



*taking care of the essentials*

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Our Ref.  
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Dear Philip,

**RE: Review of Electricity and Gas System Operator Role, Functions and Incentives: Initial Thoughts Consultation**

Centrica welcomes the opportunity to comment on the issues raised in the review of the Gas and Electricity System Operator. This response is on behalf of the Centrica Group excluding Centrica Storage Ltd. There is no confidential information contained within this response. We attempt to answer each of the questions posed in the consultation document where appropriate, although there are some areas of overlap and so some of the questions may not be individually addressed.

**Chapter 2 – System Operation in the Electricity Market**

If there is a main theme of our response to the electricity SO consultation, it is around the provision of market information. There are some areas in which it is difficult to give a full response to a question because the industry does not have sight of the underlying data or information; and there are certainly areas in which more effective provision of market information would lead to a more efficient outcome overall.

**Q1. Do the current roles and functions of the SO ensure that the SO is able to operate the electricity transmission system in the most efficient and economic manner? If not, what changes do you consider should be made to the roles and functions of the SO such that it is better able to operate the electricity transmission system in the most efficient and economic manner?**

It is a fundamental tenet of NETA/BETTA market design that there is a monopoly system operator to perform the residual balancing function post gate closure, and due to the monopolistic nature of the role, it is naturally difficult for participants to accurately assess the performance of the SO on an objective basis. There is no independent comparator to use as a benchmark. Given this situation, it is imperative that as much information as possible is in the public domain relating to the operation of the market, the conditions that affect the market and the activities of the SO, so that participants and others can make a reasonable assessment of how the SO is performing. We are generally comfortable with the remit of the SO and the functions that it performs in the market. However, in order to give a full assessment of its efficacy, more information is needed about how it operates. We recognise that some of this information may be commercially sensitive, but openness and transparency should be encouraged as far as is possible. Where disclosure is not made and

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redaction is used, this should be justified on a case-by-case basis and kept under review to ensure the approach remains appropriate.

**Q2. Do you consider that it is appropriate that only the SO can propose modifications to the Statements that the SO is required to have in place under C16 of its transmission licence? Do you think that market participant should also be able to propose modification to these Statements and should they sit elsewhere, for example in the BSC?**

We would give qualified support to allowing all users to propose charging statements methodology changes. Open and inclusive governance is a positive driver of a successful market, and there may well be insights that users could offer that would be beneficial to the industry as a whole. However, care should be taken and, if the ability to propose changes was allowed, strict guidelines should be created in order to prevent a flood of proposals that benefited only particular users, or classes of user. We would not want to see, for example, proposals as divisive as the zonal losses suite have been in the BSC. As long as participants' proposals to change the charging methodology are tested against the relevant objectives and ultimately approved by the Authority, we would not rule out including the charging Statements elsewhere such as in the BSC. In this regard we would support market participants in raising Statement modifications, and support the movement of these Statements in areas where users can actively participate in raising changes.

**Q3. Do you consider that the costs incurred by NGET in its role as electricity SO represent the costs that would have been incurred by an economic and efficient SO? Are there particular areas where you consider that NGET has not incurred costs economically and efficiently? If so, please provide details.**

However economic and efficient the SO has been or will be, there will always be a view from some quarters that their costs could be reduced. We certainly believe that there are areas in which savings could be made, however, this is difficult to prove due to the limited data available. For example, there is little visibility of the actions that the SO is taking to manage transmission constraints on a real time or even post-event basis. Some conclusions can be drawn from examining BM information, but this is one of the key areas in which transparency could be improved. There is crossover into the BSC and the Ofgem cashout review as well – the assertion during the cashout review is that there are constraint actions feeding into cashout prices, but the participants in these reviews have found it difficult to quantify this perceived defect, as the information that would prove this (or otherwise) is not available to the market. We see the actions that the SO takes but are left to draw our own conclusions as to the reasons behind the actions. The provision of more information would allow participants to manage their risk more appropriately and efficiently.

