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Dear Giuseppina,

National Grid Electricity Incentives from 1 April 2010 – Final Proposals

Thank you for opportunity to respond to the consultation entitled "National Grid Electricity Incentives from 1 April 2010 – Final Proposals". This response is in addition to our letter consenting to the proposed modification of our electricity transmission licence that gives effect to the new SO incentive scheme for 2010/11 starting on 1 April 2010.

Whilst the proposed incentive target of £577.5m is lower than our present forecast for 2010/11, we note the difference of £23.5m is in relation to constraint costs, specifically constraints arising due to transmission outages located in the Midlands and North of England. As outlined in the consultation, there is uncertainty with constraint costs and therefore we acknowledge that should there be a substantial increase or decrease in outturn constraint costs associated with these outages, we would need to consider the raising of an Income Adjusting Event.

We note Ofgem's concerns with our forecasting methodology and, in particular, concerns that we do not consider the market fundamentals affecting the key drivers of SO costs and that we rely too heavily on historic data. Whilst we do not disagree that we use historic data, we also use a substantial amount of forward looking data (such as power and fuel prices, changes to reserve volumes for changes in generation mix, LCPD impacts, balancing services contracts, transmission outages, volumes of new generation connecting) and openly consult on our forecasting approach as part of our Initial Proposals Consultation, taking on board the industry's responses where possible. We also feel that we do consider the market fundamentals affecting the key drivers of SO costs; however we acknowledge that some of these drivers are challenging to predict with the limited information we have.

For example, a new generator connecting to the transmission system will have an agreed connection date. The date the generator connects can influence:

- Outages for local works to allow the generator to connect
- Transmission work overlaid with these local outage works, such as routine maintenance (i.e. efficiently combining outages to minimise constraints)
- Outages for wider system reinforcement and the subsequent interaction with other transmission work (such as asset replacement)
- Once connected, the generation will influence the volume of generation within its constraint boundary, either reducing constraints (for import boundaries) or exacerbating constraints (for export boundaries)
- The date of the connection will influence the generation merit order, resulting in the displacement of generation located elsewhere on the transmission system. The location of this displaced generator may in turn influence other constraints (e.g. if the generator that was displaced was in Scotland).

The connection date can (and often does) change, delaying outages for local works, with subsequent changes to associated outages. In addition, the assumed generation volumes would change.

Incentive target cost adjusters are a useful method of dealing with such uncertainties and thereby reducing the potential for windfall gains and losses. As detailed in the consultation, for the 2010/11 incentive scheme, two new adjusters are proposed that seek to remove the potential for windfall gains whilst ensuring that the incentive remains on National Grid to minimise costs / reduce risk. As highlighted in the consultation, we considered a number of additional target cost adjusters than those agreed; we will continue to develop adjusters where we believe there is uncertainty in future outturns and will propose the implementation of such adjusters in future incentive schemes where appropriate.

As highlighted in the consultation, there was a significant change in costs as a result of a model correction for outages in the Thames Estuary region (specifically a correction to circuit loading in the model to better reflect actual conditions). This correction was a result of our internal process of reviewing and updating our forecast models. As an ongoing improvement, we have updated our internal processes for auditing our forecast models and have implemented a number of improvements that will be seen in the 2010/11 forecast process.

NGET supports both the move to multi year schemes with an appropriate balance of risk and reward and the review of our forecasting methodology with the aim of delivering such a multi year scheme.

The volatility seen in recent outturn costs and the subsequent volatility seen in our forecast costs, coupled with the desire to move to multi year incentive schemes, requires an improved forecasting methodology to be developed and implemented along with consideration on the way we are incentivised. We will continue to consider improvements to our forecast methodology and share these with the consultants, Ofgem and, more generally, the industry as part of the review.

Yours sincerely

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