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Dear Leonardo,

### **Initial Proposals for electricity SO 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. Three of these units have been converted to renewable biomass. 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 the Initial Proposals for electricity SO incentives from April 2017. We have reviewed the consultation and would like to raise the following points.

We consider that the proposals set out in Chapters two, four, five and six appear sensible and do not have any further comment to make on these. We do however have concerns regarding the proposals set out in Chapter three related to Black Start. These concerns mainly relate to the proposed implementation timescales.

In summary, we believe that whilst in principle an efficiency check may represent an improvement on the baseline, it is simply not practical to implement this approach in time for the 2017/18 scheme. We cannot see how, in particular, the Black Start strategy, procurement method and the efficiency check can be implemented in time for April 2017 in a manner that would give confidence to the SO and market participants.

Whilst Ofgem considers that the use of an efficiency check may encourage National Grid to take a longer term approach to Black Start procurement we believe this is not possible unless the SO incentive scheme is extended significantly beyond two years. Rather to the contrary, we believe the use of an efficiency check without thorough development will encourage National Grid to behave in a more, rather than less, short term manner.

For these reasons whilst not ideal the only viable option for 2017-18 is to retain an ex-ante target, although this should not necessarily have the same features as the overall BSIS. For example, adjustments could be made to the sharing factors, the incentive cap and collar etc. This is one way that the potential for large windfall gains and losses for National Grid can be reduced.

It is very important that a long term, robust framework for the procurement of Black Start is developed. The importance of future Black Start provision is clearly illustrated in National Grid's System Operability Framework analysis. A timely decision on the proposals is essential to ensure that procurement activities can continue effectively.

Answers to the specific questions raised in Chapter 3 of 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*

Jens Wolf  
Commercial Director

## **Appendix 1**

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

We note the two options Ofgem has considered for the interim period (2017/18), these being an ex-ante target and an efficiency check. We sympathise with the concerns raised with regards to the ex-ante target approach and therefore see some justification for removing Black Start from the main BSIS. Whilst we believe that the efficiency check approach may have merit in principle, we do not consider that the potential benefits of this approach can be achieved in time for 2017-18. We discuss these concerns further in answer to Question 3. Therefore, of the two options considered we think the only viable option for 2017-18 is to retain an ex-ante target approach, although this should not necessarily have the same features as the main BSIS. For example, adjustments could be made to the sharing factors, the incentive cap and collar etc. In particular, we see merit in significantly reducing the cap and collar values (perhaps related to the value of Black Start relative to the overall value of BSIS i.e. plus minus ~£1m). This is one way that the potential for large windfall gains and losses for National Grid can be reduced. We accept that the ex-ante target approach is far from ideal but consider it is the only viable option considering the short implementation timescales.

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

As noted above, whilst in principle we consider that an efficiency check approach may represent an improvement on the current approach to Black Start, we do not believe that a robust approach can be developed in the timescales available. Nevertheless, we have reviewed the principles set out in Table 1. Overall we think these principles are broadly suitable. However we do have some suggestions which we consider could improve the principles. These are set out below:

#### Clear, robust, and technical decision-making

We agree that this principle is sensible.

#### Diversification and optimisation of restoration approach and portfolio of service providers of Black Start

We agree with this principle. Additionally it should be recognised that the recovery from a Black Start event puts Black Start providers at risk of plant damage with significant cost implications. This risk is minimised through multiple high quality providers in adjacent areas working together. Therefore this principle should encourage National Grid procurement which ensures that no individual Black Start provider is exposed to too great a burden and that the provider can expect neighbouring providers to perform. As an example, we have strong concerns regarding the inferior Black Start service National Grid sought in the regional 2016 tender. Specifically, a greater than two hour synchronisation service implies placing a heavy burden on the assets expected to perform Black Start to the traditional standard i.e. synchronisation within two hours.

#### Transparency of approach, procurement, and service status

We agree that there should be transparency of the value of future commercial opportunities.

#### Flexibility of approach for the licensee

We agree that this principle is sensible.

