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Dear Sirs,

**Re: Consultation on market coupling and Levy Exemption Certificates and call for evidence on wider impacts**

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 the units are fully converted to run on biomass. Haven Power Limited (“Haven”) is an electricity retailer and a subsidiary of Drax. Haven supplies small and medium (SME) sized business customers and larger Industrial and Commercial (I&C) customers. This response represents the views of both Drax and Haven.

Whilst EU policy is moving towards the creation of a Single European Market for energy, it should be recognised that the CCL, in respect of which LECs are issued, is a UK-specific tax regime. The CCL was designed on the premise of a LEC market, which forms a price signal incentivising:

- GB consumers to contract for the supply of renewable electricity and so demand for renewable generation increases; and
- generators to deliver renewable generation, thereby stimulating investment in new renewable generation over conventional generation.

As a result, LECs now form an important part of the investment case for independent renewable generation in GB. The value of a LEC has been explicitly recognised as a source of income for renewable generation (e.g. during the formation of CfD strike prices) that has been factored in by those that have made, or are considering making, GB based investments. The continued success of the scheme, and the associated incentives, are based upon a functioning LEC market.

It is understandable that there is a desire to ensure EU energy market policy and GB renewable energy incentives do not adversely interact. However, it is equally as important to ensure any change to the existing framework does not undermine the very purpose for which the CCL was introduced. To that end, it is essential that the impacts of any change are assessed holistically against the original policy intent of the CCL regime.

It is recognised that some respondents to this call for evidence will suggest that a failure to allow the recognition of LECs in respect of implicitly traded power would lead to distortions of cross-border trade and flow economics. However, this reflects a confusion of two issues. Where they are issued and accepted for CCL purposes, LECs represent an additional benefit on top of, and quite separate from, the price of power.

The outcome of this consultation has no bearing upon the ability of an overseas renewable power generator to trade power implicitly over coupled markets in competition with generators located in GB or other Member States. Power is a homogenous product, with the price differentials across EU markets being a reflection of supply and demand within those markets (national or multinational) and the constraints of transmission across the EU. In contrast, overseas LECs can be used for different purposes to GB LECs (e.g. to offset ss-FiT and, in future, CfD liabilities), therefore LECs have different values to GB suppliers depending on their origin; in other words, there is some product heterogeneity associated with LECs.

Drax supports the development of coupled markets. However, current Ofgem/HMRC rules do not cater for implicit interconnector flows and so far as we are aware there is no credible evidence that the current policy approach is distorting the international power market. In considering any suggestions of trade distortion, we would encourage Ofgem to be alive to the need to compare “apples with apples” and not to accept bold assertions that negative consequences will flow that are unsupported by credible reasons/evidence.

LECs are instruments that aim to evidence the consumption of renewable energy by GB suppliers, in order to demonstrate an exemption of liabilities under the CCL. They should not be issued if delivery to GB (and therefore GB consumption) cannot be adequately evidenced. On this basis, there are three main reasons why overseas LECs should only be issued in respect of explicitly traded electricity:

1. to ensure that the link between the UK taxpayer subsidy and the displacement of conventional generation in favour of new, renewable generation in GB is retained, such that the UK is able to meet its renewable energy targets;
2. to ensure that existing renewable generators in GB, who have made investment decisions based on current market arrangements, are not adversely affected by changes in UK LEC values caused by an increase in the supply of overseas LECs; and
3. to ensure that small independent suppliers can compete effectively with their larger multinational competitors.

It is a fundamental principle of the CCL rules that a LEC should not be issued in circumstances where it is not clear to Ofgem that the power has been, or is to be, consumed in GB. In respect of implicit interconnector capacity allocation, there is no clear and simple way for Ofgem to distinguish between those LECs whose associated renewable power flow was consumed in GB and those where that was not the case.

Based on the above, it is our firm belief that any case for change should be evidence based, subject to an impact assessment and considered in the context of both EU policy on market coupling and GB policy on renewable investment.

Annex 1 contains a detailed response to the specific questions raised as part of the call for evidence. Should you have any questions or wish to discuss this response, please feel free to contact me (email: [stuart.cotten@drax.com](mailto:stuart.cotten@drax.com); telephone: 01757 612 751).

Yours sincerely,

Submitted by email

Stuart Cotten  
Market Development and Compliance Manager  
Regulation and Policy

## **Annex 1: Response to the consultation questions**

### Part A: Consultation on market coupling and Levy Exemption Certificates

*Question 1: Where renewable electricity is traded implicitly across coupled markets, is it possible to evidence the electricity is consumed (or to be consumed) in the UK? Please explain your answer.*

On an implicitly traded market, it is not clear how market participants will demonstrate where the electricity is consumed. Under the market coupling regime, trades are matched across markets and any volume delivered via the interconnectors is a net flow. It is possible for a gross import to GB to be less than the gross export to the adjoining market during a given settlement period, meaning there is no net physical delivery of power to GB, i.e. a net export occurs.

