DS3: System Services Review – Preliminary Consultation Response

on behalf of

AES Kilroot Power Ltd and AES Ballylumford Ltd

3 February 2012

1. Introduction

AES Kilroot Power Limited ("AES Kilroot") and AES Ballylumford Limited ("AES Ballylumford") (collectively "AES") welcome the opportunity to comment on the preliminary consultation on System Services Review.

AES has six merchant generating units registered within SEM which are also subject to Harmonised Ancillary Service (HAS) Agreements. In addition we have a further seven units which are contracted to NIE Energy Power Procurement Business (PPB) via Generator Unit Agreements (GUAs). It should be noted that NIAUR are currently considering the potential cancellation of the remaining GUAs however whilst such units remain under contract, the range of system service from contracted units will be limited to contracted performance characteristics.

AES believes that the DS3 work stream is timely and crucial in ensuring that the correct balance is struck between facilitating government renewable policy, maintaining security of supply and ensuring appropriate commercial incentives are provided to system service providers.

We welcome the structure of the proposed system services review including the publication of the recent KEMA report on "International System Services Review". We do however have some concerns in relation to the timetable as it may be overly ambitious given the fundamental nature of the review. We would also be concerned that opportunities for shorter term system services may be put on hold until the review is complete. Our understanding is that the Regulatory Authorities (RAs) have mandated the Transmission System Operators (TSOs) to explore new system service opportunities in the near term and we would encourage the TSOs to investigate short term system service contracts with providers in the interim.

AES is concerned that the current market arrangements (including the existing HAS regime) will continue to fail to deliver the necessary flexibility and range of system services that the TSOs will require. We strongly believe that the most effective way to deliver such flexibility is through a separate, robust and transparent system services payment which provides strong and clear commercial incentives to service providers. Remuneration for system services must not only reflect the value of these services to the system but also ensure that providers can finance any investments required in relation to the services and also recover related fixed and increment costs.

Our response follows the structure set out in Section 5 of the consultation paper.

Obligations for service provision versus remuneration

If system service provision is unrewarded and forced as a mandatory requirement, service providers will focus on Grid Code minimum specifications only and will not be incentivised to look at higher levels of performance or indeed new system services.

Looking back over the past twenty years it is clear that the commercial incentives within the GUAs in Northern Ireland have delivered high levels of not only system service delivery but also performance against reserve, reactive power and other Grid Code requirements.

AES strongly holds the view that remuneration for the provision of system services is essential in developing the range of flexible services that TSOs have indicated that are required. Remuneration should be based on the level of delivered service provision and should not be limited to provision above Grid Code minimum levels. It would seem only reasonable that if a provider is being remunerated for providing a service then there should be a charging mechanism for non-performance. The structure of

the remuneration and charging arrangements are interlinked and both need to be designed so as to strike a fair and reasonable balance and be contractually robust, consistent across providers and fully transparent. The review needs to address this point as we believe the current HAS and GPI arrangements are inadequate in this regard.

AES would suggest that the following system services should be considered within the review:

1. Operating reserve;
2. Reactive power;
3. Black Start;
4. Lower Minimum Generation;
5. Faster time to synchronise;
6. Ramp rate flexibility;
7. Flexible multi-mode operation of CCGTs;
8. Synchronous compensation;
9. Inertia;
10. Energy storage;
11. Frequency control

Given the concerns in relation to ROCOF and the impact on conventional generators there may be some merit in considering a 'ROCOF ride through' type of system service.

All services should be remunerated although not necessarily under the same mechanism, and this review should investigate how each service should be appropriately remunerated and incentivised.

In terms of Grid Code and mandatory requirements, AES would suggest that the current Grid Code and Connection Agreement provisions are sufficient, although for new generation the TSOs should ensure that new users (conventional, wind farm and others) comply with Grid Code requirements and derogations are not offered.

Purpose of payment for System Services

Payments for system services should reflect the value to the system and should not unnecessarily differentiate between existing providers and potential new investors.

AES note that in the TSOs recent All Island Generation Capacity statement there is very limited (aside from wind) new generation forecasted for the Island in the period 2012-2021, particularly in Northern Ireland. Consequently we believe that the burden of providing additional flexibility and enhanced system services will fall to existing generators and appropriate incentives must be put in place particularly in relation to existing generators/providers.

Remuneration mechanisms

As stated previously in our introductory comments, AES does not believe that an indirect remuneration regime via energy/capacity payments is appropriate.

Future payments for system service provision should be via direct payments. The TSOs seem to have identified the main options for payment and AES would suggest that all should be included within the review. AES would suggest that different payment mechanisms may be more appropriate for different services, and the review should take all these factors into consideration.

