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Response to National Grid Electricity System Operator Incentives Initial Proposals Consultation

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.

The sharp rise in BSUoS charges in the first nine months of 2008 has served to emphasize the importance of the accurate forecasting of BSUoS costs and of the need for a transparent incentive scheme that encourages National Grid to manage costs.

Due to the small cap and low sharing profiles, the current scheme (and to a large extent the proposed schemes) do not provide a sufficiently strong incentive to manage costs. Indeed, once the cap has been breached there is little incentive on National Grid to reduce costs over the remainder of the period.

We have provided some general comments in this covering letter with more detailed comments in the attached questionnaire.

Fixed BSUoS charging

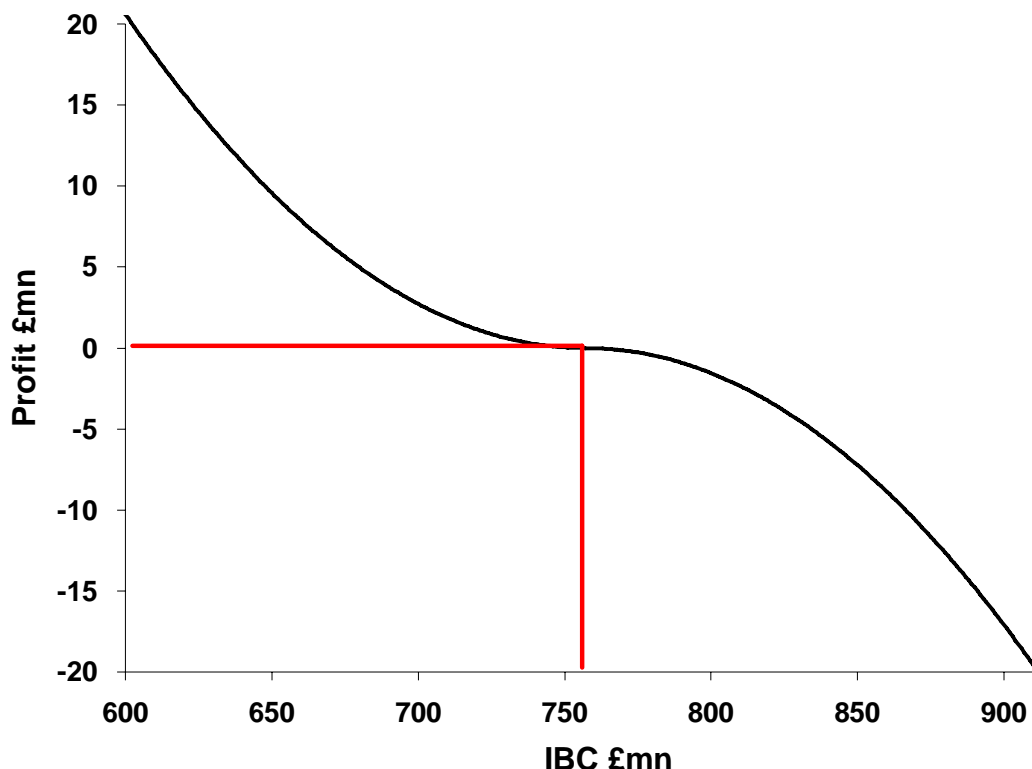
Centrica is a strong supporter of investigating the possibility of a fixed charging regime for BSUoS. It is our opinion that fixing BSUoS costs, for example on an annual basis would allow suppliers and generators to manage BSUoS volatility, and therefore avoid passing on the cost of additional risk to customers. We were very disappointed that National Grid's promised consultation on fixing BSUoS was not forthcoming, nor is the issue properly addressed in this consultation. The volatility of BSUoS has been a genuine problem for generators and suppliers alike in 2008, and there was strong support from the industry for examining mitigation methods.

Centrica believes that fixed BSUoS charging has the potential to represent the best possible outcome for customers as it would help stabilize electricity prices over the course of the twelve month period, thus enabling suppliers to set fixed tariffs on a more cost-reflective basis. Centrica realizes that such a scheme involves the transfer of an amount of risk from users to National Grid but we believe that with the possibility of recouping any losses incurred in a given year in the following year, this option can be equitable to all parties.

Option 1 should be reversed to make the penalty proportionate to the size of the breach of the target rather than inversely proportionate

Centrica is of the opinion that the variable sharing factors outlined in Option 1 should be inverted in order to punish larger breaches more than smaller breaches. As it stands, the incentive power on National Grid reduces the more the target is exceeded.

