21 January 2005

Simon Bradbury
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Dear Mr Bradbury

Consultation response: NGC System Operator incentive scheme from April 2005 – initial proposals

Thank you for the opportunity to respond to this consultation on the initial proposals for National Grid's (NGC's) System Operator (SO) incentives scheme to apply from April 2005.

energywatch has a few general concerns regarding the proposals as outlined. We are also providing specific comments on the aspects of the proposals on which views are sought, and these views are set out as an attachment to this document.

The incentivisation arrangements developed for the SO have generally been successful, and have delivered benefits to customers over a period of time. We nevertheless have the following general concerns relating to the way in which SO incentives have been set in the past and the potential impact on the current proposals:

- the past history of the SO incentives scheme since NETA go-live (as illustrated in the table on page 19 of the consultation document) is that NGC's actual outturn SO costs have invariably been below the target levels set by Ofgem, usually significantly so. This has provided NGC with substantial over-reward in terms of its share of savings, and in some years it has clearly 'profit maximised'. Ofgem's estimate of NGC's outturn costs for 2004/05 indicates that NGC will make a profit of £16.7m, which of itself is very significant given the mandate NGC is subject to under its licence.

- profit levels have generally increased significantly under NETA relative to earlier schemes though NGC's risk is no greater. Arguably because NGC has more mechanisms available to it – through the Balancing Mechanism and energy trades – its reward should be lower.

- further, a comparison of NGC's forecast outturn for 2004/05, and its actual outturn costs in previous years, clearly indicates that NGC has again overstated its forecast, potentially to secure another favourable target for the following year's incentives scheme. Ofgem needs to set a more demanding target for the coming scheme based on the evidence of NGC's actual performance on SO costs to date, and recognise the fact that NGC would seem to habitually 'game' its forecasts.

- there is a general lack of transparency regarding how NGC incurs SO costs, and the main drivers of its performance, which prevents market participants and stakeholders such as ourselves from understanding fully how NGC is performing against target within sensible timescales. Most information on performance is not made available until well after the end of the financial year in question, and usually when market participants are consulted by

- Ofgem on the following year's SO incentive target. The current documentation shows a modest improvement in the degree of rigour shown in the policy consultation process but is still poor, a point well illustrated by the 'analysis' of performance under NETA schemes to date which is little more than a generalised paragraph for each year that a scheme has been applied.

- SO arrangements are set by bilateral negotiation between Ofgem and NGC. There is no direct market participant involvement in the target setting process or oversight of the arrangements. Given the quantum of the costs and the importance of the SO role to the wider workings of NETA/BETTA, the governance needs updating.

- until there is sufficient transparency, or a change in how the incentives scheme is negotiated, only Ofgem is in a position to judge whether the target it sets is adequately rigorous for NGC to meet. There must be confidence amongst market participants and consumers in Ofgem's ability to negotiate a target which reduces NGC's SO costs to appropriate levels. The advent of GB trading arrangements, and the uncertainties around GB system operation, should not be used as a rationale for producing lenient targets which allow NGC to profit further, without any discernible improvement in its performance.

- there needs to be more clarity regarding how NGC uses the various tools at its disposal, such as BM actions and purchase of reserve, in minimising SO costs and ensuring security of supply, and the interaction between the options available to it. This is another consequence of the lack of transparency we have highlighted.

- NGC continues to be a significant player in the short-term energy markets. There is anecdotal evidence that its actions can distort energy prices and interact with BM prices. The parties with which it trades bilaterally could also be enjoying an informational advantage, especially with regard to knowledge of constraints. At the same time NGC has not, as far as we are aware, offered any information or analysis that shows that its actions in the energy markets achieve material benefits to customers.

- We have seen two significant income adjusting events (IAEs) called over the past two years, and in both cases the cost has been born by customers, not NGC. There seems to be the assumption that any unforeseen adverse changes are passed through but any windfall gains are not. Recent changes indicated by Ofgem in the processing of IAEs would bring greater clarity and transparency to the process but will not necessarily change the way such events are treated.

- We believe that there is a trend developing whereby any uncertainty is automatically translated into a higher cost forecast. Ofgem needs to develop, in our view, a much more rigorous understanding of these changes, many of which arise from new market rules, and it should ensure NGC faces a similar level of risk as it does reward.

energywatch also has specific comments to make on the proposals where views are invited. These are set out in the appendix to this letter.

I hope that these views are reflected fully in your consultation process, and would be pleased to discuss them further with you.

Yours sincerely

Lesley Davies
Director of Policy and Research

Appendix 1: Specific comments on the questions posed by Ofgem in section 7 of the consultation on NGC's SO scheme from April 2005

Scope of the GB SO incentive scheme to apply from 1 April 2005

- its initial proposal that the scope of the GB SO incentive scheme should be consistent with the scope of the existing E&W SO incentive scheme.

Yes.

Form of the GB SO incentive scheme to apply from 1 April 2005

- its initial proposal that a sliding scale incentive scheme should be developed;
- its initial proposal that a single GB wide SO incentive scheme should be developed;
- its initial proposal that a deadband target range should not be considered; and
- its initial proposal to allow asymmetric cap, floor and sharing factors in order to accommodate any perceived uncertainty in relation to GB SO costs.

Yes to the three first of these. It would seem fairer to see symmetrical sharing factors.

Duration of the GB SO incentive scheme to apply from 1 April 2005

- its initial proposal that the duration of the GB SO incentive scheme to apply from 1 April 2005 should be one year in duration.

It would be inappropriate to extend the scheme beyond one year given uncertainties surrounding Scottish costs.

Incentive scheme parameters

- its initial proposal that the drafting describing the calculation of NIA will be reviewed to reflect the merger of UKPX and APX;
- its initial proposal that the NIRP price adjuster parameters will not be reviewed at this stage;
- its initial proposal that the transmission losses element of the incentive scheme will apply consistently across GB;
- its initial proposal that the GB transmission losses target should be set at 4.6TWh;
- its initial proposal to base TLRP on prevailing forward prices for the annual package for 2004/05;
- whether a net transmission losses scheme is more appropriate than a gross losses scheme;
- the potential cost savings identified versus NGT's projected target;
- its proposed target values;
- its proposed cap and floor values and sharing factors; and
- its proposed incentive scheme options.

We see no reason to dissent on any of these proposals.

Timing of BETTA go-live

- its initial proposal that, in the event that BETTA go-live is delayed beyond 1 April 2005, a profiled version of the existing E&W SO incentive scheme should apply until BETTA go-live, at which point a profiled version of the GB SO incentive scheme intended to apply from 1 April 2005 will automatically apply;
- the appropriateness and relative merits of the profiling methods suggested above; and

- whether there are any other appropriate profiling methods which could be considered for this purpose.

Again yes to all these. On profiling we suggest using a stylised profile based on the first four NETA schemes.

BSC modification proposals and CUSC amendment proposals

- its initial proposal that the IAE provisions should not be available for a list of BSC Modification Proposals and CUSC Amendment Proposals to be specified in the Final Proposals.

Agreed. As noted in our covering response, Ofgem should be much more challenging in its treatment of IAEs.

Information concerning NGC's role as SO

- whether the current level of information provision concerning NGC's activities as SO is appropriate.

It is not, and much operating data should be made available to the market considerably sooner than is currently the practice.

energywatch
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