

Juliana Urdal
National Grid House
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Warwick
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9 December 2010

Dear Juliana

Gas System Operator Incentives Initial Proposals Consultation 2011/12

EDF Energy is one of the UK's largest energy companies. We provide 50% of the UK's low carbon generation. 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 5 million electricity and gas customer accounts in the UK, including both residential and business users.

We welcome the opportunity to respond to this consultation.

We have provided detailed answers to the questions posed by National Grid as an appendix to this letter; however, our high level comments are:

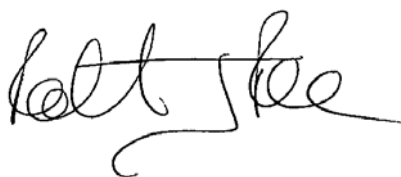
- As with most companies National Grid has its own corporate sustainability commitments. In National Grid's case this is a target to reduce its own greenhouse gas emissions by 80% ahead of the 2050 target set by the UK Government¹. Any environmental incentive funded by customers should only fund incremental reductions above that which National Grid has already pledged to deliver.
- Given the long term effects of greenhouse gas emissions, and the (sometimes) capital intensive nature of any investment to reduce these emissions, then it would be appropriate to develop a long term incentive mechanism.
- One of the key elements of the new price controls (RIIO) is innovation. Therefore, the development of any innovation funding, or incentive, to encourage an incremental decrease in greenhouse as emissions should be resolved through the price control process.
- Any Operating Margins (OM) incentive should ensure the interests of existing and future customers are protected. Therefore, at the heart of this proposal should be the aim to ensure costs to consumers are minimised. This supports the application of an incentive to this regime.

¹ Available at: <http://www.nationalgrid.com/UK/about>

- Any incentive scheme should be developed to ensure that National Grid is exposed to a symmetrical upside and downside risk to reflect the fact that they are not a risk free business and earn returns in excess of the risk free rate.

I hope you find these comments useful, however please contact my colleague Stefan Leedham (Stefan.leedham@edfenergy.com, 020 3126 2312) if you wish to discuss this response further.

Yours sincerely

A handwritten signature in black ink, appearing to read "Rob Rome".

Rob Rome
Head of Transmission and Trading Arrangements
Corporate Policy and Regulation

Appendix 1 Response to Detailed Questions

Q2.1 Do you believe Operating Margins should be subject to an incentive scheme or should the current cost pass through arrangements continue?

We believe that an incentive scheme should be developed to ensure that the costs for existing and future customers are minimised.

Q2.2 What type of incentives do you believe are appropriate for Operating Margins?

We believe that a cap and collared incentive, with symmetrical sharing factors would be appropriate. Any expenditure in excess of the level at which a cap has been used should be subject to Ofgem scrutiny to ensure that they had been efficiently incurred.

Q2.3 Should any incentive or pass-through arrangement cover the 2 year period?

In general we support longer term incentives as these provide stability, both to National Grid as an investor looking for a stable regime, and for Shippers who place a strong emphasis on being able to forecast their costs. Short term incentives that frequently change do not support these requirements.

Q2.4 If you believe an Operating Margins incentive should be put in place, should it be a single incentive covering both utilisation and holdings costs or should these be considered as separate incentive schemes?

A bundled incentive would appear appropriate to reflect the two distinct costs present in the operating margin regime – namely the option and the exercise costs – while ensuring that National Grid is incentivised to minimise the entire costs to the industry. We believe that the option and exercise costs within contracts will vary significantly with OM provider with some (traditional) OM providers requiring a higher option, but lower exercise fee; whilst newer providers will seek higher exercise fees and so a lower option fee. Incentivising these costs together should encourage National Grid to procure the most cost effective solution from an appropriately diverse range of providers.

Q2.5 Do you agree with using a target cost adjustment to enable changes in the regulated prices for OM services from NGLNGS to be reflected? If not, how would you suggest the uncertainty is handled within the incentive scheme?

