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Sent by email to: anna.kulhavy@ofgem.gov.uk

Dear Anna,

Consultation on the System Operator: Transmission Owner Optimisation Output Delivery Incentive in RIIO-2

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

Ideally, the assessment of the consumer benefits of the System Operator: Transmission Owner Optimisation Output Delivery Incentive (SO:TO ODI) should be based on data over a longer period rather than just a single year. It is possible that that any related degradation in performance in other areas or unintended consequences may not be immediately apparent. Nevertheless, we agree that the ODI should be retained for the remainder of the RIIO-T2 period given the concerns about the magnitude of constraint costs and expected increases.

Our main recommendation (under question 6) is that the ODI can be improved by adopting an approach that reduces the distortive effect of wholesale electricity prices on constraint costs savings, as an alternative to increasing the cap on rewards.

The annual cap on rewards for each transmission network operator (TO) was set with reference to the 2018-19 constraint costs attributed to its network[1]. However, wholesale electricity prices have increased significantly since 2018-19, which has contributed to the significant increase in constraint costs in recent years. Therefore the potential savings resulting from the TOs' activities and the rewards they could obtain are larger, partially because of the significant increase in wholesale electricity prices. We consider that National Grid Electricity Transmission (NGET) achieving the entire annual ODI financial cap during the first five months of 2022-23 is, in part, due to the impact of higher wholesale electricity prices.

We accept that achieving the maximum reward during the year may act as a disincentive to the TOs continuing to seek additional solutions to reduce constraint costs and, as such, it is proposed that the cap be removed. However, we are not comforted that also reducing sharing factor will

[1] See page 12 of the consultation.

sufficiently mitigate the risk of the unintended consequences resulting from the SO:TO ODI being too highly powered relative to the other ODIs in the RIIO-T2 price control.

We, therefore, recommend that constraint costs savings in a relevant year are scaled according to the relationship between a measure of average wholesale electricity prices in 2018-19 and that in the relevant year. Rewards could then be calculated based on the stylised version of constraint costs savings. This approach protects consumers by ensuring that rewards that consumers are required to fund are not 'inflated' simply because of increases in wholesale electricity prices. The approach also protects the TOs in a scenario in which wholesale electricity prices fall below 2018-19 levels.

Answers to selected consultation questions are included in the attached appendix. I hope you find this response helpful. Please contact me if you have any questions.

Yours sincerely,

Gregory Edwards
Network Regulation Manager
Centrica Regulatory Affairs, UK & Ireland

Answers to consultation questions:

Question 2: Do you agree that it is in consumers' best interests for the SO:TO Optimisation ODI to continue to operate for the remainder of RIIO-2?

We agree that the ODI should be retained for the remainder of the RIIO-T2 period.

Question 3: Do you agree with our assessment that there are some aspects of the ODI that could be improved to increase the benefits for existing and future consumers?

We agree that there are some aspects of the ODI that could be improved. Particularly, we agree that rewards available to the TOs should reflect the overall reduction in costs to consumers. There are other improvements that can also be made. They include:

The efficiency of the solutions delivered should be assessed:
We previously encouraged Ofgem to strengthen the arrangements to prevent consumers being required to provide the TOs with funding above efficient levels.[2] The proposed revisions do not strengthen the arrangements in this regard. The proposed revisions aim to protect the TOs from any funding risk. Also, proposed revisions do not require the efficiency of the costs that the TOs pass through to the Electricity System Operator (ESO) (for solutions that the ESO accepts) to be rested. Taken together, these factors create the risk that consumers may be required to provide funding above efficient levels.

We accept that the expenditure that consumers were required to fund during the first year of the trial is immaterial. However, there is no guarantee that the funding that consumers will be required to provide over the remainder of the RIIO-T2 period will remain immaterial, especially if the proposal to remove the annual financial cap on rewards is confirmed. We recommend that consumers are protected by:

- the ESO being required to demonstrate why it considers the funding provided to the TOs to be efficient (in the independent report it is required to submit to the Authority); and
- Ofgem conducting a review of the ESO's assessment of the efficiency of the funding the TOs receive.

