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15 July, 2014

Dear Lewis

### **Electricity System Operator Incentives from 2015**

Thank you for the opportunity to respond to the above consultation. We are generally supportive of an approach which seeks to avoid radical change in the scheme from April 2015. However, we believe that the scheme currently results in a target that appears overgenerous and totally derisks the incentive for the System Operator.

Our responses to the detailed questions raised are as follows:

#### **Chapter 1, Q1 - Do you have any views on how the current incentive scheme is functioning?**

We still have reservations around the indexed approach for setting the target. Having a target which is only known after the event reduces the transparency of the scheme significantly, undermining the ability of parties to understand the potential impacts on them and their customers.

It is also not clear that it results in a realistic target. The provisional target for the year 2013/14 appears to be much higher than that for previous years and the SO has been able to easily beat it, even though costs are up on the previous year and comparable with the year before. It is not clear that previous targets were too low, but even assuming that they were, an increase of over £300m seems to a significant over adjustment.

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**Chapter 1, Q2 - What are your views on our proposal to introduce a two year incentive scheme consistent with the current framework?**

If a similar scheme were to be set for next year, we believe that Ofgem would need to consider carefully how the target parameters are set. As we mention above, it currently appears to be setting a very generous target which is unlikely to incentivise the System Operator to put significant downward pressure on balancing costs for the benefit of customers. We understand the limitations associated with setting a fixed target which does not respond to factors which affect the level of balancing costs, but which National Grid has no control over. However, we are concerned that the current methodology has gone too far in de-risking the scheme for National Grid.

**Chapter 2, Q1 - Do you agree with the proposed scope of changes to the 2015-17 scheme?**

As we mention above, we believe that the scheme parameters need to be reviewed to ensure that a sufficiently challenging target has been set. Otherwise, we agree that it would be sensible to maintain a degree of stability and therefore avoid radical change to the structure of the scheme. A longer term review can therefore take place with a view to making any required changes from 2017 onwards.

**Chapter 2, Q2 - Do you consider NGET's modelling to be sufficiently transparent? How could this transparency be improved?**

National Grid already provides a significant amount of information on its modelling which seems appropriate for parties' needs.

**Chapter 2, Q3 - How do you think the additional incentives that sit alongside the BSIS could be improved?**

- a. **Do you have any views on areas of functionality of the models that should be improved or introduced? How would you like to be engaged in the model development process?**

Although the information on National Grid's modelling is good, the ability of parties to be able to critique it and provide an input into the target setting process should not be overestimated. Parties are generally interested in the information to understand the scheme and what it can tell them about expected levels of balancing costs and therefore Balancing Services Use of System charges, so they can better manage the risks associated with these costs to the benefit of customers.



We believe that Ofgem should continue to provide the main check on whether the scheme parameters are reasonable or not. Ofgem providing the dedicated team to do this centrally on behalf of all parties and customers is more cost effective than each individual party providing its own resource to do so.

- b. What value do you place on NGET's wind generation forecasting? To what extent do you use this and how? Do you see benefit in extending the incentive to other areas of forecasting?**

Parties will use whatever information is available to better understand the risks associated with trading in the market. For wind forecasting participants will rely on their own forecasting resources, as well as looking at the output from National Grid. Clearly, improving the accuracy of the forecast should be encouraged, although any incentives in place to facilitate this should be proportionate.

- c. Do you believe that the SO Innovation Roll-out Mechanism should be retained? To what extent do you consider that it encourages the SO to take an innovative approach? How could the processes for application and approval be improved?**

The benefit of the SO Innovation Roll-out mechanism is not obvious. We believe that the SO should be seeking to innovate to reduce balancing costs as a general requirement of meeting its licence. The problem with multiple financial incentives is that it can be perceived to be rewarding the SO simply for doing what it should as a reasonable and prudent operator, and it is hard to ensure that additional value has been provided by the incentives themselves or that benefits have not been provided by other mechanisms and incentives.

- d. To what extent do you find the information that NGET publishes on transmission losses in its monthly balancing services statement and ten year statement useful? Would you like more or less to be published?**

We believe that the Monthly Balancing Services Statement could generally be improved if there was more information on the confidence of the forecast in the document and in the information provided to the Operational Forum. There seems to be significant deviations in the outturns compared to forecasts, even at the end of year stage. Users need to understand the potential accuracy of the forecasts and the likelihood of National Grid to be able to hit the scheme targets.

**Chapter 2, Q4 - Is there a need for additional SO-TO financial mechanisms to facilitate whole system consideration of outage planning (i.e. taking account of the impact on constraint**



**costs)?**

We are concerned that this would introduce another financial incentive which would provide network companies with additional revenue simply for acting as they should do under their licence. However, network companies should be held accountable if they fail to plan their outages in such a manner as to minimise the impact on users and customers as a whole, or if they move their outages at short notice without proper consideration of the effects on balancing costs. This could take the form of a reputational incentive. Alternatively, Ofgem could structure it as a licence requirement which could result in enforcement action if transmission companies fail to meet their obligations.

**Chapter 2, Q5 - Is there sufficient transparency of the SO's actions? If not, where are improvements needed?**

In some areas of system balancing, the level of transparency is sufficient with reasonable amount of information on the actions that were taken. They are also taken in accordance with rules to ensure that balancing services are purchased economically. However, there are a number of services where there is little or no transparency, so it is difficult to ascertain whether economic decisions have been taken. Two particular areas where reporting could be improved are when the SO enters into inter-trip agreements and agreements for demand side response.

I hope you find the above comments helpful. Please contact me should you wish to discuss these issues further.

Yours sincerely,

**Paul Jones**  
**Upstream Trading Arrangements Manager**