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Andrew Bullimore
Interconnector Team
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Non-confidential

Dear Andrew,

Interconnector Policy Review – Working Paper review of the cap and floor regime

Drax Group plc (Drax) owns and operates a portfolio of flexible, low carbon and renewable electricity generation assets – providing enough power for the equivalent of more than 8.3 million homes across the UK. The assets include Drax Power Station, based at Selby, North Yorkshire, which is the country's single largest source of renewable electricity. Drax also owns two retail businesses, Haven Power and Opus Energy, which together supply renewable electricity and gas to over 390,000 business premises.

The review of the Interconnector cap and floor regime is timely given the forecast increase in interconnector capacity. We agree that the cap and floor mechanism has reduced revenue uncertainty and thereby reduced the risk of investing in new interconnectors. To that extent we agree that the cap and floor model is an effective framework for de-risking large project investment. Indeed, we believe that in future it could also be applied to other large investment projects which meet the cap and floor regime's objectives.

While we agree that the cap and floor regime is an effective mechanism to de-risk large investments in the future (not just interconnectors), we feel the Working Papers do not address the distortive impact on competition and particularly the capacity market. The combination of the support mechanism and the network charging treatment (where interconnectors are not subject to the same industry costs) mean interconnectors have had a clear advantage when compared to other assets. This combination has suppressed the value available through the capacity market, effectively cannibalising other projects that are exposed to additional industry costs and do not have a guarantee of support through the cap and floor regime.

We are also concerned that Ofgem appears to have reached conclusions about the future efficacy of additional interconnector capacity, when the analysis conducted by AFRY (on Ofgem's behalf) clearly shows that there is a negative socio-economic impact on GB consumers. If Ofgem disputes AFRY's analysis and conclusions, and takes a contrary position as a result, then it is incumbent on Ofgem to conduct and publish

quantitative evidence to support the contrary view, otherwise Ofgem's conclusions are unsubstantiated and untenable.

Without addressing the current market distortion and presenting compelling quantitative analysis to support a positive net consumer welfare outcome, we do not believe the case for future support of interconnectors has been proven. Until such a case has been made, it is not possible to ascertain whether and what further work (if any) is needed. To presuppose the outcome of that analysis, risks committing Ofgem and the industry to burdensome engagement and activity that could otherwise have been avoided.

Our detailed response is appended. We would be happy to discuss any aspect of our response with you further if it would be helpful.

Yours sincerely,

Submitted via email

Matt Young
Group Head of Regulation

drax

Appendix - Detailed response

Workstream one – Review of the cap and floor regime to date

Question 1: Do you agree with the approach we have taken to workstream 1?

We agree with the objective of the review, to ensure that both the Cap and Floor regulatory framework and further interconnection are in the best interests of GB consumers. However, we think that the omission of charging and capacity market considerations, and an assessment of the distortion of interconnectors on competition in general, are a weakness in the reports.

Question 2: Do you think we have missed any important strengths, weaknesses, opportunities or threats when critically assessing the cap and floor regime?

We agree with much of the SWOT analysis except that it conflates the effectiveness of the support mechanism with the strengths, weaknesses and needs case for future interconnectors. We do believe the cap and floor mechanism has been effective in reducing investor risk up to now, but we do not believe the case for further support of interconnectors has been proven.

Question 3: Do you agree with our conclusion that the cap and floor regime has met its objectives to date? Is there any other information you think we should take into consideration in our analysis?

Yes, the cap and floor regime has been effective at reducing the risk of investment in interconnectors.

Question 4: Do you agree that the principles of the cap and floor regime remain fit for purpose and suitable to potentially incentivise further GB interconnection?

The cap and floor regime is an effective mechanism, however the case for its continued use has not been proven as the only analysis presented to date indicates a negative net benefit for GB consumers.

Question 5: Do you agree with our initial proposals with respect to potential changes to the assessment framework of the cap and floor regime? Specifically:

> **b) To consider a more coordinated and system-wide approach to application windows, potentially informed by a more proactive role for NGESO. Do you have any views on the options presented for our approach to potential future application windows?**
> **d) To review our eligibility criteria for any potential future regime, and to explore the potential to raise the maturity threshold for applicants.**
> **e) To consider changes to the current incentives mechanisms to help ensure timely delivery of projects. Do you have any suggestions for modifications or alternatives?**

We are not convinced that expanding the scope and widening the role of National Grid ESO brings benefits to consumers. We also do not agree that the system operator should make or recommend decisions as to how, and to whom, the cap and floor is applied. Our view is that Ofgem (or BEIS) should be accountable and responsible for decisions that determine if financial support for a project is beneficial for GB consumers.