Evidencing the delivery of power to GB over a specific period is difficult without explicitly booking and nominating interconnector capacity. The CCL is a GB tax and LECs are, in effect, used to demonstrate exemption from CCL liabilities. The evidence provided by a supplier to claim an exemption (i.e. the demonstration of renewable energy flows over an interconnector and consumption in GB) must be clear and auditable.

If LECs were to be attributed to implicit power flows, then Ofgem must be certain that the audit process does not conflict with other EU regulation. For example, where flows are evidenced by the “matching” of related trades on one or more market-coupled exchanges (i.e. to evidence a link between generation and supply), Ofgem must be comfortable that the process does not contravene the provisions of the Regulation on Wholesale Energy Market Integrity and Transparency (1227/2011) (“**REMIT**”) or else inadvertently skew published power indices which may be relied on by other market participants.

*Question 2: What evidence might generators use to demonstrate that an overseas LEC represents electricity that is, or is to be, consumed in the UK when that electricity has been traded implicitly across coupled markets?*

Evidence of generation along with the booking and nominating of explicit interconnector capacity rights. In situations where there is net zero or negative flow across the interconnector, but there is evidence of generating together with the booking and nomination of explicit capacity over the interconnector, then the supplier can evidence the delivery of energy to GB.

*Question 3: Are stakeholders aware of any reasons for limiting the issue of overseas LECs to electricity that has been or is to be explicitly traded? Please explain your answer.*

LECs are instruments that aim to evidence generation and GB consumption of renewable energy to demonstrate an exemption from the CCL. They should not be issued if delivery to GB (and therefore GB consumption) cannot be adequately evidenced. There are three main reasons why overseas LECs should only be issued in respect of explicitly traded electricity:

1. to ensure that the link between the UK taxpayer subsidy and the displacement of conventional generation in favour of new, renewable generation in GB is retained, such that the UK is able to meet its renewable energy targets (see Section A below);
2. to ensure that existing renewable generators in GB, who have made investment decisions based on current market arrangements, are not adversely affected by changes in GB LEC values caused by an increase in the supply of overseas LECs (see Section B below); and
3. to ensure that small independent suppliers can compete effectively with their larger multinational competitors (see Section C below).

Our other general comments are set out at Section D below.

It is a fundamental principle of the CCL rules that a LEC should not be issued in circumstances where it is not clear to Ofgem that the power, in respect of which the LEC was issued, has been or is to be consumed in GB. Issuing LECs in respect of implicit power flows has the potential to result in more LECs being issued than net interconnector flows and, potentially, more LECs being issued than would be the case had all the interconnectors been importing to GB at their full capacity for the duration of the generation month in question. In such a scenario there is no clear and simple way for Ofgem to distinguish between those LECs whose associated renewable power flow was consumed in GB and those where that was not the case.

*Section A – Ensuring that the link between the UK taxpayer subsidy and the displacement of conventional generation in favour of new, renewable generation in the UK is retained*

Whilst EU policy is moving towards the creation of a Single European Market for energy, it should be recognised that the CCL, in respect of which LECs are issued, is a UK-specific tax regime. The CCL is levied on the consumption of non-renewable energy by GB business customers, collected and administered through GB electricity suppliers. The levy is offset by the acquisition and submission of LECs, which are issued in respect of renewable generation that is to be consumed in GB and which are indirectly paid for by the consumer in question. This creates an associated value for LECs under which:

- GB consumers are encouraged to contract for the supply of renewable electricity and so demand for renewable generation increases;
- generators receive an incentive to deliver renewable generation, thereby stimulating investment in new renewable generation over conventional generation; and
- HM Revenue & Customs (“**HMRC**”) receives tax income to the extent that the demand for LECs outstrips supply.

The success of the scheme, and the associated incentives, are based upon a functioning LEC market.

The introduction of market coupling has arisen as a result of the move towards a Single European Market for energy. It is understandable that there is a desire to realign the LEC market with the concept of market coupling. However, this desire risks undermining the very purpose for which the CCL was introduced. The impacts of the proposal must be considered in the context of EU policy on market coupling and GB policy on renewable investment, i.e. considered holistically. The proposal should not be implemented without simultaneously addressing the wider impacts, e.g. the detrimental impact on GB renewable investment signals.

