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6 July 2016

Dear Johannes,

**Notice and Consultation on a Proposed Income Adjusting Event submitted by National Grid Electricity Transmission plc in relation to the 2015-17 Electricity System Operator Incentives Scheme**

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

We do not agree with National Grid's assessment that the event qualifies for treatment as an Income Adjusting Event (IAE). Instead:

- **This event does not satisfy the IAE criteria because the risks were foreseeable, and so should have been foreseen, and the consequences were not beyond the reasonable control of the licensee.**

Also:

- **It is not acceptable that the process precludes the opportunity for an impact assessment.**
- **The IAE notice is premature and incomplete.**
- **Given the significant impact on costs, the costs for these contracts should be recovered via the later settlement run ('Reconciliation Final' (RF)) for the relevant settlement dates.**
- **Given the cost to customers involved, regulatory solutions should have been explored to protect the interests of consumers.**
- **This is further evidence that the Balancing Services Incentive Scheme continues to provide poor value to customers as, in practice, it is ineffective in placing incentives on National Grid.**

**This event does not satisfy the IAE criteria because the risks were foreseeable, and so should have been foreseen, and the consequences were not beyond the reasonable control of the licensee:**

In the Notice, National Grid states announcements in February 2016 regarding the potential closure of Fiddlers Ferry and Rugeley and the potential mothballing of Drax coal units, because of unfavourable market conditions, were unforeseen when mid-scheme adjustments to the Balancing Services Incentive Scheme (BSIS) targets were proposed in December 2015.

It is not credible that the increased risk of closure or mothballing of thermal units due to unfavourable market conditions was unforeseeable before December 2015, and so should have been foreseen. The unfavourable market conditions for coal-fired generation observed during 2015/16 were triggered by a combination of factors that caused material reduction in clean dark spreads. One such factor is the significant increase in the 'carbon price support', from £ 9.54 per tonne of $CO_2$ in 2014/15 (as stated in the 2012 Budget[1]) to £18.08 in 2015/16 (as stated in the 2013 Budget[2]). Many operators of thermal generation warned of the negative impact on the viability of coal-fired generation and some even announced closures during 2015.

In its response of 21 June 2016, National Grid presented a chart of gas, coal and power prices up to March 2015, just before the significant increase in the 'carbon price support'. National Grid should have taken account of data from April 2015 onwards, when the significant increase occurred, especially since the mechanism and the cost trajectory were announced in 2011 Budget[3].

There was no material or sudden reduction in the clean dark spreads between December 2015 and February 2016, which would have resulted from the worsening of market conditions compared to those before December 2015. Clean dark spreads for the 2016/17 winter period were relatively stable over 2015. The prevailing unfavourable market conditions for coal-fired generation observed during 2015 were triggered by events that caused material reduction in spreads before or just after the start of 2015. Many operators of thermal generation warned of the negative impact on the viability of coal-fired generation and some even announced closures during 2015.As such, the risk of the closure of coal-fired plant was foreseeable.

During 2015, the operators of two of the three thermal generation plant referred to in the Notice publicly commented on the unfavourable market conditions on several occasions (see Question 1).

Given these factors, it is clear that the risk of closure or mothballing of the specific thermal units referred to in the Notice should have been expected by National Grid before December 2015 when updated targets for the BSIS were proposed by the licensee. Given the risk was foreseeable and, in this instance, the consequences of the plant closure were also within the

[1] "The Government will set 2014–15 carbon price support rates equivalent to £9.55 per tonne of carbon dioxide in line with the carbon price floor set out at Budget 2011". Budget 2012, paragraph 2.162. (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/247119/1853.pdf).

[2] "The Government will set 2015-16 carbon price support rates equivalent to £18.08 per tonne of carbon dioxide in line with the carbon price floor set out at Budget 2011". Budget 2013, paragraph 2.160. (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf).

[3] Budget 2011, paragraph 1.111 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/247483/0836.pdf).

reasonable control of National Grid. As such, the event does not satisfy the criteria for treatment as an IAE.

It is also worth noting that National Grid has experienced loss of Black Start capability before, including oil and gas plant in the south of England. This demonstrates that there is nothing exceptional about these circumstances and is ‘business as usual’. As such, it should be captured by the incentive scheme.

