

Mr. John Perkins
National Grid plc
National Grid House
Gallows Hill
WARWICK
CV34 6DA

19 December 2008

RE: **GAS SO INCENTIVE PROPOSALS FROM APRIL 2009**

Dear John,

Centrica welcomes the opportunity to comment on the issues raised in the consultation on the Gas System Operator Incentives for April 2009. This response is on behalf of the Centrica Group excluding Centrica Storage Ltd. There is no confidential information contained within this response. We also attempt to answer the questions posed in the consultation document although there is a disjoint between the questions in the main body of the document and those listed in the summary.

Question 1	Do either of the two residual balancing schemes presented better reflect an appropriate balance between driving minimal residual balancing and correct allocation of costs?
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Centrica believes that out of the schemes presented in the consultation proposed scheme A better reflects an appropriate balance between driving minimal residual balancing and correct allocation of costs.

Question 2	Do you have any comments on any aspects of the scheme(s) features or parameters (including the performance target, the daily caps/collars, the balance between the strength of the LM compared to the PPM) ?
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Centrica believes that the only purpose of the linepack measure should be to ensure that undue costs of imbalance are not carried forward and applied in an arbitrary manner. To that extent if a linepack measure is required then it should not have any value to National Grid until the linepack change reaches [10] mcm and from that point onwards it should act to negate any value from the PPM for that gas day.

Question 3	Should this incentive be reviewed periodically (e.g. annually) or only when there is a specific need to?
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Until there has been experience of operation with a weaker or zero linepack measure there continues to be a need for annual review. There is also a need for a more fundamental review of all residual balancing incentives, including the relationship with UAG, default system marginal prices and nomination/scheduling incentives.

Question 4	Do you think it is appropriate to have a separate incentive on UAG? Do you agree that this should be a long term incentive?
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Centrica agrees that it is appropriate to have a separate incentive on UAG. The proposed form of incentive is not strong enough to be used as a long term incentive, however.

Question 5	Do you agree with the proposed UAG incentive and do you have any comments on the specific proposals outlined (including whether a scheme should be based around gross UAG and whether the proposed target and incentive value are appropriate)?
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The proposed UAG incentive is a small step in the right direction. Daily UAG should be a random variable with mean 0 and some variance. The incentive should therefore be designed to encourage randomness (e.g. not negative in winter and positive in summer), a mean of 0 and minimised variance. We are not sure that gross UAG is the most appropriate measure.

Question 6	Do you believe that any limits should be applied to the proposed scheme? Please describe how best to achieve this e.g. by suggesting a deadband, cap or method for resetting the target?
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Our concerns with the proposed scheme are that the base target has been set at the average gross UAG for the years 2001/02 to 2007/08 and the impact of equal sharing of benefit between National Grid and shippers. The initial target should be for a reduction in gross UAG and there should be a quarterly application related to the actual SAP values during the quarter rather than a flat £xk/GWh over the year as a whole.

Question 7	Do you believe there is an alternative proposal that would better incentivise reduction of UAG volumes?
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The ideal incentive would be for National Grid to be exposed to the difference between the value of gas sold for negative UAG and the value of gas purchased for positive UAG with an adjustment to allow for any difference between average SAP values on days of negative and positive UAG. There also needs to be a review of National Grid's meter validation obligations and allowances in order to enable this.

Question 8	Do you agree with the shrinkage volume forecasts? Do you have any comments to make?
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The overall annual shrinkage volume forecast appears to be acceptable. The quarterly targets may, however, need some adjustment to allow for non-linearity in the relationship between CFU and St. Fergus flows.

Question 9	Do you support using outturn flows at St Fergus as a target driver for the compressor fuel forecast?
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Centrica offers qualified support for the using outturn flows at St. Fergus as a target driver for the compressor fuel forecast.

Question 10	Is there still a requirement to have bands around the compressor fuel volume target or should the continuous relationship be used?
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A continuous relationship should be used.

Question 11	Do you believe it is appropriate to review the GCRP uplift?
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This question only appears in the summary of consultation questions

The GCRP uplift is required because National Grid needs to undertake residual buy or sell trades for fine tuning. The reason that these trades are required is related to variation in UAG from day to day rather than CFU, which can usually be predicted fairly accurately. This is therefore a UAG and residual balancing issue and the GCRP uplift should not be seen in isolation.

