Welsh Power

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Dear Sirs

DECC's Consultation on Electricity Market Reform

Introduction

1. Welsh Power Group (WPG) is a privately owned energy company with a strong track record of development, in both conventional and renewable energy. In August 2009 Welsh Power submitted an application to develop Wyre Power, an 850MW CCGT (combined cycle gas turbine) power plant near Fleetwood, Lancashire, with an investment of some £600 million. In January 2009 the Company commenced the development of a 49.9MW biomass plant at Newport Docks through its wholly-owned subsidiary Nevis Power Limited. We also own and operate an OCGT, Leven Power, on a STOR contract to NGC and are looking to invest heavily in other niche power projects over the next few years subject to the market structure being receptive.

2. Formerly, WPG owned and operated Uskmouth Power until its sale in 2009 to SSE. It also developed and financed at a cost of £3650 million, Severn Power, a new 850MW CCGT plant in South Wales, which it subsequently sold to DONG Energy AS of Denmark. WPG also started its own retail business, Haven Power, in 2007, but this has subsequently been bought by Drax Power Group Limited.

3. WPG has significant understanding of the problems experienced by small independent players trying to operate in the GB electricity market and we welcome the Government taking a look at the market. However, while understanding the Government's key driver is the push to a green economy, WPG is very disappointed that the fundamental problems of the market, which have made it dysfunctional are not being tackled head on at this time.

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Current Market Arrangements

Issues Not Addressed by Electricity Market Reform Proposals

4. WPG believes that the GB electricity market is fundamentally broken with illiquid markets, dominated by six large, integrated companies, and significant barriers to entry to each part of the market. WPG has experienced directly the problems caused by the illiquid GB power and they have directly and negatively impacted the way that our business has developed. It is extremely disappointing that the DECC document pushes resolving the problems back to Ofgem, who have been successfully ignoring the issue for years.

5. Concerns about market liquidity have been raised by traders and suppliers for years, and Ofgem's own corporate strategy in 2005 recognised that vertical integration needed further consideration. The Select Committee on Business and Enterprise in December 2008 said: "*We welcome Ofgem's decision to take action to improve liquidity in the wholesale electricity market.*" We therefore feel that Ofgem must have recognised at least 2 years ago that action was required and they should now be seen to be doing something rather than simply focusing on monitoring and reporting on what is a 'broken' market.

6. As there is now wide recognition that the market is <u>not</u> liquid, urgent action is required to fix it. DECC outlines proposals that Ofgem has put forward, but progress needs to be made. Ofgem's "wait and see" attitude is simply not going to deliver essential or timely changes to the market. Furthermore Ofgem seems to push ahead with projects that the smaller players do not value, such as a full review of transmission charging, rather than concentrate its efforts and resources on real fundamental problems such as market liquidity.

7. In terms of some of the claims made by the Big 6 about their level of trading, we would be interested to know if Ofgem has audited the trading of one or two of those companies to see who they trade with and how. We would be concerned that their "trading" is very limited and focused, in terms of volume, products and counter-parties.

8. WPG believes that Ofgem should also ask to see the financial models that justify some of the new build projects (in particular new nuclear) proposed by the Big 6, as it is impossible to see how with current prices, and no liquid forward curves, these utilities are justifying any new investment. As developers ourselves we know that the forward curves make justifying new projects impossible at this time , so is it that the Big 6 can hedge the power price risk directly into their supply business? There seems to be no other possibility!

9. Ofgem seems very focused on cash-out prices, with a proposal to undertake a significant code review in this area (see comments below). We do not believe that there is any evidence that cash-out causes any greater problem than incentivising the suppliers to be long to manage their cash-out risk. The wholesale market does not reflect the cash-out prices, nor should it and the market does not want to use cash-out as an index to trade around. There is no easy answer to cash-out calculations and compared to the lack of liquidity in the market it is a minor issue. Ofgem needs to cease tinkering with balancing and do their job and address the more fundamental, structural issues impacting the market.

10. WPG would like to see the Government or Ofgem refer the Big 6, or the sector as a whole, to the Competition Commission for a full structural review. The only way that the generators will bring more power to market is if they do not own supply business or they are not allowed to sell to any supply businesses with which they have any shared ownership. We believe a licence condition to stop generators selling directly to their supply businesses would be a quick and easy step towards changing trading requirements. WPG would propose that Ofgem brings forward draft licence changes with their remedies document quickly or the Government could implement changes with the legislation that is likely to follow this market review.

Wholesale not Retail

11. Recent statements from Ofgem about competition concerns have focused on the retail markets. WPG agrees that the position of the Big 6, with the timing of their price rises and apparent profitability[1], suggests the market is lacking in effective competition. However, the smaller independent suppliers have all stated that it is the lack of wholesale competition that creates problem for them in managing and expanding their portfolios.

