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

Jonathan Farrier
Ofgem
10 South Colonnade,
Canary Wharf,
London E14 4PU.

27 March 2020.

Sent by email to: RIIO2@ofgem.gov.uk

Dear Jonathan,

RIIO-GD2 NTS Exit Capacity Incentive

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

The NTS Exit Capacity Incentive should be removed:

We support the removal of the National Transmission System (NTS) exit capacity incentive mechanism. We previously explained how the incentive represents poor value for consumers[1], which has resulted in GDNs' rewards significantly outstripping 'flat' capacity cost savings. Further, consumers are required to fund shortfalls in National Grid Gas Transmission's (NGGT's) revenue due to 'flat' capacity cost savings so that NGGT recovers its pre-determined level of allowed revenues, along with incentive payments to the GDNs.

Even if the flaws within the existing mechanism could be robustly addressed, the incentive is rendered redundant because of the pending changes to the gas transmission charging regime. In its minded-to decision on UNC Modification 678, Ofgem proposed to implement the findings of the Gas Transmission Charging Review. Ofgem has signalled it is likely to approve the 'Postage Stamp' approach, because the gas system is largely operating well below capacity and location is not a significant driver of cost[2].

[1] In our response to the "Consultation on a potential RIIO-T1 and GD1 mid-period review", we explained the incentive could encourage GDNs to book capacity at expensive offtake points, the use of forecast prices have created inappropriate incentive rates and GDNs significantly rebalanced their strategies to rely on cheaper 'flexible capacity to satisfy peak demand obligations (after the 'flat' capacity baselines were set).

[2] "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.

Having decided to remove locational signals, this also removes the rationale for the incentive. In practice, it is unlikely the incentive will appropriately influence GDNs' capacity booking strategies when the changes are implemented. As CEPA states in its review of the incentive, locational price signals, which the operation of the incentive relies on, will no longer exist:

The adoption of a postage stamp methodology would mean there are no signals for GDNs as to what constitutes a cheaper offtake, and therefore no ability to reduce exit capacity costs by shifting bookings to certain offtakes[3]

Further, in the short- to medium-term, removing the incentive should have no impact on transmission investment – NGGT states any outcome of the charging review will not change its investment plans for the RIIO-GT2 price control[4].

We believe retaining the incentive will not provide any benefit to consumers.

Enhanced obligations and ex-ante assessments of proposed bookings should be introduced:

Enhanced obligations on the GDNs and ex-ante assessments of proposed bookings should replace the NTS exit capacity incentive, to avoid the risk of inefficient capacity bookings. The enhanced obligations and the transparency requirements proposed by CEPA are appropriate. We are supportive of GDNs being required to publish information that would enable a competent party to ascertain that the NTS capacity bookings were sufficient and efficient[5].

Ofgem should consider conducting ex-ante assessments of the proposed bookings to determine whether GDNs' proposals are efficient and whether GDNs have embedded improvements in practices achieved during RIIO-GD1. Ex-ante assessments should mitigate the risk of distributional impacts across different types of network users and consumers in different locations. We accept ex-ante assessments will result in immaterial levels of regulatory activity. However, the increased scrutiny should be considered in the context of the £1.6 billion[6] of costs expected to be incurred during RIIO-GD1 without that scrutiny.

I hope you find these comments helpful. Please contact me if you would like to discuss any aspect of our response.

Yours sincerely,

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

---

[3] "NTS Exit Capacity Incentive Review"; page 10: https://www.ofgem.gov.uk/system/files/docs/2020/02/cepa_riio2_exit_capacity_report.pdf.
[4] "National Grid Gas Transmission's business plan 2021–26"; page 40: https://www.nationalgridgas.com/document/129016/download.
[5] CEPA proposes requirements. See "NTS Exit Capacity Incentive Review"; page 16.
[6] Data taken from Table 3.03F of the RIIO-GD1 Supplementary Data File 2018-19. See: https://www.ofgem.gov.uk/system/files/docs/2020/02/riio-gd1_annual_report_2018-19_supplementary_data_file_0.xlsx.

Answers to consultation questions

Question 1: What specific GDN behaviours should any future exit capacity incentive mechanism seek to drive, and what consumer benefit would these deliver?

An incentive is this area is redundant because of the pending changes to the gas transmission charging regime. Once the locational signals are removed, the rationale for the incentive is also removed. Instead, enhanced obligations on the GDNs and ex-ante assessments of proposed bookings should be introduced. In combination, these place the onus on GDNs to demonstrate their capacity bookings are efficient and are in consumers' interests. Ex-ante assessments should mitigate the risk of distributional impacts across different types of network users and consumers in different locations.

Question 2: Can you provide evidence of specific actions taken by GDNs in response to the RIIO-GD1 NTS exit capacity incentive, and set out how these have delivered lasting benefits to consumers?

We do not believe specific actions taken by GDNs in response to the RIIO-GD1 NTS exit capacity incentive have delivered lasting benefits to consumers.

