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taking care of the essentials

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Our Ref. SO Incentives
Your Ref.
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Dear Sonia

Please find below Centrica's response to the National Grid Electricity Transmission and National Grid Gas System Operator Incentives from 1 April 2007 consultation. Centrica welcomes the opportunity to comment on these proposals, and we would be happy to discuss our comments in greater detail if necessary.

NGET – Electricity SO Incentive Scheme

Q1: *What are your views on NGET's revised forecast of £458m? In particular, do you consider that there are any areas where NGET is being risk-disposed or risk-averse in its assessment of costs? Alternatively, do you consider that there are any drivers of cost that NGET has not identified?*

We believe that the revised forecast of £458m is too high, and there is considerable scope for a further reduction, particularly given NGET's recent revision in its outturn forecast for 2006-2007 to £470-480m, as stated at the Balancing Services seminar on 10th Jan 2007. Wholesale prices have continued to reduce as we have come into winter, and we expect that this trend will continue given greater market confidence in fuel supply and plant margin.

Forward baseload prices are currently running at less than £30/MWh for most of 2007, and so we believe that the base price assumptions used by NGET are still too high, as they were based on a £43/MWh baseload price - a difference of more than **40%**. NGET also state in their analysis that 'the key factor behind these movements [forward power prices] is the forward wholesale price for gas'. It is also the case that gas prices are currently low, and expected to remain so for the reliably foreseeable future. Ofgem's assessment is that a £1/MWh increase in wholesale power costs equates to a £3-4m increase in costs, and there is no reason to assume that this should not be the same in the reverse scenario.

We therefore agree with Ofgem's assessment that there is 'further room for reduction of the IBC forecast'. It is essential that the IBC target is challenging, and forces NGET to strive to reduce costs to the industry. All the market fundamentals seem to suggest that balancing costs should reduce. The arguments that have been put forward in recent years to justify cost increases should put downward pressure on current forecast costs, yet we see continuous increases in BSUoS.

Our forecasts suggest that Ofgem's proposal of an IBC target of £430m is reasonable, and in fact at the upper end of our expectations.

Q2: *In this chapter we identify areas where we believe that NGET has over-forecast its costs. Do you agree with our assessments? Please provide as much analytical detail as possible in your response.*

We do agree with Ofgem's assessment of NGET's over-forecasting, and address each area in our responses to Q1, Q3 and Q4.

Q3: *Within NGET's forecast a continued area of increasing cost is mandatory frequency response costs. What do you consider to be the drivers of costs for frequency response? What impact do you consider that CAP107 will have on these costs? Do you believe there is scope for cost reductions as competition is established in this area?*

We believe that a clearer picture on frequency response may emerge after the current winter, when CAP107 should begin to have a dampening effect on holding prices. We also believe that there is scope for examination of the process to examine whether NGET, on occasion, instructs response from particular participants out of price order. We do not anticipate that frequency response costs will continue to rise as they have over the past 12 months, and so we agree that NGET has overstated its forecast for 2007-08.

Q4: *NGET is forecasting that constraint costs will continue to be of the order of £81m. Do you consider that there is any scope for reductions in these costs? In particular, do you consider that with falling wholesale gas prices there should be a reduction in within-Scotland constraint costs?*

We are surprised to see a forecast increase (albeit small) in constraint costs. With NGET having had sufficient experience in managing constraints post-BETTA, and in particular having had experience of last winter, we believe that constraint costs should be reducing for 2007-2008. In the IAE submitted for 2005-2006, NGET claimed that it had been, in effect, a 'distressed buyer' of services in Scotland to alleviate constraints, and this should no longer be the case. We agree that constraint costs for 2007-2008 should be considerably lower than those forecast by NGET. We would also expect a reduction in constraint management costs with the reductions in wholesale energy prices, and strongly agree that if outturn Scottish constraint costs remain too high, Ofgem should conduct an investigation into the underlying reasons and any potential abuses of market power.

Q5: *In November, a significant change was introduced to the electricity cashout arrangements (P205). What is your assessment of the impact of this change on NGET's* *forecast level of costs? Please provide as much analytical detail as possible in your response.*

We are very surprised not to see a mention of the significant modification P205 in NGET's analysis of potential for reduction in balancing costs. Ofgem stated in their decision letter that they expected to see £120m of balancing costs savings under P194 – even under a conservative estimate of 50% of the impact of P194 under P205, there are still £60m of savings which have not been taken into account. The sharper signals given by P194/205 should, it was always argued by NGET, give a stronger signal to participants to balance their own position, therefore reducing NGET's need to intervene to balance the market. We would have expected NGET to present data showing how P205 has improved the efficiency of the balancing regime, and if not, why that might be and why it does not have an impact on the overall IBC cost.

