

# Melton Renewable Energy UK PLC

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Ofgem  
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FAO: Andrew Self, Head of Electricity Network Charging

5<sup>th</sup> April 2017

Dear Sir

## **Response to Ofgem's Minded to Decision (on CMP264 & CMP265) and draft impact assessment**

### **Background**

Melton Renewable Energy UK PLC is the group holding company of Energy Power Resources Limited ("EPRL") and CLP Envirogas Limited ("CLP"). EPRL owns and operates five dedicated biomass power stations, using a range of fuels and technologies with a total installed capacity of c113MW. Each power station is a sub-100MW embedded generator connected to the local distribution network. CLP generates electricity from landfill gas, operating from 24 sites across the UK with a total installed capacity of over 60MW, again connected to the local distribution network.

Whilst we understand the need to reform electricity transmission charging arrangements, we do not believe that the measures proposed are fair, proportionate or supported fully by evidence. Further, we believe, based upon the consultation document, impact assessment, LCP Frontier model, associated report and workshop held on 21<sup>st</sup> March that the focus to date has been solely on reciprocating engines, and that very limited consideration has been given to operations such as ours.

EPRL and CLP do not chase triad hours, we are baseload generators that aim to operate at high availability all year round. Our focus has always been generation at the highest safe load around the winter peaks. Our assets represent long term investments in capital intensive projects which in parallel require long term biomass fuel supply contracts. In this regard, the projects have significant fixed costs and largely stable variable costs per MWh, with revenue streams currently comprising electricity brown price revenue, ROCs and triads. We are unable to change our fixed costs or variable costs per MWh and any change to revenue directly impacts business profitability.

Whilst we accept that there may be a need for reform, the proposed lack of grandfathering will directly discriminate against existing generators such as ourselves who face a 90% reduction in triad revenue and potentially lower electricity prices. By Ofgem's own admission, future Capacity Market payments will increase as result of this change as will CfD payments for both current and future renewable projects if electricity prices fall as you forecast over the longer term. In this respect these changes are inequitable in that they are essentially penalising one distinct category of assets and in so doing are favouring other potentially competing assets.

In relation to fuel supply contracts not yet entered into, the proposed changes will adversely impact our ability to compete for such fuel with other generators which are party to existing or future CfD contracts; such other generators being either partially or wholly protected from these proposed

changes. We do not consider this to be just or equitable. Further, a number of our long term fuel contracts extending to 2027 were entered into on the assumption that triad revenue would remain available at similar levels throughout the contract term, an assumption that is now substantially flawed<sup>1</sup>.

### LCP Frontier Supplementary Model and Report<sup>2</sup>

We turn now to the LCP Frontier model and associated report and the claimed £7.2bn consumer cost saving upon which Ofgem seeks to place reliance in arriving at its minded to decision.

Importantly both the model and the report are heavily caveated by LCP and Frontier. During the presentation made in the workshop held on 21<sup>st</sup> March it was expressly stated that the final regulatory decision should be based on principles, not on whether or not a particular outcome is thought likely to be achieved. Despite this, in its minded to decision at least, Ofgem appears to be doing exactly the opposite.

One of the most obvious limitations of the model is its failure to address the impact on transmission system costs arising from the forecast 7.7GWh (9%) increase in transmission system installed capacity under scenario 3. The predicted increase in transmission system installed capacity is highly likely to lead to incremental system costs with limited cost savings from the local distribution systems as the latter will be less efficiently used. (At a macro level, more embedded generation will tend to lead to more efficient and cost effective use of both the transmission system and local distribution networks.) The efficient use of the distribution network has not been modelled and is not mentioned in the analysis or the decision criteria. Any increase in transmission system costs will ultimately be borne by the consumer.

Notwithstanding the limitations of the model referred to above, option B (grandfathering existing build, defined as those plant built by 1<sup>st</sup> July 2017 at £45.33/kW plus RPI) delivers significant savings (£4.8bn), without impacting investor confidence or discriminating against a specific class of projects.

The delta between scenario 3 with phasing and option B (£2.4bn) represents the assumed incremental saving from not grandfathering existing projects. However, we believe that the LCP Frontier model is overestimating the consumer cost savings delivered by not grandfathering.

We contend that the assumed status quo costs (**amounting to some £9.5bn of triad payments**) against which savings are measured have been overstated in respect of current sub-100MW embedded generators, as the analysis appears to assume that these operators will continue to generate until 2034, there being no evidence of any decline in installed capacity year on year. This fails to reflect the reality that some technologies will see a natural decline (e.g. landfill gas), some will reach the end of their economic life as ROC entitlement ends from 2027 onwards (e.g. biomass and wind), some will become uneconomic over time due to recent revenue reductions (LEC and ROC Recycle) and some assets will reach the end of their technical life.

