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Dear Giuseppina,

System Operator Incentive Schemes from 2013: Principles and Policy

Bearing in mind the different structure and nature of SO incentives in gas and electricity, we provide general comments on both schemes, below.

Electricity System Operator Scheme

We continue to believe that it is too early to be contemplating significant change to the SO incentive arrangements. The current scheme represents a significant departure from the previous methodology, with an incentive duration of two years and the adoption of extensive indexation within the target. It would be more appropriate to continue with this scheme for a while to ensure that it works appropriately before planning any further significant changes.

We are particularly concerned about the prospect of the scheme being extended out to four years' duration. As you will know from our previous responses on this issue, one of the biggest risks to BSUoS payers is that the incentive scheme is reopened due to an Income Adjusting Event, or similar mechanism, meaning that they are exposed to further costs. The likelihood of such a reopener occurring increases for longer schemes as it is more difficult to anticipate events that will have an influence on the level of costs incurred by the SO. This is why we were uncomfortable about the scheme being extended out to two years from the original one year duration. We feel that the success or otherwise of this extended scheme should be assessed before it is doubled in length again.

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We note that it has been suggested that sharing factors that the SO is exposed to should be increased from 25% to 40% in order to bring it in line with incentives provided through the RIIO mechanism. This is a significant increase in the strength of the incentive signal. However, it is not clear that this would necessarily drive any improved behaviour from the SO. A financial incentive is helpful, but this can be provided by more modest sharing factors. We believe that the sharing factors are currently too high and would suggest that they should be lowered to around 10% to 15%. Similarly, the caps and collars should not be moved significantly.

We would need to understand how any uncertainty mechanisms would work before we could comment on their appropriateness. However, we would be concerned if they resulted in a significant risk of being exposed to regular scheme reopeners as we mention above. Our experience of previous reopeners is that they are generally work in one direction resulting in additional costs to BSUoS payers. This is because industry parties generally are not in a position to argue that the target had originally set at too high a level. This is increasingly the case as a result of greater indexation within the target which means that industry parties don't know what it is until after the event.

Gas System Operator Scheme

We have overriding concerns about setting the underlying methodology for SO incentives for potentially an 8 year period, particularly in light of changing patterns of usage of the National Transmission System (NTS) and future European Code changes, both of which have the potential to significantly alter the wholesale trading arrangements in GB. As highlighted in previous responses to SO incentives, we favour shorter incentive periods as this is most likely to better reflect the use of the network and costs incurred in operating it, avoiding exposing consumers to excessive risks.

We are unclear what Ofgem's reference to gas and electricity SO interaction means in practice and would need to understand this in more detail. The suggestion is that the gas SO should take account of the electricity market, which appears broadly sensible; but National Grid should be careful that one market is not favoured over the other, or to impose penalties or restrictions on participants in one market because of what is happening in the other. Therefore such a scheme would have to be very clearly defined, if it were to be progressed.

As proposer of UNC Modification Proposal 0373, we understandably welcome the added focus on National Grid Gas (NGG) better meeting customer's needs for gas connections. However, at this stage, it is unclear what giving NGG a "*financial incentive to deal with all connection applications in a timely manner*" means in practice. By way of illustration, under UNC Modification Proposal 373, a maximum period of 9 months for producing a connection offer is stipulated, although connection offers made sooner than 9 months would of course be welcome by customers and are not precluded under the UNC. However, the deadlines set out in UNC Mod 373 represent a compromise between what Shippers/Developers want and what NGG has said it can deliver. Clearly, we do not have the revised connection process currently in place and therefore the accuracy of the proposed timescales is untested. We would therefore, not want to see an incentive scheme that awarded NGG for finishing connection offers early, when in practice they are able to already complete the majority of offers comfortably within the UNC timescales. Additionally, there is a risk of stipulating specific time periods in the SO Incentives which may then effectively preclude future UNC Modifications unless there is also a price control re-opener; e.g. as a results of linking the SO incentives to the specific 9 months UNC maximum time period for offers. Overall, we believe such an incentive scheme requires careful definition of what *exactly* is being incentivised here.

In terms of the potential residual balancing costs scheme, we strongly believe this proposal needs to be considered in much more detail by industry as it is only briefly outlined here and is lacking a full and necessary consideration of the issues. Ofgem states that "*such an incentive could result on NGG taking actions that were not close to the market price and therefore would have a greater effect on cash out prices, which could result in shippers having a greater incentive to balance their own positions*". We are not aware of evidence of an increase (or expected increase) in Shippers being out of balance and therefore what problem Ofgem is seeking to "fix" with this proposal / incentive. Above all, NGG should not be encouraged to potentially distort the traded market or affect liquidity by trading significantly out of line with market prices. We urge Ofgem and NGG to fully consult on such a proposal in detail to ensure the potential implications are appropriately captured.

Yours sincerely,

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