Our Ref
Your Ref 280/04

Simon Bradbury
Ofgem
9 Millbank
London
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Dear Simon

NGC System Operator incentive scheme from April 2005

EDF Energy is pleased to have the opportunity to respond to this initial consultation document on Ofgem's Initial Proposals for the NGC System Operator incentive scheme to apply from April 2005.

We have provided comments to the points on which views were specifically invited as an attachment to this letter. We hope that these will be helpful to you in developing this year's version of the SO incentive scheme and also in the design of any future scheme which will be able to take on board the experience of operating a GB wide balancing system.

EDF Energy agrees with Ofgem's view that there has been a historic discrepancy between NGC's forecast of IBC and the actual out-turn. We therefore welcome the efforts made to reduce NGC's own bid for what must inevitably be a very soft target, so that they are given a real challenge. We recognise that the introduction of BETTA does give rise to a number of uncertainties, particularly with regard to constraint costs across what is now the England-Scotland interconnector, which would reasonably increase NGC's view of IBC for 2005-06. However, we would expect that after some experience of GB system operation there will be scope to reduce IBC still further.

If you have any queries on these comments please do not hesitate to contact Stephen Moore on 020 7752 2524 or me.

Yours sincerely

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Scope of the GB SO Incentive Scheme

- *The initial proposal that the scope of the GB SO incentive scheme should be consistent with the scope of the existing E&W SO incentive scheme.*

Whilst it is, in our view, sensible that the initial GB SO incentive scheme is consistent with that which currently exists for England and Wales, we would urge Ofgem to consider ways in which any future scheme can be enhanced. In particular we would like to see a greater focus on those areas where NGC can make a demonstrable reduction in costs rather than those costs which will, by definition, be uncertain and over which NGC has limited influence.

For example, costs associated with competitive aspects of the balancing arrangements are to a large degree dictated by market conditions (i.e. bid/offer prices) and can change unpredictably from one year to the next or even during the course of a year. NGC's only opportunity to influence these costs lies in developing more efficient and competitive arrangements for procurement of balancing actions and in optimising the way that they utilise different balancing tools to achieve the most efficient outcome.

Form of the GB SO Incentive Scheme

- *The proposal that a sliding scale incentive scheme should be developed.*

We remain concerned that a sliding scale incentive encourages NGC to submit a conservative estimate of IBC and then profit from costs out-turning below this level. We welcome Ofgem's view that NGC's methodology for predicting IBC is biased, but this is unsurprising given that the scheme incentivises NGC to forecast increasing costs in order to obtain a generous IBC target value. We would suggest that Ofgem consider alternative schemes in the longer term such as international benchmarking.

- *The proposal that a single GB wide SO incentive scheme should be developed.*

As BETTA will introduce a single GB balancing mechanism, we agree wholeheartedly with Ofgem's view that the SO incentive scheme for that mechanism should be GB wide.

- *The proposal that a deadband target range should not be considered.*

We agree with Ofgem's view that a deadband is not necessary in a scheme designed to reduce the scale of IBC.

- *The initial proposal to allow asymmetric cap, floor and sharing factors in order to accommodate any perceived uncertainty in relation to GB SO costs.*

We do not agree with the use of asymmetric caps, floors or sharing factors within the incentive scheme. Whilst there may be a large degree of uncertainty as to balancing costs under BETTA we fail to see how the use of asymmetric parameters constitutes an appropriate balance of risk and reward for NGC. For example Option 1, offers NGC a very high potential reward but far lesser risk – an IBC of £450m (£30m below target) would earn NGC a bonus of £18m, but allowing it to rise to £510m (£30m above target) would result in a penalty of only £4.5m.

In addition, where NGC has limited influence over costs we cannot see any justification for a 60% reward sharing factor. We believe that the sharing factors should be more reflective of NGC's ability to influence costs. Therefore we consider that symmetrical sharing factors of 25% or less would be a more appropriate response to costs that are uncertain.

Duration of the GB SO Incentive Scheme

- *The proposal that the duration of the GB SO incentive scheme to apply from 1 April should be one year in duration.*

Whilst EDF Energy would favour a scheme of longer duration than one year, we feel that the level of uncertainty surrounding BETTA, particularly with regard to constraint costs, means that a one year scheme is more appropriate for 2005-06. Likewise it should be noted that, when the next scheme is being considered in a years time, there will still be considerable uncertainty as to the costs of operating the GB system as less than a years operation under BETTA will have passed and this will not have included a full winter. A further one-year scheme would therefore also be appropriate for 2006-07.

However, it would be preferable to consider a longer term scheme to apply from April 2007 onwards consistent with transmission price control timescales. Such a scheme would offer greater potential for NGC to develop more innovative solutions to optimise the efficiency of the transmission system through a combination of system operation activities and transmission network investment.

