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Dear Malcolm,

Consultation on the Development of an Incentive Target Indexation Methodology

Thank you for the opportunity to respond to the above consultation. This response is made on behalf of E.ON UK plc.

Our responses to the specific questions raised are as follows.

1. Do you agree with the principle of indexation?

Yes, in principle indexation is a good idea if it can be achieved correctly. We had some reservations about previously proposed indexation as very little correlation could be identified. Some of the proposals in this document seem to merit further exploration.

2. Do you support the use of indexes for the scheme starting in April 2009?

We are wary of introducing a scheme on the basis of the analysis undertaken so far. The data that the regression analysis has been undertaken against contains some information from this year, but given the volatility in balancing costs recently, it would be sensible to redo the analysis when more values from this year are available. It may be that this can be done in time to implement an index for next year. If not, it would be worth considering delaying until the next scheme year.

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3. What incentive components should be included in the indexation methodology?

The present analysis would suggest implementing an index against Market Prices and system length for the combined group of costs associated with Energy, Reserve, Downward Regulation, Fast Reserve and Frequency Response. There may also be a case for a Reactive Power index against market price.

4. Considering the volatility of the index and the individual components, are there any periods that should be excluded from the development of indexation components e.g. exclude the data from 2005/6 due to the market being unsettled in the first year of BETTA?

It may be sensible to undertake the analysis excluding the 2005/6 data as well as including as much data from this current year to see if the correlation is improved. 2005/6 data does appear to be out of alignment with that from other years.

5. Do you agree with the proposed method of indexing balancing costs?

The exact method is not entirely clear. We assume that the target for the costs concerned will be directly driven by the form of algorithm in paragraph 93 of the consultation paper. It is labelled at present as an “adjuster” which suggests that the target for the indexed elements will be adjusted rather than set by it. We would like to clarify that the target would actually be set by the algorithm and not merely flexed by it.

The example in paragraph 97 is not entirely clear. Our understanding is that this new index would replace the Net Imbalance Adjustment. However, the example in paragraph 97 contains a NIA term too. Are they in fact supposed to coexist?

6. Are there any additional benefits / drawbacks of implementing the proposed indexation?

Our aims of indexation would be to avoid the requirement for Income Adjusting Events at the end of the year arising from unaccounted for levels of prices and market length. Therefore, we believe that any indexation should operate through the year so that companies are better able to assess their positions with respect to BSUoS costs. We would not support an index that was applied at the end of the year as this would defeat some of the benefit of indexation for users.

7. Do you have any comments on the development and implementation of an energy indexation?

We do not believe that this should be pursued in isolation. A combined index should be developed where feasible to minimise the possibility of incentives being played off against each other.

We have an additional comment on the proposal for an Ex Post Unconstrained Schedule (EPUS) approach to determining energy costs. The creation of an EPUS has been

proven in the assessment of BSC modification P211 to be highly problematic. Firstly, it is clear that the system operator seeks to minimise costs over a longer period than a half hour. Therefore, building an EPUS that minimises the cost for each half hour may not represent the most efficient solution over the longer term. Secondly, it proved very difficult to reflect properly the generation dynamic parameters that would affect the availability of certain bids and offers. This meant that the EPUS tended to understate the level of costs as unfeasible lower priced actions were often included. We would therefore not recommend the use of an EPUS in the development of an energy indexation methodology.

8. Do you have any comments on the development and implementation of reserve indexation?

As with the proposal for an individual energy index, we do not believe that this should be pursued in isolation.

9. Do you have any comments on the development of constraint cost indexation? What incentive arrangements should be considered for constraint costs?

We agree that this appears too volatile to create a meaningful index.

10. Do you believe that a reactive power index should be developed? What is your preferred option for a reactive power index?

A reactive power index would appear to be feasible. The approach set out in appendix B seems sensible.

11. Do you believe that a frequency response index should be developed? What is your preferred option for a frequency response power index?

As with the proposal for an individual energy index, we do not believe that this should be pursued in isolation.

12. Do you have any comments on the benefits and drawbacks of unbundling? If any, what incentive components could and should be unbundled?

As there are often tradeoffs between elements, we believe that a bundled scheme should be retained.

13. Are there any other forms of indexation that you believe should be further considered further?

No.

14. Do you believe that there are benefits in developing longer term incentives? Are there any benefits or drawbacks not covered by this consultation?

Single year incentives would continue to be our preference. Longer term incentives

increase the likelihood of Income Adjusting Events which are highly problematic for market participants.

15. Did you find the level of information within this consultation informative? What additional information should National Grid provide to explain better?

Yes, in general the information was helpful. Some of the analysis could have been more clearly explained but we appreciate that this is a highly complex area.

I hope the above comments prove helpful. Please contact me on the above number should you wish to discuss any of these comments further.

Yours sincerely

Paul Jones
Trading Arrangements