Centrica plc
Regulatory Affairs
Ground Floor, Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY
www.centrica.com

Julie Black
Programme Director, Network Price Controls
Ofgem
10 South Colonnade,
Canary Wharf,
London E14 4PU.

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Dear Julie,

Call for Evidence on the Electricity Transmission, Gas Transmission, Gas Distribution and Electricity System Operator Business Plans for RIIO-2 - Incentives

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

This aspect of our response focuses on some financial incentive mechanisms proposed by companies across the three network sectors.

We present our findings in the attached appendices. In summary, whilst we support the use of incentives in general, we have identified issues with a number of the proposed incentives:

- For some incentives, companies have not demonstrated the customer benefit.
- For some incentives, companies have not embedded performance achieved in RIIO-1 in the proposed baseline targets for RIIO-2.
- For some incentives, companies have not taken account of the latest data.

We also make the following general point:

Companies have not proposed targets that capture performance revealed during the price control and have not proposed the 'relative performance' principle for any incentive:

In the *Sector-Specific Methodology Decision*[1], Ofgem decided that, where appropriate, targets for some incentives would be updated to capture performance achieved during the RIIO-2 controls, or targets could be set on a relative basis. We support these approaches. Dynamic targets

[1] "RIIO-2 Sector Specific Methodology", paragraphs 5.11 – 5.14: https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_core_30.5.19.pdf.

(subject to minimum standards) allow consumers to benefit more quickly from the performance improvements they have funded.

Furthermore, in a competitive market, it is improvements in customer service *relative* to competitors that will bring rewards. However, we have not identified any proposal that adopts either of these approaches. As a starting point, we recommend Ofgem applies the relative performance principle for common customer-/stakeholder-related incentives, in order to mimic competitive market outcomes.

We hope you find these comments helpful. Please contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Industry Transformation, Investigations and Governance
Centrica Regulatory Affairs, UK & Ireland

Appendix 1:
Centrica's assessment of targets proposed by the electricity transmission companies

Energy Not Supplied incentive:
The TOs propose targets for the Energy Not Supplied (ENS) incentive that represent a tightening of the RIIO-1 targets to various degrees. The extent to which the proposed targets are considered ambitious should not be based on the degree of 'tightening' compared to RIIO-1. Instead, ambition should be considered in the context of actual levels of performance during RIIO-1.

Table 1: RIIO-1 performance against the Energy Not Supplied incentive[2]

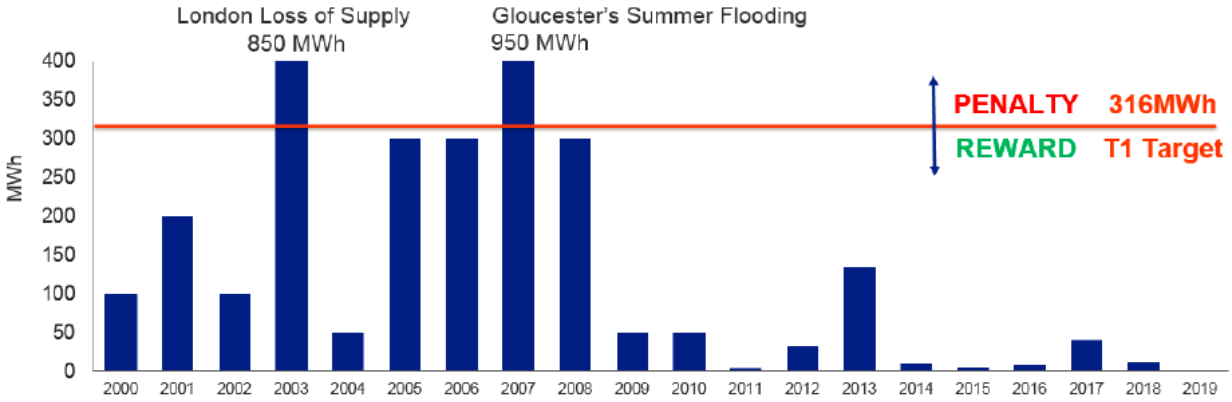
	NGET	SPT	SHET
RIIO-1 target (MWh)	316	225	120
Worst annual performance (MWh)	135.0	42.2	106.1
Average performance (MWh)	34.5	18.6	28.4
Proposed RIIO-2 target (MWh)	175	178	90
Annual reward for no improvement in average performance (£m)	2.3	2.6	1.0

None of the TOs proposes targets that embeds average levels of performance achieved during RIIO-1. Indeed, the poorest annual performance in RIIO-1 NGET and SPT is better than the proposed RIIO-2 targets. For SHET, annual performance is better than the proposed RIIO-2 target in all but one year. Assuming the TOs maintain the average RIIO-1 performance across the RIIO-2 period, the companies will earn rewards of £29m over RIIO-2 for no improvement in average performance[3]. This does not represent value for consumers. Financial rewards are appropriate only in those circumstances in which performance is both good and improving.