Whilst it is not entirely clear, it appears from the model that approximately one-third of 2034 triad avoidance payments are to current embedded generators. Applying a 5% annual reduction in generation from existing projects from 2018 and a 50% reduction in 2027 to reflect the decline in

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<sup>1</sup> It is unrealistic for Ofgem to believe that we would operate on short term fuel contracts (due to financing requirements) and equally unrealistic to assume that we can revise our business model over a three year timescale. Neither of these is possible, and as such any assumptions made to the contrary cannot be supported by the available evidence.

<sup>2</sup> LCP and Frontier Economics' Transmission Charging Arrangements for Embedded Generation Report dated March 2017.



installed capacity referred to above, the actual cost of grandfathering existing entitlement may be around £1.2bn, one half of that which has been assumed in the analysis. Additionally, the projected consumer cost of grandfathering will be further reduced by the accelerated closure of sub-100MW embedded projects arising from the impact of lower revenues under scenario 3.

Taking all of this into consideration, we estimate that the lower cost savings of grandfathering may be in the region of £1bn over the 14 year forecast period, or £70m per annum.

### Market Distortion

The consultation document claims to have as its focus a concern about market distortion, however this argument does not bear scrutiny, the unarguable fact being that one of our small landfill gas sites or biomass power stations could no more connect to the transmission system than a 2GW thermal plant could connect to the local distribution system. Neither one is technically feasible. We do not believe there to be any such distortion, but rather an active competitive market with generators of differing scale, with varying fuels operating different sized projects in different locations.

Further, it should be noted that the original RO banding review had diversity of technology at its heart, acknowledging that a one size fits all approach was not desirable, favouring instead a mix of diverse renewable technologies. That approach appears to have been lost in this review of transmission charging arrangements, which review appears to conclude that bigger is better, albeit using forecast efficiencies and costs that are open to question (and were disputed at the workshop).

The proposed changes will in fact create their own distortion, by penalising existing RO generators in favour of future CfD projects. As noted in paragraph 4.12 of the LCP Frontier report *"....as more efficient CCGT are able to clear through the CM, consumers benefit as wholesale prices are depressed. This represents a saving to consumers. This will be partially offset by an increase in CfD costs, where strike prices for new CfD plant will increase to account for lost triad and wholesale revenue."* So existing RO plant will not receive the Triad benefit and will face lower wholesale electricity prices, but future CfDs will factor this in to compensate new projects.

This statement is reinforced further in paragraph 5.3 *"....CM payments and wholesale cost savings roughly cancel each other out. This makes intuitive sense, as CM payments should broadly speaking represent the missing money required by the units to deliver, which will be increased as wholesale prices decrease (and thus wholesale cost savings to consumers increase)."*

The natural conclusion is that new entrants (CfD and Capacity Market) will not be impacted by this change but existing projects will be. These inequalities could and should easily be addressed by the provision of grandfathering, which as set out above would have a relatively marginal impact on the annual consumer cost savings modelled.

### CMP264 and CMP265

In terms of process, CMP264 as originally drafted did not recommend changes for existing smaller embedded generators. Further, none of the WACMs associated with CMP264 extended its scope to existing generators. CMP265 proposed the exclusion of Capacity Market generators from Triad avoidance payments. It did not propose any changes to existing embedded generation not party to Capacity Market contracts. Such generators include RO accredited renewable projects, such as ours, which are specifically excluded from the Capacity Market.

It is the Workgroup Alternative CUSC Modifications which proposed no grandfathering and have managed to include existing embedded generators, including not only those which are not in the Capacity Market but also those which are specifically prohibited from participating in it.

We are at a loss to understand how these two original proposals have morphed into Ofgem's minded to decision, one that impacts all embedded generators and without any grandfathering of entitlement. This is particularly the case given (i) the lack of rigour that has been applied in estimating the savings purportedly arising from the minded to decision, and (ii) the express recommendation made by LCP and Frontier, that the final regulatory decision should be based on principles, not on whether or not a particular outcome is thought likely to be achieved.

### **Capacity Market**

In our opinion, the reason the first Capacity Market auction failed to attract any larger CCGT generators (and as a result is perceived as a failure by some) was not because of Triads, but because the overall revenue, cost and risk/reward balance did not work. It did however attract a number of small diesel engines as an unintended consequence. We believe that this is the market distortion to which the original consultation referred.

