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Dear Corey,

NGET and NGG System Operator Incentives from 1 April 2007
Preliminary views consultation

Thank you for the opportunity to comment on your consultation on the incentive scheme for NGET and NGG SO for the year.

We note that this paper contains the proposals only for the first year of the coming Price Control period, from 1 April 2007 until 31 March 2008. We recognise that it will take some time to develop more meaningful incentives to apply for the remainder of the Price Control Period and set the standard beyond. As stated previously, we are more generally supportive of the structure of an incentive regime being set over a longer period particularly to ensure a consistent application of incentives as long as they are proving to have the intended and desired effect.

Chapter 3 - Electricity SO Cost Forecast

Our responses to the specific questions are below; in addition we would like to make two further comments. Firstly that we believe that there is a strong argument for a ‘deep’ incentive scheme, whereby a separate incentive would be set for the various components of the overall IBC target. This would be much more cost-reflective and transparent, and would avoid issues of cross-subsidy.

Secondly, we believe strongly that the SO Incentive Scheme for 2007-2008 should see a return to symmetrical sharing factors, caps and floors. The asymmetry was originally introduced as a measure to accommodate the unpredictability of the first year of BETTA operations. Scotland has now been part of the trading arrangements for some time, and we consider that there should now be a return to equality in the risks and the rewards of the scheme.

Question 1. Do you consider that it is appropriate to have a form of indexation for external costs to wholesale electricity prices? If so, do you consider that the merits of this approach outweigh the additional complexity?

Centrica agrees with the view expressed in the consultation document that the principle of indexation of external costs is worthy of further consideration. However, no detail relating to how the indexation would work in practice has been provided, and there would need to be a robust and transparent methodology developed and agreed. It is difficult to come to a conclusion on the complexity and benefits of indexation until more firm proposals are put forward for industry to assess.

In order to minimise complexity and cost, it may be possible to use existing industry flows and data to calculate the indexation. For example, the 'reverse' price used in the BSC cashout calculations could be used as a basis for indexation as a proxy for market price. We do, however, recognise that at present it is designed to only represent the spot market up to 20 hours away from gate closure, and with a limited number of products. Any use of the reverse price as it currently stands would therefore not be representative of the whole market, and we would suggest amending the calculation (for this purpose only) to include all products and all timebands.

The method and frequency of indexation should also be examined – i.e. whether the adjustment calculation would happen once at the end of the SO incentive scheme on an average annual price, or on a more frequent (monthly) basis. We would prefer the latter, as the average index prices would be more reflective of market conditions throughout the year, and it would become clearer through the year which direction, if any, the indexation was going to move the target.

Question 2. If you consider that a form of indexation to wholesale electricity prices is appropriate, please give your views on the components of NGET's external costs that should be covered by indexation.

It is Centrica's view that unless there is a compelling reason not to, all external cost components should be covered by the indexation. Changes in wholesale electricity prices will have at least a knock-on effect on the majority of the components of the IBC forecast.
Furthermore, because there is only a single IBC target and not a more transparent 'unbundling' of the target, it may be more appropriate to keep a single indexation methodology.

Question 3. Do you have any views on a possible approach of indexing through the use of a 'price risk band', which would adjust the IBC target only if wholesale electricity prices moved outside the price risk band, and any comments on the appropriate size of such price risk band?

Centrica does not believe that a price risk band would be appropriate, and that a 'sliding scale' approach to indexation would be more equitable and workable in practice. Any size of risk band, whether a fixed amount or a percentage of total target, would be an arbitrary figure and impossible to justify over other possible levels. There would be no objective criteria for reviewing the band and whether it should be changed or retained from one year to the next. We can also foresee situations where, for example, NGET's expenditure could turn out to be 19.99% away from their target, but because the risk band was set at 20% no action could be taken.

We would suggest that if a system of indexation is to be used but Ofgem still want appropriate incentives in place for NGET to manage risk, then a non-linear indexation curve could be used as a solution. The further away wholesale prices are from the initial forecast, the greater the change in target would be, but there would be no step change at an arbitrary point. We believe that a symmetrical upside/downside curve would be most appropriate and equitable.

Question 4. Do you have any comments on whether the current IAE licence provisions are appropriate, or whether they should be amended, and if so, how?

Centrica sees the IAE process as a valuable tool for retrospectively amending targets in unforeseen or particularly unusual situations. However, the current mechanism does not provide the requisite level of transparency for it to be a true two-way mechanism and enable participants other than NGET to raise IAEs. This ensures that the benefits are only available to NGET. Any method of resolving this situation, either by a change to the licence provisions or by implementation of a ‘deep’ incentive scheme, would be much more equitable and in line with the intent of the IAE provisions.

