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Johannes Pelkonen
System Balancing
9 Millbank
London
SW1P 3GE

14 July 2016

Dear Mr Pelkonen,

National Grid's IAE request for the SO incentive for Black Start

Calon Energy was founded in October 2012 and, following a series of acquisitions, is the owner of 2.1GW of flexible and efficient gas-fired generation at Baglan Bay, Sutton Bridge and Severn and has just bought the site at Willington to build a new 1.5 GW CCGT. Calon deploys international capital from a range of major international investors from across the globe and is keen to participate in the continued development of a sustainable, secure and economically-efficient electricity generation sector.
Calon Energy is grateful for the opportunity to comment on this issue but is very concerned that the information provided to parties to respond to this consultation makes a full judgment to its appropriateness difficult. However, even with this limited view, it is clear that there are significant issues with National Grid's calculations and presentation of information to Ofgem.

We lack sufficient information regarding:

- Which plants are in black start and which NG has tried to approach in the past to try to move Black Start (BS) capability from older to new plant;
- What the terms of the Black Start agreements were such that the SO had some control over notice periods for closure;
- The exact definitions of the zones to see if other plant could have been contracted with;

We would like to see this information as without it we can only focus on what we do know which is what we have had to do for this response. We would ask Ofgem to consider diligently whether the broader evidence, which it has access to, shows that NG is right and that this does constitute an IAE. We do not believe it does.

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

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

The force majeure clauses in the codes, and more widely in general contracts, rely on an event being unforeseeable.

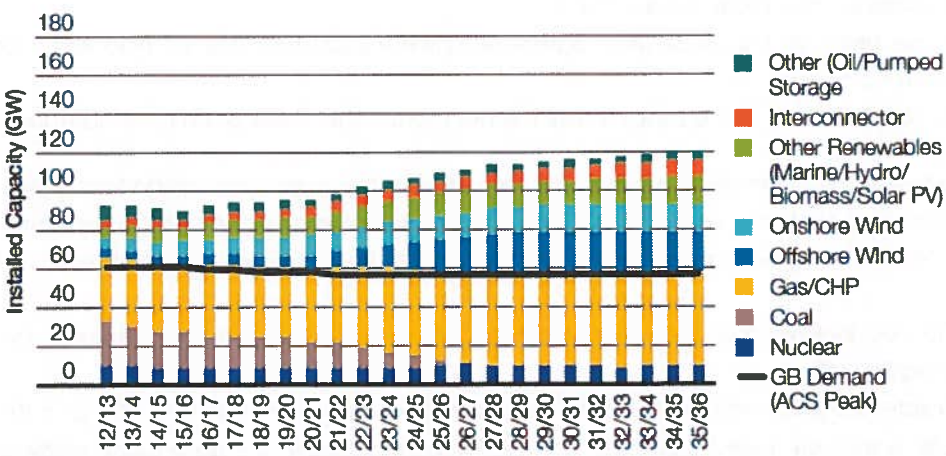
Firstly, we do not consider that this event can be construed as force majeure. The circumstances were a natural consequence of market conditions which, in themselves, were not exceptional. Whilst they may have been challenging for the plants concerned we would not consider them a force majeure event in any normal commercial contract. They were not unforeseeable. The Codes cite events such as floods, plant failure, wars and acts of God as unforeseeable. It does not cite a party failing to correctly assess market changes in a market environment. Calon Energy does not believe that the closure of coal plant was unforeseeable as it has been widely anticipated, notably in NG's own reports such as the 10 Year Statement, Future Energy Scenarios (FES) and System Operability Framework (SOF). NG may not have had certainty over which plant would shut or exactly when, but it is clear from NG's own documentation that NG considered the plant they had historically relied on for black start to be very likely to shut.

As an example of Ofgem's own rulings in similar circumstances, we would cite the precedent of transmission losses as an IAE as far back as 2013. NG applied for an income adjusting event due to increased north-south energy transfers due to the swing from gas to coal plant, increased wind generation and delays to commissioning plant. This was rejected by Ofgem as the risks around these losses could have been foreseen at the time of the agreement. We would expect Ofgem to maintain consistency in its application of rulings for similar sets of circumstances.

In March 2015, NG's "NIA Project Registration and PEA Document" shows that National Grid already knew that they needed to respond to the changes in the plant mix when looking at ways to procure and use a BS service. Before going out to tender for reports on future options for BS, Calon Energy would assume that they had internally considered the problems that they believed were going to arise. At that point it would have been prudent to take some actions to secure the BS provision for a transitional period while the longer term options were considered. We believe a failure to indicate transparent prices ahead on a timely basis is also highly likely to have exacerbated the situation.

