

Ian Marlee,
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Ofgem,
9 Millbank,
London
SW1P 3GE

28th July 2011

Dear Mr. Marlee,

Re: System Operator incentive schemes from 2013

Centrica welcomes the opportunity to comment on the issues set out in the initial consultation on the Gas and Electricity System Operator Incentives. This response is on behalf of the Centrica Group excluding Centrica Storage Ltd. There is no confidential information contained within this response.

Our responses to your specific questions are as follow:

Chapter 1: Introduction

1. Do you consider that the general principles we have used are appropriate? Are there any other principles that we need to consider?

The general principles for consideration seem appropriate to us. However, we believe that in general National Grid (NG) should not need to be further incentivised to perform obligations that are already required by its licence conditions and/or legislation. However, it is important to ensure that the general principles of incentivising high quality performance already enshrined in the licence are given full effect to the benefit of users and consumers.

Taking the example of Unaccounted for Gas (UAG), we believe that NG's performance under the incentive needs improvement. The expected forecasts provided by NG were high, and though challenged were used as the basis for development of a specific UAG incentive. However, a number of serious metering calibration errors have since been identified which had led to significant under recording and hence overstatement of UAG forecast estimates. On this basis, we believe that the UAG specific incentive requires careful review and recalibration to ensure that the incentive properties are tightened appropriately and subsequently maintained. We would therefore ask Ofgem to address this issue and the associated meter error problems as a matter of urgency in the Final Principles consultation to be published in October. We do not believe that the UAG incentive can be left to be addressed at a later date. We would be happy to meet with you to discuss our concerns and potential revisions to the incentive further if that would be helpful.

In setting incentives it is appropriate to consider a fair balance of risk and reward for the SO. However, while the consumer is exposed to additional risk and reward beyond its control, the SO does have a greater ability to influence the desired outcomes. This fundamental imbalance should be reflected in the schemes, for example by ensuring that any cost burden is more weighted to the SO than consumers when setting sharing factors, caps and collars.

Chapter 3: Determination of outputs to be incentivised

2. Do you consider that we have identified all the relevant outputs for the electricity SO? Should we consider any other outputs?

We consider it would be worthwhile including accuracy of wind forecasting as an output given the interaction between wind generation and constraint costs. We would note that renewable generation running is treated as an ex-post variable within the current electricity BSIS scheme and hence there is no direct incentive on the SO to improve accuracy of forecasts. As such we believe that this is a prime candidate for incentivisation. National Grid would not necessarily have to undertake the forecasting itself as it could source this from a third-party.

3. Do you consider that we have identified all the relevant outputs for the gas SO? Should we consider any other outputs?

We are very concerned about the prevalence and scale of meter errors affecting the recorded offtake of gas from the NTS and the consequential impact on UAG and hence shrinkage. We consider it important that the SO is incentivised, if necessary via a contract with the TO, to better control and minimise this problem. The issue is worth considering as either part of the consultation process on these proposals or as part of RIIO-T1.

4. Please provide your views on which of the outputs of both the electricity and gas SOs should be incentivised?

A large number of the outputs relate to gas and electricity system integrity and safety. This area is governed by stringent licence conditions and / or legislation. Therefore, performance related to safety or system integrity should not be motivated by financial rewards. In our answer to Q1, we refer to the need for Ofgem to consider the appropriateness of SO incentives versus regulatory controls.

5. Do you agree that it may be more appropriate to place licence obligations (funded through the internal gas SO incentive scheme) with respect to UAG and / or Information Provision?

Yes, it may be appropriate to consider this for UAG and information provision. However, we have major concerns over UAG and associated metering errors that would benefit from wider industry discussion.

Chapter 4: Packaging outputs into schemes incentivising delivery

6. Is there a need for greater incentivisation of NGET and NGG with respect to customer satisfaction? If yes, what form should this incentivisation take?

Customer satisfaction should be of prime importance to NGET and NGG. However, it is not entirely apparent how customer service could be measured in an effective and objective manner. In this respect, a reputational incentive may be more appropriate than a financial incentive. We believe that there is merit in developing some reputational framework in the next steps on the consultation

process. This area could be usefully informed by the work done during development of RIIO-T1 by the outputs working group.

7. Do you consider that the reasons we have proposed for bundling are reasonable? If not, please provide your views as to why?

The arguments are reasonable. Specifically with regards to gas, our chief concern with bundling is the potential to lose transparency and accountability for performance against key activities. The relative merits of each activity, as well as their interactions, in any bundled set will need to be fully considered in developing an incentive scheme. However, as it stands, for electricity, we agree that a bundled scheme remains appropriate as several NGET SO activities affect various cost categories and can be a substitute for one another (e.g. energy and constraints). Nevertheless, a bundled scheme should not prevent a wholly transparent reporting process of cost allocation.

