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280/04: NGC System Operator incentive scheme from April 2005 – Initial Proposals

Dear Simon

Thank you for the opportunity to respond to the above consultation.

We welcome the decision to introduce a one-year scheme. We believe this is appropriate as we agree there is a degree of uncertainty surrounding BETTA. We are not convinced that a longer term scheme is appropriate. Opting for a one-year scheme at this stage will allow a range of incentive approaches to be considered and debated within the industry and full impact assessments for alternative mechanisms to be developed.

We note that Ofgem propose that the scope of the incentive scheme continues to cover all electricity and system balancing costs which are within the SO's control. We remain of the view that regulation should be a last resort where competition is impossible or ineffective. The development of a transparent economic assessment of different reserve products would resolve this problem.

The initial proposals confirm the views expressed in our earlier response dated 27th October 2004. As Ofgem acknowledge, NGC's forecasts of IBC have been substantially higher than the target subsequently set by Ofgem and NGC have still consistently outperformed these targets. Once again NGC have proposed a level of costs using an opaque methodology that Ofgem have acknowledged as being biased and which consistently overstates the mean distribution of costs. Whilst we support Ofgem's view, we would still like to see a greater opportunity for market participants to test and challenge the NGC and Ofgem views during the process of setting the incentive.

We agree with Ofgem that the expansion of the market to include Scotland does not give rise to the same level of uncertainty as that which was faced by the industry at NETA Go-Live. However, the three options put forward by Ofgem have a mean cost of £500m. If it was assumed that the accommodation of SO activity in Scotland resulted in a 15% increase in costs compared to this year's anticipated outturn, this leaves NGC a significant risk premium in the order of £50m.

Arguably, it would be better to set the target at the lower end of the scale e.g. £450m with narrow caps and collars e.g. £10m. Narrow but symmetrical sharing factors would then provide NGC with sufficient incentive to achieve this forecast. In the event that Ofgem's view of NGC's proposed cost increases proves to be incorrect, the Income Adjusting Events procedures can be used to address these unforeseen events. The recent improvements to these procedures should ensure that such events are given full and fair scrutiny by industry as a whole and inform the debate regarding longer term incentive schemes.

If you wish to discuss any aspect of our response, please do not hesitate to contact me.

Yours Sincerely

Terry Ballard
Economic Regulation