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29 March, 2013

Dear Lewis,

Electricity System Operator Incentives: consultation on a scheme for 2013

Thank you for the opportunity to respond to the above consultation. In general, we support the implementation of a financial incentive scheme, particularly in light of apparent improvements in the methodology and National Grid's modelling. We do note however that this is subject to further evidence being provided to Ofgem on the extent of these improvements.

Our answers to the specific issues raised in the consultation are as follows:

Chapter 1 - Question 1: Do you agree with our proposal to put a balancing services incentive scheme in place for 2013-15?

Yes. Our preference would be for a financial incentive to be put in place. However, we did originally understand Ofgem's initial reluctance to do so, given the difficulties which were experienced with the last indexed scheme. Since then, National Grid has undertaken some more work on developing and assessing the models and, as long as the results of validating and back testing the models illustrate that they are robust, then we agree that a financial scheme should be adopted for 2013 onwards.

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Chapter 1 - Question 2: How much confidence do you have in the ability of the models to set a robust target given recent developments to the models and methodology?

The analysis shown at the workshops held in February appeared to show that the models are fairly robust on the basis of the back testing carried out. The Energy Model appeared to be more accurate than the constraint model. Clearly, how effective the models are in practice is heavily reliant on the input data too and the assumptions made in setting the forecast.

Chapter 2 - Question 1: What are your views on making balancing mechanism 'pseudo' prices an ex post input in the energy models? What additional considerations may exist?

It appears that this suggestion is made purely in respect of that part of the incentive scheme concerning the actions that National Grid takes in the BM. In this sense, it seems sensible to have ex post inputs as National Grid is quite rightly not in control of the prices that are submitted into the BM. However, the key issue is whether National Grid remains incentivised to use balancing options which are more economic than solely relying on the BM, such as entering into pre gate closure transactions where appropriate.

Chapter 2 - Question 2: What are views on the appropriate length of time for input of transmission limits? What value do you place on having forecasts ahead of time which are as accurate as possible?

Clearly, an agreed outage schedule makes it easier for generators to plan operation of their generating stations, not least by giving the ability to coordinate planned generation outages with planned transmission outages. However, we accept that certain deviations from that plan will be inevitable. As a first step, the suggestion to fix transmission limits within the scheme for a year rather than two years seems sensible. It may be that this approach could be refined in light of experience in time for the next scheme.

Chapter 2 - Question 3: What are your views on the requirement for, and appropriate level of, a discount factor to be applied to the constraints model?

We agree that some degree of discounting is appropriate to ensure that National Grid is rewarded for performing better than "business as usual". However, this is one of the areas where Ofgem is in a better position than industry parties to suggest an appropriate level to use. We therefore do not have any suggestions other than to use the proposed discount.

Chapter 3 - Question 1: Do you agree with our proposals for the key parameters of a BSIS?

We believe that the SO incentive scheme should be mainly focussed on the short term actions as these are what essentially drive the costs that are being incentivised. This is also consistent with the manner in which these costs are charged out to participants, through BSUoS and imbalance charges. We continue to believe that a longer term scheme runs a higher risk of being reopened part way through its duration anyway, thereby effectively undermining the long term nature of the target.

The proposals to remove the dead band and retain a 25% sharing factor seem appropriate.

Chapter 3 - Question 2: What are your views on the one year update provisions and the requirement for income adjusting event provisions?

We would suggest that a midterm update on a two year scheme of those inputs which are set ex ante in effect results in a one year scheme, at least in part. Nevertheless, as we believe that the scheme should focus on short term actions, this proposal would appear sensible.

In terms of Income Adjusting Events, these have historically created the greatest risk for market participants. Anything which can be done to minimise the risk associated with IAEs would be helpful, be it a formal restriction on their being raised or an increase in the relevant threshold.

Chapter 3 - Question 3: Do you have any views on the types of inputs that may be suitable for adjustment as part of the mid-scheme provisions?

As we believe a one year scheme is preferable, we would encourage as many inputs as practicable to be reviewed after one year, assuming that this will not change the target for the year that has already run.

Chapter 3 - Question 4: What do you consider to be the merits/disadvantages of applying the scheme retrospectively to the 1 April 2013? Do you consider this to be the best option for the 'interim period'?

Clearly, retrospective application of the scheme is not ideal. However, past schemes have been introduced in this manner and as the target is set for the whole year there is an opportunity for the calculations to catch up. However, if a significant delay is experienced before the scheme parameters become known then this will introduce more uncertainty for participants. It is also important that National Grid is aware how the scheme will be applied prior to April so that it can act accordingly.

Chapter 4 - Question 1: Question 1: What are your views on the additional incentives that we are proposing to include alongside a BSIS?

The model development licence condition and the wind forecasting incentives appear sensible. We are uncertain how a reputational incentive on transmission losses would work in practice. Clearly, there are costs for customers associated with higher losses and these can be influenced by decisions that the transmission companies make, but we accept that perhaps this is more of an issue for Transmission Owner incentives rather than for the System Operator.

Chapter 4 - Question 2: In particular, what are your views on the merits of including a discretionary reward scheme alongside a BSIS? And what are your views on our proposals for the parameters of a scheme?

A discretionary reward scheme seems to be an appropriate mechanism to incentivise longer term improvements which have effects on balancing costs. It would seem a better approach than introducing a long term scheme for all balancing cost elements. Clearly, the main issue will be ensuring that this scheme and the main BSIS do not double reward the same actions.

Chapter 4 - Question 3: What are your views on the additional incentives that we are proposing not to include alongside a BSIS?

It is not clear exactly which proposals have been ruled out other than a BSUoS forecasting incentive.

Chapter 4 - Question 4: Do you agree with our proposal not to include a BSUoS forecasting incentive? What measures could help to reduce volatility of BSUoS charging going forwards?

Given the other initiatives that have taken place with respect to BSUoS forecasting, we agree that at present it is not necessary to have a separate forecasting incentive.

One alternative approach which could be considered is a fixed BSUoS payment model similar to that being explored for contracts for differences under EMR.

I hope the above comments prove helpful. Please contact me in the first instance if you have any further questions.

Yours sincerely

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Trading Arrangements