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To SO Incentives Team

Initial Proposals for Electricity SO Incentives from April 2017

VPI Immingham welcomes the opportunity to respond to the above call for evidence. 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 oil refineries. As well as looking at future investment in new generation assets, we are proactively pursuing investment in battery storage projects.

Broadly speaking, we are supportive of Ofgem's proposals for 2017/18. In our view, it makes sense to maintain the current structure whilst a new longer term structure is developed. However, we remain disappointed that some failures in National Grid's performance continue not to be addressed and urge Ofgem to include these in their longer term review. This includes, but is not limited to, the market distorting contracts that they offer to participants and issues surrounding the accuracy of BSUoS forecasts.

Chapter 2: Balancing Cost Incentives

Question 1: Do you agree with our proposals to introduce new licence requirements / guidance around SO balancing behaviour? Please explain your answer.

Yes, we agree with the proposal to introduce new licence requirements. These should help clarify NGET's role as System Operator (SO) and will also enable Ofgem to have better ability to take action should the need arise. However, as outlined in section 6 below, we think that these proposals could be extended further to offer further clarity and to be made more specific to ensure that they can be used to drive the necessary behaviour.

Question 2: Do you agree with the clarifications we propose to introduce to NGET's licence? Is there anything missing or that should be removed? Please explain your answer.

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We support the proposed changes to NGET's licence although we would also like to see a further addition regarding transparency and market distortion explicitly. Our number one issue with the performance of the SO is in its ongoing use of market distorting contracts and services that continually undermine our business model. We are disappointed that, despite these being raised by multiple respondents to the September consultation, these issues have not been addressed for the upcoming year.

We also would also note that many of the conditions are highly subjective, such as:

- *"anticipating future system requirements and using and developing competitive approaches to procuring balancing services wherever this is in consumers' best interests"*

Wherever possible, Ofgem should be ensuring that the conditions are as specific as possible to ensure that they are enforceable.

Question 3: Do you agree with our Initial Proposal of maintaining a model-based target from April 2017 until March 2018? Please explain your answer.

Yes, we support the proposed approach of maintaining a model based target for 2017/18. It is essential that NGET has clear expectations as to what is expected of it with appropriate financial incentives attached. Rather than develop something new, it makes sense to spend the time developing a longer term solution that is fit for the future that can be implemented from 2018. Therefore, it seems appropriate to continue with current structure until a new, more robust model can be developed.

We note the comments that this year may be different from previous years and therefore the incentives may not be appropriate. Whilst the energy system is changing rapidly, we think that the 2016/17 year will be very similar to the 2017/18 year. In fact, the introduction of the capacity mechanism should give the SO added confidence as to what is available in the market and therefore enable the system to be better managed ahead of time.

Question 4: Do you agree with our proposed changes to the governance and incentive parameters? Is there anything missing or that should be removed? Please explain your answer.

We support the proposed changes to incentive parameters. We think that it is absolutely essential that NGET, as a publically limited company operating for shareholders, be incentivised financially. However, we also note and recognise the concerns regarding the robustness of the supporting models and therefore think that it is appropriate that a lower incentive is introduced for the short term.

It would seem perverse that, despite the huge cost of the black start income adjusting event, National Grid has been telling the market that they expect to out-perform their targets. This concerns us greatly and would suggest huge issues with the supporting models. Therefore, we think

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that it is right to keep the financial incentive, but also essential to sense check the models, as proposed by Ofgem. Therefore, we support Ofgem's approach.

However, given the limited number of companies available to critique such models, we would also urge that the audit must be done by a completely independent party with no conflict of interest. Statistics would suggest that you would expect to errors in both directions, but the evidence presented would suggest that this is not the case. Therefore, as a sense check, Ofgem should be ensuring that both positive and negative issues are identified.

Chapter 3: Black Start

Question 1: Do you agree with our proposal to remove Black Start from BSIS? Please explain your answer.

We do not have strong views either way as to whether the black start component of the BSIS sits within or out with the incentive scheme, especially as it is calculated separately currently. Rather, we would prefer that Ofgem correctly incentivise National Grid to procure black start services in the most efficient way that does not distort the market and has the lowest Net Present Value. This is clearly not happening today and must be addressed going forward. Given the current incentive scheme is being rolled over for a year, we do not see the need to remove the incentive per se. We see it as essential that National Grid have a financial incentive to improve their performance in this area.

Having said that, we are fully supportive of Ofgem's key objectives – achieving the optimal level at lowest possible cost, noting that the lowest possible cost must also include a long term view. So long as the changes going forward support this approach, then we do not have issues with the structure of the incentive itself.

However, we do have concerns that any ex-post approach allows after the event rationalisation of poor planning.

