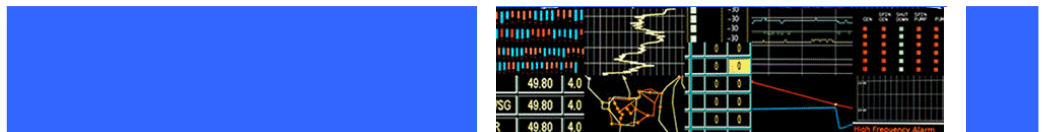


National Grid Gas and Electricity System Operator Incentives

Initial Proposals Consultation Report

Published 18 February 2008



CONTENTS

Executive Summary

1. Introduction

2. Electricity System Operator Incentives

2.1 General Comments.....	7
2.2 Forecast Balancing Costs for 2007/08 and 2008/09.....	8
2.3 Initial Proposals	15
2.4 Consultation Process.....	17
2.5 Summary of Revised Forecast for 2008/9.....	19
2.6 National Grid's Recommendation.....	20

3. Gas System Operator Incentives

3.1 General Comments.....	22
3.2 System Balancing Incentive – Shrinkage.....	22
3.3 System Balancing Incentive – Operating Margins.....	26
3.4 Residual Balancing Incentive.....	28
3.5 Quality of Information Incentive – Demand Forecasting...	30
3.6 Quality of Information Incentive – Data Publication.....	31



1. This Consultation Report summarises the industry responses to the Initial Proposals consultation, sets out our views on the issues raised and recommendations for the way forward. The report should be read in conjunction with our consultation document and industry responses. These can be found on our industry websites:
<http://www.nationalgrid.com/NR/rdonlyres/04EF3C60-192F-4EB2-82C4-7EF264AE54CE/21919/GasandElectricitySOIncentivesInitialProposalsConsu.pdf>
<http://www.nationalgrid.com/uk/Electricity/Solncentive/consultation/responses/>
2. National Grid's Initial Proposals consultation was issued on 7th December 2007 and responses were requested by 25th January 2008:
 - We received 12 formal responses to our proposals, including one from the Gas Forum representing 17 parties, some of whom also submitted separate responses;
 - In addition to these formal responses we met with 9 parties on a bilateral basis;
 - We received feedback and comments at the SO Incentives consultation held on 10 January 2008 workshop;
 - We also presented a summary of our consultation document at a number of industry meetings including Operational Forums, the Demand Side Working Group and the Energy Suppliers Forum.
3. We would like to take this opportunity to thank all parties who took the time to engage in the process, either through providing comments at industry or bilateral meetings and/or via formal responses. We have developed the recommendations for SO Incentives described in this report based on the feedback received from parties during the process.
4. Ofgem is also considering the consultation responses, and the contents of this report, in order to inform the development of its Final Proposals for the Gas and Electricity System Operator Incentives from April 2008.
5. Ofgem's Final Proposals (and the required Statutory Licence amendment notices) are expected to be published in late February in order that the potential Licence amendments can be implemented ahead of 1st April 2008.
6. The main points arising from the consultation responses are summarised below:

In Electricity

- Our forecast assumptions should be revised to reflect current forward wholesale power prices and to more closely reflect the levels of market imbalance seen during the current year, 2007/08.

- Respondents confirmed our view of the significant uncertainty surrounding the likely impact of the Large Combustion Plants Directive.
- There was no consensus as to scheme parameters. Our recommendation is based on the scheme structure preferred by the majority of respondents, with the addition of equal sharing factors.

Our recommendation for the electricity SO incentive scheme is summarised in the table below:

Target, £m	Upside sharing Factor, %	Cap, £m	Downside Sharing Factor, %	Collar, £m	Deadband?	Indexation?
544	30	15	30	15	No	No

In Gas

- **Shrinkage** incentive should be retained, with amendments to the enduring reference price methodologies to reflect prices in more prompt timescales, and provisions to carve out identified CV Shrinkage risks. There was no consensus on the duration or strength of incentives that should apply.
 - **Operating Margins** incentive should be retained, and the consensus view was that OM Utilisation costs should be shared between Shippers and National Grid should they occur.
 - **Residual Balancing** incentive should be retained, with split views regarding whether the linepack element of the incentive should be removed.
 - **Demand Forecasting** incentive should be retained, with a consensus view that the target forecast error should be made more challenging.
 - **Data Publication** incentive was the subject of a variety of views regarding whether this was the appropriate framework to progress performance improvements. Respondents expressed little appetite for the improvements proposed, with attention focused on developing a scheme that would incentivise National Grid to maintain current performance.
7. The consultation process has also produced a number of areas for further work and development. We have endeavoured to record these within the report and intend to take these broader comments forward as part of the longer term review of SO Incentives

Section 1 Introduction



Introduction

8. National Grid operates the Electricity and Gas Transmission Systems in Great Britain. We are subject to a number of financial incentive arrangements which encourage us to minimise the overall cost of balancing to consumers and to support the efficient operation of the wholesale gas and electricity markets.
9. A number of these incentives expire on 31st March 2008, and in August 2007 Ofgem initiated a process for reviewing these incentives by issuing an Initial Thoughts consultation in respect of both Electricity and Gas System Operation.
10. In a change to previous approaches to setting incentives, Ofgem, in an [open letter dated 1st November 2007](#), asked National Grid to take the lead in the next part of the process by providing and consulting upon its own set of 'Initial Proposals' for incentive arrangements to apply from April 2008. The consultation set out our initial proposals for Electricity and Gas incentive arrangements to apply from April 2008 upon which we invited industry views and preferences.
11. National Grid's Initial Proposals consultation was issued on 7th December 2007 and responses were requested by 25th January 2008:
 - We received 12 formal responses to our proposals, including one from the Gas Forum representing 17 parties, some of whom also submitted separate responses;
 - In addition to these formal responses we met with 9 parties on a bilateral basis;
 - We received feedback and comments at the SO Incentives consultation held on 10 January 2008 workshop;
 - We also presented a summary of our consultation document at a number of industry meetings including Operational Forums, the Demand Side Working Group and the Energy Suppliers Forum.
12. We would like to take this opportunity to thank all parties who took the time to engage in the process, either through providing comments at industry or bilateral meetings and/or via formal responses.
13. This Consultation Report summarises the industry responses to our Initial Proposals consultation and sets out our views on the issues raised and recommendations for the way forward. Ofgem is also considering the consultation responses, and the contents of this report, in order to inform the

development of its Final Proposals for the Gas and Electricity System Operator Incentives from April 2008.

