



FAO Vanja Munerati
Electricity Transmission Policy
Ofgem
9 Millbank
London
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12th March 2012

Dear Vanja,

Impact Assessment on National Grid proposal CMP192: enduring user commitment

Drax Power Limited (“Drax”) is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. Drax also owns an electricity supply business, Haven Power Limited (“Haven”), which supplies electricity to a range of business customers and provides an alternative route to market for some of Drax’s power output. As the holder of a generation licence, we believe we are well placed to provide comments on Ofgem’s Impact Assessment of CMP192.

Answers to the specific questions raised in the consultation document can be found in Annex 1. However, we would like to highlight the following key points:

- We believe the proposed pre-commissioning securitisation requirements under CMP192 better reflect the potential risk of stranded assets. The lower securitisation requirements for pre-commissioning generators should help to reduce barriers to entry.
- We agree that the type of investment, and associated risks, for pre- and post-commissioning generators are different. As such, it should not necessarily be considered discriminatory to have different User Commitment arrangements for each type of user.
- In principle, we agree that providing a longer notice period to National Grid could provide a number of benefits to both transmission and generation investors. However, these benefits cannot be realised in practice without a significant improvement in market signals.
- If generators do not have access to a sufficiently liquid forward market, they will be forced to use shorter-term market price signals to determine the economic viability of plant. If a relatively short-term market is combined with a four-year notice period, the User Commitment arrangements create nothing more than a ‘closure tax’.
- Generators may take action to protect themselves against the costs associated with providing late notice of closure, which may prove costly to the end consumer. We consider this an inefficient use of scarce capital resources, particularly in the current financial and investment environment.
- Drax supports the grandfathering of connection securitisation arrangements for existing connection agreements, provided such agreements are not significantly modified. Grandfathering provides greater certainty to investors and should ultimately benefit consumers by helping to minimise the cost of delivering investment.
- On balance, we consider WACM7 delivers the most appropriate enduring User Commitment arrangements.

If you would like to discuss any of the views expressed in this response, please feel free to contact me.

Yours sincerely,

By email

Stuart Cotten
Market Development Manager
Regulation and Policy

Annex 1: A response to the specific consultation questions

Chapter 4: Summary of impact

Question 1: We welcome stakeholders' views on whether we have identified all the relevant impacts of CMP 192.

Drax generally agrees with the impacts identified. Under CMP192, pre-commissioning generators would be subject to lower securitisation, which would foster a more friendly investment environment, particularly where wider and local liabilities reflect asset reuse by TOs, risk sharing with consumers, etc. As such, pre-commissioning securitisation requirements would better reflect the potential risk of stranded assets, particularly where consideration is given to the completion of key consents and financial closure.

The unpredictability of future fuel costs and market prices is a risk that requires management in any competitive market. However, the energy markets are particularly volatile and the lack of an adequate forward market makes power prices extremely difficult to predict. For post-commissioning generators, this is a significant concern when considering proposals to increase the notice period for the closure of plant / reduction of TEC. We agree with Ofgem's view that the key issue is visibility of market prices across the curve, rather than market volatility. Low liquidity in the power market beyond two years forward means that generators have inadequate information on which to base a closure decision four years forward.

We also agree that the economics of low efficiency, reliable thermal plant could change with the introduction of the Government's EMR package (i.e. as a result of implementing a capacity mechanism). Generators must be able to react to future regulatory changes (market or environment based), otherwise User Commitment arrangements risk acting as a 'closure tax'. Under such a scenario, a generator may be encouraged to recover a level of capital from the market to hold in reserve to pay the new levy (i.e. an increased risk premium), which would be a costly and inefficient use of scarce resources.

In terms of the impact on transmission investment, we support the principle of a longer notice period that would benefit TOs in planning investment. However, this can only be achieved if generators are able to make those decisions based on market indicators, i.e. market liquidity must extend beyond the notice period. Unfortunately, forward price signals are unreliable beyond two years forward.

