National Grid Electricity Transmission System Operator External Incentives 2007/8

Executive Summary

This section covers NGET's response to Ofgem's consultation on incentives for National Grid Electricity Transmission's (NGET's) System Operator (SO) External costs for 2007/08.

Overall, we consider that the aim of the System Operator Incentive Scheme should be to incentivise NGET to efficiently manage those cost areas that fall within our control. We would therefore support the further examination of mechanisms such as indexation that may militate against windfall gains or losses from areas outside of our direct control.

With regard to forecasts of likely balancing costs and scheme target for 2007/08 we note that a number of elements remain uncertain. In order to set a final target based on the most up to date data we will continue to identify areas of uncertainty to Ofgem as part of the forecast process. In particular, we note that there are some approved industry code amendment proposals that Ofgem and/or ourselves consider could have impact upon the likely levels of incentivised balancing costs for 2007/08 that are due to come into effect by January 2007 (CAP107b, P194, P205). We consider it appropriate to identify within the forecast those areas that should be re-examined once more accurate data, illustrating the impact of these amendments, becomes available.

In summary, although we continue to believe that targets should be set predominantly upon historic data, emerging trends need also to be accounted for in the target for 2007/08 using the latest data. In line with this approach, on 23rd October we submitted a revised 2007/08 cost forecast to Ofgem that reflected latest data, in particular recent falls in power prices, which has resulted in a downward revision of our forecast costs for 2007/08.

We provide our answers to Ofgem's specific questions regarding the incentive scheme proposals for 2007/08 later in this Appendix. However there are a number of issues that we would wish to highlight:

Price Indexation

We support Ofgem's comments made in paragraph 3.21. We agree that indexation of the incentive scheme target to wholesale prices should be considered in more detail as part of this consultation process, particularly if it is concluded that structural changes in the market and larger price movements could lead to windfall gains or losses under the incentive. We agree that exposing the SO to some price risk through an indexation scheme is appropriate and we believe that this could be best achieved through a "price risk band" methodology as put forward in the consultation. Our more complete views on this subject are contained within the response to the specific questions, below.

Ancillary Services

National Grid has forecast increasing costs in this area. This reflects both price and volume drivers and economic procurement strategies that have led to a greater volume of procurement being through Ancillary contracts that have led to larger reductions in BM costs. In the areas where there are differing views between National Grid and Ofgem on elements of the ancillary forecast – specifically Mandatory Frequency Response prices – then the indexation of a portion of the incentive target to the appropriate price may be a suitable way forward.

Internal Scottish Constraints

National Grid has striven to reduce costs in this area using the balancing tools at its disposal. We continue to develop our tools and strategies and would welcome further discussion with Ofgem to consider these costs and any alternative approaches that could be taken forward in this area.

Income Adjusting Events

National Grid considers that there are two different types of Income Adjusting Event (IAE):

1. Those that have been historically flagged prior to scheme commencement (e.g. Scottish constraints in the 2005/06 scheme), and;

2. those that emerged during the scheme that could not have been forecast in advance, such as Force Majeure events or, as in the case of IAEs in 2002/03 and 2003/04, extensions of the scheme to cover additional cost elements which lay outside our understanding of the scheme at its outset.

For the 2007/08 scheme National Grid believes that there should not be the need to retain the first "ex-ante" category of IAE providing appropriate costs are reflected in setting the scheme target. However National Grid continues to believe that the Income Adjusting Event process provides for the most efficient way of accounting for significant but unforeseen changes to Incentivised Balancing Costs after an incentive target has been agreed. We also consider that changes to the existing IAE process may be appropriate and discuss this more fully later in this appendix.

Balance of Risk and Reward

National Grid would reiterate that it is important that scheme proposals developed by Ofgem are self-consistent. That is to say we would prefer to see a balance between higher risk being rewarded through potentially higher rewards and lower risk being accompanied by proportionately lower rewards. We do not consider that this was the case with regard to the proposed 2006/07 scheme options which did not, in our view, offer an even balance of risk and reward.

Overall we hope that you find the more detailed comments below useful and if you would like to discuss any part of this section of our response in more detail please contact Duncan Burt on 01926 656703.

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?

Question 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?

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?

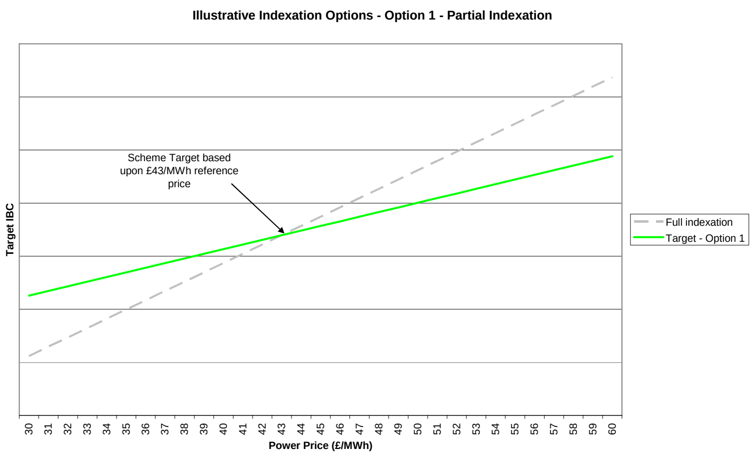
Our view is that the additional complexity of indexation is appropriate where wholesale prices are forecast to be volatile or where there is a possibility of structural changes in the market that could result in price shifts. These price shifts could result in windfall losses or gains by the SO through structural changes in the wholesale price (which are beyond the control of the SO) and such windfall losses/gains mean that the financial incentives to perform are diluted. Overall, market conditions have led to greater price movements and given the ongoing possibility of such price movement we would support further consideration of indexation.