Question 6: Do you agree with our initial proposals with respect to potential improvement to parts of the technical design of the cap and floor regime?

No comment.

Question 7: Do you have any suggestions for ways in which any potential future regime could work better for a broad range of developers?

The scope of the cap and floor mechanism could be expanded to include other capital-intensive non-interconnector projects where there is a net benefit to GB consumers.

Question 8: Are there any other potential regime improvements that we should explore that are not considered in this section?

No comment.

Workstream two – Socio economic modelling

Question 1: Do you agree with the approach we have taken to workstream 2?

Yes, we broadly agree with the approach taken. Commissioning an independent report is both necessary and proportionate in the circumstances. However, it is unusual to dispute such a report's conclusions without presenting a more credible and compelling counterfactual. If the analysis was disputed, then it would have been prudent to conduct further analysis prior to forming and publishing a conclusion.

Question 2: What are your views on the scenarios, assumptions and methodology that AFRY has used to model notional future interconnectors and the impact of cross-border interconnector flows?

No comment.

Question 3: Do you agree with our view on the results of AFRY's modelling? Do you agree that this modelling supports the needs case for further interconnection?

We do not agree that the modelling supports the case for further interconnection. It is clear to us that the conclusion of the modelling is that any further interconnection would not be of benefit to GB consumers. There may be a benefit to consumers in connected countries but there is no significant positive impact on GB overall. Section 5.1 of the AFRY report states, "*All of these connections have a negative impact on GB consumers due to the high share of exports from GB on all of the links (except for the Irish projects in the High scenario).*"

It is our view that if there are benefits accruing to consumers in connecting countries, then those consumers should support the development and proportionately share the cost of more interconnectors.

Question 4: Is there any further information or additional studies that you think should be factored into our analysis?

Not that we're aware of.

Question 5: Do you agree with our conclusions? If not please explain why and provide supporting information if available.

We cannot agree with the conclusions Ofgem presents. The AFRY report concludes that increasing the number of interconnectors is not in the interest of GB consumers. We therefore cannot agree that it is correct to continue to have a cap and floor regime supporting additional interconnector investment. Moreover, as highlighted in our previous answers, the existing charging arrangements for interconnectors has distorted competition in the GB market and the continuation of that, or indeed removal, should be factored into any future analysis and the resulting conclusions.

Workstream three – Review of the wider impacts of interconnection

Question 1: Do you agree with the approach we have taken to workstream 3?

We do not dispute the need for consideration of other impacts, as well as the removal of the current distortive charging arrangements. However, we are concerned that this exercise is trying to justify a conclusion that Ofgem appears to have already reached, which is counter to that of the independent AFRY report.

Question 2: Do you agree with the potential wider impact categories we have focussed on? Are there any other areas we should consider?

No comment.

Question 3: Do you think the discussion presented in this document adequately represents the potential impact of interconnection within each category? If not, please explain and provide supporting evidence if possible.

The discussion on the three themes identified by Ofgem is relatively limited for such an important topic and there is limited recognition of counter views presented in the report.

Question 4: Do you agree with our initial views with respect to each potential wider impact category? If not, please explain why.

We do not wholly agree with some of the points that have been made and believe certain aspects warrant further consideration:

- **Decarbonisation** – We agree that interconnectors are generally likely to have a positive impact on decarbonisation as they can help alleviate constraints and help manage intermittent generation from renewable sources. However, as interconnection increases, we think it is imprudent to assume that all flows across interconnectors will be from renewable sources all the time, and that flows of renewable power will continue (directionally) into GB all the time. Given the differences in charging arrangements and carbon costs in the EU compared to GB, there is the risk of perverse outcomes leading to carbon intensive production being imported/exported or indeed leaving a shortfall in renewable energy on one side of an interconnector in any given period.

- **Flexibility / System operability –** It is not clear that flexibility and system operability are clear and separate needs / services. We therefore agree with Ofgem in 3.20 that it is important to avoid double-counting, as otherwise we believe there is a high risk that any analysis could lead to an

overstatement of benefit. Also, in assessing flexibility / system operability, Ofgem should consider the downside risk of cannibalising or foreclosing the market to existing or future system service providers, including providers of new innovative solutions that consumers may benefit from.

