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Dear Ian,

Electricity SO Incentives Initial Proposals for 1st April 2011

Thank you for the opportunity to respond to the above consultation. Generally, we are concerned that a number of fundamental changes are being proposed to the scheme at once, namely:

- The move to introduce a target which is not set ex ante as now, but which is calculated ex post as actual data becomes available;
- Moving from a one year scheme to a 2 year scheme; and
- Removing dead bands, increasing sharing factors and relaxing caps and collars.

This is a significant amount of change which is being consulted on in relatively tight timescales. This limits participants' ability to comment meaningfully.

We note that National Grid is suggesting that its implementation timescales are such that an Ofgem decision would be required at the beginning of January for implementation in April. Therefore, making such radical changes, with limited consultation time and to such tight timescales seems very risky. Therefore, we would recommend that this approach is reconsidered in order to introduce a more proportionate level of change for the next scheme year.

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One approach we would strongly recommend is to retain a one year scheme for a few years. This would allow an assessment of how well the ex post method is working before applying it for a longer period. Similarly, it would seem premature to be adopting new sharing factors until it is clear that the new approach is appropriate.

Indeed, we continue to have concerns about the consultation process adopted for the SO incentive scheme and the level of industry resource required. We believe that consulting with the industry can be helpful in providing another set of views on the approach being taken. However, we do not believe that it is efficient to rely on individual industry parties to provide a detailed examination of the analysis that has been carried out to set the scheme parameters. This is an unnecessary duplication of effort and such a level of detailed scrutiny should continue to be the responsibility of the negotiating team in Ofgem. Moreover such engagement would require greater access for parties to source data in order to enable a meaningful analysis to take place.

The role of industry parties should therefore be mainly to comment on the general approach that is being adopted and to cover any issues such as the impacts that the scheme has on the charges that parties face and any information transparency requirements. Therefore, in this response we sometimes group a number of questions together in order to provide more general comment on the direction being proposed.

Notwithstanding the general view expressed above, our answers to the detailed questions raised in the consultation are as follows.

Question 1: To what extent do you think that the proposed approach to incentivisation, with the use of Ex-Post data for volatile, difficult to forecast parameters, will result in more appropriate incentivisation of National Grid's system operator activities?

It appears to be a sensible approach to seek to remove windfall gains and losses which are caused by factors outside of the control of National Grid. However, care needs to be taken to ensure that these aren't replaced with other windfalls arising from inappropriate or inaccurate relationships being defined between inputs and outputs.

Attempts at introducing indexation into previous schemes have been generally unsuccessful, except in the case of reactive power costs, due to an inability to derive clear enough relationships between inputs and outputs. We have a concern that these relationships may still not be as strong as they need to be in certain cases. Indeed the R^2 s quoted in the back testing analysis in the appendices are often around or below 50%, which does not suggest a particularly close relationship.

Question 2: Do you agree with the criteria used by National Grid to assess the extent to which it can forecast or control BSIS drivers? Are there other criteria that you think National Grid should consider?

The criteria appear sensible enough. However, clearly it is not simply whether an input is

predictable or is controllable which determines whether ex ante or ex post treatment is appropriate, but the precise interaction between the inputs and outputs and whether National Grid is in a position to affect the outcomes associated with that input.

As stated in paragraph 59 of the document in some cases where National Grid doesn't have control over inputs it still may be able to control costs. What is important is that this relationship is fully understood and any indexation set accordingly. Otherwise, National Grid may be credited or penalised against the incentive for apparent benefits or costs which were actually the result of incorrect scheme target parameters.

Question 3: What are your views on National Grid's conclusions regarding the treatment of Generation Availability in BSIS models?

The inference we took from the consultation was that generator planned outage information from OC2 data was relatively reliable and controllable and would generally be treated ex ante, but that OC2 information is less reliable the further out it is from the date to which it relates and so should be updated through time. We believe that the accuracy of all OC2 data is somewhat variable. We would recommend a further review of the reliability of this data before it is assumed that it is suitable for ex ante treatment.

For unplanned outage information the view appears to be that this is unpredictable and so should be an ex post input to the scheme. Again on the face of it this appears appropriate except that presumably National Grid must assume a certain level of risk of plant trip when setting reserve and response levels. Therefore, a sensible approach must be to assess National Grid's performance against what an efficient level of plant risk rather than for it to be assessed fully ex post as appears to be the current suggestion.

Question 4: What are your views on National Grid's conclusions regarding the treatment of Generation Running in BSIS models?

Question 5: What are your views on National Grid's conclusions regarding the treatment of Demand Volatility in BSIS models?

Question 6: What are your views on National Grid's conclusions regarding the treatment of Transmission Availability in BSIS models?