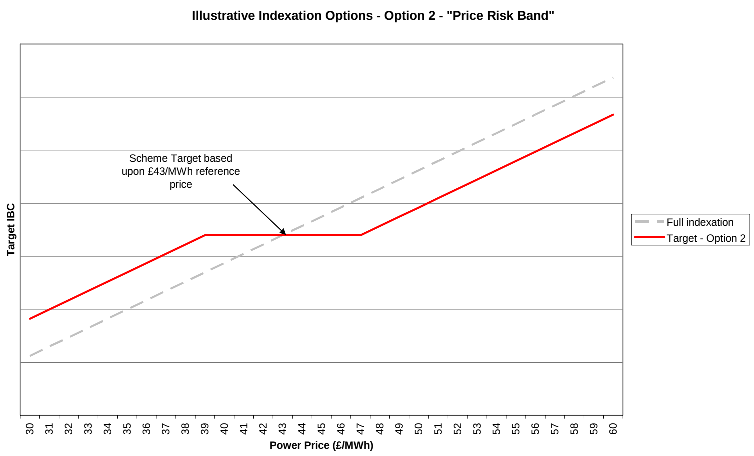
In our view, if indexation is used to manage the risk of ongoing price movements, then it should include Balancing Mechanism costs (Bid and Offer Prices), the Net Imbalance Adjustment, the costs of National Grid's forward trading activities and Reactive power costs. These costs represent approximately 25% of National Grid's current forecast of incentivised balancing costs for 2007/08 and would represent a full indexation level of a +/-£3.5m adjustment to the scheme target for each +/- £1/MWh price change in outturn baseload prices.

This level would represent the full indexation of the scheme. We consider that it is appropriate to retain some price incentive on the SO and we can see two possible methods by which this can be achieved.

1. through the use of a partial indexation level, for example +/-£2m for each +/- £1/MWh change in outturn baseload price. Overall, any indexation level would be dependent on the indexation mechanism and other scheme parameters as a whole, but would leave National Grid partially exposed to any move in wholesale prices including those caused by structural movements in the market, or;
2. through the use of a dead-band with full price indexation outside of that deadband, i.e. the "Price risk band" methodology as described by Ofgem in section 3.22 of the consultation. This would leave NGET incentivised within the "price risk band" but would limit NGET's exposure to structural shifts in power prices.

These Options are shown diagrammatically below:





Overall we can see merits with both options. With regard to option 2 we consider that the tolerance band of 20% would perhaps be too great as on the basis of a £3.5m per £1/MWh change in costs would result in an approximate £30m shift in costs before indexation became active. We consider a narrower band, such as 10%, may be appropriate and would welcome further discussion with Ofgem in this area.

On balance, at this stage we consider the “price risk band” method (option 2 above) appears to be more effective against structural price shifts in the market and therefore more appropriate. However any indexation methodology will need to be considered as part of the scheme parameters as a whole.

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?

As we have indicated above, there are two distinct categories of Income Adjusting Event. There are those that can be arranged in advance of the scheme year, as part of scheme proposals as was the case for 2005/06, and there are those that the requirement for which during a scheme year arises as a result of unforeseen events. For the scheme year 2007/08 National Grid currently does not envisage there being a requirement for any IAEs of the type that can be arranged as part of scheme proposals, prior to the scheme year.

National Grid believes that a mechanism to cater for a material impact upon incentivised balancing costs of circumstances not foreseen when the incentive scheme was set or Force Majeure events occurring within the scheme year is still required. Force Majeure clauses are standard commercial tools for managing extreme risks and there are a number of events that if they were to occur in the UK could lead to significant unforeseen costs, e.g. an outbreak of Bird Flu, acts of terrorism directed at the electricity network or protests leading to the disruption of electricity or fuel supplies.

The probabilities of such events occurring are low, however their potential impact upon incentivised balancing costs, though highly uncertain, could be very large. National Grid sees the following options to potentially manage such costs:

(a) direct cost pass through post-event (similar to the way the IAE provisions currently operate);
(b) licence provisions that would allow the incentive to be suspended under certain conditions; or,
(c) by perhaps providing an explicit allowance for such events within the IBC target for each scheme year that would on average and, over the longer term, allow such costs to be recovered (similar to an insurance premium).

