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13th September 2016

Electricity System Operator Incentives from April 2017

Response from VPI Immingham

VPI Immingham welcome the opportunity to respond to the consultation on the Electricity System Operator incentives from 2017, dated 4th August 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.

We support the principle of a fundamental review of the System Operator (SO) incentives and believe that this is required with a matter of urgency. As noted in the consultation document, the changing landscape of the system and increasing conflicts of interest mean that a full review of the appropriate incentives is essential at this time. However, it must be done rigorously to ensure a robust system operator for the future and to ensure perverse incentives are not put in place at this critical time for the power industry. Therefore, in the interim we support Ofgem's proposal to continue with the existing scheme with some necessary adjustments.

Whilst we note that a consultation on the longer System Operator Incentives scheme will follow in due course, and we will respond as appropriate, there are easy "quick wins" that could be applied before the wider review has concluded, i.e. to the existing scheme. We believe that while Ofgem has identified some of the necessary areas of focus, there are other areas that should be easy to implement and would benefit industry whilst making the role of System Operator easier. These are outlined below:

- Addition of an incentive to stop the introduction of market distorting contracts, such as indexed voltage control contracts:
    - These indexed contracts, effectively a CfD, are destroying market value for other participants and hence have the potential to cause wider security of supply issues. On the back of the market distorting SBR contracts, the SO must be incentivised to ensure contracts do not distort the market.
- Improvements in forecasting of costs extended to solar and BSUoS:
    - With the forecast of solar output and BSUoS now becoming critical for industry parties, National Grid should be incentivised to provide accurate forecasts of these on a settlement period by settlement period basis at day ahead.
- Adding a qualitative customer focus incentive to ensure that the SO is fully transparent in its actions and engaging widely with all industry parties:
    - With a growing number of industry parties, many of whom do not have the relationships that incumbents have with the SO, National Grid must ensure that it is serving all industry parties equally by ensuring the availability of all data in appropriate timescales. Often larger incumbents have an advantage over smaller, non-portfolio players by the very nature that they are aware of ancillary services being despatched which can give

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an indication of what is happening on the system. This information must be disseminated to wider industry in real time. We do not believe that this is the case currently and would urge Ofgem to put an obligation on the SO to provide timely and accurate data.

Below outlines our responses to questions 1 to 8. We are not in a position to comment in detail on any SO-TO mechanism but would request that Ofgem ensure the principle of charges being allocated a "polluter pays" basis.

Question 1a: Should we place financial incentives on the SO in the period between 1 April 2017 and when we are in a position to implement longer term SO incentives?

Yes, financial incentives are the most appropriate manner to incentivise a profit making, shareholder owned System Operator (SO) as this is how the business is run. We believe that until the wider, longer term review has concluded, a cap and collar currently in place should remain in place.

Noting the analysis in Chapter 2 of the consultation document, we would note that a retrospective view of balancing and constraint costs is not appropriate for the future and therefore any future incentive scheme. Significant costs, to the tune of over £200M have been added in 15/16 to pay for the additional black start and SBR costs. Whilst these costs may only be for one year given the early introduction of the capacity mechanism, we would expect that the £850M stated is only likely to increase due to growing costs of new services. National Grid themselves have confirmed this view by stating in the media that they expect balancing costs to increase from c. £1bn to £2bn by 2020[1]. As a result, we believe that Ofgem should be basing their analysis on a future view of costs, whilst noting that this is a forecast and therefore only the best view.

Furthermore, while the analysis suggests that the impact on consumer bills is £9 per annum, the impact of highly volatile, unpredictable BSUoS costs can be the difference between profit and loss for generators. In a world where thermal generators are struggling and there are ongoing security of supply issues, this could result in higher costs in future for consumers. Therefore, we would urge Ofgem to consider the wider context of the impact on the market rather than an absolute impact on consumer bills.

Question 1b: If we maintain financial incentives from April 2017 to spring/summer 2018, should we use the existing BSIS framework?

Given the proposal to introduce new incentives from 2018, it would seem appropriate to continue with the existing framework, with adjustments in areas where performance needs to be improved.

Again, looking at the analysis in Chapter 2, just looking at performance against the target is a naïve view of the world. Wider factors, such as the incident (or approval) of Income Adjusting Events (IAEs) must be factored in when considering whether the current framework is appropriate. The analysis actually suggests that National Grid is able to come in under their target unless there is an

[1] http://www.telegraph.co.uk/business/2016/06/26/balancing-demand-could-cost-national-grid-2bn/

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unexpected cost. We would therefore suggest an update of the wider targets.

