NG Consultation on Gas System Operator Incentives 2011/12 Initial Proposals AEP[1] Comments

The Association welcomes the opportunity to comment on this consultation, we provide comments against the specific questions below.

Operating Margins

Question 2.1 Do you believe Operating Margins should be subject to an incentive scheme or should the current cost pass through arrangements continue?

The Association believes a properly structured incentive scheme would be appropriate

Question 2.2 What type of incentives do you believe are appropriate for Operating Margins?

The Association considers a bundled incentive is appropriate to promote the minimisation of total costs passed onto shippers and customers. However we do recognise that some cost drivers, such as the level of regulated prices at LNG storage facilities are beyond NG's control and their impact on the incentive should be considered.

Question 2.3 Should any incentive or pass-through arrangement cover the 2 year period?

We consider an incentive covering the two year period would be appropriate, since decisions would need to be taken regarding the second year before there is a full year's experience of the new incentive.

Question 2.4 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?

[1]The Association of Electricity Producers (AEP) represents large, medium and small companies accounting for more than 95 per cent of the UK generating capacity, together with a number of businesses that provide equipment and services to the generating industry. Between them, the members embrace all of the generating technologies used commercially in the UK, from coal, gas and nuclear power, to a wide range of renewable energies.

The Association considers a bundled scheme would be the most appropriate means to ensure that there was no bias towards certain providers, in an environment where there are diverse cost structures between holding and utilisation costs.

Question 2.5 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?

This seems a reasonable approach at this time, but it is not entirely clear when and how the target will be set and the transparency around this process.

Question 2.6 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%?

Yes.

Question 2.7 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

Given the process of reviewing the target and the low sharing factors to mitigate risks outside of NG control a deadband of 5.5M seems rather wide. Sharing factors and caps/collars should be symmetrical to ensure that National Grid faces equal exposure to good and poor performance.

Question 2.8 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?
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?

Given fluctuations in the use of OM from year to year it may be more appropriate to include the average utilisation plus a percentage say 20% as the utilisation cap.

Question 2.9 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?

The average historical volume would seem appropriate to use in the utilisation cost target

Question 2.10 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?

This seems a reasonable approach

Question 2.11 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?

We consider all cost should be included since all costs are ultimately passed onto shippers / customers

Question 2.12 Should the 2012/13 incentive target be based on the outturn in 2011/12? If not what would be an appropriate target?

Basing the incentive target on just a single year may lead to fluctuations, it may be better to use an average of costs since contestability was introduced. This will avoid windfall gains or losses as a result of an exceptional year.

Question 2.13 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?

Effective incentives that are appropriately designed should promote year on year improvements in performance, so the deadband and / or sharing factors should be reduced for the second year.

Environmental Incentive
The Association recognises the importance of environmental performance schemes and NG along with all companies in the energy sector and beyond have obligations to reduce emissions. Indeed NG in its Corporate Responsibility report[2] flags its own

[2] http://www.nationalgrid.com/corporate/Our+Responsibility/200809CRReport/

commitment to greenhouse gas reductions of 45% by 2020 and 80% by 2050. Each business has developed a five year plan to 2015 to set a trajectory to the halfway point at this time. The plans were adopted in April 2010 and Executive compensation is linked to performance under these plans. Hence it would seem that NG may already have plans to reduce these emissions which one would assume also have funding associated with them. Therefore it is not clear to us why further funding from customers is necessary at this time. We would welcome clarity on whether this incentive and any proposed new ones or requests for funding to reduce emissions are in addition to the commitments already made in the Corporate Responsibility report. We consider that this should be more appropriately and fully considered as part of RIIO for the next price control

We provide comments to the questions below on the basis of the current incentive continuing until the next price control review.

Question 3.1 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 Association agrees that NG should be exposed to the marginal cost of natural gas venting.

Question 3.2 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.
Do you feel these targets reflect an effective and efficient target, given the increasing supply and demand uncertainties?
If you do not support either of these target proposals, how would you suggest the volume target should be set?

Of these two options a two year average is preferred since one year's data may include short term excursions which may not be present in the longer term. As more consistent data is provided this should be extended to a 5 year rolling average. We acknowledge the uncertainty created by changing supply and demand patterns and that NG is evolving operational practice to best manage these, we therefore consider a target set in this way to be challenging but appropriate.

Question 3.3 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?

Yes to both

Question 3.4 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?

The Association does not have a strong view on this issue, but a small deadband may continue to be appropriate

Question 3.5 The proposal does not include any caps or collars on the NTS Environmental incentive. Do you agree with this proposed approach?

Yes

Question 3.6 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?

See comments at the introduction to this section

Question 3.7
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?

The incentive should cover the two year period to the next price control

Question 3.8 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?

Environmental incentvies should only cover areas where NG has the ability to influence the outcome, whilst also having challenging targets to promote improved performance in addition to what NG has already committed to. Consideration will also need to be given to other environmental obligations and incentives that NG faces to avoid complex interactions. Further consideration will need to be given as to whether these are truly issues for SO or TO incentvies or better addressed via the price control.

09 Dec 2010

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