The impact of forecast versus actual costs:

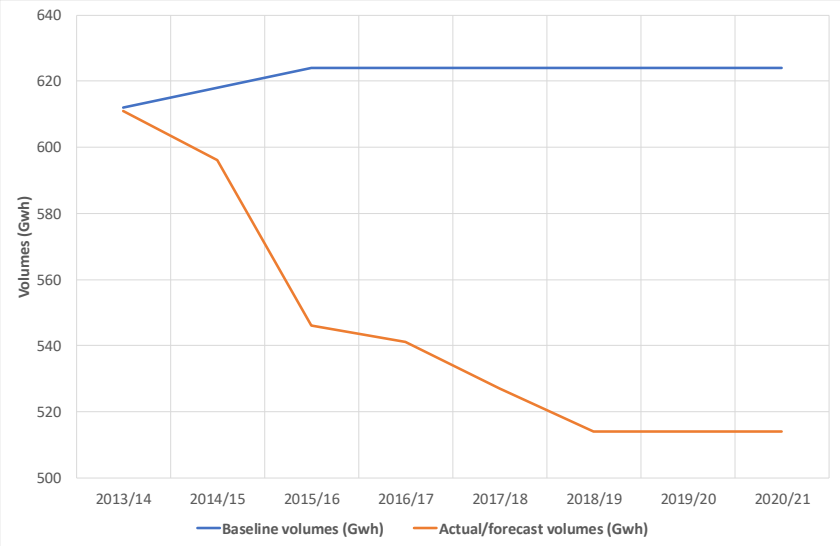
The incentive has rewarded network companies for performance beyond their control and, as such, represents poor value for consumers. In its review of the incentive, CEPA highlights that rewards for the first five years of the RIIO-GD1 price control were about 181% greater than the £50.4m reduction in GDNs' exit capacity costs relative to baseline forecasts[7]. CEPA identifies two main factors not within the GDNs' control that have contributed to the reduction in exit capacity costs relative to baseline forecasts of 4.7% during first five years of RIIO-GD1[8]. One such factor - actual prices being lower than forecast prices – accounts for about 77% of the 'flat' capacity cost savings[9].

The impact of falling demand:

Falling gas demand has contributed to network companies being rewarded for performance beyond their control. The variance between forecast and actual volumes across some networks should be considered. For example, NGN states it outperformed the target bookings by 17.4% during 2018/19[10]. As shown in Figure 1, the outperformance has increased from 0.1% in 2013/14 to 17.7% in 2018/19. It is not credible that the significant variance from baselines is due wholly to network performance.

[7] "NTS Exit Capacity Incentive Review"; page 6.
[8] "NTS Exit Capacity Incentive Review"; page 7.
[9] "NTS Exit Capacity Incentive Review"; page 9.
[10] "RIIO-GD1 Year 6 Report; page 25: https://www.northerngasnetworks.co.uk/wp-content/uploads/2019/10/NGN-RIIO-GD1-Year-6-Report.pdf.

Figure 1 – NGN's Baseline and Actual/Forecast capacity volumes



* Data taken from NGN's RIIO-GD1 Year 6 Report

CEPA states exit capacity costs relative to the target are partly driven by fewer capacity bookings due to lower 1-in-20 peak gas demand levels relative to the baseline[11]. Sectoral peak demand has reduced by about 5% since the start of the current price control[12], requiring less capacity to meet obligations. Nevertheless, this contributes to performance against the incentive.

The impact of significant spare capacity on the transmission system:

The availability of NTS daily products, due to significant levels of spare capacity on the transmission system, has contributed to network companies being rewarded for performance beyond their control. Some GDNs have rebalanced their capacity booking strategies to rely more heavily on cheaper 'flexible' capacity to meet their peak demand obligations. NGGT can offer 'flexible' capacity products, due to the significant levels of spare capacity[13]. The rebalancing means GDNs have been able to reduce costs relative to target simply by utilising cheaper capacity products instead of becoming more operationally efficient. This rebalancing occurred after 'flat' capacity baselines were set during the RIIO-GD1 price control review. The incentive mechanism does not distinguish between the use of various types of capacity products and, as such, this approach contributes to performance against the incentive.

Given the existence of significant spare capacity on the transmission system, we agree the value of price signals as may be generated by the incentive is less clear. Indeed, such price signals could have led to inefficient investment given the flaws of the existing mechanism.

[11] "NTS Exit Capacity Incentive Review"; page 7.
[12] "RIIO-GD2 NTS Exit Capacity Incentive"; paragraph 2.6: https://www.ofgem.gov.uk/system/files/docs/2020/02/ofgem_riio2_exit_capacity_consultation_1.pdf.
[13] "RIIO-GD2 NTS Exit Capacity Incentive"; paragraph 2.6.

Question 3: Do you agree with the considerations we've identified and the issues associated with them?

We agree with the considerations identified and the issues associated with them.

Question 4: Are there any considerations, beyond those we've identified, that we should take into account for incentivising exit capacity bookings in RIIO-GD2

We have not identified any other considerations.

Question 5: Do you agree with the options CEPA has identified, and if not, what others should we consider for RIIO-GD2?

The options CEPA has identified are appropriate.

Question 6: Which of the options presented by CEPA is your preference for RIIO-GD2 and why?

The incentive should be removed but replaced with mitigations. An incentive is this area is redundant because of the pending changes to the gas transmission charging regime.

Question 7: If we removed the existing incentive mechanism without any mitigations, what are the potential risks and how should these managed?

The incentive should be removed but replaced with enhanced obligations and ex-ante assessments of proposed bookings.

Question 8: If we remove the existing incentive mechanism, what enhanced obligations could we consider introducing for RIIO-GD2 that would effectively maintain GDN booking restraint? Please provide any specific examples.

The incentive should be removed. Instead, enhanced obligations on the GDNs and ex-ante assessments of proposed bookings should be introduced. In combination, these place the onus on GDNs to demonstrate their capacity bookings are efficient and are in consumers' interests. Ex-ante assessments should mitigate the risk of distributional impacts across different types of network users and consumers in different locations.