#### Efficient costs

We agree with this principle. However we note that it is the nature of many Balancing Services that the purchase of one impacts the cost and purchase of others. For example, the purchase of Firm Frequency Response in most cases provides Reactive capability, Reserve and Inertia. Moreover a Black Start contract maintains units in a warm or hot state (cold units cannot provide a high quality service). This by default provides Reserve and when dispatched Inertia and Reactive capability. Therefore when considering efficient costs it is not necessarily correct to consider Black Start costs (or the cost of any single Balancing Service) in isolation. In summary efficient costs are likely to be achieved where different services/system requirements can be bundled and procured together.

We also believe that there is a need to be explicit that efficient costs are not the same as a cost plus approach. The amount of possible providers of the Black Start service is falling and the price formation needs to encourage new entrants if the black start service is to be delivered on a consistent basis going forward. Procuring services in a transparent, competitive and market based fashion is the best way to ensure long term value to consumers.

### Consistent standards across GB

We strongly agree with this principle. In a Black Start event all regions must perform to a similar standard to ensure fast recovery. One weak link can create delays in connecting islands leaving the recovery vulnerable. In addition, we agree with the Ofgem statement that where there is a trade-off to be made between cost and security, security will prevail.

### Optimal integration of Black Start in the wider policy framework

We agree with this principle. However, it is currently the case that many revenue streams cannot be forecast with any certainty and are thus not bankable. For an existing generator, wholesale market spreads can only be locked in for around 18 months, only one year capacity contracts are available in each auction and Balancing Services (with some limited exceptions) are only available within year. Therefore, we consider it will be difficult to meet this principle without changes to other markets and services. As a minimum, reform to the procurement of all Balancing Services is required.

### Promotion of competition

We agree with this principle.

### Minimising distortion in wider markets

We agree with the sentiment of this principle. However, it must be recognised that the services sought by the SO, including but not limited to Black Start, cannot be regarded as separate from the wider electricity market. These services play an essential part in enabling the market to operate. The current market design, for both the wholesale and capacity markets, has no mechanism to secure the essential ancillary services the GB system requires to function securely. Ideally, the capacity auction would preferentially encourage those plants which can provide the range of essential services and the wholesale market would recognise the value of reliability and security over the long term.

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

We have considered the proposed framework for 2017/18. As noted above we do not believe that the proposed framework can be implemented in time for 2017/18. Therefore all comments on the substance of the proposed framework below are provided on the assumption that the new framework is implemented for 2018/19 at the earliest.

### Impact of premature implementation

In summary we believe the approach in principle (i.e. from 2018) can represent an improvement relative to the current framework, although this will to a large extent depend on the approach adopted for the efficiency check. We provide comments on the main tenets of the 2017/18 framework later. However, before discussing the framework in more detail, we believe that it will be impractical to effectively implement this framework in time for 2017/18. We cannot see how, in particular, the Black Start strategy, procurement method and the efficiency check can be implemented in time for April 2017 in a manner that gives confidence to the SO and market participants that contracts will not be disallowed.

Of particular importance is our belief that implementing an efficiency check approach in haste will result in National Grid acting in a more, rather than less, short term way. One of the main reasons provided by Ofgem for rejecting the ex-ante target approach was that it would incentivise National Grid to focus too much on short term decisions. This may be the case but we do not consider that an efficiency check approach will encourage National Grid to take a more long term approach to procurement particularly when considering the short implementation approach proposed. Fundamentally, unless the SO incentive scheme is extended significantly beyond two years we do not believe that National Grid can take a long term approach to its procurement of Balancing Services (including but not limited to Black Start).

To the contrary we believe that implementing the efficiency check approach in the timescales envisaged will result in National Grid facing a number of perverse incentives which result in it taking a more, rather than less, short term approach. This is essentially because without understanding how the efficiency test will be applied (as there is not sufficient time to develop it) National Grid will seek to minimise the short term costs of Black Start regardless of the long term impact on service development and value to consumers. This is because National Grid will seek to minimise the possibility of cost disallowance even where the costs incurred are justified. The focus on short term price reduction is unlikely to be palatable to Black Start providers who expect the price of the service to reflect the long term value of its provision.

