



Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Giuseppina Squicciarini
Head of Regulatory Economics
Ofgem
9 Millbank
London
SW1P 3GE

Telephone: 01738 512909
Email: Claire.Basil-Ratley@SSE.com

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Dear Giuseppina

System Operator (SO) Incentive Schemes from 2013: Principles and Policy

Thank you for providing SSE with the opportunity to comment on the above open letter. SSE is involved in the generation, transmission, distribution and supply of electricity, the production, storage, distribution and supply of gas and in the provision of other energy-related services.

We have detailed our answers to the questions asked in the attached annex; however we would like to highlight some key areas of concern to Ofgem.

1. Unaccounted for Gas (UAG)

UAG accounts for roughly a third of the SO costs industry are required to pay for. Over the last three years, the UAG cost faced by industry has been in excess of £300 million. The current UAG levels reported by the SO are clearly unacceptable, and we firmly believe that action must be taken by NG NTS to reduce these levels.

Earlier this year, Ofgem stated¹ that it is "considering a wide range of options ahead of setting SO incentives from April 2013" to solve the issue of UAG. We had expected the range of options to be provided in this consultation document for comment, however were disappointed to find that so little information was provided in relation to UAG.

We would urge Ofgem to treat the publication of these options as a matter of priority, to allow industry to provide comment on the proposals in a timely manner, and consequently enable Ofgem to come to a fully informed decision on the most efficient and effective method to use to set the SO incentive.

2. Total Balancing Costs (TBC)

Incentive

We do not believe it would be appropriate to expand the TBC incentive scheme period beyond the existing two year period because:

- o The role of the electricity SO is highly likely to change significantly over the next couple of years due to the introduction of a number of new policy and regulatory measures; and
- o The TBC incentive scheme has yet to been proven to be effective as it has only been in operation since April 2011.

It is clear that Ofgem has not fully taken into account the extent of the impact that the following new policy and regulatory measures will have on the role of the electricity SO:

- o The implementation of the Energy Market Reform (EMR);
- o The implementation of the European Network Codes;
- o The Transmission Constraints Licence Condition (TCLC); and
- o Changes in the regulatory framework that will arise as a result of the electricity significant codes reviews.

We acknowledge that Ofgem has proposed to introduce an Uncertainty Mechanism which will allow Ofgem to re-open the incentive period if it is found that the new policy and regulatory measures impact the role of the SO. However, as it is certain that these measures will affect the role of the SO, we do not believe it would be consistent with Ofgem's duty in respect of better regulation to introduce an extended incentive period when it is known that the re-opener will need to be used.

¹ Ofgem (01/02/12) "National Grid Gas System Operator incentives from 1 April 2012"

Even if Ofgem introduces an extended TBC incentive scheme period, we do not believe it will alter the SO's current behaviour as it is unlikely to take long-term actions if it believes that its role will change significantly in the next couple of years, and that the incentive scheme is highly likely to be re-opened under the uncertainty mechanism.

Given the level of uncertainty that exists in relation to the future role of the electricity SO, we believe that Ofgem should postpone the introduction of longer term incentives until these details have been finalised.

Current behaviour

We do not believe that the electricity SO currently acts in a commercially astute manner and do not believe that the introduction of an extension to the period of the electricity incentive scheme has resulted in an improvement.

We believe that the SO should be required to demonstrate that it uses all the market based options available to contract and trade efficiently. We believe that there may be merit in introducing an Economic Purchase Obligation to the electricity SO scheme. However, as a minimum we recommend that some form of independent audit/benchmarking process is introduced to ensure that SO are exploring all trading/contract solutions.

We believe the electricity SO must become more dynamic in relation to how it reacts to changes in the market. To date all changes have to go through a bureaucratic process which quite often takes a lot of time and resource and achieves very little. For example Wind balancing tools have been debated for over 2 years with no conclusion at this stage.

The SO has not published an updated cost forecast since the beginning of the current two year scheme. It is vital that the SO do so to allow suppliers to adjust their forecast to avoid large swings in the BSUoS cost that will ultimately be paid for by consumers. This situation would only be exacerbated if the scheme period were to be extended.

3. Gas Maintenance Scheduling Incentive

In July 2011, Ofgem published its first consultation document² regarding the SO incentives from 2013. In that document, Ofgem acknowledged that during previous gas SO incentive consultations, shippers had suggested that it might be appropriate to incentivise the SO to take into account the costs incurred by shippers pursuant to the maintenance schedule. Ofgem asked that respondents provide their views on the introduction of such an incentive.

