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Dear Anthony,

Project Transmit: Impact Assessment of industry's proposals (CMP213) to change the electricity transmission charging methodology

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. In March 2009, Drax acquired an electricity supply business, Haven Power Limited ("Haven"); Haven supplies small and medium sized business customers and provides an alternative route to market for some of Drax's power output.

A full response to the questions detailed in the consultation can be found in Annex 1. In summary, our main comments on the Impact Assessment consultation are as follows:

- The quantitative analysis is inconclusive and cannot be used to justify the adoption of any of the charging options (including the Status Quo). The decision of the Authority must rely on available qualitative evidence;
- We do not consider that any of the charging options (including the Status Quo) are incompatible with meeting sustainability objectives. As such, no one option has a comparative advantage in this regard;
- Options employing ALF (including Ofgem's preferred option, WACM2) are not consistent with the SQSS (GSR009), which rather employs generic scaling factors. There is no evidence presented to suggest that ALF is more cost reflective relative to different scaling factor methods. As a consequence, there is no reason to believe that options employing ALF better facilitate effective competition;
- In fact, options using ALF are likely to be more complicated, restricting tariff predictability and accurate tariff forecasting. It is also likely to distort generator dispatch decisions to some degree. These effects will negatively impact effective competition;
- Should the Authority decide to approve a change to the charging arrangements, it should make its decision as early as possible, but set an implementation date for no earlier than April 2015. Providing market participants with sufficient notice to enable efficient commercial decisions will increase the likelihood of the perceived benefits being realised. There is a fundamental difference between early implementation and an early regulatory decision with appropriate notice.

Overall, it is clear that the quantitative analysis is inconclusive. There is no reason to believe that the options presented are more cost reflective than the current ICRP charging methodology. Rather, the options presented introduce additional complexity to the charging arrangements. Therefore, on balance, we believe that the Authority should retain the current charging methodology.

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

Yours sincerely,

By email

Cem Suleyman

Regulation and Policy
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Annex 1

Chapter 4: Quantitative modelling of the charging options

Question 1: Do you think we have identified the relevant impacts from NGET's modelling and interpreted them appropriately?

We believe that Ofgem has identified the relevant impacts. However, we disagree with its interpretation of the modelling to a large extent. Overall, we do not consider that the quantitative modelling provides a strong basis for determining that any of the options (including the status quo) are significantly better relative to all the options presented. We believe this is the case for the following reasons.

The total levels of renewable and low carbon generation developed under different options vary significantly

The first of the two most important outputs that give an indication as to the desirability of different charging options is Power Sector Costs (the other being Consumer Bills). Differences between the charging options in terms of Power Sector Costs are largely driven by differences in total renewable and low carbon generation build. Therefore it is essential that the levels of renewable and low carbon generation developed under different charging options are similar to allow effective comparison. Ofgem has concluded that, broadly speaking, the results indicate similar levels of renewable generation development under the different charging options. However, this is not the case. Importantly, the Status Quo has greater renewables penetration than the Original and Diversity 1 options. As such this helps drive an increase in costs under the Status Quo relative to other charging options. This does not allow an equal comparison of the different methodologies, which undermines the analysis.

The Baringa report makes the above point well. "Overall, whilst the Original shows a benefit relative to Status Quo, we expect that a scenario with more similar low carbon build to the TransmiT results, and with similar levels of renewables, could show a closer result"¹. And also, "By 2030 Diversity 1 results in the lowest overall renewable level... and as a result this also reduces generation costs and thus presents the Diversity 1 run in a more favourable light than if the renewable generation matched exactly"².

It should also be noted that the modelling leads to different levels of CCS and nuclear build due to differences in transmission charging models. This is unrealistic as the development of these generation technologies will be determined by the level of government support provided, rather than different charging methodologies/locational signals. However, those models which have more nuclear (for example Diversity 3) are put at a cost disadvantage relative to the other charging models. Again, this will distort comparisons between the different charging options and their impacts on Power Sector Costs.

It seems that Redpoint, for the Project TransmiT analysis, 'tweaked' the CfD FiT strike prices to a much larger degree to ensure more comparable levels of renewables penetration between the different charging models. Unfortunately, it does not seem that there was sufficient time available to take a similar approach to the modelling subsequently undertaken during the Workgroup meetings. With the modelling results in its present state, we do not consider that the different levels of Power Sector Costs under the different charging options can be considered to support any of the charging options.

