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19<sup>th</sup> September 2008

Dear NGG,

**Consultation on Shrinkage and Residual Balancing Incentive 2009 – EDF Energy Response**

EDF Energy welcomes the opportunity to respond to NGG's SO Incentives consultation and has answered the questions in the consultation in numerical order. Where the questions are not in an area of our expertise or where we do not have a view we have chosen not to comment.

We trust that you will find these comments helpful.

If you have any queries please contact me on the number below. Please direct queries in relation to these response to John Costa on 0203 126 2324.

Yours Sincerely,

A handwritten signature in blue ink, appearing to read 'Seb Eyre'.

Dr Sebastian Eyre  
Head of Energy Regulation  
Energy Branch

**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?**

We believe in a daily balancing regime in the UK and support cost targeting where possible. There are merits in allowing the system and balances to drift over days in the expectation that balances can and will net off however we believe the risk and costs of this could far outweigh the current regime, especially as the UK becomes an importer of gas where more erratic gas flows are expected as witnessed recently. We therefore do not believe it warrants changing at this time.

**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?**

We agree that NGG's decision on whether to take balancing actions depends largely on the accuracy of nominations and that sometimes these vary in relation to physical flows, particularly at the start of the gas day as figure 3 shows. However, Figure 3 of the consultation also shows that on average the information received is accurate and the uncertainty of PCPL (Projected Closing Linepack) reduces throughout the day thereby creating a reliable trend. We would also note that the level of uncertainty can lead to NGG taking efficient actions from uncertainty for example in a case where NGG do not take balancing actions due to uncertainty of information and yet the system brings itself into balance anyway. Although this is not always a desirable situation to be in we would note that NGG will always have to make some judgement on whether to take balancing actions and their incentive scheme is based on this methodology.

We believe that it would be difficult to design an incentive as Shippers have a licence and UNC obligation to always provide the most accurate and up-to-date information to the transporter as possible. In terms of the nominations for NTS inputs and offtake s this means nominations should be revised within 1 hour's notice where there is any deviation from the prevailing nomination. We do not see any greater incentive on shippers to provide more accurate information than this from a threat of licence breach. If NGG is referring to some sort of Information Provision charge these have been raised in the past but with little effect such as the INS (Incentivised Nomination Scheme) for example. However, it is worth noting that Shippers balance to NGG's demand forecast and so changes in the demand forecast during the day may result in variances to the nominations and flows.

## Issues/ Behaviours under the current Residual Balancing Incentive

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

We have noticed NGG's balancing actions reduce over the years since both balancing incentives were introduced and therefore believe that they are having a positive effect on the system.

## Potential options to change the Residual Balancing Incentive

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

We believe the price incentive has delivered but not sure whether the Linepack (LP) incentive has served as NGG usually try and hit the prices incentive at the expense of the LP incentive.

### **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?**

We believe there should be two elements in the residual balancing incentive as the LP incentive ensures costs are targeted in the balancing period they are incurred and the price element ensures NGG takes efficient balancing actions. However, given that NGG rarely hits their LP incentive it is worth asking the question what value is it having? Further analysis and views from NGG on the effect of removing the LP would aid the answer to whether it is needed or not.

### **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?)**

We can see the argument for introducing an absolute LP target level to reflect and align the incentive with NGG's operational requirements such as increasing linepack going into winter and as a result of extra pipeline investment – e.g. a seasonal profiled daily target. However, if an absolute level were to be introduced NGG would have to publish its view of where absolute closing LP would go each day so as to be able to meet it and inform its customers.

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

We are not aware of NGG's incentives performance being hampered or improved through the quality of information provided by market participants. We believe that such an incentive would be difficult to strike a proper balance however these issues should be addressed through the Operational Forum and Transmission workstream if they exist. Again, the INS scheme did not change behaviours and we see no arguments for raising this issue again.

**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?**

We believe the PPM incentive is still working to incentive efficient balancing and therefore do not need updating, in line with the Better Regulation Executive. It is not clear how well the LP incentive is working, but we are not sure this is because of changes to the market structure.

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

Given the short term nature of these residual balancing incentives and the constantly changing market prices we believe there is no benefit in locking in the structure and parameters for several years.

**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?**

A stepped payment structure may incentivise the wrong behaviour and therefore we believe a curved incentive line would provide more of an incentive at times close to the target LP.

