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1 October 2007

Your Ref: Ofgem doc 207/07

Dear Philip

**Review of Electricity and Gas System Operator Role, Functions and Incentives: Initial Thoughts 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.

All energy consumers, especially the most vulnerable, expect the delivery of safe, secure and reliable supplies of energy in an efficient and economic manner. National Grid Electricity Transmission (NGET) and National Grid Gas (NGG) respectively have licence obligations to ensure that system operation and balancing of the electricity and gas grids occur in the most efficient, economic and coordinated manner, in line with consumers' expectations. These obligations are in place specifically because the vast majority of consumers rely on NGET and NGG to manage the risks of system operation and balancing for them as they cannot do so either individually or collectively. The ultimate costs of system operation lie with consumers but NGET and NGG must keep these costs as low as possible.

NGET and NGG are in unique positions to take an overview of the networks and adopt the necessary action to maintain system and energy balance. We strongly believe that future system operator (SO) incentives schemes should reflect that NGET, NGG and Ofgem are taking full account of consumers' interests.

We note Ofgem's desire to separate the work of the review into two workstreams so that one-year SO incentives schemes for NGET and NGG can be implemented from 1 April 2008, while scrutiny of how long-term SO schemes may be developed is undertaken over a longer period. We agree that this is a suitable approach within the current timescales. We also believe that the scope and form of the NGET and NGG schemes should be retained for 2008/09. This provides consistency with previous schemes.

However, we expect Ofgem to carefully scrutinise NGET's forecast costs for 2008/09 when setting any target costs. Is it entirely coincidental that in 2006/07, NGET had no incentive scheme and outturn costs were significantly higher than in

the previous comparable year? What monitoring of NGET's SO costs did Ofgem undertake in that year? In previous years, as Ofgem's analysis highlights, NGET made significant gains from the SO incentives schemes. Does this highlight a lack of rigour in Ofgem's approach to analysing NGET's costs? How does Ofgem intend to address these concerns?

We will consider whether there is an appropriate scope and form for a long-term scheme when we see more details of Ofgem's initial proposals. While there may be sound reasons for aligning SO incentives with the duration of Transmission Owner (TO) price controls so that there is greater coordination between, and potential scope for, managing risks more effectively and economically, and a possible increase in stability, we need to understand how this approach would operate in practice for consumers' benefit.

We have doubts about continuing to include a quality of information incentive in the NGG scheme. Providing good quality data on a timely basis to market participants, who will be relying on it to self-balance and reduce the costs of residual balancing that NGG may incur, ought to be part of NGG's normal activity and not provide it with a separate financial reward paid for by consumers. We believe that this element of NGG's SO incentive scheme ought to be phased out in the 2008/09 scheme and in the long term. We do believe that it is worth exploring whether NGG should be subject to set performance standards for providing quality of service. We would resist any extension of the quality of information incentive to NGET's scheme.

We believe that there are certain issues, common to both the gas and electricity SO incentives schemes, which need to be considered when assessing whether, and how, long-term schemes may provide an improvement on the current position:

- transparency and understanding of SO actions – we do not believe that the balancing actions taken by the SOs can always be related back to the incentives schemes in a clear manner. Users, and, through them, consumers bear the costs of SO actions but have limited ability to judge, even with the reporting of some information by NGET and NGG, whether those costs were efficiently incurred and recovered appropriately. The NGG scheme is at least split into incentive 'pots' against which its performance can be assessed. For the NGET scheme, the use of a bundled approach does not remove the need for NGET to provide better information to the industry about the reasoning for its balancing actions. The need for greater transparency increases as the impact of various diverse factors on SOs' balancing actions takes effect. We would like to see an effective reporting framework in place for the SOs which ensures that they adequately explain their actions;
- Ofgem's regulatory role - Ofgem must state clearly how it monitors the SOs when they have no incentive scheme in place (NGET had no scheme in 2006/07 and SO costs were considerably higher in that year). Market participants rely on Ofgem to analyse and scrutinise SO actions to ensure they are in line with licence obligations. Ofgem must explore and come forward with firm proposals for how to make information transparency a key touchstone of any long-term

schemes. Obtaining a clear and adequate explanation of the drivers behind SO balancing activity is the minimum to be expected from NGET and NGG;

- harmonisation – this applies equally to aligning aspects of the gas and electricity SO incentives schemes as it does to potentially aligning the durations of the SO schemes and the TO price controls. Ofgem must consider if there is a potential for lower costs resulting from greater stability, increased flexibility and better coordination between the system operation and balancing of the different grids and whether consumers will see immediate benefits as a result.

The cash out arrangements under the BSC relate to residual balancing of energy by NGET. Ofgem's recent revival of the cash out review has highlighted a number of issues, including system pollution of the main energy imbalance price and a lack of transparency and simplicity in the energy imbalance calculation. However, Ofgem has also highlighted in this document a number of impacts on NGET's balancing activity, which are more properly considered under various governance arrangements, for instance transmission constraints and access issues under the CUSC, but which affect cash out costs. We would ask Ofgem whether, if there are concerns about the effects on cash out and the costs imposed on consumers, why a cross-governance examination of the impacts does not occur? Ofgem has a wider remit to address these issues through its statutory duty to protect consumers' interests rather than leaving the industry to mull over these matters under separate codes. Ofgem ought to be leading the debate rather than facilitating discussion for others.

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 would appreciate being kept informed of the progress of the consultation and any related issues to enable us to comment as the need arises.

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