**It is not acceptable that the process precludes the opportunity for an impact assessment and one should be conducted:**

We do not agree with the justification provided for an impact assessment not to be carried out because there is insufficient time. While it is desirable to give interested parties the maximum time to consider the merit of the application, this is appropriate only if interested parties are provided with the relevant analysis and information which enables them to do so. An impact assessment is a key contributor to the relevant analysis and information, not least because it would need to cover the effect on revenues to be recovered from suppliers (not covered in this consultation).

In the consultation, it is acknowledged that the decision on the proposal is important because of the potential for there to be:

- a significant impact on consumers and/or the general public in Great Britain or part of Great Britain, and
- a significant impact on persons engaged in the shipping, transportation or supply of gas, the generation, transmission, distribution, or supply of electricity, or in connected commercial activities.

Further, the justification of insufficient time provided implies that is it is unlikely impact assessments can ever be carried out regardless of the importance of the decision. This is unacceptable both in this instance and generally. As such, we recommend that either the ability to complete an impact assessment within the timescales is reassessed, or the timescales set out in the licence are reviewed so that impact assessments can be carried out.

**The IAE notice is premature and incomplete:**

We believe that National Grid has submitted an incomplete Notice because all the requirements set out in Special Condition 4C.17 (c) have not been satisfied. This Condition states the Notice must include particulars of:

> ...the amount of any allowed income adjustment proposed as a consequence of that event and how this allowed income adjustment has been calculated.

National Grid has not set out any proposed allowed income adjustment or calculation and so this application does not meet the requirements under licence.

Instead they set out a requested change to the BSIS target which does not necessarily result in any change in allowed income. In the latest Monthly Balancing Services Summary report (May 2016), National Grid forecasts the reward for the 2016/17 BSIS scheme will once again be at the cap (+£30m)[4]. If this forecast does not include the impact of the IAE then if the request to increase the target was allowed, the reward would remain at the cap and so there would be no change in allowed income. Impacts on allowed income cannot be fully understood until the scheme has completed.

We include more detail in our response to Question 2.

**Given the cost to customers involved, regulatory solutions should have been explored.**

In assessing whether National Grid acted economically and efficiently we note that, in National Grid's response of 28 June 2016, it is highlighted that the Grid Code does not require capability to be maintained "*at any cost"*. National Grid further states that *"...an assessment will always be made on the most cost effective level of capability, taking account of the interests of consumers"*[5]. However, the Notice and the subsequent responses contain no evidence of that assessment taking place.

The scale of the potential cost of the additional services will have become apparent during the procurement exercise and it would have been prudent to consider other types of solutions so that customers' interests could be taken into account. For example, National Grid could have explored regulatory solutions, such as derogation from the relevant condition 6.3.5 of the Grid Code so that a competitive tender exercise could be conducted.

**Given the significant impact on costs, the costs for these contracts should be recovered via the later settlement run ('Reconciliation Final' (RF)) for the relevant settlement dates:**

In the Notice, National Grid mentions the costs related to these contracts have yet to be included in charges to users. The relevant part of the Charging Methodology in the Balancing and Settlement Code is clear that costs need to be allocated to the correct settlement date[6] i.e. the date on which they are incurred. This means that, for settlement dates covered by these contracts that are past (i.e. first settlement run has been completed), costs will need to be recovered via the final reconciliation run for those settlement dates ('Reconciliation Final' (RF)). To do otherwise would be contrary to the Charging Methodology. We suggest that costs for all settlement dates (past or future) are recovered via the RF run to mitigate against the cost shock to the industry and to remove any uncertainty over treatment.