Consumer bill impact highly dependent on capacity margins

The second of the two most important outputs that provide an indication as to the desirability of different charging options is Consumer Bills. It is clear that the Consumer Bills output is highly sensitive to the modelled capacity margins, i.e. lower capacity margins equal higher wholesale prices thus higher consumer bills, and vice versa. The levels of capacity margin vary from charging option to charging option and this is the main driver behind different Consumer Bill impacts under different charging options.

¹ Baringa, Review of CMP213 Impact Assessment Modelling for Ofgem (2013) p.72

² Ibid. p88

However, the Baringa Report correctly notes that there is likely to be limited impacts from transmission charging on capacity margins³. The introduction of the capacity market, for example, is likely to have a far greater impact on capacity margins and these will be common to all charging options. Therefore, we do not believe the weighting placed on Consumer Bill impacts is appropriate when informing one's view on the different charging models. This output could have been more informative if a common capacity margin was assumed for all the charging options.

No sensitivity analysis

The modelling results are highly sensitive to the assumptions made. However, there is very little sensitivity analysis provided. For example, the Baringa Report notes that gas price assumptions can have a significant impact on the results⁴. Therefore, analysis on gas price sensitivity would have been helpful to better understand the impacts of the different charging options.

For the reasons provided above, we struggle to conclude that the quantitative analysis provides firm justification for any of the charging options presented. As such, we conclude that qualitative justification is the only basis for making a decision on whether to implement any of the charging options.

Question 2: Do you have any further evidence of the impacts of the charging options not covered by NGET's analysis

No.

Chapter 5: Strategic and sustainability considerations

Question 3: Do you agree with our assessment of the options in terms of the strategic and sustainability impacts? In particular, are there any impacts that we have not identified?

In terms of Ofgem's assessment of sustainability impacts, we believe that the assessment is unsatisfactory for the following reasons.

Ofgem claim the evidence suggests that options incorporating Diversity 1 are more likely to meet renewables targets. However, as mentioned in answer to Question 1, the reasons underpinning different total renewables and low carbon generation development mean that comparisons between the different charging options are problematic. Moreover, Ofgem's reflections on the 2050 targets are highly speculative, giving far too much weight to the importance of transmission charging, rather than government policy (in particular EMR), EU regulation, commodity prices, etc.

The assessment also highlights a trend throughout parts of the Impact Assessment for Ofgem to be selective with the evidence. For example, the speculative benefits of Diversity 1 options with regards to meeting 2050 targets are given undue prominence, whereas the potential negative impact caused by Diversity 1 options on visual amenity is disregarded, stating that other factors are more important. We actually agree with Ofgem on the visual amenity point, but believe it is inconsistent to talk up the importance of transmission charging arrangements for some areas (2050 targets for example), but dismiss its importance in other areas.

Overall, we disagree with Ofgem's conclusion that Diversity 1 options better meet sustainability objectives. It appears that all charging options, including the Status Quo, are capable of meeting sustainability targets and thus no charging option appears to have a significant comparative advantage with regards to meeting sustainability objectives.

Ofgem's discussion of strategic benefits is a bit nebulous and difficult to define. As such, we do not believe much weight can be placed on such considerations.

³ "In general, we do not believe that there is evidence to suggest that the different charging options drive materially different levels of security of supply". Baringa, Review of CMP213 Impact Assessment Modelling for Ofgem (2013) p.61.

⁴ Ibid, p9.

Question 4: Do you think that socialising some of the cost of HVDC converter stations could lead to wider benefits, such as technology learning? If so, please provide further evidence in this area.

Ofgem's analysis gives us no reason to change our view from that provided in response to the Code Administrator consultation. We believe it would be more appropriate for a specific proportion of converter station costs (that is, specific to a given HVDC connection) to be socialised, where such investment is considered similar in nature to onshore AC substation investment. The evidence already presented justifies such treatment regardless of further speculation on wider benefits, whatever these may be.

Chapter 6: Assessment against decision making criteria

Question 5: Do you agree with our assessment of the options against the Relevant CUSC objectives? Please provide evidence to support any differing views.