12. WPG would like there to be a sectoral referral because, unlike Ofgem's recent inquiries, it could look at the market as a whole rather than parts of the market in unrelated reviews. A good example of Ofgem's muddled and disjointed approach to the market was the publication last year of their Project Discovery document[2] shortly after it published its report liquidity[3]. The former argued imbalance prices were not high enough and the latter that imbalance prices were too high for independent suppliers. If the GB market is to have effective competition we need all suppliers to get the same incentives from cash-out, but also all have open and real access to a wholesale market to manage those risks.

13. We believe that if the Government addresses the wholesale market issues then many of their market problems will be solved. Further we are worried that the Big 6 may threaten Government that they will not undertake investment in the UK if the Government does not allow them to internally hedge the risk, i.e. over charge customers as a means to keep project costs down. This is simply an inefficient way to allow the market to develop. Smaller players like WPG could build more plants if we had a competitive, liquid market to sell energy into.

Could a Market Deliver Government's Policy Goals?

14. WPG sees no reason that the basic market arrangements (code structure, etc.) could not deliver the Government's goals with a few minor changes:

    - Support for renewables needs to be set at appropriate levels under a stable support regime, with clear grandfathering of support levels. The FITs regimes proposed may help do this and WPG discusses this in more detail below.

[1] Centrica s recent profits of £1.9bn
[2] Project Discovery - Options for delivering secure and sustainable energy supplies
[3] Great Britain (GB) wholesale electricity market liquidity, summer 2010 assessment

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- Decisions need to be taken and committed to. WPG's biomass project has been delayed a number of times over different elements of regulatory risk, initially through grandfathering of ROCs, then as a result of the ERM. Investors will not take the risk of uncertainty. WPG is certain it is not the only company affected suggesting significant delayed or lost green, reliable energy.

- The building of new plant is being hampered by the lack of liquidity in the market, not by the level of imbalance prices. Changes to the planning regime may help bring plant forward, but liquid markets and lower levels of regulatory uncertainty are the key to faster delivery.

15. On balance we do not agree with the Government that the market could not deliver low carbon generation, but we believe delivery could be more efficient with some changes to the market arrangements being speedily and resolutely signalled to the market.

Options for Decarbonisation

The Objectives for Reform

16. WPG recognises that the Government's drive to low carbon electricity market does require some consideration to be given to the way the market is structured and operates. We feel that there are specific elements of the market that face new challenges with the emergence of increasing amounts of intermittent generation and new, larger, nuclear power plants. That said we are not convinced that the main problem is the structure of the rules so much as the existence of dominant players who create barriers to entry and gain commercial advantage from their integrated nature. We are extremely disappointed that structural remedies are being left with Ofgem to pursue at their leisure, particularly given their past failures.

17. The objectives of the reform should be:

    - To address the dominance of the Big 6;

    - To check that the current rules (Balancing and Settlement Code and Grid Code) will treat all plant equitably while facilitating the roll out of lower carbon generation;

    - Not to create further complexity unless it alters the incentives on players to significantly change their behaviour;

    - To put in place a stable market framework for the future where the regulator will not push for further radical change in the medium term;

    - To better define the role of Ofgem and Government in setting future energy policy; and

    - To stop yet another cash-out review until Ofgem can demonstrate there is a problem.

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Carbon Floor Price

18. WPG believes that the proposals from HMT provide a good basis for setting a carbon floor price. The issue is how to link the new "*CCL carbon price support rates*" to the price of the EUAs under the EU ETS scheme such as to achieve the desired price of carbon. We do not believe that linking the price on a daily or weekly basis is either feasible or desirable given the volatility it will add to generation costs for marginal plant. Such volatility is highly likely to feed into electricity prices as generators seek to hedge the carbon risk.

19. WPG believes that setting the new CCL rate annually, while creating some, risks over or under achieving on the target price delivers some stability. A fixed escalator may lead players to believe that the Government is highly likely to alter the costs if they can see their target value is going to be missed. It may be better to set the target rate and adjust the CCL rate annually to meet the rate. With a forward price for carbon generators should have a clearer idea of what the CCL rate will be if they know the target price.

20. As a generator we would prefer to have a rate that we know is fixed (with the known escalator). However, the political risk would appear to be less with a fixed target rather than an escalator as there would be less chance of sudden change if the rate set ended up a long way off target. If the Government goes with its proposed CCL start rate and known escalator it should commit to hold to that formula for, say, the life of the Parliament.

21. WPG has responded to the Treasury consultation, but would like DECC to note that we believe that the impact on prices that the HMT document outlines, are unjustifiably low. DECC and HMT need to be honest with customers about the level of price rises they are likely to experience as a result of the package of policies or there will be a complete breakdown of trust.