Question 12	On what basis do you believe the GCRP Uplift should be set for 2009/10 (e.g. storage based or market based)?
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This is numbered as question 11 in the main body of the text

The GCRP should continue to be set at some fixed ex-ante level, which National Grid can use to decide whether or not to buy storage against.

Question 12	Do you support the proposed enduring ECRP methodology based on wholesale prices uplifted to reflect retail costs? Is there a more appropriate reference that could be used for the wholesale prices?
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This question only appears in the main body of the text

Centrica supports the proposed enduring ECRP methodology.

Question 13	Do you agree that the outturn UAG volumes should be passed through this scheme?
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See the answer to question 7 above.

Question 14	Do you have a preference between an annual or quarterly scheme (as described in options 1&2)? Under a quarterly scheme how should quarterly caps and collars be set?
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Centrica prefers a quarterly scheme as this allows for real incentives to improve performance to continue to apply from the beginning of each quarter.

Question 15	Do you have any comments on any of the parameters (e.g. caps, collars, sharing factors) of the scheme and the duration that the scheme should be set for (e.g. 1,2 or 3 years)?
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Until a scheme which works properly has been seen in operation any scheme should not be set for more than 1 year.

Question 16	Given the uncertainty over the impact of OM contestability, do you support passing through the OM holding costs for 2009/10, subject to Ofgem scrutiny?
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Centrica supports the continuation of the current scheme for a further year although we would want to see a separation of the contested and uncontested OM holdings as soon as practicable.

Question 17	If not do you have any suggestions on how OM could be incentivised for 2009/10?
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See the answer to question 16 above.

Question 18	Do you support the proposal to keep the existing OM utilisation incentive?
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Centrica supports the continuation of the current scheme for a further year.

Question 19	Do you agree with the proposal for the continuation of the existing historic average approach for setting a volume target for gas turbine driven compressors?
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No. There is a variation of 20% between the highest and lowest volumes vented and so it is unclear why the target volume cannot be at the level of the second lowest of the previous 8 years rather than using the historical average.

Question 20	Which option do you support to best reflect environmental costs associated with the venting of natural gas?
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Scheme A best reflects the environmental costs associated with the venting of natural gas as all components of natural gas are factored in.

Question 21	Do you support the proposed parameters (including the 3.2% target) for an annual Demand Forecasting Incentive?
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3.2% may be an appropriate target if there is significant activity at Aldbrough and Milford Haven. Centrica would, however, suggest that the target should be set at 3% but with a change in the downside gradient to reduce the impact on National Grid in the event that there is significant activity at Aldbrough and Milford Haven such that the outcomes at 3.5% are equivalent.

Question 22	Should the incentive be set for more than one year?
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No. Once the behaviour of Aldbrough and Milford Haven has been observed the target percentage and/or gradients should be tightened.

Question 23	Do you agree that the current Data Publication incentive should be rolled forward unchanged?
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Yes.

Question 24	Do you believe this incentive should be set unchanged for the remainder of the price control period (2012)?
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Yes.

Question 25	Should the funding arrangements for upgrading the website be made enduring or be removed?
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This should be made enduring as one of the principles of these incentives should be to reward investments which continuously improve operational efficiency or performance.

Question 26	Do you believe that the package of incentives are designed to drive the desired behaviours from the System Operator, providing the right balance between risk and reward?
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The package of incentives proposed does not appear to be providing the right balance between risk and reward. In some cases National Grid again appears to be seeking to increase its reward without an appropriate increase in risk. For example with regard to shrinkage historically NGG's performance has been off the scale and they have collected the maximum £4m incentive for themselves and passed all the costs to shippers leaving the impression that this has been easy money for them. NGG's proposal is a new UAG incentive with an unsatisfactory target and no cap or collar, plus an increase in the maximum shrinkage incentive to £5m.