Question 5. Do you have any comments on NGETs overall forecast of, and assessment of drivers related to, external SO costs it expects to incur in 2007/2008?

In last year’s round of SO incentive scheme consultations, NGET revised its estimates of wholesale electricity prices upwards as it became clear that forward prices were rising ahead of the scheme. We hope that a similar exercise will be undertaken this year with the opposite effect. Gas and power forward prices are currently trading at a significantly lower level than those used by NGET in its forecasting, and we expect this pattern to continue.

We would see the uncertainty in the forward price of wholesale electricity as a possible argument for a system of indexation, as noted in our response to Q1 above.

Recent changes in the BSC cashout rules also suggest that balancing costs should reduce significantly. In its decision letter for BSC Modification P194, Ofgem stated that they expected balancing costs to reduce by £120m in an average winter under a P194 regime, and up to £180m in a 1 in 50 winter. Only £2m of P194-related reduction in the IBC target is mentioned in the SO incentive scheme consultation document. We would be interested to know why there is this discrepancy and why in footnote 27 Ofgem mentions a figure of £13m of savings – significantly lower than in previous analyses.

We acknowledge that under a similar methodology applied to the recently approved P205 regime, these savings are likely to be lower than £120m. The signal for Parties to balance their own position under P205 is less than under P194, but a much stronger signal than prior to P194 still exists, particularly at times of system stress. We would expect a much greater and explicit reduction in costs to be attributed specifically to P205 and subtracted from the IBC target, given the conclusions of the previous Ofgem analysis on P194.

Question 6. Do you have any comments on NGET’s forecast increases in Ancillary Services costs in 2007/08?

At the present time we are seeing an ongoing increase in frequency response costs as the period of price discovery continues. We expect this increase to continue further before stabilising after the 2006-2007 winter period. Under the current frequency response procurement methodology, therefore, NGET’s forecast of a small increase would seem reasonable. However, we do have concerns that NGET may not be procuring frequency response in the most economical way possible, and that it is not always clear why NGET instruct frequency response from particular participants out of price order. There may, therefore, be scope for costs to be reduced by examining the efficiency and equitability of the procurement strategy.

In terms of standing reserve costs, we note Ofgem's comment that there are 'reasonable prospects that the actual level of standing reserve costs… could be less than its [NGET's] initial forecast', and hope that this belief will feed through into revised forecasts.

We also note the recognition of double counting with regard to forecast warming costs and agree with the recommendation to reduce the costs by £5m

Question 7. Do you have any comments on our preliminary view that there are good prospects for external SO costs incurred by NGET in 2007/2008 to be less than its initial forecast?

Yes. There is scope for a reduced forecast based on the likelihood of lower power prices in particular; but also the double counting of warming costs; Ofgem's belief that standing reserve costs will reduce; and more efficient frequency response procurement. We believe that the IBC target should be a challenging one and should continue to put downward pressure on overall cost. There is no point in having an SO incentive scheme in place at all unless it places pressure on the SO to improve its performance, in this case by reducing costs.

Question 8. Do you have any comments on whether there are any further potential rule amendments that might assist in placing further downward pressure on prices for Ancillary Services?

We supported CAP047 in the belief that frequency response prices would be reduced as a result of its implementation, whereas in fact the opposite has been the case. If this trend continues into 2007, then it may be necessary to review the CAP047 mechanism.

Question 9. Do you have any comments on how internal Scotland constraint costs might be best minimised during the 2007/08 external SO incentive scheme?

We are disappointed that NGET do not offer any additional solutions to resolving the internal Scottish constraints issue and only make reference to outages as a factor in cost. Our main concerns are over the fact that one power station appears to be so integral to the management and alleviation of constraints within Scotland, and also that the contract that NGET managed to procure last winter was in the context of them being a 'distressed buyer' and therefore may not have been on the best available terms. We would hope that this contract is subject to significant regulatory scrutiny in order to give comfort to Ofgem and the industry that effective and fair competition is being maintained in the market.

Question 10. Do you have any comments on whether the current IAE licence provisions are appropriate, or whether they should be amended, and if so, how?

Please see response to Q4 above.

Question 11. Do you have any comments on NGET's overall forecast of internal operating and capital SO costs it expects to incur between 2007/08 and 2011/12?

The forecasts appear to be reasonable, although we note and approve of Ofgem's comments relating to savings in capital expenditure, and the adjustments made for wage growth and insurance costs.

Question 12. Do you have any comments on our preliminary view that the efficient level of opex over the duration of the incentive scheme is £251.5m?

Please see response to Q11 above.