Feed-in-Tariffs

22. WPG supports the introduction of feed in tariffs (FITs) as a more efficient mechanism than the current RO regime. However, it is the level of the FITs and the complexity of the scheme that will determine if it is a mechanism that will deliver the right volume renewables in time to meet the various Government targets. To this end WPG does not support the FITs with CfD mechanism DECC proposes.

23. WPG appreciates that the economics of the FITs with CfD are attractive. We recognise they are an efficient mechanism in theory and would give good value to customers. However, for a developer the regime looks too complex, too expensive to participate in and likely to slow developments further at a time when the Government must speed them up. WPG therefore supports the development of premium FITs or fixed FITs. We therefore do not agree that FIT CfD will lower the cost of capital for renewable generators to the degree that the Government believes and the regime will create a number of problems that are discussed below in more detail.

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24. FITs with CfD will require the developer to be successful in a tender before he can start a development. Investors and lenders will simply not finance speculative work on developments, for example starting mandatory environmental surveys that take at least a year to complete, while at the same time not knowing the plant will be successful in getting support when built. One of the key benefits of the RO regime has been the knowledge that once built a scheme will get support, assuming the renewable generation criteria are fulfilled. The developer takes the risk of upfront work and power prices under the current regime. These incentives and risk allocations seem to be both correct and economic.

25. WPG also suspects that companies may tender sites where they cannot actually build plant, for example the sites lack a local connection agreement to the host DNO. Other companies may be successful in a tender, but then subsequently cannot get planning permission for the proposed new plant. When these circumstances arise, the central buyer may believe the tender has secured 200MW, but in fact only 100MW will be delivered. If the Government agrees this is an issue, the tender could look to secure say 50% more capacity that it actually wants to be built. So the Government would tender for 300MW, and it is built when the Government actually only wanted 200MW. These crude examples merely highlight the problems with civil servants (be they in DECC, Ofgem or another new body) trying to run markets, rather than setting the policy framework and leaving the market to respond.

26. We also believe that the tender process will be resource intensive, especially for small companies like ourselves. If smaller companies are excluded from the market in future then the limited amounts of competition will simply reduce further damaging the market. Experience with the STOR tender process suggests to us that these are not simple and that the players facing a monopoly feel they tender with too little information or too little understanding of how tenders are assessed.

27. WPG is further concerned that in a FIT with CfD world the agency buying the power would then have to sell the power into the market. How it sells the power will also impact the liquidity in the market, which as noted above is already significantly less liquid than a mature market should be. We are not convinced that it will be easy to find a CfD strike price that can account for changes in say fuel prices for biomass on a 20 year basis. We suspect that the strike price will need some form of mixed indices that can account for power prices and fuel prices for plant such as ours. These sorts of details are simply not covered in the EMR document, but we feel that when the Government starts to try to design the scheme the complexity of the regime will become apparent.

28. Premium FITs could work like the current RO regime. The generator can manage the power risk in a market it understands. The support will be more bankable as the finance can be raised against a support mechanism that the banks will understand and can easily model. The support can be direct to the generators, without any link to power sales and the banding can easily be maintained. The impact on the liquidity in the wholesale market should be very limited and the developers can go on building plant in a timely manner, once the new banding levels are set. WPG therefore believes that this regime will slightly lower investment risks and deliver more power into the market

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29. The fixed FITs may be more difficult as the "buyer" of the power will also have to sell that power on with many of the downsides outlined in relation to the CfD FITs. Removing any power from the wholesale market will further damage liquidity. The strike price for the fixed FIT will be bankable, but the customers will have to take on all the power price risk, which they are unlikely to have the skills or infrastructure to manage. WPG believes this regime is workable, but may offer a slightly less economic solution compared to the premium FIT regime. In terms of helping investments the fixed FIT will help developers most, but seems to create a lot of risks for the customers in terms of carrying all the power price risks.

30. Under any new regime where there is a form of central buying or contracting WPG assumes that there will have to remain an obligation on suppliers to buy this power. As already noted, we have serious concerns that a central buying model is likely to result in a distortion to the operation of the wholesale power market. The obligation on suppliers to buy renewable energy does not appear to have created any specific problems and the Government should consider straightforward obligations going forward.

31. The technology banding has been a relatively successful way to try to reward renewable generators enough to get their technologies off the ground and to build up experience on the capital and operating costs of some cutting edge technologies. However, we would note that very few biomass plants have been built compared to say wind farms, despite biomass having the significant benefit of being continuously available, reliable and flexible, rather than intermittent. What matters most to developers is the stability of the support mechanisms. The Government may want to give further consideration as to whether it is encouraging over investment in wind compared to other more productive and stable renewable energy sources.

