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Friday, 25 January, 2008

Dear Duncan & Mark,

RE: National Grid Gas and Electricity System Operator Incentives - Initial Proposals Consultation

We are writing to you in response to your consultation on the proposed SO incentive scheme for National Grid, setting out our views on the questions posed for both the Gas and Electricity incentives.

Electricity Related Questions:

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

It is very difficult for market participants to comment fully on the assumptions and indeed forecast. National Grid has access to more information on past outturn and the reasons for why certain events occurred and actions were taken. It is therefore in the best position to gauge how future costs may be impacted.

For parties to be able to critique National Grid's forecast fully, it would be necessary for them to have full access to the past performance data that National Grid has utilised and to the full calculations used in the forecast. Each market participant would then be required to undertake at least as much analysis as National Grid, in order to understand how exactly the forecast was derived and to ascertain where they agreed and disagreed with numbers presented. We are not advocating this course of action. As well as concerns over the commercial confidentiality of certain items of data, this would also represent a significant duplication of effort. Although

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we are happy to comment on assumptions and scheme proposals where we can, in our opinion the main role of scrutinising National Grid's forecast has to be undertaken by Ofgem. Not only does Ofgem have the ability to access confidential information, it is also clearly more efficient for one party to carry out this role rather than numerous market participants duplicating the effort.

In as far as we are able to comment, the assumptions that National Grid has made do not appear unreasonable.

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

In light of the information presented to us, National Grid's assumptions on NIV appear sensible. We agree that it would be wrong to assume that the shortness experienced in summer 2007 would necessarily be repeated in 2008. Therefore, a forecast that was a combination of the position for the current and previous year, as proposed, would seem appropriate.

As underlying costs can alter market price and the costs of some balancing services, we can see how a view on wholesale prices might affect National Grid's expected balancing costs. However, we are unconvinced that a strong correlation has been proven between the two to allow balancing costs to be indexed against wholesale prices.

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?

Again, participants are not in a position to ascertain whether or not the

assumptions and the associated cost implications are fully accurate. We agree with the description of how the increased planned level of outages will put upward pressure on costs. However, it is not possible to validate National Grid's calculation of size of increase that may occur as a result. Similarly, whilst we understand the mechanisms by which increased output from wind generation could increase balancing costs, it is not possible to assess accurately whether National Grid's forecast is correct or not.

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?

We broadly agree with National Grid's description of how LCPD opted out plant may choose to run. Such plant could be expected to adopt a number of strategies, but the underlying rationale would be for stations to be run in such a manner so as to maximise the profitability of the limited running time they have remaining. We agree with the view presented at the seminar on 10 January that early experience of the market this year would appear to support National Grid's assumptions on the regimes that plant might adopt.

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

The main comment we have is that the analysis results in quite a range of outcomes. This illustrates the uncertainty inherent in such a forecast. It is helpful to have the forecast converted into BSUoS costs and we welcome this development. It is BSUoS that participants are exposed to and this will allow parties to monitor the scheme against outturn BSUoS costs.

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

We are uncertain about what this question refers to. No areas for improvement appear to have been specifically identified.

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

Please see our response to question 9.

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?**

We are not convinced that power price indexation is appropriate for this scheme. In paragraph 95 of the consultation document National Grid states that “*the relationship between daily wholesale prices and daily IBC is not clear or stable*”. The table at paragraph 96 illustrates this. It shows that the calculated relationship in 2006/07 was just over half that calculated for 2007/08. This is a significant difference rather than merely being an error of a few percentage points. We are therefore not confident that a meaningful index can be constructed on the basis for such analysis for 2008/09.

We are also sceptical about an index for Cheviot constraint costs even though at first sight it appears a more straight forward proposition. The costs of constraints on the Cheviot boundary will differ under different market and system conditions. Therefore, to index costs to a fixed £m per week of outage would seem to be overly simplistic.

We do not, therefore, support either form of indexation.

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?

All of the schemes have sharing factors that are too high in our opinion. We have maintained for some time that National Grid does not require a high level of sharing factor in order to undertake what is essentially already a requirement of its licence. It is not clear that the more efficient operation of the system requires a high capital outlay. Therefore, a relatively modest sharing factor should be sufficient to act as an appropriate incentive.

It is also unclear why the upside sharing factors are consistently higher than the downside factors regardless of the level at which the target is set. We appreciate that the distribution of expected costs may drive asymmetric factors. However, it is to be expected that as the target increases, the downside factors would become closer to the upside ones and ultimately would be higher than them. Without access to the full data set for the distribution of expected costs it is not possible to ascertain whether the sharing factors are correct or not. However, visually they would appear to be the reverse of what we would expect, at least for some of the options with higher targets.

