



Potential Income Adjusting Events under NGET's 2005/06 system operator incentive scheme – Consultation response by the Association of Electricity Producers

August 22, 2006

The Association welcomes the opportunity to comment on NGET's claims for additional income arising from Income Adjusting Events (IAE) during the period 2005_06. The Association of Electricity Producers (AEP) is the UK trade association representing electricity generators. It has some 90 members ranging from small firms to large, well-known PLCs. Between them they embrace nearly every generating technology used in the UK. Many member companies have interests in the production and development of renewable energy where the government has set ambitious targets for development over the next decades.

Summary

The Association has little sympathy with the claims made by NGET and sees no compelling reason why any of them should be allowed.

Below we make a number of general comments that apply equally to the constraints and frequency response claims and then we make responses specific to each class of claim.

General Comments

- 1) The SO Incentive schemes represent the result of negotiation between NGET and Ofgem (on behalf of the rest of the industry and ultimately the customers). There is no current SO Incentive Scheme. This is clear evidence of NGET's freedom to walk away if it feels the deal is inadequate in any way, including the presence of a risk that it does not feel confident it can manage.
- 2) Any serious claim for an IAE must be due to events of substantial materiality that were unknown and not reasonably foreseeable at the time of contractual negotiation. NGET was fully aware of the risk of additional costs arising from constraints under BETTA and arising from the implementation of CAP047. Indeed the text of the consultation demonstrates their full awareness of this risk before the end of negotiation.
- 3) The purpose of an SO Incentive Scheme is for NGET to be incentivised to manage the risks of uncontrolled costs of balancing the system in operational timescales. If the costs could all be foreseen and accurately forecasted, there would be no need for a scheme.
- 4) NGET volunteered to provide a service against an agreed reward structure. They are uniquely placed to have an informed view of the dynamics of the market place and the interaction between the transmission system and the market. How they choose to manage the risks they take on is entirely their decision; as far as we are aware Ofgem does not prescribe the mix of long and short term contracts, and balancing actions. Therefore in considering any IAE claim, it is not necessary to consider whether or not NGET's approach to managing these risks is reasonable. It is only necessary to know if NGET was aware of the risks prior to concluding the negotiation for the scheme.

- 5) NGET now has over a decade's experience of incentive schemes and has previously always ended up comfortably in the 'upside' part of the scheme. This year 2005/06 it has ended up in the downside. If this did not happen occasionally, customers would rightly query whether the regulator was negotiating hard enough on their behalf.

Constraints Specific Comments

- 6) **Question 1:** *Do you consider that, prior to the start of the 2005/06 SO incentive period and based on available information at the time, NGET acted economically and efficiently in deciding to manage internal to Scotland and Cheviot constraints in the BM?*

Whether or not they act efficiently and economically is NGET's choice, having decided to enter into an SO Incentive Scheme.

- 7) **Question 2:** *Do you have any comments on whether the analysis we present in relation to forecasting the level of self-despatch of generation is appropriate in addressing this issue?*

The Ofgem analysis is interesting and indicative that the SO had the information available to form a detailed risk management plan. It is normally easier in retrospect to determine a better way of managing risk. However, that is not the central point. NGET had willingly undertaken the SO Incentive scheme, knowing that there would be constraints and therefore must have believed prospectively that its systems and methods were adequate.

- 8) **Question 3:** *Do you consider that, in November 2005, NGET acted economically and efficiently in managing internal to Scotland constraints through a commercial contract?*

- 9) **Question 4:** *Do you consider that NGET acted economically and efficiently in negotiating this contract?*

See answer to above questions and general comments.

- 10) **Question 5:** *Do you have any comments on the methodology used by NGET in estimating the total cost of managing internal to Scotland and Cheviot constraints following the start of BETTA, and the amount of the proposed income adjustment?*

Association members have made attempts to estimate the costs of constraints. They indicate that the methodology used by NGET would produce extreme values for the cost of constraints. However, not all members agreed with the estimates made. This is because of the difficulty of disentangling the interactions between energy, system and margin, and the judgements required to assign costs. Whether NGET's (or anyone else's) assessment of the value of constraints is uniquely correct is not relevant. We presume that the method used by NGET to assess their IAE values is the method they used to assess the value of constraints when they negotiated and agreed the scheme.