Developing an incentive mechanism when there is so much uncertainty is complex, and we recognise that there are elements of uncertainty that are outside of NG's control. A target cost adjustment may therefore be reasonable.

Q2.6 Do you agree that it would be appropriate to reassess the incentive target cost if there is:

- **Further suspension of regulated prices for OM services from National Grid LNG Storage than in the current year?**
- **If regulated prices are outside the analysed range?**
- **A change in the volume of Operating Margins requirement between 2011/12 and 2012/13 of greater than 10%?**

We do not support this. National Grid is remunerated at a rate greater than the risk free rate. It is therefore important to recognise that gas transmission is not a risk free business and so National Grid should be exposed to some of these risks.

Q2.7 Given the levels of uncertainty in the cost of providing Operating Margins, do the sharing factors, deadband, cap and collar proposed reflect the level of risk and control? If not, what values of these would you think appropriate? Sharing factors: 25% upside & 10% downside, Deadband: £5.5m, Cap: £2m, Collar: £-1m

No, we believe that the proposed sharing factors and cap and collar expose National Grid to excessive upside, but limited downside risk. Any incentive should be symmetrical in risk and reward. We therefore believe that a sharing factor of 25% or 10% should be applied to both the upside and downside, and that the cap and collar should be set at either +/- £2m or +/- £1m.

Q2.8 Large utilisations are less common than smaller utilisations, and can be triggered by events outside National Grid's control, such as following a supply loss. Do you support the approach of having a volume cap to manage the level of control and risk in utilisation?

This would appear appropriate, although any costs in excess of the cap should be subject to scrutiny by Ofgem to ensure that they were efficiently incurred.

Do you agree with the approach of using average historical volume of utilisations (35.5GWh) as the utilisation cap? If not, how do you think this would be best calculated?

No. National Grid has not supported any analysis to demonstrate that the historical volume of utilisation would represent an appropriate cap. An alternative would be to use the maximum historical utilisation, as this would represent normal OM requirements.

Q2.9 Do you agree with the approach of using average historical volume of utilisations (35.5GWh) within the utilisation cost target? If not, how do you think this would be best calculated?

Average historical volumes of utilisation within the utilisation cost target appear appropriate. However, any outliers should be removed and figures developed based on a 95% confidence interval.

Q2.10 Should the utilisation cost target be based on the average prices accepted through tender this year? If not, what do you feel would be most appropriate methodology?

Yes, although this should be the volume weighted average price.

Q2.11 Should all utilisation costs be included in an utilisation performance measure (i.e. including costs from capacity and delivery contracts) or just those costs that are not recovered through neutrality?

All costs should be incorporated to ensure that National Grid is incentivised to minimise all costs.

Q2.12 Should the 2012/13 incentive target be based on the outturn in 2011/12? If not what would be an appropriate target?

As a historical average has been used for the 2011/12 incentive then this would also appear appropriate for the 2012/13 incentive.

Q2.13 Do you agree with the proposal of incorporating the same deadband around the 2011/12 outturn for the 2012/13 scheme? If not, what would you consider to be appropriate?

This appears appropriate.

Q3.1 Do you agree with the proposed style of incentive where National Grid are exposed to the marginal cost of natural gas venting? If not, what would you suggest to be a suitable style of incentive?

The basis of this incentive is that the emission of greenhouse gases represents a public cost and so to ensure the appropriate behaviour these costs should be internalised on National Grid who would then be able to make the most economic decision on the use of scarce resources. Ultimately this will result in National Grid choosing to either invest in greenhouse gas emission reduction or fund the cost of emissions. This will ensure the most economically efficient outcome.

The simplest way of facilitating this would be for National Grid to be exposed to all of their greenhouse gas emissions, and no incentive mechanism in place – i.e. all costs would be internalised. This would also address the issue that National Grid has made public commitments, which are on its website to reduce greenhouse gas emissions by 80% by 2050. National Grid's shareholders will have been aware of this commitment and have expected to fund it; indeed some investors may have chosen National Grid because of its sustainability credentials and commitments. It is therefore important to ensure that any incentive would deliver incremental savings in addition to those which National Grid has already publicly committed to. Otherwise this will represent a windfall gain to National Grid's shareholders who have invested expecting to fund these corporate commitments.