**Inter-day Energy Transfer Service Concept**

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

EDF Energy supports a daily balancing regime where costs are targeted in the period in which they are incurred. However, we agree with NGG that maintaining end of day LP within the current tight commercial bands set under the Residual Balancing regime is not operationally necessary, especially when NGG has a view that the system will itself come back into balance the next day due to the supply and demand data it receives. It is not clear how such an incentive would work in practice however it would provide NGG with a considerable amount of flexibility on when to take residual balancing actions and therefore the incentive would have to be tightened such that if the right level of LP balance was not attained after the second day then NGG would be exposed. This is to ensure a right level of risk and reward is maintained however, we have concerns that this could generate inappropriate behaviour and lead to more extreme LP fluctuations and therefore greater/ more inefficient balancing actions in the long-run. We would also note that this could impact on the UK's security of supply. For example if NGG were to allow the depletion of linepack in expectation of an increase the following day – which did not occur – then this would limit the ability of the UK to respond to unexpected changes in supply or demand. Also, we would like to know if this incentive would lead to a move away from daily balancing, in contrast to previous arguments which were going in the opposite “sub-daily balancing” direction?

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

The APX as per usual or other form of transparent platform visible to the whole industry.

**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.**

Provided there are no detrimental impacts on security of supply, then there would potentially need to be a daily and weekend product if it were to work, with absolute targets published ahead of these periods.

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

We are not able to say without knowing the precise rules and mechanisms which have yet to be designed.

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

It is not clear what information will be necessary as NGG hasn't defined the product but we envisage the publication of absolute LP target day ahead stage, the length of the system and NGG's performance against it after the day/ period.

### **Effect on PCLP**

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

N/A

**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?**

We are not able to say at this time without more detailed knowledge of the potential rules and mechanisms of how it would work.

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

We believe that minimising fuel should not be the only objective to reduce balancing or shrinkage costs. For example, it may be necessary to run compressors more often to reduce balancing exposure at the expense of Shrinkage usage costs where these would be lower. It is therefore important that NGG are sufficiently incentivised to make this economic decision considering other incentives such as their environmental ones and that in total these produce the right behaviours

**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?**

Yes, in the absence of any other/ better industry supply and demand information source.

**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)?**

We believe there is merit in developing drivers that move in line with key CFU drivers to minimise the potential for windfall gains or losses on volume under the Shrinkage incentive. However, there is not enough information or experience to set a long-term incentive.

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

N/A

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

Retaining the quarterly scheme prevents NG hitting the cap/collar too early in the year thereby diluting the incentive effect. We believe this still has merit.

**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?**

We believe that in the absence of another incentive, controlling the level of UAG is important and therefore should be retained as part of NGG's overall incentive. This will ensure some form of improvement is generated to reduce outturn UAG levels. We would note that the main driver of UAG is metering errors, with the UNC detailing the accuracy that these meters reach. In addition NGG is only responsible for maintaining a handful of these meters, with the majority being the responsibility of GDNs or terminal operators. It would therefore appear odd to place an incentive on NGG to ensure the accuracy of meters that they are not responsible for. In addition it would appear odd to incentivise companies to undertake actions that they are required to under the UNC, and so it may appear more appropriate to place a charge on companies who are failing to comply with the UNC.

**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?**

Potentially, yes we would agree with this suggestion.

**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.**

We believe that all meter owners should adhere to the metering standards as laid down in the UNC and ensure that errors are within the agreed tolerances. If there is evidence that metering volume errors in total are greater than the tolerances then this should be investigated as it's effectively a breach of licence, not a poor performance under a financial incentive.

**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.**

We do not believe it is necessary or appropriate for NGG to become a supplier of electricity in order to meet its electric compressor demands.

**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.**

We believe that an uplift related to retail prices is not warranted as NGG should/ would be buying from the wholesale electricity market in order to supply its compressor requirements.

**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.**

This seems sensible.

**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 believe NGG can use either a fixed price retail contract based on a snapshot of forward curve prices or rely on a basket of products such as month ahead or week ahead with Bsuo and TNous charges pass-through. Either way NGG would have to agree ahead of time the index or fixed price they want to accept so that they have a target to work against. Balancing charges should be the responsibility of NGG to account for any over or under-delivery.

**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.**

Whilst we believe that UAG should be accounted and analysed separately to Shrinkage volumes we do not believe it should be a separate incentive for now. However can not think of an alternative or more appropriate reference price although we do not believe it should be a prompt price to allow NGG some flexibility in procuring and managing their exposure going forward.