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[4] Table 10.2 – Latest projection of scheme outturn costs
[5] Response of 28 June 2016, page 4.
[6] The formula of for BSUoS costs contains the term BSSCAd which is defined as *'Non Settlement Period specific Balancing Contract Costs for settlement day d less any costs incurred within these values relating to Supplementary Balancing Reserve and Demand Side Balancing Reserve'*

**This is further evidence that the Balancing Services Incentive Scheme continues to provide poor value to customers as, in practice, it is ineffective in placing incentives on National Grid:**

In our response to the Initial Proposals for the 2015-17 System Operator Incentives Scheme, we repeated our concern that the Scheme was unlikely to affect behaviour as costs generally fall well outside the range subject to incentives. We stated that some of the flaws of the incentive could create a perverse incentive to increase spending and "*...we believe in practice that this incentive scheme has little or no impact on Grid's behaviour...*"

Latest data from National Grid's Monthly Balancing Services report indicates that the expectation is that performance will again fall outside the range subject to incentives. In the last seven schemes (since 2008) the incentive value has exceeded the cap or floor[7], on occasions flipping between the cap and floor. This reinforces our view that BSIS has not provided any clear benefits to customers whilst costing around £50m since 2008.

We believe the integrity and credibility of this incentive scheme would be further damaged if it is permitted that the event proposed is treated as an IAE. The licensee is currently permitted to propose updated target for elements of the scheme by 31 December ahead of the relevant year. As stated in the consultation, the licensee proposed updated targets in December 2015, which resulted in the target for 2016-17 being increased to £34.75m (compared to £22.35m for the previous scheme year).

As we have outlined above, there was information available in the public domain about the continued deterioration of wholesale market conditions for thermal generation. Operators of the units referred to in the Notice publicly signalled the impact of market conditions on the viability of their operations (and risk of closure and mothballing) well in advance of the licensee submitting revised targets in December 2015. The licensee accepted that risk when the targets were agreed and should have appropriately factored those risks into the proposed targets.

The licensee now seeks relief from the targets it proposed only a few months before the proposed event occurred and because of factors it should have accounted for. We believe such relief is inappropriate and would not protect consumers' interests. The Scheme can encourage the correct behaviours only if the licensee is practically exposed to both the upside and downside risks of its actions. If accepted for Black Start, this may encourage the view that higher than expected costs for other ancillary services would be treated similarly. Relief from targets due to events the licensee could have reasonably anticipated does not expose the licensee to the downside risks and, therefore, weakens the effectiveness of the incentive to encourage the correct behaviours.

[7] The 2011-13 was only brought back within the floor following an Income Adjusting Event.

We hope you find these comments helpful. Answers to the questions included in the consultation are attached. Please do not hesitate to contact me if you have any questions.

Yours sincerely

Andy Manning
Head of Network Regulation, Forecasting and Settlements

**Question 1: Do you believe that the event submitted by NGET as an Income Adjusting Event constitutes an Income Adjusting Event?**
**Do you consider the proposed IAE to constitute force majeure as defined in the BSC or in the CUSC?**
**Do you believe that the event submitted by NGET was unforeseen? Please provide evidence to support your view where possible.**
**Do you believe that the proposed IAE costs were beyond the reasonable control of NGET?**

As we have discussed above, it is not credible that the increased risk of closure or mothballing of thermal units due to unfavourable market conditions was unforeseeable, and so should have been foreseen, before December 2015. As such, we do not agree that the event qualifies for treatment as an IAE and the consequences were beyond the reasonable control of the licensee.

There was no material or sudden reduction in the clean dark spreads between December 2015 and February 2016, which would have resulted from the worsening of market conditions compared to those before December 2015. Clean dark spreads for the 2016/17 winter period were relatively stable over 2015. The prevailing unfavourable market conditions for coal-fired generation observed during 2015 were triggered by events that caused material reduction in spreads before or just after the start of 2015. Many operators of thermal generation warned of the negative impact on the viability of coal-fired generation and some even announced closures during 2015. As such, the risk of the closure of coal-fired plant was foreseeable.
In its response of 21 June 2016, National Grid presented a chart of gas, coal and power prices up to March 2015, just before the significant increase in the 'carbon price support[8]'. National Grid should have taken account of data from April 2015 onwards, when the significant increase occurred, especially since the mechanism and the cost trajectory were announced in 2011 Budget[9].

