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Dear Philip,

Review of Electricity and Gas System Operator Role, Functions and Incentives

International Power (IPR) is responding to Ofgem's Initial Thoughts paper on behalf of First Hydro Company, Saltend Cogeneration Company Ltd, Rugeley Power Ltd, Indian Queens Power Ltd. and Deeside Power Development Company Ltd. Our comments are restricted to discussion of the external electricity SO incentive arrangements.

We note that there is to be another one year scheme from April 2008, and IPR supports the continuation of an annual NGET SO incentive scheme – it remains a more efficient approach than the alternatives. A number of industry developments are highlighted as having a future impact on SO costs. However, we do not see these developments as being sufficient to warrant radical overhaul of the current arrangements. In fact, they suggest that there would be significant risks inherent in a multi-year scheme.

Answers to some of the key questions raised in the consultation document are provided below.

Question 1: Do the current roles and functions of the SO ensure that the SO is able to operate the electricity system in the most efficient and economic manner?

Whilst there are always imperfections in any division of roles and functions, we believe that in general, the current roles and functions of the SO allow it to operate the system efficiently. We have been wary of the SO's ability to enter the traded markets at times, but given that its traded volumes are fairly limited, it appears to operate well within its 'residual balancing' remit.

Question 2: Do you consider that it is appropriate that only the SO can propose modifications to the statements that the SO is required to have in place under C16 of its transmission licence?

No. We believe that market participants should have greater input into the development of these documents. Bringing their governance under the BSC would allow marker participants to propose modifications to the statements.

Question 3: Do you consider that the costs incurred by NGET in its role as electricity SO represent the costs that would have been incurred by an economic and efficient SO?

Clearly this is not an easy question to answer without comparative data. From our perspective National Grid have sought to develop competition in a range of services, and deliver on their incentive to manage costs on behalf of the consumer, with due regard to their role in balancing and securing electricity supplies. Given the breadth of coverage of its incentive scheme, and the vast number of contracts and balancing actions involved, there will always be examples of decisions that in hindsight may turn out to be sub-optimal.

Question 4: Do you agree that through BSUoS is the most appropriate way to recover the costs incurred by the SO?

BSUoS remains the most appropriate method for recovering SO costs.

Question 5: Do you consider that previous SO incentive schemes have been effective in ensuring that NGET as SO has operated the electricity system in an efficient and economic manner and managed the external costs of managing the system effectively? To what extent was the increased level of system operation costs incurred by the SO in 2006/7 attributable to the absence of an incentive scheme for that period?

We believe that having an incentive scheme in place does help to reinforce National Grid's other licence obligations through financial means. However we cannot attribute the higher costs in 2006/7 to the absence of an incentive scheme. As far as we are aware, the SO was under much greater scrutiny from Ofgem over that period in relation to its balancing and contracting decisions and therefore we consider it unlikely that costs were allowed to increase unduly. In any case, NGET continued to operate under licence conditions that required it to manage the system in an efficient and economic manner. The main change year-on-year can be seen to be attributable to increases in CAP47 costs, as this new frequency response market developed.

Question 6: Do you consider that a sliding scale scheme is the most appropriate way for an SO incentive scheme to operate? If not, please indicate what you consider to be a more appropriate type of scheme.

A sliding scale mechanism is appropriate. It can be modified to match the objectives at the time, and its simplicity is appealing. As the NETA/BETTA market has matured, it has moved logically towards a shallower incentive design. It seems sensible to continue on this basis.

Question 7: Do you consider the use of the Net Imbalance Adjustment to be an appropriate way of adjusting for the costs resulting from market participants' actions that the SO has little control over?

The NIA is a necessary adjustment to outturn costs in order to provide the SO with a more appropriate incentive measure. We continue to believe that market participants should be incentivised, through appropriate and cost-reflective cashout prices, to balance their positions. The SO should neither gain, nor be penalised by the extent of any residual market imbalance.

Question 8: Is it appropriate for participants (including the SO) to have the ability to raise Income Adjusting Events when unexpected events occur resulting in increased or decreased costs?

