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Consultation on a Proposed Income Adjusting Event (IAE) in relation to 2015-17 Electricity System Operator Incentives Scheme

Response from VPI Immingham

VPI Immingham welcome the opportunity to respond to the consultation on National Grid's Income Adjusting Event as a result of the additional contracts for Black Start capability, dated 8th June 2016. VPI Immingham is a combined heat and power (CHP) plant near Immingham, on the south bank of the river Humber. It is one of the largest CHP plants in Europe, capable of generating 1240MW – about 2.5% of UK electricity peak demand and up to 930 tonnes of steam per hour, which is used by nearby Humber and Lindsey oil refineries to help turn crude oil into products, such as gasoline.

Whilst we recognise the requirement for black start capability, we do not believe that this should come at any cost. Forward looking, proactive management of all aspects of the system is required to minimise costs to consumers. Not only are we appalled by the magnitude of the two black start contracts, but also by the process by which they were procured. We do not believe that National Grid in their capacity as System Operator has procured these services in an efficient and economic manner. In fact, it appears to be a last minute panic measure that will cost industry parties and hence consumers a great deal.

In our view, these costs were foreseeable well before the tender was published on 25th February and that National Grid, as System Operator, should have been aware of these issues. Whilst not at liberty to share our own analysis, industry commentary was expecting further coal closures in 2016 on the back of weakening dark spreads. For those generators that had already sold power for Winter 2016 on an assumption of certain BSUoS charges, should the IAE be approved, then these additional costs come as a direct hit to profitability. For thermal plant that is already facing challenging market conditions, this could be the difference between profit and loss.

We would also refer Ofgem to our confidential annex outlining some of our concerns regarding the procurement process. It is our view that a more competitive tender process, open to a wider selection of participants, would have resulted in a similar service procured for lower cost. Furthermore, these services could have been procured on an enduring basis instead of high cost one year contracts.

To summarise our detailed response below, our view is that the event outlined in the consultation does not constitute an IAE for the following reasons:

- The events leading up to the publication of the black start tender on 25th February were completely foreseeable. Our own analysis, plus analysis from financial institutions and industry experts, was showing a very high likelihood of coal closure in early 2016 as a result of worsening conditions for coal. Looking at forward curves as far back as 2014 would suggest likely closure of coal

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- The procurement process itself was fundamentally flawed and resulted in uneconomic procurement of services. The late notice and short duration, plus immediacy of start meant that no-one outside of traditional black start providers were able to apply, perhaps the outcome that National Grid desired
- National Grid's cost benefit analysis appears to be flawed and inaccurate with VoLL overstated. Based on our interpretation of the London Economics report on VoLL, we believe that the benefits are overstated fourfold as the four hour outage window is included both in the VoLL number and again when calculating the benefit instead of a total four hour cost
- Alternative, more economic methods should have been in place well before the tender was opened, from non-traditional players. The reactive, knee jerk nature of these contracts suggest that the forward planning at National Grid is sadly lacking and as a result, we do not believe that these constitute an IAE

Our answers to the specific questions are detailed below, but we feel the following four points, not covered by the consultation itself should also be taken into consideration:

- Firstly, we believe that National Grid's cost benefit analysis is flawed and inaccurate. National Grid have used a value of £67k for VoLL for a four hour period, as defined in the London Economics paper commissioned by DECC and Ofgem. Our interpretation of this is that this is purely the value of VoLL for a one hour period (£17k) multiplied by four and is therefore the value for a whole four hour period, not a cost per MWh. Similarly, a six hour outage would be six times £17k or c. £100k for the total down time. However, in the cost benefit calculation, National Grid have multiplied this by the number of hours to calculate the cost benefit, when in fact the four hours is already factored into the VoLL number – this is set out in the table below to replicate the Fiddler's cost benefit analysis. In our view, this therefore has overstated the benefits fourfold. We would urge Ofgem to check the information provided to them and to determine whether these costs truly are to the benefit of the consumer given wider risks.

