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Dear Frances,

Open letter: Charging arrangements for embedded generation

Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station in North Yorkshire. The 4,000MW station consists of six separate units, which together produce around 7-8% of UK generation. Two of these units have been converted to renewable biomass and a third unit is currently enhanced co-firing, with plans to fully convert in 2016. Drax is now a predominantly renewable generator, having completed the largest single site decarbonisation project in the EU.

We welcome Ofgem's timely review of embedded benefits and generally agree with the position outlined in the open letter. There is an urgent need to address the disproportionate increase in the value of embedded benefits and its impact on the wholesale electricity and capacity markets.

Whilst we agree that industry code processes are best placed to deliver necessary change over short timescales, we believe early action is required on a strategic, coordinated programme of reform to the enduring embedded benefit regime. We encourage Ofgem to begin this process as soon as possible, ideally via a Significant Code Review (SCR).

Demand residual tariff

We agree that TNUoS demand residual payments should be a priority for reform. There has been a rapid increase in the value of these payments over recent years, yet there is no evidence to suggest that the value of the service provided by embedded generators has increased. Rather, the change in payments is an unintended consequence of the GB generation transmission tariff, which is capped by EU regulation in order to protect competition in the wider Internal Energy Market.

Given the value of demand residual payments is forecast to almost double by 2020, we agree that the structure of embedded benefits requires reform. The demand residual payment represents the largest distortionary factor in the embedded benefit regime, at present and for the foreseeable future, artificially increasing the profitability of embedded generators regardless of their impact on the local and wider system.

Furthermore, analysis performed on behalf of the CUSC CMP264/265 workgroup has demonstrated a detrimental feedback mechanism inherent in the current charging methodology. As the volume of embedded generation capacity (negative demand) increases, the total net demand (the denominator) decreases. This feedback mechanism will continue to incentivise suboptimal generation investment, exacerbate system management requirements, and thereby increase costs to consumers.

Behind the meter generation

The open letter notes concern over a potential increase in plant connected "behind the meter" as an unintended consequence of reform, thus resulting in the same inefficient outcomes in investment. This is absolutely correct – embedded benefit reform will have failed if the problem simply shifts to another area of the connection regime.

Suppliers have very little visibility of behind the meter generation. Changes to the arrangements that create a swing to generation being located behind the meter, where cost avoidance is greater than the Triad benefit, would expose suppliers to forecasting errors, particularly at times of system stress. Managing the impacts of

this unknown quantity is likely to increase costs, not just for suppliers but also for local and wider network operators.

However, this potential consequence is likely to be manageable via further incremental change (e.g. via industry code modifications) or a wider review of the embedded charging regime (e.g. an Ofgem led SCR). As such, the issue is not by any means insurmountable and should not delay the priority work on demand residual payments.

We believe it would be constructive if Ofgem were to signal, early in the reform process, that any investor seeking to build new embedded plant, or make modifications to existing connections, does so at the risk of such loopholes being closed at a later date.

Transition

A transition period will be required to enable market participants to adapt their processes, systems and commercial arrangements. Nevertheless, the transition should aim to deliver reform in a timely manner. The approach adopted under Project Transmit – implementation to be completed one full charging year following determination – may be appropriate in this case, in effect allowing a transition of up to 24 months.

We agree with Ofgem's initial thinking that grandfathering would not be appropriate. The value of embedded benefits has increased rapidly over recent years, with early investors potentially benefiting from windfall gains as the demand residual payment increased. It would not be appropriate for this level of remuneration to be preserved and it should be readjusted to a sensible level that removes competitive distortion.

It is commonly accepted by the industry that the charging arrangements are not grandfathered. To grandfather the embedded benefit, which a prudent investor would not have expected to continue, potentially rewards inefficient investment, resulting in moral hazard.

Way forward

As noted above, we agree the industry code modification route is the most efficient process to deliver targeted, timely reform to demand residual payments. We are supportive of the existing CUSC modification scope and timeline for CMP264/265 and believe it is in line with Ofgem's priorities for reform.

However, the issue goes beyond demand residual payments and we believe a holistic, coordinated programme of reform is required. Industry participants had expected Ofgem to signal a thorough review of embedded benefits during summer 2016. We believe an early signal is required that a strategic programme of reform is planned for the enduring embedded benefit regime, in order to ensure investors are prepared for such change. We trust Ofgem will present a timetable for reform in the near future.

Please do not hesitate to contact me, should you wish to discuss any aspect of our response.

Yours sincerely,

By email

Stuart Cotten
Head of Regulation and Compliance