Given the inherently large risk involved with such costs should the “insurance premium” approach be adopted then such premiums would in our view necessarily have to be significant. Therefore we believe that such a mechanism would be far less efficient than either of the two alternatives.

We would welcome further debate on possible alternative arrangements to the current IAE mechanism. We would also make a number of comments on the current mechanism.

We have noted the critical comments made by some industry participants about the Income Adjusting Event claims submitted for the incentive scheme for 2005/06. However we would highlight that the areas in which the IAE claims and the arrangement to do so were clearly flagged and put in place as part of the process by which the scheme parameters for 2005/06 were set. Additionally, market participants were also kept informed about the evolution of these cost areas through the year at operational forums. In our view such criticisms are therefore unfounded.

On the basis of our experience of the IAE process for Scottish constraints and CAP047, we would also like to suggest some potential improvements to the existing Income Adjusting Event process should it be retained in its current form:

Firstly the timeframe over which Income Adjusting Events must be assessed by the Authority is currently a maximum of three months. Where, as was the case for the IAEs raised for the 2005/06 scheme year, an IAE claim is complex and highly detailed, National Grid believes that the Authority should have the power to extend the period over which it assesses the IAE beyond the current maximum of three months.

Secondly, within the current process there is insufficient time or opportunity for Ofgem's final proposals with respect to any IAE to be consulted upon with industry participants prior to Ofgem issuing a decision. Again, we consider that where the decision is made to adjust the claim from that submitted, or where the claim is complex then Ofgem should consult on alternative proposals before making a final determination.

Finally there is currently no formal mechanism to appeal Ofgem's decision or present an alternative view to the Authority. We consider that in the event that Ofgem and the claimant do not agree on the figure, that the claimant should be able to represent an alternative view within Ofgem's final document for determination by the Authority.

Question 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?

Our original forecast, represented a reasonable view of 2007/08 costs as of the time of submission. Due to the earlier date of preparation of the forecast as compared with previous years there were some areas that were likely to be subject to change and we endeavoured to identify these clearly within that forecast (notably in the areas of power prices, frequency response and standing reserve). We have since submitted to Ofgem on 23rd October 2006 a revised forecast for electricity external incentivised balancing costs of £457.9million for 2007/08, reflecting the changing underlying drivers witnessed since the original forecast was constructed.

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

The majority of the Ancillary Services cost rises forecast by National Grid in 2007/08 on 2005/06 are in fact increases that have already occurred in 2006/07. These rises can be seen in either in the monthly monitoring reports National Grid provides to Ofgem for 2006/07 and in the monthly balancing services summary that we provide to the industry.

With respect to Mandatory Frequency Response cost projections for 2007/08, given the price uncertainty in this area Ofgem's and National Grid's views on the overall level of these costs appear to differ significantly. We have endeavoured to provide clear justification for our forecasts throughout this consultation process and we would welcome Ofgem providing a similar level of detail including explanation of drivers and assumptions to support any alternative forecast. If National Grid and Ofgem are unable to agree on a suitable level of costs one solution to the issue may be to index a portion of the incentive target to Mandatory Frequency Response prices, the net effect of which would be to incentivise National Grid to reduce volumes of Mandatory Frequency Response holding while price risk would be shared between National Grid and consumers.

Question 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?

We would agree with Ofgem that there is scope for further changes from the forecast level submitted by National Grid in July 2006 and published by Ofgem in October 2006 as part of this consultation. Within our forecast we have tried to identify those cost areas where greater uncertainty exists as to the likely level of costs for 2007/08. We have updated our forecast in a number of areas within our revised forecast submitted to Ofgem on 23rd October. For this revised forecast, changes to our July forecast have arisen as a result of a number of factors including the recent fall in power prices and our operating experience from summer 2006.

We also note that once the target is agreed, National Grid has an incentive to efficiently manage these costs. Our historic record in achieving such savings is strong. Pointing to 2005/06 as an example, despite the fact we made an overall loss in the scheme year we made savings in the following areas:

Constraint management England & Wales	£7.3m
Constraint management Scotland	£16.3m
Refinement of reserve requirements	£2.7m
New response contracts	£2.9m
TOTAL	**£29.2m**

The above savings are already factored into our forecasts for 2007/08.

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?

National Grid continually reviews the codes in order to identify changes that would facilitate the further development of efficient and economic system operation. We seek to facilitate such improvements both through amendments to the codes, and also through wider reviews of Balancing Services such as those we have instigated through the recent National Grid reserve review.

In two key cost areas of Frequency Response and Balancing Mechanism costs we will continue to review progress and identify further amendments or modifications following the "bedding in" of P194/P205 and CAP107b. We will also continue to review other areas and look to bring forward modifications/amendments in due course.

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?

National Grid continues to efficiently and economically manage the costs of constraints in Scotland, developing innovative means of minimising the costs where possible. The cost forecast for 2007/08 is lower than the equivalent forecast for 2006/07 as a result of balancing tools implemented by National Grid with service providers.

We continue to develop our tools and strategies and would welcome further discussion with Ofgem to consider these costs and any alternative approaches that could be taken forward in this area.

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?

See answer to question 4 above.