

Malcolm Arthur
National Grid Electricity Transmission plc
National Grid House
Warwick Technology Park
Gallows Hill
Warwick
CV34 6DA

Contact Bill Reed
Phone Phone 01793 893835
Email bill.reed@rwe.com

Swindon, 15th December 2009

Email: soincentives@uk.ngrid.com

National Grid Electricity Transmission System Operator (SO) Incentives for April 2010 – Initial Proposals Consultation

Dear Malcolm

Thank you for the opportunity to comment on the initial proposals consultation for National Grid Electricity Transmission System Operator (SO) Incentives for April 2010. This response is provided on behalf of the RWE group of companies, including RWE Npower plc, RWE Supply and Trading GmbH and RWE Innogy GmbH.

We welcome the thorough and comprehensive approach that sets out on the details of electricity incentive scheme from April 2010. However, we have a number of general concerns about adopting an unbundled approach for the “energy” and “constraint” components of costs.

We believe that prior to the introduction of an unbundled approach a detailed, transparent and robust methodology for cost allocation is a requirement. This methodology is critical in determining the overall efficiency of each of the cost arrangements. We remain to be convinced that actions that deliver more than one benefit can be consistently classified into either the energy or constraint actions.

We are also concerned about proposals to introduce a longer term (2-year) scheme for the energy elements of the costs. As we have noted previously, the uncertainty over potential cost outcomes in year 2 creates the risk for significant adjusters (which may be automatic) or, more importantly, for income adjusting events. This has the effect of increasing the potential risk that the scheme outcomes significantly differ from those forecasts.

Our preference therefore is to retain a bundled one-year scheme system. Further work is required to understand whether unbundling or longer term schemes will consistently deliver value to customers.

On a related note we continue to believe that the incentive arrangements associated with both system operation, transmission investment and the efficient level of constraints on the transmission system requires detailed review to ensure that appropriate incentives are placed on the relevant parties (the system

RWE Supply & Trading GmbH
Swindon Branch
Windmill Hill Business Park
Whitehill Way
Swindon SN5 6PB
United Kingdom
T +44(0)1793/87 77 77
F +44(0)1793/89 25 25
I www.rwe.com
Registered No. BR 7373
VAT Registration No.
GB 524 921354
Advisory Board:
Dr Ulrich Jobs
Board of Directors:
Stefan Judisch (CEO)
Dr Bernhard Günther
Dr Peter Kreuzberg
Richard Lewis
Alan Robinson
Head Office:
Essen, Germany
Registered at:
Local District Court,
Essen
Registered No.
HR B 14327

...

operator, transmission owners and users of the transmission system).

Our comments on the specific questions raised in the consultation document are included in the attachment to this letter.

If you wish to discuss any aspect of our response, please do not hesitate to contact me.

Yours sincerely

By email

Bill Reed,
Market Development Manager
RWE Supply & Trading GmbH

Attachment 1: Response to the specific Consultation Questions

Attachment 1: Response to the specific Consultation Questions

1. Have all cost drivers for Energy, Reactive Power, Black Start and Transmission Losses been captured and correctly identified as being within or outside National Grid control

The document appears to present a comprehensive overview of the elements of costs that are influenced by National Grid's actions.

2. Have all the cost drivers for Constraints been captured and correctly identified as being within or outside National Grid control

In addition to a presumed "efficient" level of constraints in operating the transmission system in compliance with the NETSSQSS there are incremental costs of constraints created by the outage programme. This incremental cost is influenced by the expected patterns of generation and demand across the transmission system and new connections.

In order to provide a view on constraint costs, further information is required on the interaction between the TO outage plans, connection plans and the expected cost of system operation. This information is required to assess whether the incentive scheme operates economically and efficiently. In this context, it is important that National Grid correctly identifies the elements of constraint costs under its control as system operator separately from costs under the control of the transmission owners.

3. Is historic market length a suitable proxy for future market length?

It is difficult to predict market length given the number of factors that influence the contracting strategy of market participants. Historic market length may provide an indication of future outturns if similar historic market circumstances prevail. However, we would note that the increase in intermittent generation connected to transmission and distribution systems, the effect of the recession on demand and the operation new CCGT and older LCPD opted out power stations will all influence market length in the incentive period. Given the uncertainties in potential outcomes a 1-year rather than 2-year scheme may be appropriate. As a starting point however, we would accept that a forecast based on historic trends adjusted for the effects of the recession may be appropriate for a one year scheme.