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?

The answer to this question depends on the technologies concerned and the manner in which they are expected to be deployed, both physically and commercially.

If National Grid is developing services that it will exclusively use to balance the system then it would be appropriate for some form of funding to be allowed by Ofgem and for this to be recovered from customers. However, it is not clear that BSUoS would be the appropriate mechanism through which such costs should be recovered. BSUoS covers costs that are incurred during the year concerned. Longer term investments of this kind would be better served by a specific mechanism in the price control.

If the technology is planned to be marketed directly to customers as an energy or carbon saving feature, it is not clear why National Grid should be funding its development. Presumably in this instance customers would ultimately fund the research costs in the price they pay for the product. Customers will pay this price if the energy savings or carbon benefits they can expect to make are sufficient to justify it. If National Grid were to fund such a venture, we would expect that to be in the role of an investor and that this would be in return for a share of the rights to the product concerned. If this were the case, it would be inappropriate to recover the costs of such investment from customers and it should be for National Grid's shareholders to decide whether they wished the company to become involved in such ventures as an unregulated business.

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?

We have discussed above the information imbalances that make it difficult for participants to comment fully on these forecasts. However, we also stated our belief that the solution is for Ofgem to resume its role challenging the forecast and setting the incentive. In the context of this particular exercise, we believe that National Grid presented the information as clearly and concisely as possible to explain their position, even if it is not possible for others to challenge it fully.

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

No.

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

No.

Gas Related Questions

13 Do you agree with the approaches used in forecasting the various elements that make up NTS shrinkage?

As indicated in our response to Question 1, it is very difficult for market participants to comment fully on the assumptions and indeed the forecast. Nonetheless, since Shrinkage gas represents the largest overall cost component of the SO Commodity charge it is very important that forecasting by NG of this element is robust and reliable. Given the significant cost to market participants, we believe it is right that NG continues to have an incentive in place to manage this cost effectively. However, on the basis that NG has received the maximum incentive payment under this part of the SO incentives since 2003/04 (which perhaps suggests that NG may be over-forecasting their requirements for shrinkage gas) consideration should be given to a tightening of this incentive, for both cost and volume, to reflect repeated out-performance by the SO.

14 Do you support the continued linking of shrinkage target volumes with flows at the St. Fergus entry point, and do you support the move to an increased number of bands?

Changing patterns of supply over the next few years may suggest that reliance purely on St. Fergus flows could be a risky approach to adopt for a multiple year incentive scheme. Taking into account gas flows at other key entry points to the system (such as Easington) may give a more accurate view of likely compressor fuel requirements. Given the uncertainty surrounding the likely pattern of flows, we advocate a single year incentive for shrinkage.

We would question the inclusion of compressor fuel requirement at the St. Fergus Total Oil Marine terminal ('TOM'). It is our understanding that historically this terminal used to be excluded from NTS compression reporting on the basis that NG has no influence on the extent of the operation of the compressor and that its use is not related to moving gas around the NTS. Excluding the TOM terminal from the incentive would significantly reduce compressor fuel requirements (and therefore the cost to market participants) and may, as a result, allow a better correlation between entry flows and compressor energy.

For clarity, we do not support multiple year arrangements for any part of the SO incentives package. We do not believe that there is much that NG can do in future years to materially reduce actual shrinkage from today's levels and therefore we fail to see the advantages of a multiple year scheme. In addition, uncertainty around where gas will enter the network and therefore the extent to which compression is required, suggests a strong need for single year arrangements.

15 Do you agree that the SO should not be incentivised on CV shrinkage that is outside of its control? Please comment on whether you believe it is necessary for Ofgem and BERR to review the continuing appropriateness of the CV capping rules in the Gas (Calculation of Thermal Energy) Regulations.

In terms of CV shrinkage, NG appears to have presented extreme scenarios for CV outturn at some specific points, but then agree that a central case scenario would not present a particular problem to them. Therefore, we believe that a central-case target should apply for this incentive, which would give a more realistic target for CV shrinkage.

We have no objection in principle to a review of the current CV capping rules.

16 Do you have an objection to the proposed interim GCRP and ECRP methodologies for 2008/09? If so please explain why and outline your suggested alternative.

17 Do you support the proposal to establish the proposed enduring GCRP and ECRP methodology arrangements into the National Grid's GT Licence for an extended period, (to avoid the need for interim arrangements in the future) regardless of the duration of any incentive scheme?

As far as we understand them, the methodologies appear broadly appropriate.

18 Which of the scheme options do you believe provides the most appropriate incentive arrangements for the management of NTS Shrinkage?