The IAE process has been the subject of much debate over recent years. IPR believes that it is now an unnecessary element of the incentive scheme, particularly in relation to annual schemes. Furthermore, as set out in the final 2007/8 scheme, market participants' behaviour remains under scrutiny to the extent that they could distort costs for the SO unexpectedly. The market, and the SO's role in it, has matured since the early days of NETA, and risks should be capable of being broadly understood on a year-ahead basis. If it is to continue, its application should only be in very limited and exceptional circumstances.

Question 9: Do you consider that the costs of operating offshore networks should be included in the SO incentive scheme? Are there any other additional elements that you consider should be included? Are there any elements that are currently included in the scheme which should be removed?

It would seem logical to include the costs of offshore network operation into the existing SO scheme, as with any other incremental expansion of the transmission system. Development of separate schemes would be inefficient.

Question 10: Do you think it is appropriate to consider unbundling the electricity SO incentive scheme? If so, which areas do you consider should be separated out and how might the SO be incentivised in these circumstances?

IPR does not believe that the scheme should be unbundled. We would be concerned that unbundling would create perverse incentives given the high degree of interaction between that various cost elements of the scheme. Scope must be given to the SO to make trade-offs between these areas in order to manage costs overall. A bundled scheme will deliver the most efficient outcome.

Unbundling would also add to the complexity of the scheme, and associated administration costs.

Question 11: Would longer term SO incentive schemes provide greater opportunities for investment that ought over the longer term result in greater net efficiencies in SO costs?

IPR is not convinced that this would be the case. National Grid should, irrespective of the term of their SO incentive scheme, be able to take a view on opportunities for investment in order to seek greater net efficiencies. Rather, a longer term scheme will tend to place more emphasis on an appropriate IAE process that we believe would be counter-productive. Therefore we believe that an annual scheme, without

IAEs represents the most appropriate format – it enables significant market changes to be factored into the scheme through the annual negotiation and consultation process. This also helps with maintaining transparency of the scheme on a regular basis.

Question 12: If we were to consider a longer term SO incentive scheme, what are the key drivers of SO costs that would need to be considered over the longer period? In what way could these drivers be captured in the incentive scheme?

As above, IPR does not support the introduction of longer term schemes. We believe that it is not appropriate to base a long term scheme on key drivers of the SO's costs. This is because relevant drivers, and their weighted contribution towards overall costs, will change considerably over, say, a five year period. This will mean that any scheme designed on this basis is likely to fail to reflect the true costs incurred and the prevalent market environment, especially in the latter years of any scheme.

Question 13: What are the key developments that will affect future System Operator costs? How will these developments impact on costs?

From National Grid's analysis provided as part of the Initial Thoughts paper, it seems clear that the increase in wind and renewables capacity will introduce additional balancing risks to the SO, across a range of timescales. Its response to these changes may be limited by the reduced levels of system flexibility in relation to the constrained operation of thermal plant that has opted out of LCPD. Increased costs of system management should be considered in the context of wider UK and EU targets on renewables development.

However, changes to the cashout regime have the potential to radically shift the balance of the market at gate closure, and this effect could swamp other developments in terms of the volume and costs of balancing actions that the SO would be required to incur.

Question 14: Are there areas in which the current transmission losses scheme could be enhanced to improve further the incentives on the SO to operate the electricity transmission system in an efficient and economic manner?

No – it is a relatively small, static, but important part of the overall scheme.

Question 15: What additional market information do you consider should be made available to the market by the SO, and vice versa?

The SO should seek to provide the market with information on wind forecast output as wind penetration increases, in order to assist in pre-gate closure balancing.

Question 16: Is there sufficient transparency surrounding the SO incentives both in terms of the process for setting the incentive parameters and in terms of the information on costs provided by NGET? If not, what additional information do you consider should be made available?

IPR notes some increased transparency in recent years regarding the setting of incentive schemes. The exception to this improving trend, was the lack of comparable information on the SO's costs during 2006/7 when it operated without an incentive scheme. This perhaps highlights a side-benefit of having a scheme in place.

Question 17: Do you consider it appropriate that the electricity SO should have quality of information incentives placed on it (as is the case with the gas SO)?

IPR believes that incentives of this nature are unnecessary and overly complex. Ofgem should be able to set expectations for the SO effectively, without the need for an additional incentive scheme.

I trust that these comments have been helpful – please contact me if you require any further clarification. We look forward to participating fully in the remaining elements of the review.

Yours sincerely,

Kevin Dibble
Regulation