The ability to identify incremental emission reductions will be complex, as ultimately these will not be identified until 2050 when it is clear whether National Grid has met its corporate commitments or not. The simplest solution would be to create a mechanism so that any emission reductions greater than 80% are funded, provided that the cost of these reductions is less than the environmental cost of the greenhouse gas emission. This would require a base year (when National Grid made its corporate commitments), with any reductions greater than 80% funded at the equivalent cost of carbon. For example:

National Grid base year venting: 100 units.

Corporate target: 20 units.

Venting for 2013: 15 units.

Cost imposed on National Grid for greenhouse gas emissions: £18,885 (15 units @ £1,257 based on DECC non-traded cost of carbon).

Incentive earned on 5 units (different between actual and corporate targets):
£6,285

Total cost of scheme: £12,570

Q3.2 Do you support either of the two approaches suggested to set the volume target in the Environmental Incentive?

- **Using the previous calendar year outturn to set the volume target;**
- **Using a 2 year average of outturns to set the volume target.**

As previously noted we believe the most efficient mechanism would be for National Grid to be exposed to the costs, with only incremental savings incentivised. However, were National Grid to continue with their proposed incentive then a 2 year average would be the most appropriate, although this should be extended to a 5 year rolling average as soon as the data is available on a consistent basis.

Do you feel these targets reflect an effective and efficient target, given the increasing supply and demand uncertainties?

No. National Grid's target is an 80% reduction, and so any target greater than this would represent a challenging target. Otherwise the risk is that consumers will fund something that National Grid has already committed to do.

If you do not support either of these target proposals, how would you suggest the volume target should be set?

See previous responses.

Q3.3 Do you support using DECC's non-traded carbon price to set the environmental price for the incentive?

Do you support updating the environmental price for 2012/13 should the DECC's non-traded carbon price be updated prior to the start of the incentive year?

DECC's consultation on the carbon price floor and electricity market reform is due by the end of the year. We believe it would be appropriate to wait until these consultations have been published to identify the most appropriate source for the carbon price. If DECC's prices are to be used, then these should be updated in line with any review by DECC, although it may also be beneficial to take into account the work that has been done by the Climate Change Commission (CCC) to reflect the effort required to meet the UK's statutory targets.

Q3.4 What level of deadband do you think would be appropriate in the NTS Environmental incentive?

- **±5% deadband as in current year & suggested by modelling uncertainty**
- **Between 0 & 5% deadband – if so, please quantify this**
- **No deadband**

If you do not support any of these options, what level of deadband do you think would be appropriate?

If National Grid is to progress with the incentive as proposed, then no deadband would appear appropriate.

Q3.5 The proposal does not include any caps or collars on the NTS Environmental incentive. Do you agree with this proposed approach?

Yes, although we do not support the overall approach taken to the incentive.

Q3.6 Do you support the proposal to make funding available to enable future environmental performance schemes to

- **Understand and measure emissions?**
- **Develop technologies and processes to reduce or eliminate the effects of venting natural gas from the NTS?**

If not, how do you think we should be encouraged to plan for future efficient emissions reductions?

No. Please see our response to Q 3.1

Q3.7 Do you support the proposal of the incentive covering a 2 year period? If not, what time period should the incentive and funding arrangement cover?

Given the investment lead times, and pay back periods identified then a longer term incentive would appear appropriate.

- Q3.8 What do you consider to be the right approach to develop the NTS Environmental incentive in the longer term?**
- **Do you agree with the use of benchmarks?**
 - **Would it be appropriate to include activity adjustments within the target?**
 - **Do you have any views on the level of pricing that should be used?**

Please see response to Q3.1.

EDF Energy
09 December 2010