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Potential Income adjusting events under NGET's 2005/06 SO Incentive Scheme

Dear Sonia,

Centrica welcomes the opportunity to comment on the above Ofgem consultation. In summary, we believe that the deviation in outturn costs from the Scottish Constraints allowance and the Frequency Response allowance should **not** be considered Income Adjusting Events ("IAEs") under SC AA5A. Our views are outlined in more detail below where we answer the specific questions raised in the consultation document.

Constraints

Question 1 – Do you consider that, prior to the start of the 2005/06 SO incentive period and based on available information at the time, NGET acted economically and efficiently in deciding to manage internal to Scotland and Cheviot constraints in the BM?

Based on the information available to us, we do not believe that NGET has acted economically and efficiently in deciding prior to the start of the 2005/06 SO incentive period to manage the internal Scotland constraints and Cheviots constraints (together the "Scottish constraints") in the BM.

The Scottish constraints are in our view structural system problems and they were recognised as such by Ofgem and the rest of the industry prior to the implementation of BETTA in April 2005. NGET has a range of tools available to balance the system, both inside and outside the BM. Relying on the BM to resolve longer-term constraints problems is in our view only justified if that decision is based on thorough analysis, particularly if NGET is reliant on a small number of generators (or just a single generator) to alleviate a particular constraint.

Internal Scotland constraints

With regards to the internal Scotland constraints it seems on the basis of the Ofgem consultation document that this analysis has either not been carried out at all or at least not sufficiently. The information on the level of self-despatch of Peterhead should have been known to NGET prior to the 2005/06 incentive period. If NGET had

any difficulties in obtaining the relevant Peterhead data, NGET could have raised the issue with Ofgem.

Cheviot constraints

Our view is the same with regard to the Cheviot constraints. We believe that NGET should have carried out further analysis to establish that commercial arrangements outside the BM would not result in an overall reduction of costs. We agree with Ofgem that although there is a relatively large amount of generation in Scotland, the ownership is concentrated in the hands of only three companies and therefore NGET should not have been deterred from negotiating contracts.

We believe that, had it carried out further analysis, NGET could have taken more economic and efficient action to mitigate cost overrun. Managing the Scottish constraints in the BM rather than entering into commercial arrangements has led in our view to an avoidable increase in both imbalance prices and BSUoS charges.

Question 2 – Do you have any comments on whether the analysis we present in relation to forecasting the level of self-despatch of generation is appropriate in addressing this issue?

We believe Ofgem's analysis is appropriate in addressing the issue. As mentioned above, in our view NGET should have carried out further analysis with regards to the Scottish constraints to ensure that they would manage these constraints in the most economic and efficient manner. The analysis carried out by Ofgem with regards to forecasting the level of self-despatch of generation is the least that we would have expected NGET to have carried out before the start of the 2005/06 SO incentive period.

Question 3 – Do you consider that, in November 2005, NGET acted economically and efficiently in managing internal to Scotland constraints through a commercial contract?

Internal Scotland constraints

Without knowing the details of the contract, we believe that NGET has probably acted more economically and efficiently in managing the internal Scotland constraints from 22 December 2005 through the WSS contract rather than the BM. However, we agree with Ofgem that negotiations ahead of November 2005 could have significantly reduced NGET's costs and therefore NGET has not acted as economically and efficiently as could have been expected.

Cheviot constraints

It is our understanding that NGET did not enter into commercial arrangements during the 2005/06 SO incentive period to manage the Cheviot constraints. Based on the pricing behaviour (including negative bids) of Scottish BMUs in, for example, the September-October 2005 period, we believe that NGET has not acted economically and efficiently in managing these constraints. We have raised this issue and the subject of negative bids with Ofgem in 2005 and we look forward to the outcome of Ofgem's further investigation in this area.

Question 4 – Do you consider that NGET acted economically and efficiently in negotiating this contract?

Without the full details of the contract, it is difficult to say whether NGET has acted economically and efficiently in negotiating the WSS contract with SSE. However, as mentioned above, we believe that NGET should have entered into an agreement with SSE before November 2005 to minimise the costs of managing the internal Scotland constraints. Leaving it until late November to commence discussions with SSE has in our view probably resulted in a situation where NGET was a 'distressed buyer'. This could very well have resulted in a less favourable outcome than if the contract had been negotiated earlier.

