

Sonia Brown
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Ofgem
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30th August 2006

Dear Sonia,

NGET's External System Operator incentive scheme 2005/06: Submission of Notices under Special Condition AA5A Part 2(i), paragraph 11 of National Grid Electricity Transmission plc's Transmission Licence in respect of Scottish Constraints and CAP047.

EDF Energy is pleased to have the opportunity to comment on NGET's submission of an Income Adjusting Event (IAE) for constraints and frequency response. Directly below we provide our views on the key principles of the IAE. At the end of our response we provide answers to the specific questions asked in the consultation document.

Approving the Income Adjusting Event will pass NGET costs on to Users and consumers.

The adjustment to the Incentivised Balancing Cost (IBC) that the IAE is seeking to achieve has arisen for one, or both, of the following reasons. Either NGET produced an inaccurate forecast at the time the scheme was being developed or mismanagement of constraint / frequency response costs by the System Operator (SO) occurred.

The industry has two options for bearing the costs. Either:

- through the existing SO scheme parameters, whereby the costs are proportionately recovered from participants and NGET; or
- through the proposed IAE, such that these costs are borne solely by system participants through BSUoS reconciliation (and subsequently passed through to consumers).

The removal by the IAE of £35.7m from the IBC would result in participants having to pay an additional £7.1m in BSUoS charges to NGET. A proportion of these costs will, in turn, be borne by consumers.

We believe that NGET should bear its share of costs in the incentive scheme and that NGET does not have an automatic right to call for an IAE simply based on poor commercial performance.

We believe that an IAE is not justified. NGET has historically benefited from the IBC when it has performed well either by managing the system efficiently or over-forecasting IBC. It should not have an IAE granted simply because it has underperformed either because it under-forecast IBC and/or failed to manage constraints economically.

We realise that NGET, as stated by it prior to the issuing of the 2005/06 incentives scheme, signalled that it was likely to have some difficulties in managing constraints and frequency response costs against the incentive scheme. It argued that it had no accurate way of

predicting costs in the BETTA environment. Against this, we would state that the SO incentive “target” in any year is but a forecast, which is invariably an inaccurate representation of the costs of balancing the system. NGET will always operate against such inaccurate incentive targets that may well prove to be in its favour (as in previous years). That the target is now unfavourable to NGET does not necessarily justify an IAE. NGET should not enter into SO incentives schemes on the basis that it has the right to make a profit in every single year (we note that NGET made £135m profit from its electricity SO incentives schemes during 2001-04). It is also worth noting that NGET refused to enter into an SO incentive scheme for 06-07 on the basis of perceived unmanageable risks but contrastingly willingly entered the 05-06 scheme and accepted the scheme parameters offered by Ofgem. This behaviour indicates to us that NGET considered the risks of the 05-06 scheme to be manageable.

Participants need to believe that the SO is actively encouraged to reduce system costs and that it will be liable for system underperformance. An incentive scheme is the principal tool that the industry has to ensure the operator manages the system economically. We have concerns that the level of incentive is too lax if ex-post IAE adjustments are used too frequently. If approved this will be the third IAE since the start of NETA in 2001 – the frequency of IAE approval appears too high given the intended purpose of the mechanism.

We do not consider the submission to be an “event” and therefore it is unsuitable for an IAE

The specific and unusual “event” trigger that NGET appears to be distressed about in respect of 2005/6, was in fact that it failed to forecast and manage across the whole year. It was entirely predictable that constraint compensation costs would go up following BETTA because the increase in constraint compensation rights to Scottish generators was at the very heart of BETTA, which NGET will, or should, have been more aware of than any other party. An IAE should be a rare and very specific event outwith anything that NGET might have expected in negotiating a balanced and reasonable scheme with Ofgem.

[i] Transmission Constraints

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?

- We consider that, (prior to the start of the 2005/06 SO incentive period), NGET should have taken greater consideration of the impact of managing constraints in the BM. That contracts existed to cover problems with the Cheviot and NLOANSSE constraints prior to BETTA, should have given NGET an indication that there would be some commercial requirement to manage constraints and that managing constraints through the BM might prove to be uneconomic.
- All system participants have been exposed to greater costs through NGET’s uneconomic and inefficient decision to manage constraints through the BM via imbalance cashout prices. There have been examples of where units have been bid-off at negative prices during the day, such as LOAN-1 having bids accepted on the 18th November 2005, reducing its FPN of 520MW to 230MW at prices of up to -£50/MWh, influencing a negative SSP up to -£20/MWh.
- It is evident that the enlargement of the BM to cover Scotland, coupled with NGET’s inability to manage the resultant constraints economically and efficiently, has led to higher BSUoS costs for participants.

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?

- Yes: We agree the analysis is appropriate in addressing the issue. We also agree that it clearly indicates that local NLOANSSE plant, through TEC submission and plant classification, were not likely to self-despatch. That the NLOANSSE represents 90% of internal Scotland constraints and is a well known problem is proof that NGET should have better evaluated the likelihood of self despatch.
- Our only point of concern with the analysis is the inclusion of transmission costs in the merit order as we do not believe this influences the SRMC despatch decision of plant.
- It should be noted that all the information used in Ofgem’s analysis was available to NGET.

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

- No: NGET has stated that the contract was economically superior to managing the constraint in the BM. It may indeed have resulted in reduced costs compared to its original strategy (of BM offers and PGBTs), but NGET have no proof that the economics and efficiency of the contract was superior to that of a contract effective in the same period if it had been signed prior to BETTA.

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

- No: the contract was established whilst the event was occurring, thus we can infer that the contract was not commercially advantageous. The contract prevented constraint costs escalating further, but did not prevent costs escalating in the first place.

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?

- Yes: We agree with Ofgem’s view that reference energy prices, based on those submitted at gate closure in England and Wales may be suitable for calculating Cheviot constraint costs, but unsuitable for calculating internal Scottish constraint costs.

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

- We would prefer a single cost allowance within a simple, multi-year scheme.

[ii] CAP047 Frequency response

Question 1: Do you consider that NGET has acted economically and efficiently in procuring frequency response to minimise costs?

- No: We do not believe that NGET has acted economically and efficiently in procuring frequency response, post CAP047. Our rationale is that since the introduction of “market” holding prices for mandatory frequency response, there has yet to be substantive evidence produced to show that NGET has managed to utilise the most economic service provider. NGET has created an opaque market, with a lack of transparency and inadequate provision of information to service providers. Providers cannot assess the impact of prices submitted (as holding information is provided a month in arrears) and cannot easily judge actions of the system operator in “holding” BMUs (as the data provided does not indicate if NGET is holding the cheapest provider). By so doing, NGET has not acted efficiently, as it has not easily allowed providers to submit competitive holding prices.

- We also believe that the high prices for Response Energy Payments in providing the “high” service has led to an increase in holding payment prices. Whereas this is not necessarily NGET’s fault, other SO incentive scheme elements are influenced by energy prices, yet have not been referred to the authority as IAEs. It is a weakness in the SO incentives scheme rather than justification for an IAE.

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?

- Yes: We do agree with Ofgem that the method that NGET used in assessing the value of the proposed IAE did not consider a trend upwards in holding prices. NGET’s approach in setting prices (in the absence of CAP047) for November 2005 is likely to overestimate the total value of the proposed IAE.

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?

- Yes: We do not believe that there is a justified IAE to be calculated for frequency response, and as such disagree with any method of calculating such a submission.

We hope that you will find these comments helpful.

If you have any queries please do not hesitate to contact me.

Yours sincerely,

Jim Beynon
Head of Energy Market Strategy