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Our Reference:
Your Reference:

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Dear John,

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

SSE welcomes the opportunity to comment on the above consultation document.

SSE is concerned that a lot of focus and attention has been given to the introduction and development of a Linepack product and service. There is a significant amount of uncertainty regarding:

- the nature of the product
- the extent to which it could be made available
- how and when it could be made available
- interactions with entry and exit capacity availability, and
- implications for operation of the network and associated costs e.g. compressor running costs

"Linepack" has recently been referred to interchangeably as a capacity and commodity product. It is our understanding that both are very different. We had understood that "Linepack" was essentially a tool used by the System Operator to manage flows across the network and maintain system pressure. The suggestion that some could be made available on a commercial basis to Shippers for energy balancing purposes represents a significant change. We are concerned that it could have significant implications for the safe and efficient operation of the network and availability of entry and exit capacity (particularly flexibility capacity). We are also concerned that it would fundamentally change NG's role, potentially introducing conflict between its role as System Operator and its ability to participate in and influence the market. We believe this would be inappropriate.

We do not believe a "Linepack" service would deliver any significant benefit for Shippers. In fact, we are concerned that it would introduce significant additional complexity and introduce additional risk for all participants in terms of:

- determining availability of the product or service
- developing and implementing a release mechanism
- calculation of Shipper imbalance positions, contribution towards system imbalance and allocation of residual balancing costs where imbalance positions are allowed to be carried over into other periods
- interaction with system operation and capacity arrangements

SSE believes the focus of the consultation should be on developing robust and transparent incentive arrangements that:

- help improve the industry's understanding of the criteria applied by NG in determining when and to what extent residual balancing actions should be taken
- help minimise NG's role in balancing and
- minimise costs to market participants.

We believe this can be achieved through the existing Price Performance Measure, Linepack Measure and Information Incentive.

In relation to Shrinkage Incentive arrangements, SSE believes further analysis is required to explain variations in unaccounted for gas volumes and potential causes. We believe it is extremely unlikely that the level of year on year variation can be accounted for by meter errors alone. UAG also includes theft and leakage; we believe further analysis of these elements is required,

Finally, SSE is surprised that very little focus has been given to CV issues, particularly given the level of concern identified during the consultation process last year. We had hoped further analysis and consideration of alternative arrangements would have been progressed through industry workstream in time for this year's incentive consultation. We would urge that further analysis is carried out of current and future levels of new NTS and DN supplies and CV variations to aid industry discussion and help develop appropriate regimes.

We hope you find these comments helpful.

Yours sincerely

Robert Hackland
Regulation Manager

SSE Response to Specific Questions Raised by National Grid

1. Do you believe an objective of the Residual Balancing Incentive should be to provoke NG 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 days?

We believe NG should be incentivised to resolve imbalances within day. We are concerned that any proposal to transfer imbalances to other periods could have operational implications and potentially increase risk and exposure for market participants. There is no guarantee that market conditions in future periods will be more favourable or that it would be easier or more economic for NG to resolve imbalances. Also any arrangement which allows imbalance positions to be transferred or settled over longer periods of time, introduces additional complexity and difficulty in terms of attributing costs.

2. Should the objective of the RBI take account of accuracy of information from NG 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?

We believe the NG daily demand forecast is key to the whole process and underpins actions taken by participants. Accuracy can have a significant financial impact on Shippers. A robust mechanism is essential to incentivise and monitor accuracy of forecasts. We believe incremental changes could be implemented in this area.

With regard to Shipper nominations, scheduling charges are currently applied to incentivise accurate Shipper nominations. Shippers are also obliged under Licence to provide accurate information and not knowingly mislead Transporters. We also understand NG monitors actual performance against nominations, in conjunction with Shippers. We are not aware that any significant issues have emerged as a result of this process.

3. What are the effects or impacts Shippers experience as a result of NGs residual trading behaviours?

The criteria applied by NG in terms of when and on what basis they take balancing actions is not always apparent to Shippers e.g. there can be occasions where very small actions are taken by NG when the level of system imbalance is low yet on other occasions actions are only taken at higher levels of imbalance. Also there can be inconsistencies in terms of timing, with actions taken early in the day on some occasions and very late in the Gas Day on others. Actions taken early in the day are more likely to be unwound by NG later in the day as Shippers bring end of day positions into balance. However actions taken by NG very late in the day can have a significant detrimental impact on Shippers as they influence cashout prices and leave very little time for Shippers to react. We believe further transparency is required in terms of criteria applied by NG and to help distinguish between operational and energy balancing actions.

