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30th October, 2006

National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1st April 2007
October 2006

Dear Sonia,

We welcome the opportunity to comment on the issues raised this consultation on System Operator (SO) Incentives from 1st April 2007. This response reflects the views of RWE npower and the UK based business of RWE Trading GmbH.

General Comments

In setting out proposals for incentive schemes for the gas and electricity SO's, there is a presumption that such schemes continue to be required. Although previous incentive schemes may have contributed towards reducing the cost of system operations, the extent to which there are further opportunities to reduce costs is not clear. This would imply that the incentive scheme sharing factors simply represent a cost for system users when positive and a risk for National Grid's shareholders if negative. The option for licensees of not consenting to licence modifications to implement incentive schemes or initiating Income Adjusting Events to ameliorate losses, arguably further undermines the perception of incentive schemes.

NGET is currently operating without a SO incentive scheme, with Ofgem monitoring performance against transmission licence and statutory obligations to ensure that economic and efficient actions are taken. This raises the important question as to the role of the SO incentive scheme given the prevailing licence objectives under which the scheme has been managed. It would be helpful to understand why licence compliance together with Ofgem monitoring, wider market scrutiny and greater information transparency and reporting would not deliver sufficiently strong incentives on both the gas and electricity SOs. A key test for the benefit of incentive schemes is what would have happened in their absence? It appears to us that there is now an opportunity to make this assessment and we would welcome analysis from Ofgem in this regard.

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There is a significant information asymmetry between the licensees and the rest of the market, including Ofgem. Arguably, this has allowed NGET and to a lesser extent NGG to set performance targets within the various incentive schemes at a level that permits maximisation of incentive revenues. There also remains a lack of transparency regarding the main drivers of SO costs and performance and this prevents network users in objectively assessing performance and the level of the targets themselves.

In this context we also have a concern that incentive schemes may constrain the development of market-based mechanisms that would pass responsibility for some aspects of system balancing from the SO to market participants. In this case, the market would deliver the most efficient solution and remove the need for incentives on the SO. We do accept that some elements, such as management of constraints, will need to remain under an administered scheme.

To the extent that Ofgem remain of the view that incentives are still required, we believe that the incentive schemes should have symmetrical caps and floors and narrow sharing factors. Ofgem should set challenging targets towards the lower end of the forecast that strike a reasonable balance between risk and reward for the SOs and reflect their inherently cautious approach to forecasting. The licensee will still have the opportunity to raise an Income Adjusting Event where the allowances are insufficient against the actual costs.

Electricity Incentives

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?*

Electricity prices are a key driver of estimated outturns for the SO incentive scheme. It is important that NGET forecasts these appropriately. However the recent price increases and then decreases illustrate the difficulty in predicting outturn costs. It would, therefore, seem appropriate that further consideration is given to the construction of appropriate means of reflecting changes in assumed electricity costs in the design of the SO incentive scheme.

Given the materiality of electricity prices to the outturn incentive scheme target, it would appear appropriate to consider such a scheme despite the additional complexity. This complexity could be addressed by ensuring that:

- There is an automatic means of changing the IBC target when there is a significant change in electricity prices when compared with the forecast electricity assumption when the target was set;
- The adjustment mechanism should only be applied to those components of the incentive scheme which are dependent on electricity price as a key driver, namely actions in the balancing mechanism, frequency response and the energy delivery components of reserve services (i.e. excluding option fees);
- There should be open and transparent reporting of any such change in the IBC target that arises as a consequence of change in the electricity price assumptions.

It should be noted that an appropriate means of reflecting change in electricity costs would reduce the likelihood of an Income Adjusting Event if electricity prices increase. It is also worth noting that it would also protect consumers from any windfall gains under the incentive scheme if there were significant falls in electricity prices when compared with the underlying assumptions and targets.

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?*

The adjustment mechanism should only be applied to those components of the incentive scheme which are dependent on electricity price as a key driver, namely actions in the balancing mechanism, frequency response and the energy delivery components of reserve services (i.e. excluding option fees).

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?*

Ofgem has presented initial thoughts on the creation of a "price risk band" for electricity indexation, but the proposal lack much. The suggestion is that if the electricity price moved outside the price risk band (say +/-20%) then the IBC target could be adjusted accordingly. This approach could ensure that the target more appropriately reflects the change in electricity prices, and could remove the need for an IAE. By definition, the price risk band would need to be set at the level that sets the threshold for an IAE for change in electricity price.

The details for setting the price risk band are unclear and would appear to be set in relation to NGET's assumptions of "summer" and "winter" electricity prices, versus the actual outturn. Different price risk bands could therefore be set for each season. There are other approaches towards the price risk band such as an absolute £/MWh difference from the assumed level in order to rebase the target. However all of these approaches seem to have different levels of complexity and depend on the assumptions made by NGET and Ofgem in setting the target.

A more simple approach could be to enable the target to be adjusted on an ex post basis for each season reflecting the outturn prices for electricity when compared to the assumed level. Such an ex post calculation would enable the relative performance of NGET to be more accurately reflected in the incentive scheme.

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?*

If there is to be an incentive scheme with explicit targets based on forecast assumptions it seems appropriate that there should be provisions for unforeseen changes in circumstances, both positive and negative for the scheme.

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?*

NGET have based their forecasts on assumed electricity prices for summer 2007 of £44/MWh and winter 2008 of £58/MWh. We note that Ofgem have observed that power prices are now significantly lower with a consequent impact on the target external costs.

In addition, Ofgem recently approved modification proposal P205. This may have an impact on the incentive scheme target.

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

NGET identify that they anticipate future increased utilisation of response and reserve contracts based on its experience of prices during 2005/06. This reflects movement in electricity prices during 2005/06 and after contract prices for standing reserve were agreed. It is possible that price movements will reverse this trend with response and reserve contracts more expensive than acceptances in the BM. Therefore this assumption may be invalid. Also, NGET are anticipating increased cost of reserve by £23m supported by “confidential information”. It is not clear on what basis NGET has assumed that reserve costs will increase.

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?*

Based on the fall in electricity prices it does appear that there are reasonable prospects that the target costs for 2007/08 will be less than in the initial forecast.

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?

It is unclear what sort of rule change Ofgem is anticipating given the approval of CAP107b.

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?*

There is insufficient information to determine whether there is scope to reduce costs.

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 response to question 4.

Question 11, 12 and 13*:*

It is for NGET to comment on the financial issues raised in these questions.

Gas Incentives

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?*

If there is to be an incentive scheme with explicit targets based on forecast assumptions it seems appropriate that there should be provisions for unforeseen change ins circumstances, both positive and negative for the scheme.

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

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

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 target?*

NGG's forecast appears to be overly cautious and in the case of Own Use Gas, the TPA counter-proposals, based on reduced north-south flows, does seem credible. Whether this results in the assumed 30% reduction against NGG's forecast is difficult for us to judge. We do not have sufficient information to assess whether using the actual assessed data for Unaccounted for Gas represents a more appropriate base case than the one presented by NGG. As a general observation, we would prefer challenging targets to be set, which suggests using the low or central cases.

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

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

Question 7*: 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 reserve incentive scheme target?*

Again, NGG's forecast appears overly cautious and TPA have highlighted anomalies, such as the provision for multiple events, that would support Ofgem's preliminary views on the most appropriate basis for the system balancing gas reserve incentive scheme target.

Question 8*: 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 response to question 1.

Question 9, 10 and 11:

It is for NGG to comment on the financial issues raised in these questions.

We hope these views are helpful and if you wish to discuss them further please contact me on 01793 893983.

Yours sincerely,

Charles Ruffell
Economic Regulation