14. Ofgem's Final Proposals (and the required Statutory Licence amendment notice) are expected to be published in late February in order that the potential Licence amendments can be implemented ahead of 1st April 2008.

15. Copies of all consultation material and responses can be found on the SO Incentives sections of our website at the following addresses:

Gas: <http://www.nationalgrid.com/uk/Gas/soincentives/>

Electricity: <http://www.nationalgrid.com/uk/Electricity/Solncentive/>

16. The remainder of this document is structured as follows:

- Section 2 - Responses to Electricity SO Incentive Proposals
- Section 3 - Responses to Gas SO Incentive Proposals

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Section 2 Responses to Electricity System Operator Incentives

2.1 General Comments

17. This section presents a summary of responses to our proposal for Electricity System Operator Incentives commencing April 2008:
 - i. We received 11 formal responses to our proposals for Electricity SO Incentives.
 - ii. In addition to these formal responses we met with 8 parties on a bilateral basis¹.
 - iii. We received feedback and comments at the SO Incentives consultation held on 10 January 2008.workshop
 - iv. We also presented a summary of our consultation document to the Electricity Interim Operational Forum on 12 December 2007 and the Energy Suppliers Forum, established by Cornwall Energy Associates, on 23 January 2008.
18. The majority of comments made at bilateral and industry meetings were reflected in parties' formal responses. For completeness, we have also summarised those comments and suggestions offered by participants at meetings that weren't reflected in any formal consultation responses.
19. Although we received no confidential formal responses, a number of confidential comments were made at bilateral meetings. These comments are reflected in the summary of comments within this report (whilst preserving confidentiality) and have informed our views in certain areas, in particular LCPD opted-out plant likely running behaviour.
20. We would like to take this opportunity to thank all of those who offered comments on our proposals, through formal responses and comments at industry or bilateral meetings.
21. The remainder of this section:
 - i. Summarises responses and comments to our Electricity SO Incentives proposals consultation;
 - ii. Presents the changes made to our proposals and;
 - iii. Presents our recommendation for scheme proposals.

¹ Bilateral meetings were held with Centrica Energy, EDF Energy, Scottish Power Generation, Scottish and Southern Energy, Scottish Power Transmission, Scottish Hydro Transmission, RWE Npower and First Hydro

22. For brevity, we have avoided repeating the detail of the consultation document and, as such, this report should be read in conjunction with the same.

2.2 Forecast balancing costs for 2007/08 and 2008/09

Question 1: Do you agree with the assumptions (described in detail in the appendix) used to forecast the various elements that make up underlying balancing costs?

Question 2: In particular, do you have any comments on views on National Grid's forecast assumptions for cost drivers:

- i. The behaviour of NIV during 2008/09 can be expected to be broadly in line with that seen during the current year, 2007/08.**
- ii. That the forward price is the most appropriate figure to represent the likely outturn wholesale price during 2008/09.**

That wholesale power price either directly drive or act as an appropriate proxy to index certain balancing costs.

Basic forecast assumptions

23. The majority of respondents commented that our forecast level of costs and the assumptions behind this forecast appeared to be, on the whole, reasonable and that we had correctly identified the main drivers of balancing costs. Those respondents who did not agree some of our assumptions highlighted, in the main, our forecasts for Scottish constraints and wind.
24. All attendees of the workshop who provided feedback said that the information provided at the workshop and in the consultation document had been useful or very useful to their understanding of our forecast costs. A number of parties also said that to comment fully would necessitate the publication of detailed forecasts. Some commented that the publication of such forecasts would not be appropriate for reasons of confidentiality (and also because this would reveal the assumptions used to assess competitively tendered services). These parties felt that it was not appropriate for the industry to comment on the detail of our cost forecasts and that Ofgem should continue to do this on behalf of the industry.

National Grid's View

25. We have received good feedback on the consultation process. All parties who commented on the process said that they have found it to be a positive step and/or an improvement. We have received a number of suggestions as to where we could improve our presentation of information, such as publication of volumes and prices as well as costs. We were not able to meet these requests in time for this consultation but will look to develop the information we present in future consultations.
26. We agree that it would be inappropriate to share certain commercially sensitive or confidential information as part of the consultation and can confirm that such data has been subject to Ofgem review as part of this process.

Level of NIV

27. We received a range of comments on the appropriate level of NIV to assume in our forecast for 2008/09 but the general consensus was that NIV for 2008/09 was likely to continue in line with the trend seen in 2007/08:
 - i. Some identified that they would expect NIV in 2008/09 to be even shorter than 2007/08
 - ii. Others believed that summer 2007/08 was slightly shorter than the long term trend due to the unusually wet weather and flooding. Therefore summer 2008/09 would be slightly less short than 2007/08 but that otherwise NIV would be the similar.
28. Overall, the vast majority of respondents and other comments reflected the view that there had been a change in the market and that the shorter level of NIV seen during 2007/08 relative to 2006/07 would endure, notwithstanding smaller seasonal fluctuations.
29. The explanation offered by a number of participants for the change in NIV seen between 2006/07 and 2007/08 is that the market has matured and parties now have greater confidence in the typical level of imbalance prices. This means that participants are more comfortable to make economic trade-offs between trading forward or paying imbalance charges. This maturation of behaviour is what has caused the more balanced market seen during 2007/08 relative to the longer markets seen in 2006/07 and earlier. This view was offered by a number of parties, both in responses and at bilateral meetings.

National Grid's View

30. Our original forecast assumption was that NIV would be broadly in line with levels seen (to date) during the current year 2007/08, but adjusted this for the longer markets seen historically. As such, our forecast for NIV in 2008/09 was weighted equally between outturn values 2006/07 and 2007/08.
31. The majority of respondents felt that the trend for NIV to be less long seen in 2008/09 was likely to continue, this is supported by latest NIV data for winter 2007/08, which indicates a continuation of the trend seen during summer 2007.
32. As a result of these comments we have adjusted our NIV forecast to be weight 66% to 2007/08 levels and 33% 2006/07 levels. This results in a forecast for NIV that remains slightly longer than seen during 2007/08, reflecting the unusual summer weather during 2007/08 and the trend to a less long average.
33. The result of this assumption change is an increase in forecast incentivised balancing costs of approximately £13m (as a less long NIV means results in higher forecast volumes of reserve being procured) and a larger increase in forecast BSUoS costs, as Bid receipts decline and reserve costs increase.

Power Price

34. All respondents agreed that the forward price was the most appropriate figure to use within the forecast. Several parties identified that our forecast should be updated with the latest power price prior to the final scheme target being agreed with Ofgem.