Q6: *Do you think it is appropriate that we take into account the then current wholesale market conditions when setting the IBC target in the final proposals?*

Yes, the most up to date view of wholesale market conditions available should be used. This view should also include longer-term consideration of the likely state of the market further down the line.

Q7: *What do you think is an appropriate level of IBC for 2007-2008?*

As stated in our response to Q1, we believe that Ofgem's estimate of IBC for 2007-2008 of £430m is reasonable, albeit at the higher end of our expectations given the current and expected market conditions.

Q8: *Do you have any comments on our indexation analysis? Specifically, do you support the way in which indexation has been applied in the option we have proposed? Do you have any comments on our approaches to determining the adjustment factor? Are there any alternative approaches that we have not considered? Do you have any comments on the deadband size?*

The fact that there is currently an overall IBC target, rather than our preferred option of a 'deep' incentive scheme, with different targets for different IBC components, means that there should also be an indexation applied to the overall IBC target, as suggested by NGET. Any attempt to separate balancing actions into 'system' and 'energy' has, in past experience, derived an insufficiently cost-reflective solution. We also do not necessarily agree with the assertion that 'actions that NGET undertakes for energy reasons would be expected to change with movements in wholesale prices whereas system related trades would not'.

The size of the deadband is by its nature somewhat arbitrary, but we agree that NGET should be capable of managing the risk of small changes in wholesale price, and 10% seems like a reasonable level at which to set a deadband.

Q9: *What are your views on the four proposed options?*

While we would have hoped that there would be an option for equal sharing factors applicable to both NGET and the industry, we believe that Option 3 offers the best balance between a challenging IBC target, and the levels of risk and reward.

Q10: *Do you agree with our views on IAEs going forward?*

We believe that there are more fundamental issues with the IAE process than those suggested by Ofgem's 'do nothing' approach. As noted in the consultation document, most respondents stated that the provisions are not equitable, and that there is an information asymmetry favouring NGET. These issues still need resolving.

We do agree that if the provisions remain the same and indexing is introduced, NGET should only be able to raise IAEs on those issues outside the indexation.

Q11: *Do you have any comments on the draft Terms of Reference for a review of the external SO incentive scheme contained in Appendix 12?*

We believe that the ToRs should include consideration of IAEs, and the mechanism whereby NGET can reject the scheme if it does not consider that it is going to be financially advantageous.

Strong consideration needs to be given to whether it would be more efficient overall to implement a long-term incentive scheme, or whether a 1-year scheme is more flexible and able to adapt to changing market conditions.

Q12: *Do you agree with our Initial Proposals for levels of internal opex, capex, tax and pensions allowance?*

The initial proposals seem reasonable.

Q13: *What are your views on implementing fixed sharing factors for internal capital expenditures? If so do you have a view on the level of these sharing factors? What are your views on the alignment of the operating expenditure sharing factors?*

We believe that all sharing factors should be equally balanced, and could also be fixed for internal capex and opex.

Q14: *Do you think incremental internal costs associated with modifications to commercial frameworks (e.g. BSC) should be remunerated through the existing IAE provision or via a more automatic cost recovery process built around enhanced cost reporting and accountability to industry through the existing commercial frameworks?*

It is difficult to see how a transparent and accountable cost recovery system could be implemented without an IAE-style appeal going through consultation and a robust Ofgem decision-making process. We do not see that a monthly industry update would be transparent enough, nor give enough scope for consultation and/or comment from participants.

<u>NGG - Gas SO Incentive Scheme</u>

Q1: *Do you agree with the proposed introduction of a new incentive to limit emissions of methane from the NTS from April 2007, and link this incentive to the prevailing price of carbon?*

We can see the merit of applying an incentive to limit the emission of methane given the impact on the environment. However, we would advocate this being very closely aligned with the incentives on Shrinkage. The regulated party must not be in a position to receive a double benefit from the reduction of gas escaping to atmosphere. This issue is more closely linked to LDZ Shrinkage as it has always been assumed that the NTS does not allow gas to escape to atmosphere.

Q2: *Do you agree that the scope for all other components should remain the same as previous years for the external gas SO incentives?*

We agree that the scope of other components should remain the same. This is particularly the case if a more general review is to be undertaken in the near future.

Q3: *Do you agree with our proposal to vary the target for gas shrinkage on the basis of actual (2007/08) flows through St Fergus?*

Yes. This reflects change in pattern of flows across NTS and the reduced need to compress gas for movement from far north of system.

Q4: *Do you consider the proposed volumes for the shrinkage targets to be appropriate?*

We believe this is appropriate given that the pattern of gas flows has changed

Q5: *Do you consider it is appropriate to retain the existing gas reference price methodology for the gas shrinkage incentive?*

At this stage in the process, we concur that it is appropriate to retain the existing arrangement, applying a gas reference price for shrinkage. A more fundamental review may identify more appropriate arrangements going forward.

