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**Review of Electricity and Gas System Operator Role, Functions and Incentives: Initial Thoughts  
August 2007**

Dear Philip,

1. We welcome the opportunity to comment on the issues raised in this consultation. This response reflects the views of RWE npower and the UK based business of RWE Trading GmbH.
2. The document raises fundamental questions about the role of the gas and electricity System Operators (SO), whether the SOs have appropriate tools to undertake their roles and whether it may be beneficial to have incentive schemes of longer duration than the current annual schemes. However, the document avoids the key question of whether incentive schemes continue to be required. Although Ofgem appear to support their continuation, it is difficult for market participants to challenge this position as we do not have access to sufficient information to assess whether outcomes would have been different absent an incentive scheme. We believe that it is important that network users have an understanding of how NGET and. NGG., evaluate the various tools and contracts available for balancing and securing their systems and whether a formal incentive scheme affects the decision making process. It is extremely disappointing that Ofgem has not provided any insight into electricity SO costs during 2006/07 when NGET operated without an incentive scheme. Although costs were high during this period, it is unclear whether this was as a direct result of there being no incentive scheme in place or to other identifiable drivers, such as constraints.
3. There are a number of wider policy initiatives that will affect the role of the SO. These range from emerging European policy on unbundling or establishment of an independent system operation to domestic initiatives such as the Transmission Access Review and cash-out review. Further, there are industry developments that will also be important for how the SOs manage

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their networks, including changes to NTS flows as imports increase or the growth in distributed and renewable generation. All are at a relatively early stage of development and, where significant changes to the SO role do emerge, these will clearly need to be reflected in various licences and industry codes and agreements. On this basis, fundamental reform of the SO role, functions and any associated incentives is only likely to be practicable in the longer-term and should be considered by the workstream constituted to consider broader issues.

4. A key element of the review is consideration of the extent to which the annual schemes could be replaced by schemes more aligned to price control timescales, currently five years. The purported benefit is that longer-term incentive schemes will allow the SOs to trade-off operational costs against investments that would only reduce costs over the course of several years. In our view, it is extremely difficult to forecast most costs and setting longer-term incentives carries the risk of frequent re-openers and Income Adjusting Events. The proposal to link costs to certain output drivers needs further development. Where it is possible to identify costs that are predictable over the medium-term, we would argue that these should not be subjected to an incentive in any case. To the extent that incentives are retained, we would prefer to see annual schemes, subject to scrutiny of costs and coupled with a more transparent target setting process.
5. Turning to specific proposals that may be implemented from April 2008:
  - We would support removal of the linepack incentive element from NGG's residual balancing incentive as it appears to have little, if any, influence on their behaviour;
  - We would support increasing the transparency obligation on NGET, although we are not convinced that this requires a separate information incentive. There are clearly wider system operation benefits if improved information reduces the volume of SO activity.
  - We would caution against any change to the gas cost reference price methodology which reduces the period of time between the period during which the index price is set and the index period, bearing in mind the success NGG have had in out performing the gas cost incentive.

We hope these views are helpful and if you wish to discuss them further please contact me on 01793 893983.

Yours sincerely,

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