Question 1c: Do you agree that if we maintain the existing incentives framework during this period, we should seek improvements from the 2015-17 scheme?

Yes, in our view the System Operator performance requires improvement and therefore the incentive scheme should be improved to achieve this outcome. Whilst much of this will be delivered via the wider fundamental review, as outlined above, there is the opportunity to make short term "quick wins" that will improve performance. As a monopoly, the most appropriate method to do this would therefore be via the existing incentive scheme.

With the energy world evolving on an ongoing basis as older plant closes and new types of generation appear, the dynamics of a System Operator have changed and the introduction of new products and services has accompanied this. This has been particularly notable in recent years with the introduction of the market distorting Supplemental Balancing Reserve and the recent high cost black start contracts. With a wider "customer" base, different types of generation and new technologies, National Grid must be incentivised from now to engage with and innovate to adjust to the new world. Waiting until a wider review has concluded would leave the System Operator with a significant amount to do to catch up to where it should be. We have anecdotal evidence that under the current arrangements, they are doing neither.

Question 3a: How could the BSIS target setting approach and modelling methodologies be improved in the short term?

We have no comment.

Question 3b: Do you believe the existing BSIS sharing factor and cap and floor remain appropriate?

There is no reason to suggest that the sharing factor and cap and floor is not functioning appropriately. However, without detailed analysis of the models and structure of the incentive scheme, it is hard to comment. We would note that the points above regarding the ability of National Grid to achieve the target, in the absence of an IAE. We would also suggest that in a world of rising costs, some consideration of relativity to total cost may be required. This may be more appropriate in future when National Grid have suggested that the costs could be as high as double what they are today.

Question 4: What is the best way to set an incentive on the SO to incur efficient costs when procuring Black Start from April 2017?

We have huge concerns regarding the increase in black start costs and maintain our position outlined in the black start IAE consultation that these costs were both forecastable and avoidable. Given the changing nature of the transmission system, National Grid must be incentivised to innovate and engage with new potential providers who may not conform to the existing guidelines. The huge amount paid out in warming costs currently for coal plants that are sat cold is entirely

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avoidable by investing a small amount of capital in new providers, particularly must run plant that will always be available on the very basis that they do not switch off. In our view, it is not appropriate to continue to offer these contracts to large, coal plants when others can offer a similar service. We would hope that National Grid are proactively pursuing new, innovative black start services, but given our recent engagement with them, we remain concerned that they are not doing so.

We think it appropriate to introduce a challenging cost target for the provision of black start costs, but the SO must also demonstrate the Net Present Value (NPV) of alternatives to demonstrate that in the long term, their approach is the most cost effective. We would also suggest an independent benchmarking exercise to compare the costs of the services procured against the potential services out there in other countries. As a result, it may be appropriate to introduce some qualitative aspect to the incentive to ensure that National Grid are engaging widely and considering all potential technologies.

Question 5a: Do you agree that we shouldn't maintain the MDLC?

No, we do not support this view. We believe that given the lack of clarity regarding the wider review, 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 5b: Do you agree that we shouldn't maintain the SO IRM? Are there any alternative ways to encourage innovative behaviour from the SO in the short term?

Without information on usage of this fund and innovation that it has funded, it is hard to comment. However, the SO must be incentivised to continually innovate, especially in the changing landscape. A challenging financial target with an allowance for research or pilot costs would seem an appropriate framework.

Question 6a: Do you believe there is a need for a new incentive on short term demand forecasts from April 2017? How could this be designed? What timescales should it be based on: week ahead, day-ahead, hour-ahead, other?

Yes, we believe that there is a need for a general improvement in forecasting across the board. Currently, National Grid's forecasting in some areas is not fit for purpose and is unusable by market participants. Areas for improvement include, but are not limited to, demand, wind, solar and BSUoS. Whilst BSUoS forecasting has improved, it is still far off what is required by industry, in terms of accuracy, timeliness and granularity. This would be a key area of improvement that the SO should be incentivised on.

Any incentive must be based on accuracy, but also on the correction of errors contained within such data. Currently, we frequently query National Grid analysis and often it is a result of errors in the data. There does not seem to be any incentives to correct these errors in a timely manner. We would like to see accuracy of forecasting at day ahead, wherever possible, with a granularity of settlement period by settlement period, and improving as the time gets closer to the actual

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settlement period. Given cost are recovered on this basis, this would seem appropriate.