Drax agrees that the type of investment, and associated risks, for pre- and post-commissioning generators are different. As such, different User Commitment arrangements for both types of generator should not necessarily be considered discriminatory.

Question 2: Do stakeholders agree with our assessment of the potential environmental impacts of the proposal?

Lowering barriers to entry associated with the current User Commitment arrangements could encourage more renewable and efficient thermal plant to connect to the transmission system. However, should a four year post-commissioning notice period be implemented, a perverse incentive may be created for some power stations to close earlier than may otherwise be the case. Whilst this could be seen to further environmental aspirations, it may occur at the expense of security of supply, i.e. flexible plant that is capable of responding to fluctuations in intermittent generation could be forced to close early. In addition, this could have an adverse impact on affordability.

It is important that market participants are empowered to make efficient investment decisions. Whether this involves developing new capacity, or mothballing, decommissioning or upgrading existing capacity, it should be the role of the *market* to signal the most efficient solution.

Question 3: We seek stakeholders' views on the potential implications of the potential perverse incentives, and views as to how they may be mitigated.

The offshore wind farm scenario highlighted on pages 31-32 of the Impact Assessment may cause a potential problem in terms of unnecessary delays in planned generation investment. However, we are unsure of the materiality of the identified problem.

The counter argument could be that it may be beneficial for renewable investors to build new generation sooner in order to access ROC revenue at the prevailing support level. The early realisation of ROC revenue may outweigh the temporary increase in costs associated with securitisation. In any event, investors are likely to make a decision based on these competing factors and ultimately decide which effect outweighs the other.

Further work to investigate this issue may be required.

Chapter 5: Impact of the proposals on pre-commissioning generation

Question 4: Do stakeholders agree with our summary of the impact of the CMP 192 original proposal on pre-commissioning generation?

We broadly agree with the impacts identified in this section. However, we do not agree with Ofgem's position on grandfathering.

Grandfathering is a clear and visible signal to investors that regulatory agencies will not attempt to undermine investments by making retroactive changes to the regulatory arrangements. This approach would encourage generators to invest in the GB market, provide greater certainty to financiers and lower the cost of capital. This is highly important for the power sector, where an unprecedented level of investment is anticipated over the course of the decade. This should ultimately benefit consumers by helping to minimise the cost of delivering investment.

We are unconvinced that the cost of administering overlapping User Commitment arrangements will be prohibitive. The existing arrangements will only continue for a finite period alongside the new arrangements. In addition, we believe any cost impacts associated with grandfathering the current User Commitment arrangements will be outweighed by the benefits associated with fostering investor confidence.

We are also concerned by the claim that only a small number of parties will wish to remain on the current arrangements. The number of parties that would opt for the new arrangements, should an option be permitted, will remain unclear until the new enduring User Commitment arrangements are implemented. There should be further consultation with those parties holding existing connection agreements prior to ruling out grandfathering options.

Finally, with regards to whether a generator should retain the right to grandfather if they modify their connection agreement, we believe that grandfathering rights should cease if a significant change is made to the original offer, e.g. the generation technology changes, the point of connection moves, TEC is varied, etc.

Question 5: Do stakeholders agree with our current thinking that placing a four-year liability for wider works on pre-commissioning generators is appropriate?

Yes. Drax agrees that it should not be considered discriminatory to differentiate between pre- / post-commissioning User Commitment. The type of investment, and associated risks, for pre- and post-commissioning generators are different. As such, the User Commitment arrangements should be capable of reflecting the difference in risk profiles.

Question 6: Do stakeholders agree with our view that the proposal to halve the liability on generators for local works that are designed to accommodate demand, either existing or in the future is not appropriate for the reasons set out in this chapter?