National Grid's View

35. We agree that the latest wholesale forward power price should be used within our forecast. We have updated our forecast to reflect recent power prices, which have been at approximately £56/MWh for 2008/09 annual baseload through January and early February 2008. This represents an increase of £8/MWh on the price of £48/MWh assumed in the December consultation document.
36. Within our revised forecast we have adjusted a number of components to reflect the shift in prices, these are: Energy Imbalance, NIA, Margin, Reactive and Cheviot constraints². The changes are shown in the table at the end of this section. Our analysis indicates that net effect of only the power price increase on our forecast is an increase of only £1m for an £8/MWh rise in wholesale prices. This low figure has resulted from the model because price-driven increases in Reserve, Cheviot and Reactive costs are cancelled by a large negative shift in NIA. This small change further demonstrates the need for further analysis on the appropriate level of any power price index.

Power Price as a Driver of Balancing Costs

37. The majority of parties agreed that, in theory, balancing costs should be correlated to trends in wholesale power prices. However, all expressed concern that good correlation had not been demonstrated by the analysis presented in our consultation document. As a result, parties had concerns as to the appropriateness of indexing the scheme target to wholesale power prices. These comments are discussed in detail in response to question 8.

National Grid's View

38. We agree that further work needs to be undertaken to demonstrate any correlation between the trend in incentivised balancing costs and wholesale power prices. Our views on indexation are discussed under question 8.

Question 3 Do you agree with the assumptions used to forecast Cheviot and Scottish constraint costs, and the costs associated with the forecast rise in Wind output in 2008/09?

Cheviot and Scottish Constraint Costs

39. We received a number of comments during meetings and in parties' responses in relation to these forecast constraint costs, presence within the incentive scheme and in relation to Transmission Owners:

² Effectively, these categories represent Reactive Power (prices indexed to power prices) and our main reserve and energy balancing costs. The inclusion of Cheviot costs is because a significant portion of this cost is driven by the costs of replacement energy (Reserve) in England and Wales.

Forecast costs

40. The broad range of comments on this cost area expressed concern at the level of costs being incurred to manage these constraints. Several respondents commented that they could not verify the accuracy of our forecasts without further detail. Some parties commented that, given the scale of costs and the potential impact of constraint actions on imbalance prices, there should be more regular reporting of these costs and actions through the year.
41. Those that commented on the detailed forecast assumptions (in particular for Cheviot costs) gave a range of views.
- Two commented that they would expect costs to be lower:
 - In one respondent's view our assumed prices for Bids available in Scotland was too low and fell below the marginal cost of generation for that plant. If this number was revised upwards it would reduce the forecast cost.
 - In another respondents view, the new constraint management tender being developed by National Grid for 2008/09 should lead to lower costs.
 - Several indicated that costs appeared reasonable and in line with their expectations based on the information available. One of these respondents was concerned that the forecast assumed zero Scottish Import constraint costs during 2008/09 and that, if these did occur (as they had done in 2007/08), it could give rise to an Income Adjusting Event;
 - A number of comments were made during meetings in formal responses looking to clarify our assumptions of generation output levels in Scotland and noting that uncertainty of generation output in Scotland is a significant driver of uncertainty in this section of the cost forecast.

Incentivisation of Cheviot and Scottish constraints

42. A number comments and responses expressed concern at the level and potential volatility of cost in this area. Several respondents suggested that the high degree of uncertainty regarding the costs meant that National Grid should not be incentivised on these costs and/or that the level of costs and the fact that these costs are forecast to continue for a number of years meant that the arrangements for the key constraint boundaries should be subject to much wider review.

Transmission Owners

43. A number of comments were made at meetings and in responses regarding the role of Transmission Owners (TOs) in ensuring that network outages are efficiently minimised to ensure constraint costs are minimised. A number of parties felt that incentives should be placed on TOs to help minimise network outages, particularly on the Cheviot boundary.

National Grid's View*Scottish and Cheviot constraint costs*

44. Whilst we consider some information on local constraints to be cost-sensitive, in response to requests for further information, we will look at ways of increasing the transparency of cost reporting and forecasting in this area for 2008/09. Our detailed forecast for constraint costs has already been provided to Ofgem as part of the consultation process.
45. With regard to our forecast assumptions for Bid prices in Scotland, our forecast level for 2008/09 is based on the historic ratio of Bid price achieved in Scotland compared to those achieved in England and Wales. We have not identified any driver that may cause this to change during 2008/09 unless the introduction of the new constraint management tender is successful in achieving better Bid prices.
46. It is our view that the new constraint management tender can be successfully developed and introduced and if it does deliver improvements in pricing then these savings should be treated as efficiencies and not incorporated into the scheme target at the start of the year. However, Ofgem has also queried the level of Bid prices assumed in our forecast and it is our expectation that Ofgem will factor its own view into any final scheme proposals.
47. Whilst we agree with those participants that expressed concern at the possible volatility of these constraint costs, we believe it may be overly complex to try and isolate and remove these costs from the incentive scheme. In any event, it would not be possible to develop options to remove these costs from the incentive scheme and consult on those options in the time available. Therefore we propose to feed these comments into the longer term development of incentives.
48. With regard to the possibility of incentives on TOs to ensure critical network outages are minimised, we recognise the key role TOs have in this area. Again, we recommend that the development of such schemes is considered as part of the longer term development of incentives.

Cost impact of Increasing Wind Generation Output

49. A number of parties commented that they would require additional information to be able to comment fully on our forecasts for wind-driven cost increases. Those parties that did comment on the headline costs and impacts said that the cost forecast was reasonable, in line with their expectations or did not appear unreasonable.

National Grid's View

50. Unfortunately it proved difficult to provide good detail on our wind forecast within the consultation. This is because to do so would have required publishing sensitive data that was relevant to the latest tender for Short Term Operating Reserve, STOR, which occurred contemporaneously to the consultation.
51. A full description of our forecast assumptions was provided separately to Ofgem. We have responded to a number of Ofgem questions on our wind

cost forecast. We remain confident that the assumptions we have used are reasonable. However, we understand that Ofgem may use a slightly lower figure for the cost impact of increasing wind output when preparing final proposals.

Question 4 Do you have any comments on our initial analysis of the likely impact of the introduction of the Large Combustion Plants Directive, in particular on the likely operation of opted-out plant?