32. There was a hiatus of investment while DECC arrived at a decision on grandfathering ROCs for some technologies last year, notably biomass, and now there is concern that the banding review will alter the RO support in 2013. So developers who waited for the grandfathering decision may now have left it too late to ensure completion of a build by April 2013, so now have to wait to see what support levels will be in 2013. While DECC has announced it will bring forward the banding review, such indecision and the apparent total lack of understanding about how business and investment in energy projects works has clearly hampered the roll out of additional capacity negatively impacting Government targets.

33. Following the announcements on the banding review hopefully later this year, the market will then move towards yet another uncertainty, that of the FIT regime. Once again developers, investors and lenders will obviously want more details on FIT levels, cut over policies, grandfathering, etc. before progressing projects. While a 2017 go-live data for FITs seems a long way off in political terms, for project developers and financiers it is a very short time compared to the life of the asset. Therefore DECC must move to provide greater certainty and detail over the longer term regime as quickly as possible or yet again Government's targets will simply not be met.

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34. WPG notes that the Government specifically asks about the impact of the various regimes on different types of players. We feel that only the premium and fixed FITs regimes are likely to allow smaller developers to go on building renewable projects. As discussed above, FITs with CfD are too difficult to bank and may be administratively complex. Given our wider concerns about the level of competition in the GB power market we do not think that the Government should risk going forward with any policy that simply shores up the controlling position of the Big 6.

35. WPG can see no reason why Ofgem should run these types of schemes. We recognise that Ofgem has ended up with the role of administrator, or delivery agent, of various policy tools such as the Renewables Obligation and existing FITs scheme. In the case of the FITs scheme we were disappointed that there was no competitive tender to select the most efficient and cost effective administrator. We believe such roles are best done by an organisation that delivers high quality IT solutions and Government could consider hiving the E-Serve function off for sale, into HMRC or another existing body. Alternatively the provision of these services should be put out to tender.

36. WPG does not believe it is credible to say the RO and the FITs will run in tandem for years. Apart from anything else, running two regimes will be expensive in terms of administration. We therefore suggest that the Government designs a cut over regime that allows the slow closure of the RO regime and puts all the renewable generators onto FITs. This need not be done with any degree of speed, but it would make the market more efficient if the renewable generators were treated in an equitable manner. It would be imperative that investors and lenders were given assurances that a movement from RO to FITs would not have a negative impact on their investment or yet again it will be impossible to get projects funded on the back of the RO regime further damaging the ability to meet targets.

Emissions Performance Standards

37. WPG believes that the introduction of an EPS of the form outlined by the EMR document will have a limited impact on the market. The second option, with lower limits, seems to suggest a plant with CCS on say 40% of the plant will then run at 40%. WPG believes that this is an unrealistic assumption and a dangerous one to use in setting any EPS limits. If a plant has an EPS then it will have to be designed to run economically at the EPS, so an EPS should be set to encourage investment in the most efficient and "clean" technology available at the time a plant is built. Part loading plant in the manner suggested would be totally uneconomic. We would therefore suggest that DECC goes with the higher limit, but is realistic that at present it is difficult to see many coal plants being built.

38. WPG welcomes the Government's recognition that the EPS must be set at the point of planning and grandfathered for the life of the plant. We do however think that the Government may want to set a limit to the size of plant it applies to just to make it easier to administer. Putting such limits on smaller plant tends to add to cost with very little benefit. WPG also agrees with the Government that there is no point in applying limits to existing coal plant as this will simply result in their early closure. Phasing them out via the EID and the carbon price seems more efficient.

39. Generally WPG does not think that the proposals will have much impact on the market going forward. It has already become clear that new coal without CCS is unacceptable and therefore none is being built and gas plants being built are all choosing the most efficient technologies available. CCS demonstration technology needs to be fully proven before new plant of any commercial size can and will be built such that the EPS could be lowered. WPG prefers the market based approach to regulation as a general rule and thinks that it should be the carbon price that makes CCS economic in the longer term. However, we appreciate the particular issue the Government is trying to address.

40. WPG does not believe that there is any point in setting an EPS and then saying if the system gets tight it will not apply. Given the only players building CCS plant are the Big 6, if the Government creates rules that allow those plants to run more when plant margins are low, the Big 6 could simply withhold other plants in their portfolios to create a margin problem and fill the gap with their own coal plant. Again this is a risk arising as a result of the lack of effective competition in the power market. It is also difficult to know what is "short-fall"? WPG agrees in an emergency all bets are off, but in a cold winter would all coal suddenly run outside its EPS if margins were at say 9%?