**Q4. Do you agree that through BSUoS is the most appropriate way to recover the costs incurred by the SO? If not, please provide details of how these costs should be recovered.**

Yes. The socialisation of SO costs is appropriate, as it would be extremely difficult to apportion 'blame' for the costs of actions that the SO takes. Parties already face a 'polluter pays' principle in the BSC cashout mechanism, and this provides sufficient and appropriate incentives around plant reliability, self-balancing and security of supply.

**Q5. Do you consider that previous SO incentives schemes have been effective in ensuring that NGET as SO has operated the electricity system in an efficient and economic manner and managed the external costs of operating the system effectively? To what extent was the increased level of system operation costs incurred by the SO in 2006/07 attributable to the absence of an incentive scheme for that period? Please provide details of any areas where you consider that the SO incentive schemes have not been effective.**

We were pleased to see in the last incentive scheme that the equality of sharing factors was re-introduced, and also the use of a 'deadband' is a reasonable concept. We see one of the fundamental problems of the SO incentive scheme as being the ability of the SO to reject the scheme if they do not believe it to be in their best interests. This undoubtedly leads to a sub-optimal solution, where Ofgem only make an offer to the SO that they know is palatable enough to be accepted. The SO incentive scheme should be binding and challenging. While a truly

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challenging target is difficult to set if the threat of rejection is there, the determination of the SO should not deter Ofgem from its intent of having a demanding incentive scheme put forth and accepted by the SO. The necessary steps should be taken by Ofgem so that the SO accepts the appropriate challenging incentive scheme.

It is true that SO costs increased in the year in which there was no SO incentive scheme. However, it is difficult to attribute this increase entirely to the SO not having an incentive to reduce costs, as it coincided with a large increase in wholesale energy costs. We were extremely disappointed to see that the promised 'increased scrutiny of the SO's actions' by Ofgem did not lead to a published report, presentation or any view to industry of Ofgem's opinion of how the SO performed during that year. We cannot answer the question of whether the SO acted efficiently or not during this time as we have no information on which to base our view.

The SO stated in one presentation that they would not have acted differently in any case had there been an SO incentive scheme, which does beg the question of the value of the scheme, if it is not tough enough to challenge and incentivise. We firmly believe that a challenging target is not one that should be negotiated by the SO, it should be imposed by Ofgem on the SO given a robust, quantitative analysis of the information available.

**Q7. Do you consider the use of the Net Imbalance Adjustment to be an appropriate way of adjusting for the costs resulting from market participants' actions that the SO has little control over? If not, how could this adjustment be improved?**

The concept of a Net Imbalance Adjustment is valid, as NIV will reflect the energy imbalance for each half hour, caused by parties and therefore unmanageable by the SO. However, the current calculation of the NIA adjustment is not appropriate. The costs that the SO incurs to manage energy imbalance are those of bids and offers taken in the BM. However, the NIA calculation takes the volume of NIV and multiplies it by two arbitrary figures, -0.5 and 2.5 – which are presumably designed to reflect the asymmetric costs of balancing a long and short market but in fact ensure a non-cost-reflective solution is reached for each settlement period. It would be much more cost-reflective to use the actual Bid and Offer prices that the SO used to balance the system, so we would suggest that the actual volume-weighted costs of the Bids & Offers currently deemed as 'energy actions' in the BSC imbalance price calculation (i.e. after all tagging mechanisms except PAR tagging have been applied) are used instead. There is no need to use proxy numbers as the actual data is available.

**Q8. Is it appropriate for participants (including the SO) to have the ability to raise Income Adjusting Events when unexpected events occur resulting in increased or decreased costs? If not, how could such cost uncertainties be addressed under an incentive scheme?**

While we have concerns about the detail of some of the IAEs that have been approved in previous schemes, the concept of adjusting income after a significant event is not wholly unpalatable. Care should be taken, however, to use this adjustment only in a very small number of instances and where it is clear that there was no way that the SO could have foreseen the issue arising. It should not be used in situations where issues have been known but poorly managed – i.e. transmission constraint resolution.