52. The majority of respondents agreed with our scenarios of likely impacts of LCPD and with our view that, at this stage, it was difficult to predict precisely how many stations would change behaviour significantly.
53. A number commented in responses and at bilateral meetings that they agreed with our initial assessment presented at the workshop that behaviour in early January 2008 was consistent with the central to high range of our scenarios.
54. One respondent considered that there would be little change that would impact costs other than opted-out stations operating on a 'stack' basis as a result of the LCPD hours constraint and that, as a result, our forecast was overly cautious. The respondent suggested no provision should be made in the target and that any additional costs resulting from the introduction of LCPD should be subject to an Income Adjusting Event (IAE).
55. Several parties commented that our assumption of uniform running (2500hours/annum) across all eight years up to 2015 closure was too conservative. These parties' view was that most stations would heavily discount the final few years in their economic assessments and therefore run more regularly in the near-term. Some parties said that the decision would be a tactical one as well as economic and that they expected parties to hold hours back for the later years to see how the market evolved.
56. The majority of feedback at industry and bilateral meetings agreed with our view of the likely range of impact, and the range of views offered was broadly consistent with the range of our scenarios. Those who offered confidential information on their expected plant running reinforced the view that our forecasts were reasonable but that there was a wide range of possible outcomes. In particular, some comments indicated scenarios under which costs could be much higher than our forecast, should plant chose not to run or to submit high prices when not running.

National Grid's View

57. We are very grateful to all for the level of comments and engagement on what we had identified as the most uncertain area of the forecast. The feedback reinforced our view that this is an uncertain area and one that many parties are waiting to see how it evolves in this first year of operation of LCPD.
58. We do not agree with the suggestion that we should not include these costs in the forecast but should instead submit an IAE when costs arise as a result of LCPD. Separately, we have investigated the possibility of an index to adjust the scheme target based on outturn behaviour (such as the BM prices

and summer outages of opted out plant) but concluded that such a mechanism would be too complex and could not accurately isolate the effect of LCPD. For the same reasons it is our view the costing the impact after the event as part of an IAE would also be complex. However, given the interest in the impact of LCPD we will endeavour to provide updates during the year at Operational Forums and elsewhere, as requested by some respondents.

59. Agreement with our initial range and with our assessment presented at the workshop that behaviour exhibited in early January was consistent with our central to high range. This suggests that we should revise our forecast up from the current level of £15m. This upwards driver was, in our view, tempered by parties comments that opted-out stations were likely to discount the final few years and therefore use more hours in the early years, which should serve to reduce the effect of LCPD. Our view is that these two factors counteract and, as a result, we have held the forecast at £15m for 2008/09.
60. Finally, a number of participants discussed arrangements National Grid may put in place to assist in the efficient procurement of energy from BMUs at opted-out stations. We intend to review the situation in early March 2008 and, in line with parties' comments, we will look to ensure that any arrangements we take forward are transparent to all participants.

Question 5 Do you have any comments on the forecast range of incentivised balancing costs and BSUoS costs for 2008/09?

61. A number of respondents welcomed the inclusion of BSUoS cost and price figures as part of our forecast. In addition, several respondents noted the wide range of costs within the forecast and noted that the width of range was driven by the uncertainty relating to constraint and LCPD costs. One respondent noted that if LCPD costs were removed from the forecast and different prices were assumed for Scottish constraints, in line with their suggestion, then the target would be lowered by the same amount.
62. At a number of bilateral meetings participants expressed concern at the likely range of BSUoS costs and suggested that consideration should be given to a fixed annual BSUoS price. Under such an arrangement any difference between forecast and outturn could then be corrected in the following year's charges.

National Grid's View

63. We agree with participants that the wide range of costs reflects the uncertainty of certain cost elements such as constraints and LCPD but would highlight that the range of costs is also driven by variables such as weather and market conditions. We propose to take forward the discussions on BSUoS charging as part of the longer term review.

Question 6 Do you agree with the main areas for efficiency identified by National Grid?

64. Respondents that commented stated that they felt the areas identified were reasonable although many requested more explicit detail. A request was also made at the workshop for more detail on the main areas for efficiencies

targeted by National Grid. This is something we intend to do for future consultations.

2.3 Initial Proposals

Question 8

Do you support the use of indexes for the 2008/09 incentive scheme?

- ***Do you agree with the proposed level of scheme target indexation for wholesale power price?***
- ***Do you prefer wholesale power price index option (a) or (b)?***

Do you agree with the proposed level of scheme target indexation for Cheviot outage weeks?

65. Whilst the majority of respondents did support the principle of a power price index, many expressed concerns that an appropriate value for the index had not been established.
66. A number of participants suggested that, given the lack of a clear relationship, a conservative approach of indexing the value of reactive power should be adopted for 2008/09. Others suggested further analysis of the relationship to power price (and NIV) should be undertaken before establishing indexes for schemes from April 2009.
67. All respondents who expressed an opinion felt that power price option (a) was more appropriate. Option (a) indexed the target to outturn power prices through the year, whereas option (b) was not a true index as it simply fixed the target based on average forward power prices at the start of the scheme year.
68. The majority of participants felt that an index linked to the number of weeks of Cheviot outages was inappropriate because it would remove the incentive on the System Operator to minimise the number of weeks of outages. Two respondents felt that it may be appropriate to use an index but had some reservations regarding the mechanism proposed.

National Grid's View

69. In relation to a power price index, we agree with respondents' views that broadly speaking an index would be correct in principle but that the analysis presented does not present a clear case. As such, we recommend that work on this is taken forward as part of the longer term review.
70. Given respondents views, we do not recommend indexing the scheme target to Cheviot outage weeks.

Question 7 Do you agree with the range of proposed scheme options? Are there alternative scheme structures that should be considered for 2008/09?

Question 9 Which is (are) your preferred scheme(s)? (please provide reasons). If your preferred scheme is scheme 3 or 4 do you consider these should have a target indexed to power price and/or Scottish outage weeks or not?

Range of schemes

71. No respondents suggested alternative scheme structures. One respondent suggested that a range of targets should have been offered. Another respondent commented that it was difficult to assess the appropriate level of sharing factors without the numerical figures for the distribution of balancing costs. A number of respondents indicated a preference for equal sharing factors above and below the target.
72. One respondent commented that, whilst useful for consultation, the wide range of options was likely to elicit a wide range of views and that it would be difficult to identify a majority preference for any scheme structure. As such, in future years the scheme structure should be consulted on earlier in the process.

