Scottish and Southern Energy
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

John Perkins
National Grid
National Grid House
Gallows Hill
Warwick
CV34 6DA

Telephone: 01738 456712
Facsimile: 01738 456415
E:mail: beverley.grubb@
scottish-southern.co.uk

Our Reference:
Your Reference:

Date 19th December 2008

Dear John,

National Grid Gas (NTS) SO Incentives for 1 April 2009
Initial Proposals Consultation

Thank you for providing SSE with the opportunity to comment on the above consultation document.

The consultation is very comprehensive, covering all aspects of the current SO Incentive scheme. However there are clearly varying levels of change and uncertainty across areas. For instance residual balancing and Operating Margins are key to the above consultation document.

Whilst we believe proposals relating to Residual Balancing are relatively straightforward, there is much more uncertainty and complexity associated with forthcoming changes in relation to Operating Margins. Until further clarity emerges in relation to potential future service providers, volumes required and associated costs is very difficult to form a view on an appropriate incentive framework, or parameters going forward.

Similarly, in relation to UAG which falls under the shrinkage incentive, there is clearly still a lack of understanding regarding the drivers behind the significant year on year variations in net UAG volumes. Coupled with changes in gas prices, this has led to significant year on year variations in costs. We believe a fundamental review of UAG is required to understand the relationship between net and gross values and the drivers behind variations in net volumes. Until this is achieved we can not be clear what measures need to be taken to address the issue or develop an appropriate incentive framework and parameters.

As a general point, we believe there is a need for more detailed analysis of past performance under each individual aspect of these incentives. In addition we believe updated forecasts are required of future performance in terms of volumes and costs. Without this information participants can not reach an informed view. We believe most of the information required should be available to NGG. It should be provided in a clear and easily understood format as part of the next consultation document. The structure, format and level of detail provided against each aspect in the electricity SO Incentive consultation document is a useful reference.

We have attached our detailed views on the issues highlighted above and in response to the specific question raised in the consultation document. We hope our comments are helpful. Should you require any additional information or wish to discuss any aspect in more detail please contact me at the above address.

Yours sincerely

Beverley Grubb
Regulation Manager

National Grid Gas (NTS) SO Incentives for 1 April 2009
Questions and Consultation Feedback

1. Do either of the two residual balancing schemes presented better reflect an appropriate balance between driving minimal residual balancing and correct allocation of costs?
SSE supports measures to retain but widen the Linepack Measure. We believe the current target introduces an artificial barrier, and potentially leads to unnecessary balancing actions being taken by NG. This ultimately imposes additional costs on the industry. NG suggests widening the Linepack Measure from 2.4mcm to 2.8mcm would result in fewer balancing actions. We assume this would be without a significant detrimental impact on the system. However it is not clear what the level of reduction in actions and costs would be. Based on historical data on the NG website it appears that there have been variances of more than 2.8mcm on a significant number of occasions over the last few years. In a significant proportion of cases, variances have exceeded 2.8mcm by a significant amount. As such, we believe further detail is required before any conclusions can be reached. However, our initial view is that Scheme B is a pragmatic first step. It introduces incremental change to the LM, but retains the existing PPM. In addition to widening the LM, it tightens incentive arrangements where linepack is within a 1.5mcm band, as incentive payments to NG would become flat. It also introduces a steeper downside sharing factor to help ensure large deviations would be resolved.

2. Do you have any comments on any aspects of the scheme(s?)
In the absence of more detailed analysis, it is extremely difficult to form a view on the detailed aspects of the scheme. We believe more information should be provided under the next phase of the consultation process.

3. Should this incentive be reviewed periodically (e.g. annually) or only when there is a specific need to?
Given the proposal to change aspects of the scheme, we believe it would be appropriate to review the performance annually, at least in the initial stages. Leaving arrangements to be reviewed "when there is a specific need" introduces unnecessary uncertainty for all interested parties.

4. Do you think it is appropriate to have a separate incentive on UAG? Do you agree that this should be a long term incentive?
SSE is concerned by the level of variation in annual net UAG volumes and costs. We note that gross UAG volumes are relatively constant year on year. We are unsure why this is and are concerned by the continued lack of understanding in this area. We believe a fundamental review is required to try and understand the problem, before embarking on solutions. We are not convinced that volumes are solely due to problems associated with metering. In order to maintain focus on this area and help provide an incentive to reduce costs, we believe a separate incentive is appropriate. Given the nature of the problem and timescales involved in developing and implementing potential solutions, a long term incentive of 5 years seems appropriate.