This is also another area where the lack of market information ensures that the IAE process is very one-sided. While the industry has the power to raise IAE's, there is insufficient information emanating from the SO in order to enable participants to do so. This should be remedied to ensure symmetry of incentives.

**Q9. Do you consider that the costs of operating offshore networks should be included in the SO incentive scheme? Are there any other additional elements that you consider should be included? Are there elements that are currently included in the scheme which should be removed?**

If the SO role is extended to cover offshore networks (and we believe that it should be, with some reservations about bidding for offshore TO roles), then it should naturally be included in the SO

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incentive scheme. We do not believe that there are any special considerations that apply specifically to offshore system operation, which might suggest that there would be a separate scheme for offshore.

**Q10. Do you think it is appropriate to consider unbundling the electricity SO incentive scheme? If so, which areas do you consider should be separated out and how might the SO be incentivised in these circumstances?**

We believe that there is scope for separating out the incentives for the costs of managing system issues (as distinct from the fixed costs of personnel, IS etc). The fixed costs could be managed on a longer-term basis, for example on an RPI-X basis, whereas the costs incurred in managing the system could be kept on an annual incentive scheme as they are much more volatile. This would give some additional visibility and stability of costs over a longer term. It is possible that a longer-term incentive plan would lead to more long-term investment decisions by the SO, bringing an overall benefit. However, we would want to avoid a situation whereby the incentive scheme was being opened up every year, or a larger number of IAEs were being raised, because the scheme in place was unrepresentative of the issues currently being faced in the market. Any longer-term view of SO incentives should not address the IBC costs, as these will be liable to change on a much more frequent basis than the remainder.

**Q13. What are the key developments that will affect future System Operator costs? How will these developments impact on costs?**

There is a list of future issues in the consultation document, which we believe covers the major drivers of industry and SO-related change over the next few years. A number of these are contingent on change, and it is difficult to quantify the exact impacts without yet knowing what those changes might be. It seems likely, however, that growth in renewables and revision of transmission access arrangements will have a large impact on SO behaviour and costs. We see the challenge for these future developments as not necessarily the costs incurred by the SO under the new regime; but rather the cost-reflectivity of the charges coming through BSUoS. Our answer to Q4 above may be different in future years if, for example, costs that can be solely attributed to specific new generation coming on stream in constrained areas are socialised.

**Q14. Are there areas in which the current transmission losses incentive scheme could be enhanced to improve further the incentives on the SO to operate the electricity transmission system in an efficient and economic manner?**

We do not believe that there should be a specific transmission losses element to the SO incentive scheme. It is impossible to say how much of the losses on the network can be attributed to SO actions and how much to participant actions or siting decisions. The SO has a general obligation to manage the system economically and efficiently, and having general consideration of losses is part of that. However, to have a specific incentive is not appropriate and our belief is that it should be removed altogether. It could be seen that the SO might also have a conflict of interest were it to provide a particular strong view on any BSC losses modifications, for example, although we note that they maintained a relatively neutral stance during the losses deliberations.

**Q15. What additional market information do you consider should be made available to the market by the SO, and vice versa? Please explain how this information would improve system operation and market efficiency.**

We believe that there is additional information available to the SO and to Ofgem relating to the management of the system that is not presented to parties. Ofgem in particular has a specific remit to monitor the market, and so it would be useful for them to provide views of how the market is operating in general, for example at NG's operational forums. This might allow flagging of issues that are not currently visible to participants, and also allow parties to conduct their own analysis.

