

Louise Wilks
SO Incentives Development Manager
National Grid
Warwick
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Dear Louise

Stakeholder Consultation: Gas System Operator Incentives

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, combined heat and power plants, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We welcome the opportunity to respond to this consultation. The key points of our response are:

- The timetables for setting the SO incentives are tight, and it is unclear how National Grid will be able to further develop these proposals with industry.
- There is a lack of detail and explanations as to how some of these incentives would operate and the assumptions behind these.
- When using a reputational incentive it will be important to ensure that the reporting metrics are clear, transparent and relevant.
- Overall the proposals appear reasonable in principle; although we have some concerns with some specific incentives and believe others require further development and scrutiny.
- We do not support the inclusion of exit capacity constraints in the constraint management incentive.
- We would encourage National Grid to consider what incentives they could develop on the accuracy of the NDM D-1 Demand Forecast as it is this forecast that NDM Shippers are required to balance against.

We note from the consultation that the timeline associated with developing and finalising the SO incentives to start in 2013 is tight. This compares to intention of the RIIO process which requires significant early engagement with stakeholders to identify their requirements over the price control period and the outputs that are expected to be delivered. There was significant industry engagement and debate by National Grid to support the RIIO-T1 process and it is not clear how this can be supported for the SO incentives in the timelines identified. In particular based on the timelines it appears that there is no opportunity for further stakeholder engagement and development, which has occurred during the TPCR periods.

These SO Incentive proposals are also very high level and do not provide detail on how the mechanisms would work, or the assumptions behind them. This is a welcome improvement on previous arrangements, where in the past the focus was on the detail and so it was not possible to set high level principles to judge the detailed incentives against. However, given the tight timelines identified it is not clear how industry can engage with National Grid in developing these principles into detailed proposals, or challenge some of the assumptions made. Going forward we would welcome earlier engagement with National Grid to develop the high level principles and then the detailed incentives and assumptions behind these proposals.

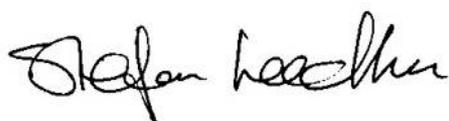
We also believe that when developing reputational incentives, it is important that National Grid engages with the industry and Ofgem to identify how these should be reported and the information provided. From our perspective a reputation incentive will only encourage appropriate behaviour if the incentive has a clear positive, or negative, impact on the reputation of the companies involved. This would require the publication of clear and detailed information tracking performance over time so that the industry is easily able to identify performance and recognise this in an open forum. Given that the price controls are dealing with regulated monopolies we believe that the information provided should not be on a confidential basis and should be publicly available on National Grid's website. We recognise that there is a longer lead time to develop these matrices, but would encourage early engagement with the industry so that National Grid, and if applicable the GDNs, are clear as to what they will be measured against.

Our detailed responses are set out in the attachment to this letter.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact me on 020 3126 2312.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in black ink that reads "Stefan Leedham".

Stefan Leedham
Senior Transmission & Trading Advisor

Attachment

Stakeholder Consultation: Gas System Operator Incentives

EDF Energy response to your questions

Residual Balancing

Q1. Do you agree with our proposal to maintain the current Residual Balancing incentive structure of linepack and price performance measures in preference to a cost minimisation scheme?

Overall the current residual balancing mechanism appears to work well and ensures that National Grid is incentivised to minimise its balancing actions and ensure that sufficient levels of linepack is available. At the same time there has been long standing concerns that there are tensions between the price performance and linepack measures which is preventing National Grid from making optimal use of the facilities available to it through linepack. However, we also recognise that a pure cost minimisation scheme, as occurs in electricity, may not be appropriate for gas due to the differing characteristics of the products and the markets.

We therefore support the maintenance of the current Residual Balancing incentive, but believe that this could be improved if this were combined with a cost minimisation incentive so that National Grid were incentivised to limit its balancing actions but make the maximum use of linepack in the most cost efficient manner. For the avoidance of doubt we do not support the introduction of a flexibility service.

Q2. Do you support the proposed change to link price and linepack targets to market volatility and imbalance? If not, how do you consider a performance measure should be set?

Overall this appears appropriate as the current pricing target gets wider when prices are higher. However, we would welcome consideration as to whether there should be seasonality in the market volatility measure.

Q3. Does our proposal of a daily maximum value (£9,240) represent a suitable potential reward for our residual balancing performance? If not, what value do you attribute to the Residual Balancing role?

Although the calculation appears reasonable, based on current performance, we note that this value is almost double the daily value that is available to National Grid when they take no actions and linepack ends "within target". As such it is not clear where this additional value comes from.

In addition we note that incentives should also be designed to encourage continuous improvement in performance, and not maintaining current performance. This is similar to the process used by competitive companies when setting targets which expect continued improvement in performance. As such there may also be value in applying an efficiency mechanism to this value to encourage continued improvement and benefits to consumers.

