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Dear Leonardo,

Consultation on Electricity System Operator Incentives 2015/17: Initial Proposals

Thank you for the opportunity to respond to the consultation regarding the 2015/17 Electricity System Operator (SO) incentive regime. This is a non confidential response on behalf of the Centrica Group excluding Centrica Storage.

In our response to the recent consultation on the proposed regime[1], we demonstrated that the Balancing Services Incentive Scheme (BSIS) was highly unlikely to be affecting behaviour as costs were generally falling well outside the range subject to incentives. We are disappointed the Initial Proposals have not addressed this and we continue to believe the sharing factor for the BSIS should be reduced to 10% for the following reasons:

- **The inherent difficulty in setting robust scheme targets has resulted in frequent breaches of the cap or floor of the scheme.**
- **Perverse incentives are created when the incentive returns breach the cap or floor.**
- **We believe the roles of the SO and TO are fundamentally different and do not require the same sharing factor to produce effective incentives.**

Difficulty in setting robust scheme targets:
The evidence demonstrates that, despite best endeavours, it has been challenging for Ofgem to set robust targets for the current and previous schemes. In our response to the previous consultation we made a number of observations relating to the performance of the SO against BSIS targets between 2006/7and 2013/14, including:

- In the last five schemes (since 2008) the incentive value has exceeded the cap or floor[2], on occasions flipping between the cap and floor.

[1] Electricity System Operator Incentives: Incentives from 2015. https://www.ofgem.gov.uk/publications-and-updates/electricity-system-operator-incentives-incentives-2015.
[2] The 2011-13 was only brought back within the floor following an Income Adjusting Event.

- As it is unlikely underlying SO performance will vary this much year-on-year, such volatility in balancing costs indicates that the incentive returns are instead dictated by unsuitable targets.
- In most of these years, costs have varied from target to such an extent that even a change in outturn costs of 10% would not have brought performance back within the cap/floor. It is difficult to argue that the incentive remains effective if a range of 10% around performance makes no difference to the value of the incentive to the SO.

We are sure that you would have been rigorous when inputs and assumptions were verified when setting the targets for the current and previous schemes. It is, therefore, difficult to share your confidence that simply placing focus on verification of inputs and assumptions will produce robust and credible scheme targets that preserve the integrity of the BSIS framework proposed for 2015-17, when it has failed to do so for previous schemes.

Creation of perverse incentives:
It is stated in the consultation that the incentive schemes have been effective in ensuring National Grid Electricity Transmission (NGET) is efficient in its role as SO and are able to drive improvements from NGET. Whilst this is not supported by any clear evidence, the logic that leads to this conclusion must also lead to the conclusion that the incentive properties are no longer effective once the cap or floor has been breached. Throughout 2013/14 (including before the finalisation of the 2013/14 scheme) NGET presented a forecast of external balancing costs ranging between £845m and £878m, compared to a provisional target of £1,100m. It is therefore likely NGET would have been aware throughout the period that the cap would be reached and its performance was unlikely to affect its reward. In fact, breaches of the cap or floor create perverse incentives on the SO to *increase* spending, in order to influence easier targets for future schemes without impacting returns from the current scheme. This has the potential to severely damage the integrity of the scheme as it is important for all parties to be confident that correct incentives are being given. For clarity, we believe in practice that this incentive scheme has little or no impact on Grid's behaviour and believe Grid are committed to improving efficiency regardless of the scheme.

We welcome the steps NGET has taken to improve efficiency but believe this an indication of how it generally operates as a business and not as a result of the incentive scheme. It is not safe or sensible to conclude that Grid becoming more efficient in particular areas is a direct result of this incentive scheme. We note that being efficient is part of National Grid's licence and are sure Grid would view efficiency as an integral part of their culture.

Sharing factors for the SO and TO:
We are unconvinced that savings to consumers should have equal value regardless of whether they come from smarter operations of the system or outperformance against RIIO-T1 incentives. We consider that incentive sharing factors should be calibrated to the level necessary to drive the appropriate behaviour from either the SO or TO.

The role of the SO is fundamentally different to the role of the TO. Whilst higher sharing factors may be necessary to change an organisation's approaches to long term capital investment we do not believe that it follows that the same sharing factors are required for such short term operational expenditure associated with the SO. We believe that much smaller sharing factors will motivate the

SO to reduce operational expenditure without weakening the incentives on the TOs to improve the efficiency of its capital investment programme.

National Grid, in its role as TO is only able to deliver efficiency savings in relation to the England and Wales transmission network, whereas in its role as the SO will deliver efficiency savings in relation to whole GB transmission network – therefore we do not believe that different sharing factors for the SO and TO will have any impact on National Grid's approach to seeking efficiency improvements in either role.

Transparency:
We support initiatives that increase understanding and modelling transparency amongst wider stakeholders. In our response to the earlier consultation, we stressed the necessity for much greater transparency as some parameters used to derive targets for the BSIS may be updated mid-scheme without scrutiny from wider stakeholders. We continue to believe it is important that the methodology, modelling, input parameters and the financial impacts of the SO's balancing actions are widely understood. We also believe there is a need for a wider understanding of:

- The extent to which the actions of the SO, as the single buyer of balancing services, shapes the market for those services and whether better customer outcomes can be delivered; and
- The SO's approach to system balancing based on actions that fall within the controllable and uncontrollable cost categories.

We highlight this especially since it is proposed to expand the scope of changes that can be made by the SO mid-scheme to include the target-setting methodology.

We hope you find our comments helpful. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements
[via email]