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Dear Catherine,

Project Transmit: Further consultation on proposals 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 (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.

Our comments reflect five general areas. These are the CBA, cost reflectivity, consistency of regulatory decisions, dispatch distortion and notice of implementation. We discuss our views on these five areas below.

CBA

We consider that the updated modelling approach represents a major improvement on that presented in the previous Ofgem impact assessment. The model outputs provide a much clearer indication of the potential effect on industry costs and end consumers. Overall, the modelling indicates that there is minimal difference in the outcomes delivered under the Status Quo and WACM2 methodologies.

The modelling confirms that WACM2 is likely to increase transmission network costs, from both a transmission build and congestion management perspective, relative to the Status Quo. This conclusion appears reasonable, on the basis that the modification will lead to more favourable investment signals for intermittent generation in the north, relative to the Status Quo, in light of a reduction in TNUoS tariffs for this technology.

The modelling also indicates that Capacity Market payments are likely to increase under a WACM2 scenario. TNUoS payments form a major element of a generator's fixed costs. Given that the generators will seek to recover a proportion, or all, of their fixed costs via the Capacity Market auction, it appears a reasonable conclusion that higher capacity payments would result from introducing WACM2, particularly in the context of the Delivery Year encompassing two TNUoS charging years.

We note that these cost increases are somewhat balanced by lower low carbon generation costs incurred under WACM2. However, the analysis tends to show that, overall, there is a net consumer cost in the majority of modelling timescales and scenarios.

Ofgem highlights that it believes there are 'dynamic benefits' associated with WACM2, which are not captured by the model, but can be expected to improve the case for WACM2. It is not entirely clear what these dynamic benefits are and why these are not captured by the model. Regardless, if dynamic effects exist which are not

captured by the model, it does not appear to us that these will always improve the business case for WACM2. It seems just as likely that they could worsen the case for WACM2. As these effects are highly speculative we believe they should be excluded from consideration.

Overall, the modelling reveals that the increase in transmission and Capacity Market costs, observed under WACM2, are unlikely to be offset by savings that result from increased low carbon generation build. Ofgem considers the benefits of perceived improved cost reflectivity and 'dynamic effects' will tip the balance in favour of WACM2.

However, it is difficult to understand why the benefits of perceived enhanced cost reflectivity do not materialise in the analysis. In our view, this represents something of a gamble, particularly as it appears that the transmission cost increases associated with WACM2 have a higher probability of occurring, relative to savings brought about via the costs associated with low carbon generation. It is far from clear how reductions in the TNUoS costs associated with northern wind generators will translate into savings in CfD FiT and RO payments, particularly in the context of continued uncertainty of final allocation methods (such as competitive auctions), budget funding available under the Levy Control Framework etc.

Cost reflectivity

There has been much debate on the perceived improved cost reflectivity of WACM2 and, in particular, the merits of employing the ALF methodology. The ultimate justification for ALF as provided in the consultation document, appears to be that National Grid use it for determining future investment decisions. However, if this is the case, then we question the use of historic plant load factors (particularly for fossil fuel generation) to inform future transmission investment, when it is clear that plant load factors will be much reduced in future years due to factors including increased renewables penetration and environmental legislation.

Consistency of regulatory decisions

The Authority's decision not to implement P229 is of particular relevance to the Authority's final decision on CMP213. In the case of P229, the Authority (correctly in our opinion) considered that the large distributional impact of the proposal could not be justified in the context of the small net positive benefits that were modelled. In the case of CMP213, the distributional impacts on individual market participants are in the same region (and potentially larger), yet no modelled benefits exist to justify the distributional impacts. Therefore, we question the justification for the conclusion reached on WACM2. This inconsistency in decision making does not appear to be consistent with better regulation principles.

Dispatch distortion

The analysis undertaken by Baringa to model plant dispatch impacts of WACM2 also raises concerns. The modelling approach taken is unable to evaluate the impact of dispatch decisions on future TNUoS charges. The analysis does not capture the complexity of the ALF methodology. Specifically, the need of generators to understand whether a variation in output in a given year will produce a one-off anomaly in the ALF calculation or forms part of an upward/downward trend in load factor (thus charges). If the change represents a one-off anomaly, then the change in output will not incur an increase/decrease in future transmission costs (as these are discarded by the ALF methodology). If the variation in output does form part of a trend in ALF, then the generator must recognise this and adjust its Short Run Marginal Cost (SRMC) to account for the effect on future TNUoS charges.

The key consideration is that there is little a generator can do to determine what changes in output are relevant or not, which is the root cause of the complexity associated with the ALF methodology. This can give rise to inefficient dispatch or anomalous changes to generator SRMC calculations.

Notice of implementation

We are pleased with the approach that Ofgem has adopted with regards to the possible implementation of CMP213. We hope that the principle of providing sufficient notice to market participants will continue to apply to code modifications which are of similar significance to market participants in both the wholesale and retail markets.

Conclusion

Overall, we consider that the case for WACM2 is, at best, tenuous. In particular, the claims of enhanced cost reflectivity are weak and, in any case, cannot be justified by modelled benefits to end consumers (as these do not exist). While Ofgem consider that benefits associated with WACM2 exist outside the modelling undertaken ("dynamic benefits"), we also consider the case for these to be weak, unquantified and to have the potential to result in further costs. Moreover, the decision to implement WACM2 is inconsistent with the Authority determination on P229.

Finally, the complexity associated with WACM2, relative to the current methodology, and the negative impacts associated with this complexity (for example the potential for dispatch distortion and less predictability of future TNUoS tariffs) means that there are further disadvantages related to WACM2 that have not been adequately considered. Therefore, we consider that the Authority should not approve WACM2.

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

Yours sincerely,

By email

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