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Ian Marlee
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27th March 2009

Dear Ian,

RE: National Grid Electricity Transmission and National Grid Gas System Operator incentives from 1 April 2009

As we have outlined in earlier responses, whilst we welcome the opportunity to get involved in the development of the incentives, we have an on-going concern about the suitability of National Grid setting its own incentives and the lack of visible engagement in the process by Ofgem. Ofgem's detailed views on the SO incentive packages for both gas and electricity have only become clear at this late stage of the process. Whilst there have no doubt been detailed discussions going on between National Grid and Ofgem, this aspect of the process is opaque to all who are not party to the bilateral discussions taking place. If Ofgem wishes to continue to encourage stakeholder engagement in this process, then there must be a visible feedback loop between consultation respondents and the regulator. We would, therefore, urge Ofgem to consider not only how the SO incentives can be improved in future, but also its own role in the setting of them.

Please note that the following comments are aimed at the proposed Gas SO Incentives package only.

NTS Shrinkage - Unaccounted for Gas (UAG) Incentive

As indicated in previous responses, we were somewhat uncomfortable with this new incentive, as in our view, it risked giving NGG money without any obvious indications of how, or where, it would be spent. There was also a risk of rewarding National Grid for improvements which were beyond its direct control. We are pleased to see that the proposed scheme has been shortened from five to three years, but consider that this incentive should be reviewed on an annual regular basis to ensure it is delivering the anticipated benefit of reducing gross UAG volumes. We would, therefore, welcome an annual report from National

Grid on what specific actions have been taken to reduce UAG and the expenditure incurred in doing this.

Operating Margins Incentive

We are relatively comfortable with the concept of proposed cost pass-through for holding costs; however, this may only be suitable for the forthcoming incentive year. For future years, NGG should revert to being incentivised on both utilisation and holding costs, particularly now that competition for OM provision has been proven. Furthermore, there are lessons to be learnt from the recent tender, which would benefit competition between providers in future.

For instance, we believe Ofgem was wrong to have considered suspending the regulated “C3” prices for NG LNG storage retrospectively; i.e. after the outcome of the recent tender was known. As we stated in our response to Ofgem’s open letter on Operating Margins Contestability in February 2009:

> *“The lack of Safety Case approval for non-storage providers means that National Grid are currently limited to contracting for OM services from storage (i.e. National Grid LNG (NG LNG) and a handful of other non-regulated storage sites). National Grid also stated in their OM tender that at each storage site they will only contract for OM equivalent to the site’s maximum daily deliverability. Therefore, National Grid seems almost obliged to accept some of NG LNG’s bids in the current tender, since there are insufficient alternatives elsewhere to meet the OM requirement. Removing the capped ‘C3’ prices could, therefore, allow NG LNG to have bid above the regulated price in the knowledge that the bids will be accepted by National Grid. As the cost of OM procurement is then passed through to Users under proposed SO Incentive arrangements, Shippers and their customers may end up paying more for OM service procurement than if the C3 prices continued to apply.”*

In future years, Ofgem (if they feel it is appropriate to do so) should suspend the C3 prices *ahead* of the tender, assuming that HSE Safety Case approval for non-storage sites is granted. This will surely lead to true price discovery, which may not have been fully realised in the recent tender process, given the uncertainty over the C3 prices.

However, when considering whether to suspend the C3 prices, Ofgem should take into account whether cost pass-through would be appropriate given the significant proportion of regulated storage sites in the make-up of the accepted tender bids. We suggest that for future years, if C3 prices are suspended, that this is combined with a cap on holding and utilisation costs. Otherwise, whilst we may see a wider range of OM providers, there may be no discernible benefits for consumers in terms of cost savings.

Residual Balancing Incentive

We believe this scheme retains an appropriate cost targeting framework and reduces the likelihood of unnecessary balancing actions being taken by NGG when linepack is close to target levels. However, we note that the absence of an absolute target means that Shippers will continue to be funding operational changes in linepack through the balancing mechanism.

Information Incentive

We oppose the data publication incentive being rolled forward in any form. We believe it represents little more than “money for old rope”, since it is, in our view, paying NGG to do something which they should be doing anyway. As we have set out repeatedly, we believe the appropriate industry benefits have now been delivered and the incentive should therefore be abandoned. Nonetheless, we welcome Ofgem’s scepticism about the value of this incentive and believe that it is right customers are consulted on the value they place on this particular incentive before it is removed.

I hope that the above comments prove useful. Should you wish to discuss our response further, please do not hesitate to contact me on the number above.

Yours sincerely

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