The chart below shows profit and loss with sharing factors increasing the more the target is exceeded. As the sharing factors on this curve increase rather than decrease, a cap and collar would need to be factored into the scheme.



Replacing fixed caps and collars with percentage caps and collars

Currently, caps and collars are fixed at an absolute level (e.g. £15 million for the 2008/09 scheme). The problem is that once the cap has been breached, the burden is placed entirely on users through higher BSUoS charges with no additional payback. Users have been significantly affected in the 2008/09 scheme. The £15 million cap represented only 3% of the initial IBC of £535 million, and as the latest IBC estimate from National Grid is 44% higher than the original target, it is clear to see how limited the cap has been as a tool of correction.

One way of improving this situation would be to calculate the caps and collars as a percentage of the IBC. For example, if the cap and collar for the 2008/09 scheme had been fixed at 3% of the IBC rather than £15 million, the cap and collar would have risen to £23.1 million in the light of the latest forecast. This would have gone some way in mitigating the increased costs faced by users whilst increasing the incentive on National Grid to manage costs.

The core focus of the current incentive scheme is to judge National Grid on its ability to predict future power prices

The current scheme, as well as those proposed in this consultation, are largely focused on incentivising National Grid to forecast forward power prices accurately. Centrica believes that increasing the efficiency of balancing the Grid should be the focus for the TO, and as such this should be more explicitly built into the incentive scheme. In the light of this it would be logical to allow the IBC to move in line with movements in power prices, as has been proposed for the reactive power segment.

Transmission losses should be omitted from the incentives scheme

Option 6 in the consultation proposes the unbundling of transmission losses from the other segments and applying a lower sharing factor due to the limited amount of control that National Grid has over minimising these losses. Centrica believes that due to the limited control that National Grid has over transmission losses, this segment should be omitted from the incentive scheme.

National Grid should have monthly targets profiled on risk

Centrica agrees in principle with Option 2 which would break the yearly incentive into monthly or quarterly targets. We believe that shorter incentive periods would increase the pressure on National Grid to manage costs over the entire year. However, we believe that rather than having monthly or quarterly targets of equal size, the targets should be profiled to reflect varying costs throughout the year. Should National Grid underrun or overrun on its target, we could explore the possibility of a mechanism whereby this would have a knock-on effect to the following month's forecast (e.g. reducing it or increasing it).

Centrica does not believe that there is a strong argument for longer term incentives

Options 7 and 8 in the consultation propose extending the target period for reactive power and transmission losses to a multi-year target. Centrica disagrees with these specific proposals and does not believe that the targets of any other components should be considered for extension. Under existing licence conditions we would expect National Grid to invest in long-term efficiency tools and we do not believe that any changes to this area would be in the interest of users.

We hope our comments are helpful. Should you require any additional information or wish to discuss any aspect in more detail please contact me.

Yours sincerely,

Ricky Hill
Industry Development Analyst
Centrica Energy

1. Do you agree with the areas identified as the main cost drivers 2008/09? Are there any other drivers not explicitly identified?

Centrica agrees that temperature, plant availability, market length, network constraints, overall demand and their effects on wholesale prices are the key drivers of National Grid's forecasts. However, that these are the key drivers is largely due to the fact that under the current scheme the overriding focus for National Grid is to forecast forward power prices accurately rather than to manage the network effectively. It is for this reason that Centrica believes that indexing the IBC to wholesale power prices would provide a stronger incentive to National Grid to make efficiency improvements.

2. Do you agree with the high level assumptions outlined:

- utilisation of forward power prices and the 60% - 160% range?
- market length central and ranges?
- generation availability and utilisation of OC2 data?

3. Do you agree with the assumptions (described in detail in the appendix) used to forecast the various elements that make up underlying balancing costs?

Centrica is largely in agreement with the assumptions in calculating the forecasts for 2009/10.

Whilst we are comfortable with the way in which forward power prices have been utilised in the forecasts, we believe that there would be merit in factoring in a forward price adjustment throughout the year which would shift the IBC in line with power prices. Given that electricity prices cannot be forecasted over the medium term with any certainty, we believe that this would be a logical adjustment to the scheme.