If Ofgem wishes to remove embedded benefits from diesel generators, it should make that case. It should not, however, propose a sweeping and unjustified reform by removing Triad revenue from all eligible embedded generators, the vast majority of which have made significant investment in long term projects, and which rely on this valuable income stream and are not operating diesel engines.

The proposed change does not address the failure of the Capacity Market, it merely makes the overall market more uncertain and therefore less attractive for all generators. To put this another way, we question whether the optimal approach to increasing the investment outlook for over 100MW embedded generators and those connected to the transmission system (paragraph 4.81) is by applying retrospective changes to the historical revenue streams of other embedded generators. This would simply make the outlook more uncertain (and therefore worse) for all investor groups, irrespective of the size of the project.

### **Impact on Embedded Generators**

Section 5 of the minded to decision considers the impact of the proposed change. It states that *"it is unlikely that embedded benefits revenues were a primary business driver for such plant. We do not expect the revenue impact on them to be as significant [as for some thermal generators], with these payments forming a much lower proportion of income"*.

In response we comments as follows. Firstly, this statement directly conflicts with your allegation of distortion. If such revenues were not a driver for embedded generation, and their impact on revenue is not significant, how can they be a distortion to the market and how can the lack of them be the reason that larger more efficient plant did not take part in the Capacity Market?

Secondly, this income is significant to embedded generators, and could account for as much as 15% of profit. This to be viewed against the background of the removal of LEC entitlement from August 2015, and low recycle ROC values and low wholesale electricity prices for RO accredited generators.

We believe that Ofgem has significantly under-estimated the financial implications of these changes for individual operators whilst at the same time over-estimating their ability to accommodate these changes.



A significant proportion of the embedded operators that would be impacted by this proposal, if implemented, are renewable generators such as ourselves, accredited under the Renewables Obligation regime<sup>3</sup>. We were actively involved with DECC between 2008 and 2012 as the ROC banding and grand-fathering changes came into effect. The banding of renewable technologies that resulted was ostensibly based upon the relative build and operating costs, revenue, risks and rewards (and recognised the benefits of a diverse generation portfolio). On this basis it was assessed that our businesses were adequately rewarded and supported, given the risks and cost base, and those assessments assumed that the Triad regime would continue.

However, as touched on above, wholesale electricity prices are generally lower now than they were in the 2008 to 2012 period and certainly lower than assumed, whilst nominal operating costs have remained reasonably flat with upward pressure on biomass fuel costs (for example due to the demand stimulated by ROC banding). Subsequent to these reviews the renewables industry has further suffered through the removal of LEC income from August 2015 and the effective removal of ROC recycle income through the erroneous forecasting of the annual RO target by DECC. To keep the mathematics simple, our business has lost around £5 million of revenue and profit per annum from each of the above issues. The proposed loss of Triad revenue represents a further £5m reduction in annual revenue and profit for our business, and one which we cannot afford.

This latest proposal certainly calls into question the viability of our power station in Westfield, Scotland, which has not made a profit or generated positive cash-flow since April 2015 as a result of the decline in wholesale electricity prices, removal of LEC entitlement and reduction in ROC recycle value. The closure of Westfield power station would result in the loss of around 25 mainly skilled jobs and potentially the landfilling of around 100,000 tonnes per annum of poultry litter, the costs of which would have untold consequences for the poultry industry in Scotland.

In addition, the current proposal, if implemented, will certainly result in the earlier closure of some of our landfill gas generation sites which will need to revert to flaring gas.

We accept that, viewed in isolation, these impacts may not appear significant to Ofgem. However, they are just two examples within an industry sector the future of which will be significantly threatened if the proposed changes take effect.

### Conclusion

Whilst as noted above we understand and accept the need to reform electricity transmission charging arrangements, we do not believe that the measures proposed are fair, proportionate or supported fully by evidence. We believe that there is justification under scenario 3 to grandfather the entitlement of existing generators (option B) at £45.33/kW plus RPI. This delivers significant forecast savings (£4.8bn), without impacting investor confidence or penalising a specific group of projects. Further, the projected consumer cost of grandfathering we estimate to be around £1bn, less than half of Ofgem's estimate.

Yours faithfully



Eddie Wilkinson  
CEO

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<sup>3</sup> We note that the embedded generation types (Figure 2) does not specifically reference dedicated biomass and landfill gas – both important renewable technologies.