Drax Power Limited

Drax Power Station • Selby • North Yorkshire • YO8 8PH • T. +44 (0)1757 618381 • F. +44 (0)1757 618504

Alena Aliakseyeva
Smarter Grids and Governance: Transmission
9 Millbank
London
SW1P 3GE

16 January 2014

Dear Alena,

Impact Assessment on CMP201 – proposal to remove balancing charges from generators

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 (SME) sized business customers and larger Industrial and Commercial (I&C) customers; this 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:

- Ofgem's conclusion that there is likely to be a low EU benefit, high GB consumer cost outcome is untenable. Where lower EU benefits (in the form of increased cross border trade) does not materialise, GB consumer cost increases must be limited as a consequence;
- We are concerned that Ofgem's decision not to approve CMP201 signals an inconsistency in its efforts to promote a more effective single European market; the benefits of which are well understood and widely supported. When viewed logically, the decision implies that interconnection between GB and other electricity markets is only desirable where the interconnector is expected to be a net importer of electricity. This is not in the spirit of the development of the single European market;
- We do not understand Ofgem's scepticism of the ability of wholesale prices to fall in the long run due to dynamic, rational economic behaviour, i.e. higher generation profits attracting market entry and expansion. This scepticism is not warranted;
- Ofgem has failed to consider the undue cost disadvantage faced by GB generators when compared to equivalent generators in other Member States. This disadvantage results from the current treatment of BSUoS costs, which has been further exacerbated following the implementation of CMP202. This distortion of EU cross border trade cannot be in the interests of facilitating the European single market and consequently disadvantages end consumers;
- We consider that the benefits of fostering an efficient EU single market far outweigh any likely modest and transitory cost increases for GB consumers. Competition is a key component of an efficient market. We do not consider that any other policy developments prevent the implementation of CMP201. In particular, if Ofgem believes it is acceptable to recommend changes to the transmission charging arrangements at this time, it must follow that it is acceptable to make changes to the mechanism for BSUoS cost recovery;
- We continue to believe that WACM1 should be approved by Ofgem as it provides the optimal notice period to the market (three full charging years) to minimise windfall gains and losses.

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
Drax Power Limited

Annex 1

Chapter 3: Impact of CMP201

Question 1: Do respondents consider that we have identified the relevant impacts of the CMP201 proposal?

On the whole, we agree that Ofgem has identified the relevant impacts. However, we do not agree with how Ofgem has interpreted the impacts as part of its initial assessment (see our answer to question 4 for more detail). We also believe that Ofgem should have considered in more detail the optimum implementation approach, the expected benefits to EU consumers as a whole and the enduring disadvantage to GB generation (see our answer to question 5 for more detail).

Question 2: Do respondents have any quantitative or qualitative evidence on the likelihood of additional investment in generation that would offset the relative increase in wholesale prices?

We do not believe that it is possible to provide quantitative analysis of the long term impacts associated with higher GB generation profits and the subsequent effects on investment and wholesale prices. Such analysis is highly speculative due to the high number of variables and assumptions. The absence of any quantitative analysis in Ofgem's Impact Assessment suggests that the regulator has been unable to produce any reliable quantitative analysis.

We consider that the qualitative evidence presented in the Final Modification Report[1] (FMR) on this issue is perfectly adequate in demonstrating that, in isolation, any increased consumer costs resulting from higher wholesale prices are unlikely to persist in perpetuity where higher generation profits exist. Market entry can be expected to compete away any super normal profit, reducing wholesale prices. There is no evidence to suggest that the GB generation market is uncompetitive and thus that such dynamic behaviour is unlikely to occur. As such we are puzzled as to why Ofgem is so sceptical about the potential for rationale economic behaviour.

Question 3: Do respondents have any further evidence on the effect of CMP201 on supplier credit risk.

No.

Chapter 4: Initial Assessment

Question 4: Do respondents agree with our initial assessment of the proposal?

We agree with Ofgem's assessment against the Applicable CUSC Objectives, although we are more positive about the potential for CMP201 to better facilitate effective competition in generation. However, we disagree with its assessment made with reference to the Authority's statutory duties. In summary, Ofgem believes that "the benefits of increased competition and increased EU integration may not be realised. In addition, there is a risk that the near term impact of CMP201 on GB consumer prices may never be fully offset by increased investment in GB generation in the longer term"[2].