We favour single year SO incentive schemes and low sharing factors.

19 Which of the scheme options do you believe is the most appropriate way to incentivise the costs of utilising OM?

The purpose of this part of the incentive scheme is to minimise the cost of the provision of OM bookings. Although Ofgem's current review of competition in the provision of OM services may impact on the appropriateness of this particular incentive, it is our belief that whilst competition may be possible in future, the current strict requirements for provision of OM services currently restricts the possible service providers to just NG LNG. Nonetheless, we would welcome greater transparency from NG on the process for assessing the economic viability of alternative OM providers.

In terms of the actual incentive scheme, during the 2008/9 incentive period, we understand that NG NTS is not expecting to change the current pool of service providers and therefore an extension based on the current scheme would seem appropriate. However, future incentive arrangements need to reflect the outcome of the current consultation process by Ofgem; for instance, amending the sharing factors as competition between providers increases.

20 Do you agree that a one year scheme is appropriate pending a potentially more fundamental review of residual balancing incentive going forward?

We fully support a one year scheme in respect of the residual balancing price incentive. In our previous response to Ofgem's initial thoughts consultation we stated and continue to believe that:

'the daily price incentive for gas balancing continues to provide the right incentive for efficient residual gas balancing, but the fairly constant year-on-year payments to NGG might suggest adjustments to the mechanism are warranted. This might include increasing the downside penalties and/or the

percentage below which incentive payments are received.'

21 Which of the scheme options do you believe provides the most appropriate incentive arrangements for the residual balancing activity for 2008/09, and what are your views on the potential removal of the linepack element of the incentive?

As outlined in our response to the Ofgem initial thoughts consultation, we believe there may be merit in considering abandoning the linepack incentive given that operational drivers (i.e. the safe operation of the system) have a more significant influence on NG than the linepack incentive. However, we are unclear whether removal of the linepack incentive would affect accurate targeting of balancing costs on particular days and therefore would welcome a fundamental review of this part of the incentives. If the linepack incentive is retained, we would like to see stronger incentives on the SO to limit the extent to which imbalances can be transferred between days.

22 Do you agree that the current Demand Forecasting incentive should roll forward to 2008/09, pending a more fundamental review of the residual balancing activity and incentives?

We have no particular objections to this.

23 Do you think it is appropriate to widen the data items that are subject to incentivisation to include the additional data items outlined in the proposal?

24 Do you agree with the proposed scheme design in terms of timeliness and availability elements, and the provisions for planned upgrades / monthly measurement intervals?

We are satisfied that National Grid has largely achieved performance improvements in respect of forecasting and data publication. We are therefore sceptical as to whether there is actually an appetite from market participants for additional or different data items to be provided. UNC Review Group 0140 explored in detail the current (and future) provision of data items by NG to market participants and customers. Since the

conclusion of the Review Group the appropriate changes were made by NG to reflect the outcome of the Review. Any additional data items would now require a UNC Modification Proposal to create the obligation on NG NTS to publish the information. We believe this is the right approach as it ensures that only information that is genuinely required is published and, of course, funded appropriately.

We are not aware of any overarching “data provision” project that NG plans to undertake (for which it could be given allowed revenue - subject to Ofgem scrutiny) and the proposals on this matter seem woolly and over-generalised. The only industry appetite that may exist is for NG to provide a more reliable service rather than a quicker or more varied one but either way, this could be adequately managed through a ‘standards of service’ scheme, rather than a purely upside incentive mechanism which exists at the moment.

We believe the current and proposed incentive schemes now represent an unnecessary cost to market participants as NG is being funded to provide information, which as SO, we would expect to see provided as part of its day-to-day role. As such, we would like to see this particular incentive removed from the package.

25 Which of the proposed performance improvements and associated incentive schemes do you believe is most appropriate?

As above, we believe that the demand forecasting and data provision incentives could now be managed economically and efficiently through a standard of service scheme. Where the SO incurs costs for providing further information than is presently made available, this could be provided for through adjustments to SO allowed revenue.

26 Are there any other points that you would like to raise in relation to the setting of the Gas SO incentives from April 2008?

We would welcome further information on NG’s intended strategy in regard of running gas and electric compressors. We understand that for the electric compressors, NG could potentially avoid the demand tariff payable on the average demand over the triad by running the gas-driven compressors instead of the electric compressors. If this operational strategy



would provide savings against NG's electricity SO costs, then we would expect to see more detail on this and therefore request that NG provide more information on the matter.

I hope that the above comments prove useful. Should you wish to discuss our response further, please do not hesitate to contact me on the above number in relation to gas issues, or Paul Jones on 02476 183 383 in regard of electricity issues.

Yours sincerely

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