Sonia Brown
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Ofgem
9 Millbank
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SW1P 3GE

16 January 2007

Dear Sonia

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

EDF Energy welcomes the opportunity to respond to the NGET and NGG System Operator Incentives from the 1 April 2007. Please note that our response is not confidential.

We regard indexation to forward prices as an important element in an SO incentive scheme for 2007/8, to avoid the risk of windfall profits to NGET in a falling market. NGET's profits should not be capped and the sharing factor should be high, as otherwise potential benefits to the grid-user community could be lost.

There needs to be more transparency than at present over NGET's utilisation of frequency response, to enable the frequency response market to operate efficiently; there may be inefficiencies in NGET's despatch of frequency response at present.

Our responses to the questions raised in the consultation are attached to this letter

If you have any queries on this response please contact Paul Mott on 020 7752 2517, John Costa on 020 7752 2522 or myself.

Yours sincerely

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Attachment

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

EDF Energy's responses to the questions raised in the consultation

Chapter Two (electricity)

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?

In the discussions/negotiations with the supplier negotiating team and, latterly, with Ofgem, leading up to each year's SO incentives scheme, NGET has invariably over-forecast the outturn costs for the period from that point up to the end of the current scheme year. This enables NGET to in turn over-forecast the next year's costs. Therefore both the £463m forecast for this year and the £458m forecast for next year that have been presented by NGET to Ofgem are likely to be much too high, in line with experience since 1995. We would suggest £400m as a more likely final 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 note that NGET has over-forecast the expected out-turn costs in the remaining three months of each financial year (January to March) every year since the first "UMIS" and "TSS" SO incentives schemes from 1995, in its negotiations initially with the Supplier Negotiation Team and more recently with Offer/Ofgem. This will certainly have been the case again this year, in NGET's forecast of the 2006/7 IBC outturn – it is a normal negotiating tactic. We agree with the forecast reduction in wholesale prices and the impact this should have on the costs for system operation. A more efficient market could be facilitated if more information were provided to frequency response providers about NGET's frequency response utilisation decisions; this would in turn help cut frequency response costs. There would appear to be considerable scope for NGET in turn to improve its despatch efficiency in the utilisation of frequency response services, as the market in such services is primarily national (albeit temporally segmented) and some of NGET's decisions in despatching frequency response services do not appear to have used the most economic service options available to it.

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?

Mandatory frequency response competes with Firm Response and FCDM (frequency control by demand management) Response. At present it is NGET's only source of High Response as there are no firm providers contracting with NGET.

The main problem with the frequency response market is the lack of transparency: CAP047 introduced a market where providers can submit prices to NGET on a monthly basis, for the month ahead. When doing this, providers have no knowledge of the holding volumes of the previous month. This results in a two month delay in market data. It is also impossible for providers to assess NGET's decision on which BMUs to hold, as NGET's algorithm takes into account Bid-Offer prices, Holding rates and Firm Frequency Contracts in assessing whether or not to hold a BMU for Primary, Secondary and High or Primary and High Response. Providers have different levels of capability and there is not any data on how NGET values this "capability" above price, i.e. some BMUs can supply a greater volume of Response, yet may have a higher price than others.

It is not easy for a provider to understand what holding rate will be competitive as many BMUs are selected out-of-price order, often if part-loaded, or with different Bid-Offer prices. All of these factors have led to providers approaching the Response market in a cautious manner. If Response is a "commodity", that is effectively the same no matter which BMU is providing it, then it should be easier for companies to price effectively and competitively. However the opaque manner that NGET procures Response does not assist providers. There are some BMUs with higher holding rates that consistently outperform others. NGET must provide much more, and more timely, information in order for the frequency response market to work. This improvement in transparency should facilitate a more efficient market and reduce future costs.

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?

We believe that constraints are a major problem on the transmission system and were surprised at NGET's inability to manage constraints in Scotland during 2005/06 after the implementation of BETTA. If the costs in managing constraints in 2005/06 (when NGET struggled to manage internal Scotch constraints and those on the Cheviot boundary) turned out to be £80m then, with 2 years experience and the opportunity to act ahead, NGET should not be forecasting £81m for 2007/08. It has also had the chance to manage investment in the transmission system to reduce these constraints.

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 note that NGET has made no reference to this change as part of their most recent forecast of external costs (see Appendix 6, document ref 208/06b). Considering that it was NGET who advocated the move towards a more marginal imbalance pricing regime on the basis that parties would be more balanced, we find it quite concerning that they do not seem to have accounted for this in their forecast of external balancing costs. We expect P205 to reduce NGET's forecast level of costs.

We also note NGET's comments in relation to the impact of the introduction of BM Start-Up:

"*Whilst we anticipate longer-run benefits from these changes in terms of efficiency and economy, in some cases these services will take time to roll out to all providers, and in all cases will naturally take time to bed in"*

Part of the rationale for implementing this change was to reduce Offer prices associated with warming contracts by paying the option fee separately, so by definition Offer prices and the associated balancing costs incurred by NGET should have decreased.