NGET's negotiating position may explain the fact that the WSS agreement was only agreed in principle nearly a month later on 22 December 2005. From experience we know that NGET can often act swiftly in negotiating balancing services outside the BM. We are therefore keen to understand whether NGET had any issues with negotiating reasonable contract prices and if so, whether these concerns have been raised with Ofgem, having specific powers under the Competition Act and the Generation Licence to deal with these issues.

Question 5 – Do you have any comments on the methodology used by NGET in estimating the total cost of managing internal to Scotland and Cheviot constraints following the start of BETTA, and the amount of the proposed income adjustments?

We believe that the extent of the Scottish constraint could and should have been foreseen by NGET based on data available to NGET before the start of the 2005/06 SO incentive scheme. Therefore we do not believe that a deviation in outturn costs from the allowances set by Ofgem should be subject to consideration under the IAE mechanism, if at all. The deviation cannot be linked to a specific unforeseen event or circumstance other than BETTA, the implementation of which was announced in June 2003. In addition, we believe that the asymmetric sharing factors and the asymmetry between the cap and floor values already take into account the uncertainties associated with NGET becoming the GBSO. If NGET did not agree with these risk-sharing factors, it could have rejected the SO incentive scheme altogether.

Question 6 – Do you have a view on the appropriateness of having separate cost allowances within the overall SO incentive scheme cost target?

We believe it is not appropriate to have a separate cost allowance for Scottish constraints costs within the overall SO incentive scheme cost target. In our view a separate costs allowance has reduced and will reduce the incentive on NGET to manage the Scottish constraints especially if IAEs can be raised when outturn costs deviate from the actual allowance set within the SO incentive scheme. Without further guidance around what should/should not be considered an IAE by Ofgem under SC AA5A, we believe that Ofgem should only set the overall SO incentive scheme cost target.

However, we do believe there should be visibility of how the Scottish constraints are managed. This would enable an examination of incentives on the TO to invest in additional transmission capacity. The question of whether this should be done via a "deeper" incentive scheme or a different mechanism should be reviewed, together with other shortcomings of the scheme (for example NGET's option to reject), when considering the SO incentive scheme for the period 2007/08.

Frequency response

Question 1 – Do you agree that NGET has acted economically and efficiently in procuring frequency responses to minimise costs?

Based on the information available, we believe that NGET could have acted more economically and efficiently in procuring frequency responses. However, we agree with Ofgem that the set allowance will have reduced NGET's incentive to reduce cost and therefore NGET has probably not acted as economically and efficiently as could have been expected.

Question 2 – Do you have any comments on the methodology used by NGET in estimating the total cost of procuring frequency response following the implementation of CAP047, and the amount of the proposed income adjustment?

See response to question 3 below.

Question 3 – Do you have any comments on our proposed alternative methodology and the amount of the income adjustment that may result should we determine that the events or circumstances surrounding the increase in frequency response costs incurred by NGET is an IAE?

For the same reasons as for the Scottish constraints, we do not believe that deviation in outturn costs from the frequency response allowance should be considered an IAE (see response to 'constraints' question 6 above).

However, if Ofgem does consider this to be an IAE, we believe that the calculation of the income adjustment should be based on Ofgem's alternative "profiled" methodology. We agree with Ofgem that NGET's prices should be aligned with the actual pre-CAP047 prices. In our view the "profiled" approach should be used rather than the "flatline" approach as it is unlikely that prices will have stabilised.

This is not to say that the income adjustment should be the revised outturn costs minus the IBC target. As mentioned earlier, the asymmetric sharing factors and the asymmetry between the cap and floor values already take into account the uncertainties associated with NGET becoming the GBSO. It should also be taken into account that the allowance has probably reduced NGET's incentives to minimise cost in this area. In light of this, we believe that the original IBC target of £7.35m was not unreasonable.

Question 4 – Do you have a view on the appropriateness of having separate costs allowances within the overall SO incentive scheme cost target?

As mentioned under "constraints" above, we do not believe it is appropriate to have separate cost allowances within the overall SO incentive scheme cost target (see question 6). However, we do believe it is important to have visibility of the strategy behind and the costs associated with NGET's various balancing tools. We trust that Ofgem will continue to strive for increased transparency in this area.

I hope these comments have been useful. Please do not hesitate to contact me if you have any questions or comments relating to our response.

Yours sincerely,

Merel van der Neut Kolfshoten
Commercial Manager