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Dear John,

RE: NGG (NTS) - Consultation on Shrinkage and Residual Balancing Incentive Issues

E.ON UK welcomes National Grid Gas (NGG) sharing its thoughts on its proposed SO incentive arrangements. We welcome the opportunity to get involved in development of the incentives; however, we have an on-going concern about the suitability of the monopolist, NGG, setting its own incentives and an apparent lack of Ofgem involvement in the development process. We firmly believe Ofgem should be focusing its attention on monopoly regulation, since this is where it has the relevant expertise and knowledge, rather than obliging Shippers who do not have access to the same level of information, to “police” NGG. A Shipper’s role in this process should be to provide our operational insight and feedback to inform development of incentives – not to be reviewing and setting detailed incentive structures.

Residual Balancing

Q1. 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?

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The current “zero linepack change” incentive certainly appears to drive NGG’s behaviour. In last year’s response, we thought there may be merit in considering abandoning the current linepack incentive on the grounds that operational drivers (i.e. the safe operation of the NTS) should have a more significant influence on NGG’s behaviour than the linepack incentive.

On reflection, we still consider that the current structure is not delivering any tangible benefits; particularly in terms of operation of the system, but we believe there may be a case for retaining a form of linepack incentive to ensure appropriate cost-targeting and to prevent large volumes of gas being transferred between days.

Q2. 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?

Shippers will almost certainly be carrying out their own demand forecasting already, so we do not believe that there is any merit in extending NGG’s incentives to include daily demand forecasting accuracy. Providing accurate and timely information is something that NGG should be doing already as System Operator.

We do not understand what is driving a need for more accurate shipper nominations. If there is a particular problem, this should be addressed transparently through the UNC governance process.

Q3. What are the effects or impacts that Shippers experience resulting from National Grid’s residual trading behaviours?

From a Shipper’s perspective, at times there doesn’t seem to be much consistency about NGG’s residual balancing behaviour and consequently its actions can take the market by surprise. Recognising that there is greater diversity in supply and demand sources, we have nonetheless observed NGG take action one day but not the next; despite what appears to be the same market conditions. We also note that NGG appears to be very reticent to take balancing actions during normal daily working hours, when doing so, it could be argued, would have more effect. Instead, NGG often takes actions late in the day when response is likely to be minimal and therefore the potential impact on imbalance prices is more significant.

Q4. Have the Residual Balancing Incentives delivered against their original objectives?

Price Performance Measure

Given that default SMPs apply for ~70% of the time, it could be reasonably assumed that the market is working in terms of “incentives” for Shippers to balance, thereby reducing the need for residual balancing actions by NGG.

Linepack Measure

Whilst the incentive can be considered effective in terms of (quite rightly) preventing large imbalances being transferred between days, we believe that the linepack incentive is driving NGG to take residual balancing actions which are not always necessary – i.e. in order to drive to a certain linepack level rather than just to maintain safe and efficient operation of the system. We do not believe this is an efficient outcome, because residual balancing actions taken by NGG to maximise the gains or minimise the losses from the current linepack incentive structure have an unwanted and avoidable impact on imbalance prices, which may adversely affect Shippers.

Q5. 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?

We agree that NGG should be incentivised to trade as close to market when taking balancing actions, however, this should only be for maintaining system operational requirements. Due to what we view as potentially unnecessary residual balancing being carried out, we do not support the continuation of the current linepack incentive. If it is to be retained, but in a different structure, then we believe further consultation would be required before implementation.

Q6. 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?)

If the Shipper community were aware of the opening linepack levels for varying demands then we would question whether this would drive the community rather than NGG having to enter the market in order to achieve the linepack level. This would seem to put greater onus

onto Shippers to balance the system. With this in mind, we are uncertain how NGG could be incentivised around this objective, given their limited role.

Q7. What are your views on adjusting financial risks/rewards based on the quality of information provided by market participants?

We do not believe it would be appropriate to do this. In essence, NGG is requesting to be paid more for balancing of the system on a “difficult day”. NGG cannot balance the system alone: It is the Shippers who bring on and off-take gas, not NGG, so we fail to see why they should be paid more for taking balancing actions in the same circumstances as faced by Users of the system.

In addition, it is important that the parameters for incentive schemes should be known in advance in order to promote the appropriate behaviour by NGG. Any adjustment that related to errors in shipper nominations as judged against actual would not be known until after the day, so could not determine behaviour on the day.

Q8. Do the incentive risk / reward parameters need reviewing on either PPM or Linepack in light of market changes since they were originally set?

Given the more changeable market that we now face, it may be appropriate to give consideration to this issue, but this is not something we have the relevant expertise to be able to comment on.

Q9. Do you have any views in relation to re-establishing this incentive for multiple years e.g. 3?

We believe that single year incentives are more effective, targeted and cost-reflective than multiple year arrangements. This is particularly pertinent for operational incentives (such as residual balancing) which are based around short timescales.

Q10. 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?

However the incentive is structured, we would prefer to see NG taking balancing actions to meet system needs rather than a particular linepack target or band.

Potential New Linepack Service

Q11. Do you believe that such a service concept would be an enhancement to the efficiency of the wholesale gas market?

