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Dear Philip,

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

Scottish and Southern Energy plc (SSE) welcomes the opportunity to input early in the design of National Grid Electricity Transmission's (NGET) and National Grid Gas's (NGG) system operator (SO) incentive arrangements from 1 April 2008. In addition to the high level points below, we have responded to the specific questions asked.

On NGET's incentive, we have a fundamental concern regarding the focus of the scheme. We believe there is an unhelpful focus on constraint costs, which is in direct conflict with current energy policy and the drive to bring on more renewable energy. By incentivising low constraint costs, NGET is actively discouraged from allowing new and renewable generation on to the system. Whilst this may have worked historically, in order to be consistent with current energy policy, we believe there needs to be a change in emphasis to ensure that NGET is actively rewarded to both connect renewable generation and utilise the existing network capacity to its full potential. Therefore, whilst it is right that NGET remains incentivised on its constraint costs, we believe that, going forward, it is appropriate to relax the target and widen the focus of the incentive scheme.

More generally, we believe NGET's incentive would benefit from greater transparency and a less bundled approach. Indeed, although we do not consider it necessary to harmonise the two incentive schemes, we support the unbundled structure of NGG's incentive and consider that there may be merit in adopting a similar approach in electricity.

Although we support the structure of NGG's incentive scheme, we believe that Ofgem has identified areas where further work is needed. We support efforts to put in place a longer-term incentive regime and as such welcome proposals that will result in a more dynamic incentive that is able to reflect the changing market conditions. Consistent with this, we believe it is unlikely that flows through St. Fergus will remain an appropriate reference point for shrinkage volumes in the long-term, particularly given the steps already taken by NGG to move its charging methodology away from this north-south relationship.

We hope this response is helpful Should you require any additional information or clarity, please do not hesitate to get in contact.

Yours sincerely,

Robert Hackland
Regulation Manager.

**NGET**

1. Do the current roles and functions of the SO ensure that the SO is able to operate the electricity transmission system in the most efficient and economic manner? If not, what changes do you consider should be made to the roles and functions of the SO such that it is better able to operate the electricity transmission system in the most efficient and economic manner?

   *We broadly support the scope of NGET's existing incentive scheme. If correctly implemented, the incentive mechanism should continually incentivise NGET to make efficiency gains through innovative services and contracting. We believe however that NGET's incentive would benefit from greater transparency. From a market participant's perspective, certain decisions taken by NGET can appear to be inefficient due simply to the lack of transparency. Greater information provision would help to alleviate this concern.*

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? Do you think that market participants should also be able to propose modifications to these Statements and should they sit elsewhere, for example in the BSC?

   *We believe there is value in allowing market participants to propose modifications to the Statements that NGET is required to have in place under C16 – 'Procurement and use of balancing services'. We do not believe that these Statements would sit better under the BSC.*

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? Are there particular areas where you consider that NGET has not incurred costs economically and efficiently? If so, please provide details.

   *We have raised concerns in the past that NGET dispatches frequency responsive plant out of merit despite the frequency response market being regarded as both non-locational and transparent. In the absence of any firm reason, we have suggested that this is due to a lack of fully compliant plant and a homogeneous frequency response plant or service. We have also suggested that NGET could reduce its costs by putting in place longer-term contractual arrangements for products specific to its needs.*

   *More fundamentally, we believe there is an unhelpful focus on constraint costs, which is in direct conflict with current energy policy and the drive to bring on more renewable energy. By incentivising low constraint costs, NGET is actively discouraged from allowing new and renewable generation on to the system. Whilst this may have worked historically, in order to be consistent with current energy policy, we believe there needs to be a change in emphasis to ensure that NGET is actively rewarded to both connect renewable generation and utilise the existing capacity to its full potential. Therefore, whilst it is right that NGET remains incentivised on its constraint costs, we believe that, going forward, it is appropriate to relax the target and widen the focus of the incentive scheme.*

   *We believe NGET could further reduce costs by taking a proactive and innovative approach to ancillary services. NGG should be reviewing these services on a continuous basis to ensure that any improvements are consulted upon and implemented.*

   *Finally, although outside the scope of this current review, we would like to raise a concern relating to NGET's internal incentive. We are concerned that the limits in place may be preventing NGET from making the necessary investment in central systems and resources. We believe it may be in the industry's interest to accommodate such expenditure under the SO incentive. Going forward, greater transparency surrounding NGET's capital and operating costs would be helpful.*

4. Do you agree that through BSUoS is the most appropriate way to recover the costs incurred by the SO? If not, please provide details of how these costs should be recovered.

