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Dear James,

Proposed Income Adjusting Events under NGET's 2011-2013 Electricity System Operator Incentive Scheme

Thank you for the opportunity to respond to the above potential Income Adjusting Events (IAEs) raised by National Grid. E.ON does not believe that these proposed IAEs constitute Force Majeure or should be upheld by Ofgem for any other reason.

We do not support IAEs in principle, as they allow National Grid to opt out from the target they have accepted in certain circumstances, effectively offloading potentially significant additional costs onto consumers. Although in theory it is possible for Users to raise IAEs regarding events which may have reduced outturn costs, which could result in some money being paid back to BSUoS payers, in practice lacking the knowledge and information, it is very difficult or impossible for them to do so. Thus the most likely scenario, as now, is NGET raising IAEs with a view to removing the effects of events that increase balancing costs, or increasing the target allowed under the scheme. This allows NGET to benefit from any events which lower balancing costs whilst removing the effects of events which increase costs, providing a one-way hedge. Therefore in principle we do not support the IAEs NGET have proposed.

In practice, we note that the 2011-2013 scheme was the first to be highly indexed, enabling the target to be flexed through the year in response to factors such as power prices that are outside of NGET's control. It was expected that this should reduce the requirement for income adjusting events and yet the proposed IAEs total an additional £51.1m across the scheme.

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The final proposals for the 2011-13 scheme set out that:

‘4.37. We would normally only expect NGET to raise an IAE in the event that there are unexpected and fundamental changes in wholesale energy markets. . . .

4.38. . . .We consider that NGET’s modelling should be sufficiently robust to consider the impact of these issues and that a deadband will also allow for reasonable variation in these elements. We do not consider that any further amendments need to be made to allow NGET to manage ‘known unknowns’.’

E.ON believes that none of the events proposed as IAEs can be defined as Force Majeure under the CUSC or BSC, or result from unexpected and fundamental changes in wholesale energy markets. In terms of detailed comments, our answers in relation to each proposed IAE are as follows.

Transmission Losses

We do not consider that outturn losses of 12.11TWh mean that an IAE has occurred. Neither the underforecasting itself, nor the events which led to higher than forecast generation in the north, lower in the south, meet the definition of Force Majeure under the CUSC or BSC. Furthermore, notwithstanding the removal of a financial incentive on the SO for transmission losses in the 2013-15 scheme, NGET agreed to the inclusion of transmission losses in the 2011-13 scheme, and to the reduction in its transmission losses target from 11.0TWh to 8.9TWh. We understand that this was agreed partly on the basis of an assumption that increasing power flows across the reinforced Cheviot boundary, from wind generation in the north, would be offset by new southern generation, continuing the marked reduction in losses witnessed in 2010/11, which did not transpire in 2011-13. This is attributed to changes in spark spreads and delays to commissioning of new plant; neither of these are rare events. This target was also agreed by National Grid knowing that, as acknowledged in the IAE proposal, ‘No predictive model of transmission losses on the GB system existed at the time this scheme was agreed due to the breakdown of previous models’. Nevertheless, it was agreed and we do not believe that NGET’s underestimation of losses due to their assumptions made and modelling limitations known before agreeing the target, is reason for the Authority to adjust that agreed target ex-post. Consumers should not be asked to bear significant costs just because modelling failures led the SO to miss a target that they had signed up to.

FMJL Transformer Replacement

We do not believe that IAE(s) can be justified by the replacement of the transformer at either Smeaton or Strathaven substations, together or individually. Apart from being the same TO and involving replacement of the same type of current transformer, we do not see why separate outages from 02/08-19/12/12 at Smeaton and 07/01-08/02/13 at Strathaven should be considered together, but that they should be considered as separate proposed IAEs.

National Grid’s argument is that these constitute unplanned outages as they had not been formally submitted by Scottish Power for inclusion in the transmission outage plan prior to

the start of the 2011-13 BSIS and thus no provision made for their costs in the scheme. However, the failures of a number of FMJL type transformers that instigated the replacement programme occurred in 2009 and 2010. As these failures resulted in the need to replace all such transformers, even if not formally requested prior to the scheme, it must have been possible that this would occur in the two-year period. As National Grid acknowledge in their Proposed IAE notice, due to operational and safety considerations around FMJL type transformers the outages had to proceed. The SO incentive scheme should incentivise more innovative working from National Grid and one area largely within their control is the scheduling of outages. Knowing that outages would have to proceed promptly for safety reasons owing to faults that they were aware of in 2009 and 2010, we would have expected that National Grid should have pro-actively managed this risk, liaising with SPTL to discuss a draft schedule for all such replacements if possible, regardless of planning for the pending 2011-13 BSIS. Had this been undertaken, better constraint management could have been possible and the actual costs incurred via BM, intertrips and trading as a result of these works might have been mitigated.

Alcan Closure

Alcan's closure might not have been anticipated, but by no means does the unavailability of one such plant appear to meet the definition of an IAE. The financial assessment of the closure in December 2011 is significantly greater than the £2m trigger threshold for a potential IAE. However as summarised in National Grid's notice this appears to be the only real argument for proposing this as an IAE: 'the level of cost in the absence of Alcan is considered to be an Income Adjusting Event (IAE) as the level of cost exceeds the £2m IAE threshold and the closure of Alcan was beyond National Grid's control'. The closure or otherwise unavailability of any ancillary services provider, large or small, may be beyond the SO's control, but its procurement strategy is not. As such events are unpredictable but could happen at any time, one would expect the SO, when contracting, to consider the risk that one or more provider might be unavailable for a length of time, and to bear costs resulting from any decision it took to rely heavily on any particular provider(s) itself, instead of attempting to pass £10m costs to consumers after the event. We also note that this closure occurred prior to the halfway stage of the 2011-13 BSIS when NGET sought a number of methodology amendments to the scheme in light of changed circumstances; we do not believe that an effort was made to reflect Alcan's loss in the target at this stage so as to minimise the effects of this as a potential IAE.

Moyle Outage

Interconnector outages, like reserve/response provider closures, may not be predictable but a certain level of unplanned outages must be expected by NGET. A 2 month halving of capacity followed by 6 months of complete outage is significant, but if not experienced since the introduction of BETTA, it is not without precedent. We note that following this outage and the application of National Grid for BSIS methodology amendments in July 2012, the Authority directed that changes to modelling interconnector availability could be applied from 14 Sept 2012, but not retrospectively. Thus we recognise that in respect to the Moyle outage National Grid did apply to reflect the closure during the scheme, so has consequently proposed an IAE for the June 2011-Feb 2012 period. However, by nature, granting such an IAE would still effectively equate to a retrospective increase in costs to

consumers. As Ofgem state, NGET's modelling should be 'sufficiently robust' to consider the impact of these 'known unknowns', and 'under any incentive scheme it is considered appropriate that NGET is exposed to a certain level of risk'. Hence, as with outages of ancillary service providers or other Users, we believe that the SO must be prepared for a certain level of unplanned outages and bear the risk that from time to time these will be greater than usual.

In summary, we do not believe that any of these incidents constituted unexpected and fundamental changes in wholesale energy markets. Consequently, that there is not sufficient reason to declare them as IAEs, to potentially reduce NGET's costs by 90% but burden consumers with up to an additional £51.1m.

I hope the above comments prove helpful. Please contact me in the first instance if you have any further questions.

Yours sincerely

Esther Sutton
Trading Arrangements