

28th September 2007

Philip Davies
Director, GB Markets
Ofgem
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Dear Philip

REVIEW OF ELECTRICITY AND GAS SYSTEM OPERATOR ROLE, FUNCTIONS AND INCENTIVES: INITIAL THOUGHTS

British Energy welcomes the opportunity to comment on the issues raised by your consultation paper on the above as published in August 2007. Please note that our comments primarily relate to the electricity system operator arrangements.

British Energy continues to support the adoption of transparent incentive arrangements as the most appropriate means through which to ensure that NGET are incentivised to operate the transmission system in an efficient and economic manner. We did not support the backstop approach which was in place for 2006/7, where NGET's costs were regulated under its licence, to be the most effective way of protecting the interests of system users and ultimately customers. Interestingly, we note that balancing services costs in this year were much higher than the previous year, for which an incentive scheme was in place

Detailed Comments

Roles & Functions of the SO

At present, we do not consider a case has been made to change the roles and functions of the System Operator. The adoption of an appropriate transparent incentive scheme placed on the system operator should ensure that the electricity transmission system is operated in an efficient and economic manner serving the interests of system users and ultimately customers.

C16 Statements

Data on the volumes and prices of balancing actions taken by the System Operator are required for determination of imbalance prices and settlement under the BSC.

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These data are currently specified in the BSAD and ABSVD statements. Transferring governance to the BSC might provide more flexibility for participants to specify the information which is required for imbalance calculations. For example, use of disaggregated data representing individual balancing actions would allow all actions including bids and offers to be treated equivalently in pricing calculations. However, we do not consider this a priority at the current time.

Transfer of the Balancing Principles Statement and Procurement Guidelines to BSC governance could improve the ability of participants to influence the methods used by the System Operator to balance on their behalf. However, we foresee considerable practical difficulty in achieving such a transfer and do not consider this a priority at the current time. Improved clarity and detail would be a more cost-effective improvement.

Duration

We note that Ofgem has in the past been advocating longer duration incentive schemes. In principle, we are not opposed to the idea of a scheme with a longer duration than twelve months together with the possibility of aligning such a scheme with transmission price controls periods. A longer scheme may in principle provide increased freedom and flexibility to the SO over the scheme period, resulting in reductions in SO costs over time. However, we are concerned that, depending on the actual design of such a scheme, year on year variations within a longer duration scheme may become more volatile and increase the uncertainties faced by system users managing costs over shorter periods.

Furthermore, as highlighted in the document, there are a number of significant market developments under review at the present time which will need serious consideration and may prove problematic when setting target cost levels. In particular, we note that proposed modifications to the cash-out arrangements are currently proceeding through the BSC modification process and other potential fundamental changes to cashout are being discussed. Any changes to the existing arrangements will have an impact on SO balancing costs and consequently the proposal to implement another one year scheme from April 2008 is appropriate.

Bundled Approach

Whilst we recognise that there are some transparency benefits in unbundling the various incentive pots, we do not consider this alone is a strong enough argument to change from an overall target. Consequently, we currently support the continuation of a transparent incentive scheme with a single incentivised balancing cost target. Provision of detailed information to support the breakdown of costs between different balancing activities has improved over the years, and we would expect this to continue in the future.

Net Imbalance Adjustment

The methodology for determining the net imbalance adjustment has not been seriously reviewed for several years. This has a significant effect on the incentivised amounts. There may be better ways of estimating the idealised cost of meeting the Net Imbalance Volume. For example, comparison of actual Balancing Mechanism costs with those achievable from a theoretical 'constrained schedule' and an 'unconstrained schedule' could give an indication of the costs of non-optimal balancing and transmission constraints respectively. We think it would be sensible to draw the methodology into the incentive scheme arrangements explicitly, thereby consolidating the incentive arrangements under a single licence condition.

Income Adjusting Events

We fully support the continued use of incentive scheme arrangements that include income adjusting event provisions designed to protect both the interests of system users and the SO. However, these provisions are designed to take account of unanticipated events that result in a material change on outturn costs and should therefore be limited in number. However, over the past five years the SO has been allowed income adjustments four times totalling over £40M, some of these on the basis of costs which were neither unforeseen or unexpected. These events raise serious concerns regarding the incentive arrangements and in particular the setting and agreeing of targets by Ofgem and National Grid. In particular, we would be concerned if one of the consequences of moving to a longer duration scheme were to be more frequent claims for income adjustment events.

Transparency and information provision

We support continued improvements in prompt and clear reporting by the System Operator. However, we prefer an evolutionary approach to this, rather than a fundamental change which would require expensive redevelopment of existing systems and processes.

Management of transmission constraints is a significant activity for the System Operator, and is likely to become even more important in future. We think a clear and transparent methodology for estimating the actual and the optimal costs of transmission constraints is essential for measuring the effectiveness of the System Operator within the incentive scheme.

Offshore networks

At this stage it is not clear what type and size of additional balancing and system operation services will be required to operate offshore networks, over and above those required for onshore networks. The primary requirement should be for transparency of the special system operation costs associated with such networks. When these costs are better understood, a decision whether to include them as part

of an overall incentive scheme, or whether to develop an additional separate incentive arrangement will be better informed.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Steven Eyre', with a long horizontal flourish extending to the right.

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