   *NGET's costs, both internal and external, are currently recovered from market participants via BSUoS. BSUoS charges are calculated on a half-hourly basis and are based on each participant's metered usage relative to the total use of the system. We believe that the current BSUoS arrangements offer the most appropriate mechanism for fair and transparent cost recovery.*

   *Importantly, we do not support proposals to move towards locational BSUoS charging. The system is designed to accommodate connected generation and meet the GBSQSS. A payment that includes a locational element is already made for using the system (TNUoS). This cost is encompassed within generators' costs on the basis that the market operates according to least cost generation dispatch (either self- or NGET dispatch). If the network cannot accept connected generation and the SO incurs a constraint cost, any recovery of this cost on a locational basis would impose a double penalty on generation that is already paying locational TNUoS. Recovery of costs on a locational basis would also expose particular points within a constrained zone to the pricing actions of generators outside that zone, which they would have no control or influence over. Non-locational BSUoS is therefore the only appropriate charge out methodology.*

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 operating the system effectively? To what extent was the increased level of system operation costs incurred by the SO in 2006/07 attributable to the absence of an incentive scheme for that period? Please provide details of any areas where you consider that the SO incentive schemes have not been effective.

   *Please see our response to Q3 and, in addition:*

   *The fact that NGET has received a payment under its SO incentive in four out of five years could suggest that the target has been set at too low a level. For the incentive scheme to be effective, the target must challenge NGET.*

   *In terms of the increased costs incurred by the SO in 2006/07, we believe it is difficult to attribute all these increased costs to the lack of an incentive scheme. Due to the introduction of new products, for example the first full year following changes to the frequency response product, and higher wholesale electricity prices, we do not believe that the increased costs in 2006/07 can be wholly attributed to the lack of an incentive scheme. Nevertheless, we do believe that an incentive mechanism is an effective way to keep costs down and incentivise all possible efficiencies.*

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.

   *We believe the sliding-scale scheme is effective. However, if it is to be applied going forward, rather than the single sliding-scale scheme in place currently, we believe there may be merit in applying a number of sliding-scale schemes to unbundled incentives.*

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? If not, how could this adjustment be improved?

   *NGET does not have any control over the extent to which market participants choose to balance and the NIA aims to offset some of the resulting cost incurred by NGET. It is difficult to foresee NGET agreeing to an incentive mechanism without some protection against this given that it has* *no or little control over these costs. We would however welcome greater transparency on how the NIA is calculated.*

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? If not, how could such cost uncertainties be addressed under an incentive scheme?

   *It seems to make sense to include some sort of appeal mechanism against excess charges (be it on NGET or participants). We believe the current procedure for raising an income adjusting event is appropriate.*

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 elements that are currently included in the scheme which should be removed?

   *NGET is designate SO for UK offshore transmission networks. It would seem to make sense to include the resulting costs in the SO incentive scheme. We would certainly want to see these costs incentivised.*

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?

    *We believe an unbundled incentive would result in greater transparency. If, going forward, the incentive scheme is to cover multiple years, we believe an unbundled mechanism will facilitate more accurate indexation resulting in a more reflective incentive regime. We believe this is the most significant challenge in implementing a longer-duration incentive.*

    *Again, whilst outside the scope of the current review, we believe an area that would benefit specifically from unbundling is NGET's internal SO incentive. This would enable market participants to comment more fully on the appropriateness of NGET's future investment plans.*

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

    *Yes. It has proved difficult to agree NGET's incentive scheme on an annual basis, with recent years resulting in retrospective application. The downside of a longer-term scheme is that it is more difficult to avoid extreme outcomes. For this reason, we support efforts to introduce more dynamic incentive parameters, for example, through price indexation. We do not however believe that the end result should be to remove all price risk from NGET. NGET should have sufficient tools to manage some price risk, i.e. through longer-term contracting.*

    *Importantly, a longer-term incentive scheme will not necessarily be enough on its own to provide greater investment opportunities. In order to invest, market participants will need more information regarding the requirements of the system going forward. There is, for example, technology now available to enable offload plant to deliver reactive power. If plants are to invest in this technology, they need to be certain that there is a market for this service and that they will be considered within it. This is not currently the case.*

12. If we were to consider longer term SO incentive schemes, 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?

*We consider there to be three key drivers of SO costs: (i) wholesale prices; (ii) the location and configuration of future generating plant, for example, the increase in renewables and more unpredictable generation; and (iii) investment in the NTS.*

*We believe the introduction of indexation would help to accommodate changes in wholesale prices. For indexation to be effective, we believe it is necessary to unbundle the current incentive. In terms of investment in the transmission system, we believe this could be suitably incentivised by lessening the emphasis on constraint costs and factoring in an incentive on NGET to increase the amount of renewable generation on the system and the extent to which the existing infrastructure is utilised.*

