energywatch
your gas and electricity watchdog

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Dear Sonia

National Grid Electricity Transmission (NGET) and National Grid Gas (NGG) System Operator (SO) incentives from 1 April 2007: Initial proposals consultation

energywatch welcomes the opportunity to respond to the issues raised by this consultation. This response is non-confidential and we are happy for it to be published on the Ofgem website.

As Ofgem is aware from our previous responses on SO incentives, we believe that there should be appropriate incentives on NGET and NGG, as the respective GBSOs for electricity and gas, to keep the costs of system operation low, as these costs are ultimately passed through to consumers. Consumers expect these costs to be efficiently and economically incurred in order to provide safe, secure and reliable operation of both the electricity and gas transmission networks. Consumers also expect that the benefits of savings in costs should be shared with them. NGET and NGG manage the risks of system operation for consumers but there should be an appropriate balance in terms of the rewards which they obtain as a result.

We look forward to taking part in Ofgem's proposed review of all shallow SO external incentive arrangements during 2007. We believe that the terms of reference of the review should encompass an inquiry into whether the targets and incentives in previous schemes have been set at appropriate levels, taking into account the cost savings and rewards which NGET and NGG have been able to obtain. We would enquire specifically about whether those cost savings have been sufficiently shared with consumers and whether this has been done in a transparent manner. We do not believe that this has been the case. Any harmonisation of electricity and gas incentives should yield benefits to consumers and these must be transparent in any future schemes.

Form, etc. of the NGET SO external costs scheme

We continue to support a one-year scheme using a single target cost for NGET's SO external costs, with appropriate caps, collars and sharing factors around the set level. However, the target level itself must be reflective of efficient costs of operation and the caps, collars and sharing factors must balance risk and reward effectively. We have had little useful information about NGET's balancing costs so far this year in the absence of an incentive scheme. There has been no benchmark against which to assess whether costs are currently being incurred efficiently and this is a symptom of an opaque rather than transparent process of reporting. Without more information about how efficiently the system is being operated, we are unable to say which of the options outlined for the target level is appropriate.

We note that NGET has reduced its forecast of external costs for 2006/07 in recognition of the impact of lower wholesale prices. We believe, however, as is suggested by Ofgem's lower proposed targets, that the forecast may still be too high. Some of the forecast is based on experience from 2005/06 which could be regarded as exceptional and atypical in terms of volatility of prices for comparative purposes.

While we accept that wholesale prices can be volatile and could be so in the future, the impact may be caused by fluctuations arising from temporary lack of availability of gas which then influence wholesale gas and electricity prices but is short-lived. We also consider that forecast data on weather and other influencing factors on wholesale prices may already be factored into forward prices this winter which reduces the possibility of significant volatility. However, we agree that some form of linkage to changes in wholesale prices could be adopted in the incentive scheme to ensure that the effect is appropriately recognised. Without fully assessing the details of the indexation approach proposed by Ofgem, we see merit in a link in the incentive scheme for those aspects of SO costs which may vary as wholesale prices change. However, Ofgem should consider a simple and transparent approach which allows proper comparative assessment when future incentive schemes are set.

We are concerned about the rise in balancing costs such as frequency response. In a more competitive market in frequency response, introduced after the removal of a holding price through CUSC amendment CAP047, any initial rise in costs ought over time to come down. NGET seems to suggest higher prices over a long period. If the level of costs is expected to remain high, we would urge Ofgem to undertake a review of why this is the case. We agree with Ofgem that downward wholesale prices and further reform through approved CUSC amendment CAP107b should stabilise and reduce these costs. If some companies are seeking to profit from the removal of holding prices, then strong regulatory action should be considered. We note Ofgem's view that constraints management by NGET could be more effectively undertaken to reduce those costs further. NGET is well aware, as the GBSO and as a TO, of the impact of system constraints and ought to develop appropriate strategies to manage the costs of constraints better.

We believe that Income Adjusting Event (IAE) claims require full information from NGET, presented in a transparent manner, allowing proper assessment of their validity. We agree that there should be no change to the current approach to IAEs, with NGET presenting claims regardless of whether the cost source of a potential claim has been flagged beforehand. All such claims will be assessed on their merits.

NGET's SO internal costs scheme

We have no specific comment on NGET's internal costs target. We expect NGET to make efforts to ensure that those costs are incurred efficiently. We believe that NGET's costs relating to implementing approved modifications ought to be clarified before recovery. However NGET seeks to recover such costs, the process must be transparent and comprehensible as those costs will be passed through to consumers. We would need to understand the detail of any enhanced cost reporting mechanism before agreeing to dispense with recovery through the current IAE process.

Form, etc. of the NGG SO external costs scheme

We agree that the current incentives on NGG should be retained as part of an external costs scheme, with the possible addition of an incentive to reduce methane emissions. The additional incentive should assist in achieving sustainability objectives as part of a cost efficiency incentivisation process. We would look to NGG to manage as effectively as possible the costs of shrinkage, noting that there is some uncertainty around how those costs are incurred at present.

Ofgem is well aware that we feel that specific incentives are not required for quality of information as NGG should be managing these costs – of website performance and improved demand forecasting - effectively as part of its SO role without additional financial reward. We would like to see sufficiently tight incentives on NGG if Ofgem considers retaining this incentive. The retention of a downside risk in any quality of information incentive scheme is necessary so that NGG seeks to improve performance over time. The use of winter 2006/07 data should assist in determining whether the application of an incentive scheme to NGG's data provision is needed, and which parameters are set for caps, collars and sharing factors.

As with NGET's external scheme, we believe that the IAE process should continue to be used for NGG's claims of additional exceptional costs but also be transparent and clearly understandable to the industry.

NGG's SO internal costs scheme

We have no specific comments on the proposals other than to reiterate that NGG should also aim to incur expenditure efficiently.

Going forward, we will continue to keep these issues under review as and when they are raised, always considering the possible impact on consumers. We look forward to Ofgem's further updated proposals on SO incentives in due course.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

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Head of Regulatory Affairs