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Dear Sonia,

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

Thank you for the opportunity to comment on your initial proposals for system operator (SO) incentive schemes for National Grid Electricity Transmission plc (NGET) and National Grid Gas plc (NGG) to apply from 1 April 2007. 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: What are your views on NGET's revised forecast of £458 million? In particular, do you consider that there are any areas where NGET is being risk disposed or risk averse in its assessment of costs? Alternatively do you consider that there are any drivers of cost that NGET has not identified?

We agree that NGET has identified the main drivers of external SO costs for 2007/08. However the sharp variation in NGET's forecast of the 2006/07 outturn from £463m to £481m over a period of 6 weeks highlights the potential volatility in SO costs and the difficulty in forecasting a year ahead. We do not believe that a case has been made by NGET for increases in any of the major components to outturn in 2007/08 above the 2006/07 outturn level and with reductions anticipated by NGET in some components then the overall 2007/08 level should be below the 2006/07 outturn.

Question 2: In this chapter we identify areas where we believe that NGET has over forecast its costs. Do you agree with our assessments? Please provide as much analytical detail as possible in your response.

We agree that the anticipated reduction in wholesale prices in 2007/08 from the 2006/07 level should enable external incentivised balancing costs to be reduced below the 2006/07 outturn level. NGET's revised forecast is based on forward wholesale baseload prices of £38/MWh for summer 2007 and £48/MWh for winter 2007/08. In early January 2007 these prices have fallen to £27/MWh for summer 2007 and £38/MWh for winter 2007/08. NGET has highlighted that all the major changes in balancing costs have already occurred from last year to this year and thus the established strong correlation between balancing costs and power prices should continue into 2007/08.

Question 3: Within NGET's forecast a continued area of increasing cost is mandatory frequency response costs. What do you consider to be the drivers of costs for frequency response? What impact do you consider that CAP107 will have on these costs? Do you believe there is scope for cost reductions as competition is established in the provision of these services?

Ofgem's analysis has shown that there is a weak correlation between mandatory frequency response costs and power prices and thus we would not expect mandatory frequency response costs to fall from their 2006/07 level in 2007/08 with the anticipated reduction in wholesale prices. The competitive mechanism for mandatory frequency response was only introduced in 2006 and it is too early to assess whether prices have stabilised. Ofgem has identified some evidence that frequency response costs in the early months of 2006 may have been influenced by the opportunity costs faced by generators foregoing selling power in the Balancing Mechanism by offering to provide high frequency response. In view of the limited experience to date in the operation of the competitive mechanism for mandatory frequency response and the weak correlation with power prices we suggest that the forecast level of mandatory frequency response costs for 2007/08 should be set at the latest estimate of the 2006/07 outturn.

Question 4: NGET is forecasting that constraint costs will continue to be of the order of £81 million. Do you consider that there is any scope for reductions in these costs? In particular, do you consider that with falling wholesale gas prices there should be a reduction in within Scotland constraint costs?

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 2007/08.

Question 5: In November, a significant change was introduced to the electricity cash out arrangements (Modification P205). What is your assessment of the impact of this change on NGET's forecast level of costs? Please provide as much analytical detail as possible in your response.

We do not consider that the change to the electricity cash out arrangements, basing imbalance prices on the most expensive 500 MWh in the net imbalance volume rather than the whole net imbalance volume, introduced through Modification P205 will have a significant impact on NGET's forecast level of costs.

Question 6: Do you think it is appropriate that we take into account the then current wholesale market conditions when setting the IBC target in the final proposals?

With the establishment of the strong link between the external incentivised costs faced by NGET and power prices we believe it is essential that the most recent view of wholesale prices in 2007/08 is taken into account when setting the target level of costs.

Question 7: What do you think is an appropriate level of IBC for 2007/08?

We believe that an appropriate level for 2007/08 would be to set those elements, such as frequency response and standing reserve costs, which have been identified as not being correlated with power prices to the latest estimate of the 2006/07 outturn level and to reduce the level for those elements, such as balancing mechanism and reactive power costs, which have been identified as being strongly correlated with power prices in line with the anticipated reduction in wholesale prices from 2006/07 to 2007/08.

Question 8: Do you have any comments on our indexation analysis? Specifically, do you support the way in which indexation has been applied in the option we have proposed? Do you have any comments on our approaches to determining the adjustment factor? Are there any alternative approaches that we have not considered? Do you have any comments on the deadband size?

