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**National Grid Gas (NTS) System Operator Incentives
Consultation on Shrinkage and Residual Balancing Incentive Issues
August 2008**

Dear John,

Thank you for providing us with 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.

Energy balancing is a primary shipper responsibility and incentives on the SO should reinforce its residual balancing role and encourage it to take actions when operationally necessary. We would make the following comments:

- We believe that there should be a residual balancing incentive on National Grid and that the price performance measure, which incentivises gas balancing trades at prices close to the system average price should be retained and potentially enhanced;
- The effectiveness of the linepack incentive is less clear. Operational necessity is a key driver rather than the prospect of incentive revenues and linepack cannot be managed to a fine resolution as implied under the current incentive structure. We support a review of this incentive with its parameters potentially relaxed;
- At this stage we are not convinced by the requirement for or practicality of the proposed inter-day energy transfer service but would welcome further development in this area;
- The activities covered by the shrinkage incentive are wide-ranging and diverse and National Grid has only limited influence over certain elements. There is additional analysis required in

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- determining the scheme parameters and identifying the principal drivers. We agree that forward looking gas prices should be used, but believe that more work is required into how that reference price is determined. Our preference of for National Grid to procure its electricity requirements from suppliers;
- A key element of the review is consideration of the extent to which the annual schemes could be replaced by schemes more aligned to price control timescales. Where longer-term incentive schemes allow the SOs to trade-off operational costs against investments that would only reduce costs over the course of several years these should be considered;

Our detailed comments in response to the questions raised in the consultation are appended to this covering letter.

We hope these views are helpful and if you wish to any aspect of our response, please do not hesitate to contact me on 01793 893983

Yours sincerely,

By email so unsigned

Charles Ruffell
Economic Regulation

CONSULTATION QUESTIONS

Question 1: Do you believe an objective of the Residual Balancing Incentive should be to try and provoke National Grid to act to avoid Shippers transferring imbalances between gas days (thereby upholding the polluter pays principle) or to trade against the physical requirements of the system thereby potentially resolving imbalances on different gas days?

The reality appears that operational drivers influence National Grid's linepack decisions as much as gaining incentive revenues. While we recognise that it is important to correctly target imbalance costs, we believe that true residual balancing decisions will be taken against physical as opposed to commercial reasons.

Question 2: Should the objective of the Residual Balancing incentive take account of accuracy of information from both National Grid and Shippers, particularly in relation to a daily demand forecasting element to the incentive and a mechanism by which accurate Shipper nominations could be incentivised? Do you have any views on how this could be achieved?

We do not think this should be an explicit objective as shippers already face sufficient incentives to provide accurate nomination information.

Question 3: What are the effects or impacts that Shippers experience resulting from National Grid's residual trading behaviours?

National Grid's trading behaviour is reasonably predictable and this is a consequence of their actual observed performance in the market and the transparency created by the publication of the SMPS and Procurement Guidelines and reporting through the Operational Forum. This allows shippers to interpret National Grid's actions and respond appropriately. The timing of National Grid's actions may be argued to limit shipper's opportunity to respond.

Question 4: Have the Residual Balancing Incentives delivered against their original objectives?

The price performance measure has broadly delivered against its objectives, but it is less obvious that this is true for the linepack measure. There is evidence that National Grid trade-off between the two incentive elements and this might reflect the relative influence that it can exert over each.

Question 5: Having weighed up the implications, do you believe the two elements of the Residual Balancing incentive should be retained and should their relative incentive properties be changed to promote either more or less residual balancing activity?

As highlighted in Q4 above and as National Grid point out the price performance measure and linepack measure may sometimes conflict and National Grid's behaviour is driven more by the price performance measure over which it has more control. The price performance measure should be retained. We believe that some form of linepack measure incentive is still required but that the parameters need to be relaxed or perhaps reformed. If this change in relative importance between each element does occur, the incentive associated with the price performance measure should be sharpened.

Question 6: Given the operational requirement to increase linepack levels in periods of higher demands, what are your views in relation to setting an absolute linepack target level at the start of the day (rather than driving a return to opening linepack?)

This approach has some merit and we would welcome further detailed proposals in this area.

Question 7: What are your views on adjusting financial risks/rewards based on the quality of information provided by market participants?

We do not support this. It would introduce additional complexity and, in any case, National Grid's difficult balancing days are not always triggered by inadequate shipper information.

Question 8: Do the incentive risk/reward parameters need reviewing on either PPM or Linepack in light of market changes since they were originally set?

It is always difficult to judge what might have happened had the incentives been set differently or not introduced at all. The incentives have generally worked but, as we point out in Q5, the balance between the two components of the incentive could be adjusted given operational experience. We do not advocate making the risk/reward parameters more generous.

Question 9: Do you have any views in relation to re-establishing this incentive for multiple years e.g. 3?

The benefit of a longer-term incentive scheme would be to allow the SO to trade-off operational costs against investments that would only reduce costs over the course of several years. In our view, given the clear operational role of the residual balancing incentive, longer-term incentives would not be of benefit.

Question 10: If a linepack incentive is established, should a stepped payment structure be developed rather than the current linear structure which suggests an infinite balancing resolution?

A stepped approach may have merit if it better reflects National Grid's ability to manage linepack. In turn, balancing might be manageable to a finer level of resolution if NG took more physical/locational actions

Question 11: Do you believe that such a service concept would be an enhancement to the efficiency of the wholesale gas market?

