

**Response from AES to Consultation Paper on**  
**Harmonised Ancillary Services, Other System Payments**  
**and System Charges**

AIM-SEM-08-128

28<sup>th</sup> October 2008.

- 1) The consultation highlights the key objectives in the provision of ancillary service payments; transparency, predictability, simplicity and non-discriminatory (in regard to technology). The comments in this response are made in the context of these objectives.
- 2) As a general point, we found the paper (and workshop) to be more focused on short-term needs and the allocation of an ancillary services “pot” amongst the existing plant mix. Indeed at page 9 the paper makes it clear that the focus is on the requirements for the next few years and not the longer term. We think this is a mistake because, to deliver on energy policy, the focus needs to be on signals for new investment. Investors need to be able to predict likely revenues over the next 15 years, not over the next few years. If the signal is short-sighted, there is a real risk that the wrong type of plant will be built.
- 3) Appendix B sets out indicative rates for ancillary services (although it is stated that final rates will be consulted on later). These indicative rates for operating reserve appear to be 50% of the rates quoted by Eirgrid in “*Statement of Charges and Payments for Ancillary Services Providers 2008*”. It is unclear why these rates have been halved. The justification for proposed final rates shown be provided.
- 4) It appears that the RAs will decide annually on a fixed sum of money for ancillary services. To inspire confidence with existing and potential investors, and to facilitate predictability for investment decisions, it is important that the basis for this sum is clearly set out and consulted on, including the volume required for each ancillary service and the applicable rates. By way of comparison, the basis for determining the amount of generating capacity required in the SEM and the cost of this capacity is clearly established and consulted on annually. The same approach needs to happen for ancillary services. The absence of a published basis for determining ancillary service payments risks creating the suspicion that the RAs will simply use this as another discretionary “lever” to control costs.
- 5) The proposed rates for each ancillary service should be benchmarked with those prevailing in ancillary service markets elsewhere.
- 6) It is also important that investors understand the basis for determining the total volume required for each ancillary service. For example, how is the amount of required operating reserve determined? How does this relate to (a) the maximum generation in-feed and (b) the amount of wind generation on the system? Clearly the amount of required operating reserve will increase with the amount of wind generation on the system. Section 3.2.1 refers to the TSOs planning for the procurement of ancillary services each year to ensure transmission system security and economic operation. The RAs and TSOs should publish and consult annually on a clear methodology for determining the level of ancillary services required to meet these operational security standards.

- 7) The capacity pot at present is based on the amount of capacity required in an unconstrained system; i.e. the determination of capacity required ignores the need for operating reserve and the existence of transmission constraints. We consider this determination to be flawed because, amongst other things, both aspects result in a need for additional capacity which has to be paid for by customers. The capacity pot must be increased to allow for this. For example, if operational security standards require that 80% of the largest in-feed must be carried as operating reserve, this would equate to 80% of the Moyle capacity or 360 MWs. However, the RAs determination of capacity required for 2009 results in a surplus of capacity of 436 MWs over peak demand. This would mean that, in the unlikely event that all capacity was available on the system (including 450 MWs from Moyle), only 76 MWs would be available for replacement reserve. This is clearly unrealistic and incapable of ensuring that operational security standards would be met.
- 8) It is important not to offset the size of the “Capacity Pot” to accommodate a needed increase to the size of the “Ancillary Services Pot”. Whilst there may be economic justification for subtracting ancillary services payments from the BNE price, the requirement to increase the volume of ancillary services overall (e.g. to accommodate more wind generation) cannot be offset by reducing the capacity pot. With increasing wind penetration there will be a need to increase both the capacity required and the volume of ancillary services required. It is concerning that the paper repeatedly refers to budget constraints (set by the RAs) and the need to consider all market payments collectively. This implies off-setting just to control costs and creates suspicion that the RAs may not adequately remunerate costs necessary to deliver on genuine system requirements.
- 9) We cannot see any good reasons to introduce TSO incentives to manage ancillary service costs. In fact we can think of two reasons why incentives should not be introduced. First, the rates for ancillary services should be based on market rates. These should be set by the RAs using benchmarks from other AS markets. Second, the volume of ancillary services required is a function of the operational security standard set by the RAs in licence conditions. Therefore there is no scope to reduce this mandatory volume requirement. To seek to reduce either rates or the volumes required risks alienating providers and ultimately security of supply.
- 10) The paper refers to fixed minimum regulated rates for ancillary services. It is not clear what this means. Can the TSOs set payment rates higher than the minimum rate?
- 11) The paper appears to be silent on the area of co-optimisation of the provision of active power, reactive power, reserve and the management of transmission constraints. Under current SEM rules, generators receive the SMP on the basis of the unconstrained dispatch and are paid the difference between SMP and SRMC if

