

Ian Marlee
Director, Trading Arrangements
Ofgem
9 Millbank
London
SW1P 3GE

Our Reference:

Your Reference:

Date : 25 March 2009

Dear Ian,

Final Proposals Consultation: National Grid Gas System Operator Incentives from 1 April 2009

SSE welcomes the opportunity to comment on the above consultation document. We are generally supportive of the proposed amendments. It is clear that NGG has consistently benefited under the SO Incentive scheme. In recent years benefits have been close to £9m per annum. We believe there is scope to tighten targets whilst providing an opportunity for NGG to benefit where they outperform. Amendments proposed by Ofgem would cap potential benefits at £12.5m per annum and limit downside exposure at £9.8m.

Request for Additional Data And Analysis

Throughout the consultation process, SSE has expressed concern regarding:

- lack of detail regarding historic costs for all components and all timescales,
- the lack of analysis comparing the impact of alternative proposals and
- limited detail regarding forecast future costs.

In a number of areas, this has made it very difficult to form a complete picture and detailed view on the appropriateness of proposed targets, caps, collars and sharing factors. For instance, the forecast costs for OM and Shrinkage services is approximately £170m but we are unclear what level of costs have been forecast for other elements such as residual balancing. Without this it is difficult to tell whether the overall cap of £12.5m is proportionate to the level of risk and costs incurred by NGG. Against costs of £170m a cap of £12.5m provides a reasonable return of 7%. But total costs are likely to be higher, making the likely rate of return to NGG lower.

Whilst the comparison of costs relative to incentive benefits provides a useful benchmark when assessing incentive parameters, we would stress that it is also important to consider the wider impact of NGG's actions or inactions on the market. For instance, it may be preferable to incentivise NGG to take action and incur costs by providing a high return, if the alternative costs to the industry as a result of NGG

not taking action would be higher. For instance a reward of between £2.3m and £3m for accurate demand forecasting may on the face of it seem generous, but the consequences for the industry if performance deteriorated could be considerably greater.

Shrinkage

This is clearly a significant element of the SO Incentive scheme. Own Use Gas and Compression Energy are the most significant components of shrinkage. NGG has consistently performed below target hitting the ceiling payment of £4m. Payments are expected to be lower this year at £1m but this appears to be driven by prices, rather than volumes. As such we believe there is still scope to reduce targets. There is credible evidence to suggest compression energy requirements are likely to reduce as supply flows change. Although changes introduced to the forecasting model should help deliver more realistic targets it would have been helpful to have a little more detail regarding assumptions made by Ofgem in reaching its conclusions.

Unaccounted for Gas is the other significant element of shrinkage. Ofgem has previously urged NGG to carry out work to gain a better understanding of drivers but progress has been limited. We welcome the introduction of a separate target and a 3 year incentive scheme. We believe this will help ensure work is undertaken to better understand contributing factors and reduce volumes going forward. However we are still concerned that the proposed incentive scheme focuses on gross volumes only which have been relatively stable. We believe more work is required to understand variances in net volumes. The proposed incentive scheme won't deliver this. It would also have been helpful to have an update on expected outturn volumes and costs for this year and forecasts for next year. Notwithstanding, we believe the proposed cap of £2m in the first year looks to be proportionate, providing a reasonable reward relative to risk for NGG. We are less clear on the impact of the proposed caps for year 2 and 3.

We have no specific comments on proposals relating to CV Shrinkage. We support the request from Ofgem that NGG initiate a review of CV shrinkage arrangements. This has been requested in previous years. We hope more progress will be made this year, so that any amendments can be taken forward at the next review.

Residual Balancing

Whilst we agree the two main elements of the scheme (Linepack Measure and Price Performance Measure) have generally incentivised the correct behaviour, it has been difficult to form a clear view on individual components without additional detail. Given benefits realised by NGG in previous years, we agree there is scope to sharpen the regime. We believe proposals set out by Ofgem appear appropriate but it would be helpful to understand whether any analysis has been carried out to help understand the impact on the market should action not be taken by NGG as a result of the impact under the incentive scheme. As mentioned earlier, we are concerned that sometimes incentive parameters need to be considered alongside wider consequences to the market.

Quality of Information Incentive

We support proposals set out by Ofgem, particularly those which tighten the target applied to demand forecasting accuracy. We believe past performance shows a target of 3% is realistic and should still provide upside benefit to NGG.

Environmental Incentive

As indicated in our previous response, we support proposals to include emissions from electric compressors and to broaden the scope of the regime to include all emissions. Ofgem has also asked NGG to bring forward initial proposals for a fugitive emissions incentive scheme. We look forward to receiving more detail.

Operating Margins Incentive

There have been a number of significant developments and separate consultations on this. We believe good progress has been made but some further work is still required to facilitate increased competition. In the meantime we agree that holding costs should be passed through to customers, leaving NGG incentivised on utilisation costs only. We believe the proposed target parameters are appropriate.

Maintenance

Several respondents suggested NGG should be incentivised to minimise deviations from original planned maintenance dates. Ofgem has not proposed arrangements for the forthcoming year but has asked NGG to consider this further. We believe this is a significant issue and urge NGG to progress this in time for the consultation process next year.

Process

Whilst we believe proposals set out in the above consultation document are moving in the right direction, we urge Ofgem to ensure more transparency is provided under future consultations so that a greater level of understanding of actual costs and drivers can be formed. This will help facilitate more active participation by interested parties and help deliver more robust arrangements. It should also increase participant's confidence in the outcome. We believe there would be some merit in looking at information provided under the electricity SO incentive process. The level of detail provided is far greater and would provide a useful starting point. We also believe final proposals need to be presented earlier in the process. This would provide more time to seek clarification and address new issues. This isn't possible where a range of options are provided by NGG and final proposals are only forthcoming in February under the Ofgem publication. The current process has resulted in key decisions being made at the end of the process and very close to the implementation date. We urge Ofgem to review the process ahead of next year and implement incremental improvements

Further Work

Ofgem has asked NGG to undertake further work in a few specific areas. We believe this will help inform future consultations and deliver improvements but some

requests are repeated from previous years. We hope more progress will be made this year so that incremental improvements can be brought forward next year.

Conclusion

On balance we believe Ofgem's proposals strike a reasonable balance between risk and reward and continue to provide an incentive for NGG to take actions which will reduce costs to economic and efficient levels. However more detailed information would have been helpful to allow us to reach a more informed view. In addition Ofgem has requested further work be carried out by NGG. We hope reasonable progress will be made over the coming year to inform future debate.

We hope you find these comments useful.

Yours sincerely

Beverley Grubb
Regulation Manager