5. Do you agree with the proposed UAG incentive and do you have any comments on the specific proposals outlined (including whether a scheme

should be based around gross UAG and whether the proposed target and incentive value are appropriate)?
Given the level of volatility in net UAG volumes we believe it would be inappropriate to set an incentive on this basis. We believe the incentive should be based on gross UAG volumes, with a target set using historical data as proposed in the consultation document.

6. Do you believe that any limits should be applied to the proposed scheme? Please describe how best to achieve this e.g. by suggesting a deadband, cap or method for resetting the target?
Until we have more information to help us understand the nature of the problem and potential solutions, it is difficult to assess the level of costs likely to be incurred by NG going forward. It is not clear to us that there should be no downside sharing factor for NG. We believe a downside sharing factor may be appropriate, albeit with a collar applied. We support continuation of the 50% upside sharing factor.

7. Do you believe there is an alternative proposal that would better incentivise reduction of UAG volumes?
Given the lack of understanding in this area currently, it is difficult to assess whether there may be more appropriate alternative proposals.

8. Do you agree with the shrinkage volume forecasts? Do you have any comments to make?
We have no specific concerns regarding the forecasts at present but would appreciate an update on the position for 2008/09 as part of the next phase of consultation and an updated view of the forecast for each element going forward.

9. Do you support using outturn flows at St Fergus as a target driver for the compressor fuel forecast?
We welcome the detailed analysis presented by NGG in this area. Based on information provided, it would appear that St Fergus remains the most significant driver, as such we support the methodology proposed.

10. Is there still a requirement to have bands around the compressor fuel volume target or should a continuous relationship be used?
We believe a continuous relationship is more accurate; it smoothes out unnecessary volatility and removes the potential for windfall gains and losses introduced under a banded approach.

11. Do you believe it is appropriate to review the GCRP Uplift?
SSE supports the review. We believe it is timely.

12. On what basis do you believe the GCRP Uplift should be set for 2009/10 (e.g. storage based or market based)?
We believe the GCRP Uplift should be set ex-ante based on storage. This would avoid the potential volatility that introduced under a market based approach.

Question 12 Do you support the proposed Enduring ECRP methodology based on wholesale prices uplifted to reflect retail costs? Is there a more appropriate reference that could be used for the wholesale prices?

We have no disagreement with the principle of providing an Electricity Cost Reference Price nor the use of the month immediately preceding the delivery quarter. However, we would like to understand better the justification for a continuation of a 16% Uplift, and indeed the use of an inflation rate of 5.02% (with RPI currently running at 3%). We would also like to understand the application of TNUoS charges, in particular whether Triad charging has been included and how appropriate it is to apply if site demand at the Triad can be reduced.

13. Do you agree that the outturn UAG volumes should be passed through this scheme?

Given the apparent lack of direct control that NGG has in this area and the lack of understanding, it would be difficult and potentially inappropriate to try and implement more complex arrangements. We believe pass through of volumes may be appropriate until a better understanding of the issues is developed. However some form of incentive is required to encourage NGG to work with the industry to investigate problems and develop and implement potential solutions.

14. Do you have a preference between an annual or quarterly scheme (as described in options 1 & 2)? Under a quarterly scheme how should quarterly caps and collars be set?

SSE believes it would be appropriate to revert back to an annual scheme. As highlighted in the consultation document, initial concerns around compressor fuel forecasts that prompted the quarterly scheme no longer exist. An annual scheme provides a better incentive framework for maximising savings across the whole year. As such our preference is currently for Option 1. However analysis of the potential impact of both options would be helpful. We urge NGG to bring this forward under the next phase of consultation.

15. Do you have any comments on any of the parameters (e.g. caps, collars, and sharing factors) of the scheme and the duration that the scheme should be set for (e.g. 1, 2 or 3 years)?

We do not have any other comments or views, beyond those set out under option 1, which proposes retaining upside and downside sharing factors and slight widening of the annual cap and collar.

16. Given the uncertainty over the impact of OM contestability, do you support passing through the OM holding costs for 2009/10, subject to Ofgem scrutiny?