The TOs and the ESO should be required to publish their annual assessment reports:
We are unable to form an independent view of the benefits to consumers of the trial because the TOs' and the ESO's assessments reports have not been made publicly available. We, therefore, recommend that the TOs and the ESO be required to publish their assessment reports over the remainder of the RIIO-T2 period. For the avoidance of doubt, the requirement should also include the reports for the second year of the trial.

[2] In our response to the 2021 consultation on the SO:TO Optimisation Governance Document.

Question 4: Do you agree with our preferred option to use both the forecast and outturn constraint cost savings in the ODI reward calculation from year 3 of RIIO-2?

We agree that outturn constraint cost savings should be used in the ODI reward calculation from year 3 of RIIO-2.

Question 6: Do you agree with our preferred option to remove the annual financial cap on the ODI reward from year 3 of RIIO-2?

We understand why Ofgem has proposed that the annual cap on rewards from year 3 of RIIO-T2 be removed. However, we think the alternative solution we describe below should be explored.

The annual cap on rewards for each TO was set with reference to the 2018-19 constraint costs attributed to its network. We understand why Ofgem has proposed that the annual cap on rewards from year 3 of RIIO-T2 be removed. However, removing the cap still creates the risk of unintended consequences due to the SO:TO ODI being too highly powered relative to the other ODIs in the RIIO-T2 price control. Reducing the sharing factor on constraint cost savings from 10% to 5% will not fully mitigate this risk.

We note that NGET asked Ofgem to remove the cap on rewards for 2022-23 as it achieved the full ODI financial cap during the first five months of that year. We expect that, at least in part, NGET achieved the full ODI financial cap during the first five months of 2022-23 because of the significant increase in wholesale electricity prices since 2018-19. By way of illustration, the average day-ahead wholesale electricity price for 2022-23 to date is about 250% higher than the 2018-19 average, as shown in Table 1.

Table 1 - Average Day Ahead Baseload Power Prices[3]

Year	Price (£/MWh)
2018-19	57.9
2019-20	39.0
2020-21	45.6
2021-22	163.6
2022-23[4]	202.2

The significant increase in wholesale electricity prices has contributed to the significant increase in constraint costs in recent years. All other things being equal, a solution implemented during 2022-23 will result in a larger saving in constraint costs simply because of the significant increase in wholesale electricity prices. We consider that NGET achieving the full ODI financial cap during the first five months of 2022-23 is, in part, due to larger saving in constraint costs caused by higher wholesale electricity prices. This can be considered to represent a windfall gain to NGET because the significant increase in wholesale electricity prices was not foreseen when the RIIO-T2 price control was agreed and the larger saving in constraint costs is not entirely due to NGET's actions.

[3] Data taken from: https://www.ofgem.gov.uk/cy/energy-data-and-research/data-portal/wholesale-market-indicators.
[4] Data available to January 2023.

Alternative approach:
An alternative to removing the annual cap on rewards would be to scale the savings in constraint costs in a relevant year according to the relationship between a measure of average wholesale electricity prices in the base year (2018-19) and that in the relevant year.

By way of a hypothetical example, we assume saving in constraint costs for 2022-23 is valued at £150m. Based on the data in Table 1, the wholesale electricity price scalar is 0.286, which is calculated by dividing the average wholesale electricity price for 2018-19 (£57.9/MWh) by that for 2022-23 (£202.2/MWh). The value of saving in constraint costs to be used for the purpose of calculating rewards would be £42.9m. Based on the existing 10% sharing factor, NGET would earn a reward of £4.3m.

The alternative approach we propose scales the range of saving in constraint costs over which the incentive is effective based on wholesale electricity prices and seeks to ensure that the TOs continue to be encouraged to seek solutions even if average wholesale electricity prices in the relevant year fall below that for 2018-19. Additionally, the approach we propose mitigates the risk of the SO:TO ODI being too highly powered relative to the other ODIs.