- **Security of Supply –** We do not agree that additional interconnectors necessarily lead to improvements in Security of Supply for GB. Interconnectors provide the link to another market, but do not provide certainty that energy will be transported across those cables when needed. Importantly, interconnectors could continue to export when we most need energy, especially if the connected market has coincident security of supply issues. Moreover, allowing interconnectors to displace GB generation by virtue of the undue competitive advantage they receive through the Capacity Market and charging arrangements, could be detrimental to GB's overall security of supply because that displaced generation would otherwise have been there to react to security of supply events.

Question 5: Do you agree with our view on how wider impacts have been captured in past needs case assessments?

We agree that as the market evolves and interconnectors role therein changes, it is prudent to review the approach to assessing the needs case to ensure all impacts are appropriately considered. We therefore believe any future needs case assessment should factor in (and address) the potential distortive effect created by the undue competitive advantage interconnectors currently benefit from.

Question 6: How do you think we should approach future needs case assessments within the framework presented in this working paper? Are there any other options we should consider?

We think Ofgem should work with its independent advisors (AFRY) to refine their methodology (as appropriate) and factor in any additional wider impacts that are warranted. Without such independent challenge, the results and conclusions will inevitably lack the required credibility. As per above, we believe such an assessment should consider the prevailing distortions due to the charging arrangements.

Question 7: Do you agree with our initial conclusions? If not, please concisely explain why and provide supporting information if available.

While we acknowledge the value that interconnectors can bring to the GB system under certain circumstances, we're unable to agree with the conclusions reached by Ofgem. As stated in our previous answers, the AFRY analysis demonstrates there is a negative outcome for the GB consumer. We are therefore unable to reconcile how Ofgem has reached the stated conclusions about the future need and efficacy of additional interconnector capacity. If Ofgem disputes AFRY's analysis and conclusions, and takes a contrary position as a result, then Ofgem should conduct and publish quantitative evidence to support the contrary position.

Moreover, without addressing the current market distortion, particularly regarding charging arrangements, we do not believe a valid assessment of the case for future support of interconnectors can be properly conducted.

We also note that Ofgem states (section 5.1, working paper 3) that participation of interconnectors in the Capacity Market is a matter for Government. While we recognise Government is the ultimate responsible party for the Capacity Market, we believe Ofgem should be appraising Government of the impact interconnectors can and do have on the efficient operation of the Capacity Market and wider market. And

notwithstanding that, we believe it is within Ofgem's mandate to ensure charging arrangements are appropriate and efficient.

Question 8: Do you agree with our initial proposals? If not, please concisely explain why and provide supporting information if available.

We do not disagree with the core tenet of the Initial proposals, i.e. to conduct an appropriate needs case assessment. However, that should be undertaken without presupposing the outcome.

Question 9: Do you have any further feedback on our analysis, conclusions or proposals presented in this consultation document?

We have no further feedback at this time.

Workstream four – Multiple purpose Interconnectors (MPIs)

Question 1: Do you agree with the approach we have taken to workstream 4?

We offer no comment.

Question 2: Do you think we have missed any important benefits that MPIs could deliver?

We offer no comment.

Question 3: Do you agree with our views on the conclusions of the ITPR?

We agree that the ITPR did not come to any firm conclusions as to the treatment of MPI other than to maintain continuity of regulatory treatment if an existing transmission asset evolves into an MPI.

Question 4: Do you agree with our proposal to further explore the applicability of the cap and floor regime for the MPI projects currently under consideration? Please provide supporting information if available.

It is reasonable for Ofgem to explore MPI's further and to clearly determine how an MPI with an associated support mechanism (Cap and Floor or alternative) is able to deliver a positive outcome for the GB Consumer.

Question 5: Do you agree with our proposal to also consider alternative regulatory models for MPI projects in the long term? What models should we consider? Please provide supporting information if available.

It is reasonable to consider alternative regulatory models based on a thorough needs case assessment. We offer no comment on the regulatory models at this time.

Question 6: What other wider policy issues or aspects related to MPIs should we be aware of?

There are several issues that will need to be considered by Ofgem:

- Charging avoidance for transmission access and use.
- Impact on GB-based renewable generation.
- Impact on flexibility providers.

- Security of supply impact caused by a loss of an MPI that incorporates both interconnector and generation.
- Unbundling requirements.