NGET explains its proposed targets were derived based on a variant of the methodology used to set the T1 targets[4]. The methodology employed involves previous performance over different periods being combined to produce a weighted target. We are unsure what applying the T1 methodology, without variant but updated for actual T1 performance, would mean in terms of targets for all the TOs. This would be a further useful comparator for context.

NGET's target is based on performance over the previous five years comprising only 40% of the weighted target[5]. The chart below, taken from an appendix to NGET's business plan, shows that the vast majority of the data used to calculate the weighted target related to performance that occurred before RIIO-1.

[2] RIIO-1 performance data taken from https://www.ofgem.gov.uk/system/files/docs/2020/02/riio-et1_supplementary_data_file_2018-19_0.xlsx.
[3] This is based on the RIIO-1 value of lost load figure of £16,000/MWh.
[4] "Annex NGET_A9.11 ENS Incentive", section 4.3: https://www.nationalgridet.com/document/132131/download.
[5] "Annex NGET_A9.11 ENS Incentive", page 7.



*. Taken from "Annex NGET_A9.11 ENS Incentive".

In addition to not embedding the current levels of performance in the RIIO-2 targets, NGET has proposed a target that is weighted 60% in favour of performance that occurred no later than 2013-14. Further, data that are at least 15 years old contribute 20% to the weighted target. We note the National Audit Office stated a key reason why consumer value has been lost in the current (RIIO-1) price controls is due to insufficient weight being placed on the most recent data when setting targets for incentive mechanisms[6]. The weighting given to more recent data should be reviewed.

[6] See: https://www.nao.org.uk/wp-content/uploads/2020/01/Electricity-networks.pdf.

Appendix 2:
Centrica's assessment of targets proposed by National Grid Gas Transmission

NGGT has proposed a package of financial incentives, some of which already exist in the current price control. We agree commercial organisations should be exposed to financial incentives and should be rewarded if performance is both good and improving and delivers consumer benefits. We have concerns that, in some instances, it is unclear which behaviours are targeted by the incentive and whether it is meant to encourage improvements in SO and/or TO behaviour.

As an example, Ofgem has explained that targets for the Capacity Constraint Management (CCM) incentive were set at the start of RIIO-1 to manage the risk that NGGT may incur low-probability/high-impact constraint management costs, such that rewards in a typical year would be offset by larger penalties during atypical years[7]. However, NGGT has not incurred 'buyback' costs since 2007 and current network usage patterns, compared to existing baseline obligated capacities, suggest that is less likely to occur. Ofgem concluded that CCM targets during the RIIO-1 period may not have appropriately reflected the actual risks of constraint management action[8]. We are concerned that if these actual risks are overstated, making the incentive too powerful, then this would lead to inefficient decisions being taken (e.g. not reinforcing when it would be efficient to do so).

More information regarding the expenditure, actions and options involved is needed to demonstrate the efficiency of decisions and so the effectiveness of the incentive scheme.

Demand forecasts:
NGGT proposes to retain the demand forecasting incentives but with a lower cap on rewards. We previously stated Ofgem should consider whether the incentive should be retained as it may not benefit the generality of consumers and performance levels could be encouraged via other mechanisms. Notwithstanding our comments, we note NGGT has not proposed changes to the existing targets for either the D-1 or the D-2 to D-5 forecasts. NGGT has not embedded the levels of performance that allowed it to earn rewards of approximately £14m during the first five years of the RIIO-GT1 control in targets for the RIIO-GT2 control. This does not represent good value for consumers since the proposed RIIO-2 targets do not capture revealed performance.

We recommend the baseline target for the first year of RIIO-GT2 should be the average of the performance achieved in the last three years of the current price control. The targets would then be updated on a 'rolling' basis throughout the price control to capture revealed performance. The target for the first year should be set as the minimum standard, to prevent performance deteriorating below levels already achieved.

[7] "RIIO-2 Sector Specific Methodology Annex: Gas Transmission", paragraph 3.70: https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_gt.pdf.
[8] "RIIO-2 Sector Specific Methodology Annex: Gas Transmission", paragraph 3.70.

Environmental Incentive:

NGGT proposes a symmetrical financial incentive to encourage it to deliver beyond the baseline commitments in its Environmental Action Plan. We recognise NGGT proposes targets for each element of the scorecard that increases baseline requirements as the RIIO-GT2 control progresses. We recognise that stakeholders support NGGT delivering against an Environmental Action Plan but do not believe a financial incentive is required. A reputational incentive may be more appropriate.