4. Do you agree with the conclusions we have reached with respect to the observed changes in NIV since BETTA go-live? If not, why not?

Given the range of factors involved and the different prevailing market conditions it is difficult to arrive at firm conclusions as to the reasons for changes in market length. We would expect that efficient operation of the market will result in an efficient level of market length.

5. What do you believe is the impact of wind on market length at this time; how do you see this varying as wind penetration increases and what do you believe are the key drivers? What additional analysis could be carried out to determine the current and / or future impacts?

The increased connection of intermittent generation will inevitably have an effect on market length. However, there is an important feedback link between system prices and market length. Our expectation is that over time system prices will become more volatile, that the cost of imbalance will rise and that operators of intermittent power stations will respond to the appropriate market signals by contracting forwards a proportion of output (having taken into account the subsidy through the ROC mechanism). Over the time horizon of the current

incentive scheme proposals we believe that the uncertainty associated with the residual (uncontracted) output of renewable generation will influence system prices and therefore costs in the system operator incentive scheme. It is the residual (uncontracted) output and price interaction that requires consideration in the development of the incentive scheme.

6. Do you agree with our base case scenario for NIV? If not, which scenario should be used and why?

Given the comments above it is difficult to predict whether the historic trend in reducing NIV will be maintained. However, we believe that the NG assumption is a reasonable basis for forecasting outturn costs.

7. Are there any other factors or scenarios that you believe should be considered in deriving a NIV forecast?

The interaction between contracted wind output, system prices and renewable subsidies (either ROC or connect and manage incentives) requires careful consideration in the NIV forecast.

8. Do you believe that installed wind capacity will increase as indicated? If not, please indicate how you believe the rate will change and why.

National Grid is best placed to provide information on the expected levels on installed capacity connected to the transmission system. Given the uncertainty over precise connection dates the assumption with regard to wind connection appears reasonable.

It is unclear from the document as to the level of assumed wind capacity in the energy incentive arrangements. The document states: "*in each case the installed wind capacity will increase from 4.1GW at the end of 2009/10 to 5.3GW by the end of March 2010*". We assume that this should mean the "*end of March 2011*" (based on Data in Figure 25).

Given the impact of intermittent generation on balancing costs this assumed level of wind capacity is an important driver of costs and we would welcome further information on the assumed wind capacity level in 2011/12.

9. Do you believe that nuclear generation will maintain its current level of availability

We see no reason to assume that the future availability of nuclear will be different to historic availability factors.

10. Do you agree with the assumptions made in producing a frequency response volume forecast? If not, please indicate why not.

We agree that the assumptions made in producing a frequency response forecast are reasonable.

11. Do you agree with the assumptions made in producing a fast reserve volume forecast? If not, please indicate why not.

We agree that the assumptions made in producing a fast reserve forecast are reasonable.

12. Do you agree with the assumptions made in producing a reactive volume forecast? If not, please indicate why

We agree that the assumptions made in producing a reactive volume forecast are reasonable.

13. Do you agree with the assumptions made in producing a demand forecast? If not, please indicate why not.

We agree that the assumptions made in producing a demand forecast are reasonable.

14. Do you agree that the relationship between the volume of margin actions and market length is an appropriate input to the model?

Given the information presented the relationship between margin actions and market length seems to be an appropriate input to the model. However, we note that we are unable to verify the data used since this appears to be based on information on margin actions derived by National Grid from all actions taken in the balancing mechanism. We do not have either information on “margin” actions or the methodology used by National Grid to classify certain actions taken for margin.

15. Do you believe that wind generation will displace conventional generation behind key boundaries? Do you believe that conventional generation behind constraint boundaries will stop running?

In the absence of constraints it is logical that renewables will displace conventional fossil generation in the merit order. Renewables have lower marginal costs (based zero fuel costs and a subsidy) when compared conventional fossil generation. Conventional fossil generation will therefore operate when it is “in merit” in the unconstrained schedule and will not operate when it is “out of merit”.

