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Dear Giuseppina,

**Electricity System Operator incentive schemes from 2013:
disallowing costs and the efficiency in system operations reward scheme**

We welcome the opportunity to comment on Ofgem's recent overview document covering disallowed costs and the efficiency in system operation reward scheme.

We recognise the difficulties that have come to light in this current incentive scheme with regards to forecasting and the need for significant and unwelcome retrospective adjustments. We believe the latest proposals, in particular in relation to improving the accuracy of NGET's BSUoS charge forecasts, are a welcome development. However, importantly, this does not ignore the longer term aspiration of developing a robust financial incentive on NGET's balancing costs, which we agree should be the longer-term goal.

Key to us is that any incentives should not be about rewarding activities or behaviours that are matter of course.

Attached are our responses to the specific questions asked. Should you wish to discuss any aspect of this response, please do not hesitate to get in contact.

Yours sincerely,

Gillian Hilton
Regulation

ANNEX

SECTION: Two

Question 1: Do you agree with the way in which we propose to monitor the SO's costs?

Presumably Ofgem will have a sense for how effective its current monitoring of NGET's activities is and we understand that Ofgem is proposing to build on this. We believe the 'tiered' approach outlined by Ofgem is appropriate and we support the application of a threshold to determine whether or not an informal review is appropriate.

Question 2: Do the various steps of the process we propose to follow to disallow costs seem appropriate?

Yes.

Question 3: Is the proposed threshold level, and the way in which it will be applied, proportionate?

Balancing costs are relatively sensitive and can move considerably year-on-year in response to wholesale prices and market events. We agree with the use of a trigger, but question whether the level (0.5% of the previous year's balancing costs) is too sensitive.

Question 4: Please provide your views on whether it would be appropriate to introduce a limit on the maximum level of costs that can be disallowed?

Providing the process of monitoring NGET's costs is reasonable and, as proposed, considers only information that NGET could reasonably have had access to at the time, we do not believe it is necessary to introduce a floor.

Question 5: Do you agree with our examples of uneconomic or inefficient costs? If not, why not?

Yes. This provides a helpful overview of the types of behaviours that could be considered inefficient on NGET's part. We understand that this is not intended to be an exhaustive list.

Question 6: Should any disallowed costs be clawed back retrospectively or prospectively?

In order to 'refund' the 'right' parties, in this instance, we believe disallowed costs should be clawed back retrospectively. As we understand it, BSUoS costs are already subject to a final reconciliation mechanism; as such, it would seem sensible to try to utilise this existing mechanism to accommodate any disallowed costs identified within final reconciliation timescales.

In the event that this is not possible and disallowed costs are subject to prospective recovery, it would be key that this future claw-back was well-signalled to the market, i.e. year ahead, to ensure that retail contracts in particular had an opportunity to reflect this.

SECTION: Three

Question 7: Do you agree with the proposed process for granting rewards?

As per paragraph 3.22 of Ofgem's overview document, we understand why the payment of any reward is not realised until year 3. What is not clear from this document or Appendix 4 is how the reward is paid for eligible projects that do not come forward in year one. Does the

'commitment' to reward over the subsequent period continue or is the reward condensed in some way?

Question 8: Is it appropriate to include an “ex ante” option for granting rewards, when significant up-front costs for the SO are involved?

Yes, providing there are adequate controls in place, we believe an ex ante element is less likely to limit the scope of NGET's thinking and innovation.

Question 9: How should the net benefit to consumers be measured?

We consider that there may be parallels with similar initiatives in networks regulation in terms of measuring the benefit to consumers, which could be applied here.

Question 10: Have you any views on the composition of the independent Expert Panel?

This should be independent from the Authority and be balanced in terms of the individuals' expertise and backgrounds.

SECTION: Four

Question 11: Do you agree with our proposal to introduce a financial incentive on the accuracy of the BSUoS cost forecasts produced by the SO?

As outlined in our previous response, we believe more should be done to improve the accuracy of NGET's BSUoS cost forecasts. We highly value BSUoS forecasts as part of our planning process and, as such, welcome the introduction of this incentive.

Question 12: To what forecasting time period should the incentive apply? (We have proposed the incentive should apply to a year-ahead forecast)

We agree that this incentive should be based on a year-ahead forecast. However, we believe it would also be helpful to include a longer-term forecast (2-3 years) outside of the incentive mechanism.

Question 13: Do you agree with the proposed parameters for the scheme?

For this incentive to be effective, we agree that it should be symmetrical. We are comfortable with the proposal to combine internal and external balancing costs into a single target.

Question 14: Do you have a preference for the timing of the submission of the forecast to the Authority? (We have proposed 14 days before commencement of the scheme year).

Whilst 14 days before commencement of the scheme year would be appropriate for the final forecast, for our planning purposes we would want to have sight of a draft forecast in December / January.

Question 15: Is it appropriate to require NGET to continue developing its models?

Yes, this is key. We support Ofgem's view that a long-term financial incentive on balancing costs should be the aspiration.