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System Operator Incentive Schemes from 2013
June 2011

Dear Ian,

Thank you for the opportunity to comment on this consultation. This response is provided on behalf of the RWE group of companies, including RWE Npower plc and RWE Supply and Trading GmbH.

Ofgem is consulting on the design of System Operator (SO) incentive schemes to apply from April 2013. We agree that, as interventions in the market by the SO can lead to costs being incurred that are ultimately borne by consumers, it is important that these costs are efficiently incurred. Meeting environmental objectives and securing energy supply will require significant development of both the gas and electricity transmission networks and pose new operational challenges.

In setting out the principles that should underpin future developments in the gas and electricity SO incentive schemes, Ofgem has identified that there may be benefits from enhancing the key design parameters, including the extent of any alignment between the SO incentives and incentives in place through the transmission price control being set from April 2013 under RIIO–T1.

It is disappointing that, with the exception of better alignment of the SO and TO incentives, Ofgem's initial proposals simply roll forward and/or re-package the current commercial incentive structures. We support an incentive-based approach towards system operation, so development of the current schemes may not necessarily be the appropriate way forward. There may be merit in considering a different approach from 2013.

An option might be to develop a performance-based approach that relates to specific areas of controllable costs where National Grid should have relevant incentives to influence outcomes. Such an approach would help to reduce any windfall gains or losses that may arise from external events such as the rapid increase and subsequent decrease in commodity price. A performance based scheme should provide National Grid with sufficient returns to provide incentives to innovate and deliver enhanced levels of service. The incentive scheme should be supported by evidence that National Grid, in performing its role, has influenced the out turn costs. This would indicate that the incentive scheme is delivering value for money for all users and customers. More tightly defined

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incentives may also create greater stability and predictability in BSUoS and the gas SO commodity charge.

Our comments on some of the issues raised in each of the chapters are set out below:

Chapter 3: Determination of outputs to be incentivised

Generally, the scope of outputs covers the key activities undertaken by the gas and electricity SOs. For the electricity SO, Ofgem proposes that the outputs incentivised under the April 2011 scheme should, at minimum, continue to be incentivised from 1st April 2013. With respect to the gas SO, the majority of the outputs currently incentivised should continue, with two activities considered as licence requirements. Of these, we agree that information provision is a key SO role and should form part of NGG's direct licence requirements. We are less convinced that UAG can satisfactorily be separated from the other elements of shrinkage that are currently subject to incentives. As the primary cause of UAG is believed to be inherent metering tolerances associated with entry and exit meters, NGG clearly has a role, along with the gas DNs, in managing UAG.

Ofgem has also identified a number of possible additional incentives:

- *Incentive on NGET as electricity SO in respect of energy not supplied:* this is consistent with better alignment of TO and SO incentives and should be developed further;
- *Incentive on NGG as gas SO for maintenance scheduling:* we believe that short notice changes to the maintenance schedule have a material impact on gas-fired generation and an incentive should be considered;
- *Incentive on NGET and NGG in respect of customer satisfaction:* we do not support further work in this area and question whether it is possible to define, calibrate or measure a customer satisfaction incentive.

Chapter 4: Packaging outputs into schemes incentivising delivery

We accept, in principle, that where outputs are interlinked that there should be benefits in bundling. Ofgem has set out a range of options for packaging incentive schemes and believes that, wherever practical and efficient, SO outputs should be packaged together and incentivised through a bundled scheme. Packaging will inevitably reduce the level of transparency over the SOs' actions and blur the classification of actions that have more than one benefit and whether the classification has been applied consistently. Consequently, it is difficult to assess the effectiveness of the incentive components.

For April 2013, the proposal is that the current fully bundled electricity scheme is continued. For gas, Ofgem's preference is to increase the level of packaging and although Ofgem has produced, as an option a single, bundled scheme, we would need to better understand how any single cost/volume minimisation scheme would work in practice.

We note and agree with Ofgem that the degree of interaction between the various gas outputs means that moving to a single, fully bundled scheme would be difficult to achieve. Ofgem has identified a number of the existing incentivised gas outputs that might be packaged together. Their parameters need to be carefully specified and we would be concerned that NGG was not paid twice for the same action.

Chapter 5: SO incentive scheme length

Arguably, extending the duration of many of the current SO incentive schemes would incentivise the SO to consider actions that may have higher upfront costs and which may require a relatively longer cost recovery period. However, we believe that system operation is essentially a short-term activity and even investment in IT systems only permits the SO to better manage day-to-day activities.

Extending the length of incentive schemes requires the introduction of uncertainty mechanisms to manage the increased risk faced by the SO and has implications for how those risks are shared. Generally, we support the implementation of a 1-year scheme as the uncertainty over potential cost outcomes in following years creates the risk for significant adjusters (which may be automatic) or even for income adjusting events. This has the effect of increasing the potential risk that the scheme outcomes differ materially from that forecast.

Although Ofgem identifies the potential benefits from moving to longer-term SO schemes the, albeit limited, examples from gas offer little support. The objective for the UAG scheme introduced in 2009 was to encourage longer-term actions to reduce the volumes of UAG, but they have increased significantly over the incentive period to date. The Compressor Fuel Usage (CFU) scheme, also introduced in 2009, had an objective of minimising the costs of purchasing gas and electricity for running compressors. Concerns about the continued validity of part of the CFU target volume model have resulted in NGG seeking to introduce an adjuster to the target volume. Further, NGG historic performance against the cost targets is arguably due to changing wholesale gas prices rather than NGG's purchasing performance per se. While both the industry and NGG have benefited, prices could have moved the opposite way. We would support further work to understand whether longer term schemes will consistently deliver value to customers.

Chapter 6: Achieving better alignment between SO and TO

We agree that it would be of overall benefit to consumers to better align the incentives of the SOs and the TOs as system operation activities can be affected by decisions made by the TO. For example, in the context of transmission the performance of the SO in managing the system in operational timescales is to some extent relate to the performance of TO in managing outages of the transmission system.

Ofgem has suitably characterised these interactions as "behavioural" and "capital expenditure". In principle, we agree that there should be a mechanism by which the TO can be incentivised to change the level of certain outputs. However, there needs to be considerable further work to specify this mechanism, which will need to sit alongside better aligned economic parameters within the TO and SO price controls. This framework would need to facilitate efficient trade-offs between the SO and TOs and provide increased transparency of the decision making processes where the SO and TOs are not under common ownership

We hope these views are helpful and if you wish to discuss any aspect of them in further detail, please do not hesitate to contact me.

Yours sincerely,

By email so unsigned

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