Question 7: What are your views on National Grid's conclusions regarding the treatment of Transmission Capability in BSIS models?

We have no specific comments on these questions other than the general views expressed in the answer to question 2.

Question 8: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Energy Imbalance will act as an appropriate incentive to deliver cost efficiencies?

This doesn't appear to be very different from the present scheme so seems sensible.

Question 9: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Margin will act as an appropriate incentive to deliver cost efficiencies?

Question 10: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Fast Reserve will act as an appropriate incentive to deliver cost efficiencies? Are there any areas where you think that improvements to the models could be made?

Question 11: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Frequency Response will act as an appropriate incentive to deliver cost efficiencies?

Question 12: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for Footroom will act as an appropriate incentive to deliver cost efficiencies?

This is an extremely complicated element of the proposals and it is difficult for us to comment in detail in the timescales allowed. However, one clear point appears to be that there is an interrelationship between different options for providing various forms of reserve in that using one source more may reduce the requirement for others. If these elements are indexed differently then there appears to be scope for windfalls to arise simply because the ex ante assumed mix of services feeding into the margin cost model is different from that which outturns. It is not easy to gauge whether the proposed scheme accounts for this.

Question 13: To what extent do you think that National Grid's proposed approach to delivering a modelled target cost for reactive power will act as an appropriate incentive to deliver cost efficiencies?

As reactive power costs are already subject to an indexed incentive, it would seem to be sensible to continue to do so unless significant issues have been experienced with the current scheme.

Question 14: To what extent do you consider that there exists the potential for windfall profit or loss under the scheme if a single snapshot of the generation outage plan were to be taken prior to scheme start (and used in the models for the duration of the scheme)?

Question 15: To what extent do you consider that a rolling Ex-Ante approach to modelling planned generation outages, as notified via Grid Code OC2 processes, is an appropriate mechanism to ensure the modelled outage plan remains representative (and suitable for incentivisation)? What other mechanisms could be considered?

Clearly, there is scope for windfalls to exist whenever assumptions subsequently change. However, the approach to update OC2 data as the scheme progresses needs to be better explained. At first glance it seems that this update could be another ex post adjustment and it would be helpful to understand how this approach is different.

Question 16: To what extent do you consider that there exists the potential for windfall profit or loss under the scheme if unplanned generator availability is not considered when calculating target costs for constraint management incentivisation?

Question 17: Do you agree that treating generation faults as an Ex-input to [constraint] models is an appropriate mechanism to ensure the modelled target cost remains representative (and suitable for incentivisation)?

Again we understand that there is scope for windfalls to exist whenever assumptions underpinning the original forecast subsequently change. Clearly different faults can have different effects on outturn constraint costs depending on where the generation is located and the timing of the fault. It is not clear how the model would reflect these specific circumstances, when ex post data on generation faults is used as has been suggested.

Question 18: To what extent do you consider that there exists the potential for windfall profit or loss under the scheme if a single snapshot of the transmission outage plan were to be taken prior to scheme start (and used in the models for the duration of the scheme)?

Our view on this element is similar to that under questions 14 and 15 relating to generator outage information. That is, the approach to update OC2 data as the scheme progresses needs to be better explained as it seems it could simply be another ex post adjustment in reality.

Question 19: To what extent do you think that BM price submissions can reasonably be forecast?

Question 20: What are your views on the use of submitted BM prices Ex-Post as a means of determining target costs for constraint management?

Question 21: What are your views on the use of a 'pseudo BM price' to apply to contracted BM Units when calculating target constraint costs? To what extent do you agree that the options outlined in paragraph 355 might be suitable?

It would appear to be very challenging to predict BM prices, especially for the term of a 2 year scheme as has been proposed. Therefore we can see how it may seem appropriate to treat BM prices as an ex post adjustment. However, it is also apparent, as has been pointed out in the consultation document, that there are some potential significant issues associated with this, namely:

- That this could act as an incentive for National Grid to rely on the BM as the target would always track this outcome; and
- A further disincentive to contract to beat the BM could be introduced as the contracts struck could directly or indirectly affect generators subsequent BM behaviour, which could undermine the perceived benefits of those contracts against the target.

However, it is not obvious how this issue could be adequately addressed. Including some form of pseudo prices would seem to be a somewhat subjective exercise which could be seen to negate the benefits of including ex post BM prices.

Question 22: Do you agree that National Grid should be incentivised to beat historic constraint contracting performance?

Question 23: If yes, what in your view is the most appropriate way to achieve this in practice?

Yes, it would seem sensible to promote this. A simple method may be more appropriate such as a discount against BM prices although of course this may suffer from the issues pointed out in the consultation document and touched upon in our response to questions 19 to 21 above.

