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Dear Martin,

Strategy Consultation: Revenue, Incentives and Outputs for National Grid's Role in Electricity Market Reform

Thank you for the opportunity to respond to the above consultation. We do not have many comments to make on the proposals set out. However, we do have some views on the System Operator's budget and the proposed incentive scheme against the processing of stage 1 disputes.

We believe that it is important that the System Operator is subject to appropriate incentive arrangements in its role as the EMR delivery body. Clearly its performance in this role is important to ensure the efficient operation of the EMR arrangements and to promote investor confidence. However, any incentives that are put in place should also be proportionate to the cost of undertaking the role.

We are not really in a position to comment on whether or not the budget of £7m that National Grid has proposed for the first 20 months of its EMR delivery role is realistic. However, one of the main reasons cited for awarding the role to the System Operator is the ability to achieve cost savings through the synergies that would exist between its EMR and other responsibilities. Therefore, we would expect any costs claimed to reflect these savings and for Ofgem to satisfy itself that they are indeed additional EMR related costs, and not attributable to the other System Operator roles which are

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already funded through the RIIO arrangements. We agree with the proposal to set an initial budget £5m with a reconciliation later when more information is known. The practical arrangements which have been to put this into place seem appropriate, including a requirement for a business plan from the System Operator.

However, the proposals for incentivising the efficient administration of tier 1 disputes appear to be overly generous. There is also a significant asymmetry between the potential for the System Operator to make money out of the incentive compared with the losses it could face. In total, if the System Operator were to have no tier 1 disputes overturned at the tier 2 stage, then it would be set to make an additional 3.5% return on this element of the business (based on a maximum £175k incentive payments and budget of £5m). Conversely, for a similar sized reduction to occur 6 or more tier 1 disputes would have to be overturned in each of the 4 areas incentivised.

Additionally, there is a large step in incentive for the first overturned dispute in each area whereas the subsequent 5 instances attract a much smaller incentive at 20% of the size of the initial one. This means that once the first dispute has been overturned in a particular incentivised area, such as CM prequalification, the proposed structure provides an incentive for the System Operator to concentrate on the other 3 areas more, as they are still open to the higher level of incentive.

Indeed, it is not clear why the incentive has been split into the 4 areas. Our expectation is that relatively few disputes will be raised against the System Operator's decisions if they are taken in a robust and consistent manner. Therefore, it would seem to be simpler and more proportionate to incentivise all areas together. This would also minimise the scope for prioritising one area over another as described above.

The other areas covered in the consultation, such as the arrangements to put the changed incentives into effect through the licences and handbooks, seem appropriate.

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

Yours sincerely

Paul Jones
Upstream Trading Arrangements Manager