By providing improved forecasting and hence greater transparency to market participants, the SO should actually be making their role easier as participants are able to adapt their behaviour to the changing conditions resulting in, potentially, fewer actions needing to be taken by the SO. Therefore, accuracy in forecasting should be an incentive in itself.

Question 6b: Do you think there needs to be any changes to the wind generation forecasting incentive or new incentives on any other system forecasts?

Please note our response to question 6a.

Question 7: Do you think the SO's procurement of balancing services needs to be more transparent and open? If so, what steps should be taken? Should the SO pursue more market-based approaches? Should we introduce any incentives or requirements on the SO in this area from April 2017?

Yes, we think the approach to procuring balancing services is lacking currently in some areas and the SO should be incentivised to be more transparent and open. We would note that the procurement of STOR would appear to be best practice that the SO should be aiming to achieve in other areas, where possible. With an ever growing list of contracts, many of which appear to be bilaterally negotiated and opaque to the wider market, the ability of market participants to forecast costs grows ever harder.

Furthermore, the SO is increasingly using indexed contracts, primarily for voltage control. As outlined to Ofgem previously, we have serious reservations about the use of these contracts and believe that they should be scrapped with immediate effect. The reason for this is the severe distortionary effect that the contracts have on the wider market and hence the huge negative impact on other plant. In these contracts, a strike spark price is agreed with a BMU. When the SO calls the option to bring the BMU on, it pays the difference between the strike and market price. Crucially, the BMU must sell its Physical Notification (PN) into the market meaning that a generator might be selling power into the market when it would otherwise not be and it is price insensitive as it is being "topped up" to a pre-agreed level. There is zero transparency around these contracts beyond who they are given to so we cannot be sure how often they are being used but there is a corresponding impact on BSUoS which market participants are unable to forecast as a result. There is also severe market distortion as that plant is selling its output into the market below the price it would ordinarily accept, out of merit and impacting other plant that are generating.

The SO should not only also be incentivised on transparency of the process itself and corresponding contracts issued, but on when the contracts are called on. Over Summer 16, there has been an ever increasing usage of BSAD actions, which lack transparency and do not provide real time information to the market. We do not believe there is any justification for the increasing use of these actions. For some contracts, such as the indexed voltage contracts, it is not always obvious that the despatch of a plant is lined to a wider ancillary services contract making the forecast of the impact on BSUoS virtually impossible. Therefore, there should be a requirement on the SO to publish, via SONAR (if it

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works) or, preferably via BMRS, a notification of what plant has been despatched for what reasons.

Another "quick win" could be the provision of information regarding the availability of non-BM STOR at week ahead plus despatch of non-BM STOR before the event. Neither of these is currently shared, despite not being commercially sensitive. In general, the SO should be incentivised on sharing as much information as possible, which is a step change from the current way of thinking.

Question 8: Do you agree with our proposed scope of changes? Is there anything else you believe should be changed, added or removed from the existing scheme?

We support the proposed scope of changes, but would also urge Ofgem to widen the scope somewhat. Clearly the areas identified are critical, but in a world where even very small pieces of information, such as despatch of non-BM STOR can impact market prices, then National Grid must be exposed to the same level of transparency as all other parties. Therefore, the three areas we suggest that Ofgem consider are

1. Transparency of actions (as outlined in question 7) – it is essential that National Grid are exposed to the same requirements as other market participants. In a world of growing uncertainty and rising costs, a detailed understanding of the data is critical. This can only be achieved by the SO increasing transparency of their actions. We believe that much of this is easy to achieve – the underlying data exists in the format required and just needs to be published.
2. Customer focus – the role of the SO is changing and there are a growing number of parties operating in the market. With this in mind, we think that a qualitative "customer focus" measure should be introduced. As a relatively new entrant to the market, we often struggle in getting a response out of the SO that is either accurate or is in a timely manner. In fact, on numerous occasions, most notably the incorrect cash out prices, it was VPI that identified errors in the SO's data or analysis. A more cohesive approach with industry should be adopted.
3. Market distortion – increasingly, many of the actions taken by the SO or new products introduced are market distorting. We have outlined most of these above. As regulator, we would expect Ofgem to promote the market at all times. Therefore, there should be a financial incentive on the SO to ensure that ancillary services and actions do not distort the market.

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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