We agree with Ofgem that sharing local works liabilities equally (i.e. 50%) with demand, where such transmission investment is designed to accommodate demand, is not justified. It appears likely that demand will not drive half of the requirement for local works. We agree that, in principle, demand could share local works liabilities in proportion to the investment demand requirement it is driving; however, this would require a more complicated liability calculation to accurately apportion liabilities between generator and consumer (demand) requirements. Due to the additional complexity this would entail, we do not support this element of the proposal.

Question 7: Do stakeholders agree with our view that the proposed credit cover arrangements are appropriate and provide valuable protection to consumers?

Drax believes that credit cover will always be a material issue for independent market participants. It is important that the right balance is struck between the risk of default and ensuring that viable economic projects can be developed. The proposed credit cover arrangements would reduce the financial burden on parties by scaling the liability profile and reducing security requirements. We welcome this approach.

For the avoidance of doubt, we believe the differentiation of existing credit cover arrangements based upon a company's credit rating is justified on the basis that different parties will pose a different level of default risk.

Chapter 6: Impact of the proposals on post-commissioning generation

Questions 8: We seek stakeholders' views on the extent to which asset health and the associated plant life assessment could hinder generators in providing four-year user commitment notice.

We expect that the evaluation of asset health will be an issue for all plant. The operating and maintenance regime for all plant must reflect the expected plant life and potential future investment options. This assessment must be made whilst simultaneously considering expected future market profitability. As such, even if asset health could be assessed relatively easily (which it cannot), future price / investment signals would still play a large part of a decision on the future operating regime of a given plant. The lack of reliable price signals in the forward market makes this task more difficult.

If generators do not have access to a sufficiently liquid forward market, they will be forced to use shorter-term market price signals to determine the economic viability of plant. If a relatively short-term market is combined with a four-year notice period, the User Commitment arrangements create nothing more than a 'closure tax'. The operator would be forced to make provisions for the four year post-commissioning liability, should shorter-term market signals become unfavourable. We consider this an inefficient use of scarce capital resources, particularly in the current financial and investment environment. Such costs would be borne by the end consumer.

Question 9: We would be interested to hear stakeholders' views on whether we have appropriately identified all the relevant interactions with other policy developments, and potential impacts on user commitment arrangements in general and more specifically, our consideration of CMP 192 proposal.

Regulatory uncertainty will be a key concern if generators were required to provide such a long period of notice to National Grid. The main regulatory developments (which have also been identified in Ofgem's Impact Assessment) are set out below.

Environmental legislation

Ageing transmission connected capacity faces significant uncertainty from environmental legislation. LCPD and IED opted-out plant will be required to disconnect over the next decade. There is also uncertainty over the future development of environmental legislation (both GB-specific and EU led work-streams). Both existing and new investors must be able to react to the changing regulatory landscape.

Electricity Market Reform (EMR)

We agree that the development of the EMR proposals is at an early stage, therefore the interactions between CMP192 and the EMR proposals are not yet fully understood. However, there are aspects of the proposals that would clearly make a four year notice period more onerous for generators.

Capacity Mechanism

Generators are currently in the process of investigating investment options where decisions will need to be made prior to the introduction of a capacity mechanism (e.g. Selective Catalytic Reduction (SCR) investment for ageing coal plant). The CMP192 proposals could have an effect on investment decisions, in that generators are forced to make decisions earlier in what may, or may not, be a less favourable economic environment (e.g. decisions could be made now, rather than when more information is available on the design of the proposed capacity mechanism). The liabilities associated with the four year notice period would effectively increase the cost of keeping investment options open.

Moreover, there is significant uncertainty surrounding how the short-term nature of market liquidity today will interact with proposed longer-term capacity signals produced by a future capacity mechanism (i.e. the value that is not signalled today, but could be realised if a capacity mechanism is introduced). In particular, how these potentially conflicting signals will translate into investment in reliable, flexible plant. It is very difficult for generators to evaluate (currently unreliable) forward price signals when there are potentially conflicting future capacity signals which have yet to be developed. Two potential scenarios could be:

- a) A generator could submit notice to disconnect based on the lack of future expected profitability, but this would be at the risk of then failing to capture potential value from a future capacity market; and
- b) A generator may decide to risk remaining connected to the system regardless of future projections of profitability in the hope of capturing future value from a capacity mechanism, which is by no means certain to signal any value.

