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21st September, 2012

System Operator incentive schemes from 2013: Initial Proposals July 2012

Dear Giuseppina

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

We are not convinced that System Operator (SO) incentives need to be set for eight years in line with the Transmission Owner (TO) price control. As incentive schemes become longer, there is an increased risk of windfall gains and losses. This risk will be amplified as the way that the gas and electricity systems are operated in future will need to change and setting meaningful, long-term SO incentives will become more difficult. The introduction of uncertainty mechanisms such as specific re-openers, ex-ante or ex-post adjustment mechanisms in conjunction with profit caps and floors highlights the difficulty of setting targets. This will introduce additional complexity and could lead to increased volatility and unpredictability in transportation charges used to recover SO costs.

The overarching regulatory framework is changing with the introduction of RIIO which we believe creates an opportunity to review fundamentally the approach to SO incentives. Under RIIO, a number of the TO outputs will be delivered by the SO, so it is important that there is clarity between the two roles. In our view, the boundary between the TO and SO roles has become increasingly blurred and this is likely to continue under RIIO. Where the companies are under common ownership, outputs and incentives set under the TO and SO controls must be properly aligned such that National Grid exploits synergies to drive the most efficient and economic operation of the networks. Historically, it has not always been transparent where these trade-offs have occurred.

We have long argued for the development of a performance-based approach that relates to specific areas of controllable costs where National Grid as SO should have relevant incentives to influence outcomes. Synergies between the TO and SO should be externailsed and set out in more commercially-based shadow contracts. This would improve transparency and help to reveal true efficiency gains rather than windfall gains from external changes out with the SO's control, such as the rapid increase and subsequent decrease in commodity price. A performance-based scheme should provide National Grid with sufficient returns to

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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. Ultimately, the SOs' performance would be underpinned by its licence obligations.

Our view is that the performance based scheme is akin to Ofgem's proposals for NGET's Balancing Service Costs, although the assessment of performance and magnitude of any benefits needs to be better understood. It is interesting to note that the basis of the proposal is "that NGET could be able to retain a proportion of any measurable net benefit to consumers resulting from the actions it takes that go well beyond "business as usual"."[1]. Subject to a robust definition of what constitutes business as usual, we believe that this approach should form the template for the design of all SO incentives, where the onus is on the SO to demonstrate to Ofgem how its performance has led to measurable benefits.

As we support the development of short-term, performance-based incentives, we have only provided additional comments in respect of new incentives or policy areas proposed by Ofgem. These are set out below in Appendix 1.

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

Charles Ruffell
Economic Regulation

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[1] System Operator incentive schemes from 2013: initial proposals Overview July 2012

APPENDIX 1: CONSULTATION QUESTIONS

SECTION Four: Electricity SO Incentives

Question 2: Please provide your comments in respect of our proposals for an incentive on renewable forecasting. In particular:
a. Do you agree that an incentive is appropriate?

b. Which renewable output forecast would you like to be incentivised (5pm, 5am, 11am or 11pm)?

c. Do you have a view on which error measure should be incentivised and whether the monthly target should be set on an annual or a seasonal basis?

d. Do you agree with the proposed cap, floor and range of the incentive?

e. Do you agree that the incentive should initially be set for 2 years?

Given the forecast penetration of renewable generation and the impact of intermittency on both the electricity and gas networks, we agree that NGET should develop its forecasting capability in this area.

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

Yes, we agree with Ofgem's proposed approach for a more widely specified, performance-based incentive.

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?

A Licence Condition appears to be required to protect consumers against the pass through of the inefficient costs. We think the establishment of the assessment panel will be key, as will the introduction of robust governance arrangements for the panel.

Question 5: Please provide you comments in respect or our proposals for a discretionary reward mechanism. In particular:
a. Do you consider that the proposed process for agreeing to a reward is appropriate?

b. Who should be the members of the panel that decides upon reward requests?

c. Is the size of the potential reward appropriate?

d. Are the examples of behaviours that might lead to a reward being made appropriate?

We support the principle of a discretionary reward mechanism. We think the establishment of the assessment panel will be key, as will the introduction of robust governance arrangements for the panel.

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 would support measures to develop further the alignment between SO and non-NGET TOs priorities. Demonstration of the results of these contracts will be important.

SECTION Five: Gas SO Incentives

Question 11: Please provide your comments in respect of our proposals for demand forecasting incentives. In particular:
a. Do you agree that by fixing the targets for the eight year period in respect of the D-1 forecast this will provide an NGG with an incentive continuously to improve its performance in this area?

No, we are not convinced of the benefit of setting "fixed" targets that are subject to reopeners.

b. Do you agree with our proposal to amend the calculation of the error target, including increasing the weighting for days of higher demand?

As higher demand days, ceteris paribus, have a higher impact on the system we agree with the proposed amendment.

c. Do you agree with our proposals for the D-5 to D-2 forecast incentive?

These forecasts have little value for our business and we do not really see their wider benefit, given the level of uncertainty the further away from Day D. The emphasis should remain on the D-1 forecast.

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

Yes, we agree.

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 have no specific concerns in this area and our experience is that NGG works flexibly and in collaboration with Users to coordinate maintenance. Both NGG and User-initiated changes have been agreed. We do not see the need for specific incentives. Maintenance is a good example of where "business as usual" and enhanced performance need to be carefully defined.

If an incentive was introduced, it would be more meaningful if the affected party was compensated directly rather than indirectly via adjustments to the SO commodity charge or there was a downside only incentive.

SECTION Six: Uncertainty Mechanisms and Risk Premium

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

We can see the benefit of having a mechanism to reopen the price control settlement in light of a material change in the background against which it was set. The IAE mechanism has the benefit of being available to all industry parties, although the materiality threshold could be increased. Our concern with the uncertainty mechanism is that the opportunity for wider industry challenge is removed.

We agree that a risk premium should not be included. The exposures faced by the SO should be proportionate to its ability to manage the risks and the schemes need to be calibrated to remunerate the SO for its demonstrable performance.