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National Grid Electricity Transmission and National Grid System Operator Incentives from 1 April 2007 – Ofgem's Initial Proposals

Thank you for the opportunity to comment on the initial proposals issued on 5 December. Our response is on the electricity elements of the proposals. This covering letter highlights three general points.

We have maintained through the two previous consultations that the starting point for the assessment – the 2005-06 baseline – is evidently wrong as that year saw a combination of exceptional events, and not just the Rough outage that has been removed. It would be more reasonable to take the baseline assumed in setting the target for that year as the starting point for establishing the external scheme target.

The forecasts seem to make no allowance for any efficiency savings. Future schemes as a matter of course should make some allowance for a reasonable level of efficiency savings.

We would reiterate the argument made in our previous responses that there is no obvious reason why subsidiary caps cannot be set for the different discrete components of National Grid's forecast (BM, BSCC, ancillary services and trades) rather than a single cap. This approach need not pre-empt reclassification of costs within year provided there was a process for notification and approval with Ofgem. We would also like to see a formalised reporting mechanism whereby National Grid reports across the main cost components to the Operations Forum with specific regard to achieved and expected performance against IBC. A quarterly compliance report would fit the bill.

Please let me know if you have any questions on this response or would like any further comment.

Kirsten Elliott-Smith

National Grid incentives from 1 April 2007
Response from Immingham CHP to Initial proposals consultation

This appendix sets out Immingham CHP's comments on the Ofgem initial proposals consultation issued on 1 October. It addresses the questions raised by Ofgem on the electricity incentive schemes only.

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 continue to consider the forecasts produced by National Grid to be high, and reflective of untypical recent conditions.

The starting point for the assessment – the 2005-06 baseline – is evidently wrong as that year saw a combination of exceptional events, and not just the Rough outage that has been removed. It would be more reasonable to take the baseline assumed in setting the target for that year as the starting point for setting the target for the external scheme.

At most these factors suggest use of the 2005-06 baseline of £428mn as the highest credible estimate, which corresponds loosely to NG's low scenario from its revised forecasts of £423mn. Allowing for the various adjustments implied by Ofgem's analysis in chapter 2, this suggests a target in the region of £400mn is appropriate.

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 with Ofgem's assessment. In particular we concur that:

- *wholesale prices look set to decrease further (and have reduced since National Grid's revised forecast was submitted);*
- *transmission constraint costs have been over-estimated (a reduction of c£10mn seems feasible over the level of £80mn achieved in 2005-06 in the light of operational experience) and;*
- *CAP107 should bring to bear some downward pressure on the costs of frequency reserve.*

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?

CAP 107 should, as we have noted above, impose early downward pressure on costs. Over time competitive pressures should reinforce this.

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?

Yes. The position in 2005-06 was brought about by a revised pattern of generation, which has already dissipated. Operational experience should also enable this estimate to be scaled back. Ofgem's analysis on the relevant income adjusting event has already demonstrated the scope for reductions.

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.

P205 should provide stronger incentives at the margin to balance and should mitigate the extent to which the SO needs to take action when the system is under stress, thereby reducing the costs of balancing.

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?

Yes. There is every expectation that forward prices could be lower than those assumed in the revised forecast. Ofgem should also review any final estimate closer to April.

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

As we have noted above a figure of around £400mn seems in order, reflecting National Grid's low scenario and the additional possible saving identified by Ofgem.

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 sense a categorisation approach is closer in line with wider thinking on SO incentives, though the statistical approach is a considerable improvement on prior year arrangements. A correction factor/indexation is essential to deal with energy price movement, and a 10% deadband seems justified.

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

A menu of risk and reward is an interesting approach and seems to have merit, and we believe the various sharing factors, caps and floors represent a suitable package – save that we would wish to see the target lowered in all cases consistent with our remarks in previous answers.

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

Yes, especially that costs subject to the energy price index should be removed. We repeat the comments made in previous consultation that there has been a lack of transparency in these arrangements in the past and that National Grid enjoys a considerable information asymmetry.

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 need for a more thorough review. The draft terms of reference seem to capture the main points.

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

Yes with regard to capex. There is insufficient comment on the reasons for the increase in the opex estimate to make a judgement. The proposed increase to the tax and pension allowances seems justified.

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 do not have a view on this mechanism, other than to note the arrangements seem to have become rather complex.

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 support the latter approach, as this should increase transparency and accountability.