The statement also seems to overlook the fact that changes in relation to the allocation of option fees as a result of the introduction of BM Start-up are having a significant impact on system prices, particularly over the peak when the system is most likely to be short. We believe that the impact of this change should be accounted for in NGETs forecast level of costs, as this is having an immediate effect on system prices.

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. We believe that a central estimate of wholesale prices is useful in setting the central IBC target, and that the indexation will then protect NGET and ourselves against movements in wholesale prices. .

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

We consider OFGEM's view that the IBC can be reduced to £430m to be quite conservative. On the basis that electricity prices may reduce, NGET should be able to more effectively manage constraints after two years experience. If there were increased provision of market data on mandatory frequency response, then taken together with the invariable tendency of NGET to over-forecast the current year's outturn by over-forecasting the outcome for January to March, this would imply that outturn IBC in 2007/8 could well be below £400m.

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?

The indexation analysis proves that it is useful as it goes some way to protecting consumers and NGET from wind-fall gains and losses. It should help to reduce the overall inaccuracy of the IBC target against actual costs. We can see no rationale for the application of a deadband in applying the indexation.

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

The difference between options 1 and 2 indicates that the indexation to wholesale prices reduces NGET's risks to a level that allows the target price to fall by -£10m. The difference between options 1 and 4 indicates that allowing NGET to make up to £20m profit at a sharing factor of 50% increase NGET's rewards to a level that allows the target price to fall by -£25m. Taking these two factors together would imply a possible target of about £405m if the scheme parameters allow NGET to make up to £20m profit at a sharing factor of 50%, with indexation of the target to wholesale prices so as to reduce NGET's risks. Ideally NGET's profits should not be capped, since if the outturn costs were a long way below target one would, nonetheless, wish NGET to continue to work hard to reduce them further to all parties' benefit. If a sharing factor of 50% were used with indexation and no cap on NGET's profits then perhaps the target could be £400m. This would have seemed the best option and falls logically out of the options offered. However, of the offered options, we believe that Options 2 and 4 are the most suitable.

We have rejected Option 1, which has too high a target and too small a sharing factor for it to incentivise NGET.

Option 3 has asymmetric sharing factors on an undemanding IBC target, with perhaps too low a penalty to NGET if the costs are higher than expected.

Option 2 has the more accurate IBC thanks to the indexation, and will also adjust to any major shift in wholesale prices, protecting the consumer from any significant reduction in costs.

Option 4 incentivises NGET to the greatest extent (highest sharing factor), but the overall target should be more demanding (lower), and the indexation from option 2 should be available.

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

The information asymmetry of IAEs is a major problem with the current process. As is the consideration by NGET as there being two types of IAE; one that was "flagged" and one "unforeseeable". We disagree with the possibility that there may be any "flagged" IAEs as this would undermine the IBC process, which is about valuing costs and targeting NGET to reduce them. The "flagged" IAE is a process for NGET to refute/reject any targets that it is set.

We agree with Ofgem that if indexation is used, then an IAE should not be considered on costs that are indexed to wholesale prices.

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 find the terms of reference to be broadly appropriate, and welcome particularly the strong commitment that is made therein to having a multi-year scheme finally in place. This can draw out deeper investments and has been an agreed aim since the first SO Incentives Scheme, UMIS, in 1995. With a one-year scheme, even with a symmetrical 50% sharing factor, any investments made by NGET to reduce the IBC would have to have a 6 month payback for them to be justified within the scheme – this clearly must be ruling out many possible investments and changes of practice.

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

EDF Energy does not have a view on these elements of the proposals.

Question 13: What are your views on implementing fixed sharing factors for internal capital expenditures? 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?

The implementation of fixed sharing factors is appropriate and would align the treatment of SO capital expenditure variation with that used for TO and electricity and gas distribution companies. We have no particular view on the strength of the level of the sharing factors. However, the current TO capex sharing factor of 25% was set at that level due to a lack of output metrics for assessing that appropriate investment has been undertaken over a longer period of time. This must be taken into account when determining the SO factor.

Question 14: Do you think incremental internal costs associated with modifications to commercial frameworks (e.g. BSC) should be remunerated 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?

The income adjusting events (then called re-openers) in the early SO Incentives schemes, "UMIS" and "TSS", which we negotiated on behalf of Suppliers, were limited to extremely adverse weather type events. It was the generally-accepted intention in those early schemes to remove them in future years as confidence grew. NGET was able to make investments in some IT and hardware (e.g. the helicopters and live line working equipment) as a result of those schemes without having special pass-through clauses or re-openers. We are opposed to the creation of extra pass-through clauses in relation to the areas discussed, such as costs in relation to approved modifications under various industry codes. The SO Incentives schemes are something which have rewarded NGET overall for all but one of the years since 1995 when the schemes were first introduced; with reward comes some risk. "Automatic cost recovery" mechanisms for NGET are thus not something that we see as desirable, with or without enhanced reporting. We do not feel that expenditure by NGET as a result of changes under the codes should be allowed as an IAE, either.

Chapter Three (gas)

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?

