

Mr Dermot Nolan
Chief Executive
Ofgem
9 Millbank
London
SW1P 3GE

07 September 2016

Dear Mr. Nolan

RE: CHARGING ARRANGEMENTS FOR EMBEDDED GENERATION.

As you are aware, Stag Energy, through its subsidiary Watt Power, is a major independent developer of flexible generation, and new participant in the UK market, in line with Government policy and the objectives of the Capacity Market (CM).

We have to date secured CM contracts for ~150 MW of reserve power generation capacity. We also have 2 x 300 MW of permitted OCGT gas fired projects, that were available for the 2015 CM Auction and will be bidding again in 2016. We are looking to build on this portfolio of flexible assets up to 1,200 MW of new transmission connected gas-fired capacity and circa 200 MW of additional reserve power generation projects, all of which are dependent on securing long term capacity contracts via participation in the CM.

We are extremely concerned at the direction that Ofgem seems to be taking in seeking to curb, or eliminate immediately, the income that distribution connected generators can earn from reducing transmission grid usage. We believe this to be an ill-considered, piecemeal initiative that could seriously undermine both existing and new investment in essential flexible generation and demand side response (DSR). Such action risks eroding confidence in the investment required to ensure affordable security of supply in a world of shrinking capacity margins.

In this letter we do not recommend specific policy changes or reforms; the issues are far too complex to take any particular element in isolation at this stage.

On the contrary, we seriously question the validity of the assumptions behind what is being proposed but, even if there were any grounds for concern about the level of additional revenue available to distribution connected generators, then imposing a temporary reduction in embedded benefits in isolation is not the answer.

Embedded charging arrangements provide a benefit to overall system costs by reducing the need for investment in the high voltage transmission grid. However, this system also provides an income opportunity for many elements of the generation sector that the Government is trying to encourage, such as battery storage, combined heat and power, DSR and biogas, amongst others.

A simple curtailment, or elimination, of embedded benefits will inevitably create unintended consequences with respect to areas of the market that the Government is actively seeking to promote.

In the CUSC proposals, and Ofgem's approach, there is a fundamental assumption that there is too much embedded generation (EG) and that the combination of CM payments and Triad residual payments is depressing the CM auction price. However, no evidence has been presented to demonstrate that competing EG has forced the closure of existing network plant or crowding out new investment in network generation. Indeed, over 2.5 GW of new, grid connected, gas fired generation accepted contracts in the 2014 and 2015 CM auctions along with some 2GW of EG. While it is true that reducing or eliminating embedded benefits may result in some increase in the CM auction price, there is no guarantee that this action would ensure an auction clearing price sufficient to support further investment in new grid connected CCGT or OCGT.

Concerns have also been voiced that the level of benefit available to EG is disproportionate to the avoided cost benefit to the high voltage transmission system. There is clearly a case for further review, but principally driven by unrelated system changes, notably a) the €2.50/MWh cap on TNUoS cost recovery from generation and the split for transmission use of system costs between generation and distribution (27:73), both of which are driven by EU legislation.

Finally, Stag Energy with other developers and finance providers, has worked closely with Ministers, Ofgem, National Grid and officials in DECC and Treasury to support the development of a CM which would unlock essential new investment to meet both regular demand and peak demand. A critical component of the package of commercial parameters agreed with Government in 2013 was the need to "grandfather" the terms and conditions of the statutory CM contracts. However, in Ofgem's Open Letter and in DEFRA's parallel review of the potential harmful effects of pollution relating to diesel generators, it is implied that changes to permitting regulations and/or more importantly embedded benefits, would be applied retrospectively and impact negatively on developers with existing CM contracts, as well as developers bidding into the next CM auction in December 2016.

In short, EG developers could be faced with both a revenue reduction (i.e. removal of Triad payments) and cost increase (retro-fitting pollution abatement technology). Such a move would further damage investor confidence in the energy sector which is already suffering from a lack of clear policy direction and the plethora of consultations on issues such as EG.

The question of charging arrangements for EG is an extremely complex one, with numerous implications that cuts across all sectors of generation, storage and DSR. A quick decision to make substantial changes risks creating new problems that will again need to be addressed by short term, often inappropriate, fixes.

We strongly recommend that Ofgem re-considers its decision not to launch a Significant Code Review (SCR). And, that based on evidence to date it rules against the current CUSC modifications and institutes a longer term review, which would address the wider issues associated with network and EG and more importantly allows all stakeholders to participate in the debate and not only those with representation on the CUSC Panel. We would welcome an opportunity to discuss our arguments in person.

Yours faithfully

A handwritten signature in black ink, appearing to be "G. Grant", written over a large, loopy circular flourish.

George Grant
Managing Director