41. Were the Government to allow EPS coal plant to run at times of "short-fall" then it risks putting off new investment in peaking gas plant that would expect to operate at times of system stress. It will rightly be concerned that its new plant may become uneconomic if it is competing against EPS coal plant, running outside its limits and financed on the back of subsidies. The Government would have distorted the view of "plant margin" against which investors are making decisions.

Options for Market Efficiency and Security of Supply

Capacity Mechanisms

42. WPG believes that the GB market already has a mechanism for delivering new capacity in the form of the National Grid STOR contracts[4] These contracts, now they are being made for longer periods (up to 15 years), offer the market a way to encourage new build at competitive prices via an open tender process. WPG agreed with National Grid that there is a longer term requirement to increase the reserve on the system. But in terms of a supply demand balance the market should be competitive enough to respond. There is significant evidence[5] that enough capacity will be built to meet general demand levels, replacing aging plant, what seems to be missing is the reserve element in the market. We therefore agree with Government that a capacity mechanism could increase security of supply.

43. National Grid needs reserve to manage the pick-ups in demand where fast response is required, for example at lighting up time, when wind farms lose power due to the wind, or a large plant has a technical problem and drops off the system. The increasing amount of intermittent generation requires additional capacity be held in reserve to manage these real time system issues. The larger nuclear plants will also mean National Grid requires additional reserve as the new plants will be the largest plants on the system, so back-up must exist for when they trip off. These two factors are combining to require additional reserve is held by the system operator.

[4] Short Term Operating Reserve – an Ancillary Service
[5] See National Grid Transmission Entry Capacity Register

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44 WPG therefore supports the tender for targeted resource (TTR) option proposed by DECC which can operate just like STOR. We believe that any other form of reserve market creates the risk of the customers being forced to buy and pay for capacity that the market should deliver in a competitive manner. Customers at the last electricity market review in 2000 argued strongly against any mechanism that paid generators simply for being available. This was because under the Pool all generators got paid, even if the system did not need them, and it could be argued that this lead to the excess generation capacity seen at NETA go-live in 2001

45. This type of reserve capacity must be fast responding, but will only run for limited periods. The nature of the plant with low running, high wear and tear costs through peaking, and the only counter-party being National Grid, will not simply be built by the market backed by these long term contracts. Even if suppliers were required to show they had contracted for enough generation to meet their customers' demand, they would not purchase these reserve style generators' output. Suppliers buy energy chunks not energy "shape". It is only the system operator who requires such services and it is more economic that they are purchased centrally as their benefit is spread over all customers

46. If the new capacity mechanism works along the lines we have outlined, we believe that they should be providing a specific type of plant, based on longer term contracts, paid when it runs as well as for being available. As this plant is not being built by the wider market, but bought by the SO on behalf of the customers it should be dispatched in an economic manner, not as a last resort. Its interference with "energy" market is limited due to its close to real time operation. However, we acknowledge it does mean that in future "peaking plant" becomes an ancillary service rather than being operated in the way current oil plant does.

47. National Grid in trying to extend the length of STOR contracts has recognised that without these longer term agreements financing such new build will be extremely difficult. However, the development of these longer term reserve contracts needs some further work. Notably:

- National Grid must structure a long term contract that works in the context of energy markets that will change in future years, i.e. they must be flexible;

- National Grid must outline what capacity it requires for reserve purposes and where it wants stations to locate, so the tenders are more likely to deliver the capacity that the system operator wants;

- Ofgem must agree with National Gird that the prices the capacity is bought at will be passed through in the years to come, i.e. a commitment to allow cost recovery in future price control periods/incentive schemes;

- If the Government only wants capacity of a certain type (for example gas rather than fuel oil) for environmental reasons it needs to place that statutory requirement onto National Grid in a transparent manner; and

- National Grid needs to better understand the costs of this type of generation to ensure fair treatment of small providers facing a monopsony

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48. WPG is worried that the Redpoint modelling suggests that the capacity mechanism will only pay an availability payment to the plant that is successful in the tender WPG does not believe that this is a viable mechanism as the fuel price risk will be too expensive for the generator to manage. It would be possible to get a 20 year gas contract, but the premium is likely to be excessive. The peaking plant is only likely to run at times of peak power demand, which will most likely occur with peak gas demand, making the provision of gas supplies expensive for the gas supplier. Without knowing how much gas the generator may use, the supplier will also have problems hedging this risk. Overall WPG therefore believes that the mechanism would be more economic if it paid both an availability fee and an exercise fee that covers fuel costs when the generator is called.

