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Dear Juliana

National Grid Gas (NTS) System Operators Incentives for 1 April 2012 Initial Consultation

Thank you for providing SSE with the opportunity to comment on the above consultation. The key areas for change in relation to a 'roll over' of the existing five incentive schemes included in the consultation to 2013 are the treatment of UAG volumes within the Shrinkage Incentive, the UAG Incentive and the Demand Forecasting Incentive.

SSE believe the treatment of UAG volume within the Shrinkage Incentive needs to change as the UAG volumes dominate the incentive and remove focus from the components of shrinkage that NG has more control over. In addition, given the large increases in UAG in recent years SSE believe the effectiveness and appropriateness of the UAG Incentive should also be reviewed.

In terms of the Demand Forecasting Incentive, SSE continue to believe the inclusion of seasonal targets and a limit on the maximum daily forecast error would be preferable to the current average daily forecast error measured over the year.

Although not the subject of this consultation, SSE believe the Capacity Buyback Incentive rewards NG too excessively, year on year, for operating a system which has a significant margin of excess capacity the majority of the time.

SSE offers the following responses to the specific questions raised in the consultation.

Shrinkage

Question 2.1 Are there any additional items which require consideration for the roll over of the Shrinkage incentive?

No additional items need to be considered for the Shrinkage Incentive as CFU, CV Shrinkage and UAG are the key components. However, SSE believes the treatment of UAG within the Shrinkage incentive needs to be reviewed in light of the large increases in UAG in recent years. These increases mean the Shrinkage Incentive is now dominated by UAG volumes.

NG state that they have little control over UAG and there is already a separate incentive to cover UAG. Unexplained variations in UAG affect the outcome of Shrinkage incentive payments to NG, for example an unexplained fall in UAG in 2012/13 could lead to the maximum incentive performance payment for NG even with no improvement in the other areas of the Shrinkage Incentive.

It is questionable whether it is appropriate to have UAG volume included in the Shrinkage Incentive given the stand alone UAG incentive now exists. However, for the purposes of a roll over it would seem reasonable to revert to an appropriate fixed UAG target for 2012/13 rather than passing through the net outturn volume of UAG.

Question 2.2 What is the appropriate level of change and what are your priorities for the rollover of current arrangements in respect of the Shrinkage Incentive for a single year scheme for 2012/13?

SSE note that NG has out-performed incentive targets and received the maximum incentive performance payment over the last few years. The scale of cost target out performance is currently + or - £20 million and out performance was £107m in 2009/10 and £25 million in 2010/11. If the Shrinkage Incentive is rolled over to 2012/13 in its current form, SSE view it as necessary to tighten the targets.

Question 2.3 Do you consider a review/update of the current CFU model appropriate for a rollover year, or do you believe that a more fundamental review is required? If so what approaches and/or techniques should be explored?

SSE do not consider it necessary to undertake a fundamental review of the CFU model for a one year rollover and a review/update of the current model is sufficient.

Question 2.4 Do you consider TBE base case at seasonal normal demand remains an appropriate supply-demand scenario assumption for CFU target setting?

Yes, the TBE base case remains appropriate as SSE do not believe there is currently a better alternative.

Question 2.5 Do you believe it is necessary to review the CFU adjuster? If so, should this be an update of the current values or a revision of the methodology itself?

Given the importance of the CFU adjuster in reducing the CFU target error it would be prudent to review the adjuster along with the CFU model. Because we are dealing with a one year rollover, an update of the current value rather than a revision of the methodology is more appropriate.

Question 2.6 Are the latest programmed dates for the installation of electric drive compressors an appropriate basis for the disaggregation of the baseline CFU target into gas and electric target volumes? If not, what do you believe would be the appropriate basis?

Yes, this appears to be a suitable basis to split out the baseline CFU target into gas and electric target volumes.

Question 2.7 In respect of the Shrinkage procurement incentive, do you believe that it remains appropriate for the UAG component of the gas volume target to continue to be based upon net outturn volumes?

As discussed in our response to Question 2.1, SSE questions the inclusion and treatment of UAG volumes within the Shrinkage Incentive. However, for the purposes of the 2012/13 roll over, SSE believe it is appropriate to change the treatment of UAG within the Shrinkage Incentive rather than propose removing the UAG volume from the incentive.

Given UAG volumes have increased substantially in recent years and therefore remove focus from the other components of the Shrinkage Incentive, it would seem sensible to revert to an appropriate fixed UAG target for 2012/13 rather than passing through the net outturn volume of UAG for the purposes of a roll over.

Question 2.8 Do you believe it is appropriate to maintain the mechanism that enables exclusions (for specific CV risks that cannot be mitigated economically) to be identified within the current incentive structure? If not, how should these risks be accommodated within the incentive structure?