With regard to market length, National Grid has used a weighted average of the previous four years to develop the forecast assumption on a 4:3:2:1 weighting for BSIS years 08/09, 07/08, 06/07, and 05/06. Centrica believes there is a risk that such an approach as the most recent year may not necessarily be a more accurate forecast of the forthcoming year than the previous three.

4. Do you agree with the areas identified as the main cost drivers for 2009/10? Please explain your rationale. Are there any other drivers not explicitly identified? In particular, do you agree with the assumptions used to forecast margin (reserve, STOR and BM start up) and constraint costs?

5. Do you have any comments on the assumptions used in determining the increase in costs associated with the revised operation of the England / France interconnector known as Use it or lose it?

Centrica is largely in agreement with the areas identified as the principle cost drivers for the 2009/10 period. We have reservations with regard to 'New NIA' which are outlined in our response to question 7.

With regard to the forecast of margin costs, we agree that due to the interactions between reserve, BM start up, and STOR costs, it is logical to combine these.

We believe that National Grid is correct in reducing its latest 2008/09 operating reserves forecast of 4.3 TWh by 0.3 TWh in the 2009/10 forecast. Due to the connection of a number of new CCGTs coming online and the additional wind capacity, we are of the opinion that the system is likely to be longer during 2009/10 and that headroom will be higher. We also believe that the system will be helped by additional generation units having been fitted with FGD and becoming fully available and a reduction of demand due to the poor economic environment.

With regard to constraints, Centrica recognises that these have been an issue for National Grid over during 2008 and that they are likely to become even more of an issue during the 2009/10 period. We urge OFGEM to continue to work with TOs to encourage long term investments in the network.

We agree that the 'use it or lose it' changes to the interconnector will have an effect on constraint costs in southern England. It is logical that removing NG's ability to utilise short-term capacity means that the possibility to alter flows is not guaranteed and that National Grid may have to take alternative measures.

6. Do you believe that we should include some provision for a volume of additional generation connecting as a result of the interim connect and manage arrangements? If not, how do you believe we should manage the risk of additional generation connecting?

We do not believe that any changes to the access regime during the 2009/10 period would have a significant impact on the amount of generation coming online.

7. Do you agree with the implementation of a new adjustment as described as new NIA? If not, please outline your rationale?

Whilst Centrica believes that all aspects of the incentive scheme should be cost reflective we do not currently feel that there is sufficient evidence to adopt the new methodology for calculating NIA.

'New NIA', as it is shown in Figure 2.8 of the Consultation Document, does not appear to distribute costs evenly between a short system and a long system. For example, when the system is long under 'New NIA', cost per MWh is higher than the current NIA between 0 MWh and circa 300 MWh. However, when the system is short, cost per MWh is higher than current NIA between 0 MWh and circa -1300 MWh. Although National Grid admits that "at the extremes of operation... [e.g. at very short or very long markets] the current NIA adjustment more accurately reflected the costs incurred", it would be useful if National Grid could provide further proof that the new formula provides a better fit.

8. Do you agree with the implementation of a new reactive power index? If not, please outline your rationale? Are there any other indices that we should consider?

Centrica believes that there is a strong argument for indexing costs that cannot be directly influenced by the SO. Indeed, we are of the opinion that, as a general principle, all costs which cannot be directly influenced by the SO should be indexed. This allows the incentive to be focused on those costs that can be optimised by the System Operator. Such a move would help shift the incentive away from NG's ability to forecast power prices to NG's ability to manage the system efficiently.

9. Do you have any comments on the forecast range of incentivised balancing costs and BSUoS costs for 2009/10? Specifically do you believe that the range is too wide or narrow or do you believe it represents the full range of costs?

Centrica believes that the range of possible balancing costs identified by National Grid is reasonably accurate.

10. Do you have any comments on option 1? In particular:

- sharing profile
- benefits / drawbacks of such a scheme
- do you support implementation of such a scheme in April 2009

Centrica believes that the sharing factors in Option 1 should be inverted in order to punish larger breaches to a larger extent than smaller breaches. As it stands, the sharing factor in Option 1 decreases the further the target is breached, hence, the pressure on National Grid to manage costs decreases the further it misses its target. Inverting the sharing factors would overcome the core drawback of this scheme. Please see the covering letter for an example of how the curve could look with the sharing factors inverted.

As it stands, Centrica would not support the implementation of such a scheme in April 2009, although we would support the inverted curve as described above.

11. Should we consider a change to the incentive period to ensure that an incentive remains on National Grid over the year? Would you support the implementation of such an incentive?

