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Ian Marlee
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Our Reference:
Your Reference:

Date : 27 March 2009

Dear Ian,

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

We welcome the opportunity to comment on the above consultation.

In general we support the proposals set out by Ofgem. We welcome the fact that Ofgem has taken onboard many of the comments made in response to the previous consultation, and, following discussion with NGG, forecasts have been updated and target costs have been reduced. Although we believe these adjustments represent a more realistic view of costs going forward it is not entirely clear to us what assumptions have been made, and therefore it is difficult to reach a more informed view. The 2009/10 forecast range is still wide and the targets are still significantly higher than the forecast outturn for 2008/09, which in turn are significantly higher than the 2008/09 target.

We continue to support incentive regulation. We believe there is strong evidence to show that incentive regulation can drive improvements in performance, which ultimately drive down costs. However, it is important that the rewards are proportionate to the risk and that the benefits are shared with customers. In electricity we believe it is becoming more difficult to set appropriate targets to incentivise the correct behaviour. Costs have fluctuated significantly in recent years. In the first 4 years of NETA, NGET significantly outperformed against target, making between £12.2m and £48.6m per annum under their incentive scheme. Their returns were significant, relative to costs, at 17% in some years. This could have been viewed as disproportionate. However, the position has reversed in recent years with NGET forecast to incur the maximum level of costs this year of £15m. Although significant, relative to forecast total costs, this is less than 2%. NGET's downside exposure has been far less than their upside benefits over the period. As such we agree with Ofgem's proposals to rebalance the incentive regime and ensure NGET remains incentivised over the range of costs forecast.

NGET has indicated that the key contributing factors to rising costs next year include:

- Higher wholesale prices,
- reduced system length,
- loss of free head room and
- increase in constraints.

We have previously argued that NGET has placed too much emphasis on 2008/09 data. In our view, operating reserve, frequency response, constraint costs and volumes appeared to be too high. We believe that this is largely as a result of 2008/09 being unique. Indeed, this has been recognised in Ofgem's recent letter on TAR, issued on 27 February 2008, where, in NGET's commentary on Project Rationale, it is stated that *"data in respect of the current year is atypical and is influenced by unusual conditions which are not believed to be representative of the long term outlook"*. The combined impact of LCPD, loss of nuclear, tight plant margins and high prices created very difficult conditions in 2008/09. We believe the situation will be very different in this coming year. As such we welcome the recent reduction in forecast costs. We believe the revised central target for 2009/10 of £813m is a step in the right direction but without further information it is difficult to tell whether this enough.

Following the application of the new NIA this brings the target range down to £600 - £630m. This is still an increase of between 13% and 15% compared to the IBC target for 2008/09. We believe more needs to be done to develop new and more innovative tools to manage both risks and costs.

Constraint Costs
Constraint costs have risen substantially in 2008/09. They are forecast to outturn at £238m this year, representing approximately 30% of total imbalance costs. Whilst costs are now forecast to increase to £262m in 2009/10, the constraint volume over these two years should not have come as a surprise. Investment plans were developed and approved some time ago and as such, it should have been clear that a consequence of this would be the need to constrain the interconnector flows in order to carry out the much-needed investment to connect renewable generation in Scotland.

NGET state that the level of costs predominantly results from the addition of 800MW of wind generation. We believe this is extremely high. Comments made recently in other Ofgem documents and presentations refer to 450MW of additional wind connecting. In our view the additional new wind generation likely to connect in Scotland in 2009/10 is around 100MW. We believe therefore that there is significant potential to reduce the new forecast of constraint costs further by taking a more realistic view of the impact of wind generation.

There has been much industry debate about what measures are required to reduce costs. The range of options and potential impact is significant. So much uncertainty so late in the day, created to an extent by the raft of industry changes being put through at the moment, has exacerbated the problem. We believe it has made it very difficult for NGET to determine whether actions they could take would be considered appropriate. Understandably this has had a detrimental impact on NGET's behaviour and there appears to be a reluctance to look at more innovative ways of managing risk and entering into longer-term contracts to reduce costs.

With so much uncertainty regarding the future level of constraints and associated costs we question whether annual incentive targets are the correct approach. We believe the only credible option to manage these costs for 2009/10 is to pass through all constraint costs or introduce a mechanism which includes monthly targets for constraint costs, a dead band and a monthly cap on the benefits and risks to NGET from constraints. This will help ensure NGET remains incentivised over the full range of costs over the full year.

Other Issues

Transparency of Information

In addition to the comments made above, we believe there is a need for much more transparency regarding constraint requirements and costs. NGET state there has been a 25% increase in the number of outage days, although this requirement was not apparent to the market. Without this knowledge it is difficult for potential service providers to respond to such requirements. Also, a greater understanding of costs is required; it is not clear what proportion of costs and where these arise, in relation to both replacement energy and replacement margin associated with managing constraints. More transparency would help potential service providers understand the issues and provide an appropriate response to NGET's requirements.

Frequency Response

Although costs have been reduced compared to initial proposals, we are still unclear why they are forecast to increase relative to this year. It is not clear whether this is as a result of addition wind generation. Further clarification would have been helpful.

Ongoing Work

We supported proposals to unbundle and introduce a reactive power index and unbundle the transmission losses incentive. Although this hasn't been included in proposals for 2009/10, we welcome the request from Ofgem that further work is carried out next year with a view to incorporating changes in 2010/11. Ofgem has also asked that NGET carry out more work to see whether incentives can be broken into quarters and whether variable sharing factors and longer term incentives could be introduced. Whilst we support all of these initiatives, we believe the greatest benefits would be delivered from greater transparency regarding costs and drivers.

Given the rate at which costs are changing and the potential variability, more work is urgently required to develop and introduce mechanisms that will deliver more certainty to participants. The levels of volatility that we have seen recently introduce significant risk for participants, which could have a detrimental impact on competition. We believe urgent consideration should be give to solutions such as fixed price BSUoS, with a view to implementing arrangements over the next year. In the meantime we encourage ongoing monitoring and reporting on costs and drivers, particularly in the areas of constraints.

We hope these comments have been helpful.

Yours sincerely

Robert Hackland
Regulation Manager