At this stage we are not convinced that this service is either required by shippers or can be practicably delivered by National grid. The likely available volumes seem modest and shippers will only use this service if they anticipate their exposure to imbalance on any day can be lessened and will encourage inter day arbitrage. The service would be subject to discretionary release and shippers will need to understand how frequently it could be made available. A further concern is the impact on day-ahead and with-in day liquidity. The service will introduce significant extra complexity operationally, from neutrality/invoicing perspective and will have a systems impact.

Question 12: Do you have any views on what the most appropriate mechanism/platform is for procuring this service?

It is hard to see a 3rd party operator establishing a product trading platform unless there was a demand for such a product. Using Gemini is likely to be costly and complex and raises the question of how would development be funded.

Question 13: Please provide feedback on how the timing of the release of this service, and also on the product length, would affect its potential value to shippers.

Releasing the product across a weekday/week-end (or vice versa) would only be of interest to shippers if they could carry forward a short position from a weekday to a week-end or a long

position from a week-end to a weekday due to the current weekday/weekend spread, although this spread might narrow if this were introduced.

Question 14: How would volumes available and frequency of availability affect your perception of the value of this service? Is there a deminimis level below which it is not worth pursuing?

As noted in our response to Q11, the likely volume, which will be somehow linked to any linepack measure, seems unlikely to be sufficient to satisfy the collective needs of the entire shipper community. The service would need to be available regularly to support the operational and systems resources shippers would have to expend to participate.

Question 15: What market information would you want to see accompanying such a service?

The service needs to be better defined before we can comment meaningfully. As a minimum some form of release methodology statement is required.

Question 16: Do you have any views on how to deal with the impact of transfer on PCLP?

PCLP is one of the fundamental measures used by market participants to monitor and trade in the gas market and we would require to understand the relationship between PCLP and the quantities made available under any service.

Question 17: Would your organisation be interested in making use of such a service, and are there any other issues you wish to raise at this time?

The service needs to be better defined before we can comment meaningfully.

Question 18: Fundamentally, should minimising compressor fuel use and therefore compressor operation remain an objective of the shrinkage incentive?

On balance we support retaining an incentive to minimise compressor fuel usage as shippers pay for compressor fuel used (through shrinkage).

Question 19: Do you believe the 2008 TBE Base case at seasonal normal demand levels forms an appropriate set of supply and demand assumptions to input into a CFU forecasting model?

Yes.

Question 20: Do you support the development of target drivers to move incentive target in line with key CFU drivers as an appropriate way of insulating against the most significant external factors? Would an effective target driver provide sufficient confidence to set an incentive for multiple years (e.g. 3 years)?

We support target drivers based on statistical modelling but believe appropriateness of them must continue to be assessed as entry flows change (i.e. using St Fergus alone may become increasingly irrelevant). Incentive parameters could be set for multiple years providing there are investment alternatives that could deliver benefits over a number of years.

Question 21: Do you have any comments on the potential alternative modelling / target setting approaches for CFU target setting purposes outlined above?

The distance travelled model and theoretical network model look costly and complex options and because they are still reliant of locational supply and demand assumptions we are not convinced it will offer any benefits over the current model.

Question 22: Do you believe retaining a quarterly scheme enhances or reduces the effectiveness of the incentive compared with an annual scheme?

The quarterly scheme should be retained.

Question 23: Given National Grid's indirect influence over UAG volumes, should the current shrinkage incentive be changed to incentivise and measure National Grid directly on the activities it undertakes which influence UAG, rather than on UAG outturn? Do you have any views on which activities should be targeted?

As a general approach, incentives should only be on those areas where National Grid has some direct influence, so there may be merit in revising the incentive. Activities should in the first instance be centred on more frequent and rigorous meter validation checks on their own meters and pro active programme of independent witnessing of validation of DNO/Direct Connect meters. This will help to highlight and correct problems associated with the disparity and appropriateness of the validation procedures and enhance meter assurance

Question 24: Given the timescales needed to influence some of the UAG drivers do you think an incentive for UAG should be provided over a longer period e.g. 3 years?

Yes the incentive should be designed to apply for remainder of price control.

Question 25: We also invite views on whether Ofgem should additionally consider progressing financial incentives on meter owners directly to drive improvements in metering performance to potentially reduce UAG levels.

More frequent and vigorous meter validation could obviate the need for considering new financial incentives on meter owners and promote an enhanced climate of compliance with exiting obligations from meter owners.

Question 26: We would welcome views in relation to National Grid Gas becoming an electricity supplier to supply its electric compressors and if supported whether this should be encouraged by the incentive structure or funded at next TPCR.

We would favour National Grid purchasing its electricity requirement competitively from current electricity suppliers rather than becoming an electricity supplier itself. If National Grid is to be allowed to become a supplier this should be encouraged through the incentive structure.

Question 27: We would welcome views over whether a methodology based on a wholesale prices uplifted by a %age to represent retail costs is an appropriate form of benchmark going forward, and whether a methodology which tracks prices over a likely procurement period (as the GCRP does) is appropriate.

This is an appropriate basis for establishing a reference price.

Question 28: We welcome views as to whether, due to their location specific nature, delivery charges should continue to be treated separately to the reference price methodology.

We agree that it is appropriate to treat them separately.

Question 29: We welcome suggestions by market participants (particularly those with electricity retail businesses) as to how an appropriate retail benchmark could be derived for a large industrial load of the order of 80MW and any relevant factors which should be considered.

We have no suggestion..

Question 30: We welcome views on the appropriateness of deriving a different reference price to apply to outturn UAG volumes in the event National Grid is not directly incentivised on reducing UAG volumes.

SAP or Heren mid point within day price would seem appropriate reference price for UAG

Question 31: Are there any other points that you would like to raise in relation to the setting of the Gas SO Incentives from April 2009?

No.