The most useful additional information that the SO could provide is probably around management of transmission constraints – either on a real time or an ex post basis. As mentioned above, this would enable parties to have a better insight into where costs are occurring, how they are being managed, and then make appropriate and efficient pricing and investment decisions. There are

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also some specific issues that we have raised in our response to NG's consultation on market information provision.

**Q16. Is there sufficient transparency surrounding the SO incentives both in terms of the process for setting the incentive parameters and in terms of the information on costs provided by NGET? If not, what additional information do you consider should be made available?**

The work that Ofgem performs prior to the setting of SO incentive schemes is useful for helping participants understand the process behind the setting of incentive levels, although there is naturally a certain amount of guesswork involved as NG still have the ability to reject the scheme and so a certain amount of negotiation (and therefore opacity) is inevitable.

There is also a certain lack of clarity in terms of some of the SO's costs, although we recognise that some of this (for example with constraint management) is due to commercial confidentiality considerations. However, we would hope that Ofgem exercises its obligations relating to regulatory oversight of such transactions, and should provide greater certainty for the industry in terms of the appropriateness (or otherwise) of the SO's contracting strategies.

**Q17. Do you consider it appropriate that the electricity SO should have quality of information incentives placed on it (as is the case with the gas SO)? If so, how should the SO be incentivised?**

Centrica does not believe that there is a need to incentivise the SO to provide accurate information. There is a built-in incentive already – the better the information that the SO publishes, the more appropriate the behaviour of market participants. It is already in the SO's best interests to publish accurate and timely data and we do not see the need for a formalised incentive. However, as above, we do believe that there is a requirement for a more formalised obligation in terms of actual reporting and transparency.

### **Chapter 3 – System Operation in the Gas Market**

**Q18. Are the current roles and functions of the SO appropriate, and do they ensure that the SO is able to operate the NTS in the most efficient and economic manner? If not, what changes would you recommend?**

Centrica believes that the SO is currently more focused on the incentives themselves rather than efficient and economic operation of the system. Therefore provided the information which the SO uses in order to make decisions is also made available to shippers, the SO should be given more freedom to act as they see fit. If shippers then believed that the actions taken by the SO were not efficient and economic they could make representations to Ofgem in order to force investigation afterwards.

**Q19. In the electricity market the SO as residual balancer is able to contract ahead for various services. In the gas market the SO as residual balancer does not have the same ability. Do you consider that this difference is appropriate? Please explain your view.**

Centrica believes that it would be reasonable to allow the SO to contract ahead for services which it believes may be required. There are, however, issues to be addressed in terms of the correct structure of option and exercise fees and also verifying, in real time, that the service has been provided when the option is exercised.

**Q20. Do you consider that the costs incurred by the SO represent the costs that would have been incurred by an economic and efficient SO? Are there any particular areas where you consider that the SO has not incurred costs economically and efficiently? If so, please provide details of these areas and why you consider that to be the case.**

Centrica believes that the SO sometimes delays action until late in the gas day i.e. until it is clear that one or both incentives have been lost for that gas day. This leads to actions being required of a greater magnitude which in turn leads to more extreme prices being set than would otherwise be the case.

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**Q21. What are the developments that will affect future SO costs? How will these developments impact on costs?**

Centrica believes that there are three developments which may negatively affect future SO costs: Gas quality, a reduction in short-term flexibility of supply, and use of LNG importation facilities which may have medium-term flexibility causing a need to frequently re-configure the operation of the NTS.

**Q22. Do you consider that the current form of the residual gas balancing incentives is appropriate? Please explain your reasoning.**

See the answer to Q18. Centrica believes that the linepack incentive should be removed altogether. Safe operation of the system means that linepack has to remain within certain limits and the SO should be free to operate within those limits as they see fit, not receiving £5,000 per day for doing so. This should leave the price incentive only, which should be re-structured in order to give a tighter incentive which is less easy to achieve.