Question 2: Do you agree with the principles of our Black Start regulation? Should we add or remove any principle? Please explain your answer.

We support all of the proposed principles. These are a good foundation for developing a robust black start incentive framework going forward. We would suggest adding an element of Net Present Value to ensure that a longer term view is considered.

Question 3: Do you agree with our proposed regulatory framework for 2017/18? Please explain your answer.

We disagree with the argument that the costs are volatile and hard to predict. There are many power stations in the GB market that could provide the service on a long term basis at low cost. The

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reason that the costs are volatile is that National Grid has continued to contract with expensive coal plant who are trying to recover their money through ancillary services due to reduced revenue from the wholesale market and, who as they are not running baseload any more, need to be warmed. A change of strategy and approach from National Grid would require minimal capital expenditure and result in long term, forecastable costs. It is disappointing that Ofgem do not recognise this despite all of the evidence presented to them.

The reason that the costs are volatile is because NGET failed to adequately prepare for the changing market. We hope that the mistakes of 2016 have been learnt and a longer term view is adopted going forward that recognises the changing nature of the electricity system. We believe that an ex-post approach will allow National Grid to justify its decisions retrospectively and will continue to fail to plan effectively in this area. However, given there are issues in this area, we think an ex-ante incentive with an ex post reconciliation is appropriate for 2017/18.

NGET must be incentivised to find the most efficient long term option. Clearly keeping old coal stations open via black start contracts is not a viable option long term due to the very high associated costs and imminent coal closure. We stand by our previous submission that National Grid must take a long term view that does not distort the market (i.e. plant being kept open or run when not needed). This must also be more transparent that it is today. We would also hope that the approach would support some more innovative approaches that may not fit within today's strict parameters but that can deliver the same service under different parameters. We would urge Ofgem to look at the approach in other countries.

As above, we believe that a combination of an ex-ante incentive with an ex-post reconciliation is appropriate. This should avoid the short term focus that exists today and should also allow for longer term incentives to be introduced. We have concerns that the approach outlined by Ofgem is overly complex with National Grid essentially auditing its own strategy, due to a lack of skills in this area. With all due respect to Ofgem, we would also question whether the necessary skills exist within the organisation for a deep critique of the thinking as the knowledge all sits within the SO.

The benefit of our proposed approach would be a level of certainty to generators and suppliers regarding BSUoS costs. The 2016 approach to black start recovery was inadequate and resulted in many parties taking significant hits due to the retrospective nature of the cost recovery. It is important that parties can accurately forecast their BSUoS costs when taking long term positions in the market. This will benefit consumers as a lower risk premium will be factored in to forecasts.

CHAPTER: Four – Forecasting Incentives

Question 1: Do you agree with our amended wind generation forecast incentive proposal? Are there any elements you feel should be changed or that are more relevant to you? Please explain your answer.

We support the proposals, particularly the proposals for the more granular approach. However, we believe that much of the over-forecast may be as a result of constraints and would suggest further analysis in this area.

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Question 2: Do you agree with our proposal to introduce demand forecasting incentives in this interim scheme? Are there any elements you feel should be changed or that is more relevant to you? Please explain your answer.

We support the proposals to add an incentive around demand forecasting. This is an area that has developed quickly in recent years and NGET should be incentivised to develop further. This will make it easier for them to manage the system and hence reduce costs to the consumer. However, we also recognise the comments that it should be in NGET's best interests to do this anyway, but as progress to date has been insufficient, a financial incentive should be the best approach to improve demand forecasting going forward. As outlined above, we also support a more granular approach as this can only help the market. Also, as identified by Ofgem, there are many different definitions of demand and it would be useful if clarity was provided over which version was used.

We assume that the demand forecast includes the "net" solar generation too. Whilst these are very difficult to forecast, it is a growing part of the market and contributes to many of the issues that NGET encountered last Summer in periods 3 and 4. They consistently under-forecasted solar and we would like an incentive to improve this area, noting that work has already started. We would advocate a separate incentive for solar forecasting, as for wind.

However, we would caution the analysis in paragraph 4.17, we do not recognise this. In fact, our own analysis of National Grid's forecasting, which we would be happy to share on request, suggests that there is no bias either way. Instead, we believe the misperception is around what is included in the different forecasts. As Ofgem have identified, there are many different definitions of demand and even the numbers that National Grid publish contain different data, Therefore, an education to the market as to what is and what is not included is required. We believe that the issues identified appear to be regarding lack of understanding as the content varies depending on the timeframes.