We do not believe that this would be an enhancement to the efficiency of the gas market and we do not consider that a market exists for this type of service. Marketisation of linepack has historically also been directly linked to wider trading gas reform (e.g. “Ofgem’s revised proposals to reform the gas balancing regime – May 2002”), including shorter gas balancing periods, reform of cash-out, etc. We do not believe that currently there is any industry appetite or indeed, demonstrable need for such reform.

The only advantage we see of this service is for NGG - within-day imbalance costs and risks that are incurred by NGG are instead transferred inappropriately onto Shippers who purchase the product.

Q12. Do you have any views on what the most appropriate mechanism/platform is for procuring this service?

We are unconvinced by the need for yet more auctions, which would only add to the current levels of complexity faced by Shippers. We do not support this proposed service and therefore have no views on an appropriate platform or product.

Q13. 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.

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Q14. How would volumes available and frequency of availability affect your perception of the value of this service? Is there a *de minimis* level below which it is not worth pursuing?

We have concerns about NGG’s suggestion that this product would only be made available when “operational circumstances are favourable”. It is not clear what would need to happen for the product to be made available, which severely limits its potential utility for Shippers.

Equally, we believe there may be serious implications in terms of residual balancing with NGG taking balancing actions just to accommodate this product and thereby having an (unwelcome) greater role in setting system prices through their actions.

Q15. What market information would you want to see accompanying such a service?

We do not support such a service.

Q16. Do you have any views on how to deal with the impact of transfer on PCLP?

We are concerned that this could prove to be an extremely complicated product, which would make it of little genuine use to Shippers and make it even harder to understand the interaction and implications of the other incentives. We also see a potential conflict of objectives between the product offering and the residual balancing incentive.

Q17. 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?

No.

Shrinkage

Q18. Fundamentally, should minimising compressor fuel use and therefore compressor operation remain an objective of the shrinkage incentive?

There is clearly a balance to be struck between cost/efficiency and system safety. Whilst there is a need to keep the costs under control, maintaining safe operation of the system should be the primary driver behind the use of compressors.

We believe that cost minimisation should remain an objective of NGG, of which fuel minimisation is a key driver. However, as highlighted by NGG, there are a number of complicated interactions at both entry and exit of the system where additional incentives come into play (e.g. capacity buyback) and therefore fuel minimisation should not be the overriding concern of NGG, where it is at the expense of efficient and safe operation of the system.

The most important objective for NGG should be to maximise availability of the NTS to its customers (Shippers) and to ensure that User rights are not compromised by NGG's operational incentives or practices.

Q19. 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?

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Q20. 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)?

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Q21. Do you have any comments on the potential alternative modelling / target setting approaches for CFU target setting purposes outlined above?

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Q22. Do you believe retaining a quarterly scheme enhances or reduces the effectiveness of the incentive compared with an annual scheme?

These are areas of monopoly regulation of which we have no relevant experience and therefore we are unable to offer comments. Understanding the implications is the role of Ofgem.

Q23. 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?

Focusing on the contributing factors to the outturn figure may prove useful in increasing transparency about NGG's performance. Therefore we offer our tentative support for further development of this area of the arrangements. There is, however, a risk that just focusing on specific targets will drive specific actions by NGG, which in reality, might not be as effective as just focusing on reducing overall UAG volume. Equally, it would only be appropriate to incentive NGG on activities over which it has control.

Further analysis is required here to explore in more detail the potential costs / benefits of this suggested approach.

Q24. 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?

Generally speaking, we do not support incentive arrangements longer than one year in duration and as regards UAG, we remain unconvinced by the case for a longer period.

Q25. 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.

Where UAG can be demonstrated to be beyond control of National Grid in its SO role, this would seem to be a reasonable approach.

Q26. 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.

Presumably the rationale for this proposal is that NGG believes that it can purchase and supply electricity at a lower cost to serve and/or requiring a lower rate of return than suppliers in the existing competitive market. We are not convinced that it is necessarily the case that NGG can operate with a lower cost to serve than established suppliers with larger portfolios of customers over which to spread trading overheads. There may be some benefits from NGG requiring a lower rate of return than in the competitive market, but clearly that would be determined by the relevant price control provisions or incentive schemes that would be put in place.

What we find most worrying about this proposal is that this would place National Grid with a larger incentive to be directly involved in trading energy for a commercial profit when it also occupies the role of Electricity System Operator. This role provides National Grid with a significant information advantage over market participants and allows it to influence market fundamentals such as the demand for balancing services. Up to now the Authority has been extremely reluctant to allow National Grid to trade in the market other than in the role of residual balancer of the system. We believe that there should be very strong reasons why this position should change. We do not believe that such a rationale has been provided in this instance.

Q27. We would welcome views over whether a methodology based on a wholesale prices uplifted by a percentage 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.

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Q28. 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.

These are areas of monopoly regulation in which we have no relevant experience and therefore we are unable to offer comments. Understanding the implications is the role of Ofgem.

Q29. 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.

Assuming that this would be a very flat load, consideration could be given to using the Argus or Heren Day-ahead offer price for Baseload electricity as a suitable benchmark.

Q30. 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.

This is an area in which we have no relevant experience and therefore we are unable to offer comments. Understanding the implications is the role of Ofgem.

I hope that the above comments prove useful. Should you wish to discuss our response further, please do not hesitate to contact me on the above number.

Yours sincerely

Richard Fairholme (by email)

Trading Arrangements

E.ON UK