During 2015, the operators of two of the three thermal generation plant referred to in the Notice publicly commented on the unfavourable market conditions on several occasions. In a

[8] 'Carbon price support' increased from £ 9.54 per tonne of $CO_2$ in 2014/15 (as stated in the 2012 Budget) to £18.08 in 2015/16 (as stated in the 2013 Budget)
[9]Budget 2011, paragraph 1.111
(https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/247483/0836.pdf).

trading update to the London Stock Exchange in June 2015[10], SSE (which operates Fiddlers Ferry) stated:

> Wholesale: total electricity output1 from gas- and oil-fired power stations was 2.42TWh (including 0.43TWh from the new Great Island power station), compared with 2.19TWh; from coal-fired power stations output was 0.41TWh, compared with 1.79TWh **reflecting poor market conditions for coal-fired generation** [Emphasis added]

In another trading update in November 2015[11], SSE stated:

> Energy Portfolio Management and Electricity Generation operating profit increased from £11.8m to £141.8m, as a result of the 1.1TWh (38%) increase in output of renewable energy to 3.9TWh, reflecting higher rainfall and windier conditions over the six months; **market conditions, however, remained challenging for thermal generation** [Emphasis added]

AND

> In the first half of 2014/15, operating profit in Wholesale was exceptionally low. The increase in operating profit in Wholesale in the first half of 2015/16 follows this, and reflects in particular: higher output of electricity from renewable sources due to higher rainfall and wind speeds than this period last year. **Very difficult market conditions affecting thermal plant, such as low 'spark' spreads, have, however, persisted for several years**. [Emphasis added]

AND

> **Forward 'dark spreads' are notably lower than at this time in 2014/15;** whilst forward spark spreads, driven by the reduction in forward gas prices, are stronger compared to forward prices at this time last year. **The long-term trend is for gas to continue to enjoy a comparative advantage over coal**. [Emphasis added]

In a statement in December 2015[12] following the announcement of the results of the 2015 Capacity Market Auction, SSE stated:

> This means 2,972MW of SSE's de-rated capacity did not secure an agreement, including Fiddlers Ferry and Peterhead Power Stations.

AND

> **SSE will continue to analyse market conditions and opportunities for 2016 and beyond including** future Capacity Market auctions at both the T-4 and T-1 stages; future SBR tender rounds; **contracts with National Grid**; and business-as-usual operation in the market. [Emphasis added]

In another statement announcing the potential closure of Fiddler's Ferry on 3 February 2016[13], SSE stated:

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[10] http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/SSE/12435415.html
[11] http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/SSE/12576636.html
[12] http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/SSE/12619711.html
[13] http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/SSE/12685743.html

> **We said in December** that following the completion of the Capacity Market Auction **we would consider the options for the future operation of our power generating plant, including Fiddler's Ferry**. This has, unfortunately, led us to conclude that commercial operations at Fiddler's Ferry may have to come to an end, subject to the consultations that will now take place. [Emphasis added]

Similarly, Drax cited concerns about the prevailing market conditions. In its trading update on June 8 2015[14], Drax stated:

> Since publishing our preliminary results on 24 February, **trading conditions in the markets in which we operate have remained challengin**g, with weak gas markets resulting in the continuation of weak power prices. [Emphasis added]

AND

> **We remain affected by the continued weakness in the commodity markets**. Low gas prices continue to depress the power markets, although the international coal market also remains weak. [Emphasis added]

Also, in its trading update on 24 November 2015[15], Drax stated:

> **Since publishing our half year results on 28 July, trading conditions in the markets in which we operate have remained challenging**, with further weakness in power prices. [Emphasis added]

Given the information that existed in the public domain during 2015, it is not credible that the potential closure and mothballing of the plant referred to in the Notice due unfavourable market conditions was unforeseeable and, as such, should have been foreseen.

**Question 2: Assuming the event is an IAE, do you consider that any or all of the costs set out in NGET's notice were caused by the relevant IAE?**
**Are there any additional interactions between costs incurred that need to be taken into account?**
**Do you consider that NGET acted economically and efficiently in procuring Black Start in this event?**

Insufficient information has been provided to enable relevant parties to assess whether an IAE has occurred and the value of the related adjustment. In the Notice, the licensee states the event was unforeseen because the announcements occurred earlier than expected under its Future Energy Scenarios (FES) and the consequences of the acceleration of the announcements were beyond its reasonable control. We suggest insufficient information has been provided to enable relevant parties to assess whether an IAE has occurred and the value of the related adjustment. For example, the licensee has not explained why it was appropriate or necessary to rely on the FES, its own publication and published in June 2015, even though there was further information in the public domain (discussed above) available

[14] http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/DRX/12380145.html
[15] http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/DRX/12594130.html

before December 2015 that highlighted the risk of closure or mothballing of the thermal generation units referred to in the Notice.

