British Gas
1st Floor, Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY

Joanna Campbell
Smarter Grids and Governance
Ofgem
9 Millbank
LONDON
SW1P 3GE

11th June 2012

Dear Joanna,

Managing Network Charging Volatility

1. Thank you for the opportunity to respond to Ofgem's latest consultation, managing network charging volatility from the price control settlement, document 52/12. This is a non-confidential response on behalf of the Centrica Group excluding Centrica Storage. Our response is structured using the questions within the consultation document.

2. We welcome this consultation as very positive progress in this area. We believe that the options outlined within this consultation are likely to have a significant impact for the benefit of customers. We are in broad support of Ofgem's assessment of Options 1-4 and these should be implemented as suggested, but believe that a cap and collar mechanism remains necessary (option 5).

3. As a stakeholder within the RIIO process we have consistently raised this as one of our key issues. We have also raised a number of code modifications to improve the transparency of information provision within the industry.

4. Overall, these proposals can bring a significant reduction to the risk borne by customers, by increasing certainty over network charges in the short to medium term. Under current arrangements suppliers are tasked with managing network volatility. This may be achieved by applying an insurance premium to network charges. These proposals present more efficient options for managing the uncertainty of network charges. This can be achieved with minimal adverse impact on NWOs as their revenues remain certain, with only limited potential delays to cash-flows.

5. We recognise that, as a general rule, some revenue streams, particularly those related to additional infrastructure investment, are not suitable to be delayed. This does not necessarily need to have an adverse impact on the predictability of charges if NWOs provide sufficient notice of the likely impact of charges. Improved information provision from NWOs, applied in conjunction with an overall cap and collar on allowed revenue changes, will provide both the tools and the incentive to ensure this.

6. Nevertheless, we believe that the poor economic climate coupled with the exceptionally high potential increases resulting from RIIO-T1, for electricity and gas transmission, in the 2013/14 charging year, requires the consideration of a one-off re-profiling of transmission revenues. In particular, National Grid issued a report in April 2012[1] that indicated that the revenues recovered through TNUoS tariffs were likely to rise by around 25% (before inflation) from April 2013, with more modest rises thereafter. Given the current economic climate, we do not believe it reasonable to place such massive increases on consumers at this time.

7. We support a cap and collar based on a comparison to year-ahead forecasts. If calibrated correctly this will allow suppliers to disregard the more extreme risks when considering risk premia, whilst being unlikely to affect revenue recoveries in most circumstances.

8. This consultation does not seek to address all sources of charging unpredictability, in particular System Operator charges and volatility arising from charging methodologies. We agree that industry governance should be able to manage these issues and will continue to engage in these areas.

9. In this respect we are particularly concerned massive year-on-year changes that National Grid is predicting (up to 5000%) coupled with the long lead time in offloading exit capacity. We believe that an urgent examination is required and that Ofgem should be aware of this issue. Whilst we believe that the normal industry governance process of the charging and user commitment methodologies should be the key arena discussion with regard to this issue, aligning the gas transmission exit charging year (beginning 1st October) with that of gas distribution (1st April) is likely to significantly reduce the predicted year-on-year swings in tariffs.

10. We have responded to the consultation questions in the attached appendix.

If you require any further information please do not hesitate to contact me.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements
British Gas
[Via email]

[1] http://www.nationalgrid.com/NR/rdonlyres/E4BFA3A5-8920-441F-8C76-41B3C6F155A7/53213/InitialViewofTNUoSTariffsin13_14.pdf

Questions

1. Question 2.1: Have we correctly characterised the scope of the problem we are trying to address?
    - As acknowledged the problem of the predictability of charges is beyond that of price control settlement. In particular volatility arises from:
        - Development and application of charging methodologies
        - Recovery of system operator revenues
    - Whilst noting this, we agree that this consultation has correctly categorised the scope of the problem it seeks to address. We agree that issues that relate to charging methodologies, and potentially the recovery of system operator revenues, can be addressed by industry governance.