Yes but it is also appropriate to monitor the situation as more unconventional gas and bio-gas projects that produce low CV gas are developed.

Question 2.9 Do you believe that swing is an incremental cost for which there should be an allowance in addition to the benchmark price?

Due to the nature of the incentives that require both forecasting volume and committing to a price based on a forward curve, there will inevitably be a swing allowance.

Question 2.10 Is the current ex-ante market benchmark approach appropriate for the purposes of a one year rollover? If not, what alternative arrangements do you believe are appropriate?

The ex-ante adjustment approach used between 2009-12 would seem appropriate for the one year rollover.

Question 2.11 Do you believe it is appropriate to review the ECRP reference price uplift?

Yes given the changes in the market outlined by NG it would seem appropriate to review the price.

Question 2.12 Do you believe it remains appropriate for the ECRP reference period within the rollover arrangements retain a bias to prompt price?

Yes a prompt price bias would appear suitable for a rollover to 2012-13.

Question 2.13 What do you consider is an appropriate incentive treatment of the TNUoS, DUoS and CRCEES costs?

TNUoS, DUoS and CRCEES costs updated with appropriate tariffs for 2012/13, would seem appropriate.

Question 2.14 Do you think it is appropriate to have a bespoke environmental dimension to the NTS Shrinkage incentive? If yes, do you believe it is appropriate to review the adjustment for the shadow price of carbon within the 2012-13 scheme to ensure the appropriate level of interaction with environmental legislation?

SSE believe there is a risk of duplication between CRCEES and inclusion of the shadow price of carbon adjustment. Managing carbon emissions should be a routine part of core business for a responsible and prudent system operator. This is recognised by NG themselves in their Environmental Policy Statement. The NTS Environmental Incentive already provides an incentive for NG to recognise the environmental impact of the compressor fleet. Therefore, it does not appear necessary to apply a carbon price adjustment to the Shrinkage Incentive for the 2012/13 scheme.

Unaccounted for Gas

Question 3.1 Do you believe that National Grid has a central role in the minimisation of UAG volumes? If not, who do you believe should take this role?

SSE believes that the minimisation of UAG volumes should be the responsibility of NG as the System Operator because there is no other party more suited. SSE appreciate the ownership of meters lies with a number of different parties the majority of who are DNs with whom NG has contracted terms.

Question 3.2 If you consider that National Grid has a central role to play, do you believe that National Grid should be incentivised to perform this role or should it be subject to a funded obligation?

In its current form the incentive appears to be unsuccessful in lowering the volume of UAG. Given the large volumes and cost to industry of UAG, a review of the options for minimising UAG volumes may be appropriate. An incentive structure that introduced an element of downside as well as upside should be considered as this would provide increased incentive to minimise UAG volumes.

Given metering measurement tolerances and metering error might be the primary cause of UAG, a review of the structure of the incentive (for example an to incentive to check calibration of meters) may be appropriate.

Question 3.3 If an incentive were in place for UAG in 2012/13, what would an appropriate incentive structure be? For example, the current incentive scheme is based upon the absolute volume of UAG in a year.

If an incentive is in place for UAG in 2012/13 then it would be appropriate to review the incentive structure. SSE sees some merit in NG's suggestion of a target for shorter periods (monthly) to create an enduring incentive across the year. It would be interesting to see more detail on this proposal.

An alternative to this proposal would be to widen the target volume band considerably to ensure the annual target can not be so easily exceeded. The UAG incentive scale runs in a narrow band between 1,791 GWh and 2,862 GWh and a wider band may be more appropriate. In addition, there is no downside to the incentive if UAG rises as was the case at the start of 2010. An incentive structure that has both upside and downside may be more successful at minimising UAG volumes.

Demand Forecasting

Question 4.1 Do you support the view that the structure of the current D-1 13:00 Demand Forecasting Incentive remains fit for purpose for incentivising National Grid to provide valued information to customers? If you do not agree with this view, do you have any views as to how the structure could be improved to apply from 1 April 2012?

SSE believe it is appropriate to continue to base the demand forecasting incentive around the D-1 13:00 demand forecast. However, the current incentive is based around the annual average level of forecast error. This structure implies that the value of an accurate demand forecast is equal for all days in the year (i.e. there is no increased value on winter or higher demand days). It also implies that the focus of NG

NTS activities is on reducing the average level of forecasting error rather than trying to specifically address the occurrence of an individual day with a large forecast error.

SSE believe that the current incentive structure should be modified to:

- Have four separate average levels of forecasting error periods; Winter, Autumn, Spring and Summer. This will reflect the different market value of days in each season.
- Have a separate incentive to avoid large peak single day errors in the Winter i.e. no more than 8% absolute forecast error.
- Reduce the current average forecast error from 3% to 2.5%. Historical evidence has shown that NG NTS can achieve this level of forecast accuracy.