	VoLL for time period	What NG have calculated	What it should be
		GW * Cost per incident * hours	GW * cost
4 hrs	4 * £17k = £67k	3.5 * 67,000 * 4 = £940M	3.5 * 67,000 = £235M
6 hrs	6 * £17k = £100k	3.5 *67,000 * 6 = £1.4bn	3.5 * 17,000 * 6 = £360M

- Secondly, the increasing cost of these services is being passed through to industry via BSUoS. Increasingly, these costs are harder to forecast and increasingly volatile, initially SBR costs and now huge black start costs at short notice. As a result, these are causing

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issues for industry and potentially increasing costs for consumers, due to the addition of risk premia to cover the lack of transparency and volatility. Whilst we are in no way suggesting that there is any evidence of wrongdoing, the fact that two parties had knowledge of these costs whilst the rest of industry were unaware is also a cause for concern and Ofgem must ensure full transparency to the market were possible. We believe that a wider piece of work (noting the ongoing CUSC modification looking at BSUoS charges) is required to identify those charges that are truly balancing costs on a half hourly basis and those that should be smeared across industry in a more robust, transparent approach.

- If approved, some consideration of how these costs are recovered is required. Lack of visibility over the exact time period that these will be recovered means that industry have no knowledge of how, or even if, to price these costs into forward prices. This could result in a negative impact on competition as different parties factor in the costs differently, potentially impacting the merit order and efficient despatch. Furthermore, the shorter the time period that these costs are recovered over, the larger the distortion on the market. As a must run generator, we already believe that we will be picking up more than our fair share of costs, which if distributed over a longer time period would be lower. The irony of this approach is that those generators who are most likely to be warm and ready to switch on in the event of a black start event are picking up a higher proportion of the costs

- We have serious concerns regarding market distortion as a result of these contracts and the impact on competition. As a direct result of the black start contract, Fiddler's Ferry has decided to remain open for Winter 16/17 when it would otherwise have been closed. Given that one unit of the plant was already contracted under SBR, the costs seem to be very large for an incremental three units. However, without detail it is impossible to comment further. However, the direct impact of Fiddler's Ferry remaining open is lower spreads, higher charging costs and indirectly this will impact the early capacity auction clearing price. As the regulator, we urge Ofgem to look into the competitive distortion as a result of the black start contracts

Detailed responses to the consultation questions can be found below:

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?**

No, we do not believe that the event submitted by NGET constitutes an IAE as the circumstances were foreseeable and widely predicted by many industry commentators. We do not believe that the

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circumstances constitute a force majeure as defined under the BSC and the CUSC, a "security period" as defined under the Fuel Security Code or another unforeseen event.

Closure of coal plants has been on the cards since the Large Combustion Plant Directive was introduced, with further closure expected as a result of the Industrial Emissions Directive and the final nail in the coffin in the Secretary of State's reset speech in November 2015, announcing that coal would be closed by 2023. Additionally, any plant that was not successful in the capacity mechanism was expected to be closed well ahead of the delivery year. With most of the unsuccessful gas platn entering the Supplemental Balancing Reserve (SBR), this left the coal power stations including Longannet, Eggborough, Ferrybridge, all of which had already announced closure, at least six months prior to the black start tender. The fact that these power stations chose the supplemental TEC notification window in September 2015 should have been an early signal to National Grid that coal power station fundamentals had changed and that coal power stations were at risk of closure.

In addition, the Fiddler's Ferry unit without a capacity contract had reduced its TEC and entered into an SBR contract. Given that Rugeley did not have a capacity agreement, to not expect it to follow suit is, quite simply, naïve at best and unbelievable at worst.

Our understanding of the timeline of events is as follows:

- May 2015 - Ferrybridge announces closure. SSE say reviewing other options
- August 2015 - Longannet announces closure
- September 2015 - Eggborough announces closure
- February 2016 – Fiddler's Ferry announces closure
- February 2016 – Rugeley announces closure

We do not accept National Grid's view of the Drax station as being at risk as no formal announcement was made, unlike with the other stations, plus the biomass units would continue to run. A comment to the press about reviewing options is very different to a formal statement regarding consultation over closure.

We find it amazing that National Grid had not considered the likelihood of further coal closures, especially as Rugeley did not have a capacity contract and seemingly had serious issues with one of its units from late 2015 and Fiddler's Ferry was widely accepted as being at risk (due to the fact that it did not have a capacity contract for 2019 and therefore the cost of closure was less than those coal plant with a 2019 capacity contract who would have had to pay two penalty fees under the Capacity Mechanism Rules and Regulations). These risks were widely reported across industry publications (such as Platts), external analysis (such as Aurora) and financial institutions (such as Jefferies investment bank) and were recognised as likely outcomes given worsening conditions for coal plant.