Scheme Preference

73. Of those respondents that expressed a preference, the majority preferred the simpler sharing factor structure of schemes 1, 2 and 5 to ensure the SO was strongly incentivised to reduce balancing costs. Amongst these respondents, views varied as to which, if any, indexes should be included with the scheme. One respondent who expressed a preference for scheme 1 said that the sharing factors should be inverted from those proposed, to be higher above the target and lower below the target.
74. A significant minority of respondents expressed a preference for scheme 3, with more complex 'shaped' sharing factors. Such a scheme would reflect the fact that costs were uncertain by offering only low risk and reward for outturns close to the forecast and offer stronger incentives to manage cost outcomes further away from the target.
75. Two respondents commented that the target should be reduced below the National Grid's forecast. One proposed a reduction based on comments elsewhere in their response and the other suggested a reduction to reflect the inevitable 'risk premium' that National Grid would have within its forecast.

National Grid's View

76. Based on respondents' views, we would recommend a scheme with a simple sharing factor structure, in line with scheme 5. We note that a number of participants expressed a preference for equal sharing factors and that a number of respondents expressed a preference for strong incentives to be placed on the SO.
77. On the basis of respondents' views we would recommend a scheme with equal sharing factors, at 30%, close to the average of the upside and downside sharing factors of 35% and 27% proposed in schemes 1, 2 and 5, the schemes preferred by the majority of respondents. On the same basis we would also recommend caps and collars £15m, between the £20m of schemes 1 and 2 and the £10m of scheme 5.
78. We would not recommend the inclusion of indexes but if Ofgem was minded to include an index then to reflect consultation responses we would advise the inclusion of a power price index in line with indexation option (a) and a

conservative indexation level in line with that of reactive power, at £0.8m per £1/MWh change in power price.

79. We do not agree that our forecast has a risk premium included. Our historic forecasting performance (as shown in our consultation document) has proved to be reliable and an accurate indicator of final outturn.

Question 10 Do you agree that longer term development of systems that will reduce the cost and carbon impact of operating the system be supported? Which manner of funding do you consider to be the most appropriate?

80. In general, the majority of respondents to this question felt that, whilst the development of such schemes could offer carbon savings, it was not appropriate to fund the development of such schemes through BSUoS. One participant stated that such a service could be funded at a level based on the carbon savings achieved.
81. One respondent who is a developer of similar services stated that:
- developers did not want funding for development of products but;
 - providers of services should be able to begin to sell services to NGET at economic prices even if the volume of such services was not yet sufficient to materially impact the operation of the system, i.e. only small volumes were available.
82. The respondent stated that this approach would allow provider to receive the economic rate for the service they could provide, even if the scale was not yet at a level that would mean it displaced alternative services.

National Grid's View

83. Based on respondents' views we do not recommend that funding of the development of such schemes is funded via additional BSUoS payments during the scheme year 2008/09. We will take forward work in this area as part of the longer term review.

2.4 Consultation process

Question 11

Did you find the level of information within this consultation, and associated documentation and workshop, on our balancing and BSUoS costs forecasts for the current year and 2008/09 informative.

What additional information should National Grid provide to explain better the costs and cost drivers?

84. A number of respondents commented that they had found the new consultation process to be an improvement. All attendees who provided feedback on the workshop said that they had found the workshop and the consultation document useful or very useful as part of the consultation process. No negative comments were received although some noted the need for Ofgem to continue to scrutinise sensitive or confidential areas of the forecast detail.

85. At meetings and within responses we have received a number of requests and suggestions for additional information. Overall, there were a number of detailed suggestions as to how information delivery to participants could be improved and requests for particular. In summary these suggestions and requests covered:
- Detailed spreadsheets with volumes and prices as well as costs;
 - Detail on areas where and how we aim to achieve cost reductions or mitigate cost increases - this would aid understanding of how different incentive structures could be more or less effective;
 - A more detailed breakdown of wind and Scottish constraint forecasts;
 - More information on the breakdown of Balancing Mechanism costs;
 - Regular within-year reporting of costs and forecasts.

National Grid's View

86. We would like to thank all participants for their comments. Due to the limited timescales we were not able to convert our full forecast data into a 'user-friendly', non-confidential format in time for the consultation process. We will be reviewing all suggestions again ahead of developing more detailed information in line with the above requests for future consultations.
87. In addition to more detailed information we note that participants welcomed the bilateral meetings, which they said had been very useful in aiding their understanding. We agree that the bilateral meetings were a very effective format within which to discuss views and the detail of our forecast and proposals and we would hope to repeat these in future.

Question 12

Do you have any further comments on the analysis and information provided within the appendices to this consultation or in the further documentation available on our website?

Question 13 Do you have any further comments on any aspect of this consultation in relation to the Electricity SO?

88. A number of comments were received in response to these questions. We intend to take these issues forward as part of the longer term review. In summary, comments were:
- A number of participants welcomed the process followed this year and considered it an improvement that should be continued;
 - That an open session should be held to report back on the results of the consultation;
 - Consideration should be given to fixing BSUoS charges on an annual basis;
 - The Ofgem should continue the longer term SO review;
 - That consideration should be given as to whether the incentives on NGET's internal incentive scheme stymie investment in the SO including measures that reduce costs on the external scheme;

- That regular, stable costs such as Black Start cost, should be moved from the external scheme to the internal scheme;
- That the longer term review of incentives needed to consider NIA as well power price indices;
- A number of detailed comments on incentive scheme structure that we intend to feed into the longer term review;
- A number of useful proposals and suggestions for more regular reporting of costs, in particular within the Cornwall Energy Associates response.
- Consultation process should be initiated much earlier.

2.5 Summary of Revised Forecast for 2008/09

89. Following the consultation we have revised elements of our forecast in line with the summary below:
- Update for the latest (higher) forward wholesale prices;
 - o This rise increases our forecast for reserve, reactive and Cheviot costs but these increases are almost cancelled out by the counteracting increase in NIA, leaving a net impact of £1m increase.
 - Adjusted for a slightly less long forecast of NIV as most respondents said to take a view closer to 2007/08, resulting in a £13m increase in forecast.
 - o We haven't used 2007/08 values as some respondents said summer 2007/08 was probably a little over-short due to weather. If we'd used 2007/08 NIV figures this would have pushed our forecast up by a further £10m;
 - Detailed feedback on our LCPD assumptions although overall the effects cancel out and the forecast cost impact of LCPD remains the same at £15m.
90. The above changes result in a revised forecast for 2008/09 of £544m, an increase of £14m from our previous forecast of £530m.
91. The increase in forward wholesale prices and less long NIV both push up the BSUoS forecast by more than the incentivised cost forecast. This revised forecast was presented alongside a summary of consultation responses at the Operational Forum on 6 February 2008. The slides can be found here:
- http://www.nationalgrid.com/NR/rdonlyres/31087A54-0D6A-4010-AFCA-A32E509665DE/23251/SO_Review_06Feb08.pdf
92. The full breakdown of the latest forecast is presented for comparison in the table below:

All Categories £m	2008-9 December forecast (consultation)	2008-9 latest forecast (Post- consultation)
LCPD	15	15
WIND	10	10
Constraints - Cheviot	67	75
Constraints - Scotland Internal	39	39
Constraints - England & Wales	19	19
STOR	65	65
Footroom	4	4
Fast Reserve	60	60
Response	145	145
Reactive	57	63
Blackstart	17	17
TLA	0	0
Unclassified BM	9	9
BM+AS General	4	4
Reconciliation	0	0
Sub-total system	511	525
Energy Imbalance	26	42
Negative NIA	-162	-196
Margin	155	173
Sub-total energy + margin	19	19
Total	530	544

2.6 National Grid's Recommendation

93. The changes to forecast result in an increase in forecast incentivised balancing costs for 2008/09, driven by the latest forward wholesale prices and adjustments to our NIV assumptions in line with the views of respondents to the consultation.
94. As described in our views to responses for questions 7 and 9, above, respondents views on scheme structure were mixed but, in summary:
- A majority of respondents expressed a preference for a simple scheme sharing factor structure, similar to schemes 1, 2 and 5;
 - A number of respondents expressed a preference for equal sharing factors
 - A number of respondents expressed a preference that National Grid should be strongly incentivised to reduce costs and mitigate cost increases and;
 - A general preference not to implement a power price index until an appropriate value can be clearly demonstrated.

95. Based on respondents' views, we recommend the following scheme structure and target.

- A scheme target of £544m, in line with revisions to our forecast made following the consultation process;
- Equal sharing factors of 30%, in line with respondents views and close to the average of the upside and downside sharing factors of 35% and 27% proposed in schemes 1,2 and 5;
- Caps and collars of £15m, between the £20m of schemes 1 and 2 and the £10m of scheme 5;
- No indexation

The recommended scheme is summarised in the table below:

Target, £m	Upside sharing Factor, %	Cap, £m	Downside Sharing Factor, %	Collar, £m	Deadband?	Indexation?
544	30	15	30	15	No	No

Section 3

Responses to Gas System Operator Incentives

3.1 General Comments

96. The Gas Forum commissioned TPA Solutions to analyse the SO Incentive proposals and prepare their response on behalf of their members. 17 parties were listed as Gas forum members in appendix 1 of their response. In addition, five of those parties responded separately in order to raise points which differed from the Gas Forum response.
97. Throughout the consultation process a number of questions and queries were raised and we have tried to address these as quickly as possible. During the consultation period we published a note which answered these questions and clarified a number of points that had been raised during the process, as well as publishing additional data that had been requested. The clarification note can be found at <http://www.nationalgrid.com/NR/rdonlyres/960FC20A-8D2A-45B9-B3DE-62E8D7BC3D87/22794/ClarificationnoteGas.pdf>.

3.2 System Balancing Incentive – Shrinkage

98. All respondents believed that the Shrinkage incentive should be retained because it is the biggest cost component of the SO commodity charge and it is important that National Grid has an effective incentive to manage the cost.
99. A number of respondents highlighted that they believed the compressor volumes associated with the TOM sub-terminal should be excluded from the incentive as National Grid has no latitude over the use of these compressors. Gas forum suggested that the correlation between St. Fergus flows and national compressor usage be checked without the inclusion of TOM compression volumes to confirm that the banding approach to varying the target is still appropriate.
100. A number of respondents suggested that the reference price methodologies should include an element of more prompt prices in the calculation. A weighting of 75% forwards and 25% prompt was suggested as an example.
101. The consensus view was that the interim methodologies for 2008/09 were broadly appropriate and that enduring pricing methodologies should be established in the NTS Licence to prevent the need for interim methodologies in the future.
102. It was highlighted that National Grid may have opportunities to operate its new electric compressors in such a way as to avoid electric triad charges, and that any benefits should be shared by adjusting the reference price uplift.

103. The consensus view was that excluding the CV shrinkage risks highlighted in the consultation from the incentive was appropriate providing the central forecast was very low (or zero).
104. There was a consensus view that it would be appropriate to undertake a review of the CV capping rules in the Gas (Calculation of Thermal Energy) Regulations.
105. National Grid was asked to make a statement regarding whether its Joint Venture to develop technologies that generate electricity at pressure reduction stations would impact on the operation of the compressor fleet.
106. There was no consensus regarding the appropriate duration and strength (in terms of caps/collars and sharing factors) for the incentive. Support was expressed for single year, 2 year and longer term incentives. Some respondents favoured a stronger incentive, some favoured a weaker incentive and some believed that the current level of incentive was broadly appropriate. Some respondents believed that sharing factors should be made symmetrical. Some respondents noted that National Grid had outperformed its incentives in the past and therefore they should be tightened.

National Grid's View

Compression Volumes

107. Our forecasts for Shrinkage include the compression requirement at St. Fergus which moves gas from the TOM sub-terminal at 40 bar and compresses it up to 75 bar to enter the NTS. From an incentive perspective, whilst these compressors are required to increase pressure at the sub-terminal, we are not clear as to what the benefit is of carving the volume out of the incentive as we still have to procure and deliver the energy to meet this requirement. The operation of these, and a number of other compressors, is still intrinsically linked to moving gas from St. Fergus to demand centres further south.
108. What is important to point out is that the costs associated with operating the compressors at the TOM sub-terminal are carved out of the SO commodity charge 'pot' and charged back to the parties that bring gas in at that location. Therefore the general Shipper community is not paying these costs through their SO commodity charges. However the incentive for National Grid to procure and deliver TOM compression energy as efficiently as possible remains.
109. The correlation analysis which underpins linking St. Fergus flows with National Compressor Usage has been repeated, excluding the St Fergus compression to test the correlation. The results show that the correlation with St Fergus supplies remains strong (the data is provided on our website) and therefore we do not believe this issue is material in relation to the use of a banded target driver linking shrinkage volumes with average flows through St. Fergus ASEP.

110. We would also like to clarify that although the banded shrinkage target moves with St. Fergus flows (because it is the most dominant flow in determining compression requirements), the compression requirement forecast does take account of flows at other ASEPs as it is determined through a multiple regression model.