13. What are the key developments that will affect future SO costs? How will these developments impact on costs?

    *We consider the key developments to be the current reviews on cash-out, frequency response, reactive power, black start and transparency. We welcome these reviews. Until they are concluded, however, it is very difficult to comment on how they will impact upon costs.*

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

    *In general, we support the current transmission losses incentive scheme and, in particular, the recovery of this cost from generators and suppliers on a uniform basis. We believe the current incentive is effective. Indeed, in 2006/07, when NGET was not incentivised, transmission losses increased by more than 500 GWh, increasing balancing costs by £9 M. Under the BSC proposals for zonal transmission losses, it would be inappropriate to incentivise NGET.. We do not believe Ofgem has considered this increase in baseline cost in its assessment of the proposed zonal transmission losses modifications.*

    *Finally, given that NGET has typically beaten its transmission losses volume targets, we believe there is merit in reducing NGET's target volume of transmission losses going forward. In addition, we support proposals to introduce a more dynamic transmission losses reference price (TLRP). This is consistent with our support for a longer-term incentive scheme.*

15. What additional market information do you consider should be made available to the market by the SO, and vice versa? Please explain how this information would improve system operation and market efficiency.

    *Again, although outside the scope of this current review, we believe greater information surrounding NGET's investment in central systems and resources, would lead to a more efficient market. Currently, it would appear that NGET has been unable to provide sufficient justification to Ofgem for system investment. We do not believe it is economic or efficient for market participants to invest in upgrading their systems without improvements first being made centrally.*

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?

    *As outlined throughout this response, we would welcome greater transparency surrounding NGET's incentives. In terms of the specific parameters, i.e. caps, floors and sharing factors, we believe there is a distinct lack of information regarding how these are set.*

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)? If so, how should the SO be incentivised?

    *Again, in line with our support for greater transparency, we welcome, in principle, the introduction of quality of information incentives on NGET. We would support further consultation on the scope and format of these incentives.*

**NGG**

18. Are the current roles and functions of the SO appropriate, and do they ensure that the SO is able to operate the NTS in the most efficient and economic manner? If not, what changes would you recommend?

    *We broadly support the scope and format of NGG's existing incentive scheme.*

19. In the electricity market the SO as residual balancer is able to contract ahead for various services. In the gas market the SO as residual balancer does not have the same ability. Do you consider that this difference is appropriate? Please explain your view.

    *We believe the ability to contract ahead is key to ensuring that NGG procures services as efficiently and cost-effectively as possible and would therefore welcome steps to facilitate the imposition of longer-term contracts. We are unaware of any provisions that currently prevent NGG from doing this.*

20. Do you consider that the costs incurred by the SO represent the costs that would have been incurred by an economic and efficient SO? Are there any particular areas where you consider that the SO has not incurred costs economically and efficiently? If so, please provide details of these areas and why you consider that to be the case.

    <u>*Shrinkage*</u>
    *Whilst the new volume-weighted approach to pricing shrinkage gas, introduced in 2004/05, is an improvement, we welcome moves to introduce an alternative approach from 2008. Between 2005/06 and 2006/07, NGG's shrinkage incentive target increased from £112.7 M to £184.4 M and yet NGG's outturn costs in 2006/07 only amounted to £115.8 M. We believe the resulting inaccuracy in the target reflects the use of historic prices, i.e. high wholesale prices in 2005/06, to set the coming year's incentive.*

    *We would therefore support an alternative approach that is better able to reflect the current wholesale price and the costs incurred by NGG in managing shrinkage. The most appropriate approach will depend upon how NGG manages its shrinkage risk. If, for example, NGG manages this risk day ahead, we would support the use of day-ahead prices. A fixed price incentive is likely to be the least reflective.*

    <u>*System Reserve*</u>
    *Concerns have been raised that NGG's forecasts include double provision of reserve. However, without clear information relating to the breakdown of volumes and prices paid for reserve, we believe it is difficult for us to comment.*

    *Nevertheless, we do have concerns regarding NGG's reliance on the Isle of Grain import facility for reserve. Due to the ability of LNG deliveries to react to global wholesale prices, we do not believe LNG imports offer NGG a reliable source of reserve. Moreover, once delivered, LNG takes days to re-gasify. Given the uncertainty of the deliveries, it is not clear to us how the Isle of Grain import facility is in a strong position to provide reserve.*

21. What are the key developments that will affect future System Operator costs? How will these developments impact on costs?

    *We agree that one of the key challenges facing NGG going forward is the change in where future gas will come from and the associated uncertainty. This uncertainty is two-fold. By relying on longer pipelines/more infrastructure, the risk of failure and therefore delivery is increased. Secondly, some of this gas, i.e. LNG, will be vulnerable to global wholesale prices and as a result there is uncertainty around where it will be landed. This will change supply patterns and* *associated flows on the network, which will have an impact on NGG's system balancing incentives (in particular shrinkage).*

22. Do you consider that the current form of the residual gas balancing incentives is appropriate? Please explain your reasoning.

