



REACTIVE POWER UPLIFT

INCENTIVE ARRANGEMENTS FROM 1999/2000

PROPOSALS

MARCH 1999

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Introduction

This document sets out the Director General's proposals to the National Grid Company (NGC) on the form, scope, duration, target and other parameters of the revised incentive arrangements to apply on Reactive Power Uplift (RPU) from 1 April 1999. NGC has accepted the proposals and accordingly the proposed licence modifications are available from OFFER's library. The modifications will take effect from 1 April 1999

OFFER's consultation paper published in December 1998 set out the issues to be considered in revising the arrangements. Nineteen responses were received and have been placed in the OFFER library. During the course of the review, NGC submitted a detailed document setting out its views on the issues, and also responded to the consultation paper. NGC and OFFER have also met to discuss the issues. In formulating these proposals the Director General has taken account of the views expressed by NGC and other parties.

Form of the control

The majority of respondents and NGC agreed that a sliding scale arrangement for reactive power is the most appropriate form of control for RPU and that the existing sliding scale arrangements have worked well.

Scope

At present the RPU arrangements apply only to the costs of reactive power produced by generators and other parties holding market agreements with NGC. OFFER's Transmission Service Incentive scheme proposals published in 1998 asked NGC to bring forward proposals on whether and how its own reactive power equipment could participate in the Reactive Power Market. NGC has yet to make such a proposal. However, it is due to report by 31 December 1999 to the Transmission Users' Group on the practicalities of establishing a unified mechanism for the provision of reactive power.

NGC said it would be premature to examine the issue of whether its assets should be included in the RPU arrangements for this year. Seven respondents expressed concern regarding NGC's use of its own reactive power compensation equipment.

Although NGC has yet to make proposals on how its own equipment could participate in the Reactive Power Market it is appropriate for OFFER to start a dialogue with NGC on this matter.

Duration

The present Transmission Services Incentive expires at the end of March 2000. Most parties considered that the new RPU control should have a further one year duration from 1 April 1999 so that both the Transmission Services Uplift and RPU arrangements could be considered for revision at the end of March 2000.

Income Adjusting Event

Income Adjusting Events, which apply to both Transmission Services Uplift and RPU arrangements, are those over which NGC has no control and which have a material effect on RPU (and also the Transmission Services Incentive) of £2 million or more. NGC proposed an additional Income Adjusting Event to cover the unavailability of reactive power capability within a Reactive Tariff Zone. At present NGC has not made a sufficiently convincing case to amend the list in the manner it has proposed. This does not preclude NGC asking the Director General in the future to amend the list of Income Adjusting Events.

Sharing Factors

Some respondents argued that sharing factors should be smaller than at present. Other respondents argued that the sharing factors should be consistent with those applying to the TSU incentive arrangements. However, the sharing factors in the RPU arrangements match those in the Transmission Service Uplift arrangements and in some circumstances the two arrangements may interact.

As the Transmission Services Uplift arrangements will be revised next year it is appropriate to retain the present sharing factors for the new RPU incentive for the next year.

Cap and Collar

The present "Cap and Collar" arrangement provides NGC with a maximum gain or loss of £2 million. NGC suggested that the increased exposure of RPU to the volatility of reactive utilisation, together with the increased scope of NGC control actions, warranted broadening the range from $\pm£2m$ to $\pm£3m$.

Half those respondents who commented on this aspect of the arrangements argued that the Cap and Collar should remain at $\pm£2$ million. Others stated that they did not object to expanding the Cap and Collar range as this would increase NGC's incentive to reduce the costs of RPU.

Increasing the Cap and Collar to give larger gains and losses to NGC especially if combined with a lower target may sharpen the incentives on NGC. At present a move to £3 million Cap and Collar is not warranted but there is still scope for NGC

to obtain efficiencies from the outturn of RPU. Accordingly the Cap and Collar will be increased to £2.5 million.