We support the indexation option identified and the deadband size of 10%.

Question 9: What are your views on the four proposed options?

We support Option 2 with indexation and a price risk band and with the target level set on the basis of our response to Question 7.

Question 10: Do you agree with our views on IAEs going forward?

We agree that the current Income Adjusting Event provisions should be retained if an option not incorporating indexation is adopted and also that if the indexation option is chosen then the Income Adjusting Event provisions should only apply to the cost elements which are not being indexed.

Question 11: Do you have any comments on the draft Terms of Reference for a review of the external SO incentive scheme contained in Appendix 12?

We support the aim of achieving stability through developing a multi-year scheme to run concurrently with the transmission price control periods.

Question 12: Do you agree with our Initial Proposals for levels of internal opex, capex, tax, and pensions allowances?

The amendments to the initial proposals appear reasonable.

Question 13: What are your views on implementing fixed sharing factors for internal capital expenditures? If so do you have a view on the level of these sharing factors? What are your views on the alignment of the operating expenditure sharing factors?

We believe there is merit in aligning the sharing factors for internal capital expenditure with NGET's recently agreed transmission price control sharing factors.

Question 14: Do you think incremental internal costs associated with modifications to commercial frameworks (e.g. BSC) should be remunerated through the existing IAE provision or via a more automatic cost recovery process built around enhanced cost reporting and accountability to industry through the existing commercial frameworks?

We believe that the current Income Adjusting Event provisions should be retained for these costs to ensure NGET continues to have an efficiency incentive. Automatic cost recovery could lead to lax cost control.

Gas System Operator Incentive Scheme

Question 1: Do you agree with the proposed introduction of a new incentive to limit emissions of methane from the NTS from April 2007, and link this incentive to the prevailing price of carbon?

We would support this incentive if it can be seen as a reasonable addition which reflects the industry's environmental obligations, although we agree it could be difficult to measure accurately. We would be supportive if it were linked to the prevailing price of carbon.

Question 2: Do you agree that the scope for all other components should remain the same as previous years for the external gas SO incentives?

Yes. We believe these have served their purpose to date.

Question 3: Do you agree with our proposal to vary the target for gas shrinkage on the basis of actual (2007/08) flows through St Fergus?

Yes. We believe that this represents a more appropriate allocation of risk.

Question 4: Do you consider the proposed volumes for the shrinkage targets to be appropriate?

Yes.

Question 5: Do you consider it is appropriate to retain the existing gas reference price methodology for the gas shrinkage incentive?

Yes, the GCRP methodology should be maintained and reviewed for the following incentive period.

Question 6: Do you agree with our proposed target for gas reserve, and our intention to undertake a more fundamental review of this incentive in 2007?

Yes.

Question 7: Do you agree with our proposal to review the reference prices that apply to the gas reserve incentive?

Yes, we agree.

Question 8: Do you agree that, where market prices exceed reference prices for gas reserve, that the SO should pay these higher prices for OM gas?

Yes, the prices should be cost-reflective, and relate to the market.

Question 9: Do you agree with our initial proposals to retain the existing form of the residual gas balancing incentives?

Yes, the parameters should remain unchanged, subject to the planned fundamental review for the following year.

Question 10: Do you have a view on the most appropriate form for the quality of information incentives in 2007/08? Do you consider these incentives should be revised in light of NGG's performance over winter 2007/08?

No. We believe that we will have an opportunity to assess the existing incentive after the winter period and take into account NGG's performance.

Question 11: Do you agree with our views on IAEs going forward?

Yes, these should be retained and consistent with arrangements for electricity.

Question 12: Do you agree with our Initial Proposals for internal costs?

Yes. We agree with the changes from the preliminary views.

Question 13: Do you agree that we should implement fixed sharing factors for internal capital expenditure? If so what should the level of the sharing factors be? Should the operating expenditure sharing factors be aligned with the capex factors, or aligned to the external incentive?

We agree with the changes in line with the proposed changes in electricity.

Question 14: Do you think incremental internal costs associated with modifications to commercial frameworks (e.g. UNC) should be accommodated through the existing IAE provisions or via a more automatic cost recovery process built around enhanced cost reporting and accountability to the industry through the existing commercial frameworks?

We believe that the current Income Adjusting Event provisions should be retained, subject to any information that comes to light with full consideration of the proposals being put forward by National Grid.

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