1. Question 2.2: Are there certain market segments or groups of customers that are particularly affected by charging volatility?
    - All customers and market segments will be affected by charging volatility to some extent. All pricing decisions taken by suppliers, for fixed-price deals and other-wise, are made with an understanding of the unpredictability of network charges.

2. Question 2.3: Do you agree with the assessment criteria? Are there additional criteria? Are there additional criteria that we should adopt for our final assessment?
    - In terms of risk-sharing, we believe that any delay in aligning revenues will be short and mechanistic under these proposals, with no risk over the eventual recovery of the correct revenue. Additionally, it is difficult to envisage how any amounts will be sufficiently substantial to have an effect on the financeability of any of the NWOs.
    - Thus, it is not clear that the NWO bears any significant additional risk through these proposals and we believe that these proposals bring an overall reduction of risk.
    - Similarly, we do not believe that any misalignment between performance period and revenue will be significant enough to affect incentive properties. Networks are by their nature long-term investments and investors are unlikely to be influenced by such short-term issues.

3. Question 3.1: Do you have any further suggestions of what could be done to mitigate network charging volatility arising from the price control settlement?
    - In addition to the ‘within price control period’ issues dealt with by this consultation there is also the unpredictability arising from the resetting of revenues following a price control review.
    - In general, we believe that the increased level of transparency and stakeholder engagement arising from the RIIO process should militate against this. The NWOs involved will share their forecasts of future revenues with the industry, through the submission of business plans, at various stages of the process. Whilst this will clearly need careful interpretation, particularly as it will only represent the NWO view, it should give a good starting point.
    - However, we do believe there is a specific issue with the start of RIIO-T1 in April 2013. National Grid issued a report on April 2012 that indicated that the revenues recovered through TNUoS tariffs were likely to rise by around 25% (before inflation) from April 2013. Increases in subsequent years are indicated to be more modest. Given the current economic climate, we do not believe it reasonable to place such massive increases on consumers at this time and believe that re-profiling of

revenues be considered. We are happy to engage fully with Ofgem in further examining this issue.

4. Question 3.2: Do you agree with our initial assessment of each option?
    - We are in broad agreement of Ofgem's assessment with the exceptions outlined in the detailed responses below, but in summary:
        - We do not believe that the incentive regime is weakened by any of these options
        - We do not believe the signals to investors are weakened by any of these options
        - We believe option 5 is beneficial

Option 1: Improved Information Provision

5. Question 3.3: Do code and licence change notification differences in each network sector create problems in managing charge changes?
    - The 40 day final price notification period contained within DCUSA is too late to use for many, if not most, April contract renewals and tenders.
    - There would a benefit in harmonising the DCUSA notice period with the UNC's 2 month final price notification. This should have very little impact on electricity distributors processes since they already provide a forecast of allowed revenue at the beginning of February through their DCP066 report.

6. Question 3.4: What information would you like the network operators to provide, that they currently do not, in order to help improve predictability of network charges for different customer groups? This should include:
    i) What information you would like to see in their business plan submissions, and
    ii) What information would you like to see provided on an ongoing basis.

    Information included in business plan submissions
    - In relation to information that should be included in business plan submissions, transparency would be improved by publishing the RIIO financial model that supports the business plan. Given that the final RIIO model will be published by Ofgem we do not see any confidentiality issues with NWOs publishing their version of the model with their business plan submissions.
    - We would also like to see information that provides a clear link between the numbers included in the RIIO model and business plan to the numbers that will be used to set tariffs. Translating the revenues inherent in the business plan submissions into the formats of the existing UNC0186 reports and DCP066 reports would help to provide this transparency.
    - Any tables or charts included in business plans which present movements in revenues or charges over time should always include the last year of the previous price control period as the base year so as to ensure the information does not unintentionally mislead stakeholders on the impact of the price control on charges.