A prudent SO would have anticipated the plant closures and we believe that NG should have been actively in the market seeking alternative Black Start plant. Looking back over the last 10 Year Statements these would have been prudent actions to take around 3-5 years ago. In fact looking at the 2013 FES, even under the Slow Progression scenario, NG was showing the reduction in coal plant (largely due the LCPD).

Demand and generation background: Slow Progression



Source: NG's 2013 FES

NG could have improved the economics of the plants, and hence prevented the closures, by extending contract terms or required longer notice of closure to give itself more warning. In our opinion, if a company relies on specific suppliers and has concerns over their future operations, extended contracts or longer notice periods would be prudent. In most circumstances, a failure to take account of such commercial realities would place a risk on the company concerned but if NG is effectively allowed to recharge for its oversights and failures to plan sufficiently it cannot be deemed to be incentivised to act economically efficiently.

It is noted that NGET is in the process of updating and redeveloping their model to take into account current and future market conditions. The implication of this could be viewed as being that the event was foreseeable if NGET had invested sufficiently in developing its capabilities previously.

In terms of controlling the costs, it is difficult to comment on the scale of the charges as we do not know the price by plant. In general, compared to the rest of the BS budget, the costs seem to be completely out of kilter with the prices paid to other BS providers.

We would assume that the Drax contract is the lower cost of the two, noting figures of £10m have been quoted in the press. We would assume that NG may have had to make capital contributions to install BS capability at the sites, but again we do not know the contract details so cannot comment on how those investments may impact the plant economics.
In the case of Fiddler's Ferry, it is essential that Ofgem considers whether their avoided £33m of capacity market penalty has been reflected in their BS price or not. We would encourage Ofgem to ensure that all the costs used to justify the IAE are thoroughly reviewed to identify not only their accuracy but also whether they are avoidable / unavoidable, including opportunity costs, in order to get a correct economic appraisal of the decision. We do not know if local plants such as Deeside, Rocksavage or Connahs Quay already have BS contracts or the ability to install BS capability. We are also not sure which other plants are in that specific BS zone. However, if the majority of the money is flowing to this plant the question must be asked about why NG was prepared to spend so much and what efforts they went to in order to secure the plant's continued operation rather than secure more economic providers for the longer term. Furthermore, it does not seem efficient or equitable that another plant in the same zone providing the same service should receive a disproportionately smaller sum just down to lack of transparency in pricing, asset specificity and strategic timing.

We also question whether National Grid's cost benefit analysis is correct and hence we are far from convinced that the prices paid are economic.

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?*

Having reviewed the London Economics document on which the VOLL is based we doubt whether the figures quoted in the National Grid request for an Income Adjusting Event and the Ofgem Consultation document are correct. Firstly, the NG document correctly quotes £67,760 for a 4-hour **event** but uses this on a £/MWh basis; our interpretation is that the correct number to be using is £16,940/MWh. Following this logic, all the consumer benefit calculations for Drax and Fiddlers cited on page 12 are inflated by a multiple of four. Secondly, the Ofgem document on page 11 cites a number of £67,760/MWh. The London Economics document refers to a linear cost of VOLL. Whilst the total for the event increases with time, we believe the rate in the model remains constant. We seek, as must Ofgem, reassurance that NG has correctly interpreted the London Economics report.

Further, NG states on page 12 of its proposal that:

"Black Start is a relatively low probability, extremely high impact event. It is very difficult to assess the probability of such low-frequency events..."

Whilst we agree with this statement we note that NG seems comfortable relying on the London Economics report which similarly asks consumers to reveal their preferences for such low probability events. We question how relevant it is to create such large costs to the industry based on such data.

National Grid also states:
"It is...more appropriate to assess the cost of contracts in the context of the Black Start Policy as an insurance policy which reduces restoration times."

We do not believe this statement to be sufficient to justify the procurement policy that has been adopted. In our opinion:

- An insurance policy would take into account probabilities in assessing the premium;
- There is no information to demonstrate this calculation;
- We believe the avoided lost hours consumer benefit is miscalculated

We do not consider it acceptable to be asked to pay for such procurement when the principles of that procurement have not been consulted upon.

We believe that the consumer benefit, if London Economics' numbers are to be believed, is around £600M but only in the circumstances of a) a black start requirement and b) one of the other contracted units not being available. For £113M, this implies a 1 in 5.3 chance of 1 black start unit in each of the 2 regions being unavailable during a black start event that is in winter at peak on a weekday. This seems a high premium by any sensible mathematics. The probabilistic elements of the modelling are redacted from the NG document so we cannot comment further. However, picking the worst case scenario and then adding an insurance of an extra unit and making a judgement on consumer benefit by applying one rate of VOLL across all periods will certainly not lead to an economically efficient conclusion. It should be noted that calculating a cost based on one high rate and applying it to all times within a year such as has been done in the justification further compounds the artificial inflation of the assumed benefits case.