NTS Shrinkage & Unaccounted for Gas

Q4. Do you feel it is appropriate to separate the baseline procurement of shrinkage from prompt purchases for changes to forecast levels?

Overall it appears reasonable to separate baseline procurement of shrinkage, from the prompt shrinkage management as a result of changes in the forecast levels. However, we are not convinced that the proposed pricing formula for baseline shrinkage performance is appropriate.

Q5. Do you consider a rolling 9 month price reference period to month ahead of the delivery quarter sets a fair benchmark price for shrinkage energy procurement performance assessment?

The current pricing structure was implemented to reflect the fact that costs to consumers could be reduced by including prompt prices within the pricing structure. This was driven by the analysis from Ofgem at the time that demonstrated that out turn prices tended to be lower than forward prices. The pricing structure proposed by National Grid would remove this potential benefit and potentially expose customers to greater costs than they are currently exposed to. We therefore believe that the baseload shrinkage procurement should be indexed to a mixture of year, quarter, and month ahead prices to minimise costs to consumers.

Q6. Do you consider the Traded Price of Carbon Adjustment alone provides an appropriate mechanism to incentivise the proper consideration of environmental impacts of compressor use?

The introduction of a carbon price floor by the Government suggests that the Traded Price of Carbon Adjustment alone is not sufficient. We would welcome clarity as to how the carbon price floor will be built into this incentive.

Q7. Are there suitable incentives to reduce UAG on all the appropriate industry parties?

Shippers have often noted that the vast majority of UAG identified has been caused by metering errors at the GDN to NTS interface, predominantly owned by Scotia. The GDNs own these meters and National Grid is the contractual counterparty through the UNC and offtake arrangements which sets out the metering standards, validation requirements etc. However, historically there have been no incentives on any of these parties to reduce UAG and ensure accurate meters, as the risks were borne entirely by Shippers.

However, Ofgem has identified that meter errors and UAG should be subject to a reputational incentive and licence requirements. To this end we believe that if a reputational incentive is to work then this will require clear, open and transparent publication of information to the industry. This will ensure that the reputational incentive will act as envisaged by creating a good or bad reputation for those transporters who are not managing their meters and UAG adequately. It will therefore be necessary for National Grid and the GDNs to agree with Shippers and Ofgem the information that is provided, how this is made publicly available and how frequently it is reported on. As a minimum we believe that this information should include statistics showing how frequently the contractual requirements have been breached, such as metering validation; number of errors identified; impact on UAG; and duration of error by GDN.

Operating Margins (OM)

Q8. Do you agree with our proposal to reconsider OM incentivisation following the OM services review?

The competitive tendering and procurement of OM services has been in place for several years. Given this we believe it would be preferable for National Grid to be exposed to incentives in this area and not a cost pass through mechanism.

Connection Offers

Q10. Do you agree or disagree that we should be incentivised to find new and innovative ways of delivering connection offers quicker than the timescales stated in the UNC?

The UNC provides the minimum requirements that National Grid has to meet in its role as the NTS Transmission Owner. Therefore as a reasonable and prudent operator we would expect National Grid to find ways of delivering this capacity earlier if available. However, we also note that the delivering of connections and capacity appears to be more of a TO issue than an SO issue. As such we do not believe that National Grid should be incentivised, or funded for a function that is already covered by the RII0-T1 process as this would create the risk of National Grid being funded twice to deliver the same service or function.

Capacity Delivery

Q11. Do you agree or disagree that a reputational incentive is appropriate to encourage National Grid to optimise the activities from signature of a bi-lateral contract to capacity application readiness, where applicable?

We note that this issue has been subject to significant industry debate and development through UNC modification proposal 0373. We believe that this modification should set the basis for any standards of service and requirements.

Q12. Do you agree or disagree that a financial incentive should be introduced to provide flexibility to adjust obligated lead times where there is a user requirement?

The ability for National Grid to deliver capacity will be greatly influenced by the level of spare capacity that is on the system.

Constraint Management

Q13. Do you support the principle that SO incentive targets will need to change to reflect the application of the TO uncertainty mechanisms?

The TO uncertainty mechanism should have an impact on the capacity constraint management incentive and so it appears appropriate to update the targets to reflect any developments as a result of the TO uncertainty mechanism. However, we are not convinced with the appropriateness of the incentive mechanism as proposed by National Grid. In particular no evidence has been provided as to why the exit capacity buy back mechanism should be subject to an incentive, or what has changed to support the costs of exit capacity buy back being funded by customers. As such we do not support exit capacity buy back within the constraint management incentive.

Q14. Do you have a view about what the relevant constraint management action price assumed within our modelling?

