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30 October 2006

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Dear Sonia,

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

Thank you for the opportunity to comment on initial forecasts of system operator (SO) costs that National Grid Electricity Transmission plc (NGET) and National Grid Gas plc (NGG) expect to incur in 2007/08 and your initial views on aspects of the proposed SO incentive schemes. This response is submitted on behalf of the UK energy businesses of ScottishPower, namely ScottishPower Energy Management Ltd, ScottishPower Generation Ltd and ScottishPower Energy Retail Ltd.

We believe that it is important that NGET and NGG have financial incentives to reduce the costs associated with their monopoly roles as system operators and that SO incentive schemes are in place for 2007/08.

Electricity System Operator Incentive Scheme

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?

We believe a form of price indexation would be desirable to ensure that NGET continues to be incentivised to reduce the external costs associated with its monopoly role as system operator even if wholesale electricity prices remain volatile. Provided the relationship between wholesale electricity prices and external SO costs is agreed before the start of the scheme then it would not be overly complex to adjust the target retrospectively based on actual outturn prices. For a one year scheme this could even be done mid-year, if felt necessary, as well as at the end of the year.

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?

We believe it should be possible to index total incentivised balancing costs (IBC) to wholesale electricity prices by for example agreeing forecast levels for each component for wholesale prices 40% above and 40% below the base price level and interpolating using these three points.

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 a price risk band?

We agree that it would be beneficial to have a 'price risk band' such that target costs would only be adjusted if wholesale prices moved outside this band and that a band width of +/-20% centred around the wholesale electricity price at the time the scheme is agreed would be sensible.

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 do not believe that any amendments should be made at this stage to the income adjusting event (IAE) licence provisions allowing NGET to submit notices to Ofgem of proposed IAEs where resulting costs are materially different to those allowed under the incentive scheme. If price indexation is included in the scheme then there should be a reduced need for NGET to raise IAEs. However there will still be other areas of potential uncertainty and given the hiatus of no scheme being in place for 06/07 we do not believe it would be appropriate to remove this safety net for 07/08.

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?

We agree that the main drivers of external SO costs for 07/08 will be forward wholesale electricity prices and balancing mechanism prices and that as sufficient plant margin is expected to be available in 07/08 that this does not need to be considered as a major driver. We are not, however, convinced by the information included in the consultation paper that external SO costs for 07/08 will increase by 13% from the 05/06 level to £483 million.

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

While we can understand the reasons for the increases in Ancillary Services costs in 06/07 from the 05/06 level we do not believe that NGET has justified its projected increases from 06/07 to 07/08. The recent introduction of a competitive mechanism for mandatory frequency response has allowed the true costs of providing this service to be realised. Provided wholesale electricity prices do not continue to rise significantly then we see no justification for continuing the recent rising trend in frequency response costs into 07/08. While we would not expect standing reserve costs to reduce from their 06/07 level we believe that they are only likely to increase in 07/08 to the extent forecast by NGET if electricity wholesale prices increase significantly, in which case if indexing were incorporated into the scheme then the target could be amended.

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 agree that particularly for frequency response, standing reserve and warming costs there are good prospects for the 07/08 outturn to be significantly less then NGET’s initial forecasts.

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 our experience that there is now sufficient liquidity in the GB Ancillary Services market for the true level of costs to have become established and we see no need for rule amendments at this stage. If energy prices fall there will be scope for reducing Ancillary Services costs but in the short term, and particularly for 07/08, the prospects for reduced prices are limited.

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?

We would have expected internal Scotland constraint costs to have fallen following NGET having entered into a contract to manage one of the key constraints and it may be that a reduction in these costs will be seen in the 07/08 outturn.

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?

We believe it is not the appropriate time to change the current IAE licence provisions for internal Scotland constraint costs as well as for the other aspects of the incentive scheme.

Question 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?

No

Question 12: Do you have any comment on our preliminary view that the efficient level of opex over the duration of the incentive scheme is £227.6 million?

Ofgem’s amendment of NGET’s forecast appears reasonable.

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 £41 million?

Ofgem’s amendment of NGET’s forecast appears reasonable.

Gas System Operator Incentive Scheme

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?

We would prefer that the arrangements in the transporter licence should continue to be consistent with those in the electricity transmission licences, with the circumstances surrounding the issuing of the notices detailed and prescriptive and subject to consultation on each occasion.

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

The high case on unbilled energy volumes appears heavily skewed in NGG's analysis.

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

We believe that it is correct to assume a lower central case for own use gas (OUG) based on the changing pattern of flows and less compression necessary to move the supply to the demand. Therefore we support the reduction overall from NGG's forecasts.

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?

We are more supportive of the central case. Apart from unbilled energy volumes (a smaller element than OUG and unaccounted for gas (UAG)), the rationale used to forecast is less arbitrary.

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

No, but we appreciate that recent experience has allowed us to assess the impact of supply loss and demand-side response, and that a lot of work has gone into quantifying demand and supply volumes required under various scenarios.

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

We agree that the double counting should be removed from the low, central and high case forecasts.

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?

We prefer the central case – we are confident that supply sources will be in place, but unsure whether we will see the same unprecedented level of demand-side response as last year which was driven by exceptional market prices.

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?

We believe in consistency of approach in this issue and appropriate controls being in place (see above).

Question 9: Do you have any comments on NGG's overall forecast of internal operating and capital SO costs it expects to incur between 2007/08 and 2011/12?

We are encouraged by the close correspondence between NGG's view and Ofgem's view of what these costs should be.

Question 10: Do you have any comments on our preliminary view that the efficient level of opex over the duration of the incentive scheme is £122.1 million?

These costs seem reasonable, and correspond with NGG's own forecasts.

Question 11: Do you have any comments on our preliminary view that the efficient level of capex over the duration of the incentive scheme is £41.5 million?

We believe that the capex costs seem reasonable taking into account the reduction brought about by efficiencies and the reduction of costs in hardware and software.

I hope you find these comments useful. Should you wish to discuss any of these points further then please do not hesitate to contact me.

Yours sincerely,

Alex MacKinnon
Regulation and Trading Arrangements Manager