AES does not believe that the current mechanism is fit for purpose in that the payments are small and they are unpredictable as they are subject to annual review and are only paid if a unit is synchronised. In addition, the current HAS agreements do not offer sufficient contractual flexibility in terms of amending contracted levels, terminating contracts and introducing new services. Furthermore, the current arrangements are discriminatory against Northern Ireland generators who receive no payment for the Black Start capability they provide. This latter point was raised by a number of NI generators in previous HAS consultations and it was our understanding that this was to be considered further as part of this broader review of system services.

Basis of Remuneration

As indicated previously, the basis of remuneration may depend on the type of service being required and/or offered. However, AES' strong preference would be to move towards a remuneration approach which is based on capability (independent of synchronisation) rather than utilisation. This approach offers substantially more predictability and certainty for those generators who are at the margin and would help mitigate exposure to unpredictable and volatile TSO dispatch decisions. A capability approach would be significantly more attractive in terms of offering enhanced and new system services, particularly in relation to financing potential investments and business planning.

Interaction with the SEM

AES does not believe that the current SEM energy payments reflect the actual value that generators offer the system in terms of system services and security of supply. By way of example, given the highly constrained nature of the North-South tie line a significant proportion of energy dispatch within NI is on a constrained basis. Currently such constrained dispatched generators, which are essential for system security within NI, only get paid their bid price. We do not believe that this approach allied with a small HAS payment appropriately rewards such generators for the value that they offer to the system.

The RAs have a separate work stream relating to divergence of market schedule from dispatch but to date on an overall Island basis the RAs have not been moved to address the issue as they do not believe it is yet material. However, we believe that the TSOs should factor this issue into this system services review.

AES has substantial concerns with respect to the potential dilution of the capacity payments and moving value from one pot to another. If system services continue to be paid for based on utilisation this re-allocation of value will present significant risk to generators and unnecessarily increase their market and commercial exposure. Such re-distribution of value and associated uncertainty could also act as a deterrent for new investment.

Basis of Contract

The basis of contract will depend on the remuneration approach adopted although in general a bilateral contract arrangement would seem to cover most options. If the decision is to move to a system service market approach where providers submit bids in relation to system services then an appropriate form of framework agreement may be necessary.

Frequency of Review

AES would suggest that the frequency of review should depend on the system service being offered. In relation to minimum Grid Code requirements relating to reserve, reactive power and black start a long term (e.g. five or ten years) may be appropriate with payment rates fixed at as determined in the

contract. Currency exposure could be addressed by using an appropriate form of f/x CfD mechanism.

AES have some concerns that for a number of services (particularly new ones) it will not be appropriate to set a 'standard' regulated rate as the cost/benefits of each service may be different depending on location, type of service and the technology of generation offering the service. AES does understand that the TSOs will require regulatory approval in relation to system service costs, but it may be appropriate to allow TSOs some flexibility as to how they best manage any system service pot. That said, all providers will need to be satisfied that system service provision is remunerated on a transparent and non-discriminatory manner.

AES also believes that shorter term arrangements would be useful to both TSOs and providers alike particularly in relation to enhanced or new system services. The flexibility afforded by shorter term products could be addressed within the terms of the bilateral agreement with respect to a broader scope for amendment, cancellation and/or termination.

The current inflexibility of the HAS contracts means that generators are likely to be conservative in relation to what they offer. If contracted capabilities (above Grid Code minimum) could be changed/declared more frequently (just like availability) then generators are likely to be less risk averse in their offerings. Depending on the system service, capabilities could be changed in real time (with appropriate incentives/charges) or on a weekly/monthly basis.

Incentivising performance

AES accepts that mechanisms are required to incentivise reliable performance and compliance with Grid Code. However, such charging mechanisms need to be proportionate, reflect the level of remuneration and provide robust and transparent charging methodologies and dispute frameworks. We would also suggest that going forward the TSOs need to provide a much more comprehensive level of performance reporting particularly in relation to frequency events, Grid Code compliance and other relevant system service metrics.

Recovering the cost of system services

AES believes that it is appropriate to continue with the existing approach of recovering costs from demand customers.

Service Providers

Without doubt in the near to medium term, the main source of system service provision will remain dispatchable conventional generators. However, other providers who can meet standard specifications for difference classes of system services should also be eligible for remuneration.

AES does not believe that the value of service from different types of provider are the same. For example the operating reserve and also reactive power performance of conventional generators is superior in terms of reliability, level and system impact to other types of generation (e.g. wind, distribution connected providers etc.) and the remuneration mechanism should reflect this.

Network Considerations

Within SEM, generators do not typically carry the risks associated with network constraints and it would seem logical to continue to apply this principle at a transmission level. However, where a provider locates behind a known network constraint, then there may be just reason to exclude such a provider

from remuneration if services cannot be provided due to network limitations.