Question 24: To what extent do you agree with National Grid's views on the need for a cost 'dead-band' under the proposed approach to incentivisation?

Question 25: To what extent do you agree with National Grid's views on the magnitude of the profit cap and loss floor under the proposed approach to incentivisation?

Question 26: To what extent do you agree with National Grid's views on the magnitude of sharing factors under the proposed approach to incentivisation?

What do you consider to be an appropriate level of sharing factor?

We are unconvinced that the risk sharing parameters of the scheme automatically need to change as a result of these proposals. If the changes lead to lower risk of windfall gains and losses then there may be a case for the removal or reduction of the dead band which is clearly there to account for the uncertainty in the target. However, the sharing factors, caps and floors are not necessarily required simply to cover the risk of the targets being incorrect.

The sharing factors should reflect the level of incentive that National Grid needs to balance the system efficiently; essentially it is already required to do under its licence. We do not disagree that a financial incentive helps provide focus for this, but we are not convinced that sharing half of any benefits and costs is necessary. Our view is that sharing factors are as high as they should be and if anything could reduce.

Caps and floors simply represent the maximum amount that National Grid could stand to gain or lose under the scheme. Clearly windfall losses and gains associated with the target being incorrect may have the effect of causing these limits to be reached sooner or later than might otherwise have been the case. However, it is not apparent that any possible reduction in this risk means that the maximum level of exposure should be increased.

Question 27: Do you agree that National Grid should be concerned about the potential for parties to influence its performance under the incentive scheme by using information that it makes available to the wider industry?

We do not agree. If the target is to flex in response to ex post inputs then it is important for market participants to understand the relationships behind this. Therefore, they need to know the parameters of the scheme and ex post input data should be reported in a sufficiently timely manner, so that they can calculate how the inputs will affect the charges they face.

Question 28: Do you agree that the creation of an open, transparent statement describing National Grid's methodology for determining whether model inputs should be treated on an Ex-Ante or Ex-Post basis is appropriate?

Yes. This information should be made available.

Question 29: What are your expectations of National Grid when it comes to the production of an Incentivised Balancing Cost/BSUoS charge forecast?

Question 30: What are your views on the timing of such forecasts? For example, do you have processes that will be impacted by the timing of publication of an IBC/BSUoS forecast?

We would wish to see a forecast of the IBC and details of how this forecast changes as it is updated. It will also be important to report how the scheme target changes as the inputs are updated. It may be sufficient to report every month on this.

We also believe that a BSUoS forecast would be helpful both for suppliers and generators in the market, who have to take a view on future levels of BSUoS when setting some tariffs and undertaking certain trades. Our preference would be for a 15 month rolling forecast with £/MWh average figures reported for each of the 15 months.

Question 31: Do you agree with the concept of (and need for) a Scheme Adjusting Event? If so, what sort of events do you consider it appropriate to adjust for?

Question 32: To what extent do you consider that the scheme needs to be able to cope with the 'known unknowns' listed in section 4.4.2? How might the impact of these events be managed?

Income Adjusting Events are presently one of the biggest risks associated with the present scheme as they occur after the scheme year, by definition are significant in size and cannot effectively be managed by suppliers and generators. Anything to reduce the exposure of market participants to ex post sunk costs of this magnitude would be welcome. We do not have any specific views on how this would be achieved, but we do continue to have concerns about how a 2 year scheme might influence the number of adjusting events that occur.

If an ex post input model is adopted for the scheme, our preference would be for a 1 year scheme to be retained. Once the new approach is proven, it would then be possible to alter the length of the scheme. Our present concern is that a number of major changes are being proposed for implementation in April of next year without being appropriately tested and that there should be a limit on the number of changes which are applied at one time.

Question 33: Do you consider that your systems will be impacted by the proposed change to scheme structure outlined in these Initial Proposals? If so, what information will you require (and in what timescales) in order to accommodate the change?

We believe that it needs to be explained how the billing for BSUoS might be affected by this change. If the scheme target is going to alter throughout the two year period then presumably it will have the potential to affect the level of BSUoS costs for the whole of the scheme. This means that costs for days which have already occurred could be affected as well as future days. Therefore, we would be interested on what this may mean for reconciliation risk. In particular, we would like to understand the effect that a flex to the target in year 2 of the scheme could have on BSUoS costs in year 1.

Constraint Charging Addendum

Given the timing of the issuing of the addendum and the consultation period allowed for response, it has not been possible for us to provide detailed views on what is being proposed over and above our answers to questions 14 to 23 above.

I hope that the above views prove helpful. Should you have any comments then please feel free to call me on the above number.

Yours sincerely

Paul Jones
Trading Arrangements