Question 13. Do you have any comments on our preliminary view that the efficient level of capex over the duration of the incentive scheme is £47m?

Please see response to Q11 above.

Chapter 4 - Gas SO cost and volume forecasts

General Comments

As stated above we favour a longer-term approach to the setting of Incentives in order to provide consistency. Therefore we welcome the exercise which will be carried out during 2007 in order to set this in the longer term from April 2008.

Although we recognise that it is a decision made, we are disappointed that the Linepack incentive is to continue. As stated in our previous response, there are operational reasons why the SO would actively preserve linepack and to reward this stance through incentives is, in our view, unnecessary.

Question 1: Do you have any comments on whether the current IAE licence provisions are appropriate, or whether they should be amended, and if so, how?

In common with our views with regard to NGET's incentives above, Centrica sees the IAE process as a valuable tool for retrospectively amending targets in unforeseen or particularly unusual situations. However, the current mechanism does not provide the requisite level of transparency for it to be a true two-way mechanism and enable participants other than NGET to raise IAEs. This ensures that the benefits are only available to NGET. Any method of resolving this situation, either by a change to the licence provisions or by implementation of a 'deep' incentive scheme, would be much more equitable and in line with the intent of the IAE provisions.

Question 2: Do you have any comments on NGG's shrinkage volume forecast for 2007/08?

On a practical level, there are some concerns about the manner in which shrinkage volumes are assessed. Of necessity, these are influenced by experience and we question the validity of a direct application of this information. There have been a series of mis-allocations of "unaccounted for gas" (UAG) which could affect the calculation of the relevant values for shrinkage volumes. The incentive should be based upon a realistic, if challenging, objective to reduce costs to the industry and thereby enable the SO to experience a part of the benefit. The assessment by an independent body (TPA) is welcome in this respect as this provides an informed insight.

Question 3: Do you have any comments on our preliminary view on the appropriate shrinkage volume for 2007/08?

Following on from the above, we believe that the Ofgem preliminary view sets a challenging but realistic target which if beaten warrants an incentive.

Question 4: Do you have any comment on which of the low, central and high case forecasts presented by NGG and in our preliminary views is the most appropriate basis for the system balancing gas cost incentive scheme target?

In respect of OUG, we believe it is reasonable to apply a significant reduction to reflect the changing pattern of deliveries of gas to the system. For reasons sated above we believe that to simply apply UAG from experience unadjusted would be inappropriate.

Question 5: Do you have any comment on NGG's gas reserve volume forecast for 2007/08?

Question 6: Do you have any comments on our preliminary view on the appropriate gas reserve volume for 2007/08?

We concur that there is real potential for over provision to allow for co-incidence of requirement. In reality, the likelihood of this co-incidence is very low. Therefore the exclusion of this over provision is prudent. In keeping with the anticipated use of OUG reflecting the changing pattern of deliveries, this also affects the requirement for OM gas. The creation of Entry points at parts of the system previously considered at the extremity means that less is required for system support.

Question 7: Do you have any comment on which of the low, central and high case forecasts presented by NGG and in our preliminary views is the most appropriate basis for the system balancing gas reserve incentive scheme target?

Question 8: Do you have any comments on whether the current IAE licence provisions are appropriate, or whether they should be amended, and if so, how

Please see response to Q1 above.

Question 9: Do you have any comments on NGG's overall forecast of internal operating and capital SO costs it expects to incur between 2007/08 and 2011/12?

Although there appears to be very limited scope to achieve additional economies, if some further efficiencies have been identified then these amounts, even if modest, should be removed.

Question 10: Do you have any comments on our preliminary view that the efficient level of opex over the duration of the incentive scheme is £122.1 million?

Given the comment at 9, the absolute reduction is small

Question 11: Do you have any comments on our preliminary view that the efficient level of capex over the duration of the incentive scheme is £41.5 million?

We note that a significant factor contributing toward the capital overspend between 2001/2 and 2006/7 was system development, Ulysses and Gemini. Our experience of the system development, particularly of Gemini was not effectively, or efficiently, project managed. Principally, with this in mind we support the disallowance proposed. In a similar vein, we welcome the more enlightened approach to procurement of a modelling package provided by TPA. It is regrettable that it requires this external intervention to realise this saving.

We trust that these comments are informative and of use in deciding upon the structure and form of the incentives package for NGET and NGG for the period of 12 months from 1 April 2007. We look forward to the Initial Proposals to be published shortly. We also anticipate playing an active part in the discussions of the longer term Incentive Arrangements during 2007.

Please contact me if you require any further information.

Yours sincerely,

Mike Young

Commercial Manager