Ofgem states that it believes all the options presented better meet the applicable CUSC objectives. In particular all options are more cost reflective than the baseline and thus more likely to promote effective competition (as well as being consistent with developments in National Grid's business). Of the options presented, Ofgem believes that WACM2 best meets the applicable CUSC objectives. Essentially, Ofgem's main argument for wishing to implement WACM2 is that it is the most cost reflective option and as consequence will best facilitate effective competition. The reason Ofgem give for believing WACM2 is the most cost reflective option is that it most accurately reflects the behaviour of National Grid in its role developing the transmission network.

We do not agree with Ofgem's view that WACM2 is more (or indeed most) cost reflective simply because WACM2 best reflects changes made to the SQSS (following implementation of GSR009). We doubt this claim primarily because of the use of ALF (indeed this argument applies to all options employing ALF). Specifically, the use of ALF does not feature in the SQSS, rather fixed generic scaling factors are utilised. Ofgem has not undertaken any analysis to determine whether the use of ALF is indeed more cost reflective than employing the SQSS scaling factors (or any other scaling factor methods). Rather it seems to be faithfully relying on National Grid's assertion that load factor is a manifestation of all the factors which drive congestion costs. We agree that congestion costs are driven by a number of different factors including load factor, plant diversity, boundary capacity, production patterns, etc. However, the claim that all these complicated factors manifest themselves in ALF is clearly just assertion and not backed up by any convincing evidence.

We also note that the Year Round Component, which features in the Original, Diversity 1 and Diversity 2 proposals, does not appear to be entirely consistent with the SQSS. Specifically, the Economy Background detailed in Section 4 of the SQSS is set for an ACS peak demand scenario (rather than year round scenario) and uses fixed/uniform scaling factors (See Appendix E of the SQSS) rather than ALF. The 'Under conditions in the course of a year of operation' section (also in Section 4 of the SQSS) appears to represent some form of year round scenario, but the Year Round Component developed by the CMP213 Workgroup bears little resemblance to this. For example, the SQSS seems to envisage the inclusion of forecast demand cycles and typical planned outage patterns. None of this appears in the CMP213 proposals which use a Year Round Component.

For the reasons given above with regards to ALF and the Year Round Component, we cannot conclude that WACM2 is any more cost reflective than any of the other charging options presented (including the Status Quo) and thus cannot be used as an argument to suggest that WACM2 will better facilitate effective competition. To the contrary we consider that there are reasons to believe that WACM2 is likely to negatively impact effective competition.

Ofgem correctly identify that the Hybrid option may distort a generator's dispatch decisions. However, it does not accept that this will apply to the ALF historic approach, even though both options create a new variable cost of generation (although it is the case that the Hybrid option would tend to more materially affect generator dispatch decisions). The effect is exactly the same in principle and it is clearly incorrect to state that the use of ALF will not affect generator dispatch decisions. The additional and unnecessary complexity which is being introduced to the wholesale market can only negatively impact effective competition.

No substantial analysis has been provided on the potential for increased tariff volatility/predictability (which is a major deficiency of the quantitative modelling). However, it seems clear that all the presented charging methodologies will increase the complexity of determining parties' transmission charges. For example, generators are still not clear on what their ALF for 2014/15 will be and, as a result, cannot accurately forecast their respective TNUoS tariffs that are due to take effect in less than 6 months' time.

We suggest further evidence of the increased complexity can be observed by the fact that National Grid has struggled to produce forecast or modelled tariffs which have not required repeated subsequent revision. Examples include:

- The modelling results produced by National Grid have had to be continually refined to improve its accuracy (we are up to a third version of modelled results), which has hindered the development of stakeholder views on the merits of the proposals.
- The tariff forecasts initially produced by National Grid for the September TCMF have had to be recalculated to remove errors.
- Also at the TCMF it appears that changes to demand TNUoS tariffs are far greater than initially predicted by the Final Modification Report.

We believe the above examples are a consequence of the increased complexity of the proposed charging options. The resulting incorrect forecasts reduce parties' confidence in National Grid to provide accurate forecasts, and perhaps even final tariffs. Insufficient weight is given by Ofgem to how this additional complexity will make it more difficult for parties to take a view on future transmission charges. If National Grid is struggling to develop forecast tariffs, how can market participants be expected to do any better? This can only have a negative impact on effective competition.

