

System Operator incentives workshop 1 November 2007

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What I will cover...

- Helicopter level assessment of record of SO incentive regime under Neta/Betta
- Personal view of way forward
- But note that:
 - focus on electricity, though wider applicability
 - not representative of any party's point of view
 - nevertheless a very important issue for independent suppliers
- A simple thesis.... Evolution, not revolution

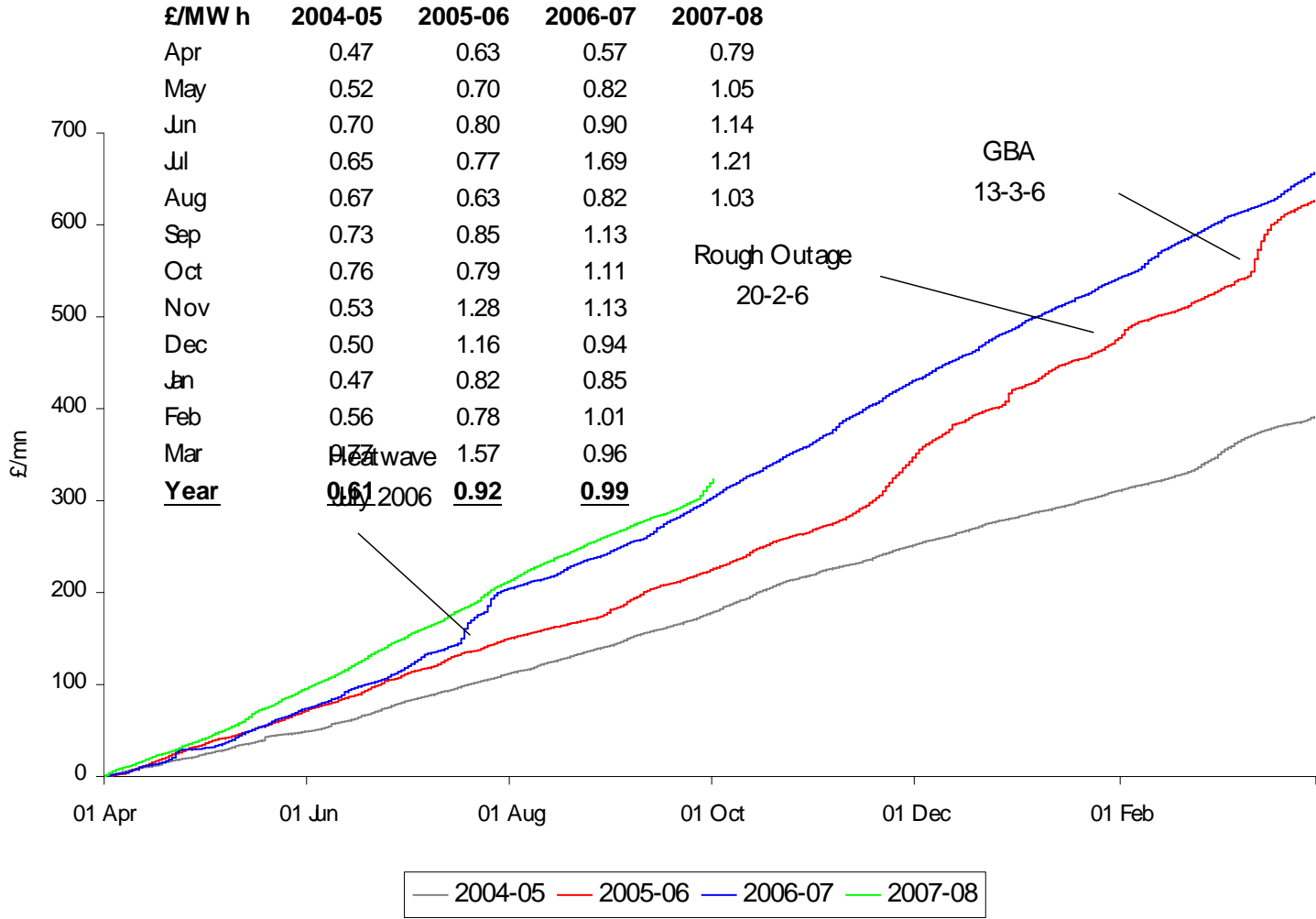
Sharing benefits (1)

£ m	Target	Sharing factors		Cap	Floor	Actual	NGET share
		Upside (%)	Downside (%)				
2001/02	382	40	12	46.3	-15.4	263.0	46.3
2002/03	367	60	50	60	-45	285.6	48.6
2003/04	340	50	50	40	-40	280.8	32.2
2004/05	320	40	40	40	-40	289.2	12.2
2005/06	378	40	20	40	-20	427.2	-4.0
2006/07	na	na	na	na	na	na	-