    Information to be provided on an ongoing basis
    - The existing UNC0186 and DCP066 reports provide a reasonable mechanism to provide a degree of predictability in network charges and we would like to see such quarterly updates provided in transmission as well. These reports have been

improved by the industry and should continue to develop towards providing a level of granularity that allows the user to see every significant step between base revenues, contained in the licence, and revenues used for tariff setting.

- Clearly, having a mechanism in place to provide regular updates to forecast revenues is only as useful as the level of care put into such forecasts- there is a recent example, for an electricity distribution licensee, where the forecast for 2013/14 allowed revenue has increased by 6% since the previously quarterly update. We believe introducing a mechanism that provides a cap and collar on changes to the revenues, based upon year-ahead forecasts, will provide network operators with the incentive to ensure reasonable care is put into forecasts. Should we state what the cap should be? E.g. 5%?

7. Question 3.5: What information do you think we could provide, that the network operators cannot, that would benefit you in terms of improving predictability of network charging?
    - Ofgem could require network operators to provide to them monthly updates of incentive performance and then publish consolidated information to stakeholders. This information should include both historic and within year performance. This would enable stakeholders to better understand the assumptions behind the forecasts provided by NWOs and would allow them to form their own view of future incentive payments.
    - Ofgem could also publish the annual revenue and cost reporting submissions by NWOs. This would improve intra-price control transparency of allowances.
    - As mentioned above, we would expect NWOs to publish the RIIO financial model that forms the basis of any business plan submission, however these are unlikely to contain common assumptions and so Ofgem could further improve transparency by publishing the RIIO financial models on a common basis (e.g. with common financial assumptions) during the price control process.
    - We would naturally expect Ofgem to publish the final RIIO financial models that form the price control settlement as well as any annual updates to the models.
    - Ofgem should also publish any requests for additional funding, for example when a NWO triggers an uncertainty mechanism.

Option 2: Restricting the Frequency of Intra-year Charge Changes

8. Question 3.6: In the last five years how frequently have networks introduced intra-year changes? What were the main reasons for these changes?
    - In the last five years we believe there have been intra-year changes to tariffs in every year. We believe there have been intra-year changes in each sector (Electricity Distribution etc) during this period also. NWOs are best placed to provide the details and the reasons behind the mid-year changes.

9. Question 3.7: Are there any business processes that would mean only allowing one change per year on 1 April would not be feasible?

- We presume this question is primarily aimed at NWOs. In relation to gas transmission charging, we believe there is merit in harmonising price changes to apply from 1 April.

10. Question 3.8: Do you think that there should be exemptions that would allow changes due to specific events? Do you think these events should include the occurrence of errors when calculating charges or changes to charging methodologies? Are there any other events that should potentially be exempt?
    - We agree that there should be exemptions that would allow changes to tariffs mid-year, but these should be limited to exceptional circumstances and subject to Ofgem approval. Only events such as manifest errors in calculating charges and urgent changes to methodologies should be allowed to change charges mid-year.

11. Question 3.9: Do you agree with our proposed change to the penalty for over or under recoveries were this option to be implemented?
    - We agree that any change to the penalty for over and under recoveries should take the form of a widening of the band rather than a softening of the penalty interest rates, however we are not convinced that the bands need to be widened. If some of the other options in this consultation are implemented, for example the lagging of incentive payments and over/under recoveries, then we see no reason why NWOs should not be able to forecast revenues to within the current bands.

12. Question 3.10: Do you agree with our initial view that there should be a two year lag on adjustments due to the over or under recovery of revenue through the correction factor?
    - Yes. This would also make it easier for NWOs to forecast the allowed revenue as part of their tariff setting process and so reduce the potential for over and under recoveries.

13. Question 3.11: Are you aware of any errors that have been made when calculating network charges in sectors other than electricity distribution?
    - No.