In areas affected by constrained export transmission boundaries where there is significant renewable capacity, nuclear capacity and limited conventional generation we would expect an increased risk of additional costs associated with creating “headroom” or “margin”. These costs will occur when the conventional fossil generation is “out of merit” in the unconstrained schedule and required to be despatched for system operation. National Grid is in the best position to forecast the potential impact of constrained despatch on the incentive scheme.

16. Do you have any comments on the assumptions made in producing a margin volume forecast? Are there any other considerations that should be included in the margin volume assumption?

The assumptions made in producing a margin volume forecast appear reasonable though we would note that there appears to be a limited data set used to establish the underlying relationship between constraint volumes and the constraint margin management volume. As noted in the consultation additional data may help to better understand this relationship.

In the context of constrained margin management there is limited visibility or transparency of the methodology used to determining those actions that have been used to replace sterilised headroom behind export constraints. It is difficult, therefore, to determine if the underlying trend that is identified is internally robust for all actions. We would welcome more information on this issue.

17. Do you agree that the Argus forward price values are an appropriate measure of wholesale prices over the forecast period? If not, please indicate why not.

We agree that the Argus forward price value provide an indication of wholesale prices in the forecast period and are a reasonable basis for forecasting potential costs. However, we would note that the values are valid at the time that the forecast is made and that these prices should be revised in the final proposals to reflect the latest information and should be kept under review throughout the incentive scheme period.

18. Do you agree that Bloomberg is a suitable source for Carbon prices and the Euro to Sterling conversion rates used within the forecast? If not please indicate why not.

We agree that the Bloomberg is a reasonable source for carbon prices and the Euro to Sterling conversion rates. However, we would note that the values are valid at the time that the forecast is made and that this data should be revised in the final proposals to reflect the latest information and should be kept under review throughout the incentive scheme period.

19. Do you agree with the assumptions made in producing a BM energy price forecast? If not, please indicate why not.

We agree that the assumptions made in producing a BM energy price forecast are reasonable.

20. Do you agree with the assumptions made in producing a BM Response price forecast? If not, please indicate why not

We agree that the assumptions made in producing a BM response price forecast are reasonable.

21. Do you agree that a 12 month average of the prices for Footroom is a reasonable assumption? If not, please indicate why not.

We agree that the assumptions made in producing a 12-month average of the prices for Footroom are reasonable.

22. Do you agree with the assumptions made in producing a Fast Reserve price forecast? If not, please indicate why not.

We agree that the assumptions made in producing a fast reserve price forecast are reasonable.

23. Do you agree with the assumptions made in producing a Margin price forecast? If not, please indicate why not.

We agree that the assumptions made in producing a margin price forecast are reasonable.

24. Do you agree with the assumptions made in producing a Balancing Services price forecast? If not, please indicate why not.

We agree that the assumptions made in producing a balancing services price forecast are reasonable.

25. Do you have a view on the future trend of STOR contract prices?

We would expect that the costs incurred by the system operator in procuring STOR will increase in line with the requirement to manage intermittent generation on the transmission system.

26. Do you have any further comments regarding this forecast or the assumptions made in its development?

We have no further comments.

27. Do you have any comments on the background and assumptions made in constructing the constraints volume forecast?

Clearly the constraints volume forecast is driven by the connection of new generators to the transmission system, the system outage programme for system reinforcement and the maintenance programme. National Grid is in the best position to forecast these volumes and in the absence of detailed information it is difficult to comment on whether the assumed volumes are reasonable.

28. Do you have any comments to make regarding the assumptions made in constructing the constraints price forecast?

We note the assumptions used to construct the constraints forecast and consider that they are reasonable. We believe that high bid prices for constraining wind generation reflects the strong incentive for wind farms to operate at all times under the current renewables subsidy arrangements. We believe that further work is required to consider the potential for wind farms to be more flexible in offering services in the balancing mechanism. This should include issues such as the relative operational inflexibility of wind farms, the dynamic characteristics of wind farms, the risks associated with offering bids and the facilities required to control wind farm output. Given the right economic incentives we do not believe that there are any intrinsic reasons as to why wind farms cannot offer services to National Grid.

29. Do you agree with the methodology used to forecast the second year of a two year scheme for all components except constraints?

