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Dear Philip,

Review of Electricity and Gas System Operator Role, Functions and Incentives: Initial Thoughts

Thank you for the opportunity to respond to the above document. Our response covers System Operator issues in both gas and electricity. The response considers each market individually.

1. System Operation in the Electricity Market

We are generally content with the current roles and functions of the GB System Operator (GBSO). It is important that the GBSO's role continues to be limited to that of a residual balancer. For instance, we would be concerned if it were to become more active in the energy markets, given its privileged access to market data.

Cost Recovery

In terms of the correct methodology for recovering the costs of the GBSO, we are not aware of a particularly strong alternative candidate to Balancing Services Use of System (BSUoS) charges. It would therefore seem sensible to maintain it. Of course, in reality it is the combination of BSUoS and the Residual Cash flow Reallocation Cash flow (RCRC) that recovers the deemed net costs of system balancing. BSUoS contains the costs of all balancing actions taken, for both energy and system purposes. RCRC represents the deemed cost of energy balancing that has been recovered from parties in energy imbalance through cash out prices, and is allocated to those same parties who pay

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BSUoS. Therefore, the effect is for the cost of energy imbalance to be refunded to BSUoS payers as it has already been paid by parties in imbalance. The net effect of the two is therefore for BSUoS payers only to pay for those actions deemed to be for system purposes. The fact that these two complementary payments are administered separately often causes confusion amongst parties as to their correct purpose.

Performance of the GBSO

Due to the complex and interrelated nature of the GBSO's activities, it is sometimes difficult to understand precisely why individual actions have been taken. Indeed, certain actions will have more than one benefit. We are therefore unable to comment on whether or not National Grid is operating in an efficient and economic manner in its role of GBSO. Ofgem's regulation of this activity through the SO incentive scheme is therefore important. Ofgem alone is able to obtain the necessary information from National Grid in order to set appropriate performance targets. It is also difficult for us to measure the exact effectiveness of past incentive schemes. However, setting a scheme must by definition provide National Grid with a greater incentive to control balancing costs than not doing so.

Scheme Parameters

In terms of the form that the scheme should take we support the continued use of a sliding scale incentive. However, we do not necessarily agree that the parameters should continue to be set as they have been in the past. For instance, we continue to believe that the opportunity for Income Adjusting Events to be raised should be minimised or removed entirely from the scheme. IAEs essentially mean that the incentive scheme is a one way bet. Whilst other participants have the right to raise IAEs if costs are lowered by an unexpected event, in reality they do not have access to the same information and cannot analyse the drivers of the scheme to the same extent as the GBSO. Therefore, IAEs work solely to increase the benefit, or reduce the cost, to the GBSO. In other words BSUoS payers always end up paying more when an IAE is allowed. These cost increases occur retrospectively after the year to which they relate. They therefore create significant financial uncertainty for parties, particularly suppliers.

We also maintain the view that previous sharing factors have been set at too high a level. We note that National Grid has always made a significant profit from the scheme, apart from in 2005/06. The scheme does not need to provide a profit to the GBSO of tens of millions of pounds for it to be effective. Better system operation is not necessarily a capital intensive practice and a sufficient incentive could still be provided by more modest sharing factors.

It may be time to review how the costs that go into the scheme are structured and reported as it is often difficult to ascertain exactly how the scheme affects the market. Users are primarily concerned with the costs to which they are exposed. This essentially means BSUoS charges and losses. At present, it is difficult to reconcile the costs reported under the scheme with outturn BSUoS costs. Therefore, it may be helpful to structure the scheme closer to the actual commercial parameters used in the market.

Similarly, the Net Imbalance Adjustment mechanism could benefit from review. As we

mention above, it is the RCRC payment that reflects the deemed cost to the GBSO of addressing energy imbalance, as this is the direct result of payments made to and from parties in energy imbalance. RCRC may therefore be a more appropriate measure of the effect of energy imbalance on balancing costs, than the fixed multiples of 0.5 or 2.5 times exchange prices that are presently used.

The role of the SO in electricity is significantly more complex than it is in gas. This makes the design of discrete operational incentives difficult. We therefore believe it is more practical for the scheme to continue to be set against aggregate costs and that it should not be unbundled. In electricity balancing it is not always possible to minimise the costs of every individual balancing service and trade offs ultimately have to be made. Additionally, it is possible for certain actions to meet more than one purpose. Measures to attribute actions to particular services are often somewhat arbitrary. Users are interested in the total cost of balancing services as a whole as this affects the charges that they have to pay. Therefore, National Grid should be allowed to optimise this total cost whilst maintaining flexibility to determine the best combination of actions to do so.

We do not believe that a longer term incentive should be set. Whilst we understand the theoretical reasons for doing so, we do not believe that it would be helpful in practice. A scheme that is set for a period of longer than a year will be less accurate, particularly for later years, as it will not be able to account for changing circumstances year on year. Whilst introducing drivers that flex the scheme in reaction to such changes is theoretically possible, identifying and setting such drivers to do so accurately would be extremely challenging. The increased inaccuracy of a longer term scheme would also make it more likely that IAEs will be required. This would introduce further financial risk for market participants as described above.

Therefore, on balance we believe that the effort required in order to construct a longer scheme and the inaccuracy that would be introduced as a result, would outweigh the possible benefit that could be provided.

