RWE npower

Sonia Brown
Director, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Your ref 208/06
Our ref LOG301
Name Charles Ruffell
Phone 01793 89 39 83
Fax 01793 89 29 81
E-Mail charles.ruffell@rwenpower.com

16th January, 2007

National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1st April 2007 – Initial Proposals Consultation December 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 principle, we agree that well-designed, transparent incentive regimes could ensure that National Grid Electricity Transmission (NGET) and National Grid National Transmission System (NG NTS) are incentivised to operate their respective transmission system in an efficient and economic manner. Benefits for system users and ultimately consumers would be through financial incentives on the System Operators (SO) to minimise system management and balancing costs. These incentives would reinforce existing licence obligations regarding economic and efficient system operation.

That said, in our response to Ofgem's earlier consultation[1], we suggested that as NGET is currently operating without a formal SO incentive scheme, some detailed analysis of their performance in 2006/07 would help network users to assess the requirement, or not, for future schemes and how they might be structured. We believe that it is important that network users have an understanding of how NGET and, to a lesser extent NGG, evaluate the various tools and contracts available for balancing and securing their systems and whether a formal incentive scheme affects the decision making process. The availability of this information will help to assess performance objectively and we would welcome analysis from Ofgem in this regard. Publication of data that Ofgem has received as part of its monitoring of NGET during 2006/07 would also help to address the significant information asymmetry concerning incentives that exists between the licensees and the rest of the market.

[1] National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1st April 2007 October 2006 Ref: 179/06

RWE npower
Trigonos
Windmill Hill
Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

T +44(0)1793/89 39 83
F +44(0)1793/89 29 81
I www.rwenpower.com

Registered office:
RWE Npower plc

Market Observations

Both Ofgem and NGET have raised concerns over recent increases in costs, particularly Frequency Response and constraint costs, which have been against a background of falling wholesale power prices. These are key drivers both in the level of outturn costs for 2006/07 and the determination of the IBC forecast for 2007/08

It is worth noting that there are complex interactions between and within the different markets and participants will have differing views of future market conditions. Market rule changes must also be factored in and together these are assessed and reflected into bids and offers. In our view, the market is in a transitional period so it is difficult to make definitive judgements. For instance, CAP047 has only been in place for just over 12 months and the provisions introduced under CAP107 were introduced at the end of December 2006. Further, Ofgem's assessment is retrospective, whereas the outlook for market conditions suggests that the cost of creating the headroom to allow response to be provided may reduce and this may allow less reliance on comparatively expensive commercial response. From the level of activity we see, the Frequency Response market is competitive and submitted prices appear to have been reducing in the last few months.

Specific Comments

As Ofgem is proposing a fundamental review of the existing SO incentive schemes for both gas and electricity SOs during 2007, changes to the existing schemes to apply from April 2007 have been relatively modest. Ofgem has set challenging targets towards the lower end of the forecast range that reflect the SO's inherently cautious approach to forecasting, but where applicable, we would prefer to see symmetrical caps and floors and narrow sharing factors.

Electricity Proposals

- Although the proposals reflect Ofgem's view that there are opportunities for further cost savings by NGET, it is clear that there is still uncertainty around those cost drivers that have put upward pressure on costs since 2004/05.

- Although Ofgem has set out four incentive scheme options, we believe that it may be worth exploring some form of price band approach to reflect the uncertainty associated with what we think will be a transitional period over the next 12 months. This would still expose NGET to some price risk but avoid windfall gains or losses. We support the **categorisation approach**, in which components are selected based on which elements are most likely to be "energy" trades rather than "system" trades (such as trades relating to balancing mechanism costs, forward trades, all reserve and reactive power).

- It is evident that the Net Imbalance Adjustment is now a significant factor in the calculation of Incentivised Balancing Costs. It would interesting to know what analysis has been undertaken to establish that it remains a reasonable estimate of the costs incurred by NGET, due to the level of Net Imbalance Volume, that are beyond NGET's control.

Gas Proposals

- We have previously argued that NG NTS did not need a quality of information Incentive and we welcome the much tighter incentive in the 2007/08 scheme.

- We agree with Ofgem's proposal to set the shrinkage volume target on the basis of actual (outturn) level of flows through the St Fergus entry terminal.

- On System Reserve, there is merit in introducing a new licence condition to introduce competition in the next two years. Whether alternative providers will emerge is unclear but the current position where National Grid plc is both the monopoly seller and buyer of the majority of OM gas needs to be addressed.

Both NGET and NG NTS have raised the issue of costs that may be incurred above the baseline allowances related to modifications to commercial frameworks. We agree that IAEs are not the most appropriate way of dealing with this issue and would support an approach based around enhanced reporting and increased transparency of new development costs and funding of costs above baseline through an adjustment in non-specific incentive charges.

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