The unintended consequence of the proposal is that where National Grid and Black Start providers are unable to agree on the price/value of Black Start, Ofgem will effectively become the de-facto arbiter of the value of Black Start capability which we do not believe is the intention.

As such we consider that the efficiency check approach is best taken forward alongside the other issues that will comprise Ofgem's work on the new SO incentive scheme for implementation in 2018. This would have the added advantage that further thought can be given to applying an efficiency check approach to other Balancing Services where it is envisaged this will add value.

#### Efficacy of the proposed framework in principle

Below we consider the main tenets of the proposed 2017/18 framework in principle. We believe that our comments will further illustrate how it is impractical to implement the efficiency check in time for 2017/18.

#### Black Start strategy

We agree with this principle but do not believe it can be effectively developed in time for 2017/18, specifically the requirement for it to be approved by Authority, if it is to form the basis of an efficiency check assessment. In particular, setting an incentive scheme for 2017/18 a short time before April 2017, or possibly after April 2017 when procurement will have been undertaken some time before the new arrangements will have been known, will not effectively deliver any change in behaviour and will potentially result in windfall gains and losses.

#### Black Start Procurement methodology

We agree with this principle but do not believe it can be effectively developed in time for 2017/18, specifically the requirement for it to be approved by Authority, which would be required before the procurement process could start. This would leave no time to undertake an effective procurement exercise for a contract start on 1 April 2017.

#### Annual audited report

We agree with this in principle.

#### Efficiency check

We understand there are essentially two main approaches available when developing an efficiency check:

- Ex-ante efficiency test, essentially does the Black Start procurement process ensure efficient outcomes and consumer value?
- Ex-post efficiency test, essentially does the price agreed through negotiations represent an efficient outcome?

We expect that an ex-ante efficiency test is likely to be the better option. The reasons for our view are presented below.

#### *Ex-ante efficiency test*

We expect that an ex-ante efficiency test will entail the following:

- Ofgem (possibly advised by National Grid) would develop a set of criteria/guidelines which Black Start procurement processes would have to adhere to
  - These requirements should ensure competitive outcomes in the Black Start market in the longer term by facilitating market entry and innovation

The criteria/guidelines would ideally consist of:

- A transparent, consistent and accessible bidding process, including even handed assessment of bids
- Clear requirements for bidders in advance of the process
- Ability to do longer term contracting
- A level playing field across technologies and encouragement of innovative solutions
- A single set of guidelines which apply across all regions

We suspect that an ex-ante efficiency test is likely to be easier to administer for Ofgem and if designed well should provide improved transparency for new entrants, allowing efficiencies from competition to be realised in

the longer term. However the process above will take time to prepare and be consulted on which will likely rule out implementation in 2017/18.

On the other hand we consider an ex-post efficiency test will likely be inferior to the ex-ante efficiency test approach for the reasons detailed below.

#### *Ex-post efficiency test*

In assessing whether the Black Start price is efficient on an ex post basis, we expect Ofgem would have to carry out a local assessment i.e. what is fair value in a particular region? Possible approaches include:

- Regional benchmarking: compare Black Start costs in different regions
- Fair return test: what price allows a return commensurate with the risk of providing Black Start services?
- Versus technology counterfactual: what price stimulates investment in alternative technologies that could provide Black Start?

In addition to increased administrative burden for Ofgem, assessing a fair price is methodologically difficult for the following reasons:

- It is difficult to estimate the required rate of return for Black Start
- It is difficult to assess what price would incentivise new entry (what are the relevant comparators?)
- Will Ofgem only take into account conditions prevailing at the time of bidding?

Moreover, Ofgem would need to provide transparency on how it would conduct the test in advance of the bidding process to avoid legal challenge. Even if this was undertaken, an ex-post efficiency test is likely to create uncertainty for investors. This is fundamentally because there will be the added uncertainty on whether the price agreed with National Grid will prevail.