- 11) **Question 6:** *Do you have a view on the appropriateness of having separate cost allowances within the overall SO incentive scheme cost target?*

See response to question 4 below.

CAP047 Specific Comments

- 12) **Question 1** *Do you agree that NGET has acted economically and efficiently in procuring frequency response to minimise costs?*

Implementation of CAP047 was delayed by approximately 12 months at NGET's request in order to ensure they had systems and processes ready to deal with it. NGET had plenty of time to observe the market and to design how they would manage any risk of additional costs arising from the implementation. Therefore the risk was foreseeable. It is in the nature of an SO Incentive scheme that by agreeing to a scheme NGET must decide how to act; otherwise there would be no basis for an incentive.

- 13) **Question 2** *Do you have any comments on the methodology used by NGET in estimating the total cost of procuring frequency response following the implementation of CAP047, and the amount of the proposed Income adjustment?*

NGET made an initial proposal of a sum of £15m for the implementation of CAP047 (see Para 2.17). They subsequently settled for a target that included an allowance of £7.35m. They freely negotiated a package without any contract re-openers. We can only assume that NGET had agreed this package in the light of a robust strategy to assess and manage the risk of higher costs. If the consequences are more costly than NGET anticipates, that is a risk it must have been prepared to take. Therefore our opinions regarding how NGET estimates and procures frequency response are largely irrelevant. However, Ofgem has rightly pointed to the continuing difficulty for generators under the current arrangements for Response Energy Payment. This is acknowledged by all and NGET and the CUSC Panel have recommended a means of mitigating this issue via CAP107 Working Group Alternative B.

- 14) **Question 3** *Do you have any comments on our proposed alternative methodology and the amount of the income adjustment that may result should we determine that the events or circumstances surrounding the increase in frequency response costs incurred by NGET is an IAE?*

In the light of our comments above, we do not see a case for allowing an IAE.

- 15) **Question 4** *Do you have a view on the appropriateness of having separate cost allowances within the overall SO Incentive scheme cost target?*

To date, the scheme has been constructed bottom-up with the individual components being summed to achieve the target. This approach has merits during the negotiation phase, in that it allows Ofgem the ability to mitigate the asymmetry of information which inevitably lies between it and NGET. However, we infer that NGET must take a holistic view of the target when they decide whether or not to accept. Otherwise why did they accept a CAP047 component of the target that was ~1/2 of their initial bid? Therefore, subsequently to assess NGET's performance on a component by component basis is inappropriate, not least because of the interaction between components of the scheme.

Process Issues – Appendix 10 *Please forward to Andrew MacFaul*

Timeline

- 16) It is regrettable that Ofgem has decided to limit the time for other parties to respond to the consultation to 4 weeks, during the height of the holiday season. After all, Ofgem took five weeks to create the consultation document. It is also unfortunate that the consultation document was not in the 'Live consultations' section of the Ofgem web site (as at 22/8/6).

Negotiation versus Direction

- 17) In the consultation document Ofgem appear to suggest that they direct what the scheme will comprise and NGET accept this imposition without demur. See for example:

- a) Para 2.6 'we set annual incentive schemes'
- b) Para 2.7 'NGET is set a target'.

The current lack of an incentive scheme illustrates that this is an inappropriate description of a process of negotiation.

Consultation Questions

- 18) Ofgem's recently introduced practice of locking its consultation documents means that consultees have to re-copy the questions posed by Ofgem, rather than just cut and paste them. If Ofgem do not wish to provide unlocked documents, would they please routinely

provide the questions in an easy to manipulate format. This will help us wasting time re-copying or scanning documents.