We welcomed the proposal for the introduction of a new Maintenance Scheduling Incentive as we strongly believe an incentive is required to improve performance in this area. Our particular concern is with regard to changes being made to the originally agreed maintenance date with NG NTS being entitled to only give 30 days notice.

When NG NTS subsequently changes 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. There is currently no mechanism for the power station to recoup its losses from NGG.

Given the significant lost revenues that are incurred by generators when they are unable to generate, we believe the SO should be incentivised to keep to the originally scheduled maintenance date, (unless agreed in advance by mutual consent). If the SO does change the maintenance date, then the SO should be required to reimburse if not all, at least a proportion, of the losses incurred by the generator. The lost revenue could be calculated using a standard market rate or specific costs based on open book disclosure.

We were very disappointed to discover that no mention was made of the maintenance scheduling incentive in this open letter, and would urge Ofgem to provide further details of such an incentive in the next round of consultation.

4. Consultation Process

We understand that the intention of this open letter was to share Ofgem's views to date on the SO regulatory framework, and that the proposals detailed are still at an early stage of development. However, without any indication of the impact each change to the existing regime will have on the

² Ofgem (14/06/2011) "System Operator incentive schemes from 2013"

costs faced by industry, and ultimately consumers, we have struggled to provide detailed comment on the proposals.

It should also be noted that as the electricity output and cost incentives will be adjusted at the end of the scheme period for factors which are unpredictable or uncontrollable within that period, it is extremely difficult for us to forecast the level of costs we are likely to face. Consequently, it is vital that industry is confident that Ofgem has fully scrutinised the incentives and the consequential costs, when setting the scheme.

We urge Ofgem to ensure that more transparency is provided in relation to costs in the next stage of the consultation process, as doing so will allow consultees to provide Ofgem with fully considered views. We believe Ofgem should provide this transparency by publishing a full impact assessment to accompany the next consultation document.

We hope you have found our comments helpful. If you would like to discuss any of the points we have raised in further detail, please do not hesitate to contact me.

Yours sincerely

Claire Basil-Rathey
Regulation

Annex: Consultation Question Responses

1. Do you consider that we have captured the full role of the SOs going forward?

We believe that Ofgem has captured the current role of the gas and electricity SOs.

However, we do not believe that Ofgem has captured the full role of the gas and electricity SOs in the context of the next price control period, as Ofgem has not taken into account the impact that the following new policy and regulatory measures will have on the role of the gas and electricity SOs:

- o The implementation of the Energy Market Reform (EMR);
- o The implementation of the European Network Codes;
- o The Transmission Constraints Licence Condition (TCLC);
- o Changes in the regulatory framework that arise as a result of the electricity and gas significant codes reviews; and
- o Any gas security of supply measures Ofgem decide to implement as a result of its wider security of supply investigation.

We believe that these policy and regulatory measures are highly likely to alter the current role of the SOs, with the impact being the most significant on the electricity SO.

We understand that the detail of many of these measures has still to be finalised, but will be over the next couple of years. Given the level of uncertainty that exists in relation to the future role of the electricity SO, we believe that Ofgem should postpone the introduction of longer term incentives until these details have been finalised.

As there is far less uncertainty in relation to the future role of the gas SO, we believe it would be appropriate to introduce longer term incentives from 1st April 2013.

2. Do you consider that our minded to position on the length of the regulatory framework is appropriate?

We support Ofgem's proposal to fix the central SO regulatory framework (objectives, principles and the overall policy) for a period of eight years to encourage long-term thinking through a clear, transparent and stable regulatory framework.

We also support the principle of moving to a longer term SO output and cost incentive scheme for both gas and electricity. However, we only support the move to longer term schemes, on the basis that the regulatory environment is stable, and the incentives have been proven to be effective. We disagree with some of Ofgem's proposed timeframes for the output and cost incentives, however we still believe there is benefit in setting the framework for the eight year period to align with RIIO-T1.

3. Do you consider that our proposals regarding SO-TO interactions provide the SOs with sufficient incentive to consider interactions with the TO in a longer term context?

Yes. We agree with the principle that improvements made to the alignment between the SOs and TOs are likely to result in an overall benefit to consumers. However, where there is common ownership of the SO and TO, we believe it would be highly inappropriate to provide an economic incentive to drive SO-TO interactions as we believe this to be an integral part of the operator's role. Consequently, we welcome Ofgem's move away from its previous proposal to introduce a financial incentive to encourage SO-TO interaction.

We believe that putting in place the proposed payment mechanism should encourage the SO to improve its alignment with the TO sufficiently. However, as there has been so little alignment historically between the SO and the Scottish TO's, we believe that Ofgem should carry out a review of the payment mechanism every year for the first couple of years of the scheme, to ensure that the mechanism is creating the behavioural change Ofgem desire.

If once the review has been conducted, Ofgem does not feel that the level of alignment is still not deemed to be sufficient between these parties; an obligation rather than an incentive should be imposed upon the SO.

4. Do you agree with our minded to position on SO outputs, and the interactions with SO and TO outputs?

Stakeholder Satisfied

If the proposed stakeholder surveys are structured in such a way that they actually allow stakeholders to flag concerns, action is taken by the SO or Ofgem to mitigate those concerns, and the incentive reward or penalty faced by the SO is proportionate, we believe the introduction of a Stakeholder Satisfied incentive may be of benefit to the industry and ultimately consumers.

In order for this incentive to provide benefit to the industry, we believe that:

- o The survey must be targeted at the appropriate stakeholders i.e. covering new and existing stakeholders, and disconnections as well as connections;
- o Responses from stakeholders must be weighted appropriately i.e. if a stakeholder has multiple dealings with the SO, their comments should be given more weighting than a stakeholder who has only a one off experience;
- o Stakeholders should be fully consulted on the form of survey to ensure that they are able to feedback their views in a tangible form;
- o The survey must clearly differentiate between TO and SO activities; and
- o The results of the survey should be published in detail on the SO's website to improve transparency with regard to the SO's level of service provision.

Information on Renewable Generation

We support Ofgem's proposal to incentivise the SO to improve the accuracy of its forecasts. However, we do not support the proposal to incentivise the SO to publish the resultant information in a timely manner. We believe the requirement to publish such information forms part of the SO's core role and consequently, the SO should not need to be incentivised to carry out this task.

As Ofgem have proposed with regard to the publication of gas related forecasting information, we believe Ofgem should introduce a licence condition to require the publication of the information, rather than introduce a financial incentive.

Transmission losses

At this time, we have no concerns with the transmission losses output incentive proposed.

Reduction in Venting Emissions

We welcome Ofgem's statement that it believes it is appropriate to look carefully at the interactions between the SO's incentive schemes as we continue to believe it is inappropriate for the SO to have a specific 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 the SO in its Environmental Policy Statement 2009. We believe the SO is already adequately incentivised to minimise shrinkage through the UAG incentive and to further reward it under the guise of an "Environmental Incentive" is rewarding them twice and is excessive.

Ensure efficient and timely connections

We do not support the introduction of the proposed 'Ensure Efficient and Timely Connections' output incentive. As we believe that requirement to ensure connections are carried out in an efficient and timely forms already part of the SO's core role, we do not believe the SO should require a financial incentive to carry out this task.

If Ofgem feel this is an area where improvement is required, Ofgem should introduce a licence condition to require the SO to carry out connections in an efficient and timely manner, rather than introduce a financial incentive. It is important to note that all such requirements should be made applicable to disconnections, as well as connections.

Minimise Impact on the On The Day Commodity Market

We believe that the SO should continue to be financially incentivised such that any actions it takes in the OCM, are as close to the market price as possible.

We understand that incentivising the SO in respect of the total cost of its actions in the OCM (rather than on keeping actions as close to market price), could result in the SO taking actions that are not close to the market price and therefore would have a greater effect on cash out prices. We also recognise that this could in turn result in shippers having a greater incentive to balance their own positions. However, we believe that is inappropriate to attempt to influence shippers' behaviour via the SO incentives scheme. If Ofgem believe that shippers should be further encouraged to balance their position, this should be address via the Gas Cash Out SCR.

Accuracy of demand forecasts

As with electricity, we support proposals to incentivise SO to improve the accuracy of its forecasts. However, we believe the following improvements should be made to the forecasts to provide additional benefit to the market:

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

Minimise change in linepack

At this time, we have no concerns with the 'Minimise Change in Linepack' output incentive proposed.

Gas Maintenance Scheduling Incentive

In July 2011, Ofgem published its first consultation document³ regarding the SO incentives from 2013. In that document, Ofgem acknowledged that during previous gas SO incentive consultations, shippers had suggested that it may be appropriate to incentivise the SO to take into account the costs incurred by shippers pursuant to the maintenance schedule. Ofgem asked that respondents provide their views on the introduction of such an incentive.

We welcomed the proposal for the introduction of a new Maintenance Scheduling 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 generators when they are unable to generate, we believe the SO should be incentivised to keep to the originally scheduled maintenance date, (unless agreed in advance by mutual consent). If the SO does change the maintenance date, then the SO should be required to reimburse if not all, at least a proportion, of the losses incurred by the generator. The lost revenue could be calculated using a standard market rate or specific costs based on open book disclosure.

We were very disappointed to discover that no mention was made of the maintenance scheduling incentive in this open letter, and would urge Ofgem to provide further details of such an incentive in the next round of consultation.

5. Do you agree with our minded to position on the period for which the various outputs and associated incentives will be fixed?

We support Ofgem's proposal to fix the central SO regulatory framework (objectives, principles and the overall policy) for a period of eight years to encourage long term thinking through a clear, transparent and stable regulatory framework.

We also support the principle of moving to a longer term SO output and cost incentive schemes for both gas and electricity. However, we only support the move to longer term schemes, if the regulatory environment is stable, and the incentives have been proven to be effective.

Stakeholder satisfied

As this is an unproven incentive, we believe it should be set on a 2 + 2 + 4 or 2 + 6 year basis, rather than an 8 years basis.

Information on renewable generation & Transmission Losses

At this time, we have no concerns with the period proposed for these incentives.

³ Ofgem (14/06/2011) "System Operator incentive schemes from 2013"

Gas

As the existing gas SO incentives, with the exception of UAG, have been proven to be appropriate and effective, we agree with Ofgem that it is appropriate to extend the length of the gas incentive period to eight years.

6. Do you agree with our views on incentivising SO outputs?

In general, we support the principals Ofgem has used when taking a view on incentivising outputs. However, we noted that no analysis was provided in the open letter with regard to how the changes to the incentive scheme will affect consumers.

Any action taken by a SO can lead to costs being incurred, both directly by the SO and more widely by the market. Since consumers ultimately bear these costs, it is important that the SOs act in an efficient manner when taking such actions, to keep these costs as low as possible. We believe that, at the next stage of consultation, Ofgem should provide a full impact assessment of the costs industry and consumers will face as a result of the proposed changes to the incentive scheme.

7. What areas, in addition to DSR, should a broad environmental output cover? What is your view on having a financial (rather than reputational) incentive on NGET and/or NGG as SOs to encourage them to deliver against a broad environmental output?

We think the proposed coverage is sufficient, but we do not believe venting should be a financial incentive. We believe all of the environmental output incentives should be reputational, rather than financial.

8. What is your view on having a financial output incentive on the accuracy of NGET's forecast of wind generation and the timeliness and availability of the information on its website?

Please see our response to question 4.

9. What is your view on introducing an incentive based on the total cost of NGG's balancing actions? Should such a total cost incentive replace or be in addition to current incentives for NGG to minimise the impact of its balancing actions?

We do not support the proposal to introduce an incentive based on the total cost of the SO's balancing actions as we are concerned that it will create distortions in the OTD commodity market. We believe that the existing incentive regime has proven effective and created stability in the market, and as such, should remain.

10. Do you agree that the cost incentives we are minded to apply are appropriate? Please explain your reasoning.

Total Balancing Costs (TBC) Incentive

We do not believe it would be appropriate to expand the TBC incentive scheme period beyond the existing two year period because:

- o The role of the electricity SO is highly likely to change significantly over the next couple of years due to the introduction of a number of new policy and regulatory measures; and
- o The TBC incentive scheme has yet to been proven to be effective.

It is clear that Ofgem has not fully taken into account the extent of the impact the following new policy and regulatory measures will have on the role of the electricity SO:

- o The implementation of the Energy Market Reform (EMR);
- o The implementation of the European Network Codes;
- o The Transmission Constraints Licence Condition (TCLC); and
- o Changes in the regulatory framework that arise as a result of the electricity significant codes reviews.

We acknowledge that Ofgem has proposed to introduce an Uncertainty Mechanism which will allow Ofgem to re-open the incentive period if it is found that the new policy and regulatory measures impact the role of the SO. However, as it is certain that these measures will affect the role of the SO, we do not believe it would be consistent with Ofgem's duty in respect of better regulation to introduce an extended incentive period when it is known that the re-opener will need to be used.

Even if Ofgem introduce an extended TBC incentive scheme period, we do not believe it will alter NG's current behaviour as the SO is unlikely to take long term actions if it believes that its role will change significantly in the next couple of years, and that the incentive scheme is highly likely to be re-opened under the uncertainty mechanism.