Reference Price Methodologies

111. We note with interest the consensus view to calculate reference prices to include an element of more prompt prices. Whilst we believe there are benefits in keeping the reference price period well ahead of prompt timescales, we have no objection to a set of arrangements with a 75% year ahead / 25% prompt split. We would however highlight three points:
- moving to a set of reference price arrangements which has an element of prompt pricing is likely to introduce more volatility and therefore potentially significant revisions to SO commodity charges as a significant proportion of the costs will not be known until the end of the delivery year.
 - the rationale given for the 75/25 split is that this more closely aligns with National Grid's current procurement strategy. National Grid has complete discretion over its procurement decisions and our strategy is driven by a number of factors including the incentive arrangements in place at the time and our view of market conditions, both of which may change year on year.
 - If this arrangement is to apply to the electricity procurement for electric compressors, it would need to align with the flexible procurement arrangements available to us through retail market contracts.
112. We agree with the consensus view that the interim methodology for GCRP and ECRP should prevail for 2008/09 and that enduring reference price arrangements should be set out in NGG's Licence for 2009/10 to 2012/13 (i.e. until the year after the end of the current Transmission Price control) to reflect the fact that gas is procured in the year ahead of the delivery year and to provide certainty over the reference price arrangements going forward.

Operation of Electric Drives

113. It may be possible to operate electric driven compressors in such a way as to minimise the electricity delivery charges (i.e. triad avoidance). However it should be noted that peak levels of electricity generation naturally correlate to very high levels of gas demands and the need to ensure maximum pressures at generator's offtakes. As the electric drive change-out program is in its early stages, we do not yet have sufficient operating experience to know whether this is practical or cost effective. We believe that the aim of the incentive is to promote the development of such strategies to minimise the costs to consumers without compromising physical security and therefore if this proves to be an area where savings can be made, then these benefits should be shared between National Grid and consumers through the scheme sharing factors, rather than assuming savings can be made when the target is set.

CV Shrinkage

114. We can confirm that the central forecast for the low probability, high impact CV shrinkage risks identified is zero and agree with the consensus view that these risks should not be part of the SO incentive arrangement. We also note the general desire for a review of the CV capping rules in the Gas Regulations and are happy to take this issue forward subject to support from both BERR and Ofgem should material levels of CV shrinkage become prevalent.

Joint Venture

115. The existence of technologies that generate electricity at pressure reduction stations will have no bearing on how National Grid chooses to operate compressors on the NTS, whether they are part of a National Grid Joint Venture or developed by any other party.

Strength and duration of incentive

116. National Grid continues to believe that the shrinkage incentive is a good candidate for agreeing a long term scheme, as many of the potential volume efficiencies can only realistically be considered over a number of years. We recognise that this is countered by the level of uncertainty regarding flow patterns that may emerge as new supplies enter the market and believe that the target driver approach to setting the incentive mitigates this to an extent.

We therefore recommend Scheme D for a long term incentive, or Scheme B for a 1 year incentive. We also the enduring reference price methodologies should be established until 2012/13.

Scheme	Duration	Annual Cap	Upside Sharing Factor	Annual Collar	Downside Sharing Factor
A	1 year	£10m	40%	£-6m	35%
B	1 year	£5m	25%	£-3m	20%
C	2 years	£8m	30%	£-5m	25%
D	4 years	£10m	40%	£-6m	30%
E	4 years	£6m	25%	£-4m	20%



3.3 System Balancing Incentive – Operating Margins

117. All respondents believed that an Operating Margins (OM) incentive should be retained as an appropriate way to minimise the cost of procuring OM.
118. The Gas Forum put forward a view that despite the reductions in OM requirements from 2007/08, the requirements are overstated on the grounds that some events it covers for are extremely low probability events, and that there may be double counting of the requirement for orderly rundown and offshore failure scenarios. It was noted that this would require a change to National Grid's Safety case and that this would be difficult to achieve for 2008/09. They also highlighted other areas which they believe should contribute to lower OM requirements.
119. The general view was expressed that as contestability in the provision of OM increases, it may be appropriate to introduce sharing factors (i.e. less than 100%) into the scheme.
120. The consensus view was that it was appropriate for National Grid to share utilisation costs with Shippers, as the costs only arise as a result of efficiencies in the procurement of a space only (rather than bundled) OM product. The majority of respondents suggested that Option B was appropriate (National Grid takes the risk of background utilisation up to £0.5m) with no allowance incorporated into the overall target to cover this. One respondent preferred option C (National Grid take all utilisation risk) but with the inclusion of 2 times the background allowance in the target rather than 4, as this would lead to ex-ante certainty over costs for Shippers.

National Grid's View

OM Requirements

121. National Grid's OM requirements are determined to satisfy the requirements of its Safety Case and the provisions contained within the UNC. We do not agree with the assertion that the requirements are overstated nor that there is 'double counting' within the determination of the requirements. We do acknowledge that the events covered by OM have a very low probability of occurring contemporaneously, but they can occur and are required to be covered to meet the requirements of National Grid's safety case.
122. The Gas Forum response asserted that the volume of OM associated with Major Events should be eliminated. We believe that, whilst this approach would obviously reduce OM costs, this could lead to more frequent declarations of National Gas Supply Emergencies which would not be in the overall interests of the efficient market operation or consumers. In any case, as acknowledged in the response, this would require a change to our Safety Case which cannot practically be achieved for 2008/09.
123. In the context of the OM review we are in discussions with the HSE, who have made it clear that they will adopt a precautionary principle to any potential change to our Safety Case in relation to the requirements or provision of OM. We intend to consult with the industry within the next few weeks in relation to

the OM Review and will include consideration of these issues within that process.

Scheme Sharing Factors

124. The OM review is considering how to promote further competition in the provision of OM services. As the output from the review becomes clear, we believe the incentive arrangements should be developed to align with the nature of the procurement mechanism that is developed, which may involve a sharing of risks and rewards between National Grid and Shippers. However we are conscious that any potential changes resulting from the review may take time to manifest in terms of a potential increase in the pool of active and competitive service providers.

Utilisation Costs

125. The consensus view was that a combination of options A and B was appropriate, with a target comprising holding costs only (£23.3m) with a collar on National Grid’s exposure to Utilisation costs at £-0.5m. We agree with market participants that National Grid and Shippers should share the costs of utilising OM, as efficiencies have already been made by National Grid through the procurement of the ‘space only’ product.
126. We do not however believe it is appropriate, having returned 100% of the savings associated with Space Only products to Shippers, that National Grid should then be exposed to any utilisation costs unless there is some form of upside as this does not represent a balance of risk and reward.

