



National Grid Gas (NTS) SO Incentives of 1 April 2009 – Consultation on Shrinkage and Residual Balancing Incentive Issues
Comments from AEP¹

The Association of Electricity Producers (AEP) welcomes the opportunity to provide comments on this consultation. We detail our views against the questions listed below.

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 Association considers that daily balancing is an important feature of the regime that has worked well over many years. The objective of the residual balancing incentive is to compliment that through National Grid trading where necessary to set cashout prices to incentivise shippers to balance each day, Even in the absence of any trading by Grid incentives for shippers to balance remain through the cashout price differentials. The objective of the incentive should be to trade against the physical requirements of the system to ensure its safe and efficient operation rather than to trade when the system is within an acceptable operational envelope simply to try and ensure that small imbalances are not transferred between days.

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?

Shippers are already incentivised to provide accurate nominations by scheduling charges and licence conditions. If this is an issue of concern to

¹ The Association of Electricity Producers (AEP) represents large, medium and small companies accounting for more than 95 per cent of the UK generating capacity, together with a number of businesses that provide equipment and services to the generating industry. Between them, the members embrace all of the generating technologies used commercially in the UK, from coal, gas and nuclear power, to a wide range of renewable energies.

National Grid then it should be progressed via the UNC modification processes.

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

NG tends to trade in the second half of the day and therefore set cashout prices after 1800 on the day, this means that shippers the only have limited time to address their imbalance position if this is necessary.

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

We believe the price performance measure has delivered against the original objective; however this is less clear for the linepack measure. In this context it is important to consider the degree of influence NG has over these performance measures. NG can determine which trades it undertakes and may reconsider whether to take the next highest priced trade if there is a gap from the current marginal price set or if that next trade is only for a small volume. We consider this to be an appropriate response to the incentive. Whereas NG has less direct control over how the closing linepack outturns particularly within the relatively tight 2.4mcm band. There may be supply of demand changes late in the day which are beyond the influence of any price signal. There are also geographic linepack drivers and times when NG needs to change the linepack target in response to changing demand. At such times we believe NG simply disregards the linepack incentive and rightly focuses on the operational requirements of the system.

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?

The Association believes that the price performance measure should be retained and perhaps tightened given that Grid has routinely benefited under this incentive but the linepack measure be disregarded to reduce unnecessary residual balancing activity.

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?)

If the linepack measure is retained this approach would seem more sensible than the current arrangement, as it should drive the system to a more appropriate operational linepack target.

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

It seems here that National Grid is seeking greater reward for balancing the system on a 'difficult day'. The concept of a difficult day has been discussed before but it is difficult to define. Also it is accepted that National Grid will not always be able to benefit under the incentive scheme, but losses on some days are balanced against gains on 'easy days', notwithstanding that National Grid has licence conditions requiring it to manage the system efficiently even when an incentive payment cap or collar has been reached.

Furthermore the parameters for incentive schemes should be known in advance in order to promote the appropriate behaviour. Any adjustment that related to errors in shipper nominations as judged against actuals would not be known until after the day, so could not determine behaviour on the day. As such this does not seem appropriate and would introduce unwarranted complexity.

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?

See Question 5

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

Longer term incentives structures are desirable where the regime and performance is stable and where NG may invest to seek to improve performance. Given the short term operational nature of this incentives its not clear that either of these apply.

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?

We agree that linepack cannot be managed to a fine resolution, and accept that a stepped structure more closely related to operational linepack requirements may be more appropriate. However we would prefer to see NG taking balancing actions because the system needs that rather than to meet a particular linepack target or band.

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

The Association is sceptical whether the inter-day energy transfer service would enhance the efficiency of the wholesale gas market, it could impact on

the availability of entry and exit capacity and constraint management costs. We consider market efficiency might be better facilitated by NG retaining its holistic view of the system and managing linepack both geographically and nationally in the best interests of all participants. Furthermore we do not understand the drivers for NG considering this service at a time when it reports system operation is becoming more challenging due to changing supply / demand patterns.

As discussed above it is accepted that system linepack cannot be managed to a fine resolution by NG's actions. This is because individual shippers who are involved in physical gas supply are also unable to manage their imbalance position exactly. This means that if such a service is provided shipper may be no more able to meet a long or short position than they can a balanced position. This would leave shippers with cashout exposure and NG potentially needing to take balancing actions. We believe this would be further exacerbated by uncertainty over whether the service is available or not, uncertainty in the quantity available and the time at which it is made available.

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

We do not believe this service should be introduced

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.

See above

Question 14 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?

See above

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

Overtime the market would need to predict the likely availability of the service so would need to understand how National Grid arrives at its decision to release this product. A methodology statement may be necessary.

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

If this service were to be introduced, the market would need to understand what quantities had been made available and how this affected the end of day linepack target.

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 Association is not a shipper.

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

In principle minimising compressor fuel use should probably remain the main objective of the shrinkage incentive, so long as there remains a healthy tension with other drivers such as the provision of entry capacity and management of unbilled energy.

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?

We agree this would seem like a good starting point.

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)?

This would seem like a reasonable approach, however extending this for three years at a time of significant change in supply sources may not be appropriate.

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

The historical outturn option seems rather simplistic, whilst the network simulation approach seems rather complex. If it was applied retrospectively then it may be rather harsh given the value of hindsight as opposed to realtime operational decisions being made by operators. The distance travelled model, may be worthy of further exploration but it seems unlikely that a new model could be developed in time for next years incentives. The target driver approach seems to be reasonably well tested; we agree with National Grid that this may be the best way forward.

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 seems to mitigate some of the risks of discrepancies between forecast and outturn and as such it seems appropriate to retain this.

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?

The purpose of any kind of incentive regime is to influence performance, it is therefore important that the performance measure in question is to at least some degree under the control of the party that is being incentivised. In this context it is suggested that National Grid has little influence over some of the elements of shrinkage, namely UAG. It would therefore seem to be appropriate to take these volumes out of the main shrinkage incentive and treat them separately perhaps with a softer incentive or a new incentive better designed to target behaviours that could lead to improved performance. In any case there clearly needs to be further investigation of these volumes to understand the drivers so that more appropriate arrangements can be developed in the future.

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?

We consider there may be merit in a longer incentive period for a UAG incentive.

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.

An incentive may not be necessary if more frequent and rigorous meter validation was undertaken.

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.

The Association would have some reservations over National Grid Gas becoming an electricity supplier and seeking to trade for profit. We acknowledge that there are limitations on the market information that may pass between electricity and gas operations but do not feel this would sit comfortably with NGG's role. It is not self evident that NGG would be able to trade at lower cost than existing suppliers that may be better positioned to manage trading risks across a larger portfolio.

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 would seem reasonable for the duration of this price control until more data is available for review.

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.

Further consideration should be given as to whether Grid should be incentivised to manage its demand in order to manage TNUoS charges.

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 would expect suppliers to provide a view

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.

We agree that a benchmark based on prompt prices would be appropriate, however this would need to be reviewed if it became apparent that UAG volumes were becoming more predictable such that forward pricing might then be appropriate for at least part of the volumes.

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

Not at this time