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Dear Leonardo,

Funding arrangements for new balancing services: Initial Proposals

Thank you for the opportunity to respond to the above consultation. E.ON is broadly supportive of the proposals for how efficient procurement of the services is incentivised. However, we do have some concerns about the impact of ex post disallowance of costs and how this might impact on service providers, as well as the interaction between SBR and DSBR.

Our answers to the specific question asked are as follows:

Chapter 1, Question 1: Do the draft licence conditions published alongside this document appropriately reflect our initial proposals?

Yes they appear to. They need some tidying up as there are currently two clauses numbered as “4” in the drafting.

Chapter 1, Question 2: Do you agree with our assessment that a financial incentive would not be fit-for-purpose at this time?

Yes. Given that these are two new products, then there will not be the experience or information on which to base a financial incentive.

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Chapter 2, Question 1: Do you agree with our approach towards funding for the internal costs associated with the services?

Yes, it would seem appropriate to cover these through the mid-scheme review within the RIIO price control arrangements.

Chapter 2, Question 2: Do you agree with our view that the targeted efficiency check protects consumers and increases transparency to industry?

The main issue that the targeted efficiency check approach raises for the industry is the potential for costs to be allowed or disallowed on an ex post basis. Although this risk initially falls on National Grid, it has the potential to affect providers of the service if National Grid seeks to offset the risk onto them through the contractual terms they offer for the service. It may also make National Grid unduly cautious of using certain providers, if this would expose them more to the risk of costs subsequently not being allowed. For instance, the risk of not being allowed to recover warming costs may incentivise them to utilise more expensive plant which does not need warming.

We agree that if such an approach is adopted that any assessment of costs should be against methodologies and principles set up front, so that National Grid and the industry are able to understand the basis against which National Grid's decisions will be judged. We note that the first tender for Supplemental Balancing Reserve (SBR) is due to take place during early 2014. However, the licence condition as drafted only requires National Grid's methodologies to be produced by May 2014. It would seem appropriate for these methodologies to be available before the date that the tender is due to take place, so perhaps the date in the licence should be brought forward.

Chapter 2, Question 3: Do you agree with how we have proposed to fund each of the cost components of SBR and DSBR?

The approach appears correct in how the split is made between ex ante and ex post assessment of the parameters which affect the cost. Our concerns, that the providers of the service may bear the risk of costs being disallowed, remain of course.

Chapter 2, Question 4: Do you have any views on NGET's proposed approach towards identifying a volume cap and volume requirement?

It seems a reasonable approach to identify the volume cap and requirement.

However, the intention to procure DSBR ahead of SBR, as outlined in paragraph 22 of National Grid's report to Authority of 18th November, does seem to introduce a discriminatory approach which would not necessarily lead to the most economic outcome for customers. The reason given in the report for procuring in this manner is that DSBR is simply an extension of the current balancing arrangements, whereas SBR is a last resort mechanism used once other opportunities are exhausted. However, DSBR is not simply an extension of the existing balancing arrangements, as National Grid will only tender for it if there is a requirement for additional reserves identified. This requirement for additional reserves can be met by a combination of DSBR and SBR.

Therefore, both services are aiming to achieve the same objective. Additionally, the decision has now been taken by National Grid not to call DSBR until all other actions in the Balancing Mechanism have been used. Therefore, DSBR and SBR are now both last resort products and addressing the same risk of a capacity shortage, there is an argument for them to be procured and despatched in competition with each other.

Secondly, consideration needs to be given to what this means for the total volume of services being procured. If a shortage is identified for 2014/15, as SBR is to be tendered before DSBR, National Grid will have to tender for an amount of SBR based on a forecast of the amount of DSBR that will be forthcoming. If they are too optimistic about this number, then too little SBR (and therefore too little capacity over all) will be procured. If they are too conservative about this number then too much capacity will be procured. We would assume that National Grid are likely to be cautious and would err towards being conservative. Therefore, this approach would seem to tend towards over procurement of capacity at a greater cost to customers.

Chapter 2, Question 5: Do you agree with the principles behind each of the ex ante methodologies and any proposed details that we or NGET have suggested should be included within the methodologies?

Yes, these generally seem appropriate. We assume that any references to plant owners paying for additional availability tests refers to any tests they instigate for their own purposes, rather than any additional tests called by National Grid.

Chapter 2, Question 6: Are there any other principles or details that should be included within our targeted efficiency check approach?

No thank you.

I hope the above proves helpful. Please contact me on the above number should you have any further questions.

Yours sincerely

Paul Jones
Upstream Trading Arrangements Manager