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Dear David,

Electricity System Operator incentives from April 2017

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

We agree that the current approach to setting a financial target for balancing costs may not be working as well as it could be and that it is necessary to conduct a fundamental review. While the review is being conducted:

- **We support maintaining commercial incentives on the System Operator (SO)**
- **Improvements should be made to the current incentive regime to ensure its effectiveness.**
- **Further consideration and consultation should be given to the arrangements between SO and Transmission Owner (TO), potentially as part of the price control mid-period review 'parallel work' programme.**

Improvements are required to the current incentive regime to make it effective from April 2017. In order to ensure that the SO has a sufficiently sharp incentive, the sharing factors should be reduced. In all recent schemes, SO financial performance has either been outside, or near the edge, of the range for which it has a financial incentive. The incentive will weaken considerably as expected performance nears the cap or collar. This is likely to be, at least in part, due to inappropriate targets being set. The information imbalance, and related issues with target setting, is recognised in this consultation. The increase in sharing factors, combined with the difficulties in target setting, has therefore effectively dulled the incentive on the SO. Reducing the sharing factor to 10% will widen the range over which NG is incentivised to control BSUoS costs from £200m to £600m. This would ensure the SO is consistently given an effective incentive.

Detailed views on other elements of the incentive scheme are given within the responses to the consultation questions.

Greater coordination between the SO and TOs and allowing the SO to fund TOs to undertake certain works may reduce overall system costs. Ensuring incentive arrangements are appropriate for all parties is not a straight-forward task. It is important that a regulatory assessment is carried out to determine whether such costs were efficiently and appropriately incurred and that the TO is not receiving additional funding for delivering outputs for which it has already been funded. This should be considered as part of the parallel work for the RIIO-T1 mid-period review.

We hope you find these 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

Responses to Consultation questions

CHAPTER 2: Whether to maintain the existing incentives framework

Question 1a: Should we place financial incentives on the SO in the period between 1 April 2017 and when we are in a position to implement longer term SO incentives?
Yes

Question 1b: If we maintain financial incentives from April 2017 to spring/summer 2018, should we use the existing BSIS framework?
Yes, there is insufficient time to development an alternative framework.

Question 1c: Do you agree that if we maintain the existing incentives framework during this period, we should seek improvements from the 2015-17 scheme? Please provide evidence to support your answers
We agree that the current approach to setting a financial target for balancing costs may not be working as well as it could be and we support the use of the existing incentive framework but with improvements. Improvements for the interim framework should be:

- Reducing the sharing factor to 10%;
- Introducing an incentive relating to short term demand forecasting;
- Introducing a penalty-only incentive relating to the transparency and openness of balancing services procurement.

We would also note that BSIS targets should not be adjusted once fixed. The recent Income Adjusting Event, for example, weakens the ex-ante incentive properties.

Reducing the sharing factor to 10%
In schemes since 2008, the incentive value has exceeded the cap or collar several times and has flipped between positive and negative rewards. Figure 4 of the consultation shows that the cap has been hit in three of the last five schemes. For the two schemes that remained within range, performance was close to the edge of the range. The 2011-13 scheme landed marginally within range after an Income Adjusting Event whilst we note that for the 2013/14 scheme National Grid's 2013/14 Performance Report[1] states that outturn costs were £830m compared to a target of £980m, which implies the cap was hit again.

As expected costs approach or exceed the cap or collar in any year the incentive properties of the scheme are significantly weakened as the incentive value is potentially zero. Once performance is certain to fall outside of the incentivised band, the incentive properties may become perverse since any additional efficiencies may lead to tougher targets in future schemes without any marginal reward in the present scheme. A 10% sharing factor combined the current maximum reward/penalty of £30m would provide a range of £300m over or under target within which the incentive properties of the scheme are maintained. The evidence presented in Figure 4 of the consultation shows that that the maximum variance between actual and target costs in the last 5 schemes is £257m. Therefore we

[1] Our performance scorecard for 2013/14 – We will…focus on the delivery of our outputs
http://consense.opendebate.co.uk/files/nationalgrid/nationalgrid/transmission/NG_Electricity_Transmission_Detailed_Performance_Scorecard_..pdf

believe that a sharing factor of 10% is appropriate to ensure that National Grid remain incentivised to seek efficient cost solutions in most circumstances.

Given the extensive concerns with target-setting outlined in this consultation, it would not be appropriate to increase the cap/collar.

Introducing an incentive relating to short term demand forecasting
We support the introduction of an incentive relating to short term demand forecasting which captures the effects of intermittent and embedded generation because it is unlikely balancing actions and costs will be as efficient as can be without sufficient understanding of these influencing factors. Further, without sufficient understanding of these factors, the SO may unintentionally provide inappropriate signals and distort the markets for balancing and ancillary services.

Any incentive relating to the transparency and openness of balancing services procurement should be penalty only
Our expectation is that National Grid should always be seeking to be open and transparent with respect to its balancing services procurement and should always be seeking market based solutions. As such, any incentives should not reward National Grid for these behaviours. Any incentive relating to the transparency and openness of balancing services procurement and the pursuit of market-based approaches should be penalty only.

