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Dear Giuseppina,

Electricity System Operator incentive schemes from 2013: disallowing costs and the efficiency reward scheme

Please find attached our responses to the questions in the above consultation. We are generally in agreement with what is being proposed.

Question 1: Do you agree with the way in which we propose to monitor the SO's costs?

Yes generally. It is good idea to use the models that have been produced for previous incentive schemes and to develop them further for monitoring purposes. We agree with Ofgem that these models have not been effective in setting the target, particularly in recent years with the indexation which was introduced to flex the target throughout the length of the scheme.

At this point in time it does seem appropriate for Ofgem to take this sort of approach to monitoring the SO's performance in balancing the system, rather than relying on the more mechanistic approach which does not appear to be working particularly well at present.

Question 2: Do the various steps of the process we propose to follow to disallow costs seem appropriate?

The steps that are proposed as described in a high level seem appropriate. The main issue will be the detail around this. Clearly, some form of trigger is needed to start the

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process. Thereafter, National Grid should be given the opportunity to make a case as to why the relevant costs were efficiently incurred and there appears to be provision for sufficient consultation with industry participants.

Question 3: Is the proposed threshold level, and the way in which it will be applied, proportionate?

The threshold idea appears sensible. However, it is not clear as to how it will be applied exactly. The consultation states that an investigation would be triggered if the costs are higher than would be efficiently incurred, by an amount equal to or higher than the threshold in any month. The key concept here is what an efficient amount would be.

For this approach to work best, the SO and industry must be able to gauge what an efficient level might be. Otherwise there is a risk that costs could be retrospectively judged on a somewhat subjective basis which would increase regulatory uncertainty.

Question 4: Please provide your views on whether it would be appropriate to introduce a limit on the maximum level of costs that can be disallowed?

It is understandable why a cap should be sought. This is reasonable as long as it is set at such a level so as to still provide a sufficient incentive for efficient behaviour.

Question 5: Do you agree with our examples of uneconomic or inefficient costs? If not, why not?

They seem reasonable as theoretical examples. However, it would not be possible to predict every circumstance which could arise that could lead Ofgem to consider that an investigation of the costs incurred is appropriate. The most appropriate approach would be for the general principles to be set down as to how Ofgem will determine whether or not efficient costs have been incurred. Relying on specific examples which could lead to investigation will run the risk that other events may be missed.

Question 6: Should any disallowed costs be clawed back retrospectively or prospectively?

Prospectively. This is easier to handle from an Ofgem and industry party perspective.

Question 7: Do you agree with the proposed process for granting rewards?

Yes, it would appear equitable to have a reward available as well as a penalty. The challenge will be in assessing when a reward is appropriate and if so how high it should be.

Question 8: Is it appropriate to include an “ex ante” option for granting rewards, when significant up-front costs for the SO are involved?

Again it is possible to see the benefits of such an approach. The clear importance here is that when investment is made in a capital asset, ensuring that the investment is not rewarded twice (ie once through the normal price control as well as through the reward process).

Question 9: How should the net benefit to consumers be measured?

This is a difficult question to answer. Leaving it up to the SO to forecast the benefits going forward as proposed, runs the risk that the benefits are overstated, unless Ofgem is resourced to be able to provide a robust challenge to the relevant analysis.

Question 10: Have you any views on the composition of the independent Expert Panel?

None other than they should be independent of any party who could seek to gain from their decisions and possess the appropriate technical and commercial expertise required to assess the schemes put to them.

Question 11: Do you agree with our proposal to introduce a financial incentive on the accuracy of the SO's forecasts of BSUoS charges produced by the SO?

Yes this would be helpful especially in conjunction with CUSC modification CMP208, were it to be approved by the Authority.

Question 12: To what forecasting time period should the incentive apply? (We have proposed the incentive should apply to a year-ahead forecast)

Year ahead would seem appropriate initially.

Question 13: Do you agree with the proposed parameters for the scheme?

These seem reasonable as a starting point. The scheme could then be reviewed after its first year of operation to see if the parameters are appropriate going forward.

Question 14: Do you have a preference for the timing of the submission of the forecast to the Authority? (We have proposed 14 days before commencement of the scheme year).

If CMP208 is approved, it would be sensible for the forecast to be submitted in timescales consistent with that so as to avoid duplicated effort. Otherwise, the suggestion from Ofgem would be suitable.

Question 15: Is it appropriate to require NGET to continue developing its models?

Yes. However, BSUoS costs are very difficult to forecast and therefore we would be concerned if they were relied on too heavily, such as appeared to have occurred with the indexation of the current scheme.

I hope that the above comments prove helpful. Please contact me in the first instance should you wish to discuss this further.

Yours sincerely

Paul Jones
Upstream Trading Arrangements Manager