Q6: *Do you agree with our proposed target for gas reserve, and our intention to undertake a more fundamental review of this incentive in 2007?*

As we were one of the parties holding the opinion that there is multiple provision of reserve, we do believe that there is scope to reduce this provision. There is some comfort to learn that the area will be within the more fundamental review but until this is revised the incentive will not be effective in exercising the SO performance.

Q7: *Do you agree with our proposal to review the reference prices that apply to the gas reserve incentive?*

We concur that if we are to move to a market-based pricing for system reserve, then it is a logical interim step to adopt the C3 price as a minimum but linked to a suitable market for storage services. This should ensure that the value of the service is not undermined.

Q8: *Do you agree that, where market prices exceed reference prices for gas reserve, that the SO should pay these higher prices for OM gas?*

This specific point is a direct consequence of application of market-based arrangements to the SO. This is an important element of the incentive to ensure that the SO secures the appropriate quantity at the optimum time. With the circumstances which presently apply it is appropriate to retain the sharing factors, caps and collars remain unchanged at this time.

Q9: *Do you agree with our initial proposals to retain the existing form of the residual gas balancing incentives?*

We have previously stated that we believe that the Linepack incentive is of very limited value as the SO will have a strong incentive to maintain linepack for operational reasons. We do not believe that this financial reward provides any further stimulus and do not support the retention of this incentive.

With regard to the price incentive, this does provide appropriate reward and exposure although we concur that a review may result in better arrangements. Such a review must be undertaken in a clear methodical manner to ensure that it continues to provide appropriate incentive and avoids unintended and unforeseen consequences.

Q10: *Do you have a view on the most appropriate form for the quality of information incentives in 2007/08? Do you consider these incentives should be revised in light of NGG's performance over winter 2007/08?*

Although we support the application of incentives to the provision of information, we believe that the current structure is of low value to the industry as a whole. We have previously stated that the accuracy of demand forecast, although focused upon the right area, does not reflect the true effect of the impact of variations in within-day demand caused by these errors. With regard to the Timeliness and Availability of NGG Website, the availability measure is easily attained and does not test the SO's ability. The timeliness aspect is not yet proven as even where there are figures provided by the due target, it has not always reflected the true position. More time is needed to assess whether there is a value in the continuance of this incentive. It should be noted that NGG have already processed two Modification proposals that change the timescale on which information is required under UNC. A number of respondents to the consultation have pointed out that this is likely to have a detrimental effect upon data quality.

Q11: *Do you agree with our views on IAEs going forward?*

We recognise that there is a continuing role for Income Adjusting Events, not least in the consistency of treatment of gas and electricity and controls. However, we also share the concerns about the lack of transparency around the process and the data considered. We would also recommend the facility for a User to propose an IAE. We welcome the development of an improved process further forward.

Q12: *Do you agree with our Initial Proposals for internal costs?*

We have no particular issues to raise with the internal costs proposals.

Q13: *Do you agree that we should implement fixed sharing factors for internal capital expenditure? If so what should the level of the sharing factors be? Should the operating expenditure sharing factors be aligned with the capex factors, or aligned to the external incentive?*

Q14: *Do you think incremental internal costs associated with modifications to commercial frameworks (e.g. UNC) should be accommodated through the existing IAE provisions or via a more automatic cost recovery process built around enhanced cost reporting and accountability to the industry through the existing commercial frameworks?*

We have a number of concerns about the manner in which internal costs arise from modifications to the UNC. Whilst we can see some merit in automating a cost recovery process it is difficult to envisage a mechanism sufficiently sophisticated to cater for the multitude of variables. Modification Proposals that entail significant commercial change will usually require an Impact Assessment. Whilst this is primarily intended to identify the overall costs/benefits to the industry as a whole, it would be a reasonable development of this process to assess the impact upon NG's internal cost where thought to be significant. We are particularly concerned that in a presentation to Transmission Workstream in January, NGG indicated that a sum of £0.25m was included within the baseline for internal costs of this nature. Given that Modification Proposals will often result in systems changes, this provision does seem particularly low. A specific example demonstrating the level of costs associated with Modification Proposals is that of Proposal 006 where NGG indicated that their costs were high but these figures could not be validated by Users or the Regulator. Whilst we welcome the increase in transparency that this would bring about and provide clear accountability to the industry, through its workstreams, this threshold does seem to have been set at a level where there is scope to pass costs, which would normally be regarded as part of the SO operation and development, on to Users.

Please do not hesitate to contact me if you need any clarifications or details relating to this response.

Best regards,

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