



First Hydro Company is part of a joint venture between
International Power plc and Mitsui & Co., Ltd.

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Malcolm Arthur
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8 January 2009

Dear Malcolm,

Electricity System Operator Incentives – Initial Proposals Consultation

Please find attached the responses to the questions raised in the Initial Proposals Consultation on the Electricity SO Incentive Scheme for 2009/10. These comments are provided on behalf of all of the International Power/Mitsui assets in the UK.

If you have any questions on our response then please do not hesitate to contact me.

Yours sincerely

Kevin Dibble
Director, Marketing (First Hydro)

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International Power/ Mitsui response to Consultation Questions

1. *Do you agree with the areas identified as the main cost drivers for 2008/09? Are there any other drivers not explicitly identified?*

The principal cost drivers seem to have been identified.

2. *Do you agree with the high level assumptions outlined:*
 - *utilisation of forward power prices and the 60% - 160% range?*
 - *market length central and ranges?*
 - *generation availability and utilisation of OC2 data?*

One of the central assumptions of the analysis is that the conditions seen in 2008/9 will be replicated in 2009/10 (with some weighting allowed to previous years). However, given the increase in new plant and greater availability of the nuclear fleet that is forecast for next year, it is possible to argue that 2008 has been exceptional and that NIV will be longer next year to a greater degree than is allowed for in the analysis, i.e. less weight should be placed on 2008. The difficulty in relying on 2008 is exemplified by the substantial swing in NIV that has been seen between autumn and winter this year.

3. *Do you agree with the assumptions (described in detail in the appendix) used to forecast the various elements that make up underlying balancing costs?*

The assumptions used are reasonable; however, the assumptions demonstrate the great uncertainty that is inherent to out-turn balancing costs. The incentive scheme is predicated on the idea that these costs can be accurately forecast and, therefore, incentivized. However, the uncertainty which underlies the necessary assumptions means that it is not possible to forecast costs in such a precise fashion.

4. *Do you agree with the areas identified as the main cost drivers for 2009/10? Please explain your rationale. Are there any other drivers not explicitly identified? In particular, do you agree with the assumptions used to forecast margin (reserve, STOR and BM start up) and constraint costs?*

The main cost drivers have been identified. The assumptions used to forecast margin are reasonable but, as our answers to previous questions suggest, there is a wide margin of error.

We are concerned at the significant increase in the forecast constraint costs but it is difficult to comment on the assumptions used without further information.

5. *Do you have any comments on the assumptions used in determining the increase in costs associated with the revised operation of the England / France interconnector known as Use it or lose it?*

There seem to be significant unknowns surrounding the analysis of how changes in the rules governing the operation of the England/ France interconnector will affect costs. The £21m figure may significantly underestimate or overestimate costs and, whilst obvious care has been taken with the analysis, it may be questioned as to whether it is possible to establish a robust conclusion given that is subject to such uncertainties.

6. *Do you believe that we should include some provision for a volume of additional generation connecting as a result of the interim connect and manage arrangements? If not, how do you believe we should manage the risk of additional generation connecting?*

We do not consider that any further provision should be made for additional generation that connects as a result of the interim connect and manage arrangements. Given the timeframe involved it seems that there would be minimal additional generation connecting.

7. *Do you agree with the implementation of a new adjustment as described as new NIA? If not, please outline your rationale?*

The old NIA mechanism does seem to require updating. Therefore, the use of new NIA appears reasonable. However, this does assume that the relationship will continue to function in 2009-10 as in previous years and it is not certain that this will hold true. The appropriateness of the value of 'Volume Offset' requires careful monitoring and further suggests that there should not be a multi-year scheme.

8. *Do you agree with the implementation of a new reactive power index? If not, please outline your rationale? Are there any other indices that we should consider?*

We agree that it is appropriate to employ a reactive power index. There are no other indices that should be considered – the consultation on indexation demonstrated the difficulties of using indices for other cost drivers.