- Benefits mostly captured by SO in years 1-4 but excessive returns a thing of the past?
- Caps, collars and targets have been asymmetric
 - but art not science
- NG has captured upside and been protected from downside

Current scheme in right ball-park given size of business and regulated profits

Sharing benefits (2)



But consumer costs did not noticeably decrease with SO performance

Cost predictability (1)

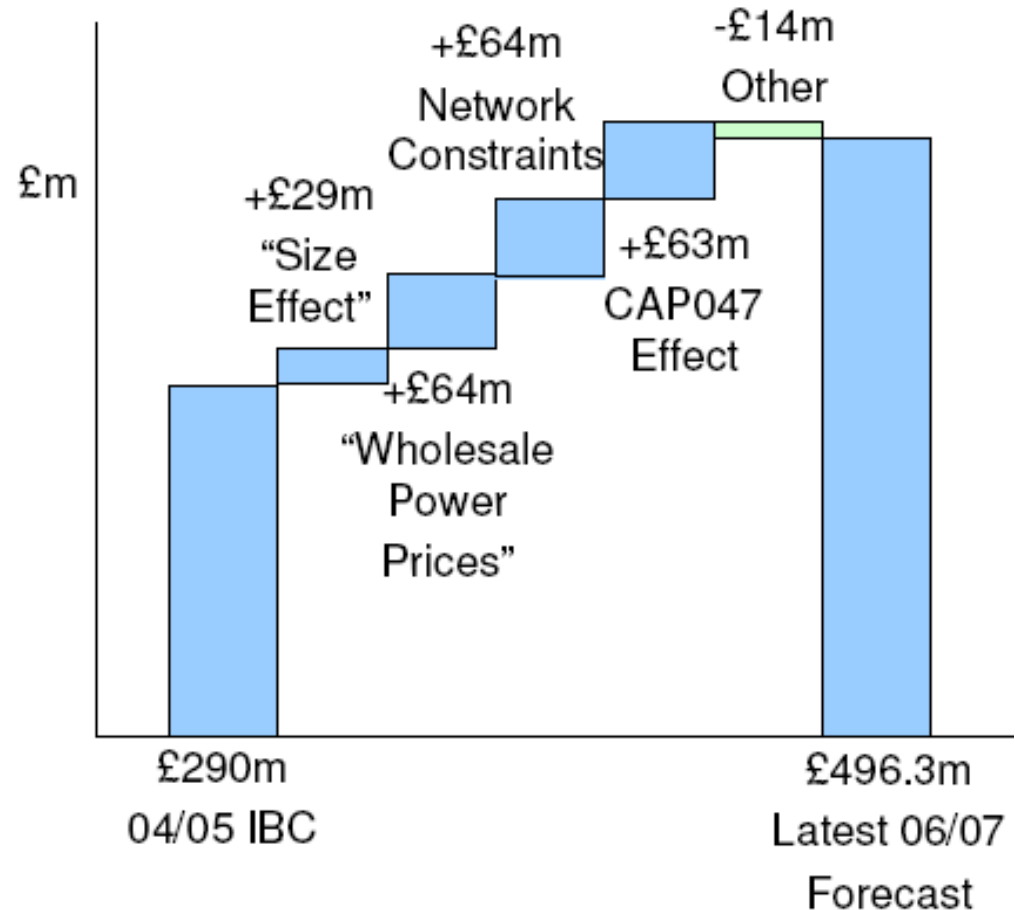
- No obvious pattern even before Betta
- Evidenced by reliance on (one sided) income adjusting events and failure to agree scheme in year 6
- Obvious interactions but how can stakeholders determine basis for decisions?
- Transmission constraint costs have become significant rogue element

£mn	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Balancing services	172.6	211.4	192.4	205.4	249.3	374.6
Forwarding trading	-22.0	-18.0	8.8	11.1	34.2	29.8
PGBT's			4.7	2.4	13.1	3.1
Balancing mechanism costs	65.7	58.5	74.5	83.1	240.5	143.2
Total	216.3	246.6	280.4	302.0	537.1	550.7
% change year on year		14.0	13.7	7.7	77.8	2.5

Few real signs of stability and predictability

Cost predictability (2)

- Recent NISMs (19 Oct and 30 Oct) show balancing risk and uncertainty
- Sources of material risk going forward:
 - 12GW of Scottish wind
 - LNG effects
 - fuel prices
 - offshore
 - decentralised markets



