Alkane
GAS TO POWER

23 September 2016

Frances Warburton
Partner, Energy Systems
Ofgem
9 Millbank
London
SW1P 3GE

Dear Mr Nolan

Charging Arrangements for Embedded Generation

Alkane Energy owns and operates ~150MW of Embedded Generation (EG) at 26 operational sites in the UK. These include sites running baseload which utilise Coal Mine Methane from redundant mines, as well as natural gas fired peaking power sites providing system support services to National Grid.

In response to the introduction of the Capacity Market (CM), Alkane has been proactive in developing other sites to provide fast response, flexible, relatively high efficiency peak gas fired generation to support the market at times of system stress. Alkane has 49MW contracted in the 2014 auction and 30MW contracted from the 2015 auction, with a further 92MW of potential new build seeking prequalification for the 2016 auction.

In Autumn 2015 Alkane Energy plc was delisted from AIM following the purchase of its shares by Basalt Infrastructure Partners. As an investment manager Basalt were attracted by what was seen by them as a stable regulatory environment offering acceptable and reliable risk adjusted returns over the long term. Specifically, Basalt had noted the informal consultation undertaken by National Grid in 2013/4 and the outcome that confirmed net charging demand from the transmission system via the Triad remained an appropriate charging basis.

This investor confidence has been completely undermined by the current process considering changes to the CUSC via CMP264 and CMP265, and Ofgem's letter on EG.

We would like to reinforce the comments made in the letter sent to you on 19th August 2016, by WWA, which we were happy to countersign in support. We agree that the current forecast trajectory of Triad embedded benefits is unsustainable and unjustifiable in terms of cost reflectivity, but note this results from a cost recovery mechanism that was approved by Ofgem after years of consideration.

We see the increase in Triad is being driven primarily by a 40% increase in transmission cost recovery over the next five-year time horizon as a consequence of government policy subsidising the development and construction of more remote renewable power generation, primarily intermittent wind generation onshore in Scotland as well as offshore.

ALKANE ENERGY LIMITED
Edwinstowe House, High Street, Edwinstowe, Nottinghamshire NG21 9PR
T: +44(0)1623 827927 F:+44(0)1623 827930 E: info@alkane.co.uk W: www.alkane.co.uk
Registered in England No. 2966946. Registered office: Edwinstowe House, High Street, Edwinstowe, Nottinghamshire NG21 9PR

EG like ours is ideally placed to complement this Government policy. Our fast response gas fired plant provides reliable capacity for short durations when the wind does not blow at a cheaper capital cost than a large CCGT, and so is ideally suitable to the operating regime required of backup capacity in a system with increasing need for it.

We believe therefore that a continuation of Triad benefit at around its current level is justified, as it maintains the charging regime that supported the investment case made by companies like us when participating in and obtaining long term obligations in the 2014 and 2015 CM. Our participation together with other EG brought significant benefits to consumers through reduced prices in the capacity market auctions, low cost supply security and peak power delivery.

We believe Ofgem's analysis over the Triad cost is done in isolation of other benefits to consumers and so is too narrowly defined. Absent other necessary change, we think these other consumer benefits will be lost if the Triad system is unilaterally modified and so consumers will be detrimentally affected as a result.

Indeed, we believe the current CUSC modification proposals seek designedly to directly discriminate against generation such as ours, particularly the projects that already have commitments following the 2014 and 2015 CM auctions. Bids were made into the CM in a good faith expectation that the basis of calculating Triads had been recently examined and, although not ideal, found to be broadly acceptable. Alkane is now locked into 15 year obligations with material penalties for failure. Our investors were comfortable taking the risk of changes to Triad within the context of the current methodology. What is now being proposed is a highly discriminatory retrospective change to the methodology that undermines the economic case for building the assets. CMP265 in particular holds the intermittent wind capacity harmless against Triad change: to the extent it is delivering at Triad it would get paid materially more than the firm capacity that supports it! We find this incomprehensibly discriminatory as stated in our response to the CMP264/5 consultation.

Alkane is therefore strongly supportive of an outcome that grandfathers or otherwise reasonably protects the investments and decisions made in or prior to the 2014 and 2015 CM auctions. There are precedents for this in prior regulatory changes of similar magnitude, and we see no benefit to consumers from not grandfathering existing and EG with 2014 and 2015 CM obligations. We find the UKPR analysis provided to the CMP264/5 Workgroup extremely helpful and compelling in support of this view.

However, in anticipation of a possible outcome to the current process which is highly negative for new EG including those with 2014 and 2015 CM obligations, we are now actively revisiting all our existing CM obligations to see whether the economic case for continuing at each site is sufficiently robust to a significant shift in Triad payments. If our equity and debt providers decide that the commercial and economic case cannot be made, then we will be forced to terminate.

This will lead to an outcome for the "energy trilemma" of reduced security of supply in the short term, higher cost to consumers as more expensive future capacity will need to be procured, and increased emissions from older less efficient plant that will have to be maintained on the system to help ease the supply shortfall created. We simply do not understand how this could be seen to benefit consumers.

The narrow focus on transmission charging in isolation, we believe, ignores the very real benefits consumers obtain from generation like ours. The Triad revenue has been viewed as a stable, reliable and predictable revenue stream which supports the provision of long term low cost project finance debt funding. Effectively it acts as a proxy for the lack of liquidity amongst buyers, who as a class are

not prepared to enter into longer term peak power purchases in the market. Firm prices available to EG from peak sales beyond one year if available at all come only at a significant discount to a reasonably expected outturn. The alternative of accepting long term market risk and hedging forward short term (if at all) requires an investor class prepared to take the risk of the inherent volatility this entails. Such investors form a very small proportion of the total potential funding pool, and require commensurately higher rates of return, so forcing up the cost of capital. This will inevitably pass through to consumers in the form of higher peak prices and/or shortage of peak capacity leading to security of supply issues at the peak.

Alkane is part funding independent studies that support the case in terms of a reasonable level of embedded benefit going forward, but unfortunately these have not been able to be delivered in final form within the accelerated timescales imposed by this process. As a small business we simply do not have the resources to undertake the depth of analysis ourselves that is reasonably required, and certainly not within the timescales imposed. We are frustrated and angry that the concerns over the impact of the short timescale means that many system and interrelated code issues have not been properly analysed or debated, and the fact that these concerns have been so casually dismissed by some on the Workgroup including some members of the CUSC Panel. We think that the inadequate defect definition and the rushed process is likely to lead to an outcome that is unsound and so will leave ongoing uncertainty for the market and investors, exacerbating the current situation, and leaving Ofgem open to legal challenge.

We note that EG like Alkane do not even have a representative seat on the CUSC Panel to ensure their position is represented in the discussions making recommendations to the Authority. We have written separately to Ofgem today requesting this to be addressed for considering CMP264 and CMP265, but still consider this to be a discriminatory way to address changes to the market arrangements that so materially affect us.

In conclusion, we are disturbed at the passive way Ofgem are acting on this issue, other than in the pursuit of increasingly absurdly rushed timescale. We believe that an independent and holistic approach to the quantification of the relative competitive position of EG and transmission generators is essential before tinkering with just one element of it.

Yours sincerely

Paul Jenkinson
Chief Executive Officer