Incentive Scheme Parameters

- *The proposal that the transmission losses element of the incentive scheme will apply consistently across GB.*

We continue to see limited potential within the scope of the SO Incentive Scheme for NGC to significantly influence transmission losses. However, it seems appropriate that this element of the scheme should apply consistently across GB as is the case for the other elements of the scheme.

- *Whether a net losses scheme is more appropriate than a gross losses scheme.*

We agree with Ofgem that a net losses scheme would be more reflective of the actual BSUoS costs to which participants are exposed and would therefore be more transparent. We therefore prefer this approach. Nevertheless, according to NGC, the most significant driver of transmission losses volumes is the zonal disposition of generation. Clearly, NGC's actions as System Operator can have little impact on this. We note that NGC have forecast a substantial increase in Scottish transmission losses of 0.15TWh (about 14%). This represents losses of 3.5% for the 1400MW of wind generation that is expected to be connected in Scotland – assuming all of this generation is in place for the full year, higher still if the generation is assumed to be connected for less than the full year. Even for Scotland this assumption seems to be on the high side.

- *The potential cost savings identified versus NGC's projected target.*

We note the potential cost savings relative to NGC's projected target value and support Ofgem's efforts to remove the over-forecasting that appears to be inherent within NGC's projections of balancing costs.

CAP047 Costs

EDF Energy agree that NGC's forecast of the impact of CAP047 on frequency response costs is excessive and that a more reasonable short term expectation would be in the range 10% to 20%.

However, this highlights the inherent flaw in this type of incentive scheme that uncertainty can lead to risk or reward without any additional actions being taken. For example, NGC forecast that the costs of Frequency Response holding would increase by 50% following the implementation of CAP047, but if this is adopted as the target value and the outturn represents a lower increase in costs then NGC will be rewarded even though no actual saving has been achieved, only a perceived saving against a conservative estimate. The outturn costs are purely driven by the behaviour of the competitive market and not by the actions of NGC. NGC may be able to reduce the overall increase in costs by better optimisation of their processes for procuring frequency response, but this scheme does not differentiate the degree to which NGC have achieved a saving relative to the market driven outcome.

Constraint Costs

EDF Energy believe that NGC's forecast of constraints across the Cheviot Boundary is excessive if reasonable market behaviour is assumed. In its "Technical Review of Connection Options – 4 July 2004", NGC forecasts the level of constraints to be £19m for 2005 under Option 3 of the proposed approaches to allocation of GB transmission access rights. On this basis Ofgem's reduction of £18.5m to NGC's latest forecast of £37m appears reasonable.

It is likely that there will be continuing uncertainty over the levels of constraint costs in the next few years and therefore an incentive arrangement that is not based on forecasting but is more focussed on improvements in efficiency should ideally be sought. Such a scheme would need to try to identify more detailed indicators of the drivers behind constraint costs to show more clearly on the one hand, where savings have been achieved as a result of NGC actions and initiatives and on the other hand, where costs are directly related to market conditions.

- *Proposed target values; cap and floor; sharing factors; and, incentive scheme options.*

On the basis of the potential cost savings identified by Ofgem relative to NGC's projections, there appears to be a reasonable possibility that NGC will be able to beat the targets of all three options. Ofgem's low scenario of £467.8m would result in a reward payment to NGC of between £7m and £13m depending which option was chosen.

Option 1 provides the highest reward of the three options for IBC below £440m, this is over £100m (almost 20%) lower than their projected IBC and therefore seems unlikely to be chosen by NGC unless they have a reasonable expectation of IBC being below £440m. We would therefore be seriously concerned at the validity of NGC's projections if this option were chosen. This option also seems to be somewhat biased

in that it offers the highest upside sharing factor and the lowest downside sharing factor.

Options 2 and 3 both deliver a reward of £10m at an IBC of £475m, halfway between the Ofgem high and low IBC projections. If it is assumed that Ofgem's adjusted IBC projections are more realistic then both options 2 and 3 are tilted in NGC's favour and are therefore less challenging than they could be.

Whilst we welcome Ofgem's desire to impose tighter costs on NGC, we believe that the proposed options could be refined. As stated above, we feel that symmetrical targets provide a fairer balance of risk and reward for the SO and for customers who will ultimately be paying for any reward earned by NGC in addition to the system balancing costs.

On balance we believe that Option 3 offers the most appropriate levels of risk and reward as it provides modest symmetrical sharing factors. However, the target value for this option may be on the high side.

Timing of BETTA Go-live

- *The proposal that, in the event that BETTA go-live is delayed beyond 1 April 2005, that a profiled version of the existing E&W SO incentive scheme should apply until BETTA go-live, at which point a profiled version of the GB SO scheme intended to apply from 1 April 2005 will automatically apply.*

EDF Energy agree that the proposed approach seems to be a reasonable and pragmatic solution to any occurrence which delays the go-live date.