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Dear Ian,

National Grid Gas (NGG) System Operator (SO) Incentives from 1 April 2010: Final Proposals Consultation

Thank you for providing SSE with the opportunity to comment on the above consultation. We have detailed our responses to the consultation questions below.

Q1. Do you consider that the final proposals for the SO incentive schemes to apply to NGG's external SO costs represent a fair balance of risk and reward.

We agree that certain elements of the final proposals for NGG's SO incentives represent a fair balance of risk and reward. For example, we welcome the tightening of the regime on residual balancing and demand forecasting. However, we continue to have concerns regarding many of the elements proposed and have highlighted these concerns below.

1. Maintenance Incentive

We are disappointed that Ofgem has determined not to implement a Maintenance Incentive as we strongly believe an incentive is required to improve performance in this area.

Our particular concern is in regards to changes being made to the originally agreed maintenance date by giving 30 days notice. When NG NTS subsequently change the maintenance date it is not always possible to reschedule the power station maintenance date and as a result the power station suffers two maintenance outages; one for NGG work and one for specific plant related work. Power station maintenance is often undertaken by third party specialist contractors who need to be booked months/years in advance. A month's notice of change is inadequate to reschedule and align to a single maintenance period. The lost revenue suffered by a power station when it has no gas supply and is unable to generate is dependent on the spark spread, but can be multiples of £100,000/day.

Given the significant lost revenues that are incurred by power stations when they are unable to generate, the first step should be to incentivise or prevent the change of originally agreed maintenance plans unless agreed to, by mutual consent. Any Maintenance Incentive would need to reimburse the losses incurred by power station operators. NGG would be incentivised on a share of these costs. The costs could be calculated using a standard market rate or specific costs based on open book disclosure. Given that only five requests were made by NGG in the period up to April 2009 to change original maintenance plans the subsequent costs would not be excessive.

2. Residual Balancing and Demand Forecasting Incentive

SSE believes that the two components of the Residual Balancing Incentive: the price performance measure; and line pack measure; are of potentially critical importance in influencing market price and trading sentiment. The two measures are directly related to one another and need to remain bundled together under the Residual Balancing Incentive. The historical incentive payments of £1.5m/year are sizeable however, against the potential impact on the wholesale market price the incentive appears to be appropriate. However, we believe there is scope to soften the line pack measure part of the incentive to reduce trades being taken to manage the incentive performance rather than for genuine system needs.

The current incentive structure is based around the annual demand weighted average level of forecast error. This structure implies that the value of an accurate demand forecast is equal for all days in the year (i.e. there is no increased value on winter or higher demand days) and that the focus of NG NTS

activities is on reducing the average level of forecasting error rather than trying to specifically address the occurrence of an individual day with a large forecast error.

SSE believes that the current incentive structure should be modified to:

- Have four separate average levels of forecasting error periods: Winter; Autumn; Spring; and Summer, to reflect the different market values;
- Have a separate incentive to avoid large peak single day errors in the Winter i.e. no more than 8% absolute forecast error; and
- Reduce the current average forecast error target from 3.2% to 2.6%. Historical evidence has shown that NG NTS can achieve this level of forecast accuracy.

NG NTS should be incentivised to continuously improve against the above measures, possibly by increasingly challenging targets for the same or lower financial incentive. Historical evidence has shown that NG NTS can achieve better levels of forecast accuracy.

3. Data Publication Incentive

NGG's Data Publication Incentive covers specific gas system data published on the NG website. NG NTS is incentivised to keep three key screens (Prevailing View, Data Item Explorer and Report Explorer) available with a target of 99.3% availability, and to publish 90.5% of the hourly updates for 4 reports (Predicted Closing Line Pack, National Forecast Flow, National Physical Flow, and Forecast NTS Throughput). The information provided is interesting and useful on a daily basis, however only becomes of real importance to shippers on Gas Balancing Alert or Gas Emergency days.

Our experience this Winter was that this information was not provided in a timely manner when it was most needed. We suggest that rather than being incentivised to provide the information a certain percentage of the time, NGG are incentivised to provide the information to provide it in a timely manner when most needed by shippers i.e. 100% availability and 100% of hourly updates on Gas Balancing Alert and Gas Emergency days.

Regardless of whether our above suggestion is implemented, we continue to believe the new incentive revenue collared at £0.1m is too high for a routine part of core business for a regulated monopoly. We would expect over time as NGG demonstrates its ability to maintain high levels of service against this incentive that the incentive payment is reduced to zero, but that the penalties for failure are maintained.

4. Environmental Incentive

We do not believe it is appropriate for NGG to have an Environmental Incentive relating to the natural gas vented from NTS compressors and other plant. We believe that it is unnecessary as methane leakage is already incentivised through the gas shrinkage incentive. We did not support the original incentive and do not support its further extension. In fact the incentive should be modified such that it only penalises NGG for the release of methane and in no way acts as another reward mechanism.

Managing shrinkage should be a routine part of core business for a reasonable and prudent system operator. This is recognised by NG themselves in their Environmental Policy Statement 2009. We believe NGG are already adequately incentivised to minimise shrinkage through the UAG incentive and to further reward them under the guise of an " Environmental Incentive" is rewarding them twice and is excessive. SSE do not have a way of knowing if the level of venting of gas from plant operation is reasonable, but it appears that the financial reward for NG to reduce the level of shrinkage by 2000 tonnes or nearly 1 million therms is excessive at £1 million.

5. Operating Margins (OM) Incentive

There are many uncertainties regarding the potential cost of OM services; different cost structures of providers, the level of competition in the market and uncertainty over whether or not regulated prices will apply to NGG LNG facilities. However, as OM costs are ultimately passed through to customers it is important that NGG contracts for these services efficiently through either incentives or regulatory scrutiny.

The introduction of demand reduction contracts will fundamentally affect the availability and utilisation incentives. Currently, storage services typically have high availability costs, but the costs of exercising OM contracts are passed through to shippers without any incentive on NGG, (exempting utilisation costs for space only storage contracts). Whereas, demand reduction services would be expected to have low availability and a high exercise price. It would not be appropriate to continue to pass these exercise costs though without incentive. Therefore, an overall cost minimisation incentive across storage and demand reduction and availability and utilisation should be considered.

6. Gas Line Pack Trading Product

We do not believe Ofgem's proposal to introduce a licence condition requiring NGG to consider both the introduction of a gas line pack trading product has been given a due consultation process, and

believe it should have been introduced at an earlier stage in the SO Incentives 2010 consultation process.

Q2. Do you consider that the proposed licence modifications appropriately reflect the final proposals as described in this chapter?

We believe the proposed Licence Conditions should be reviewed in light of the above mentioned, and another separatE consultation should be conducted upon the revised Licence Conditions.

We hope that our comments are helpful. If you would like to discuss any of the points raised in more detail, please do not hesitate to get in contact.

Yours sincerely,

Claire Rattey
Regulation Analyst