



Sonia Brown
Director, Wholesale Markets
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

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

Paul Jones
024 7642 4829

paul.jones@eon-uk.com

1 September, 2006

Dear Sonia,

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

Thank you for the opportunity to respond on the above potential Income Adjusting Events (IAEs) raised by National Grid. E.ON UK does not believe that these IAEs should be upheld by Ofgem.

We continue to be uncomfortable with the specific stand alone allowances which were included in the 2005/06 incentive scheme. We believe that the scheme should be considered as an aggregate package of incentives, against which National Grid is able to take a holistic view and decide on the appropriate action to reduce the level of balancing costs as a whole. This is particularly relevant as cost savings in respect of certain services may come at the expense of others. We feel that to carve out certain items for special treatment undermines this approach.

It is for similar reasons that we do not support IAEs in principle as they allow National Grid to opt out from the target it has accepted in certain circumstances. There is presently an asymmetry in the information available to National Grid and Users regarding the total cost of balancing services and its causes. Therefore, although it is theoretically possible for IAEs to be raised by Users in respect of events which may have lowered outturn costs, it is in practice very difficult or impossible for them to do so. Therefore, IAEs have only ever been raised by National Grid with a view to increasing the target allowed under the scheme. This is the most likely scenario for future schemes too. This allows National Grid to benefit from events which lower balancing costs whilst removing the effects of any events which increase costs, thereby providing a one way hedge.

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

Therefore in principle we do not support either of the IAEs raised in respect of the 2005/06 scheme.

In terms of detailed comments, we will split our response to cover the two individual claims, in the context of the specific questions raised in the consultation. However, in places we have been unable to provide specific answers to these questions, as we take a slightly different perspective to that set out in the document.

Internal Scottish and Cheviot Constraints

- 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?*

We do not believe that this is the correct issue to assess when deciding whether or not to allow the IAE to stand. The purpose of the incentive scheme is simply to set the parameters within which National Grid has to operate. It should then be up to National Grid to decide how best to operate to meet, or preferably beat, the target set. However, National Grid should also be exposed to the full consequences of the decisions it makes, whether they are good or bad.

However, we are surprised that National Grid decided to manage the internal Scottish and Cheviot constraints through the BM, given the lack of competition for Offers to meet the internal Scotland constraint and Bids to meet the Cheviot constraint. Of course, it may be that in light of the information available to it at the time National Grid reasonably thought that this was the best course of action to take. However, this is not the main issue to consider. What is important is that once the decision had been made, National Grid should be exposed to the consequences of its actions. Allowing this IAE would act against this important principle.

- 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?*

As above, we do not believe that the analysis is necessary in considering whether or not to allow the Income Adjusting Event.

- 3 Do you consider that, in November 2005, NGET acted economically and efficiently in managing internal to Scotland constraints through a commercial contract?*
- 4 Do you consider that NGET acted economically and efficiently in negotiating this contract?*

We are not in a position to know this. However, as mentioned above we do not believe that this is a necessary consideration. National Grid accepted a target which it has failed to reach. Therefore, it should be exposed to the consequences.

- 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?*

It is difficult for us to comment fully on whether this is the most appropriate calculation, although we note that other methodologies could be used which would significantly reduce the estimated cost. We would be keen to know whether this calculation was undertaken by National Grid when the incentive was set, so that it is possible for Ofgem to assess the factors which have changed and their effect on National Grid's ability to meet the targets.

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

We believe that it is not appropriate to have separate allowances. Please see the comments given above.

CAP047 Frequency Response Payments

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

As with our comments regarding above, we do not believe that this is the main consideration. National Grid has accepted this scheme and should fully face the outcome regardless of whether it succeeds or fails to meet its target.

- 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?*
- 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?*

Although we do not believe that the IAE should be allowed in principle and that such an assessment should not be necessary, we accept Ofgem's view that the methodology used overstates the cost of the service. Ofgem's profiled approach appears to be a more appropriate methodology to utilise.

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

As stated above, we do not believe that separate allowances are appropriate.

Other issues

As we have mentioned in the context of setting previous schemes, we do not believe that National Grid requires a scheme with high sharing factors in order for it to have an incentive to minimise the costs of balancing the system. For instance, the 2005/06 scheme would have generated up to £40m for National Grid, had it made the maximum amount of saving possible. However, the nature of the scheme is such that any cost savings achieved do not require a large outlay of funds from National Grid. Therefore, large sums of money are being used to promote behaviour which costs a fraction of this to achieve.

We believe that much lower sharing factors could be utilised which would still achieve the same effect. For instance, a sharing factor of 10% would have still allowed National Grid to earn £10m on the 2005/06 scheme, which is more than a sufficient incentive for it to operate efficiently in accordance with the requirements of its licence. In practice even lower levels of sharing factor would most likely prove effective. An additional benefit of such an approach is that it would significantly reduce the requirement for IAEs, as the sums of money concerned would be decreased considerably.

I hope the above views prove helpful in your assessment.

Yours sincerely

Paul Jones
Trading Arrangements