they are subsequently dispatched back to provide operating reserve. It is unclear how the TSOs decide which plant carries reserve. If we consider only energy payments, then it is economic to carry reserve on the plants with the highest SRMC. However once reserve payments, response rates and the cost of transmission constraints are taken into consideration, the optimal economic dispatch may be different. Under the current proposals, a generator will only receive operating reserve and reactive power payments if it is dispatched, but this is outside the control of the generator and there does not appear to be clear decision rules for this. There needs to be clear rules around these dispatch decisions to facilitate co-optimisation and intelligent investment decisions.

- 12) The current proposals are to only pay reserve payments and/or reactive power payments if the plant is dispatched to carry reserve and/or reactive power. Constrained dispatch, and therefore ancillary service payments, are very difficult to predict over the lifetime of an investment. This defeats the predictability design objective. Serious consideration should be given to payments on the basis of availability, as is the case currently in Northern Ireland. This approach (combined with penalties) results in the high quality provision of ancillary services. The generator is paid for providing an option and this gives the generator more certainty and predictability at the time of the investment decision when it has to consider if it is worth the incremental cost of providing the facility. For example, smaller gas turbines have a faster start time but higher specific cost than larger gas turbines. Also, a generator can improve its operating reserve capability by reducing its minimum generation, but this may require additional investment in NOx controls. In all cases, a generator is not likely to make the additional investment if it does not have reasonable certainty around the resulting additional revenues. TSOs could also be given incentives to optimise the use of these options.
- 13) We support the concept of penalties for poor performance with ancillary services. However, the penalty for non-provision needs to be consistent with the price paid for actual provision in the first instance. This penalty also introduces a risk for generators and therefore payments for the provision must include a risk premium. In benchmarking rates for ancillary services in other markets it is important to check if similar penalties exist. It would also help to clarify what happens to the receipts from penalties.
- 14) There needs to be a clear distinction between ancillary services which are mandatory (under Grid Code) and those which are voluntary. There is no justification for adjusting penalties down for plants with Grid Code derogations. In fact generators who do not provide essential and mandatory ancillary services should be financially penalised on an on-going basis. Otherwise they will obtain an unfair advantage over compliant generators.
- 15) We are very unclear why the TSOs would enter into long term contracts with some generators but not with others. If such contracts are to be considered, then

- they must be tendered for in adequate time to allow for competition to prevail and the details of the contract terms on offer must be very transparent to all competitors. If this does not happen, there will be a suspicion of “sweetheart deals” possibly to disguise a market failure to provide the necessary capacity to address concerns about security of supply.
- 16) Prices for black start should be based on market rates rather than requesting the generator to justify costs. Why should Eirgrid’s cost of capital be adopted when this will not represent the opportunity cost of capital for a particular black start project? What happens in the event of a failure to agree?
  - 17) Warming contracts for particular types of plants may risk technology discrimination. It might be better to just set rates and volumes for each category of reserve required and then let all technologies compete for this. For example, it may be in the economic interest of a coal-fired plant to keep boilers in a warm state if the replacement reserve payments justify the additional operating costs. Likewise, a CCGT may decide to invest in a by-pass stack to allow for open-cycle running and qualify for enhanced replacement reserve payments.
  - 18) The scope of required commissioning tests needs to be clear. The basis for charges needs to be justified and there needs to be allowances made for the inevitable “trail and error” with testing of this nature. These costs must also be included as an allowance in the BNE calculation for capacity payments.
  - 19) It’s not clear what the thinking is behind an ancillary service payment for providing an alternative fuel. The provision of a back-up fuel costs money in terms of both up-front investment capital and working capital. This provides security of supply for all customers. It should therefore be paid for by all customers either via an ancillary service payment or a PSO.