49. WPG recognises that the Redpoint modelling, by only assuming a capacity payment is probably under estimating the costs of the capacity mechanism. We also believe, looking at the modelling document, that Redpoint's model takes no account of the impact of the EMR policies on the gas market. We believe that there are a number of reasons to believe that the EMR policy suite will increase gas costs. Firstly, by moving generators' gas demand to become peakier (as it moves up the merit order) will create system issues on the gas network, which is designed around "flat" gas off takes. Gas generator demand is also more likely to coincide with peak gas demand days so the volatility of gas prices is likely to increase as well. This may not make average prices higher, but it does seem likely to make the average gas prices faced by generators higher.

50. WPG believes that the change in the "shape" of gas demand may require increased investment in the gas networks to cope with the peaks, as well as the increased ramp rates required to meet faster response times for gas generators. These costs could be targeted at the generators, feeding into power prices, or be smeared over all gas customers pushing up all gas prices. Either way WPG is concerned that the Government is not taking full account of the impacts that the EMR document will have on the gas market, and ultimately the customers' prices. We are also concerned that Ofgem is focused on the electricity market and not on the changes that may be required in the gas market if the gas fired generators are to provide the degree of back-up that the EMR document envisages.

51. Taking account of the change in operations that the gas fired plant are expected to see, combined with the changes in the gas costs, WPG is concerned that the Redpoint model may seriously underestimate the costs of the EMR market design. If the modelling assumes that the gas fired generation meeting the generation shortfalls in the future are of a similar cost to a gas fired generator today it is underestimating the costs significantly. Not only will the fuel costs have increased, but the operation and maintenance (O&M) costs associated with a plant starting 50 times a year are radically different to a plant starting 250 times a year. WPG has no doubt that we can get an O&M contract for our Wyre Power plant that will allow this flexibility, but given the impact on the lifetime of the plant and the repairs the cost per MWh will be enormously higher than if we were to build Wyre and run it base-load.

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52. WPG has already raised with officials our concerns that the Motts work on plant economics is not comparing the running of a CCGT in the current world with the running in a world with gas as the marginal, flexible, peaking plant. DECC needs to understand that in an EMR world the cost of these marginal gas plants is likely to be at least double the costs of a base-load gas plant. To suggest that the costs to consumers of the policy proposals is in the region of a 4% increase on domestic bills is totally disingenuous to say the least. WPG suggests that DECC ask Redpoint to redo some of the modelling, taking account for these issues, to get a more realistic feel for scale of the actual price rises customers are likely to see.

53. WPG would also note that DECC believes that increasing customer participation in the market (as "negawatts") would be beneficial. While WPG welcomes all forms of competition in the market, the Government must be realistic about how much demand wants to participate. Large customers currently respond to the TRIAD system, where their consumption in the three winter peak half hours dictates their transmission charges. This is an extremely effective mechanism and should be maintained. However, more active customer participation was one of the NETA design criteria. The customers do not seem to want to participate in the type of market created. This may be overcome with changes in market design, but we suspect the problem of managing their primary production while participating in the market will be extremely difficult to overcome.

Analysis of Packages

54. WPG does not agree with the FIT with CfD option of the package. As noted above we believe that the Government is missing the opportunity to do something radical about the level of competition in the market that will help deliver a more efficient, competitive, green market in the future by not tackling head on the problem with the dominance of the Big 6 and their integrated structures.

55. The Government does not seem to have really tried to look at the unintended consequences of its proposals. For example, FIT CfDs would appear to further enhance the dominance of the Big 6. Using GGCTs for peaking, and requiring more peaking because of the reliance on wind, will significantly increase the costs and probably the reliability of the CCGTs. The impacts on the gas market are not considered, nor the costs faced by industrial customers and what price rises may do to the level and shape of the electricity demand in the GB market. The document does not seem to consider the negative impact on investors in new build of a "flexible EPS", that only applies sometimes. WPG cannot see how funding would be raised on such a basis. The rather narrow analysis in the EMR document should be expanded to better understand these types of risks.

Market Risk

56. WPG believes that the Government's announced reforms could easily be seen as largely incremental changes. It has been unfortunate that so much has been made of the scale of change as this has clearly created uncertainty for developers and investors. The lack of detail in the policy proposals is also adding to risk, so the sooner the proposals are worked up the better.

57. WPG feels that the reviews being carried out by Ofgem, while getting less press coverage, actually represent a bigger regulatory risk to the market. The changes we are most worried about are:

- Project TransmiT[6], with the potential to change all transmission charges and connection fees;

- The still yet to be implemented EDCM[7] charges in the distribution networks and the associated treatment of pre-2005 generators;

- The proposed review of cash-out prices; and

- The new powers to alter industry codes that Ofgem has given itself[8].

58. We are therefore very pleased that DECC is reviewing the role of Ofgem. WPG feels that it is right that Government can propose change to the policy framework, but the role of Ofgem has become so unfocussed that it is now probably the greatest risk to our business.