9. *Do you have any comments on the forecast range of incentivized balancing costs and BSUoS costs for 2009/10? Specifically do you believe that the range is too wide or narrow or do you believe it represents the full range of costs?*

The wide range of the forecast shows how difficult it is to predict out-turn balancing costs. Given the wide variety of factors/ costs that are beyond the SO's control it is difficult to comment on whether the range is too wide/ narrow; the analysis conducted by the SO is thorough but simply demonstrates that, even given sufficient analytical resource, an accurate forecast cannot be made.

10. *Do you have any comments on option 1? In particular:*

- *sharing profile*
- *benefits / drawbacks of such a scheme*
- *do you support implementation of such a scheme in April 2009*

Variable sharing factors introduce an unnecessarily complex method and give an impression of a greater degree of SO control of costs than is actually the case: many of the factors affecting the volatility of underlying assumptions are simply beyond the SO's control. A simple linear sharing factor seems more appropriate.

We do not support the implementation of a scheme such as option 1 in April 2009.

11. *Should we consider a change to the incentive period to ensure that an incentive remains on National Grid over the year? Would you support the implementation of such an incentive?*

An alteration to the incentive period seems to be an over-complication and it is not clear that this would improve the accuracy of the incentive. It is difficult to predict costs on a monthly or quarterly basis; at best, a seasonal approach (i.e. a six month period) may be possible. We would prefer that the incentive period remains as a year.

12. *What could such an incentive scheme look like?*

- *incentive period (e.g. monthly, quarterly)*
- *caps and collars*
- *sharing factors?*

A six month incentive period seems to be the shortest timescale that would be reasonable; it would be difficult to predict the various components of balancing costs for a shorter period with any degree of accuracy.

13. *Do you agree with the implementation of reactive power indexation?*

We agree with the implementation of reactive power indexation.

14. *Do you agree with the unbundling of reactive power? Should the bundled scheme caps and collars be changed from £20m?*

We do not agree with the unbundling of reactive power. However, if reactive were to be unbundled then the caps and collars should be changed from £20m accordingly.

15. *Do you agree with the unbundling of transmission losses? Please give your rationale.*

We do not agree with the unbundling of transmission losses. It is obviously difficult to predict transmission losses and to incentivize the SO on transmission losses in such an explicit way as unbundling would imply that the SO has greater control over losses than is actually the case.

16. *The transmission losses reference price is currently calculated on an annual basis. Do you believe there are any benefits in changing this to a more frequently calculated transmission losses reference price, such as daily? Please give your rationale.*

No comment.

17. *Are there any other components that you believe should be unbundled?*

We do not agree with an unbundled scheme.

18. *Do you agree with multi-year reactive power scheme? Please give your rationale.*

No – there is too great a degree of unpredictability to justify multi-year schemes.

19. *Do you agree with multi-year transmission losses scheme? Please give your rationale.*

We do not agree with an unbundled transmission losses scheme. Further, there is too great a degree of unpredictability to justify multi-year schemes.

20. *Are there any other components that you believe should have a multi-year scheme?*

No.

21. *Which is (are) your preferred incentive scheme(s)? Please provide reasons and your views on caps, collars and sharing factors.*

We prefer a bundled scheme with reactive indexation and linear sharing factors – Option 4c.

Given the wide range of possible outcomes of costs it seems most appropriate for the scheme to be bundled. Sharing factors should be linear as, although risks may be asymmetric, the use of variable sharing factors implies a greater degree of accuracy than the analysis is capable of supporting and introduces an unnecessary level of complexity.

22. *Do you have any comments on the forecast range of BSUoS costs for 2009/10?*

The substantial variation in the potential out-turning of costs, demonstrated by the analysis, means that it is not possible to provide more accurate forecasting of BSUoS.

23. *Did you find the level of information within this consultation, and associated documentation and workshop, on our balancing and BSUoS costs forecasts for the current year and 2008/09 informative.*

- *What additional information should National Grid provide to explain better the costs and cost drivers?*

The level of information provided has been good. However, given the substantial rise in the forecast constraint costs it may have been possible to provide greater detail on this aspect.

24. *Do you have any further comments on the analysis and information provided within the appendices to this consultation or in the further documentation available on our website?*

The provision of data and the explanation of this data are welcome. Further, the two industry events have been useful in determining our response to the incentive scheme proposals.

25. *Do you have any further comments on any aspect of this consultation in relation to the Electricity SO?*

No.