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18 September 2009

**Response to National Grid Electricity System Operator Incentives Mini Consultation on the Development of Incentives for the Energy Related Components of the BSUoS Costs**

Dear Malcolm,

Thank you for the opportunity to respond to this Consultation Document. This response is on behalf of the Centrica group of companies excluding Centrica Storage Ltd.

Within this consultation we believe that National Grid has, for the most part, correctly identified the principal drivers of balancing costs. Furthermore, as we have previously stated, there is a strong argument for indexing costs that cannot be directly influenced by the SO and as such we understand why National Grid would wish to re-examine the NIA formula. However, with regard to NIA, we believe that there is a need to strike a balance between simplicity and transparency. We believe that the proposals for amending the NIA formula would introduce a level of complexity that would be detrimental to the transparency of the entire SO incentives scheme. We would also note, as National Grid has stated, that including bids and offers would involve forecasting volumes and create the potential for arbitrage.

As with the first mini-consultation on the development of incentives for Reactive Power, Black Start and Transmission Losses, we do not believe that a sufficiently strong case has been put forward for extending the duration of the incentive scheme for Energy components. We believe that under existing licence conditions National Grid should be implementing strategies where the costs are recovered over a longer time scale and should not require further incentives to do so. Furthermore, we do not understand why it should not be possible for National Grid and Ofgem to negotiate targets which take into account longer term investments.

We have provided detailed responses to each question below.

1. Are there any other risks or benefits associated with the existing one year bundled scheme?

We are of the opinion that, by and large, the existing one year scheme provides an appropriate balance between accuracy of forecast and regular oversight, although we would like to see further analysis of the effect of shorter term targets. Furthermore, we do not believe that a scheme of longer duration is required to incentivise Grid to make longer term investments. We believe that the potential for increased short term volatility is an additional drawback with longer term schemes. This is because the SO would have a longer period over which to meet its target and would have less pressure to manage costs on a short term basis. Given that the volatility of BSUoS costs is already a significant problem for generators and suppliers, we believe that any development that increases the potential for this would be highly negative.

2. Have all cost drivers been captured and correctly identified as being within or outside National Grid control?
3. Do you consider that there are elements within these cost drivers that are within National Grid control? What are these and how do you believe these should be considered going forward?

We believe this to be a largely accurate account of Grid's influence over the cost drivers identified. The prevailing electricity price and Balancing Mechanism prices are evidently key cost drivers of balancing services and largely outside of National Grid's control. We agree that the variable nature of wind will have significant consequences for how the network is managed; operating margins, STORR, plant availability and flexibility requirements are just a few examples of aspects of network operation that will be affected with greater wind generation volumes. However, it is vital that National Grid focuses on exploring ways to minimise increased costs associated with more wind generation on the system. More flexible STORR contracts and projects to improve wind forecasting techniques are potential mitigation tools. Furthermore, wind itself will begin to play a larger role within the Balancing Mechanism and as such wind should increasingly be viewed by the SO as part of the solution rather just the problem. We would also note the improvements being made in the accuracy of wind forecasting and that it is vital that National Grid utilise the improvements in wind forecasting to minimise balancing costs. In essence, National Grid's actions will require an increased amount of flexibility as more wind comes online.

4. Do you agree that Energy Imbalance, Margin, Footroom, Response and Fast Reserve share the same cost drivers and should be considered together as the Energy component?

Centrica is largely in agreement that energy imbalance, margin, footroom, response and fast reserve share the same cost drivers. However, we believe that additional factors have an influence over footroom. In addition to the power price, plant flexibility, the running patterns of the French interconnector and headroom are also key drivers of the cost of footroom. Nevertheless, on balance we do not believe that this warrants unbundling this segment from the other Energy components.

5. Do you agree with the need for an adjustment factor to mitigate the risk of variations to cost drivers outside National Grid control?

As we have previously stated, Centrica believes that, within reason, there is a strong argument for indexing costs that cannot be directly influenced by the SO as the incentive would become focused on those costs that can be optimised by the System Operator. In that respect we support the use of NIA.

6. Do you agree that it would be appropriate for any adjustment term to cover the identified items?
7. Are there any other terms that you believe it would be appropriate for any adjustment term to cover? If so, what would these be and how would these work?

8. Do you agree that there is a balance between improving the fit and simplicity or should simply the best fit be found?

We do not believe that NIA should incorporate the additional drivers outlined in the consultation. In particular, we believe that including bids and offers would introduce an extra layer of complexity. Also, as National Grid has indicated, this could also lead to the potential for inaccuracy as Grid would have to forecast bids and offers volumes and a potential for arbitrage would be created.

We are strongly of the opinion that a balance must be struck between simplicity, transparency and accuracy. Industry engagement in the development of the SO incentives process is vital for the schemes to remain legitimate. As such, we believe that a significant increase in the complexity of NIA could lead to disengagement of interested parties, thereby undermining the entire SO incentives process.

9. Which calculation period do you think is more appropriate, daily or half hourly?

At the present time, given that it is still in the initial phases, we believe that more analysis is needed in order to better understand the impact of moving to a daily calculation. We would like to see this additional analysis included in the Initial Proposals consultation when it is published in October.

10. Which variables do you think should be included in an improved NIA?

11. What other NIA formats should be considered? Do you believe that there are benefits in including a NIA methodology that has a kinked line?

Centrica is largely comfortable with the current NIA methodology and believes that any changes made to improve accuracy should not have a highly negative impact on transparency. We believe that the incorporation of a kinked line would involve an increase in complexity that has the potential to cause industry disengagement with the SO Incentives process.

12. Do you believe there are benefits in the implementation of a longer than one year scheme?

Currently we do not believe that a sufficient case has been put forward to warrant increasing the duration of the incentive scheme. As we have stated in previous consultations, under existing licence conditions National Grid should be investing in long term efficiency tools and should not require further incentives to do so. In essence, we do not consider that there are currently any obstacles to National Grid implementing strategies where the costs are recovered over a longer time scale. We do not understand why it should not be possible for National Grid and Ofgem to negotiate targets which take into account longer term investments.

13. Are there any additional benefits or drawbacks in the development and implementation of an unbundled incentive?

An additional benefit of a bundled scheme not mentioned within the consultation is the simplicity that it affords the scheme. Whilst we accept that the relationship between the individual Energy-related segments is stronger than with other system costs, we do not believe that unbundling is warranted.

14. Do you have any other comments regarding this consultation?  
- Document structure

- Overall content and level of information provided
- Process

We do not have any other comments.

I hope these comments have been useful. If you want to discuss any element of this response, please do not hesitate to contact me on 07789 579169 or at [Ricky.Hill@centrica.com](mailto:Ricky.Hill@centrica.com).

Yours sincerely,

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