8. Do you consider that the options for bundling are reasonable? Are there any additional options that we should be considering?

Yes, the rationale and options are reasonable.

9. Do you consider that, based on the current outputs that are incentivised, continuing to bundle the electricity SO scheme is appropriate?

Yes, please refer to our comments in Q7

10. If you consider that the electricity SO should be incentivised on additional outputs, should these be part of the same bundled scheme? If not, how should the incentives be packaged?

As noted above, we believe that there is a strong case for exploring options to incentivise NG on its wind forecasting accuracy. Given that it is not an explicit cost, such as arise from constraints or energy actions, this incentive would probably best sit outside the bundled scheme, at least until the reporting / effect can be judged.

11. Do you consider that there is merit in increasing the number of gas outputs incentivised through a single scheme?

That would very much depend on the incentives to be bundled and the potential benefits/risks associated with them.

12. How do you consider the outputs of the gas SO should be incentivised?

If it is decided to introduce longer term schemes, long-term targets should be established with flexibility to drive year on year target improvement during the period. In this sense the incentive on the SO should be dynamic and have the purpose of driving the SO to meet the longer term goal. For example, if the SO fell short of its Year T target by an amount equal to Y then its ex ante target (set before the scheme starts) for Year T+1 would be increased by Y (caps and/or collars would also be adjusted to reflect the shortfall from target in Year T). In this way the SO would have dynamically adjusted year on year targets incentivising it to keep the longer term target as its overarching objective.

13. How do you consider that incentives on the gas SO should be packaged?

Where possible, we would rather see individual incentives to help with transparency of performance. However, where there are obvious interactions some bundling may be inevitable, but

we believe that the interactions are not as obvious as in electricity. In such cases, if some form of “shadow” incentive tracking could be reported on (i.e. what would the alternative unbundled scheme have looked like), this might yield some useful insights.

Chapter 5: SO incentive scheme length

14. Have all the benefits associated with moving to longer term incentive schemes been captured? Should any additional issues be considered?

Please refer to our views under Question 12 – setting longer term targets, i.e. where we really want to get to in 8 years time, along with dynamic targets, caps, collars and sharing factors, may help us to construct a more useful incentive scheme. This implies an inherent assumption of continual improvement in SO performance over the period and could help to smooth out the potential for lumpy and volatile performance that might be experienced with mutually exclusive yearly performance. Unless the form of the schemes incentivises continuously improved performance, we would tend to prefer a shorter term approach to incentive setting.

Therefore, we do not necessarily subscribe to long term schemes. It would be useful to better understand what the SO would expect to be able to deliver under long term schemes, that it is currently unable to achieve.

15. Can longer term SO schemes be implemented through the different approaches discussed, year on year incentives and multi year block incentives? What do you consider are the relative merits (or otherwise) of each approach?

Please refer to our answers to questions 12 and 14.

16. Is our proposed treatment of uncertainty and risk associated with longer term schemes reasonable? If not, please explain how this can be improved?

On the whole this looks reasonable. There may be value in defining an “assumption set” for each incentive and benchmarking the assumption set at various stages throughout the incentive period. If the assumption set remains valid then there should be little argument in favour of change. However, if (for example, due to industry or regulatory change) the original assumption set is materially impacted, either positively or negatively, then there should be a case for making changes to the incentives.

Chapter 6: Achieving better incentive alignment between SO and TO

17. Do you consider that it would be of overall benefit to consumers to better align the incentives of the SOs and the TOs?

Overall, we believe that the alignment of TO and SO incentives can help reduce costs and hence be beneficial to consumers.

18. Please provide your views on the extent to which better alignment can be achieved through the alignment of the incentive schemes under the same and separate ownership?

We believe that the alignment of incentives between TOs and SOs which are under the same ownership can be largely delivered through more appropriate alignment of sharing factors and other scheme parameters. For TOs and SOs which are under separate ownership, wider-reaching incentives are likely to be required, such as cost / benefit sharing arrangements between the parties. There is also scope to consider transmission / distribution interactions.

In principle, better alignment should be achievable but it is difficult for us to say to what extent. Some form of mini impact assessment could be attached to key decisions where Ofgem would have to monitor and assess in order to determine whether a decision by the TO adversely affects the SO, and vice versa.

19. Please provide your views on the economic incentives to drive SO-TO interactions ("payment mechanism"). In what areas could this principle be usefully applied?

In some cases, certain forms of payment mechanism may be appropriate to deliver a more holistic behavioural approach. However SO / TO financial incentives might be subordinate to other technical or commercial considerations.

I hope the above response have been useful, if you would like to discuss any aspect of this response, please do not hesitate to contact me.

Yours sincerely,

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