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27 March 2007

Your Ref: Ofgem doc 35/07

Dear Sonia

National Grid Electricity Transmission System Operator (SO) Incentives from 1 April 2007: Final proposals and licence consultation

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

We agree with Ofgem's intention to separately address electricity SO incentives applicable to National Grid Electricity Transmission (NGET) from gas SO incentives applicable to National Grid Gas (NGG) in 2007/08. However, as part of the wider review of external SO incentives schemes later this year, Ofgem may wish to consider whether there are elements of system operation from which efficiency and economy can be gained through greater harmonisation over the longer term. This could potentially increase benefits to consumers by increasing the scope for shared cost savings. Ofgem should explore these issues in more detail.

Ofgem has set a target deadband for external SO costs, the upper end of which is only marginally lower than NGET's latest forecast of 2007/08 costs, and above most respondents' expectations. We are disappointed that even after respondents' views on its initial proposals Ofgem has failed to develop an even more challenging target for NGET reflecting an appropriate risk/reward balance. NGET argues that its high cost forecast reflects lower balancing costs offset by increased constraint and frequency response costs. Does Ofgem's current monitoring of SO costs tally with NGET's assessment and, more importantly, is the pattern likely to be repeated in 2007/08? If not, then NGET's costs target for the 2007/08 scheme should be lower, as the relationship between SO costs and changes in wholesale prices has not necessarily broken down.

The analysis relating to frequency response costs suggests that costs rose in early 2006 due to high wholesale prices. However, as wholesale prices have fallen significantly since late summer 2006, higher response costs in the run-up to winter 2006/07 have more to do with the impact of CAP047 which has caused higher market prices for response to be derived. In 2007/08, there should be a combination of both lower wholesale prices and stable or lower response prices after the

implementation of CAPI07. Ofgem states that this is what it is being told by the generators who set response prices. Therefore, we cannot agree with NGET that 2007/08 response costs will remain as high as it forecasts.

We agree with other respondents that the opaque nature of system operation makes it difficult to determine when actions are taken for energy balancing reasons and when for system balancing reasons, hindering understanding of how NGET derives its SO costs. Consumers rely fully on NGET to manage the risks of system operation but on a fair risk/reward basis and not to obtain excess reward. Past history suggests that NGET has gained considerably from incentive schemes, creating the impression that target levels set by reference to NGET's forecasts are invariably too high and that NGET easily meets the target. The review of external SO incentive schemes must address the lack of transparency around SO costs which prevents market participants understanding how these are derived. NGET should provide best available information to keep SO costs to end consumers low but also to allow a fair risk/reward incentive scheme to be set based on appropriate forecasts of SO costs.

Ofgem has set some conditions which NGET must accept as part of the 2007/08 scheme. We agree that NGET's ability to raise Income Adjusting Events (IAEs) should be very limited and only in specific circumstances. NGET should take more decisive hedging action to protect consumers from unnecessary SO costs and Ofgem must disallow costs which are shown to be inefficiently incurred. Ofgem should also act strongly and decisively if there is evidence, however this is made available, of other participants such as generators 'gaming' the market and creating additional constraint and response costs for NGET. Any potential breach of NGET's licence due to the failure to operate the network efficiently and economically should be subject to a thorough Ofgem investigation. Ofgem must be prepared, through effective monitoring and reporting activity, to take action where necessary.

Energywatch will fully engage with Ofgem's reviews of cash out arrangements and external SO incentive schemes, providing the consumer viewpoint. Ofgem must ensure that the outcomes of these reviews result in arrangements which lead to the efficient and economic operation of transmission networks. Consumers must be provided with transparent and actual shared benefits arising from reduced costs over the longer term expressed through future price controls and incentive schemes.

We have no specific comments on the legal drafting of the special licence conditions implementing the 2007/08 incentives scheme as they appear to be fit for purpose.

We will keep these issues under review, always considering the possible impact on consumers, and will comment further as necessary.

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

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs