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Giuseppina Squicciarini
Ofgem
9 Millbank
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19 September 2012

Dear Giuseppina,

RE: System Operator incentive schemes from 2013

Please find attached our response on the above consultation.

ELECTRICITY:

Question 1: In respect of transmission losses, do you agree with our proposal to put in place a reputational incentive and to remove the current financial incentive?

We agree that National Grid should be seeking to minimise losses as a matter of business as usual. A financial incentive has seemed to work in past years but if it is indeed the case that National Grid's ability to forecast and minimise costs is reducing due to the change in generation on the network, then it may be appropriate to remove the financial incentive in its current form. Of course, even if National Grid's influence is diminishing there should be some form of incentive to ensure that it controls losses to the extent that it is able. A reputational approach may well achieve this. We would support the introduction of this approach for a year or two, to see how it performs. There would always be the opportunity to reintroduce some form of financial incentive in due course.

Question 2: Please provide your comments in respect of our proposals for an incentive on renewable forecasting.

We would agree with National Grid being incentivised on its forecasting performance. Initially, it would appear sensible to keep the incentive simple and base it on an annual rather than seasonal target. Presumably, there are two benefits associated with this incentive. The first is the information provided to the wider market through the currently published forecast. The second is the benefit that an improved forecast should have on National Grid's ability to deal with the balancing a higher proportion of wind generation on the network. Therefore, it would seem appropriate to set the incentive against all of the forecasts that National Grid undertakes regardless of whether or not these are published or are for internal purposes only. We also note that it is likely that all four forecasts will be published in due course.

We have no strong preference over whether the target should be set against MEA or RMSE. A one or two year scheme would seem appropriate to allow an assessment of how well it performs.

Question 3: In respect of the incentive on energy balancing and constraint costs, do you agree that direct financial incentive should be removed?

It is a radical and controversial suggestion to remove a financial scheme entirely. However, we agree that the current form does not appear to be working. If there are serious concerns about the ability to forecast these costs going forward, then it would seem sensible that another approach is adopted. However, we would urge caution in abandoning a financial incentive entirely and suggest that the possibility of returning to the form of incentive which existed prior to the current could be explored.

Question 4: Do you agree that we should put in place a licence condition to enable us to disallow costs incurred by NGET if they are uneconomic or inefficient?
Question 5: Please provide you comments in respect or our proposals for a discretionary reward mechanism.

We will answer questions 4 and 5 together as they represent two sides of the same incentive.

If an ex ante approach is no longer feasible, then an ex post incentive appears to be the only other option. However, this will not be without its own challenges. For instance, there is a reasonable possibility that such an approach may make National Grid more averse to trying innovative solutions if the cost recovery can subsequently be disallowed. However, clearly having the ability to be rewarded for positive innovations can counteract this potential reluctance, depending on the strength of the incentive.

One issue which is of concern to charge payers is the ability of significant changes in charges to be imposed after the charging year has concluded. This concern originally related to the ability for Income Adjusting Events to be raised under the old scheme. If an ex post adjustment, either up or down, can be made as proposed, it is important to payers that this does not result in another ex post adjustment to the BSUoS charges that they have to pay for the charging year concerned. Our suggestion would be that any refund or payment should be rolled over into the charges for the following year.

Question 6: Do you consider that a cost incentive on black start should be retained? Do you consider that the proposed parameters for a black start scheme are appropriate?

It would seem appropriate to do so, given the increase in procurement expected. The form of incentive appears sensible.

Question 7: What are your views on NGET's proposals for commercial contracts with non-NGET TOs to incentivise them in respect of constraint costs caused by changes to their output plans?

We note that incentives are being developed as part of the RIIO-T1 price control and agree that the proposed contracts could cut across this work. We are also concerned that this could generate an incentive for TOs to initially organise outages in such a way, so as to exaggerate the requirement for such contracts and thereby maximise the returns achievable through them.

GAS:
Question 8: In respect of an incentive on greenhouse gas emissions, is your preference for Option 1 (penalty only) or Option 2 (upside and downside payment) and why?

We support Ofgem's proposed approach of NGG taking full responsibility for venting of methane from its own system. As a result, we agree with the proposed penalty only approach. We support Ofgem's more challenging target than that proposed by NGG, which should encourage continuous improvement by the SO.

Question 9: Please provide your comments in respect of our proposals for a residual balancing incentive. In particular, do you agree that by fixing the targets for the eight year period this will provide NGG with an incentive continuously to improve its performance in this area?

We support Ofgem's proposal not to materially change the residual balancing incentive and to effectively maintain the current arrangements, which seem to work well. We agree there is no pressing need to consider a cost-minimisation incentive at this stage.

However, we have strong concerns about the suitability of an 8 year incentive in this area and the plan not to re-open it for the first 4 years, however unsuitable (and costly / ineffective) it may be. We are unsure what benefits that fixing this incentive brings and are concerned that this incentive risks not reflecting the market to which it is meant to apply. We would prefer to see a fixed framework for this incentive, but perhaps an annual review to ensure it continues to reflect the daily balancing environment.

Question 10: Do you agree that we should continue to put in place a reputational incentive on NGG in respect of investigating the drivers of UAG? Do you support the proposed industry workgroup to assist the investigation of the drivers of UAG?

The large amount of UAG continues to be an important industry issue, particularly since little progress seems to be being made in reducing it, despite incentives on NGG being in place for a number of years. However, we recognise that there is no point in incentivising NGG in respect of something which it cannot control. Overall, we support NGG taking a leadership role in this area and industry meetings to consider the issues would be welcome.

Question 11: Please provide your comments in respect of our proposals for demand forecasting incentives.

All improvements in forecasting accuracy are welcomed, but we still believe the D-1 forecast is the most important and the forecast most relied upon by the industry – particularly those parties who do not have their own in-house forecasting capability. Therefore, the relative “weight” of incentives should remain in favour of the D-1 forecast.

a. **Do you agree that the improvement in the NDM forecast should be taken forward by the DNs?**

   Yes. This is something E.ON has raised repeatedly in consultation responses on SO Incentives. The DNs provide a key input into the forecast and therefore have the potential to significantly influence the accuracy of it. We are unclear what specifically is being proposed here, but would welcome more industry engagement on the matter.

Question 12: Do you consider that our proposals in respect of maintenance could address the concerns that you have in respect of NGG’s behaviour in this area? Are our proposals appropriate and likely to be effective?

We support the proposal of a financial incentive to minimise the number of NGG-instigated changes to agreed maintenance plans. As Ofgem correctly notes, changes to maintenance plans, particularly at short notice can have serious financial and operational impacts for the affected parties and therefore it is important that greater emphasis is placed on considering the customer when NGG carries out its maintenance programme.

We support the introduction of incentives to reduce the incidence of changes by NGG to maintenance plans. However, focusing solely on changes instigated by NGG may be misleading, since the original maintenance plan (over which Shippers have little control) may be completely unsatisfactory, leading to changes being requested repeatedly by Shippers. We suggest that NGG needs to focus more on accommodating Shippers preferences in the original maintenance plans, or at least negotiating mutually satisfactory outcomes, which may lead to fewer changes down the line.

We agree with Ofgem's assessment that better and earlier communication, whilst most welcome, is essentially a business-as-usual practice and therefore does not merit a specific incentive scheme and can likely be best measured in terms of stakeholder survey results.

Question 13: In respect of Operating Margins, do you agree with our proposal to put in place a reputational incentive and to remove the current cost incentive?

Yes, although we note that removing the cost incentive potentially exposes the Shipper community to higher costs and this issue must be closely monitored by Ofgem to ensure OM procurement remains costs reflective.

Question 14: Please provide your comments in respect of our proposals for a shrinkage incentive, in particular:

a. **Do you agree that it is appropriate for NGG to have in place a volume methodology statement?**

Yes, this will be a welcome increase in transparency, but it must be written in a meaningful way, otherwise it will either be too complicated to understand for those without access to the relevant data, or too simple to be of any real value.

Overall, Ofgem's proposals on shrinkage, which are designed to minimise the procurement cost (which represent a very significant cost to Shippers), are welcomed.

SECTION: Six
Question 15: Do you agree with our proposals for uncertainty mechanisms and on not including a risk premium?

We do not support inclusion of a "risk premium" and believe that NG is already sufficiently funded and organised to effectively manage risk, without charge payers (and ultimately customers) having to pay a premium for this.

Given the proposed length of some schemes of up to 8 years in duration, it is appropriate to allow the opportunity to revise SO schemes, although Ofgem should be seeking to implement a fixed framework, to allow performance year-on-year to be tracked. This is not always possible when incentive structure or parameters are constantly changing.

However, our key concern in this area is the proposal to remove the current ability of parties other than Ofgem or NGG to raise an income adjusting event. We urge Ofgem to reinstate this right in its final proposals; which has been exercised previously by a Shipper in respect of Fleetwood incremental entry capacity and although ultimately unsuccessful, led to a review of the IAE procedure and the process for triggering of revenue drivers for capacity.

Other Issues

Connections

We are pleased to note that Ofgem intend to closely monitor NGG's performance against the UNC Mod 373 requirements and agree that should performance be inadequate, then it may be necessary to re-consider the approach in terms of incentives / penalties. Industry debate on aligning connections and capacity are ongoing and it would be wrong to pre-judge the outcome with specific SO incentives at this stage.

Information Provision

Although in the past we have called for NGG's financial incentives to be removed, we believe any replacement arrangement needs to carefully consider the significant extent to which Shippers now rely on NGG's website to feed data into their own systems; a trend which can be expected to continue. A transparent and accountable measure of website and data availability needs to be in place to ensure the industry can rely on this crucial service.

Should you have any further questions please contact me on the above number in first instance on gas issues, or Paul Jones on 02476 183 383 for electricity matters.

Yours sincerely

Richard Fairholme