The TPA analysis only partly explains the rationale for lower volumes.

As with NGET's SO internal cost incentive schemes, we have no comments on the NGG equivalent, which appear appropriate. We would highlight that NGG also has an obligation to undertake efficient capital investment to reduce operational costs.

Income adjusting events (IAEs)

We believe that IAEs arise in exceptional circumstances and not if NGET or NGG can foresee potential risks and employ strategies to deal with them. Ofgem's recent determination on two IAE claims by NGET highlights that only unforeseen events should give rise to adjustments to ensure balancing costs to consumers are kept low.

Going forward, we will keep these issues under review as further proposals are consulted upon, always considering the possible impact on consumers.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

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