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David Beaumont
System Balancing
Ofgem
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15 September 2016

Dear David,

Electricity System Operator incentives from April 2017

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. The 4,000MW station consists of six separate units, which together produce around 7-8% of UK generation. Two of these units have been converted to renewable biomass and a third unit is currently enhanced co-firing, with plans to fully convert in 2016. Drax is now a predominantly renewable generator, having completed the largest single site decarbonisation project in the EU.

Thank you for the opportunity to respond to proposals on the electricity System Operator (SO) incentives from April 2017. We have reviewed the consultation and would like to raise the following points.

General position

The dynamics of the market, and the activities required to deliver effective real time management of network infrastructure, have changed. It is likely that change will continue as older generation assets retire and new assets, which will be a mixture of established and new technologies, connect to transmission and distribution network infrastructure.

With regards to the current scheme, we agree that:

- It is too short, meaning the benefits of strategic, longer-term procurement are lost, e.g. lower costs associated with increased certainty;
- It does not incentivise transparency in the procurement of balancing services, making it difficult to understand or scrutinise the SO's decisions;
- It is, or is interpreted as being, too rigid, meaning the SO does not take sufficient advantage of innovative balancing products, e.g. combined or bundled services;
- Should the role and/or governance of the SO change, then the incentive scheme must change to reflect the desired outputs.

We also note that the arrangements, as they stand, do not incentivise charging methodologies that promote predictability and stability in the recovery of system management costs (most notably BSUoS). SO balancing actions are forecast to increase sharply over the period to 2020 and market participants have signalled concerns in this area, raising industry code proposals (such as CMP250) to address the issue.

It would be prudent to incentivise the SO to develop charging principles that reduce volatility in ex post (unpredictable and unmanageable) cost recovery or promote ex ante (predictable and manageable) charging arrangements. This would reduce avoidable premiums applied in the wholesale and retail markets, which are ultimately passed through to consumers.

Way forward

The SO incentive scheme is fundamental to the efficient operation of the market, in terms of the procurement of balancing services, the impact of the SO's decisions on the wider wholesale market and, consequently, the final cost to consumers. It is therefore timely to conduct a fundamental review to ensure it remains fit for purpose.

We agree that, in the interim, it would be pragmatic to rollover the existing incentives. Any changes should be kept minimal and focused on areas where the current scheme has become redundant, no longer works or ensures readiness for the incentives scheme beyond 2018.

In terms of readiness for 2018, it may be prudent to include an incentive in the 2017 scheme to develop and agree the new enduring scheme in a timely manner, mitigating the risk of delay beyond 2018 and ensuring the benefits are realised by consumers at the earliest opportunity.

Answers to the specific questions raised in the consultation can be found in Appendix 1. Please do not hesitate to contact me, should you wish to discuss any aspect of our response.

Yours sincerely,

By email

Stuart Cotten
Head of Regulation and Compliance

Appendix 1: Drax response to the consultation on 'Electricity System Operator incentives from April 2017'

Chapter 2: Whether to maintain the existing incentives framework

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. The SO incentive scheme is fundamental to the efficient operation of the market.

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

We believe it is appropriate to continue using the existing BSIS framework over the interim period.

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? Please provide evidence to support your answers

Any changes should be kept minimal and focused on areas where the current scheme has become redundant, no longer works or ensures readiness for the incentives scheme beyond 2018. Ofgem's primary focus should be on the enduring scheme in 2018 and beyond.

In terms of readiness for 2018, in may be prudent to include an incentive in the 2017 scheme to develop and agree the new enduring scheme in a timely manner, mitigating the risk of delay beyond 2018 and ensuring the benefits are realised by consumers at the earliest opportunity.

Chapter 3: Scope of potential changes from the 2015-17 scheme

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

We do not believe it is worth investing resource in this area in the short-term. The focus of Ofgem's efforts should be on the enduring SO incentive scheme from 2018.

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

Yes, over the interim period. The effectiveness of the current approach should be considered as part of the proposed fundamental review.

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 believe it is appropriate to review the up-front BSIS target setting approach for the 2017 scheme. The recent target adjustments, and the 2016 Income Adjusting Event, suggests the current target setting approach is no longer in line with requirements. It may be prudent to move to an ex post cost efficiency assessment over the interim period, with a view to considering a revised ex ante cost target for the enduring scheme in 2018.

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

Yes. Work on the MDLC would be meaningless, given the fundamental review is likely to result in a move away from the BSIS framework.

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?

Yes, resource should be focused on the incentive scheme for 2018 and beyond.

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?
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?

We agree that a new incentive is required to drive greater accuracy in short term demand and wind generation forecasts. However, it may be sufficient to signal the introduction of such incentives in 2018 to allow the System Operator to begin work in this area, rather than developing an incentive for the interim (rollover) scheme.

Firstly, the incentive in 2017 may not align with objectives set in 2018, leading to an inefficiency in utilised resource. Secondly, it may be more appropriate to focus on incentives (or coordinated work across network owners/operators) to drive transparency in data associated with distribution connected plant, to enable the System Operator to respond to the incentive once implemented.

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 believe there should be a drive to make the balancing services market more transparent. Whilst it is unlikely that the System Operator will be able to develop a truly open, market-based procurement process over the interim period, early work in this area may inform the development of incentives for the enduring scheme from 2018.

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 agree with the general scope of proposed changes, subject to the comments provided above.

<u>Appendix 1: Consultation on SO-TO mechanism</u>

Question 9: Do you agree that there is a need for a mechanism that allows the SO to exchange funds with the TOs? Are there any additional pros and cons that we should consider in our analysis? Do you agree it should be introduced from April 2017?

We believe there may be a benefit in introducing the exchange of funds between the SO and TOs in order to deliver additional cost efficiencies. However, we believe proceeding with the proposal at this stage would be premature in light of the Government's concerns over SO independence and its recent signals on the creation of an independent SO.

Without independence, there is a risk that National Grid (as a TO and the SO) is in a unique position to exploit its own commercial interests to the detriment of other TOs and the wider market. There must be robust consideration of the potential for such exploitation, including appropriate checks and balances that should form part of the arrangements, ahead of implementing a SO-TO fund exchange mechanism.

Question 10: Do you agree with the codified-approach?
Question 11: What do you consider to be the most appropriate cost recovery levy methodology?
Question 12: Do you agree with the proposed approach with regard to the financial aspects of the mechanism outlined above?
Question 13: Do you agree with our proposed investment threshold for Ofgem approval?
Question 14: Do you think the costs incurred through a mechanism should be incentivised as part of an overarching financial target on balancing costs, or as part of a separate financial incentive?
Question 15: What, if any, impact will limiting the mechanism to the end of RIIO-T1 period have on the efficiency of potential projects that cover both RIIO-T1 and RIIO-T2 periods?
Question 16: Are there any other criteria we should consider for such projects?
Question 17: What level of transparency would you want regarding this mechanism?
Question 18: Do you consider that we have identified the changes required correctly? Are there any other changes required to the existing framework in order to implement the mechanism?
Question 19: Are there any other factors that you think we need to consider in the design of the mechanism?

No comment on the above questions.