EDF Energy considers that having a long-term framework for carbon pricing to reduce emissions is very important. Whilst the objective of the proposal to limit the escape of methane into the atmosphere is sensible , we consider it impractical to price the leakage variation at live or near-live ETS carbon prices for a scheme of one year duration. NGG should be investing to minimise NTS gas escapes in the longer-term and that leakage variation price should be set in the scheme in advance to provide certainty to NGG. The identification of this volume also appears straight forward with all unaccounted for gas (supply less demand less NGG's own use gas) essentially being the volume "lost" to the atmosphere.

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?

Given that a review of the external SO incentive scheme for 2008 is due to take place in April 2007 it appears reasonable to roll over the previous external SO incentives for a 12 month period. EDF Energy however continues to believe that a multi-year SO incentive is preferential to a one year SO incentive, providing clarity and confidence to both gas Shippers and Transporters as to the likely level of future charges.

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?

Shrinkage volumes are closely correlated to the flows of gas through the St Fergus terminal and therefore we agree that the shrinkage volume target should be based on a variety of scenarios reflecting the complex logistics of gas flows at different entry points as this impacts directly on how much NGG's compressors are used. We believe the high, medium and low scenarios and associated volume targets are appropriate however it is not clear why the target volumes have increased significantly from Ofgem's preliminary central view of 6,216GWh to 7,129GWh.

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

Please see answer above.

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

As previously noted it would appear appropriate to retain previous methodologies for the 12 month period, in light of the review that is due to commence in April 2007. However, as EDF Energy has stated in previous responses, we believe the sharing factors are inequitably set as the sharing factors are set such that there is more upside benefit than downside. We believe that NGG's shrinkage incentive should at least be symmetrical if not weighed more to the downside, especially given recent admission to have misread a meter for more than 7 years[1], to better incentivise the least amount of shrinkage gas use as possible. We believe a more sensible and effective sharing factors caps and collars would be 20% upside and 25% downside – in essence a reversal of those proposed.

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[1] NGG announced at the Billing Operations Forum in August 2006 that they had identified their previously owned Farningham meter had been incorrectly read and under-registering gas from the NTS into the SE LDZ since July 1999.

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?

The gas reserve target appears appropriate, and a fundamental review into this incentive, alongside the other external incentives in 2007 also appears appropriate. We would however note that a fundamental review should not automatically result in a fundamental change to the arrangements. A finding of the review could be that the current arrangements for setting a gas reserve volume are satisfactory and should be maintained, and this option should not be ruled out before the process has commenced.

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

The current arrangements appear appropriate when there is a monopoly supplier and monopoly buyer of this service, especially when the companies involved are closely related. It would also appear appropriate to review these arrangements in light of future market developments in the supply of this service. We would however note that these services will be location dependent and so to a certain degree will continue to be a monopoly service. We therefore believe that a requirement of the 2007 review should be to identify whether a competitive market for the provision of an OM service could be established, before identifying whether it should be.

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?

We would note that OM gas is required for safety reasons to maintain the system in certain circumstances. Given that this therefore has safety and security of supply implications, we would question whether the provision of this service should warrant prices that reflect the commercial value associated with it. We note that in a commercial environment Shippers have numerous choices, including purchasing gas in storage facilities. For OM services, under the current arrangements, NGG has no choice other than purchasing capacity in a storage facility. However if these arrangements were to be radically reformed, and a competitive market for OM services developed that provided NGG with a wide range of options, then a more market based pricing approach may be appropriate.

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

Please see answer to Question 2 above.

Question 10: Do you have any 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 ?

As previously stated EDF Energy believes that a multi-year incentive should be set that requires continuous year-on-year improvements until a level of performance acceptable to industry has been achieved. We further believe that the outcome of the Winter 2006/07 incentive should be analysed to identify whether this represents an adequate incentive and whether the scope and form should be extended. We welcome the introduction of a full year incentive on information provision.

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

Please see our answer to Chapter 2, question 10.

Question 12: Do you agree with our initial proposals for internal costs ?

EDF Energy welcomes the multi-period approach that Ofgem has adopted in these proposals. We believe that this will provide NGG with assurance and transparency around its future allowed revenues that will work its way through into more stable prices for Shippers. We would further note that if multi-year incentives can be set for internal costs, then we see no reason why they cannot also be set for external costs.

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?

It appears reasonable that fixed sharing factors should be applied for internal capital expenditure, and the proposed factor of 75%, similar to that proposed for electricity appears reasonable. An additional benefit of this sharing factor is that it is symmetrical, unlike some of the external sharing factors that are currently present.

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 through a more automatic cost recovery process built around enhanced cost reporting and accountability to the industry through the existing commercial frameworks?

We are opposed to the creation of extra pass-through clauses in relation to the areas discussed such as costs in relation to approved modifications under various industry codes.

“Automatic cost recovery” mechanisms for NGET are thus not something that we see as desirable, with or without enhanced reporting. We do not feel that expenditure by NGET as a result of changes under the codes should be allowed as an IAE, either.

EDF Energy
January 2007