Overall, we do not consider that WACM2 is more cost reflective, specifically due to the use of ALF and that there are other factors noted above which are likely to be detrimental to effective competition.

Question 6: Do you agree with our assessment of the options against our statutory duties? Please provide evidence to support any differing views.

We do not agree with Ofgem's assessment. The main three conclusions Ofgem reaches in the associated chapter are that:

- Options incorporating Diversity 1 are more likely to reduce GHG emissions;
- The quantitative modelling shows that whilst consumer bills are likely to increase under each of the charging options relative to the status quo in the short run, bill reductions relative to the status quo are likely in the long run and the long term benefits outweigh any short term costs;
- The options presented are consistent with the EU direction of travel with regards to transmission charging.

We conclude that all options presented, including the Status Quo, are compatible with achieving the necessary GHG emission reduction targets. Specifically, no one option has a significant comparative advantage in terms of meeting GHG emission reduction targets.

While noting firstly that we do not believe that any firm conclusions can be drawn from the stated consumer bill outputs (detailed in answer to Question 1), we are unclear as to how Ofgem can conclude that the perceived long term benefits outweigh the short term costs. This conclusion does not seem to be supported by any evidence. Moreover, the greater certainty of short term impacts relative to greater uncertainty of long term impacts does not seem to have had much bearing on Ofgem's view, when arguably it should have. Overall, the reasons for Ofgem's view on this issue are particularly opaque.

Ofgem also assert that the EU is moving in the direction of more cost reflective charging and, as such, it believes the modification is compatible with the EU arrangements. However, there is no analysis to corroborate this view. Details on how EU policy is developing in this area would be helpful to justify this view, but also help market participants better understand likely regulatory developments from the EU.

Question 7: Do you agree with our assessment that it is appropriate to implement WACM2 in April 2014? Please provide evidence to support any alternative implementation date.

Whatever one's view on the merits of each of the CMP213 options, we consider the implementation of change in April 2014 to be unjustified and wholly inappropriate.

The main reason provided by Ofgem for implementation in April 2014 is to achieve the perceived benefits of the change as soon as possible. Notwithstanding Ofgem's view that there are likely to be costs in the short term rather than benefits (leading to questions as to what these early benefits are), there is a fundamental difference between making an early decision, thus signposting policy changes, and early implementation.

By all means, Ofgem should make a timely decision on whether to approve the change or not, so as to provide market participants with certainty and better inform their commercial decisions. This would better enable the perceived benefits to be realised. However, early implementation is likely to result in additional costs as the risk to the market is more asymmetric in that it is far more likely to result in plant closing, but far less likely to result in new plant opening in the short run.

However for 2014/15, April 2014 implementation will also unnecessarily penalise generation plant that may have wanted to reduce/release TEC in response to the changes. This is because such plant will either have to incur the increase in TNUoS charge or face an exit penalty. This can in no way be deemed efficient and goes contrary to the principle developed under CMP192.

Ofgem lists two additional factors which mitigate the effects of early implementation, these being:

- National Grid's tariff updates will help provide certainty to market participants;
- The issue of tariff predictability is more important for suppliers than generators and as the change does not affect demand tariffs significantly, Ofgem believes this issue is less of a concern.

Firstly, National Grid's updates have left something to be desired, with continual amendments having to be made to the tariffs developed as part of the code modification process, as well as tariff forecasts made available more recently at the TCMF. These have not provided much certainty to market participants. Secondly, predictability of costs is fundamental to any business in any industry and to suggest that suppliers need cost predictability more than generators is absurd. In any case, the fact that demand tariffs seem to have been affected more than previously thought, according to National Grid's forecast, would appear to invalidate this argument.

Finally, we consider that it is only reasonable to approve this level of cost redistribution where sufficient notice has been provided to parties. Such notice will provide parties with time to respond to the proposed change and minimise some of the negative impacts identified in the Impact Assessment. Redistributing this level of costs at such short notice does not seem reasonable.

Overall, we consider the above justifies that the earliest implementation date should be April 2015, regardless of the option chosen. However, we agree that the Authority should make its decision as soon as possible to give market participants sufficient notice to make efficient commercial decisions (assuming one of the options is approved).