



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

E.ON UK plc
Westwood Way
Westwood Business Park
Coventry
CV4 8LG
eon-uk.com

Paul Jones
024 76 183 383

paul.jones@eon-uk.com

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Dear Malcolm,

National Grid Electricity System Operator Incentives – Initial Proposals Consultation

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

It is a highly complex exercise to confirm or refute particular elements of the forecast in detail. By its nature such an exercise is highly subjective and so would any critique. National Grid has clearly taken a view in light of costs it has seen in previous years about how they may outturn next year. It does seem in general that the target has been inflated above an already inflated forecast for 2008/09. We are not certain that we share this level of pessimism and feel that 2008/09 is more likely to have been an exceptional year rather than a step on a continuing upward trend into 2009/10. However, this is an understandable response as National Grid has been exposed to volatile cost increases this year and would wish to avoid being exposed to again in 2009/10. Therefore, the natural instinct would be to produce a conservative forecast which leaves less scope for detrimental exposure. We do note that the forecast is based on data that is now somewhat out of date. We would be interested to see how this view has been altered by more up to date information such as on forward prices.

We do have a number of comments on particular elements of the consultation. However, unfortunately we are not in a position to provide a detailed answer to every question raised in the document.

E.ON UK plc
Registered in
England and Wales
No 2366970
Registered Office:
Westwood Way
Westwood Business Park
Coventry CV4 8LG

Use It Or Lose It rules on French Interconnector: It is not clear why this should push costs up by £21m. Of course the introduction of such rules will have an effect on how the system operator is able to access balancing services across the interconnector. This may alter the contractual routes that the SO uses, but it does not necessarily follow that costs should increase, unless these services have been acquired at discounted cost in the past.

Introduction of Interim Connect and Manage Arrangements: There may be balancing cost implications arising from the implementation of the proposed interim arrangements. However, we would not expect these to arise in 2009/10. If any stations are successful in having their connection dates brought forward they will still be required to wait until local works are completed until they are able to generate. We would therefore expect any effects from this proposal to be experienced further into the future.

The new Net Imbalance Adjustment: We note the work carried out to create the new Net Imbalance Adjustment (NIA) term and in as much as it results in an R^2 which is better than the present NIA, then it can be seen as an improvement. However, it is not clear whether or not National Grid has used the best fit plot (ie the best R^2) available. If it has, then this would appear to be the most appropriate value to use. If not, then we would suggest the best fit is adopted instead.

Use of Variable Sharing Factors rather than Linear: The idea of this proposal appears to be to maintain the incentive on National Grid through a greater range of IBC.

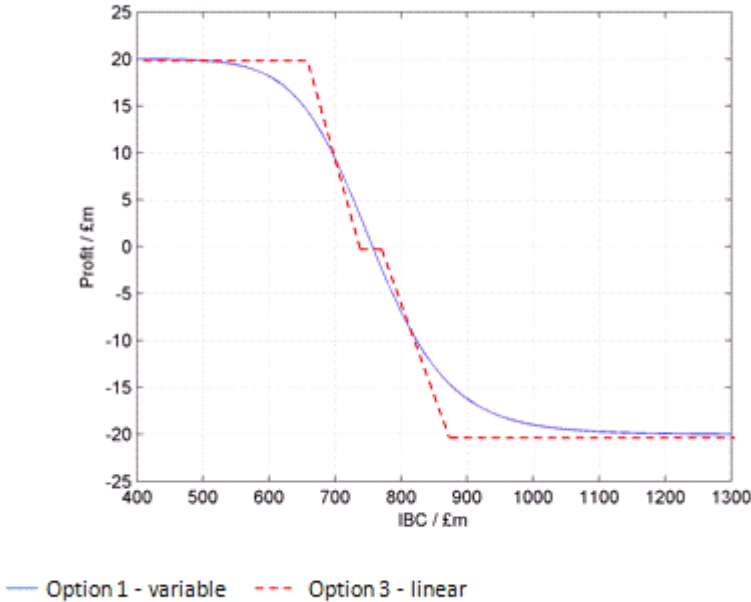


Figure 1: Comparison of two options proposed for sharing factors

Figure 1 shows the two proposed options. Option 1 includes variable sharing factors

