

Cory Dykstra
Wholesale Markets
Ofgem
9 Millbank
London
SW1P 3GE

Your ref
Our ref LOG 225
Name Terry Ballard
Phone 01793 892715
Fax
E-Mail Terry.Ballard@rwenpower.com

4th September 2006

135/06: Potential income adjusting events under NGET's 2005/6 system operator incentive scheme

Dear Corey

Thank you for the opportunity to respond to the above consultation. The first part of our response makes some general comments about the nature and scope of income adjusting events. This is followed by observations on a number of specific points relating to the costs of Scottish Constraints and CAP47 costs separately.

General Comments

We welcome the rigorous evaluation of the evidence submitted to Ofgem by NGET in relation to each income adjusting event. However, we would note that there is limited information in the public domain that would enable parties to understand fully the options available to NGET when operating the transmission system under the terms of its licence in an economic and efficient manner.

Ofgem indicate in relation to both income adjusting events that there may have been other options that could have been pursued that would have mitigated the increase in costs. Certainly in relation to both the internal Scottish constraint and CAP47, NGET appear to have entered into commercial arrangements in order to mitigate cost increases. However, such commercial arrangements are even less transparent to the market and the effect on the incentive scheme is difficult to determine.

In general we support Ofgem's view that the events were reasonably foreseeable and that the rewards available to NGET under the incentive scheme provide sufficient encouragement to manage the events in an economic and efficient manner. The fact that the outturn of the 2005/06 scheme is higher than the target should not in itself provide a trigger for income adjusting events.

Scottish Constraints

We support Ofgem's observation that the effects of the Scottish constraints were reasonably foreseeable at the time that NGET entered into the scheme. Both the internal Scottish constraint and the Cheviot boundary constraint were related to

RWE npower

Trigonos
Windmill Hill Business
Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

T +44(0)1793/87 77 77
F +44(0)1793/89 25 25
I www.rwenpower.com

Registered office:
RWE Npower plc
Windmill Hill Business
Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

Registered in England
and Wales no. 3892782

longstanding issues associated with the operation of the GB transmission system. From the information provided, NGET made a commercial decision to manage the constraints mainly through balancing mechanism actions. Consequently NGET should be held accountable through the incentive scheme for this commercial decision.

As a more general comment in relation to the Scottish constraint, we believe that all parties have been exposed to increases in wholesale generation costs during 2005/06. We find it difficult to identify the specific nature of the cost increase associated with the Scottish constraints that cannot to some extent be explained by general increase in wholesale prices. However, from the information provided there appear to be instances where NGET have incurred costs where bid or offer acceptances have been taken out of price order. Despite this, we have limited information on the specific nature of despatch decisions taken by NGET and the availability of alternative options that would enable us to take a view on whether such decision were economic or efficient.

The methodology adopted to estimate the cost of the constraints is important. We believe that the NGET methodology may overstate the costs, particularly where it is estimated by comparison with actions taken for "system" reasons. Consequently we would support a methodology that provided a proxy for the energy actions that NGET would or could have taken in the absence of the constraint. This could be estimated by constructing a set of feasible bid or offer actions that could have been taken had the constraint not occurred.

Ofgem are seeking view on whether there should be separate cost allowances within the overall SO incentive schemes. We believe that the income adjusting event for the Scottish constraints illustrates the potential consequences of constraint management for operating the GB system and the potential effects that they have in the balancing mechanism (and cash out prices). We would also note that there is greater transparency of NGET constraint actions when taken in the form of bid or offer acceptances than in the form of commercial contracts, which may be reported as system or energy net BSAD. NGET should be obliged to provide regular reports on the nature and cost of constraints prior to the introduction of any separate incentive scheme for constraint management.

CAP47

It is difficult to comment on whether NGET operated economically and efficiently in relation to managing the CAP47 issues since there is limited information on the potential alternative options available to NGET to mitigate potential cost increases. However, we would observe that all parties have been exposed to increases in wholesale generation costs during 2005/06 and we find it difficult to identify the specific nature of the cost increases associated with CAP47 that cannot to some extent be explained by general increase in fuel prices.

National Grid's submission to Ofgem relating to CAP047 makes the case that the costs of Frequency Response have increased by £12.94m in the period from November 2005 to March 2006 due to the implementation of CAP047. According to NGET there are three components to the cost increase:

- Direct Costs: NGET have estimated the prices that could have been applied had CAP047 not been introduced by comparing to the average annual increase (4.6%) in average response prices for each year since NETA go-live up to October 2005 and the actual increase in costs cost under CAP47. This gives the estimated cost difference of £10.99m
- FFR Price Increase: NGET have assumed that the cost of other non-mandatory dynamic response (specifically FFR) has increased above the level (amount per MW of mandatory service response) it would otherwise have been had CAP47 not been introduced. This has increased costs by £1.95m.

- Additional BOAs: Additional costs associated with taking more bid/offer acceptances in order to optimise the frequency response despatch ("hidden optimisation costs") may have been incurred, though this cost is considered difficult to isolate and has not been evaluated.

The methodology for calculating the cost of CAP47 is critical to estimating the value of the income-adjusting event. When evaluating the approach adopted by NGET the following issues should be considered:

- Direct Costs: Extrapolating long-term average prices is not an obvious approach for forecasting monthly changes over a short period. An alternative approach might be to look at annual price changes month by month. For example, the last month before CAP047 implementation (October '05) saw an increase of 34% above October '04 levels. If this increase is assumed to continue through the winter, the "on cost" associated with CAP047 reduces by £2.6m compared with NGET's estimate. Other approaches may be equally valid.
- FFR Price Increase: This approach adopted by NGET is difficult to understand since FFR was brought in a month before CAP047. Tender documents and the utilisation data suggest that the only accepted tender submitted after the introduction of FFR is lower than the equivalent tender submitted before the introduction of CAP047.
- Additional BOAs: NGET have noted that it is difficult to estimate the "hidden optimisation costs". It is worth noting that there may be benefits in the form of lower BOA prices as parties recover some elements of cost through the CAP47 payments.
- Energy Payments: In estimating the CAP47 effect NGET have not considered the level of payments associated with the energy delivered by responsive units. The price for this energy is set in each month by the mid-point of the average SSP and SBP in the previous calendar month. Winter 2005/06 saw these prices reach historic highs and resulted in many providers losing money when providing High Frequency (HF) Response. This has been a driver for increases in HF prices under CAP047. Although NG has included the resulting increases in the holding prices associated with rising energy prices, it has ignored the benefit gained through the frequency response energy payments.

If you wish to discuss any aspect of our response, please do not hesitate to contact me or my colleague Bill Reed on 01793-893662.

Yours sincerely,

Terry Ballard
Economic Regulation