**Q23. Do you believe that the existing linepack incentive has little impact on the behaviour of the gas SO? If so, do you have any suggested improvements for this aspect of the incentives?**

See the answers to Qs 18 & 22. Centrica believes that the existing combination of linepack and price incentives does have an impact on the behaviour of the gas SO but the impact is sometimes in the wrong direction and produces inappropriate action. The linepack incentive should be removed altogether.

**Q24. Is it still appropriate for the gas shrinkage volume target to be dependent on flows through St. Fergus? If yes, please provide details of the relationship. If no, please explain your reasoning and provide your views on how the target should be set.**

No. Centrica believes that with St. Fergus playing a less significant role in the overall system the shrinkage target should be based on total system flow.

**Q25. Is the current gas cost reference price methodology still appropriate? If not, please explain what an appropriate methodology would be.**

No. Centrica believes that a methodology based on a mixture of month-ahead and day-ahead prices would be more appropriate. A suggestion would be 75% month-ahead, 25% day-ahead.

**Q26. Is the current form and scope of the gas system reserve incentive still appropriate (in terms of the volume and source of gas reserve bookings the SO considers necessary for the safe operation of the network, the contestability and locational nature of some of these requirements and the price at which it is efficient for these bookings to be made)? Do you consider that the sharing factors, cap and floor for this incentive are still appropriate? Please explain your views.**

Yes. Centrica believes that there is a need for a separate Operating Margins (system reserve) incentive and that the current sharing factors, cap and floor are appropriate. Centrica does, however, believe that all physical storage locations, including LNG import facilities where storage which can guarantee additional rate exists, should be able to compete for this on equal terms. There is a need to link this with LNG storage regulation.

**Q27. We would welcome views on the indicative data provided by NGG on its requirements for gas reserve from April 2008, including views on its continued utilisation of LNG storage at the Isle of Grain importation facility.**

See answer to Q26.

**Q28. Would the increased stability of gas SO incentive schemes of longer duration be preferable to the increased flexibility offered by schemes of a shorter duration? Please provide your reasoning.**

Centrica would prefer a common structure to apply in parallel and for the duration of a transmission price control. Within this time period, however, there would need to be the facility for annual review and variation where necessary. We would support longer duration incentive schemes as long as

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there is enough information available to participants so that any increase or decrease in costs can be adequately monitored for the sake of evaluating the SO's view of the incentives. As long as there is information transparency there should be no reason for the SO to raise the bar in their favour when things *don't move* in their favour – unless the information proves it to be justified – hence allowing for annual variation (either way) if needed. This is, however, dependent on the information available and the timeliness of this data so that future year incentives can be adjusted in a timely manner as well.

**Q29. Are there any aspects of the gas SO incentive schemes that you consider would be more effective if bundled, rather than remaining in their current form? Please provide details of how this may be achieved.**

Centrica believes that bundling of gas SO incentives would lead to difficulties in tracking the effect and the costs in the same way as BSUoS costs are currently difficult to track. We would not wish to see bundling of gas SO incentives.

**Q30. Is it appropriate for participants (including the SO) to have the ability to raise Income Adjusting Events when unexpected events occur resulting in increased or decreased costs? If not, how could such cost uncertainties be addressed under an incentive scheme?**

Yes. Centrica does believe that it is appropriate for participants (including the SO) to have the ability to raise Income Adjusting Events. However this is currently weighted in favour of the SO as shippers simply do not have access to the information which is required when unexpected events result in decreased costs for the SO. Either System Operators should be obliged to notify the regulator in such circumstances or Ofgem should be able to pass on information which they possess.

**Q31. Do you consider that it is appropriate that only the SO can propose modifications to the Statements that the SO is required to have in place under Special Condition C5 of its GT licence? Do you think that market participants should also be able to propose modifications to these Statements?**

Market participants should also be able to propose modifications. See the response to Question 2 for details of possible limitations which might be applied to this.

If you have any queries in relation to this response, please do not hesitate to contact us.

Best regards,

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