14. Question 3.12: Do you think that introducing an additional licence condition to penalise NWOs when they make charge calculation errors is warranted?
    - We are concerned that, at the moment, when a NWO makes a charge calculation error only suppliers and customers are exposed to the effects of the error whilst, perversely, the NWO is fully protected by its impact. An additional licence condition is required to ensure NWOs are exposed to the impact of any errors.

Option 3: Increasing the lag on changes due to incentive rewards or penalties

15. Question 3.13: What do you consider to be an appropriate notice period for changes to allowed revenue?
    - We would suggest that a full year is an appropriate notice period for changes to allowed revenues as a result of incentive scheme performance. Therefore a two year lag on incentive rewards or penalties is sufficient provided that a reasonable forecast is made available at least one year ahead of the year in which allowed revenues are impacted i.e. it is sufficient to make incentive payments relating to performance in the 2010/11 year in 2012/13 provided a reasonable forecast of the

2012/13 payment is made available at the same time as publishing final charges for 2011/12.
- We do not believe a two year lag adds any cash flow risk on the NWOs since the lag simply puts into practice a mechanism by which to adjust revenues at the earliest practical opportunity once performance has been finalised. Furthermore we do not believe that such a lag has any negative impacts on the effectiveness of the incentive framework since networks are typically long term investments.
- We acknowledge that for some of the incentives (e.g. discretionary awards) it will not be possible to provide a forecast ahead of the Authority making a determination which will mean that a full years notice or a reasonable forecast is not provided. In these cases, provided the materiality of such incentives remains relatively low, we would continue to support a two year lag for consistency but would urge Ofgem to expedite the timetable for such determinations.

16. Question 3.14: Do you consider there to be any potential exemptions to our proposal to lag all incentive adjustments?
    - We are content for all incentive mechanisms to follow a two year lag mechanism. For the vast majority of incentive schemes we believe that NWOs should be in a position to provide a reasonably accurate forecast of performance a year ahead of the year in which allowed revenue is impacted. As we mention above, there may be some incentive schemes where it will not be possible to provide a forecast ahead of the Authority making a determination however for consistency we would continue to support a two year lag.
    - Our view here assumes that the year ahead forecast of incentive performance by NWOs is robust, something which we have not always found to be the case. Therefore we would suggest that introducing a cap and collar mechanism on how much target setting revenues can change from a year-ahead forecast would focus the minds of NWOs when they produce their forecasts. Furthermore, by providing regular updates on incentive performance during the year Ofgem will facilitate stakeholders making their own forecasts of performance.

Option 4: Increasing the Lag on Changes Due to Uncertainty Mechanisms

17. Question 3.15: Do you agree or disagree with our initial assessment of whether a lag should be applied to the following uncertainty mechanisms? Please explain your reasoning.
    i) Indexation
    ii) Pass through costs
    iii) Revenue drivers
    iv) Within period determinations
    v) Reopeners
    vi) Innovation funding

18. We broadly agree with Ofgem's initial assessment. If applied in conjunction with improved information from option 1 and a cap and collar mechanism from option 5, we can see few issues with progressing as Ofgem suggest.

    i) indexation

    We agree that we are able to make reasonable forecasts of the relevant values through publically available information

ii) pass through costs

We can see no reasons for not lagging these costs, and no detrimental impacts, and so would suggest they should be lagged

iii) revenue drivers

We agree these should be considered on a case-by-case basis once more fully developed.

iv) within period determinations

We accept that the potential nature of investments may mean a lag could cause funding issues for NWOs and so agree with Ofgem's approach. This means good quality information will be essential and believe introducing a cap and collar around year-ahead forecasts will be effective in focussing networks on providing accurate forecasts with good notice

v) reopeners

Similarly, we agree the proposed approach to general reopeners is reasonable. Again, a year-ahead cap and collar will encourage NWOs to provide good quality information.

vi) innovation funding

We agree that innovation funding is likely is to be predictable. As the consultation identifies some potential detrimental impacts of lagging payments, it seems sensible not to lag.