In recognising the above, Ofgem should also be aware that a LEC issued to renewable generation from the Continent, together with its associated Guarantee of Origin (GoO) for a Continental LEC, may also be used to reduce a GB supplier’s liability under the small-scale Feed-in-Tariff (ss-FiT) and, going forward, the large scale CfD regime. As such, an overseas LEC is financially more valuable to a GB supplier than a LEC that originates from a GB renewable generator (GB LEC). An increase in the supply of overseas LECs would therefore likely depress the value of GB LECs.

The net effect of a reduction in GB LEC values is at least threefold:

1. the financial returns available to developers of new-build renewable generation in GB are reduced in comparison to other EU member states, thereby risking a decrease in the level of investment in GB (see also Section B below);
2. the indirect subsidy paid for by the GB consumers under the CCL regime (i.e. by paying their supplier for the acquisition of LECs) will effectively be subsidising investment in renewable generation in other Member States, contrary to the policy intent of the CCL; and
3. the increase in the availability of LECs will mean reduced tax revenues for HMRC.

Successive case law of the European Court of Justice has upheld the right of individual Member States to develop their own rules when it comes to extending (or limiting) support to renewable energy generators outside of their own territory<sup>1</sup>. As a result, unless and until a fully harmonised renewable energy support mechanism exists across the EU, Ofgem is entitled to impose such conditions as it sees fit to the recognition of overseas LECs and is not *bound* to accept such LECs without limit.

*Section B - ensuring that existing GB renewable generators who have made investment decisions based on the current regime are not adversely affected*

Any change to the supply/demand balance of LECs as a result of the issuance of LECs based on implicit electricity flows (as set out in Section A above) would also have a detrimental effect on renewable generation in development. The value of a LEC has been explicitly recognised as a source of income for renewable generation to be factored in by those considering making GB based investments when assessing changes to RO bandings and setting CfD strike prices. Measures that lead to an unexpected erosion of value would undermine the previous analytical basis for setting incentive levels by producing a significant adverse effect to rates of return.

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<sup>1</sup> See, for example, the cases of *Alands Vindkraft AB v Energimyndigheten* (C-573/12) of 1 July 2014 and *Essent Belgium NV v Vlaamse* (C-204/12 to C-208/12) of 11 September 2014.

The CCL was introduced to encourage the uptake of renewable energy consumption and investment in renewable generation in GB. There are multiple incentive effects associated with the LEC market and, in turn, multiple impacts to changing the way in which LECs are used. It is critically important that the impacts of any change are assessed holistically against the original policy intent of the regime.

### Section C - ensure that small independent suppliers can compete effectively with their larger multinational competitors

As detailed in Section A above, the use of overseas LECs to reduce a suppliers' liability under the ss-FiT (and the CfD regime, going forward) means that the overseas LEC is inherently more valuable than its GB equivalent. These ancillary benefits may either be passed through to the customer (i.e. reducing bills) or else retained by the supplier, resulting in an increased profit margin. The latter impact is of particular concern in the residential market, where the CMA has uncovered evidence that the Big Six has unilateral market power over their 'sticky' customers.

In theory, all GB electricity suppliers have equal access to the market. However, larger multinational suppliers have greater credit, reputation, purchasing power, resources and knowledge of overseas renewables markets than small suppliers. This enables large suppliers not just to dominate the market for overseas LECs, but to then use the benefits obtained from the overseas LECs to price more competitively in tenders to GB electricity customers, thereby entrenching their strong position in the GB I&C and SME markets.

In total, there were 6.7m overseas LECs presented in 2013/14 and we expect the figure to increase over 2014/15. Should the volume of overseas LECs substantially increase, it is likely that a very small group of smaller suppliers, who cannot readily access such LECs, would be exposed to the entire cost of the ss-FiT.

A failure to prescribe limits for the number of overseas LECs which may be issued in respect of implicitly traded electricity flows may increase the appetite for those overseas LECs to the detriment of GB LECs and so exacerbate the problem still further.

### Section D – General Comments

It may be suggested by some respondents to this consultation that a failure to allow the recognition of LECs in respect of implicitly traded power would lead to distortions of cross-border trade and flow economics. However, this reflects a confusion of two issues. Where they are issued and accepted for CCL purposes, LECs represent an additional benefit on top of, and quite separate from, the price of power.

The outcome of this consultation has no bearing upon the ability of an overseas renewable power generator to trade *power* implicitly over coupled markets in competition with generators located in other Member States. Power is a homogenous product, with the price differentials across EU markets being a reflection of supply and demand within those markets (national or multinational) and the constraints of transmission across the EU. In contrast, overseas LECs can be used for different purposes to GB LECs (e.g. to offset ss-FiT and CfD liabilities), therefore LECs have different values to GB suppliers depending on their origin; there is some product heterogeneity associated with LECs.