Question 27	Do you have any other comments on SO Incentives?
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The desired behaviours have not been properly debated or reviewed. Centrica continues to believe that the SO Incentives should be benchmarked against the following criteria:

1. DO THEY INCENTIVISE IMPROVED OPERATIONAL EFFICIENCY:

- **Establish Criteria for Measurement** – Part of the SO incentives should be designed to encourage NGG to improve operational efficiency. The relevant incentives should be transparent and enable stakeholders to see the criteria which are being used in order to measure this. An example is given below.
- **Electric Compressors** – We are led to believe that electric compressors are more efficient than gas but it is unclear what the actual benefits are and how the costs to both NGG and shippers stack up against them in the following areas (NGG should be able to add to this list):
 - Energy consumption when running
 - Greenhouse gas emissions associated with normal running
 - Cost of energy consumed & electricity transmission
 - Ease of low speed running
 - Ease of shut-down / start-up (any difference to gas venting)
 - Risk of failure (e.g. electricity transmission)
 - Need for backup (e.g. on site generator, gas compression)

We can understand that there may be a case for electric compressors to be used for new works or upgrades associated with additional capacity which is funded through the User Commitment process but need to see the case for these to be used for scheduled or accelerated replacement.

2. DO THEY SEEK TO MINIMISE OPERATIONAL COSTS:

- **Shippers require entry capacity** – turning off all compressors would reduce the amount of capacity available on the day
- **Shippers require flexibility** – diurnal swing and normal variation in nominations requires variation in linepack and hence compression
- **Compressor Fuel Usage** – there is a need for more transparency in the derivation of forecasts. The CFU targets are not only related to St. Fergus throughput but also to throughput at Bacton, Barrow, Easington, Isle of Grain, Teesside, Theddlethorpe and Milford Haven. This should be made clear in the consultation documents.

3. DO THEY CONSIDER UNINTENDED CONSEQUENCES:

- **What are the effects of compressor fuel minimisation** – Does this lead to lower operating pressures and/or reduced meter accuracy, affecting UAG?
- **Conflict of objectives** - The price and linepack measures can be in conflict (as discussed - if it is considered that linepack should not move by more than x mcm then the price performance incentive should be at risk).
- **Use of cheapest option should be allowed** – Correction of an imbalance may be more efficient (e.g. use less compressor fuel) the following day
- **Incentives need to be consistent** – Balancing signal is price not volume
- **Effect of procurement** – NGG procurement should not impact market prices and the incentives should try to ensure that this is so
- **Effect of UAG** - Does UAG ever drive NGG to take the wrong balancing actions?

4. DO THEY PROMOTE CONTINUOUS IMPROVEMENT:

- **Long vs. Short term incentives** – too often in the proposals NGG seems to assume that long-term incentives at a flat level are now appropriate. While there might be a preference for long-term incentives these can only be applied once performance and target are working properly i.e. the out-turn lies between the cap and the collar
- **Continuous improvement** – areas such as UAG, Demand Forecasting and emissions associated with compressor operation should be worth investing in so that improvements can continue to be made, either the reward to NGG for past investment should decline, in order to encourage further investment, or the target should be moved. The debate should be around how the reward declines or the target moves and not be about whether or not to change at all.

5. DO THEY ENSURE AN APPROPRIATE BALANCE BETWEEN SO AND USER INCENTIVES:

- **User incentives** – e.g. Users are incentivised to balance through the cashout and energy balancing regime. If these incentives are not strong enough then NGG will be forced to take more system balancing actions than otherwise. This then conflicts with the 'reward for no action' element of the price incentive and users are not sharing the cost appropriately. Hence there is still a need for a more fundamental review of residual balancing, covering relevance of zonal linepack, whether the current regime targets costs of linepack movements appropriately and what the correct linepack deadband is

- **Rate of return and Risk:Reward has been set in TPCR** – NGG should not attempt to change these through SO incentives and should demonstrate that it has not done so.

6. DO THEY ACHIEVE AN ACCEPTABLE LEVEL OF UAG:

UAG has implications which go beyond a volume of gas which is 'lost' or 'gained' within the system on the day. It represents a volume of gas which is somewhere and may be found at a later point in time.

National Grid cannot be complacent about this. Suggestions for future work:

- Use flow meters at strategic points to check zonal linepack and UAG
- Look at relationship between compressor fuel usage, operating pressures and UAG

Please do not hesitate to contact me should you require further information about any of these responses.

Regards,

Clive Woodland
Planning & Analysis Manager