There is insufficient information within the consultation to explain how National Grid reached its proposed prices for constraint management actions. We would therefore require further information on how these prices were reached and the underlying assumptions in order to be able to comment on them. However, at a high level we note that the instances of constraint management actions are rare, with the last event occurring in 2006. It is therefore important to set an incentive at an appropriate level so that when a constraint occurs National Grid is incentivised to minimise the costs, and also ensuring that National Grid does not receive a windfall gain in years when no constraints are present. Any incentive should also reflect that fact that in its role as TO National Grid has discretion as to whether to invest or not in response to incremental signals and revenue.

Demand Forecasting

Q15. What aspects of demand forecasting do you use in your decision making and value the most (e.g. forecast times, components of demand etc) and how do you expect your requirements to change over the RII0-T1 period?

The current D-1 13.00 total system demand forecast was incentivised as it was observed that this forecast was having an impact on the market prices. It was therefore felt that improving the accuracy of this demand forecast would have a benefit to the market in terms of price discovery. This would therefore appear an important forecast to remain

incentivised. We are not clear that the forecasts provided earlier than this are sufficiently significant to warrant incentivisation.

For NDM Shippers the other important forecasts are the daily NDM forecasts as it is these that Shippers have to balance to. Volatility in these forecasts not only produces issues for Shippers' ability to balance, but can also have market pricing impacts. We are aware that there have been significant developments in the UNC and through DESC to look at improving the accuracy of these forecasts. Although all of the Transporters have been engaged in this work, we are aware that only National Grid sends its forecasting experts with others sending their regulation managers. Given National Grid's expertise in this area we believe there would be value in incentivising the accuracy of the NDM forecasts. This should help to encourage National Grid support and engagement in these important industry forecasts.

Q16. Do you agree or disagree that the absolute forecast error is a more appropriate way to measure forecasting performance than the error as a percentage of demand?

We believe that using a mean forecasting error is appropriate, although question whether there should be seasonality in this target.

Q17. Do you agree or disagree that the incentive target should reflect the level of demand volatility in the market?

We do not agree that the incentive target should reflect total demand volatility. In particular we note that although NDM can be volatile day to day, this is driven by changes in weather which should be forecastable. Including this volatility in the target would not appear appropriate.

The information presented by National Grid to the SO workshops on demand forecasting suggest that volatility for sites such as interconnectors (excluding Moyle), and fast cycle storage should be excluded from the targets. There also appears to be some evidence to suggest that volatility from power station demand should be excluded from the targets although we believe that this should be kept under review.

Information Provision

Q18. Do you agree that it is appropriate to replace the current financial incentive scheme with a reputational incentive?

The current financial incentive has worked well in improving the timeliness and reliability of the information that is provided on National Grid's website. Given this high level of reliability and timeliness we would support the move to a reputational incentive, provided that this was accompanied by agreed metrics and publication to ensure that any changes in performance have an impact on National Grid's reputation.

Q19. Are there areas where we could provide more information that would contribute to the efficient operation of the market, bring benefits to stakeholders' businesses and the value they provide to their customers?

We have not identified any additional information requirements at this time. We note that REMIT and implementation of the EU 3rd Package may have implications for the information that National Grid provides.

Q20. Do you agree with our current approach to review information provision requirements with industry before seeking appropriate funding if necessary?

This appears reasonable.

Capacity Scaleback

Q24. Do you agree or disagree that an incentive relating to the restoration of scaled back capacity would maximise the level of non-firm capacity made available to the market?

We understand that that currently National Grid has a Licence Condition to maximise the capacity that it makes available to the market, and the only obstacle to currently restoring scaled back capacity is UNC requirements. We therefore do not believe that a financial incentive is appropriate, and would expect national grid to raise a UNC modification to facilitate this as part of its Licence requirements.

Q25. Do you agree or disagree that linking the financial parameters to buyback cost assumptions is appropriate?

We are not convinced that the buyback cost assumptions represent an appropriate financial parameter. In particular we note that the buyback cost assumptions relate to firm capacity buy back; however, capacity scaleback relates to non-firm capacity and so are not comparable.

Provision of enhanced services for NTS users

Q26. Do you agree or disagree that an incentive relating to the development of new services such as shorter notice periods or higher ramp rates may be appropriate in future?

From our perspective we note that it is the ramp rate requirements that have the most significant impact on the commercial operation of facilities and not the notice periods. Currently the ramp rate requirements are contained within site specific NExAs which are negotiated on a bilateral basis between the developer and National Grid. We are aware that there are already mechanisms available to developers through these negotiations to fund higher ramp rates if required. At this stage therefore we do not believe that a financial incentive is warranted, but recognise that there may be benefits in National Grid

clearly identifying the commercial options available to NTS connected points to review and modify their ramp rates.

Q27. What are your views on the potential interactions between an incentive and the network flexibility uncertainty mechanism?

There appear to be clear interactions between the TO flexibility uncertainty mechanism and the proposed incentive. As such this creates the risk of duplicating funding for the same service. We therefore do not believe that an SO incentive is warranted at this time.

EDF Energy
May 2012