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

Aside from transparency issues, on balance it would appear the Price Performance Measure is working. However we believe that NG's performance against the incentive over the last three years indicates there is scope to tighten the incentive further. NG has received significant financial benefit under the PPI over recent years.

5. **Should the two elements of the RBI be retained and should the relative incentive properties be changed to promote either more or less residual balancing activity?**

We believe the two elements should be retained. We do not believe that either should be amended to encourage more residual balancing activity. The focus should be on minimising NG's actions. As stated above we believe there is scope to tighten the PPM but it may be appropriate to relax the LM as detailed below, to reduce residual balancing activity where this is not operationally necessary.

6. **Given the operational requirements 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?)**

As stated above we believe there may be scope to amend the Linepack Measure to take account of supply / demand conditions and operational requirements. We believe this could be achieved in a number of ways e.g. by increasing the current tolerance level, setting a target for each Gas Day or by setting the tolerance to take account of conditions. We believe all options should be considered in more detail. It is important that target measures aren't set at arbitrary levels. They should reflect system needs and encourage efficient behaviour. They should avoid unnecessary action having to be taken by NG. However arrangements must also provide certainty for Shippers and be transparent.

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

We are unclear what is intended by this proposal or how such a scheme would operate. In particular it is not clear whether it would operate ex-ante or ex-post. We believe any obligations or incentives should be clear and understood in advance. As stated above, SSE believes appropriate arrangements currently exist to incentivise and oblige accurate information to be provided by market participants. We are not aware of any significant issues in this area. Where issues arise, there are provisions within the current governance framework for participants to bring forward proposals and engage in industry debate.

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

As stated above, we believe there is scope to tighten incentives in relation to the PPM. It is evident from information provided that NG has received significant financial benefit from the PPM. However performance and benefit against the LM has been marginal. We suspect this may reflect the arbitrary way in which the LM is set. This does not appear to be driving the most efficient outcome for participants overall.

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

We believe the market would potentially benefit from a PPM incentive spanning several years as this would provide stability and certainty that would allow NG to take a long term view, potentially developing more innovative and efficient ways of meeting residual balancing requirements. We believe consistency is required in relation to timescales for the PPM and LM, to allow NG to make appropriate trade-offs between the two.

10. If a linepack incentive is established, should a stepped payment structure be introduced for linepack rather than the current linear structure which suggest an infinite balancing solution?

As detailed above we believe it may be more appropriate to introduce an incentive mechanism which sets a target based on actual conditions and operational requirements, rather than assuming a finite solution for all circumstances. However we don’t believe that this has to go hand in hand with a stepped payment structure for NG.

11. Do we believe an energy transfer arrangement would be an enhancement to the efficiency of the wholesale gas market?

SSE does not support proposals for a linepack / energy transfer service. SSE is concerned that such an arrangement would introduce significant complexity and have a detrimental impact on system operation and capacity arrangements. It is not clear what has driven development of such an option; it does not appear to be Shipper led.

There seems to be significant uncertainty regarding the extent to which NG believes linepack could be released or utilised for balancing purposes. It is our belief that it should be negligible. Linepack is essentially used for the safe and efficient operation of the network; it is used to manage gas flows through the network and maintain system pressure levels. Any suggestion that it could also be accessed for balancing purposes seems to be at odds with this principle. Furthermore, we are concerned that such an arrangement would significantly alter NG’s role. We believe it would be inappropriate for the TSO to have its role extended to effectively include trading gas to Shippers to allow them to balance. NG's actions could influence market prices. We are also unclear how such a proposal fits with entry capacity arrangements and proposed NTS exit arrangements (particularly the flexibility capacity product) as changes in linepack must ultimately impact on capacity availability; again potentially introducing conflict with NG’s role as TSO.

We are concerned that so much attention has been devoted to this issue and believe the focus for 1st April 2009 should be on developing and implementing robust incentive arrangements for existing NG performance measures, rather than developing and introducing these new commercial products and services.

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

Given comments above, we do not believe any of the platforms or mechanisms would be appropriate.

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.

Given concerns regarding such a service we do not believe it is appropriate to comment further on timing or product length.

