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DONG Energy response to the Electricity System Operator incentives from April 2017 Consultation

15 September 2016

DONG Energy welcomes the opportunity to respond to Ofgem's consultation on System Operator incentives.

Our ref. Ofgem Response - 2017 SO Incentives

DONG Energy is one of the leading energy groups in Northern Europe, the largest developer of offshore windfarms in Europe, and the largest single developer and operator of offshore windfarms in Great Britain (GB). In GB we own a number of offshore windfarms, as a sole owner, and through joint ventures, and are currently in the process of developing a number of future offshore windfarms.

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One of our key objectives is to ensure the full technical capability of our assets is utilised, and we have been proactively participating in providing ancillary services wherever we have windfarms, ie. in GB, Denmark and Germany. As a result we have provided views on the System Operator's (SO) approach to innovation and procurement of ancillary services.

Summary

- The SO's approach to procuring ancillary services limits the participation of new, proven and economical technologies such as offshore wind farms.
- The SO needs to innovate to ensure it can utilise the capability held by users of a rapidly developing electricity system. This may be through appropriate incentives, targets, or by learning from the experience of other Transmission System Operators (TSOs) in Europe.
- We support Ofgem's approach to maintain the current incentive scheme so that a broader, more fundamental review can take its place in the future.

Introduction

Our ref. Ofgem Response - 2017 SO
Incentives

Our wind farms have the proven technical capability of providing different types of ancillary services¹. Some of the procurement strategies that the SO has in place exclude wind power from participating and providing a more cost effective ancillary service, resulting in an uneven playing field. This reduces the efficiency of the market, and ultimately increases the cost of operating the system to consumers. Therefore, in our response we have focussed on the SO diversifying the market, and having the right incentives in place to do so.

The SO has an important role in maintaining security of supply, and ensuring the system is operated in an economic and efficient way. The SO's costs are ultimately borne by consumers. It is therefore crucial, to consider the measures that could result in overall savings for consumers. One of the key challenges is the lack of access to products which enable the participation of our wind farms in ancillary services (whether remunerated or not), and therefore a significant volume of our capability is not utilised. We understand from the scope of the consultation that a longer term view of the System Operator's incentives is likely to be in place by Spring/Summer 2018. However in deciding both the interim, and future System Operator incentives it is in the consumers' interest that the SO's lack of utilisation of the existing capability of the wind sector is taken into account.

We are willing to elaborate further on our recommendations, and work with you and the SO in the areas which we feel development is needed to improve the efficiency of the ancillary services market, and ensure that we maximise the value that we can create for the system and consumers.

Consultation Questions and Answers

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. Under the existing incentives, the SO's focus is towards maintaining short term security of supply, and is not on making more strategic and longer term decisions and taking a whole-system view. For example, the SO's performance in maintaining security of supply has been good, but the costs of running the system have continually increased (eg. cost of managing system frequency). At the same time, a significant volume of the capability procured by network users, such as generators like us, at the design stage, is not being utilised to minimise those costs even where it is efficient to do so. We believe that SO's procurement guidelines of balancing services, and particularly the removal of any restrictions in widening the access to the market should be a top priority in any improvements you consider. For example:

¹ This is also a Grid Code requirement, and tested as part of our connection application

1. The tender regime needs to be changed so that the procurement window for products such as frequency response, runs nearer to real time (i.e. day ahead), similar to what other TSOs do across Europe, to enable more wind, and demand side response to provide services;
2. Unbundling the products; ie. currently upward and downward response are procured together which requires wind to de-load to be able to participate in the frequency response market.

It may be necessary to incentivise the SO to make positive changes to the way balancing services are procured, when they are in consumers' interest. It may be worth exploring how other TSOs have revised their procurement and specification of ancillary services (often known as "System Services"). For example:

1. The German TSOs unbundled negative and positive reserve requirements and introduced day ahead tendering for this service
2. The Danish TSO bids for frequency response near real-time (4hr ahead)
3. The Irish TSO provides a longer term framework (contract) for procuring ancillary services

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?

We are open to the SO IRM being removed. Under RIIO, there are a number of innovation funding mechanisms to encourage more innovative behaviour by the network companies. National Grid has a single license as a transmission owner and the system operator. Therefore, access to innovation funding mechanisms such as the Network Innovation Allowance, and the Network Innovation Competition are already available to the SO.

The system operator's lack of innovative behaviour in the short term can result in market inefficiency, and increase cost to the consumers. In longer term, there will be more serious consequences of such behaviour which could impact the whole energy market and the secure operation of the system. National Grid has shown some willingness to engage with more innovative ideas, but the impact on its system operation activities has been small, and there needs to be further development, especially on minimising the overall costs. Innovation in the commercial activities of the SO, and particularly the introduction of more innovative ancillary services are examples, which can have direct impact on SO's spending and required revenue allowances.

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. The immediate requirement in this area is the review of the service specifications as part of the procurement guidelines, and a requirement on the SO to ensure the specifications do not exclude certain providers, as they do today. This includes the tender regimes, and the characteristics of the service, which mainly suit thermal power stations and not renewables.

The current method of procuring and specifying ancillary services is centred around the old power generation business model, ie. remunerating “already running power stations” for extra services that they are inherently capable of providing. The SO procures a significant proportion of its needs through mandatory products, and this makes it unclear to the market what the SO needs and what services developers should aim to provide. This is further complicated by the SO procuring services through multiple channels, many of which developers will not fully understand, such as bilateral contracts, and tenders of various design in addition to the mandatory provisions.

The service specification and procurement guidelines of balancing services, when followed by the SO, should in practice result in transparency. However in reality there are significant areas where we do not know on what basis a particular service provider is selected, or not. This has created uncertainty for many potential service providers in the mechanics of the ancillary services market, and many of the potential developments in this area have been put on hold. For example, if the exact criteria for selecting a particular service provider in an ancillary service market was clearly defined, other developers could confidently design their generators with additional capability in anticipation of having a level playing field to utilise that capability. In reviewing market information or the specific products procured by the System Operator, the criteria for selecting participants requires greater clarity. We view that this is a requirement to enable a more efficient ancillary services market.

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?

As mentioned above, in our view, the immediate requirement is for greater transparency in the SO’s procurement of ancillary services, and the “technology neutral” specification of its products and required services. We would see this as a fair expectation of the GB SO.

In setting any incentives, we believe there should be a balance between incentivising the SO to do more to reduce the cost to the consumers (which they may share), and ensuring that savings which are created naturally by the market (ie. by using newer technologies and ability to offer services at lower cost) are passed on to consumers. In this area, the SO’s incentives should not

be driving the SO to only minimise short term spending so that it may earn additional profits, as it can drive SO to do less, leading to even less commercial developments and overall higher long term and system costs. In our view you should consider what would be the most appropriate mechanisms of ensuring the SO drives down long-term costs for consumers and enabling innovation. For example this may be through incentives, targets, or licence obligations.

Our ref. Ofgem Response - 2017 SO
Incentives

If you have any questions on our response please contact Aled Moses (almos@dongenergy.co.uk, 020 7811 1055) or Vandan Hamidi (vanha@dongenergy.co.uk, 073 4205 6925).

Yours sincerely

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