CHAPTER 3: Scope of potential changes from the 2015-17 scheme

Question 3a: How could the BSIS target setting approach and modelling methodologies be improved in the short term?
The constraint model could be reviewed to ensure it remains fit for purpose and appropriately models developments, such as new voltage issues or inertia issues, as the nature of the system changes.

Question 3b: Do you believe the existing BSIS sharing factor and cap and floor remain appropriate?
No, as set out above we believe the sharing factor needs to be reduced in order to ensure that the incentive properties of the scheme are not impaired by the frequency with which incentive performance outturns above or below the cap or collar. Of the five schemes set out in Figure 4 of the consultation, three hit the cap, one landed just within the collar even after an income adjusting event (2011/12 – 2012/13) and the data for the other (2013/14) is at odds with National Grid's own performance reporting which states that it also hit the cap in that year.

This evidence suggests that rewards are dictated largely by inappropriate targets associated with the difficulty in the ex-ante modelling of efficient costs rather than SO performance because it is unlikely that the underlying efficiency of SO performance will exhibit such year-on-year variability. Given the acknowledged information asymmetry between Ofgem and National Grid it would not be appropriate to increase the cap/collar and we believe the appropriate solution is to reduce the sharing factor. We believe a 10% sharing factor, combined with a cap/collar of £30m will provide the necessary bandwidth to ensure that the system operator remains incentivised in most circumstances to deliver the most efficient outcomes.

Question 4: What is the best way to set an incentive on the SO to incur efficient costs when procuring Black Start from April 2017?

We do not believe National Grid is sufficiently incentivised on Black Start and consider it is taking an overly cautious approach. In our view the procurement process for 2016/17 Black Start costs was poor and certainly 2016/17 costs should not be used as a basis for an ex-ante allowance in future years. We also believe that the Income Adjusting Event mechanism impairs the effectiveness of an ex-ante scheme.

We acknowledge the difficulty in setting an appropriate target for Black Start costs for April 2017 and believe this further supports a reduction in the sharing factor to 10% to protect customers from an inappropriate target and to ensure that any significant deviation from target for Black Start does not diminish the incentive on National Grid to deliver efficient costs for other balancing services.

Question 5a: Do you agree that we shouldn't maintain the MDLC?

We believe there is merit in maintaining the model development licence condition. As discussed above, we support the introduction of an incentive relating to short term demand forecasting (including the effects of intermittent and embedded generation). Improvements in short term demand forecasting might affect balancing actions carried out by the SO and any improvements should also captured in the target setting models so that genuine efficiencies may be measured.

It is proposed to continue to allow the SO to *"...make amendments to the BSIS models or inputs to the models at any point during the scheme where limitations are identified which prevent them from setting an appropriate target..."*.). It would seem to us to be inappropriate to allow the SO to make amendments without an obligation to continue to develop the target setting models. Continued model development can support rather than conflict with the fundamental review of the SO incentive scheme.

Question 5b: Do you agree that we shouldn't maintain the SO IRM? Are there any alternative ways to encourage innovative behaviour from the SO in the short term?

We agree that it would not be sensible to maintain the SO IRM for a short term scheme. If the BSIS scheme is effective in giving incentives to reduce costs then this will also drive innovation and there is no need for a separate incentive.

Question 6a: Do you believe there is a need for a new incentive on short term demand forecasts from April 2017? How could this be designed? What timescales should it be based on: week ahead, day-ahead, hour-ahead, other?

We support the introduction of an incentive relating to short term demand forecasting which captures the effects of intermittent and embedded generation. Understanding of these influencing factors is needed to ensure balancing actions and costs will be efficient. Further, without sufficient understanding of these factors, the SO may unintentionally provide inappropriate signals and distort the markets for balancing and ancillary services.

In particular we believe these incentives should encourage National Grid to improve forecasting accuracy in the within day and day ahead environment (as well as longer term) to keep costs down and ensure the correct market signals are sent.

Question 7: Do you think the SO's procurement of balancing services needs to be more transparent and open? If so, what steps should be taken? Should the SO pursue more market-based approaches? Should we introduce any incentives or requirements on the SO in this area from April 2017?

Our expectation is that National Grid should always be seeking to be open and transparent with respect to its balancing services procurement and should always be seeking market based solutions. As such, any incentives should not reward National Grid for these behaviours. Any incentive relating to the transparency and openness of balancing services procurement and the pursuit of market-based approaches should be penalty only.

APPENDIX 1 – Consultation on SO-TO mechanism

Question 9: Do you agree that there is a need for a mechanism that allows the SO to exchange funds with the TOs? Are there any additional pros and cons that we should consider in our analysis? Do you agree it should be introduced from April 2017?

Greater coordination between the SO and TOs and allowing the SO to fund TOs to undertake certain works may reduce overall system costs. Ensuring incentive arrangements are appropriate for all parties is not a straight-forward task. It is important that a regulatory assessment is carried out to determine whether such costs were efficiently and appropriately incurred and that the TO is not receiving additional funding for delivering outputs for which it has already been funded. This should be considered as part of the parallel work for the RIIO-T1 mid-period review.