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FAO: Corey Dykstra

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

Thank you for the opportunity to comment on the preliminary views consultation issued on 1 October. Our response is on the electricity elements of the proposals. This covering letter highlights some more general points and picks up on themes across National Grid's proposals and your commentary.

It is plain that National Grid has had limited time to run its full model and analysis, and as a consequence it has fallen back on assumptions that lack credibility. The power price assumptions are already wrong, and the forecast should be rerun using current estimates for summer 2007 and winter 2007-08. More generally we support proposals to introduce some form of error correction given the scope for assumption risk.

The starting point for the assessment – the 2005-06 baseline – is evidently wrong as that year saw a combination of exceptional events, and not just the Rough outage that has been removed. It would be more reasonable to take the baseline assumed in setting the target for that year as the starting point for the forecasts.

We find it very difficult commenting sensibly on the ancillary service and energy trades costs as these are highly aggregated. We would question the extent to which ancillary service costs are automatically linked to power price inflation if National Grid has, as is usually supposed, a reasonable degree of contract cover. If it is exposed to simple annual resetting of prices for services that can often endure beyond a year, we would question the extent to which it is delivering its efficiency objective. As for energy trades, 2005-06 evidenced a significant increase in costs, but no explanation is provided as to why. This is an example of a wider issue, which is that the financial projections almost wholly lack any operational context.

The forecasts seem to make no allowance for any efficiency savings. Future schemes as a matter of course should make some allowance for a reasonable level of efficiency savings.

It is evident from the consultation that Ofgem envisages imposing a single IBC value. There is no obvious reason why subsidiary caps cannot be set for the different discrete components of National Grid's forecast (BM, BSCC, ancillary services and trades). This need not pre-empt reclassification of costs within year provided there was a process for notification and approval with Ofgem. We would also like to see a formalised reporting mechanism whereby National Grid reports across the main cost components to the Operations Forum with specific regard to achieved and expected performance against IBC.

Finally while there is merit in National Grid bringing estimates in front of the industry to increase understanding and stakeholder acceptance, the forecasts must have credence and a level of explanation that allows them to be properly evaluated. Our view is that its July submission does not allow for this.

We have addressed the questions you have raised on the electricity schemes in the attached appendix.

Please let me know if you have any questions on this response or would like any further comment.

Kirsten Elliott-Smith

National Grid incentives from 1 April 2007

Response from Immingham CHP

This appendix sets out Immingham CHP's comments on the Ofgem preliminary views consultation issued on 1 October. It addresses the questions raised by Ofgem on the electricity incentive schemes only.

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?*

The first point is that NG's baseline should be reduced to reflect significant reductions in wholesale electricity prices since its forecast was produced. There is every prospect that prices will come off further before commencement of the scheme. Further short term delivery prices over the last three years have shown a tendency to fall short of forward prices in normal seasonal conditions, implying the baseline could be reduced further.

With regard to indexation, the level of power prices is the primary driver of the general trend of within-year costs. We agree with Ofgem's comment that incentives on NG to contract ahead should be maintained. In circumstances of material change some form of error correction mechanism could be applied so that if variation against expectation exceeded a defined threshold there should be an automatic adjustment. Such an adjustment mechanism should apply symmetrically, and once the trigger has been activated, indexation should occur and operate in a predicable, quantifiable manner. Because of the importance of the linkage with power prices to NG performance, we believe that the triggers should be set at a lower level of, say, 10%.

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?*

While some cost areas may be amenable to carve out, experience over 2005-06 suggests a close linkage between average offer prices in the BM and power prices and also ancillary service utilisation costs (though there is much less information available for analysis). Thought should be given to the construction of a weighted index – some form of weighted average cost of balancing – that reflects different weights for the principal elements of NG's costs, for instance, with costs arising from availability payments for ancillary services and constraint payments clearly excluded.

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?*

Price risk bands are probably too coarse, and if set should apply at a lower level. We would prefer an error correction mechanism that kicks in at plus or minus 10%. This is not semantics, as an error correction mechanism would work in a continuous manner in a defined fashion once triggered. It should also be robust to any subsequent changes in the trend of power prices.

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?*

IAE provisions provide a "get out of jail (almost) free" clause for NGET. Part of this arises from reluctance of other participants to invoke the mechanism on those occasions when NG has enjoyed windfall gains. Introducing indexation and error correction mechanisms should mitigate (and possibly remove?) the need to invoke the IAE provisions.

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?*

The overall increase in the IBC forecast proposed by NG is not credible. Since 2005/6 was such an exceptional year, we fail to see why it should be the baseline for 2007/8. Wholesale power prices are falling, and these too have not been taken into account, and NG's estimate could be scaled back by around 20% subject to further analysis on the relationship between forward prices and IBC.

Ofgem's commentary also identifies a number of inconsistencies and inaccuracies in the assumptions used by NG, including:

- inadequate recognition of the impact of P205
- the beneficial impact CAP107B will have on NG's frequency response holding costs
- the double counting of warming costs
- the greater scope for efficiencies as evidenced by Ofgem's decision to disallow some elements of the recent IAE applications and the greater apparent scope for reducing constraint costs, especially those in Scotland.

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

A claim for 35% increase in ancillary service costs since the last scheme is extraordinary, especially against the high level of costs seen in 2005/06 and the volatile markets that prevailed. NGET claims that frequency response costs are increasing significantly and extrapolating a trend that has manifested itself over six months by a further 22 months to arrive at a growth figure. As already noted, a large element of the utilisation costs for several high cost services are closely linked to wholesale power prices, which seem to be on a downward trajectory, and the estimates for these can be revised closer to the point of agreement of the scheme. Intuitively, with nearly two years of experience of Betta operation, the market should be expecting to see some downward pressure on these costs, especially given some of the recent enhancement in contractual options put forward by NG.

We would comment that the level of commentary and detail for ancillary services is insufficient for us to draw any conclusions on the underlying costs and their drivers. There is also a complete lack of visibility of where and when constraints arise.

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?*

An increase of 13.1% over 2005/6 is excessive, and several of the arguments deployed in response to the previous question are relevant here.

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?*

We do not have a view on particular rule changes. Despite this opacity, we sense Ofgem is correct when it says there are opportunities for reductions in NG's forecasts.

More generally we would like to see rule changes proposed that enable increased transparency in these critical areas, especially SO to SO trades that now seem to be a feature of the balancing activity and NG's energy trading activities.

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

As noted above improved transparency is a key first step in being able to understand what is driving these estimates. Ofgem also needs to explore the interaction between these costs and capex under the transmission price control review examined to ensure the longer-term incentives are aligned.

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 our response to question 4.

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?*

We would expect to see its projections exposed to some form of challenge or consultancy investigation in a similar way as the transmission price control review (though given the lesser quantum of the costs a more top-level analysis may be appropriate).

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 text says Ofgem's view is £227.6mn, representing a 10% reduction, though it is unclear how this has been arrived at. Reductions of this magnitude should be a given bearing in mind NG's established record of talking up its costs.

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 text gives a different figure at £41mn, with £47mn being NG's view. Given NG's record of underspending, the lower figure would appear to be in the right ball-park