Given the level of uncertainty that exists in relation to the future role of the electricity SO, we believe that Ofgem should postpone the introduction of longer term incentives until these details have been finalised.

In 2011, Ofgem introduced a fundamental change to the TBC incentive scheme by employing a new approach to modelling incentivised cost targets from that of previous schemes. We supported the changes proposed by Ofgem; however we requested that the new incentive be put in place for one year only to allow for a test period. If the incentive scheme was found after that year to deliver the desired outcomes, we stated that we would support the extension of the incentive to a multi year basis. Despite our comments, Ofgem chose to set the incentive period at two years. We also note that Ofgem acknowledges that further refinement of the SO's modelling may still be required within the next incentive period.

As we are now only one year into the new two year incentive scheme period and have no measure to gauge whether or not the implementation of the new approach has been successful, we do not believe that it would be appropriate to extend the incentive scheme period beyond the two year period.

Shrinkage costs & OM Cost

We support the continued use of the existing methodologies, and the timeframes proposed.

Gas and Electricity: Caps and Floors

We do not believe Ofgem has provided sufficient evidence in the open letter to allow us to calculate whether or not the sharing factors proposed for this cost incentive is appropriate.

We acknowledge that by limiting the gains or losses that the SO can achieve over the incentive scheme period, Ofgem also limits the incentive that the SO has to manage those risks. Limiting this incentive will influence the decisions taken by the SO with regard to all actions taken. However, we are very concerned that Ofgem appears to have failed to recognise that the use of caps and floors also protect market participants and consumers from the SO achieving excessive gains, and large swings in the incentive costs which are ultimately borne by consumers.

Before proceeding any further with the proposal to alter the cap and floors, we believe Ofgem should carry out an impact assessment of the proposal and publish the results to allow industry to provide further comment.

11. Do you agree that the parameters (scheme length, sharing factors etc.) we have proposed for the cost incentives are appropriate? Please explain your reasoning.

Please see our response to question 10.

12. Do you agree with our proposals to introduce a payment mechanism to encourage efficient SO-TO interactions?

Yes. As we agree with the principle that improvements made to the alignment between the SOs and TOs are likely to result in benefit to consumers, we support Ofgem's proposal.

We believe that putting in place a payment mechanism should encourage the SO to improve its alignment with the TO. However, as there has been so little alignment between the SO and the Scottish TO's historically, we believe that Ofgem should carry out a review of the payment mechanism every year for the first couple of years of the scheme, to ensure that the mechanism is creating the behavioural change Ofgem desire.

13. Do you agree with the factors we propose to consider when deciding on the role of the uncertainty mechanisms?

In general, we recommend that Ofgem should be strongly averse to reopening price controls or incentive schemes as the use of such retrospective regulation can undermine investor confidence in the market.

However, given the length of the proposed incentive scheme periods, we believe it would be appropriate to introduce a General Uncertainty Mechanism into the SO incentive scheme, on the understanding that it is only used to mitigate events which are unforeseen, have a low probability of occurring and have a significant impact upon the SO.

Although we agree in principle with the introduction of a Specific Uncertainty Mechanism, we believe it would only be appropriate to use this mechanism to target minor events. For example, we do not believe it would be appropriate to use this mechanism to mitigate the significant impact the EMR will have on the role of the electricity SO. As highlighted in our response to question 2, if an event is

expected to have a significant impact on the SO, the event should be taken into account when setting the incentive scheme and period of that scheme, rather than through the introduction of an uncertainty mechanism.

14. Do you agree with our initial view that the caps and floors on SO incentive payments could undermine the SO taking long term decisions and could undermine alignment of incentives between SO and TO?

We acknowledge that by limiting the gains or losses that the SO can achieve over the incentive scheme period, Ofgem also limits the incentive that the SO has to manage those risks. Limiting this incentive will influence the decisions taken by the SO with regards to all actions taken, not just those which are longer term or related to the TOs. However, we are very concerned that Ofgem appears to have failed to recognise that the use of caps and floors also protect consumers from the SO achieving excessive gains, and large swings in the incentive costs which are ultimately borne by consumers.

Before proceeding any further with the proposal to alter the cap and floors, we believe Ofgem should carry out an impact assessment of the proposal and publish the results to allow industry to provide further comment.

15. Are there any areas where you think specific uncertainty mechanisms should be introduced into the regulatory framework?

Please refer to our response to question 13.