12. What could such an incentive scheme look like?

- incentive period (e.g. monthly, quarterly)
- caps and collars
- sharing factors

Centrica agrees in principle with Option 2 which would break the yearly incentive into monthly or quarterly targets. We believe that having shorter incentive periods would increase the pressure on National Grid to manage costs over the entire year.

However, we believe that rather than having monthly or quarterly targets that do not change from one period to the next, the targets should be profiled to reflect the varying costs throughout the year. Should National Grid underrun or overrun on its target, we could explore the possibility of a mechanism whereby this would have a knock-on effect to the following month's forecast (e.g. reducing it or increasing it).

Centrica believes that fixed caps and collars should be replaced with caps and collars that are a percentage of the IBC. The problem with the current and proposed schemes is that once the cap has been breached, the burden is placed entirely on users through higher BSUoS charges with no additional payback. For example, the £15 million cap in the 2008/09 scheme represented only 3% of the IBC of £535million, and as the latest IBC estimate from National Grid is 44% higher than its original target, it is clear to see how limited the cap has been as a tool of correction.

We would prefer caps and collars to 'float' with the actual balancing costs. If the cap and collar for the 2008/09 scheme had been fixed at 3% of the IBC rather than £15 million, the cap and collar would have risen to £23.1 million in the light of the latest forecast. This would have gone some way in mitigating the increases faced by users whilst strengthening the incentive on National Grid to manage costs.

With regard to sharing factors, in principle, Centrica is in favour of an inverted version of option 1, whereby sharing factors increase the further the outturned IBC moves away from the central forecast.

13. Do you agree with the implementation of reactive power indexation?

See question 8.

14. Do you agree with the unbundling of reactive power? Should the bundled scheme caps and collars be changed from £20m?

15. Do you agree with the unbundling of transmission losses? Please give your rationale.

Given that National Grid has significant control over the volume of reactive power procured, we agree with the proposition of unbundling this segment and applying high caps and collars and sharing factors. We believe that this would incentivise National Grid to reduce reactive volumes. On the other hand, given that National Grid has limited influence over transmission losses, Centrica believes that these should be omitted entirely from the incentive scheme.

16. The transmission losses reference price is currently calculated on an annual basis. Do you believe there are any benefits in changing this to a more frequently calculated transmission losses reference price, such as daily? Please give your rationale.

Given that transmission losses are set to remain within the incentive scheme for the 2009/10 period, we are in favour of reducing the time period for which the price is calculated. We believe that such an adjustment would more accurately reflect the costs involved. We see no reason why the price of transmission losses could not be calculated on a half-hourly basis using, for example, the BSC MID price as a proxy for cost.

17. Are there any other components that you believe should be unbundled?

No.

18. Do you agree with multi-year reactive power scheme? Please give your rationale.

19. Do you agree with multi-year transmission losses scheme? Please give your rationale.

20. Are there any other components that you believe should have a multiyear scheme?

Centrica disagrees with these specific proposals and does not believe that the targets of any other components should be considered for extension.

Under existing licence conditions we would expect National Grid to invest in long-term efficiency tools. In addition, we believe that there is not sufficient transparency of costs to effectively monitor and measure longer term objectives.

21. Which is (are) your preferred incentive scheme(s)? Please provide reasons and your views on caps, collars and sharing factors.

Of the incentive schemes proposed by National Grid, Centrica's preference would be for an inverted version of option 1, with sharing factors increasing rather than decreasing. We believe that the maximum sharing factor could be above the ~17% proposed by National Grid. As explained above, Centrica would be in favour of caps and collars that are a percentage of the IBC rather than a fixed amount.

22. Do you have any comments on the forecast range of BSUoS costs for 2009/10?

Centrica believes that the forecast range of BSUoS costs for 2009/10 is reasonably accurate.

23. Did you find the level of information within this consultation, and associated documentation and workshop, on our balancing and BSUoS costs forecasts for the current year and 2008/09 informative. - What additional information should National Grid provide to explain better the costs and cost drivers?

The information provided in the consultation was informative and comprehensive. The workshop was also a useful forum in which discuss the issues raised in the consultation. In terms of improving the process, we would find it helpful if National Grid were to publish the models used to generate the forecasts in full.

24. Do you have any further comments on the analysis and information provided within the appendices to this consultation or in the further documentation available on our website?

No additional comments.

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

No additional comments.