

## **RWE Innogy Comments on OFGEM Consultation Published May 2004**

### **Income adjusting event under National Grid Company's 2003/04 system operator incentive scheme**

*The following comments are made on behalf of RWE Trading, RWE Innogy plc, Innogy Cogen Ltd., Innogy Cogen Trading Ltd., npower Ltd., npower direct Ltd, npower Northern Supply Ltd., npower Yorkshire Supply Ltd, npower Northern Ltd, npower Yorkshire Ltd.*

Thank you for the opportunity to comment on the above consultation. Our response considers three aspects, the legitimacy of the process, the materiality of the event and improvements for the future.

#### **The Legitimacy of the IAE process**

We have previously raised our concerns with the Income Adjusting Event process. Under the terms of the SO Incentive Scheme, NGC are well rewarded. It is appropriate that they carry some element of risk commensurate with this reward. Therefore IAEs should only be recognised in extreme circumstances or changes in circumstances that are not only unforeseen, but are also outside the scope of the sort of activities the SO would be expected to manage in the normal course of business. The first three bullet points in paragraph 2.6 of the consultation paper set the flavour of an IAE. These are events of FM or the occurrence of a security period. Authority approval should follow these precedents. We would suggest that this 'event' does not accord with the character of these situations.

This request is the second in a relatively short period and once again it would result in an additional allowance rather than reduction. This raises two issues. First, the intention of an IAE is to be symmetrical in providing protection to both customers and NGT. However, it is inconceivable that market participants could give notice of an IAE since they do not have the same access to information or knowledge of NGC's business. Thus the IAE runs the risk of becoming a device for enhancing NGT's profitability under their SO incentive with no commensurate prospect for customers that costs could decrease.

Secondly, it remains our view that any future SO incentive schemes should continue to be of a short-term duration in order to reflect its essentially operational nature and thus be capable of reflecting changing market conditions. Any move towards a longer term SO incentive will lead to greater uncertainty and the risk of more regular recourse to the IAE provisions. This will increase the regulatory uncertainty associated with the market, which is neither in the interests of market participants nor their customers.

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## **The Materiality of the IAE**

This request for an IAE purports to arise following clarification of NGC's licence obligations in respect of the procurement of short-term reserve. We are concerned that 'Approach 2' gives NGC greater discretion in its purchasing strategy for short-term reserve without any rationale being provided for the action. This is clearly a matter that must be addressed by the NGT Transparency Review. This change in approach has been poorly communicated to market participants and appears to be a breakdown in due process. Such a change should have been heralded by way of a consulted change to the Procurement Guidelines as is anticipated in Condition 7B of the Transmission Licence.

During the setting of the 2003/04 SO incentive scheme, NGC argued that it would have to contract with additional volumes of reserve compared with its original November 2002 forecast. This was because the plant margin for the winter of 2003/04 was forecast to be approximately 1.8GW lower than had earlier been assumed. On this basis an additional allowance was made. The purchase of further reserve over and above this indicates a lack of confidence in the market arrangements that subsequently proved to be robust. Ofgem must satisfy market participants that there is no double counting in this further request. In particular it must be demonstrated how the original figure of £18m has been reduced to the claim of £5.54m. Furthermore it must be investigated whether other offsetting savings may have emerged from the purchase, or whether other NGT activities aggravated the need for the additional reserve. For example, it is not clear what the impact of NGT's forward trading during the winter months was in influencing the need for short-term reserve.

The consultation states that the assessment should focus on what was known at the time of the 2003/04 SO incentive scheme without taking into account information gained with hindsight. Although we would agree with this, it is also appropriate to test whether the methodology NGT employ in their forecasts does not lead to systematic error. NGT's view of an inadequate margin was not shared by market participants and proved in the event to be unfounded. Generally information of the nature that underpinned NGT's forecasts should be available to market participants to analyse. If this is not possible because of issues of commercial confidentiality, then it should be subject of independent audit.

## **Improvements for the future**

Although we believe the IAE process is generally inappropriate since it perverts the stability that the SO incentive scheme should help to create, we would support Ofgem's view that there is scope for improvement in the existing provisions. This applies equally to both NGC's Transmission Licence and Transco's Gas Transporter Licence. We would however go further than the provisions proposed by Ofgem which contemplate only the transparency of the information required to quantify the materiality of an IAE.

When either NGC or Transco instigates action that could potentially become associated with an IAE, details of the event should be notified to the market within a very short time. Generally FM events must be declared within a matter of hours and we would suggest that similar timescales should apply to circumstances that might be declared an IAE. This would enable participants to form their own views of any potential impact in terms of changes to BSUoS and for the market to react accordingly.

The three-month consultation period should not begin until the request is placed in the public domain. Those consulted should be given the opportunity to request clarification and/or further information during this period. We would also like Ofgem to address the issue of information disclosure such that the IAE process can become genuinely symmetrical. This will give market participants greater confidence in the process.