Furthermore, an accurate incentive for demand forecasting is required to ensure accurate cash out price and send the correct signal to the market. We believe that there are some settlement periods where an incorrect cash out price has been used due to an under forecast of demand by National Grid – the bias on this is always a lower cash out for the reasons set out below. To put this into context, if NGET over-forecast the evening peak demand, then LoLP is higher than it should be, but NGET is not required to use STOR (as they operationally plan to their own demand forecast) and therefore there is no influence on cashout. However, if NGET under-forecast the evening peak demand, then LoLP is lower than it should be, NGET are more likely to utilise STOR, but STOR is priced too low as an inaccurate LoLP is used and therefore the cashout price signal is lower than it would otherwise have been.

Question 3: Do you have any additional criteria that you would propose for the Quarterly Forecast Report? Please explain your answer.

We believe that the forecasting report should be on a monthly basis as opposed to quarterly. Without resulting in significant extra work, the added granularity to the market will be a benefit. We would also not underplay the issues around Summer in terms of the incentives. While prices are

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higher at the Winter peak, there are issues in Summer also that accurate wind, demand and solar forecasting could help resolve.

We also support the concept of a monthly cap.

Question 4: Do you agree with how the parameters for the incentives are calculated? Should we consider anything else when setting the target?

We have no comment.

Question 5: Do you believe we should introduce an additional mechanism to counter the incentive to under or over-forecast in any given month to maximise incentive value? Please explain your answer.

Yes, we agree that this is a sensible measure. However, as identified by Ofgem, it must not give rise to perverse incentives or outcomes. We therefore think that there should be predominantly an outcome based incentive that relates to the cost of the balancing mechanism activities as a result of an under or over forecast. This would better mimic the costs incurred by market participants and hence consumers.

CHAPTER: Five – We have no comments on this section.

CHAPTER: Six – Transparency, Model Developments and Innovation

Question 1: Do you agree that the proposed changes describe in Chapter 2 will enhance transparency? Please explain your answer.

Whilst we are supportive of the proposed changes and believe that they are a step in the right direction, we would like to see them go further. We would question, given the reluctance of NGET to be fully transparent, whether the proposals go far enough and whether they will actually result in enhanced clarity for industry. This is because they are too vague and non-specific about what NGET must do and publish.

We would have hoped that the SO would be publishing all non-commercial information anyway (and DNOs), but as this is not happening, we believe tougher licence conditions are required to force it to happen. Simple changes such as improvements to their website and consistent information in consistent formats across services would help transparency, not to mention the publishing of all ancillary service contracts, whether bilateral or via a tender process. We are aware of numerous ancillary service contracts out there that were not competitively tendered, sometimes for good reason, but are not visible to market participants. National Grid should be incentivised financially to always tender competitively and to always publish the contracts in place, in one central repository. This would seem a straightforward step that is easy to complete.

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Question 2: Do you agree with our proposal to not introduce a financial incentive on transparency? Please explain your answer.

We disagree with Ofgem's proposals. It is a continual disappointment in the level of transparency offered by the SO and DNOs and despite repeated pleas to relevant parties, very little has been done to date. Therefore, we believe that the only way to facilitate the change is a financial measure.

Transparency and quality of data is a key industry driver, those with better data tend to perform better. However, there is a bare minimum that all parties should have access to and hence the SO and DNOs should be publishing all non-commercial information. This can only improve accuracy and aid balancing and should drive down costs for consumers.

Furthermore, we are incredibly disappointed that there is nothing proposed regarding market distorting measures. Many of the recently introduced contracts distort the market and undermine business models and investment cases. Huge ancillary service contracts have enabled older power stations to remain in the market, and in one case, bring back units that would otherwise have been closed. However, the issue also exists in the more micro level with indexed linked contracts resulting in out of merit plants dispatching and hence reducing revenue for the rest of the fleet, most of whom are commercially despatching. NGET, as a monopoly, should be incentivised to avoid distorting the market wherever possible. This will result in a healthier market, potentially reducing the need to intervene on an ongoing basis.

Question 3: Do you agree with our proposal to retain the MDLC? If not, please explain your answer.

Yes, we agree. We believe that given the issues identified with the models outlined in the consultation document, the SO must be incentivised to continue to develop the incentive models. Whilst no evidence of wrongdoing, the MDLC must also ensure that developments do not just favour the SO, but that the SO must also identify defects that may cost them money.

Question 4: Do you agree that we should amend the MDLC to require NGET to get third party scrutiny on areas where the model could be improved? Please explain your answer.

Given the issues identified, this would seem sensible. Given the limited number of parties in a position to do such scrutiny, Ofgem must ensure that there are no conflicts of interest.

Question 5: Do you agree with our proposal to discontinue the System Operator Innovation Roll-Out Mechanism? Please explain your answer.

We have no comment.

For further question regarding any of the above, please contact:

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