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Dear Johannes,

Proposed Income Adjusting Event under NGET's 2015-2017 Electricity System Operator Incentive Scheme

Thank you for the opportunity to respond to the proposed Income Adjusting Event (IAE) raised by National Grid. This response is made on behalf of the E.ON group, including E.ON UK plc and Uniper UK Ltd. We do not believe that this proposed IAE should be upheld by Ofgem.

We are generally uncomfortable with IAEs in principle. With Users highly unlikely to be in a position to raise an IAE, they effectively create a one-way hedge allowing National Grid to relax its agreed targets in certain circumstances, passing through potentially significant additional costs onto suppliers, generators and ultimately consumers at short notice. The purpose of the System Operator incentive scheme is to provide a robust framework which protects the interest of consumers. The proposal to relax the target, in this case by up to £113m, seems contradictory to this purpose.

Regarding the specific details of this application, the costs of these contracts were a shock to industry as they were far in excess of what could be reasonably expected. It would appear that this is partly a consequence of National Grid procuring this capability at very short notice which prevented a wider pool of potential providers from being able to tender for the service. We do not agree that the situation constitutes force majeure, nor do we believe it owing to wholly unforeseen circumstances. We note that National Grid has a policy of seeking alternative providers of Black Start services, including the use of interconnectors, and whilst in the longer term this may be a sensible policy, it appears that in the shorter term the level of margin in the service was allowed to become too low. Therefore, the loss of one or two providers appears to have put National Grid into a position whereby it had to procure replacement services urgently from a limited number of parties and it effectively became a distressed buyer.

It would be unfair to other parties to pass on resulting costs potentially totalling £113m, particularly when only on 31 March were they informed that under the BSIS mid-scheme review the Black Start target would be increasing by £12.39m, from £22.35m to £34.74m. This 55% increase was only allowed by Ofgem explicitly 'if NGET finalizes and incurs the availability costs in relation to all new contracts it expects to strike in 2016/17'. As National Grid had at that point been in bilateral discussions with potential Black Start providers since prior to issuing its Expression of Interest on 25 February and indeed signed contracts with Drax and SSE by 31 March, it seems very difficult to justify a subsequent quadrupling of the new target by allowing an IAE for a further £113m to be passed on to customers.



Unexpected costs of such magnitude are essentially unmanageable for market participants. Parties that have only just been informed of the situation through this consultation have been unable to factor these costs into their plans. This is true for the £79m that it seems is likely to be passed on even if the IAE is not granted. The full £113m would be a very heavy burden to be borne ultimately by consumers. With a more volatile system the cost of BSUoS has not only risen sharply in the last few years, but is increasingly difficult to predict. Generators and suppliers both have to factor this risk into their pricing. Increasing the amount and volatility of BSUoS charges is thus also likely to result in an increase in risk premiums, compounding the cost to customers.

We have already had to revise our forecasts and adjust prices where possible to reflect the £12.39m addition to the Black Start target. Up to another £113m would mean a very substantial addition, not just to Black Start, but would also represent a greater than 10% increase in BSUoS costs as a whole. We believe that this situation adds further weight to the arguments in favour of implementing CUSC Modification Proposal CMP250 for stabilising BSUoS charges. Until that proposal is resolved, however, we would request that the Authority pay particular consideration to the mechanism for recovery of any amount that it might allow National Grid to pass on, once it has assessed their claim that contracting at this cost was justified.

We would also like to highlight our concern at the delay in this information being released to the market. There was a two-month delay between National Grid signing the contracts by 31 March and its application for an Income Adjusting Event on 24 May. Given the nature of the costs increase and the high probability that an IAE application would be forthcoming, we believe that the market should have been made aware of these costs as soon as they had been agreed, particularly in light of the relevance to parties' activities in the wholesale and retail markets. Furthermore, given that Drax and SSE were in part privy to this information since March, they have been put in the position of receiving price relevant information which was unavailable to other parties. Whilst we are not implying any inappropriate behaviour on behalf of these companies in this respect, clearly transparency of the energy market is extremely important, and the late disclosure of this information has nevertheless given them an information advantage over other parties.

Our answers to the specific consultation questions are as follows:

Question 1: Do you believe that the event submitted by NGET as an Income Adjusting Event constitutes an Income Adjusting Event?

We do not believe that the circumstances surrounding the procurement of additional Black Start contracts for 2016-7 constitutes an Income Adjusting Event. In our view it does not meet the qualifying conditions set out under NGET's Licence Special Condition 4C.

- **Do you consider the proposed IAE to constitute force majeure as defined in the BSC or in the CUSC?**

We do not consider the circumstances of the proposed IAE to constitute force majeure as defined in either the BSC or CUSC, and consequently, that the proposed IAE does not qualify as such under Special Condition 4C.13 (a) or (b).

- **Do you believe that the event submitted by NGET was unforeseen? Please provide evidence to support your view where possible.**

We do not believe that the requirement to increase Black Start cover in the north-west and/or north-east for 2016-17 was fully unforeseen. The GBSO has an obligation to contract appropriate levels of Balancing Services across the system and while perfect foresight is impossible, in current market conditions the availability of suitable thermal plant is expected to diminish. National Grid is reflecting this in developing four workstreams for a longer-term Black Start strategy. In the short-term however, while the exact timing of closure announcements may not be known, risk assessment and scenario planning should have already been undertaken for each zone and alternative cover explored in enough time to enable the SO to procure the most cost effective option and not put itself in the position of being a distressed buyer. We would hope that National Grid's modelling was sufficiently robust to have highlighted zones likely to be a particular risk



due to the features of existing plants and operators, enabling earlier engagement with potential alternative Black Start service providers.

o **Do you believe that the proposed IAE costs were beyond the reasonable control of NGET?**

As stated above, we believe that National Grid could have better controlled the cost of Black Start cover through prior investigation of alternatives that could be feasible if/when existing providers announced their closure/ mothballing.