Target

The present target of £55 million for this year's RPU control represents the previous year's target indexed by RPI. NGC's forecast of the outturn for 1998/99 is in the region of £47 million. NGC has proposed a target of £51.5 million for next year claiming that this figure is based upon its forecast outturn of £50.3 million plus an additional £1.2 million to provide an expectation of recovering its forecast operating costs of £0.6 million, assuming a 50 per cent sharing factor.

Adjusting some volume drivers of reactive power, such as demand growth forecast, output from generation sets and NGC's margins of error in its forecasts will give different Tvarh forecasts from NGC's.

On the revenue side, six respondents (including NGC) supported a target figure of approximately £50 million. However, a further eight respondents suggested a target below this figure. Of these respondents four concluded that the target should be in the region of £40 million.

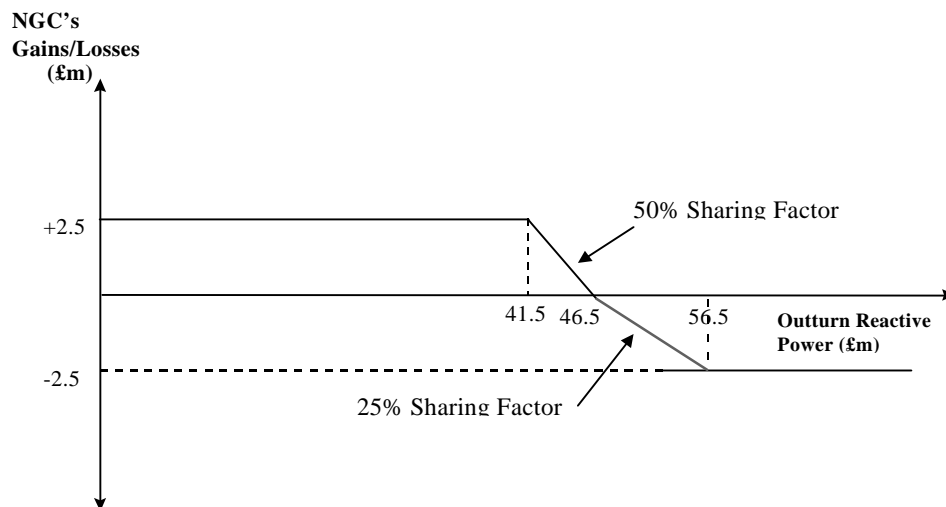
NGC forecasts an outturn for 1998/9 which will be some £7 million lower than the target. It claims this decrease is due to a number of factors: generators' inexperience in contracting; indexation of previous years' targets; lower demand due to a cooler than usual summer in 1998 and the increased use of its reactive compensation equipment.

NGC's forecast for next year is £50.3 million which NGC attributes to more generation in the north, increased demand and keener tendering by generators. These forecasts are sensitive to a number of factors and are also subject to margins of error. Overall, there is scope for the target in 1999/00 to be lower than this year's. The Director General has proposed and NGC has accepted a target of £46.5 million.

Incorporating this target into the proposed incentive arrangements will give a range over which the incentives will apply from £41.5 million to £56.5 million. Figure 1 below illustrates the proposed new arrangements.

Figure 1

Reactive Power Uplift Incentive Arrangements 1999/2000



Operating Costs

NGC had proposed that the RPU incentive be altered to take account of additional operating costs of £0.6 million incurred as a result of operating the RPU and market arrangements. NGC wished to recover the costs involved in operating the Reactive Power Market arrangements through the Reactive Power Uplift arrangements. Seven respondents opposed including an extra £1.2 million in the target in order that NGC could recover its forecast operating costs.

NGC's case for including the operating expenditure in the incentive arrangements showed that some of the costs would be to develop monitoring and evaluation software. Although the costs would be spread over three years, cost benefit analysis of the expenditure showed that benefits from the expenditure would not accrue until the next financial year.

It is not appropriate to incorporate these operating costs in this year's incentive arrangement. It is for consideration whether such expenditure may be appropriate for inclusion in subsequent years.

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