It is far from clear what a generator should do when faced with these competing signals. The choice is made even more difficult with a four year notice period.

Carbon Price Support (CPS)

Due to the way that the CPS has been implemented, it will be very difficult to develop reliable liquidity beyond two years forward. Beyond this timeframe, generators will be exposed to the risk of carbon price fluctuations; this risk cannot be adequately hedged.

Retail Market Review (RMR)

With regards to wholesale power market liquidity, it is welcome that Ofgem recognises the lack of adequate market price signals across the forward curve. Drax believes that improving market liquidity should be a key priority for the regulator.

Whilst we note Ofgem's intention to improve wholesale liquidity in the forward market, we believe it would be premature to use such intentions as a justification to implement a four year notice period. This is because:

- a) We are currently unconvinced that Ofgem's Mandatory Auction proposal will provide reliable forward price signals; and
- b) The proposed Mandatory Auction will take time to develop and has (as yet) not been proven to deliver greater liquidity across the forward curve.

Finally, we note the analysis undertaken by Ofgem on how particular generators may react to forward wholesale prices under different User Commitment notice periods (in terms of whether to continue operation, reduce TEC or close plant). The analysis assumes that generators have sight of reliable wholesale prices a number of years into the future. This analysis is unreliable due to the fact that generators *do not* have sight of reliable forward investment signals; at present, there is little beyond 18

months to react to. Moreover, generators do not base future investment decisions on historic wholesale prices, so modelling generator behaviour using historic data is unlikely to be reliable.

Questions 10: Do stakeholders consider that a level of uncertainty associated with policies currently being developed in greater detail could hinder generators in providing four-year user commitment notice?

For the reasons given above we agree that these developments hinder the ability for generators to provide four years notice. However, it should be noted that, in principle, we believe a longer notice to closure period could provide a number of benefits in terms of market efficiency, efficient investment in transmission assets, etc. The key issue is that these benefits cannot be realised in practice without a significant improvement in market signals. It may be more appropriate to revisit the length of User Commitment notice periods once tangible evidence of improvements in the development of reliable future market investment signals has been established.

Chapter 7: Impact of the proposals on network planning

Question 11: We welcome stakeholders' views on the analysis presented in this section and, where available, any additional information and/or analysis in relation to the impact of CMP 192 on the efficiency of network investment.; and

Question 12: We seek stakeholders' views on the approach to risk adopted in National Grid's analysis and on the potential alternatives to assessing the risk.

With regards to the analysis in chapter seven, we note Ofgem's observation that it is likely to overestimate the benefits associated with longer notice periods due to the risk being quantified uniformly regardless of what time period to which the information relates.

Nonetheless, we do not dispute that a longer notice period will provide additional benefits relative to shorter arrangements. The analysis demonstrates this view, at least to some degree. However, the important point to note is that whilst there is a certain amount of potential benefit available in principle, it is very unlikely that this benefit will be realised in practice due to the lack of reliable long-term investment signals. The introduction of a four year notice period is likely to result in additional costs associated with the actions taken by generators to protect themselves against the costs associated with providing inadequate notice of closure (i.e. a 'closure tax').

Question 13: Taking into account various factors discussed in this document that may have an impact on generators' ability to provide four-year notice and National Grid's analysis presented in this chapter, we seek stakeholders' views on the most appropriate length of the notice period for post-commissioning generators.

For the reasons provided above, we believe the most appropriate length of the notice period for post-commissioning generators would be two years. Having reflected on Ofgem's Impact Assessment, we believe WACM7 provides the most appropriate solution.