Drivers of Future Balancing Costs

In terms of future developments that could affect system balancing costs, the main concern that we have is that there appears to be an appetite from BERR and Ofgem to change the transmission access arrangements significantly, in order to allow more generation to connect to the system prior to the necessary infrastructure being built to accommodate it. The present transmission system is already very congested with a high level of constraint costs being incurred. Analysis carried out by National Grid for CUSC amendments CAP143 and CAP148 has shown that such relaxation of the access rules will significantly increase balancing costs.

Losses

The present transmission losses scheme, whereby a financial target is set at an average cost of £29/MWh, cannot accurately affect the impact that losses have on market participants. Losses affect users' individual imbalance positions thereby increasing or decreasing their exposure to imbalance prices. It is the level of those imbalance prices

that will drive the financial impact on participants. A historic average can be used but such an approach is always likely to be inaccurate. However, we do not believe that an enhancement to the GBSO's incentive scheme is required. Instead, Ofgem should approve BSC modification proposal P203 to target the cost of losses at parties cost reflectively, rather than smearing them across all users. This will provide an incentive for participants themselves to reduce the level of losses and should work to reverse the trend that has been observed recently of increasing level of losses on the transmission network.

Market Transparency

We are supportive of more information being made available to the market. Our response to National Grid's recent consultation exercise on electricity market information outlines a number of areas where the provision of data could be improved, such as better reporting of outturn demand, the publication of National Grid's forecast of output from wind generation and release of information on demand side actions taken. We would recommend that Ofgem considers the responses to this consultation as part of this wider SO review. Whilst we support the provision of more market data to participants, we are not convinced of the benefit of a quality of information incentive. We believe that the GBSO should have an absolute obligation to provide the specified information within defined timescales. Of course, such increased information requirements will have a cost implication for National Grid. However, this should not be accounted for with an incentive that reacts to different levels of performance. Market participants require prompt, accurate data so we would not support a scheme that provides for differing levels of accuracy or timeliness.

2. System Operation in the Gas Market

As with electricity, we do not agree with the idea of an incentive scheme for gas system operation that extends for a number of years. The current single-year arrangements are significantly more transparent and cost-reflective than the proposed multiple-year arrangements. Extending the duration will simply remove both clarity and the focus on day-to-day operational performance. We are also uncomfortable with NGG taking forward market positions, which might risk distorting the wholesale gas market. Hence reference prices for each of the incentives should be clearly market-related. Fixed-price targets might encourage NGG to unnecessarily take such positions. In the context of the gas market, discrete operational incentives also provide market participants with detailed information to enable them to question the actions taken by market participants. The ability to identify actions as being for specific purposes is greater in gas than in electricity. As such, we firmly believe that the current 'unbundled' approach to incentives should be retained. The current arrangements reflect the discrete functions that the SO performs and are targeted appropriately. Bundling the separate external incentives into a single package is, in itself, unlikely to lead to more efficient trade-offs and inevitably results in a loss of transparency.

System Balancing Incentives

In respect of Gas reserve, we note that this area is currently the subject of a separate consultation process, but as stated in our response to Ofgem's recent consultation paper

“LNG Storage Price Control - Initial Thoughts”:

The ability of LNG storage to deliver flexibility at absolute peak makes finding substitute solutions very difficult. Demand-side response may offer a solution, but with for the degree of confidence and safeguards necessary for the provision of OM gas and to resolve locational transmission constraints, it's difficult to see a viable alternative to the current arrangements.

Although we believe that competition is possible in theory, we consider that until it has been demonstrated that there is a genuine interest in, and ability of, third parties to compete with NG LNG in providing an equivalent service to the SO, we support continuation of the existing incentive arrangements regarding sourcing of gas for reserve.

Over the past year, the potential for NTS off take metering inaccuracy has proven to be a significant issue, primarily as a result of the Farningham off take metering error. We would question whether there are sufficient incentives or penalties currently in place for the SO to ensure the accuracy of off take metering. We consider that this is an area that merits further work – particularly as inaccurate off take metering will play havoc with any incentive schemes around shrinkage gas. In addition, we consider that the price of shrinkage gas should continue to refer to forward market prices. This will ensure NGG is neither unfairly penalised or in receipt of ‘windfall gains’ simply because of movements in the market price. The focus should squarely be on reducing the overall level of shrinkage, but the total cost will inevitably vary with market prices.

Residual Gas Balancing Incentives

In our view, the daily price incentive for gas balancing continues to provide the right incentive for efficient residual gas balancing, but the fairly constant year-on-year payments to NGG might suggest adjustments to the mechanism are warranted. This might include increasing the downside penalties and/or the percentage below which incentive payments are received.

We would agree that operational drivers (i.e. the safe operation of the system) have a more significant influence on NGG than the linepack incentive. We consider, therefore, that it may be appropriate to consider abandoning the linepack incentive.

Information Incentives

We remain sceptical about the information provision incentive, which seems to be a disproportionately large source of incentive payments in the last year, for what we consider to be an ‘expected’ role of the SO. We believe that timely and accurate provision of information should be managed through a ‘standard of service’ obligation, with appropriate downside penalties for non-compliance. Where the SO incurs additional costs for providing further information, this should be provided for through adjustments to the SO allowed revenue.

I hope that the above comments prove helpful. Should you wish to discuss this matter further please contact me on the above number for issues relating to electricity, or

Richard Fairholme on 02476 181 421 to discuss issues relating to the gas market.

Yours sincerely

Paul Jones
Trading Arrangements