We do not believe that this opinion is tenable. If the benefits of cross border trade, which manifest in greater GB exports and/or less GB imports, do not fully materialise (due to the carbon floor price for example) then the observed costs to GB consumers must fall. In effect, a low EU benefit, high GB consumer cost scenario is extremely unlikely. Ofgem appears to recognise this point in paragraph 4.19 of the impact assessment. "We have concerns that the benefits of increased competition indicated by

---

[1] Please see p17-19 in the Final Modification Report - http://www.nationalgrid.com/NR/rdonlyres/A9603AAA-F513-416F-8DC0-6608546B3DC1/60434/CMP201SecondFMR30forAuthority.pdf

[2] Impact assessment on CMP201 – proposal to remove balancing charges from generators, Ofgem (2013) p27-28

NGET's modelling results will not be realised to their full extent. *Similarly, the subsequent impact on supplier and consumer costs may be diluted*"[3] (italics added).

Moreover, as touched on in answer to question 2, it is perplexing that Ofgem is so sceptical about the potential for market participants to act in an economically rational manner in the event that profit levels increase. Therefore we do not understand how Ofgem considers that GB consumer cost increases will continue in perpetuity.

More importantly, the assessment appears to be inconsistent with the ambition of promoting integration of a single EU energy market. The benefits of the single market 'project' are widely understood and accepted. For example, we note the recent speech given by the Secretary of State for Energy and Climate Change, where he stated that "I'm convinced connecting the UK better into a better functioning European single energy market would spur greater competition in our electricity markets – and provide a real boost for consumers and industry"[4].

However, the impact assessment is almost wholly focussed on the costs to GB consumers, whilst the benefits that can be expected to accrue to EU consumers as a whole, which is the principal rationale for the Modification, are almost ignored. Moreover, the impact assessment fails to take account of the restriction of trade that GB generation will face as a result of the treatment of BSUoS costs, and how this situation was made worse following the implementation of CMP202. Worryingly, Ofgem's decision implies that interconnection projects should only be approved if they will result in net imports, which of course would not be in the spirit of the EU single market. Overall, insufficient weight has been placed on the benefits of fostering a single EU market while too much weight is placed on the possibility of a small and transitory cost to GB consumers.

We also note Ofgem's point that the Modification has not been raised as part of a holistic review. While a holistic review may have been beneficial, the CUSC modification process is not suitable for such processes. Whilst there is a balance to be struck between judging a modification on its own merits and taking account of other external developments; we consider that Ofgem is being inconsistent in its decision making process when it comes to how it treats external policy/market developments. For example, it raises the possibility that EU tarification developments may put the benefits of CMP201 in doubt. However, at the same time it is has made a minded-to decision to change the TNUoS charging arrangements (CMP213) prior to receiving greater clarification on the topic. This is inconsistent. We question why it is considered acceptable to recommend changes to the transmission charging arrangements at this time, whilst considering it unacceptable to make changes to the recovery of balancing services costs.

Ofgem also note that other market distortions exist which put the benefits of the Modification in doubt. However, we do not see how this can justify rejecting a modification which, in its own right, will improve effective competition. Regulatory bodies and governments should endeavour to remove as many market distortions as possible to allow the single market to develop and deliver the benefits that are so widely acknowledged.

Question 5: Are there other relevant factors that respondents consider we should take into account?

We are disappointed that Ofgem has not considered the merits of the different implementation options. Providing adequate notice to the market of a proposed change to the charging methodology is a fundamental aspect of the Modification. If adequate notice is not provided there will inevitably be unfair windfall gains and losses for market participants which are not conducive to an effective competitive market. Any windfall losses are likely to be passed onto consumers by suppliers in some way. A sufficient notice period for any change is important to minimise uncertainty and ensure that consumers do not pay more than they need to and that they are not presented with unwelcome costs at relatively short notice.

[3] Ibid. p24

[4] https://www.gov.uk/government/speeches/securing-britains-energy-future

We continue to believe that a notice period of three full charging years (WACM1) is most appropriate for the reasons set out in our response to the most recent Code Administrator consultation[5].

We do not consider that Ofgem has placed adequate emphasis on the benefits to EU consumers[6] as a whole, which the modification should deliver. While the exact numerical benefit is uncertain, there is no doubt that some benefit will be realised due to an improvement in allocative efficiency.

Almost no consideration is given to the continuing disadvantage faced by GB generators when compared to equivalent generators in other Member States. This disadvantage results from the current treatment of BSUoS costs. This treatment is providing an undue advantage to non-GB generation which will be distorting efficient cross-border trade. Furthermore, there is no consideration of the increased disadvantage GB generators face due to the implementation of CMP202. This distortion of EU cross border trade cannot be in the interests of facilitating the European single market and consequently disadvantages end consumers

[5] Please see p49 of the Final Modification Report Volume 2 http://www.nationalgrid.com/NR/rdonlyres/3A8E8D2C-3D4A-4A3D-8666-64405F76837D/59572/CMP201DraftFMRVolume2Responses.pdf

[6] This benefit is quantified as £12m according to Table 3 on page 16 of the impact assessment.