



First Hydro Company is part of a joint venture between
International Power plc and Mitsui & Co., Ltd.

Duncan Burt
National Grid plc
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2 October 2008

Dear Duncan,

Electricity System Operator Incentives - Consultation on the Development of an Incentive Target Indexation Methodology

Please find attached the responses to the questions raised in the Development of an Incentive Target Indexation Methodology Consultation. These comments are provided on behalf of all of the International Power/ Mitsui assets in the UK.

If you have any questions on our response then please do not hesitate to contact me.

Yours sincerely,

Kevin Dibble
Director, Marketing (First Hydro)

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International Power/ Mitsui response to Consultation Questions

1 Do you agree with the principle of indexation?

We agree with the principle of indexation should it be possible to demonstrate that the index is sufficiently robust. The volatility of the market and the interdependencies of the costs involved in system management mean that establishing a robust index is a very difficult task. It is not clear that the indicated index is sufficiently robust. The analysis, however, does seem to show that the employment of the NIA adjustment is not successful.

2 Do you support the use of indexes for the scheme starting in April 2009?

As indicated above it is not clear how robust any index will be and, therefore, we are cautious with regard to employing any index in the scheme starting in April 2009. Windfall gains/ losses are still possible with the proposed index (although possibly not to the same extent as the currently employed methodology) and, therefore, some care should be taken with the use of any index.

3 What incentive components should be included in the indexation methodology?

We consider that the components proposed by NG (Energy, Reserve, Downward Regulation, Fast Reserve and Frequency Response (holding payments)) should be included in the indexation methodology.

4 Considering the volatility of the index and the individual components, are there any periods that should be excluded from the development of indexation components e.g. exclude the data from 2005/6 due to the market being unsettled in the first year of BETTA?

The system has become progressively shorter over the last few years and, therefore, it seems appropriate to give greater weight to recent years, which should reflect the extent of costs that are likely to be incurred by the SO. The data from 2005/6 does vary substantially from surrounding years and so it may be appropriate to exclude it. One caveat is that the index is built from a sample set which is quite small (encompassing 2005 – mid 2008) and substantial volatility is an inherent part of the costs of managing the system, it may be useful to attempt to capture this volatility in any index. This inherent volatility exhibited over the years indicates that establishing a robust index that is reliable over longer periods (and indeed short periods) is difficult. That being said, we would be comfortable with the data from 2005/6 being excluded.

5 Do you agree with the proposed method of indexing balancing costs?

The proposed method of indexing balancing costs seems to be a reasonable approach. However, although it may be more accurate than the current NIA method, it is still open to question as to whether it is robust enough to employ in an incentive scheme.

On a minor point, the incentive cost adjustment proposed in 3.2.1.4 is:

$$\text{Incentive cost adjustment} = 679 * \text{SPNIRP} + 1 * \text{SPNIRP} * (-\text{TQEI}).$$

Yet, the results of the analysis given in Section 144 and Table 4 give a co-efficient of 676.

6 Are there any additional benefits / drawbacks of implementing the proposed indexation?

It is listed on the benefits that indexation “removes the risk of windfall gains and losses”; this is to overstate the accuracy of the index. The outturn volatility given in the analysis demonstrates that, at best, such an index may reduce the windfall gains/losses from the NIA method currently employed.

The drawback of “forward, balancing costs/ power price/ market length relationships may not be the same as historical analysis has shown” can be stated in a stronger fashion: as the market structure alters (such as through increasingly constrained coal plant through the LCPD) then

these relationships are likely to shift. The speed with which these relationships may change is a substantial unknown and a significant impediment to the success of any index.

7 Do you have any comments on the development and implementation of an energy indexation?

The interactions between various components suggest that it would be better to progress an indexation methodology as based on the components given in question 3. An EPUS energy index does not seem to be worth progressing.

8 Do you have any comments on the development and implementation of reserve indexation?

The concerns given about the interaction of components given in question 7 would also apply to a reserve index.

9 Do you have any comments on the development of constraint cost indexation? What incentive arrangements should be considered for constraint costs?

It does not seem possible to establish a constraint cost index. The analysis indicates an extreme level of volatility in the costs of constraints. Further, the role of constraint costs in an incentive scheme is difficult to evaluate as there is a general lack of sufficient information about constraint costs. However, it is important to include constraint costs within any incentive scheme in order to encourage the efficient management of outages.

10 Do you believe that a reactive power index should be developed? What is your preferred option for a reactive power index?

As in our response to previous consultations, we believe that it should be possible to develop an index with regard to reactive power. It is sensible to incentivize NG as to volume of reactive power. However, the index as described in Appendix B is not sufficiently detailed and would require further development.

11 Do you believe that a frequency response index should be developed? What is your preferred option for a frequency response power index?

It seems more appropriate to keep frequency response as part of a general index rather than developing a specific frequency response index. It does not seem necessary to conduct further analysis.

It is not clear that the options given in Appendix C would maintain sufficient incentives on NG.

12 Do you have any comments on the benefits and drawbacks of unbundling? If any, what incentive components could and should be unbundled?

Unbundling is fine if the indices are sufficiently robust on a stand-alone basis. However, the interactions between the various components mean that this does not seem possible. Therefore, we consider that it would be appropriate to include the components proposed by NG, as detailed in the answer to question 3, as it gives the opportunity some of the exhibited volatility to be netted off. Further, the method for the allocation of costs to specific components would need careful attention.

13 Are there any other forms of indexation that you believe should be further considered further?

No.

14 Do you believe that there are benefits in developing longer term incentives? Are there any benefits or drawbacks not covered by this consultation?

The volatility of the proposed index suggests that it is difficult to establish a robust index for one year and this difficulty will be amplified for any longer term schemes. Given this volatility it is difficult to envisage how a longer term scheme based on an index will be accurate enough to provide effective incentives. Further, it may be considered that if there is a broad framework, with the expectation of a suitable incentive scheme, then there is nothing to prevent NG investing over longer periods and seeing a return on that investment.

15 Did you find the level of information within this consultation informative? What additional information should National Grid provide to explain better?

The level of information provided in the consultation is informative and marks the continued improvement in the consultation process for the System Operative Incentive Schemes. It would have been interesting to have conducted the analysis of the effect of the proposed index on the scheme outturn for previous years and therefore the potential effect on any profit/loss.