We agree that the methodology used to forecast the second year of a two year scheme for all components except constraints reasonable. However, we do not support the implementation of a 2-year scheme given the uncertainties in potential scheme outcomes and the risk for significant adjusters (which may be automatic) or, more importantly, for income adjusting events.

30. Do you have any suggestions for other factors that should be taken in to consideration for the second year?

In a longer term scheme there is clearly the risk that costs will outturn on a different basis to the assumed levels. The various adjusters are designed to address this. However, we are concerned that there is a greater risk of unforeseen events giving rise to additional windfall gains and losses under the scheme. In relation to year 2 it may be appropriate to consider whether the scheme parameters should be adjusted to reflect greater uncertainty and risk, perhaps through, for example, a larger dead band. This would suggest that under a longer term scheme the incentive parameters should be more flexible.

31. Do you agree with the benefits outlined for the unbundling of constraints costs and the remaining balancing cost components into separate incentive schemes? What additional issues need to be considered?

We remain concerned about the unbundling of costs into two separate incentive schemes. As noted in our covering letter we remain to be convinced that actions that deliver more than one service can be appropriately classified into either energy or constraint components.

32. Do you agree that there is a misalignment in internal and external SO incentives caused by different scheme durations?

We are unclear as to the extent to which the different internal and external scheme arrangements give rise to additional costs and inefficiencies under the incentive scheme. We would be concerned if the current split between internal and external SO incentives actually reduced the flexibility of National Grid to develop innovative solutions or invest in new services where they are capable of delivering improved economic and efficient system operation.

However, we note that under an unbundled scheme it may be appropriate to include some element of internal costs in the overall level of the incentives. This may facilitate investment in new services or solutions. We believe that such additional internal costs should be clearly justified in an open and transparent manner, including where appropriate a cost benefit analysis.

33. What option could or should National Grid use to develop a 2 year constraint forecast?

Given the uncertainties associated with planning outages and predicting the associated cost of constraints we believe that it is difficult to develop a constraint incentive arrangement for greater than 1-year. However, if a 2-year scheme was to be developed then this should be associated with greater transparency of information from all users with regard to outage planning. This would require wider consideration of the current outage planning arrangements which is beyond the scope of the incentive scheme arrangements.

34. Do you agree with the benefits outlined for the implementation of a two year incentive? What do you believe the additional benefits and / or drawbacks are of a multi-year scheme?

While there may be benefits from developing a longer term incentive scheme we believe that this should be associated with wider consideration of the current outage planning arrangements. We note that the current arrangements provide flexibility for existing users to respond to market signals in relation to the timing of outages and connections.

35. Do you agree with the introduction of a Reactive Index Adjustment based on actual default reactive power prices? Do you agree with the form of this adjustment as presented here?

The introduction of a reactive index adjustment factor based on actual default reactive power prices appears sensible and we agree with the form of this adjustment.

36. Do you feel at this stage that there is a case for any additional adjustment terms to be introduced at this stage?

We do not see a case for any additional adjustment terms at this stage.

37. Do you believe that National Grid should include an allowance for fault outage costs within the constraint forecast? Do you agree with the level set?

The issue of fault outages highlights the interaction between system operation and investment in the GB transmission system by the transmission owners. We believe that the efficient level of fault outages should be identified and the incremental costs attributable to either system operation or transmission owner equipment reliability should be recognised. This would enable the incentives to be appropriately targeted. An incentive scheme that recognised that shared responsibility of the system operator and transmission owners would be a more appropriate way forward than income adjusting events.

38. Do you agree that Transmission Losses should remain bundled with the other components of BSIS, excluding constraints?

We believe that transmission losses should remain bundled with other components of the incentive scheme.

39. Do you agree that the Transmission Losses Reference Price should remain a fixed value for the duration of the scheme?

Since we support the bundling of transmission losses with other elements of the incentive scheme it is sensible for the reference price to remain a fixed value in a 1-year scheme. However it may be appropriate to consider adjusters for a longer term scheme.

40. Do you agree with the criteria used to develop the incentive scheme design? If not, what additional points should be considered?

The criteria used to develop the incentive scheme design appear sensible.