Option 5: Imposing a Cap and Collar on Allowed Revenue

19. Question 3.16: Do you agree or disagree with our initial assessment that the benefits of introducing one of the three options for a cap and collar do not outweigh the drawbacks?
    - We disagree with the initial assessment about the benefits of introducing a cap and collar.
    - We accept that the first option, a straight cap and collar around price control revenues, may bring material cash-flow risks but do not believe this to be the case for either of the other options, with our preference being for a cap and collar around a year-ahead forecast.
    - An appropriate method for setting a cap and collar would be to relate it to the size of the band allowed on revenue recovery before penalty interest is applied. If this band represents an acceptable expectation of annual variance then doubling the band for the year-ahead cap and collar would be a reasonable, if generous, assumption.
    - We would hope that when the other options from this consultation are applied this cap/collar would rarely be breached. Ofgem state that this would make the cap ineffectual in improving predictability. Even if this was the case, it may still reduce any risk premium applied by a supplier, depending on the approach to risk taken.
    - A supplier may decide that any risk premium needs to reflect risks that have a high impact, but with a low probability ('tail-risk'). The cap or collar, even if rarely invoked in practice, will remove this theoretical tail-risk and so has the potential to reduce risk premium.

- The year-ahead cap and collar will also incentivise the NWO to accurately forecast at the year-ahead stage to avoid penal interest. This should also improve predictability. Assuming the revenue recovery band is sufficiently tight and the use of penal interest is effective in influencing company behaviour, there should be no incentive for a NWO to over-forecast revenue for year t+1 in order to reduce the risk of hitting the cap, as this would simply increase the probability of the collar being invoked.
- Although more complicated than current arrangements, a year-ahead cap and collar will not be unduly complex. A new restriction that limits the revenue to be recovered from a charging model to a range defined from the reporting developed under option 1 would be required, but no further changes should be necessary.

20. Question 3.17: Do you consider there are any other options for the design of a cap and collar mechanism that we have not considered?
    - We have no other suggestions for a cap and collar mechanism

21. Question 3.18: Do you have any views on whether a cap and collar, if implemented, should be symmetric or asymmetric?
    - The cap and collar mechanism should be symmetric. As discussed above, this will help to ensure NWOs are incentivised to forecast accurately if the year-ahead option is adopted.
    - Additionally, whilst only a cap may be necessary to manage a supplier's risk, a collar would ensure that suppliers cannot benefit unduly from unexpected reductions in network charges when they have not borne the equivalent risk.

Timing of Implementation

22. Question 3.19: Do you agree that if changes are needed in the gas distribution or transmission sectors that they should be implemented on 1 April 2013, the start of the next price control period?
    - In general we agree with implementing from 1st April 2013. However, we note that prices for Gas Transmission have already been published, for implementation from 1st October 2012. We believe it is sensible to align Gas Transmission with Gas Distribution but do not believe it would be beneficial to users for prices to be revised only 6 months after the October 2012 revision.
    - Thus, if Option 2 were to be implemented with price changes only allowed on the 1st April we would suggest this should be implemented for Gas Transmission from the 1st April 2014. i.e. Gas Transmission prices would change on 1st October 2012, 1st October 2013 (if necessary) and then 1st April 2014. Although not the full solution (which is better suited to the normal industry governance process of the charging and user commitment methodologies) it has been such a change is would help minimise the massive year-on-year changes in gas transportation exit charges that National Grid is predicting (up to 5000%).

23. Question 3.20: When should we apply any changes to the electricity distribution sector?
    - We believe options should be implemented as soon as practicable. We accept that Options 3-5 are intrinsic to the price control settlement and so should be implemented with RIIO-ED1 from April 2015
    - Options 1 and 2 should be implemented prior to the new prior control, in order for benefits to be realised as soon as possible.