Appendix 3:
Centrica's assessment of targets proposed by the gas distribution companies

Unplanned interruptions:
The RIIO-GD2 price control will be the first gas distribution price control in which a financial incentive will apply to encourage companies to reduce the average duration of unplanned interruptions. In our response to the *Sector-Specific Methodology Consultation*, we highlighted concerns about the proposal including the need to ensure robust data exist (both target-setting and performance measurement), to avoid windfall gains or losses. Notwithstanding our concerns, we assess the GDNs proposals.

Generally, the proposed standards do not embed performance levels achieved during GD1. Instead, the standards appear to reflect poorest performance. Minimum standards should not be based on the poorest performance levels.

Companies have taken different approaches to developing standards, over different time horizons.

Table 2 - Summary of target-setting methodologies

Company	Methodology
Cadent	For each licensee: Non-multiple occupancy buildings (MOBs) - the standard is weighted 50:50 according to the slowest annual mean duration between 15/16 to 16/19 for each licensee and the lower quartile of averages for other companies MOBs – the slowest annual mean between 15/16 to 16/19 for EoE and NW, the second-fastest annual mean between 15/16 to 16/19 for Lon and the Lon target for WM (which is only slightly shorter than the slowest annual mean between 15/16 to 16/19). Large incidents – the slowest mean duration seen across any GDNs major incidents in RIIO-1 to date.
NGN	Methodology not described, based on "analysis of the last 9 years" and "analysis of our previous performance, and examination of the influence of external factors, especially severe weather, on restoration times"
SGN	For each licensee: MOBs and non-MOBS – average duration over the past three years Large incidents – "average annual impact of the largest incident caused by third-party damage over the previous ten-year period"
WWU	Methodology not described

In the information publicly available, WWU has not explicitly described how its proposed 10-hour standard was derived. Nevertheless, its performance has consistently improved over GD1 – the average duration has reduced from 10.77 hours in 13/14 to 7.7 hours in 2018/19. The standard proposed has been set at a level that WWU has bettered in every year since 2014/15[9]. Similarly, NGN has not explicitly described how its proposed 11-hour standard was derived. We highlight the standard proposed has been set at a level that NGN in every year of the GD1 price control to date.

Cadent and SGN derive 'bottom up' standards based on performance for MOBs/non-MOBs and large incidents. Cadent has adopted the longest duration on the basis that "*incidents can be very different and their low volume / high impact nature means that for the purposes of them being included in the unplanned interruptions target the worst case must be assumed*"[10]. Cadent notes this event occurred on the So network. We disagree with Cadent's approach. The approach implicitly assumes the worst case will occur in each year of the GD2 price control and embeds an unnecessary degree of headroom into the standard. Further, Cadent has not adopted its longest duration across any of its four networks – it has adopted the worst case across the industry.

SGN's approach to taking account of large incidents is "*to assess the average annual impact of the largest incident caused by third-party damage over the previous ten-year period*"[11]. Again, we disagree with this approach. This approach implicitly assumes SGN's management of large incidents has remained static over the previous ten-year period. The evidence in SGN's business plan contradicts e.g. SGN explains the measures it has implemented that has reduced the occurrence of third-party damage.

We have concerns that Cadent, NGN and SGN have proposed to base their targets on data up to 2018/19, which will be two years out of date when RIIO-2 starts[12]. We recommend provisional targets are set based on a combination of out-turn performance and forecast performance over the remainder of RIIO-GD1. The targets can then be finalised when out-turn data for RIIO-GD1 are available.

NTS Capacity Exit incentive:
Some GDNs propose this incentive should be retained. We have previously raised concerns that this incentive has not provided consumer value. We continue to believe this incentive should be discontinued.

We acknowledge Ofgem has sought to address some of the weaknesses of current arrangements e.g. the reference prices used for the incentive. However, the fundamental concern has not been addressed – spare capacity exists across the generality of the transmission network and, therefore, the GDNs' booking profiles are unlikely to trigger expansion requirements. Retaining this incentive would be in contradiction of Ofgem's minded-to position on the Gas Transmission

[9] WWU
[10] Cadent ref
[11] SGN ref
[12] WWU has not described its target-setting methodology.

Charging Review, which recognises that having a locational signal to encourage use of the transmission system in particular locations is not necessary:

In terms of distributional impacts, we are of the view that the PS approach is fairer and better reflects the characteristics of the GB gas transmission system. As the gas system is largely operating well below capacity and location is not a significant driver of cost, we think that a PS approach to pricing is more appropriate[13]*.*

[13] "UNC678/A/B/C/D/E/F/G/H/I/J: Amendments to Gas Transmission Charging Regime: minded to decision and draft impact assessment" paragraph 1.8: https://www.ofgem.gov.uk/system/files/docs/2019/12/unc678_minded_to_decision.pdf.