41. For the unbundled constraints scheme, do you agree with the parameters used? If not, what parameters should be implemented? Please explain your rationale for any changes.

As noted above we do not support the creation of a separate unbundled constraints scheme. In particular we are concerned that the cumulative caps and collars of the unbundled scheme has a total upside or downside cost of £25m in 2010/11 This compares with the current bundled cap and collar of £15m in 2009/10. We do not understand how the unbundled arrangements give rise to such an overall increase in the caps and collars of the SO incentive scheme.

In the context of the current bundled scheme target we believe that if the total acceptable level of incentives is around £15m. This could be allocated proportionately to the two schemes based on the total targeted costs. This would imply a constraints scheme with a target caps and collars of around £7m. If unbundled we would support the upside and downside sharing factors and dead band recognising that this reflects the different risk profiles in each scheme.

42. Do you agree with the implementation of two single year incentive schemes for all balancing costs except constraints? Do you agree with the parameters used? If not, what parameters should be implemented? Please explain your rationale for any changes.

As noted above we do not support a 2-year scheme for all balancing costs except constraints given the uncertainties and risks associated with outcomes in Year 2.

However, if a 2-year scheme was to be introduced we believe that the total level of costs for the BSIS and constraint schemes should be around £15m with the target caps and collars apportioned to the two elements schemes based on the total targeted cost. This would imply a BSIS scheme with a target caps and collars of around £7m. In unbundled we would support the upside and downside sharing factors and dead band recognising that this reflects the different risk profiles in each scheme.

43. Do you agree with the parameters used for the one year fully bundled scheme? If not, what parameters should be implemented? Please explain your rationale for any changes.

We note the parameters used for the 1-year fully bundled scheme. We believe that the total cap and collar should be established by reference to the current scheme and should be no more than £15m.

44. Do you agree with the development of a two year fully bundled incentive? How should the constraint cost forecast for year two be included in the incentive target e.g. agreed post scheme or some form of constraint forecast developed pre-implementation?

As noted above we do not support a 2-year incentive scheme at this time given the uncertainties and risks associated with outcomes in Year 2.

45. Do you agree with the scheme options presented here for implementation from April 2010 and what is your preferred option? If not, please provide an explanation as to why and any alternatives that you would like to see developed.

We note the proposed options presented for implementation from April 2010. Our preference is for a 1-year bundled scheme.

46. What impacts will a change in incentive scheme structure and consequential changes to the BSUoS data have on your IS systems?

We do not envisage that a change in the SO incentive scheme structure would necessarily have an impact on our IS systems if the current billing and invoicing process is maintained. However, we note that National Grid indicate that there may be potential changes to the current administrative arrangements. We are concerned that these changes may give rise to consequential changes to our IS system and we would welcome an indication as to whether National Grid consider the whether the current BSUoS charging and invoicing process would be impacted by the proposed changes. For example, is National Grid considering invoicing separately for the BSIS and constraint schemes? We are concerned that if the changes are substantial then there may be insufficient lead time to implement the required IS changes for an April 2010 start date.

47. If your systems will be impacted by a change to scheme structure what information will you require and in what timescales in order to accommodate the change?

We require information as soon as possible on the proposed changes to National Grid systems to consider the implementation consequences on our IS systems. We will be able to provide a view on potential lead times for implementation when we fully understand the scale and extent of the changes. We are concerned that with a potential implementation in April 2010 following an Ofgem decision in February 2010 that there will be insufficient time to develop, test and trial the relevant systems required. We would encourage National Grid to provide further information on the potential IS changes under consideration at the earliest opportunity.

48. Do you have any comments regarding the information provided within this consultation?

We welcome the publication of detailed information on the scheme development. However, we would note that commercially confidential information held by National Grid restricts the ability of the industry to fully comment on whether the assumptions used or the outcomes predicted.

49. Do you have any comments regarding this consultation process? What improvements would you like to see in future years

While we welcome the openness and transparency of the process adopted, we are concerned about the amount and extent of information provided to the industry. The development of the SO incentive scheme imposes a considerable regulatory burden and we would welcome some consideration as to how the process can be improved. Furthermore we remain concerned about whether there are sufficient resources available in the wider industry to enable the full engagement in this consultation process.