Question 4.2 Do you have any views or evidence regarding the volatility of demand in 2012/13? In addition, do you have any views on how this demand volatility will impact the Demand Forecast incentive?

Gas demand volatility is driven by a number of factors including GDP growth, relative fuel pricing, weather, fast cycle storage and interconnectors. SSE do not expect demand to be excessively volatile in 2012/13 and these variables can be forecast with reasonable accuracy closer to the time.

Question 4.3 If National Grid was able to improve its demand forecasts, how would this impact on your business?

Improved demand forecasting would result in a reduction in trading SSE's energy position and a saving in the amount spent on cash-out.

Question 4.4 Do you agree with the analysis we propose to undertake in order to review the annual error target as described in paragraph 140 above? If you do not agree with this proposed approach are you able to state which amendments or additions you consider are appropriate to this analysis?

Yes the analysis outlined will be useful in improving the accuracy and transparency of demand forecasting.

Question 4.5 What value (or relative value) do you place on each of the demand forecasts?



SSE value the D-1 13:00 demand forecast most highly as it is used for balancing our energy position. The D-5 to D-1 forecasts are of less value as the forecasting error is larger.

Question 4.6 Which of the forecast times do you believe should be incentivised?

As stated above SSE believe it is appropriate to continue to base the demand forecasting incentive around the D-1 13:00 demand forecast.

Data Publication

Question 5.1 What value do users put on the data items that are published under this incentive? In particular we welcome views from small suppliers and large consumers.

The provision of data under the incentive is a useful service. However, SSE believe data publication should be treated as a routine requirement rather than an action to be incentivised.

Question 5.2 Are the current target levels of website availability and timeliness of data publication appropriate?

It is important for data items to be available when most needed i.e. peak demand periods when a gas balancing alert has been issued. The current incentive does not encourage this.

Question 5.3 Do you agree with our recommendation that the structure of this Incentive should not be reviewed for the rollover year in order to allow for a more detailed focus on SO Incentive schemes effective from 1 April 2013?

SSE believe data publication should be treated as a routine requirement rather than an action to be incentivised and as such believe the data publication incentive should be replaced with a licence requirement. However, if the data publication incentive remains in place for the roll over, SSE agrees with this recommendation that the structure should not be reviewed.

Question 5.4 What information, if any, do users consider should be incentivised beyond the existing defined dataset?

SSE do not see a need to expand the coverage of the incentive.

Residual Balancing

Question 6.1 Do you support the view that the structure of the current Residual Balancing Incentive remains fit for purpose in incentivising National Grid to not enter the market where possible and minimise our impact on the market when we do enter? If you do not agree with this view, do you have any views as to how the structure could be improved to apply from 1 April 2012?

The current incentive appears to have worked well and therefore SSE view the current Residual Balancing Incentive structure as appropriate for a rollover to 2012/13.

Question 6.2 Do you support the view that the target parameters of the PPM should be reviewed?

A continued tightening of the PPM target in 2012/13 would seem appropriate as NG's incentive performance should require continuous improvement and significant payments have been made under the scheme in recent years.

Question 6.3 Do you agree with the analysis we propose to undertake in order to review the PPM target as described in paragraph 183 above? If you do not agree with this proposed approach are you able to state which amendments or additions you consider are appropriate to this analysis?

SSE believes that the two components of the Residual Balancing incentive, the price performance measure and linepack measure, are of potentially critical importance in influencing market price and trading sentiment. The two measures are directly related to one another and need to remain bundled together under the Residual Balancing incentive. The historical incentive payments are sizeable but against the potential impact on the wholesale market price the incentive appears to be appropriate but in need of tightening.

Question 6.4 Do you believe that the LPM target parameter should also be reviewed?

Yes, given the significant payout under the LPM incentive it makes sense to undertake a review of the appropriateness of the target.

Question 6.5 If possible could you provide your views on suitable levels for the residual balancing scheme parameters?

A continued tightening of the residual balancing scheme parameters in 2012/13 would seem appropriate as NG's incentive performance should require continuous improvement and significant payments have been made under the scheme in recent years. A tightening of the PPM target to at least 2% would be desirable.

Information on Incentive Performance

Question 7.1 Is the information provided as summarised above useful?

The graphical summary and more detailed Excel output are both useful outputs.

Question 7.2 Is there any further data that could be issued by National Grid to improve the level of information available in respect of SO Incentives?

It would be useful to have a breakdown of each component of the Shrinkage Incentive and progress towards the target.



Please do not hesitate to give me a call if you wish to discuss this further.

Yours sincerely

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