We therefore believe that option B as proposed provides this balance of risk and reward and most closely aligns with the industry consensus view on the treatment of utilisation costs.

Scheme	Target (pending C3 prices)	Holding Cost Cap	Holding Cost Collar	Upside Sharing Factor	Downside Sharing Factor	Utilisation Cost Collar
A	£23.3m	none	none	100%	100%	£0
B	£23.57m	none	none	100%	100%	-£0.5m
C	£24.38m	none	none	100%	100%	none



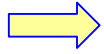
3.4 Residual Balancing Incentive

127. There was consensus that the price element of the residual balancing incentive should be retained. However there were differing views in relation to retaining the linepack element of the incentive.
128. There was consensus that a fundamental review of this incentive was appropriate to capture potential impacts of the changing supply environment, and that therefore a 1 year scheme was an appropriate duration pending the outcome of such a review. One respondent noted that they would like to have seen multi-year options provided.
129. A number of options were highlighted by respondents in relation to targets and scheme financial parameters.
130. The Gas Forum suggested a 'middle ground' option where the linepack incentive is retained, the target linepack change widened (e.g. to 4 or 5 mcm/d) with a steepening penalty as deviations increased to discourage large imbalances being transferred between days. They also suggested that the linepack incentive could be replaced by more within-day linepack information.

National Grid's View

131. National Grid believes that a fundamental review of the residual balancing incentive is appropriate and we believe that the differing views in the industry with regard to the linepack incentive supports this. We will work with Ofgem and Industry over the coming months to progress this.
132. We do not believe there is justification for removing the linepack incentive for 2008/09 and therefore recommend that the existing incentive structure be rolled forward, pending a more considered review.
133. We believe that the value of the SO behaviour promoted by this incentive, measured both in terms of balancing cost reductions and market price efficiencies, is orders of magnitude greater than the value of any incentive payment that can be realistically achieved. We believe therefore that there is justification for at least a modest increase in the financial parameters of the incentive as suggested in Scheme A, and certainly no case to reduce them.
134. In addition, with the year-on-year increase in linepack associated with the development and expansion of the NTS, a static target has created a corresponding year-on-year increase in the challenge of the target for National Grid with no increase in potential reward or reduction in risk. We believe this is inappropriate and should either be recognised through increasing the potential reward, or increasing the linepack target.
135. We have no objection to exploring a change in the linepack incentive parameters as suggested by the Gas Forum, although this may be better considered as part of the review referred above.

Our recommendation is therefore Scheme A.



Scheme	Duration	Price Incentive			Linepack Incentive			Overall Annual Cap / Collar
		Daily Cap	PIR	Daily Collar	Daily Cap	PIR	Daily Collar	
A	1 year	£+6k	10%	£-35k	£+6k	3.1mcm	£-35k	£+3.5m / £-3.5m
B	1 year	£+10k	7%	£-60k	Remove			£+3.5m / £-3.5m

3.5 Quality of Information Incentive - Demand Forecasting

136. There was general consensus that a one year Demand Forecasting Incentive was appropriate pending longer term review of the residual balancing activity.
137. Two respondents supported a straight roll-over, and three respondents supported a rollover with a tighter target.

National Grid's View

138. Since this incentive was established, we have improved the accuracy of demand forecasting significantly through a number of different initiatives. We are pleased that the value that accurate demand forecasts has to market efficiency has been recognised, and we can understand why respondents would like to see the target tightened. We would however like to point out two important factors that should be taken into account when determining the target:
 - As set out in the consultation, we believe there are market developments that will make forecasting Total System Demand more challenging in 2008/09, which effectively acts to tighten the target inherently.
 - As the demand forecast error reduces, further reductions become increasingly harder to achieve and potentially require bigger investments in people, processes and systems to understand the more complex drivers.

We therefore still believe that it would be appropriate to maintain the current demand forecasting target of 4%.

3.6 Quality of Information Incentive – Data Publication

139. A variety of views were expressed in relation the appropriateness of retaining this incentive and what form it should take. Some respondents believed the incentive should be removed as National Grid should be undertaking this type of development anyway. Some believed that National Grid should be funded for investments (on the basis of recouping efficient costs incurred) through SO revenue allowance rather than through an incentive with reward. Some believed that making improvements through this incentive was appropriate but the form of scheme should be changed to ensure that current levels of performance were maintained e.g. by introducing a “Standards of Service” scheme. Overall respondents did not demonstrate an appetite to improve information publication performance as offered by the scheme proposed.
140. Those that supported the continuation of this incentive (in whatever form) agreed that monthly performance intervals and provisions for planned outages were appropriate, and that measuring the timeliness and availability of data were appropriate measures of performance. One respondent noted that accuracy was also an important element to data provision.

National Grid’s View

141. Given the success of this incentive in delivering improvements to information publication we are disappointed that respondents have not embraced our proposals to deliver further improvements. The cost-benefit analysis of the proposals is for the community to determine - we have presented the potential improvements and the costs, so that Shippers and others can determine the potential benefits to themselves. We can only assume that this exercise was performed and that the improvements delivered no net value. If this is the case, then we would not propose to take forward these developments.
142. We note the general desire for some form of ‘standards of service’ scheme to apply to the existing incentivised information provision. Although this has not been described by respondents in any detail we assume this means an incentive with a target performance set at existing levels, with upside for improving performance, and a downside for a deterioration in performance. In relation to this type of arrangement we make the following points:
- In general we believe that positive incentives are more effective than negative ones as positive incentives generate forward looking proactive development rather than consolidation of current position.
 - We do not support the introduction of penalty mechanisms on the back of incentive schemes that have been agreed in the past. The concept that improved performance has been paid for and therefore should be maintained with downside penalties does not reflect the original basis of Ofgem setting and National Grid accepting the scheme which was to fund the investment and provide reward for delivering improvements in performance.

- National Grid will incur costs to maintain performance, therefore any Standards of Service scheme would need to recognise that there is a cost to stand still in performance terms.
- To improve performance requires investment. We believe it is unlikely that a scheme would be set that would be attractive enough to risk investing capital to try and improve performance, particularly if in future years the performance benchmark is moved up which puts that investment at risk.
- The need for monthly measurement intervals and planned system downtime would be reinforced.

143. Therefore our recommendation is that our proposal should be adopted if there is a wider benefits for consumers (that industry participants may not have identified), or dropped.