The role of a System Operator is to run through various scenarios to ensure that the system remains secure and the fact that National Grid are suggesting that they had not run a scenario with further coal closure is a cause for concern. National Grid themselves acknowledge that they were looking at other options in terms of black start in 2012. Why action was not taken as far back as 2012 when the risks had been identified remains unclear. And whilst the 2015 actions were clearly too late in the end, it does suggest that National Grid were aware of potential issues and should have taken measures to address these sooner.

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Whilst the changes to commodity prices in 2015 may have been unexpected, coal to gas switching was not a new phenomenon and was expected as a result of increasing carbon price support levels and was already happening in the Summer months. In fact, had the original trajectory of Carbon Price Support been maintained, this issue would have manifested itself earlier and it is our view that National Grid should have been prepared for this, especially given the apparent timescales for black start procurement. In any case, the coal to gas switching occurred well in advance of the announcement of the tender and the question remains as to why it took National Grid so long to react.

Whilst we are not in a position to provide our own forecasts and analysis to Ofgem, it does suggest that a £19.40/kW capacity price in 2018 (result of the 2014 capacity auction) would not be sufficient to keep coal plant open given the changing dynamics. This view was also echoed by various commentators such as Platts, Aurora Energy Services and Jefferies. Therefore, it was not unforeseeable that a coal plant with a capacity agreement for 2018 could renege on that contract and face the subsequent penalty.

We also note from the additional information provided by National Grid to Ofgem that National Grid expected the additional unit at Fiddler's Ferry to return to the market in 2018/19 to fulfil its capacity agreement. This is an erroneous statement – this unit did not have a capacity agreement and, as noted, had reduced its TEC and entered SBR. Along with the fact that the all four units at Fiddler's Ferry did not have a capacity agreement for 2019 makes the National Grid expected closure date of 2026 highly unlikely. Both of these points in themselves should have been a further warning flag to National Grid, one that appears to have been ignored,

Furthermore, we do not believe that the costs were beyond the reasonable control of National Grid. Again, we refer to our confidential annex outlining our concerns in this area. Whilst a tender was run, we do not believe that it allowed for a competitive process with the timeframes so short as to allow for other market participants and therefore, National Grid should be responsible for the higher than expected costs.

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?**

Whilst we do not assume that the event is an IAE, far from it, we do believe that there are further interactions that should be considered. However, given the level of redaction in the document, it is virtually impossible to identify which costs could in fact be an IAE and which are not. We recommend that Ofgem compare the new contracts with existing contracts to identify similar costs that would normally have been incurred. This could include warming costs for example.

We do not believe that NGET acted in an efficient and economic way. To state that comparison to

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previous costs is not relevant appears to be disingenuous – both comparison to previous costs and benchmarks with other technologies that could provide a similar service should have been included as a matter of course. Please note our comments on this matter in the confidential annex. We believe that the timeframes around the procurement process were too short to allow any meaningful competition and that therefore the highest cost solution was procured.

We note National Grid's comment in the additional information provided that due to the tight timescales, NGET determined that only an existing black start provider could tender. Whilst we agree with this statement, the tight timescales were a direct impact of National Grid's earlier failure to take action and they therefore left themselves exposed to a limited number of providers being able to tender and at considerably higher cost than historic levels. Had action been taken sooner to find alternative providers, the costs would not have increased to the £113M level.

Furthermore, this high cost solution has had a wider market impact in that it has kept an entire coal station open that would otherwise have closed, paid for by those generators who are missing out as a result of the increased level of capacity. On the day of the announcement, spark spreads for Winter 16/17 dropped by approximately £1/MWh, as a direct result of the contract and the fact that there would be higher levels of capacity available in Winter 16/17. Coupled with the increased level of BSUoS, this is a double impact on generators who are facing higher costs and lower spreads than would otherwise have been the case. For some marginal generators, this could be the difference between ongoing operation and closure.

We also urge Ofgem to look into whether year long contracts were appropriate given the context and the market distortion for Winter 16/17. It is our understanding that other options were available in slightly longer timeframes that would have been more economic. We appreciate that capability was required for April 2016, but a more proactive forward thinking strategy is required to avoid large costs such as these incurred at short notice in the future

We would be happy to discuss the content of the above response in further detail if required. We have serious concerns regarding these costs and do not believe that they constitute an IAE. The increasing levels of reactive knee jerk reactions and ongoing intervention in the market by the System Operator are destroying value in the market. The increasing level of regulatory risk in the UK market should be a cause for concern for all and one that we wish Ofgem to act upon.

We would be happy to discuss any of our comments above in more detail. Please do not hesitate to contact me on the details below should you have further questions.

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