whereas Option 3 retains linear factors. Option 1 does indeed maintain some form of incentive on the SO over a greater range of IBC compared with Option 3. However, at the extremes this incentive is very weak. If an incentive is needed over a greater range, an alternative approach would be to include a linear sharing factor that operates over the same range as Option 1. This is illustrated in Figure 2 below.

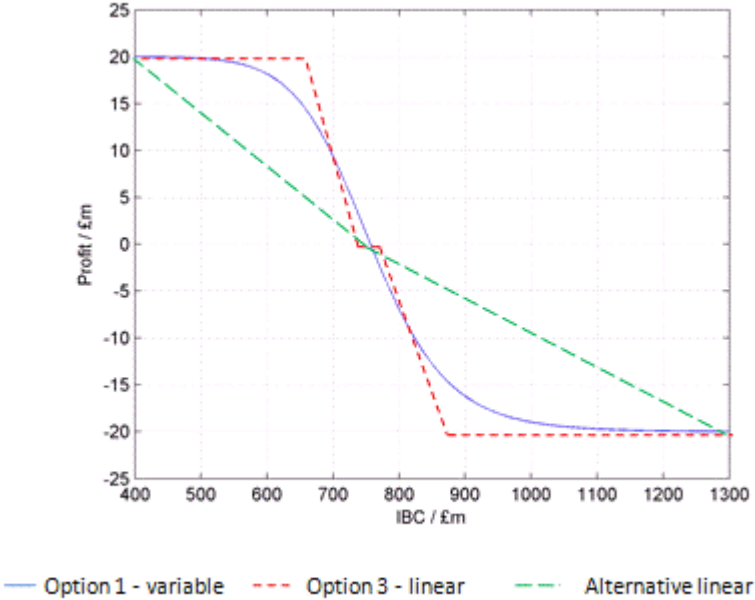


Figure 2: An alternative approach to linear sharing factors

Although over small variations from the target the incentive is not as sharp as with the alternative approaches, it maintains the same level of incentive over a greater range of values of IBC.

Reactive Power Index: In principle this appears to be a good proposal and we would support its introduction in the 2009/10 scheme.

Changing the Incentive Period

Options that have been presented are to have shorter incentive periods by breaking the annual period into smaller parts, or to have multi-year incentives.

In respect of shorter incentive periods, the theory appears to be that a sub annual incentive would ensure that the incentive would remain on the SO even if a major cost shock was experienced early on in the year. We are not presently supportive of this option. Firstly, for such an incentive to be warranted, such a cost shock would have to be sufficiently large to take the IBC so far over the capped limit of loss for National Grid that it felt that there was no point in trying to recover the situation. Secondly, and more importantly, in the absence of a major shock, a shorter period scheme would reduce the incentive on the SO to try to recover from a poor start in the year by working even harder later on. This is because the earlier loss will essentially be a

sunk cost and unaffected by the subsequent performance of the SO.

We have always been wary about longer term incentives. A major cause of uncertainty for parties, and suppliers in particular, has been the Income Adjusting Event (IAE). This is because an IAE is a one-off shock that occurs after the year to which it relates and subsequently is always a hit on a party's bottom line. A multi-year scheme makes it more likely that the target has been set against a background that is subsequently shown to be unrealistic. Therefore, the likelihood of IAEs is higher. It is for this reason that we do not support longer incentive periods.

Finally, we would wish to thank National Grid for the effort undertaken to explain its forecast for this year. The information provided, along with the workshops that were run were most helpful. Explaining issues such as the possible effect on BSUoS charges is just the sort of information the industry needs to see to understand the possible impact of the scheme.

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