Scottish and Southern Energy
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Corey Dykstra
Senior Manager, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Telephone: 01738 456400
Facsimile: 01738 456415

Date : 30 October 2006

Dear Corey,

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

We welcome the opportunity to comment on the design of the system operator incentives from 1 April 2007.

We agree that both NGET's and NGG's external incentives should be set for one year and look forward to taking part in the review of the arrangements in 2007. We believe that a bundled scheme remains the most appropriate to allow efficient interaction between actions for energy balancing, constraint and system management and therefore that a single IBC target should continue to be set for the external electricity SO incentive. In a similar regard, in relation to NGG's incentive scheme and the "quality of information" incentives, we continue to believe that such micro-management through a separate incentive scheme for demand forecasting and website performance is unnecessary.

Overall though we welcome the continued scope and form of the incentives and these early efforts to establish the appropriate incentive mechanisms from April 2007. We were disappointed that NGET felt unable to accept Ofgem's 2005/06 incentive proposals, and hope that the early start to this process and these proposals result in an acceptable scheme from April 2007.

I hope the attached is useful. Should you require any additional information or explanation, please do not hesitate to get in contact.

Yours sincerely,

Rob McDonald
Director of Regulation.

Electricity SO Incentive

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?*
Given price indexation is already in use in NGG's gas cost incentive, it is worth consideration for electricity. Its inclusion in this one-year incentive may provide some guidance to its use in the longer-term. However, whilst we recognise Ofgem's desire to leave NGET with some residual risk against price, e.g. through a price risk band, we are not convinced that the additional complexity of a nested incentive would be merited.

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?*
If there is to be indexation, then it seems appropriate that the elements of the IBC that are sensitive to price, i.e. those indicated in Table 3.3 of the consultation document, are covered.

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?*
As noted above, we are not convinced that such a price risk band merits the additional complexity.

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 continue to believe that IAE arrangements are appropriate. However, there may be scope to review the level of trigger for this one-year incentive, given the post-BETTA experience of operating the system, and the fact that it is a one-year incentive.

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 would anticipate that the drivers will remain as they have been. However without access to all the information available to NGET and Ofgem it is difficult to comment on how these will affect the absolute costs. However, we would make the following general comments: the approval of Modification P205 needs to be taken into account; the approval of CAP 107B should allow REP to more closely align with market prices; and the introduction of replacement warming contracts will affect costs going forward and need to be taken into account.

Question 6*: Do you have any comments on NGET's forecast increases in Ancillary Services costs in 2007/08?*
As noted above, the approval of CAP 107B should allow REP to more closely align to market prices and the replacement warming contracts will affect costs going forward.

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?*
Given NGET have for the first time in 2005/06 lost money on their incentive scheme, there is every likelihood that there is room for NGET's costs to come down. The areas where savings

are likely to be made have been identified by Ofgem. However, without detailed information it is difficult to comment on the scale of what these savings might be.

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?*
No.

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 believe that internal Scotland costs are likely to be minimised through NGET entering into longer-term contractual arrangements rather than relying on short-term actions in the balancing mechanism. Network reinforcement should of course reduce internal Scotland constraint costs in the longer-term.

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?*
Please see our response to question 4 above.

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?*
Again without sight of the detail of NGET's proposed costs, it is difficult to comment. However, it is noticeable that there continue to be levels of capital expenditure more in line with the changes made for BETTA. It is not clear why that should be the case.

Question 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?*
Given the uncertainty over the level of both onshore and offshore wind generation within this price control period it is not clear how NGET would be able to justify increased operating costs with any certainty.

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 £47 million?*
As noted above, we would question why the capex is of a similar level of the change to BETTA.

Gas SO Incentive

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 continue to believe that IAE arrangements are appropriate. However, there may be scope to review the level of trigger as this is a one-year incentive.

Question 2: *Do you have any comments on NGG's shrinkage volume forecast for 2007/08?*
Given NGG have routinely received the capped incentive payment through this scheme it is reasonable to conclude that a more challenging target should be set. We believe, like Ofgem, that North-South flows will be lower, and therefore that less compression will be required. This would indicate that the volume forecast for Own Use Gas (OUG) should be lower than NGG's Central Case. With regard to Unaccounted for Gas (UAG) and Unbilled Energy (CV Shrinkage), in the absence of compelling reasons to increase the forecast volumes respectively from 2006/07 and long-term average levels, the levels suggested by Ofgem seem more appropriate. We also concur that Electric Compression will be lower going forward. Overall this would lead us to believe that shrinkage volumes should be lower than NGG's Central Case.

Question 3: *Do you have any comments on our preliminary view on the appropriate shrinkage volume for 2007/08?*
As noted above in response to question two, we believe that NGG's forecasts are likely to be high and instead believe that the shrinkage volumes are more likely to be aligned with Ofgem's view.

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?*
As noted in response to question two above, we believe that the forecast shrinkage volume should be set at a level less than NGG's Central Case.

Question 5: *Do you have any comment on NGG's gas reserve volume forecast for 2007/08?*
We would anticipate forecasts to be around NGG's Central Case, on the basis of their winter 2006/07 supply forecast and little increase in demand response. This is on the basis that increased I&C demand response may not materialise and a prudent approach to forecasting. However, we agree with the comments made regarding other factors that could reduce NGG's OM requirements and double counting and on that basis would anticipate a scheme target below NGG's Central Case.

Question 6: *Do you have any comments on our preliminary view on the appropriate gas reserve volume for 2007/08?*
As above, we would anticipate forecasts to be around NGG's Central Case, on the basis of their winter 2006/07 supply forecast and little increase in demand response. This is on the basis that I&C demand response may not materialise and a prudent approach to forecasting. However, we agree with the comments made regarding other factors that could reduce NGG's OM requirements and double counting and on that basis would anticipate a scheme target below NGG's Central Case.

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?*
Please see our response to question 6 above.

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?*
Please see our response to question 1 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?*
Given that NGG's forecast and Ofgem's views with regard to opex are similar, there should be no dispute over the appropriate level of these costs. With regard to Ofgem's consultant's views on capex, there would appear to be a significant divergence of opinion on the cost of what would appear proprietary systems. We would welcome further detail of this for the December consultation.

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?*
Again, given the similarity between NGG's forecast and Ofgem's views, there should be no dispute over the appropriate level.

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?*
Please see our response to question 9 above.