Based on the information we have, it appears that if NG did require more BS it was an inefficient or uncompetitive process. This is the only way it can have ended up with securing the services from 2 plants at a cost in excess of three times the upper limit on their BS target. Noting that we do not know the split of payments, one or both companies would appear to either be so inefficient that their costs are multiples of any of their competitors, or they were able to secure prices significantly in excess of their costs. We question whether the economics of one provider can differ so widely from all of the other providers. Though a plant owner could easily construct a case for additional costs, and some would be justifiable in some cases, the scale of the additional costs seems extremely difficult to justify. We reiterate our view that Ofgem should review whether all the costs implied were truly avoidable and would encourage a thorough independent appraisal of this.

Calon Energy would not dispute that NG has paid the plants as reported to Ofgem, however, we believe NG's actions in the way they failed to plan for plant closures means that the IAE costs have been inflated. We note that DNV GL's report to NG, "Future Black Start Report" from 14 September 2015 said that: "DNV GL considers that the absence of a well-defined BS performance standard negatively affects NGET's ability to deliver BS services efficiently." In the same report DNV GL suggests that coal plant is not the best provider of BS, but instead NG should look to contract with CHP, gas plant (including embedded) and even interconnectors. Likewise, the Mott MacDonald document, "Black Start Alternative Approaches Report", suggests that coal plant that is cold does not provide the best solution.

In our view, NG needs to demonstrate that it acted in a timely manner and negotiated in good faith with alternative providers. We would encourage Ofgem to ask for a list of the potential BS providers that NG approached and discuss with them what their interaction with NG was: whether they feel they were approached in a timely manner; and offered reasonable BS terms. In a competitive market parties search and negotiate for the best deal, but if someone else is paying they will work less hard for the best deal. We suspect that NG will say a tender was good enough to demonstrate efficiency, but given the bespoke nature of the service and limited understanding around how provision is supported and paid, NG should have been on an active sales road show since at least 2013 to try and recruit new providers. As industry participants, we are deeply shocked by the size of these payments and would strongly challenge the view that an independent, profit-maximising company when faced with a similar risk profile would consider such an expensive insurance policy. Therefore, we do not consider it to be in the consumers' or industry's best interests.

We also request that National Grid and Ofgem make available all information regarding meetings and discussions held prior and subsequent to the black start agreements being put in place in relation to this Income Adjusting Event. For credibility in the sector, it is important to have transparency on such issues that distort the market and where costs are being asked to be socialised.

Calon Energy considers that NG's tender was the result of a lack of appropriate planning, with no apparent upfront education and sales process, which has resulted in a tender outcome that is far from the result they may expect in a more competitive process. There seems to be no evidence in their letter to Ofgem to justify the prices they have paid or indeed specifically what the announcements were which triggered the negotiation. For instance, there was no closure announcement for Drax.

BS contracts are commercially confidential but, in the case of these BS contracts, both the recipients felt obliged to report to the Stock Market: so they were material enough to impact their share prices. As we are not aware that any other providers have specifically reported BS contracts in this manner, this is evidence that the contracts were outside the usual income such contracts attract. In the case of SSE we would assume they hold other BS contracts that have not been specifically reported. This provides evidence that NG paid materially more for these contracts than the generators' shareholders would have expected.

When all circumstances are taken into account, it looks as though a disproportionately high price has been offered to keep Fiddler's Ferry available. It is difficult to avoid the conclusion that NG has used this process, at least in some degree, to address concerns over to the tight winter capacity margin and the inability of NG to contract with further plant. This situation was not unforeseen and we ask Ofgem to consider what NG would have done to keep plant margins higher were Fiddler's Ferry to have shut as planned. If NG did need further reserve, as seems likely, we question why it was not bought from the highly competitive STOR market at a significantly lower cost. Questions should not only be asked of NG, but Ofgem will also need to know how the plants maintained their position at all times of the negotiations.

We appreciate that it is Ofgem's role to ensure that the market is able to deliver the energy that customers require in the most economic and efficient manner. However, securing competition cannot be achieved if the SO is able to strike costly and highly distortionary bilateral contracts using opaque processes and unclear objectives; such circumstances have far reaching effects on the rest of the market both in the short and long term.

To reiterate, regardless of whether the procurement process was efficient and cost-effective or not, which we severely doubt, Calon Energy unequivocally does not view this event as fulfilling any reasonable definition of an

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Income Adjusting Event. It was not unforeseeable; it was not force majeure and the costs were not beyond the reasonable control of NG.

Calon Energy is very happy to discuss these issues further with Ofgem if that would be helpful.

Yours Sincerely

D PARKER

pp Andrew Mackintosh
Director of Government and Regulatory Affairs
Calon Energy