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Response to National Grid Electricity System Operator Incentives Mini Consultation on the Development of Incentives for Reactive Power, Transmission Losses and Black Start

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.

Centrica has been consistent in its assertion that to date a sufficiently strong case has not been put forward for extending the duration of the SO incentive scheme beyond one year. It is claimed that longer term incentive schemes would enable National Grid to take a more strategic view of its operations, and more specifically, provide a stronger incentive to make investments with payback periods of over one year. However, Centrica believes that 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 entering into long term contracts for services such as reactive power or for the SO to make investments which have a payback period of several years. Furthermore, no quantitative analysis has been provided in this consultation document to the contrary.

We believe that there is a case for the indexation of targets when the associated costs cannot be directly influenced by National Grid. The benefit of indexation is that it allows the incentive to be focused on those costs that can be optimised by the System Operator. However, whilst we are of the opinion that there is a strong argument for indexation, it would have been useful to see a thorough analysis of the financial impact on the scheme included in this consultation to confirm this. We would also note that other means of mitigating price volatility, such as hedging, were not explored within the consultation document.

The drivers used in any indexation will also need to be carefully examined in order ensure that there remains a strong incentive on National Grid to manage costs. We would accept the premise that in general risks should be borne by the party best placed to manage those risks and that parties should be rewarded or allowances reduced accordingly. In essence, the indexation of targets represents a shift in risk from National Grid to Users, and if the target is indexed to too many drivers all the risk in this area currently borne by National Grid would be eliminated and the incentive on National Grid to manage costs would be weakened. Indeed, a situation could potentially arise whereby the incentive scheme becomes meaningless as the target would simply increase or decrease according to the different variables.

With regard to black start, we agree that the current BSIS scheme places an appropriate incentive on National Grid to manage costs, and as such, does not require any modification. We also agree that the cost of providing black start could increase in the future due to the higher penetration of nuclear and intermittent generation and the resulting long periods when thermal plant contracted for black start will be left cold. However, whilst it is possible that the costs of providing black start may rise in the longer term,

no explanation has been provided as to why the current scheme (with the target adjusted accordingly) would not be an appropriate tool for incentivising the SO to manage its black start costs going forward.

We have provided detailed responses to each question below.

1. What benefits do you see for the development of an indexation methodology for reactive power costs? What drivers should be included in such an index?

Centrica believes that 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. However, we also believe it is important to understand the effects of using certain drivers within the indexation. For example, if reactive power (or any other segment) was indexed to all of the main drivers that affect the cost, the risk currently borne by National Grid would be eliminated and the incentive on National Grid to manage costs would be weakened. Indeed, a situation could potentially arise whereby the target becomes meaningless as it would simply rise or fall according to the different variables. As such, in order to conclude the most appropriate drivers to use in any indexation, Centrica believes that further analysis should be undertaken ascertain the financial impact of indexing the reactive power target to specific drivers. We also believe that other methodologies to minimise the effects of price variability, such as hedging, should have been included in this consultation.

2. What benefits do you believe there are in the implementation of a longer than one year scheme?

We do not see justification for extending the incentive scheme period over one year. Currently we do not believe that a one year incentive scheme precludes National Grid from investing in longer term services for reactive power from third parties. Furthermore, there is also a possibility that some generators maybe unable to engage in a contract of over 12 months for the provision of reactive power. Another reason put forward by National Grid is that the current schemes prevent it from investing in equipment with a longer term payback such as IT systems. Again, we believe that under current licence conditions National Grid already has the duty to invest in these if they are economic and efficient.

It is argued by National Grid that the annual schemes only allow for a realisation of short term cost benefits, and as such, the majority of resources are focused on short term savings. However, 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 also believe that another consideration with regard to longer term incentives is the potential for increased short term volatility: National Grid 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.

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

We agree with the proposition of unbundling this segment and applying high caps and collars and sharing factors. We believe that this would potentially better incentivise National Grid to minimise reactive volumes. However, we partially disagree with National Grid's assessment of the benefits from unbundling this segment and in particular the assertion that unbundling would enable greater industry understanding through more detailed analysis. We believe that there is currently

nothing preventing National Grid from undertaking and publishing analysis of reactive power to increase industry understanding in this area.

4. Please provide your views on the development of the reactive power incentive? Do you see any benefits in changing the current arrangements?

We do not believe that any other changes should be made to this segment.

5. What benefits do you see for the development of an indexation methodology for transmission losses? What drivers should be included in such an index?

As with the proposals for indexing Reactive Power, we believe that there is an argument for the development of an indexation methodology for transmission losses, on the proviso that the incentive on National Grid to manage costs would not be reduced. As such we believe that further quantitative analysis is required to better understand the impact on the incentive scheme. In terms of the drivers used, we believe that the price of transmission losses could be calculated on a half-hourly basis using, for example, the BSC MID price as a proxy for cost.

6. Please provide your views on whether the SO can influence sufficient drivers to reduce Transmission Losses?

Centrica agrees that National Grid has limited influence over transmission losses on the system. As such, we believe that the transmission losses segment should be considered for omission from the entire BSIS scheme.

7. What benefits do you believe there are in the implementation of a longer than one year scheme?

As stated above, we do not believe there any benefits in increasing the length of the incentive scheme for transmission losses or any other segment. Centrica is of the opinion that National Grid's current licence conditions should be sufficient to ensure that National Grid follows all possible long term and well as short term measures to minimise losses on the network regardless of the incentive scheme in place.

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

As noted above, given the limited amount of influence that National Grid has over transmission losses, we are of the opinion that transmission losses should be omitted from the Incentive scheme.

9. Please provide your views on the development of the transmission losses incentive? Do you see any benefits in changing the current arrangements?

We do not believe that any other changes should be made to this segment.

10. What benefit do you see in developing a transmission losses zonal forecast incentive?

The benefits of developing a transmission losses zonal forecast incentive are not immediately apparent. If National Grid would like to pursue this, we believe that it would require further analysis and consultation.

11. What benefit do you see in the development of a Transmission Losses procurement incentive similar to the Gas Shrinkage incentive?

We do not believe that a sufficiently strong case has been put forward by National Grid for it to procure transmission losses. We would also note two negative developments that could arise from such a scheme. First, the cost of transmission losses could potentially rise from National Grid being the sole, and predictable, purchaser of electricity to cover losses. Furthermore, such a change could involve significant modifications to Users' IT systems.

12. Do you agree that National Grid should be incentivised on the procurement of black start services for 2010/11 and 2011/12 as under the current scheme framework?

Centrica agrees that, given the number of black start providers available and the current generation background, the current black start component of BSIS places an appropriate incentive on National Grid.

13. Do you believe that the black start scheme should be extended to a 2 year target?

No.

14. How do you believe black start services are best procured post 2012?

We do not believe that black start services should be procured differently post 2012. Whilst we agree that a significant proportion of black start providers will close in the medium term, we do not see any reason why a different procurement process would be beneficial. If the generation background leads to increased costs for black start, this should be reflected in the targets set.

15. Did you find the level of information within this consultation informative? What additional information should National Grid provide to explain better?

Whilst we found the level of information provided useful, we would have found it helpful to see more quantitative analysis on the effects of the proposals, especially with regard to indexation. For example, National Grid could have demonstrated how targets for reactive power and transmission losses would have panned out in previous years if they had been indexed to certain drivers.

16. Do you have any further comments on any aspect of this consultation in relation to the Electricity SO?

No.

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.

Yours sincerely,

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