59. WPG believes that Ofgem's remit today should have three key roles:

- The management of the price controls and associated price regulation of the monopoly networks;

- The awarding of licences; and

- The administration of the codes that underpin the technical rules associated with the market operations and associated dispute resolution.

60. WPG believes that the Government should abolish the GEMA (the Authority) style of governance. The Authority members have created several problems:

- Direct accountability of the CEO of the regulator has been eroded;

- Decision making is opaque (with Authority minutes being anodyne, published late and with no papers available); and

- Costs have increased for no perceived benefit.

61. A good regulator acts in an open, transparent and engaging way, with all interest groups. A strong and constructive partnership with those being regulated would be helpful and the Authority is too far removed for this to be possible or practicable.

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[6] Ofgem has already announced the hiring of three sets of academics and another set of consultants for this project (Ofgem letter 10/10/2010). If they cannot resource the work we are not sure how small players are meant to participate.

[7] The charging methodology for customers connected at extra high voltages (22kV or more) in the distribution networks – due 1 April 2010.

[8] Significant Code Reviews are to be conducted by Ofgem where they appear to act as judge and jury.

62. Transparency is also being lost as Ofgem undertakes review, but excludes parties from the decision making process. For example: the Significant Code Review of gas security arrangements was started with a by invitation only working group; project TransmiT is a by invitation roundtable; and a by invitation meeting on the transmission price control. This is not the right way to take forward policy development. WPG is certain Ofgem would disapprove if sections of the industry met to say develop CUSC policy in closed session. DECC should make it clear to Ofgem that their policy making and implementation processes must be open and transparent, involving all sections of the market and not simply the Big 6.

63. We hope that DECC will ask questions about how regulation of regulators is achieved and by whom. This is fundamental to a better structure of regulation going forward. Independence is one thing, but a regulator that is unchecked simply creates regulatory risk, thereby adding to costs and limiting market entry. Witnesses to the House of Lords Select Committee investigating Regulators stated that *"there is a crucial need for greater parliamentary oversight ... over regulation bodies"*. We recognise that the Government, and EU law under the 3rd package, wants the regulator to be independent, but that is not incompatible with rights of appeal and accountability of regulators to elected members of Parliament.

64. Once DECC has set out the details of the new regime in the power market and a new regulatory regime then the reforms could provide greater certainty than we have experienced in recent years. However, while Ofgem can continue to undertake policy reviews without any demand for change (from the market players or the customers) then significant risks remains.

Implementation Issues

65. Experience with NETA in 2001 suggests it is perfectly possible to deliver a whole new market in one go if the political will is there. The personal involvement of Ministers in pushing NETA forward was instrumental in forcing players who did not support change to go along with it. That said there may be some system changes that would be best phased in, notably any larger systems changes.

66. Of the policies announced by the Government some pose more problems than others in terms of implementation. Taking each in turn:

67. ***Floor price for carbon*** – This does represent a major change in taxation, but its implementation does not look obviously problematic. There are some definitional issues that need to be considered, such as where generators are not supplied fuel by "suppliers" who are meant to collect the tax. The Government must also brace itself for the price rises that will follow the new tax. The HMT figures (based on no analysis, but market knowledge) look very low given it is the marginal generators (coal and gas) that will face a significant increase in their costs.

68. ***Feed-in-Tariffs*** – This is a significant change, but the timescale looks achievable and the use of FITs rather than ROCs is likely to deliver efficiency gains in the longer term. The conflict will arise when parties are unclear how the move to FITs will occur. It is imperative that the transition does not negatively impact investors and lenders who invested in the RO regime or they will simply not invest with this uncertainty. Some questions we would have are: can we elect to go to FITs not ROCs; how will the supplier obligation work as ROCs phase out; what are the support levels; is there going to be grandfathering; etc. The sooner these details can be worked out and communicated to developers the better.

69. Of the design options outlined, WPG believes that the premium FIT will offer the best value for money to the customers. As the RO will be maintained until 2017 there is no obvious rush to get the FITs in place, though most developers may welcome an early rather than late introduction. We do not think that the FIT with CfD will be workable in terms of delivering the required investment, in reasonable timeframe, without impacting the level of competition in the market.

70. ***Capacity Payments*** – As noted above, WPG believes that a mechanism could be delivered that simply builds on the existing market arrangements. This would be the TTR mechanism in the DECC consultation. If the Government goes further, for example dictating the specific types or location of generation to be built, there are far greater changes and the concept of free, open markets is being abandoned.

71. Obligations on Suppliers require licence changes and then some time for compliance. A capacity payment on all would require changes to, we assume, the BSC to create the payment and that will need significant system changes.