No reason to believe that surprises will diminish

Innovation and compliance

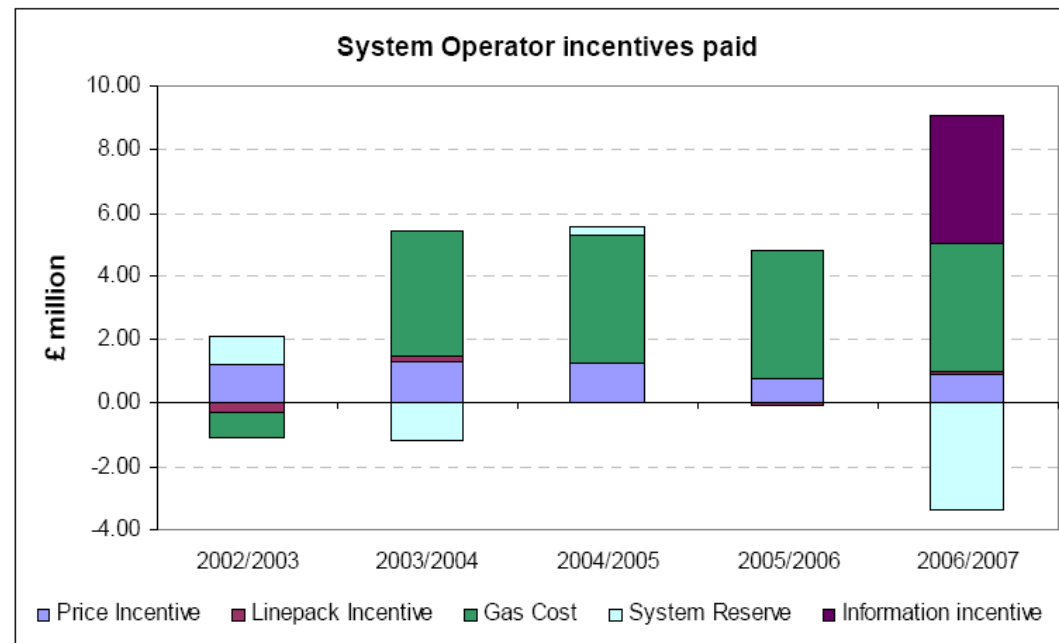
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- Existing services used in different ways (BMU specific energy trades)
- New services being procured (STOR, more proactive focus on demand side)
- Dynamic environment with synergies across services
- Increased visibility:
 - transparency review
 - monthly balancing services report a considerable improvement

A dynamic environment in which significant change has occurred

Some parallels with gas

- Unbundled approach
- Lesser rewards in the past
- Information incentive



A more appropriate model in a volatile market?

Moving forward (1)

Build on current strengths

- Maintain appropriate incentives:
 - one year, not multi-year
 - £10mn upside is more than reasonable upside, but unbundled
 - symmetrical caps, collars and sharing factors set on explicit basis
 - if real scope for larger reductions, then skew sharing factors
 - if information accuracy an issue, introduce limited incentive
- Avoid unnecessary risks
 - index power price costs
 - establish separate arrangement for offshore
 - pass through problematic costs (e.g. constraints)
 - If income adjusting events, clawback for windfalls

Moving forward (2)

Improve understanding

- Improve knowledge of drivers and interactions
 - feedback from last year, please
 - maintain improved level of disclosure and consultation in annual reset process
 - start reset process earlier
- More not less transparency
 - recognise that only scale players have resource to understand complex interactions - even they struggle
 - get within year framework right
 - one year arrangements, not longer
 - enhanced reporting

Moving forward (3)

Establish appropriate monitoring

- Flex compliance framework
 - regular within year reports, especially
 - year to date position against target/s
 - regular full year IBC and BSUoS forecast updates
 - use BM audit
- Written not verbal reporting
 - monthly operating report
 - monthly performance report
- Define performance measures and indicators
- Establish explicit contract/ agreement

Moving forward (4)

Recognise competitive impacts

- Consider participant and customer impacts
 - translate target into revenue cap assuming reasonable performance
 - take variations into account in year t+1
 - in other words provide greater BSUoS charge certainty
- Give market participants ability to propose change to condition 16 statements
- Participants need to look across BM and balancing services and understand basis for SO action
- No locational BSUoS

Key messages

- Fundamental concepts of SO incentivisation as relevant today as ever
- Considerable improvements have been made
- Going forward an evolutionary approach based on annual, unbundled arrangement key
- But much can be done to improve within year reporting, SO accountability and market understanding

Thank you for listening

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