When Ofgem announced the 2015-17 incentives in June 2015, it emphasized that the incentives are to encourage 'NGET to achieve this level of security at the lowest possible cost to consumers. We are confident that our proposed target will not lead to a deterioration in system security, but rather ensure that NGET procures the most efficient bundle of services'. This does not seem to have happened in this instance.

By putting itself in a position with a very limited pool of providers to choose from, the SO had little choice but to accept the costs presented to it. Therefore, in the context of the specific short term procurement exercise it took earlier this year, it appears that it procured the best options available to it at that time. However, we do not believe that this was due to factors beyond its reasonable control in the longer term running up to this and its apparent lack of preparedness effectively appears to have left it in a position of a distressed buyer.

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?

We cannot fully determine this without knowing more detail of the process followed and contracts agreed, but as per our answer to question one, are concerned that shortcomings in contingency planning and limitations in the procurement process followed have exacerbated the situation and led to higher costs than would have otherwise been incurred. It is not fair for consumers or other market participants to pick up these costs.

o **Are there any additional interactions between costs incurred that need to be taken into account?**

Forward trades and contracts have been agreed by parties unaware until 8 June of this potential impact on BSUoS charges and thus market prices. This will have a negative impact on their competitiveness. Unpredictability and instability in the market undermines the ability of market participants to operate efficiently for the benefit of customers. It is unfair for parties and customers to receive no prior warning of these excess costs.

If this IAE is upheld and National Grid, though best placed to manage the risk, are able to pass through the costs, they have benefitted from reduced risk in the ability to pass on their unforeseen costs ultimately to end consumers, whose third party costs are already increasing. As previously stated, it must also be noted that a large increase in costs also increases the challenge to suppliers and generators who are already trying to deal with the recent acceleration in BSUoS volatility. The additional risk management required for parties to tackle this is likely to add to costs for consumers.

We note that the £113m is a 'maximum combined' figure, but that the SO wishes to increase the BSIS target by the full value of the two contracts. It is not clear that this can be justified. National Grid have advised that there is no defined minimum value, rather, 'money will be passed back to consumers in the event that the Black Start units run in the market in excess of the level required to keep warm'. However exactly how any return of money to parties might be achieved has not been set out. We believe that the information provided by National Grid in their 28 June response to Ofgem's request should be made visible to other parties so they are better able to understand this. Indeed, we note that only aggregated cost information has been provided to the market on the value of these contracts. In this instance, it would seem appropriate to provide the market with more transparency on the split of these costs between the two contracts. The two providers concerned already have this information given that they know their own cost



and the combined cost, so there seems little reason to prevent this on the basis of commercial confidentiality.

We do not believe that this proposed IAE should be granted, but given the magnitude of the amounts in question, whatever amount the Authority might or might not decide to allow National Grid to pass through, parties will need time to manage the financial impact. To impose very high costs over a short timescale would not be reasonable. Some recovery might be better achieved by deferring the cost, for instance into 2017-18's BSUoS charges. Industry should be consulted on the process and timescale for any recovery mechanism that the Authority proposes.

Just as National Grid are reviewing their procurement strategy, when the next SO incentive scheme is drawn up, we would suggest that it would also be prudent to re-evaluate thresholds and sharing factors to ensure that they are appropriate in a more challenging market environment.

- o **Do you consider that NGET acted economically and efficiently in procuring Black Start in this event?**

As we mention above, without knowing further detail of the existing and new arrangements this is difficult for us to fully assess. However, it appears from the evidence available that National Grid's actions prior to the procurement exercise carried out earlier this year contributed to an inefficient level of costs being incurred as a consequence, namely:

- 1) It appears that the level of Black Start provision the SO was carrying was insufficient, so that the loss of one or two providers put it in a position whereby replacement contracts had to be agreed urgently.
- 2) Better planning for such inevitable eventualities could have minimised the risk by widening the pool of potential replacement providers. This could have avoided National Grid leaving itself in the position of a distressed buyer paying over the odds for two services.

Furthermore, to assess the cost-effectiveness of the procurement, we note that National Grid used London Economics' July 2013 Value of Lost Load estimate of £16,940/MWh for a one-hour outage (Willingness to Accept, domestic and SME winter peak weekday). When £3-6,000/MWh is used in other market mechanisms, the appropriateness of this figure is questionable and this may have over-estimated the social value of these contracts.

The potential total expenditure of £113m on two units is another order of magnitude to that of existing Black Start service providers and it is hard to see how such a disproportionately high cost can be justified. It equates to approximately £112/kW of capacity for the two units; this is six times more than Capacity Market income, and a similar factor more than Supplemental Balancing Reserve contracts.

Given our above concerns we believe that there is not sufficient reason to declare this event an IAE.

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

Yours sincerely,

Paul Jones
Head of UK Regulatory Management
Uniper UK Limited