Drax supports the development of coupled markets. However, current Ofgem/HMRC rules do not cater for implicit interconnector flows and so far as we are aware there is no credible evidence that the current policy approach is distorting the international power market. In considering any suggestions of trade distortion, we would encourage Ofgem to be alive to the need to compare "apples with apples" and not to accept bold assertions that negative consequences will flow that are unsupported by credible reasons/evidence.

We consider that it is too early for Ofgem to take any formal decision on the acceptance of implicit power flows for LEC purposes. Any relaxation of the current regime to accommodate implicit flows will require reporting mechanisms that are robust and transparent. We do not consider that such robust mechanisms currently exist, nor have we seen any coherent proposals for such mechanisms to date. In addition, there are no specific proposals in this Ofgem consultation for respondents to consider. If any credible proposals that do not undermine the objectives of the CCL scheme are put forward by other respondents to this consultation, then they should be shared for comment with all stakeholders in a further more detailed and focussed consultation.

Given the significant potential impacts on LEC values for existing generators, the investment signal the CCL regime sends to future renewable power investors, and the wider connected impacts (for example on the costs of the ss-FiT scheme), we consider that a detailed economic Impact Assessment will be required on such proposals. The Impact Assessment should consider at least (i) the effect of the proposals on the development



of new renewable generation in GB; (ii) the extent to which the proposal has the potential to distort the market to the detriment of small suppliers; and (iii) a full HMRC assessment on the impact of the proposals on UK tax intake.

#### Part B: Call for evidence on the use of LECs in renewable electricity schemes and on wider impacts

*Question 4: Are stakeholders aware of alternative ways of demonstrating proof of GB supply of overseas electricity that do not involve LECs, and, if so, what are they?*

No current certificate scheme demonstrates power flows across interconnectors. Generating power, holding explicit interconnector capacity rights and nominating the use of those capacity rights is the only robust means of demonstrating delivery. GoOs currently provide proof of generating renewable power within the EU, but without a demonstrable power flow (e.g. the holding of explicit capacity rights) there is no proof of delivery to GB.

*Question 5: Do stakeholders currently acquire LECs purely for non-CCL purposes?*

We believe LECs may be used to support exemption claims for other schemes (e.g. ss-FIT). If LECs are being used for other purposes, then it is important that the impacts to both the LEC market and wider indirectly affected regimes are both considered.

*Question 6: What do stakeholders foresee as potential impacts if:*

*6.1 Overseas renewable electricity can be demonstrated as consumed (or to be consumed) in the UK where it has been implicitly traded, and LECs are issued for this accordingly?*

As noted above, the CCL is used to incentivise renewable power consumption by end consumers (i.e. a reduction in tax liability) and incentivise investment in GB renewable generation (i.e. the value of the LEC). LECs form an important part of the investment case for independent renewable generators in GB. This will be negatively impacted by an increase in supply from the Continent with no corresponding increase in demand via reciprocal arrangements in other Member States.

Forward market forecasts, based upon current market arrangements, indicate that an increased import of overseas LECs will have a negative effect on the value of LECs. By linking LECs to implicit interconnector flows with no firm evidence of delivery, the trend towards zero priced LECs will be accelerated, bringing into question the appropriateness of the CCL as an investment signal and undermining the legitimate expectations of existing renewable generators and those under development. As such, the issuing of LECs on an implicit flow basis should not be implemented without simultaneously addressing the detrimental impact on GB renewable investment signals.

If overseas renewable electricity subject to implicit power flows was deemed to be capable of being consumed (or to be consumed) in GB, then it is important that the procedures for audit are robust. For example, where flows are evidenced by the “matching” of related trades on one or more market-coupled exchanges (i.e. to evidence a link between generation and supply), Ofgem must be satisfied that the process does not contravene the provisions of REMIT or else inadvertently skew published power indices which may be relied on by other market participants.

*6.2 Overseas renewable electricity was only accepted as consumed (or to be consumed) in the UK (and LECs issued accordingly) where there is explicit booking and nomination of interconnector capacity? It would be helpful to have responses to this question cover what the impacts would be on:*

- *The electricity markets (volume, price, distributional issues)*
- *CCL and UK Renewable Electricity schemes, including FMD, FIT, CFD, and SLC 21D*

Retaining a link to the explicit booking and nomination of interconnector capacity is consistent with the policy intention of linking CCL exemption with the delivery of energy. Adopting a mechanism that requires evidence of the booking and nomination of interconnector capacity will reduce the risk of distortion to the LEC market. This will have a positive impact on renewable energy schemes, by preserving the policy intent behind the CCL and maintaining the LEC market incentive to invest in renewable generation.