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

We believe "linepack" is essential for safe and efficient operation of the network. We do not believe it is appropriate to utilise the product for energy balancing purposes. We believe this could have significant implications for operating costs and potentially safety.

15. What market information would you want to see accompany such a service?

SSE has no further comments.

16. Do you have any views on how to deal with the impact of transfer on PCL (Predicted Closing Linepack)?

We believe it is inappropriate to engage in such discussions at this point. The question demonstrates just one aspect of additional risk and complexity that such a proposal would introduce.

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?

For the reasons detailed above, SSE would not be interested in making use of such a service.

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

Whilst we believe both should remain an objective of the shrinkage incentive it is important to recognise interactions, in this case with the capacity regime. It is important that fragmented and specific incentive measures encourage the most efficient behaviour overall rather than simply maximise financial benefit against each individual measure.

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

SSE believes it is appropriate to maintain consistency between forecasts used for different purposes. As the TBE process forms the basis for assumptions made elsewhere it seems appropriate to also use details for incentive purposes.

20. Do you support the development of target drivers to move the 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)?

SSE supports such a move however further consideration is required in relation to appropriate drivers and time period, particularly given current uncertainty and planned move from gas to electric compressors at a number of sites. Further information is required regarding both drivers and programme of works to allow appropriate industry input.

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

Given possible future changes, particularly in relation to supply patterns and compressor fuel type, we believe an approach based on past performance is unlikely to be appropriate. It doesn't protect against step changes and can result in significant gains and losses. SSE supports network simulation analysis as this is forward looking and allows various scenarios and outcomes to be taken into consideration. However we note NG's concerns regarding development of such an approach in time for 1 April 2009. As such we support the approach suggested by NG which focuses on agreeing a reasonable set of supply / demand assumptions to set targets, and then develop drivers to reduce the error between the forecast or target and actual outturn.

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

Whilst quarterly arrangements would protect NG against significant variations between target and actual outcomes, SSE believes they can be detrimental as they discourage NG from taking long term and potentially more innovative or efficient measures. They also introduce uncertainty and potentially instability for market participants where they result in step changes in targets and hence behaviour within year. On balance SSE would prefer longer-term incentives.

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?

SSE appreciates volumes have varied significantly year on year. It is difficult to see how such extremes could be as a result of metering errors alone as suggested by NG. We note that unaccounted for gas also includes theft and leakage.

We appreciate that UAG volumes are not entirely within NG's control. We do not believe it is appropriate to incentivise parties where they have no control over outcome. We believe further consideration should be given to removing aspects that are beyond NG’s control. However further analysis is required to identify contributing factors, relative proportions and potential changes year on year before appropriate regimes can be developed to incentivise NG in those areas where they do have control.

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?

Whilst SSE would generally support longer term incentives, given the level of uncertainty and analysis required in this area, we believe it may be appropriate to set a one year incentive at this stage.

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.

Until further analysis is carried out to try and quantify the extent to which theft, meter error and leakage contribute to UAG volumes; it is difficult to ascertain whether there is a need to progress this further at this stage. It is our view that metering arrangements are robust and very tightly controlled. We do not believe there is any evidence that further action is required by Ofgem.

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?

As with linepack proposals, SSE has significant concerns regarding suggestions that NG’s role in the market should be changed in such a way to introduce a trading function. We believe this introduces significant potential for conflict with SO obligations. More importantly it is not apparent that it is justified. We believe it is unlikely that it would result in any significant benefits relative to cost i.e. that NG would be able to secure power at lower cost compared to purchasing from an existing supplier.

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

SSE believes such an approach would be appropriate.

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.

SSE believes it is appropriate to continue to deal with use of system charges separately from the wholesale element.

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.

No comment.

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.

Whilst UAG volumes are fairly volatile year on year, there does appear to be a relatively stable minimum volume. As such SSE believes some consideration should be given to setting a price weighted between forward and prompt prices to incentivise NG to procure UAG as economically as possible.

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?

SSE is surprised that very little focus has been given to CV issues given the fact that this was raised as a point of concern during consultation last year. There does not appear to have been any progress in relation to consideration or development of future arrangements given potential variations in CV from new NTS and DN supplies. We look forward to industry discussion through the appropriate UNC workstream shortly. Some analysis of potential variations and extent of future supplies would be helpful to guide industry discussion.