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Rachel Fletcher
Interim Senior Partner, Markets
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

E.ON UK plc
Westwood Way
Westwood Business Park
Coventry
West Midlands
CV4 8LG
eon-uk.com

Paul Jones
T 02476 183383
paul.jones@eon-uk.com

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Dear Rachel,

Consultation on the potential requirement for new balancing services by National Grid Electricity Transmission plc (NGET) to support an uncertain mid-decade electricity security of supply outlook

Thank you for the opportunity to respond to the above open letter. E.ON is not supportive of the products that National Grid has proposed as we are concerned that they could distort the wider wholesale market and undermine efforts to bring in more robust mechanisms through the introduction of a Capacity Market.

In your letter, you raise three main questions:

1. **Do you agree with our assessment regarding the risk to mid-decade electricity security of supply?**
2. **If so, do you agree with our view that it is prudent to consider the development by NGET of additional balancing services, which NGET would procure and use if there is a need for them?**
3. **Do you agree with our assessment of the key factors we should have regard to when considering whether to approve any changes to NGET's Balancing Services Procurement Guidelines and associated documents?**

We agree that it is possible to derive scenarios under which plant margins mid decade are predicted to be insufficient to maintain security of supply. Our view is that there is a need for a Capacity Market to address a plant shortfall if there is a concern that something should be done soon, we believe that effort should be focussed on implementing the capacity mechanism as soon as possible. DECC has spent much time exploring options to ensure security of supply and concluded the market-wide capacity mechanism provided best value for consumers. One of our main concerns with the proposed products is that rolling over their use into future years may be seen as an "easy fix", rather than creating more effective mechanisms through the introduction of the Capacity Market.

Clearly the proposed products are not sufficiently robust to be used on an ongoing basis. The Demand Side Balancing Reserve product has been devised with simplicity in mind so

E.ON UK plc

Registered in
England and Wales
No 2366970

Registered Office:
Westwood Way
Westwood Business Park
Coventry CV4 8LG

that it can be implemented quickly. This limits the periods over which it can be used and reduces the certainty that it will be delivered. For instance, there is no provision for penalties for non delivery of the product. Nor does there appear to be any requirements for instructed demand response to confirm to National Grid that it has responded to the instruction and the amount of demand reduction achieved. There also appears to be no arrangements for information to be made to the market on how much response has been procured, at what prices, or how much has been instructed in real time.

The Supplementary Balancing Reserve (SBR) product is essentially the creation of a strategic reserve which of course has already been ruled out as a solution for the Capacity Market. One of the key concerns with a strategic reserve is it has the potential to undermine the market by providing a source of generation margin, but smearing the cost across all BSUoS payers, rather than targeting it at those who may have caused the relevant shortfall by failing to purchase enough capacity through the wholesale market arrangements. This has the potential to distort prices so that other generators become uneconomic and seek recompense through these arrangements, thereby potentially setting up a "slippery slope" whereby more and more plant are drawn in. One approach to avoiding this effect would be to ensure that this product is priced accordingly in imbalance pricing, including capacity, warming and utilisation costs. However, National Grid is not proposing to include the costs of using SBR within imbalance prices, which we believe is the wrong approach, although we accept that allocating costs accurately is very difficult to achieve.

National Grid's consultation states that it is intended that the capacity procured under the SBR product would be ringfenced from the rest of the wholesale market and that it would be used only after all other non emergency options had been exhausted. However, some doubt about this arose during discussions at the workshop held on the 17th July, where it seemed to be suggested that the product might be called in price order with the rest of the market in some circumstances. This clearly raises further concerns about the potential distortion of the wider market.

Notwithstanding our comments above, should Ofgem decide that it wants National Grid to bring forward the DSBR and SBR products, we agree with the criteria that have been set out for assessing them, namely to ensure that they are economic and efficient, do not distort the market and are procured in a transparent and fair manner.

Nevertheless, our recommendation would be not to implement the DSBR and SBR products. Instead, work should continue on the Capacity Market with a view to its introduction as soon as possible. If as time progresses concerns develop regarding the amount of available capacity in the market, the most pragmatic solution would appear to be for National Grid to increase the amount of Short Term Operating Reserve it procures for a while to cover any shortfall until the capacity mechanism takes effect.

We have attached our response to National Grid's consultation so that you can see our more detail points on these products.

Yours sincerely

Paul Jones
Trading Arrangements Manager