In any event, we also consider Notice to be premature. Special Condition 4C.19 sets out the requirements for providing notice of an IAE:

> A notice of an income adjusting event shall be given as soon as is reasonably practicable after the occurrence of the income adjusting event, and, in any event, not later than three months after the end of the Period p or the Relevant Year t in which the income adjusting event occurred.

The licence is clear that the IAE should be submitted not later than three months after the end of Relevant Year t in which the IAE occurred. If the 'Relevant Year' for the purposes of the IAE is considered to be 2015/16 i.e. when the potential closures and mothballing were announced, then there has been no impact on the costs of balancing services in that Relevant Year and the IAE claim should fail. However, it appears National Grid considers the Relevant Year to be 2016/17, in which case National Grid had until the end of June 2017 to submit a Notice that was compliant with the requirements set out in the licence.

It might be argued that National Grid has provided Notice "*as soon as is reasonably practicable after the occurrence of the income adjusting event*". This is not coherent since, by submitting the Notice prematurely, the Notice is not compliant with the requirements set out in the licence. Special Condition 4C.17 (c) states the Notice must include particulars of:

> the amount of any allowed income adjustment proposed as a consequence of that event and how this allowed income adjustment has been calculated.

National Grid has not set the amount of any allowed income adjustment as a result of the event or how that amount was calculated. Instead, National Grid requested a change to the BSIS target. However, a change to the BSIS target is not the same as a change to allowed income since the allowed income adjustment resulting from a change in the BSIS target is the difference between the incentive reward/penalty before and after the change in the target. Since performance against the BSIS target more often than not results in incentive outcomes at the cap or collar of the scheme, it is unjustifiable to equate a change in the BSIS target to a change in allowed income. Indeed, in the latest Monthly Balancing Services Summary report (May 2016) National Grid forecasts that the reward for the 2016/17 BSIS scheme will once again be at the cap (+£30m). Therefore, if we assume that National Grid is expecting to outperform its BSIS target by £213m or more (with the IAE approved), then "*the amount of any allowed income adjustment proposed as a consequence of that event"* is actually £0m since National Grid would receive the same BSIS reward regardless of whether or not the IAE is granted, i.e.:

min(£30m, 30% x £213m) = £30m (in the case the IAE is granted); and also,
min(£30m, 30% x £100m) = £30m (in the case the IAE is not granted).

National Grid has not set out the impact on allowed income and the Notice is not compliant with Special Condition 4C.17(c).

Special condition 4C.23(c) allows the value of the adjustment to be set to zero if the licensee has provided information that is insufficient to enable relevant parties to make an assessment:

> in all other cases zero, including situations where the Authority has not made a determination under 4C.15 above within three months of the date on which notice of an income adjusting event was provided to the Authority and the Authority has, before the end of that three month period, informed the relevant parties that the Authority considers that the analysis or information provided in accordance with paragraphs 4C.10 and 4C.11 is insufficient to enable the Authority and relevant parties to assess whether an income adjusting event has occurred and/or the amount of any allowed income adjustment.

Therefore in accordance with paragraph 4C. 23 (c) we believe the value of the IAE should be set to zero since the information provided is insufficient to enable the Authority and relevant parties to assess whether an income adjusting event has occurred and/or the amount of any allowed income adjustment.

In assessing when National Grid acted economically and efficiently we note that, in its response of 28 June 2016, it is highlighted that the Grid Code does not require capability to be maintained "*at any cost"*. National Grid further states that *"...an assessment will always be made on the most cost effective level of capability, taking account of the interests of consumers"*[16]. However, the Notice and the subsequent responses contain no evidence of that assessment taking place.

The scale of the potential cost of the additional services will have become apparent during the procurement exercise and it would have been prudent consider other types of solutions so that customers' interests could be taken into account. For example, National Grid could have explored regulatory solutions such as derogation from the relevant condition 6.3.5 of the Grid Code so that a competitive tender exercise could be conducted.

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[16] Response of 28 June 2016, page 4.