72. ***Emissions Performance Standards (EPS)*** – If we assume that this is a mechanism that will operate under the environmental regulations and be overseen by the Environment Agency, it would seem to fit into the current regulatory regime. While the setting of the EPS itself may have significant impact on investment decisions, implementation of the regime itself would appear to work with current monitoring and reporting.

73. WPG is concerned that the EPS principle will be applied to large plants initially and then to smaller plants later. If this is the Government's intention, then it needs to say so now. As noted above, the types of generation that best act as reserve capacity often run on fuel oil and therefore have relatively high emissions on a MWh basis, though only run for short periods so have low absolute emissions when compared to say a gas plant. While there is debate around what emissions levels of all plants should be that creates uncertainty for investors. If smaller plants, such as reserve plant, need to be gas plant the Government should state that clearly. It will cost consumers dearly if new fuel oil plant are built that must later be abandoned. That said, we note the Government's intention not to apply the EPS to existing coal plant, so similar rules could be outlined for any future change in emissions standards.

74. ***Further proposals*** – WPG has serious concerns about the review of cash-out. This is an exercise that has been undertaken by Ofgem on a number of occasions. There have been numerous changes to the BSC altering cash-out since 2001 and endless industry meetings on the subject. There are two conflicting problems that Ofgem has raised and DECC mentions:

- The level of cash-out – is it cost reflective? The issue being how to allocate the cost of energy and the system service (frequency response, STOR, etc.) costs.

- The impact on competition – with suppliers claiming the price is penal and therefore they are likely to buy more power than they need to limit cash-out risk.

75. WPG feels that there is no "correct price" for the imbalance prices. The cash-out regime we have today has been subject to much review and the possible regimes outlined by DECC (single cash-out, marginal, change in reserve cost allocation, etc.) have all been considered. We can see no evidence that the prices are wrong unless DECC wants to set different incentives on the players. For example, a marginal price is likely to be higher so make suppliers go longer into each balancing period.

76. WPG is concerned that there is some misconception about the role of cash-out in sending investment signals. We have heard Ofgem say that the prices are not high enough to encourage investment in reserve plant. However, reserve is not built based on cash-out. Plants being built to provide STOR type reserve are built based on their contracts with National Grid. Conventional, usually larger scale, plant is most often backed by longer term sales contracts. It can be argued that the cash-out feeds into the forward curve, which is the price that should underpin major capital expenditure on new build. But the forward market is so illiquid that there is no robust forward curve for cash-out to impact.

77. WPG feels that the latest cash-out review looks like job creation by Ofgem. Unless they have something new to discuss then the market has been round these arguments enough times to have well informed opinions. It is then a matter of policy choice if you want the design to result in, on average, higher or low prices. We would recommend that a review of cash-out is not undertaken unless evidence of the "incorrect" prices can be provided. Cash-out prices in any given half hour can vary widely, but do they allocate cost in a way that incentivises balancing? Yes.

78. On balancing services, while we have sympathy with the idea of better cost allocation, the costs are so small in relation to delivered prices that the work may not be worthwhile. It may simply be easier to make cash-out more penal if it is energy shortfalls the system operator wishes to discourage. Reserve costs may not relate specifically to a supplier being short of energy, but the way the energy is consumed. For example the reserve used to cope with a pick-up in demand from a TV event. Within a half hour the supplier may have enough generation being delivered, but the shape of the delivery profile may not meet the shape of demand.

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79. It is a regular mantra from Ofgem that all costs must be correctly targeted. WPG supports this principle, but believes that it is general thrust of the incentives that market players respond to. The rules of electricity trading are already very complex. Changes could shift costs between players, but if the general incentive is to balance that is what they will do. Changing systems and adding complexity simply drives up costs and creates barriers to entry. Government should urge Ofgem to remember the 80:20 rule; if 80% of the incentives target costs correctly players will respond.

Conclusions

80. WPG continues to believe that it is structural reform of the market to create a competitive, transparent and equitable market for all players that will deliver the greatest benefit to customers. The signals that the FITs regime, carbon floor price and EPS will send should help the market to move towards low carbon generation. However, the package of change should be structural reforms to achieve competition along with signals to invest in low carbon generation for the future.

81. WPG remains concerned by how much of the market is up for review and how the focus is not on the big picture issue of structural reform. We also continue to believe that Ofgem is simply piling regulatory risk on the market by undertaking work that simply does not need to be done. The majority of the Government's proposal can be made with incremental change, and adapting policy instruments already in place, but it is vital they set out some long term principles and policy details as soon as possible.

82. Current regulatory uncertainty and change has stagnated development of valuable reliable green projects. This needs to be addressed and addressed speedily before more projects are lost as independent developers lose their investment backing.

Yours faithfully

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