Currently the OM incentive is made up of two elements. The first relates to holding costs, which are currently the cost associated with holding gas in storage. The second element relates to the utilisation of gas. With the introduction of contestable services in 2009 there is a significant amount of uncertainty regarding the characteristics of new service providers, the potential costs and the volume required. SSE has previously set out its concerns regarding the potential impact of introducing OM contestability. We remain extremely concerned that there is still very little analysis available on potential costs and benefits. Whilst we appreciate that NGG has a licence obligation to develop arrangements in this area, details presented to date show a significant level of uncertainty regarding the ability of alternative service providers to provide the same level of service and potential costs. In a previous consultation document NGG indicated that incremental amounts of 150% may need to be procured in order to maintain existing levels of service. We believe it has also been suggested that parallel running of the existing and new arrangements may be required for some time until experience and confidence in new services develops. We are concerned that arrangements could result in significant additional cost to the industry, without any material benefit. Until further details emerge from the procurement exercise regarding costs, benefits and the impact on security of supply, we are unable to support proposals in this area. We are concerned by the suggestion that costs should simply be passed through to participants. Participants will have no control over the volume or cost associated with services procured by NGG. We believe a more balanced approach to risk is required given that NGG will be the contracting party. NGG should be incentivised to minimise costs.

17. If not do you have any suggestions on how OM costs could be incentivised for 2009/10?
Please see response to 16 above.

18. Do you support the proposal to keep the existing OM utilisation incentive?
It is our understanding that new service providers may seek to recover their costs through an option / exercise framework. It is likely that NG would seek to minimise exposure by procuring services with the lowest option price. This is likely to mean that utilisation costs will be high. As such it is important that appropriate incentives exist in relation to utilisation costs to ensure the industry is not inappropriately exposed where action is taken. A balanced approach is required to minimise participants' exposure to all costs. As detailed above, it is difficult to provide views until more information emerges from the tender process.

19. Do you agree with the proposal for continuation of the existing historic average approach for setting a volume target for gas turbine driven compressors?
Yes, although we believe some attempt should be made to adjust for electric compressors, even though volumes in initial years may be small. We hope this will be addressed under the next phase of consultation, once information requested by Ofgem is available.

20. Which option do you support to best reflect environmental costs associated with the venting of natural gas?
SSE's current preference is for Scheme A which factors in the costs associated with all gases vented from a compressor. However we are concerned that the reference price proposed is high relative to market prices.

21. Do you support the proposed parameters (including the 3.2% target) for annual Demand Forecasting Incentive?
SSE is supportive of the 3.2% target.

22. Should the incentive be set for more than one year?
Given current uncertainties regarding supply and demand we believe the incentive should be reviewed annually until a better understanding of key influencing factors develops.

23. Do you agree that the current Data Publication incentive should be rolled forward unchanged?

We do not believe it is appropriate for NGG to be incentivised or rewarded for basic business functions that should be entirely within their control. The level of risk faced by NGG in this area does not warrant a specific incentive or reward.

24. Do you believe this incentive should be set unchanged or the remainder of the price control period (2012)?

Please see answer to 23 above.

25. Should the funding arrangements for upgrading the website be made enduring or be removed?

Again we do not believe that it is appropriate to reward or incentivise NGG for a basic business function. To the extent that funding is required we believe this would be more appropriately dealt with under the main price control. As no information has been provided regarding future initiatives or funding requirements, it is difficult to comment in more detail.

26. Do you believe that the package of incentives is designed to drive the desired behaviours from the System Operator, providing the right balance between risk and reward?

In the absence of more detailed historic and forecast information on individual aspects of the SO Incentive scheme and performance overall e.g. volumes, prices, total costs and costs / revenues to NGG, it is very difficult to comment. We believe more detailed information is required on the potential impact of the proposed changes compared to existing arrangements to help participants make an informed decision. We believe this should be addressed under the next phase of consultation.

27. Do you have any other comments on SO Incentives?

SSE has previously raised concerns regarding changes to maintenance dates. Maintenance dates are agreed between parties in line with UNC provisions. Whilst change is permitted under the UNC, this often results in additional costs to generators, which can be disproportionate to those faced by NGG. CCGT maintenance tends to be dependent on the availability of a few key contractors. Once dates have been agreed with contractors, they are very difficult to reschedule. Any change by NGG ultimately results in longer outage periods for the CCGT, at very high cost. On occasion changes can also impact on generation margins and hence electricity security of supply. We believe consideration should be given to the introduction of incentive arrangements to encourage NGG to keep to original dates. Where changes are required greater consideration should be give to the impact on generators and the industry.