    *We broadly agree with the current form of NGG's residual gas balancing incentive. However, we are not convinced that NGG's lack of response to the Linepack Performance Measure (LPM) incentive is driven solely by operational requirements. In an effort to address this, we believe there is merit in making the LPM incentive more penal, thereby further incentivising NGG to achieve its target.*

23. Do you believe that the existing linepack incentive has little impact on the behaviour of the gas SO? If so, do you have any suggested improvements for this aspect of the incentives?

    *Please see our response to Q22.*

24. Is it still appropriate for the gas shrinkage volume target to be dependent on flows through St. Fergus? If yes, please provide details of the relationship. If no, please explain your reasoning and provide your views on how the target should be set.

    *If, going forward, shrinkage volumes are anticipated to be most sensitive to flows through St. Fergus, this relationship would appear to remain a sensible basis for the shrinkage volume target. However, we do not believe that future gas shrinkage volumes will remain particularly sensitive to gas entering the NTS through the St. Fergus entry terminal. Indeed, the justification put forward by NGG for changing its charging model from the transcost model to the transportation model was based upon this change in flows. Therefore, if the concerns raised in response to Q21 about increased imports connecting to the NTS at a variety of locations are valid, it is unlikely that the use of St. Fergus will remain appropriate.*

25. Is the current gas cost reference price methodology still appropriate? If not, please explain what an appropriate methodology would be.

    *Please see our response to Q20.*

26. Is the current form and scope of the gas system reserve incentive still appropriate (in terms of the volume and source of gas reserve bookings the SO considers necessary for the safe operation of the network, the contestability and locational nature of some of these requirements and the price at which it is efficient for these bookings to be made)? Do you consider that the sharing factors, cap and floor for this incentive are still appropriate? Please explain your views.

    *There is a concern that there may be some double provision of reserve as a result of overlap between different reserve requirements. However, without greater transparency on procured reserve, we believe it is very difficult for individual market participants to comment. In relation to this, we would welcome greater transparency regarding the volumes and location of system reserve procured.*

    *Currently, competition for OM services is limited. We therefore welcome NGG's acceptance, in principle, of a new licence obligation to develop contestability in the provision of OM services. We believe the development of this is dependent upon a suitable contract being in place to cover this. Importantly, NGG should not procure reserve solely on the basis of price as this could put the system at risk. NGG's focus should be on procuring sources that are both cost effective and reliable.*

*As effective competition in OM services develops, we believe NGG will need to take steps to introduce appropriate caps, floors and sharing factors. The basis of these should be transparent and subject to industry consultation.*

27. We would welcome views on the indicative data provided by NGG on its requirements for gas reserve from April 2008, including views on its continued utilisation of LNG storage at the Isle of Grain importation facility.

    *As stated above, when procuring OM services, we believe NGG's focus should be on both reliability and price.*

    *In terms of NGG's continued utilisation of LNG storage at the Isle of Grain importation facility, going forward we believe this should be matched by procurement of services from elsewhere. Millford Haven, for example, becomes operational next year and we would therefore expect NGG to start to procure OM services from this facility as well as Isle of Grain. However, as noted in our response to Q20, we have concerns regarding the reliability of LNG importation facilities in the provision of OM services.*

28. Would the increased stability of gas SO incentive schemes of longer duration be preferable to the increased flexibility offered by schemes of a shorter duration? Please provide your reasoning.

    *Once confident that the correct measures are in place to ensure an effective and efficient incentive mechanism, we believe a longer-duration SO incentive scheme would be preferable. This is particularly the case if NGG is to be encouraged to procure longer-term services. However, we believe there is still considerable work needed, especially in relation to the system balancing incentives, in order to instil confidence that incentives will remain effective on a longer-term basis. We believe it is likely that, even in a longer-term incentive scheme, reviews will play a role.*

29. Are there any aspects of the gas SO incentive schemes that you consider would be more effective if bundled, rather than remaining in their current form? Please provide details of how this may be achieved.

    *No. We believe an unbundled incentive results in improved transparency. Therefore we support the current unbundled incentive.*

30. 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? If not, how could such cost uncertainties be addressed under an incentive scheme?

    *As for NGET, it seems to make sense to include some sort of appeal mechanism against excess charges (be it on NGG or participants). We believe the current IAE mechanism is appropriate.*

31. 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 Special Condition C5 of its GT licence? Do you think that market participants should also be able to propose modifications to these Statements?

    *We welcome the opportunity to widen the audience able to propose modifications to the Statements that NGG is required to have in place under Special Condition C5 – 'NGG's procurement and use of system management services'.*