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Dear Judith,

Please find attached Welsh Power's response to OFGEM's Targeted Charging Review consultation.

Background

Welsh Power Group is a privately-owned energy company with a strong track-record in the development, construction and operation of both conventional and renewable power generation projects. The company has owned large thermal generating plant, Uskmouth Power; developed and financed a new build 850MW CCGT, Severn Power; established a successful supply business, Haven Power; and constructed a small 50MW peaking portfolio which it sold to Alkane Energy in July 2014.

Since 2014 Welsh Power has been working in partnership with an investor to bring forward a portfolio of new flexible, efficient gas fired generating capacity to the UK market. Having participated in both the 2014 and 2015 Capacity Market auctions Welsh Power currently has over 300 MW of gas fired embedded generating capacity either operational or actively under construction.

The development, finance and build cycle of these plants is typically three years. The company is part way through the build out programme and welcomes OFGEM's consultation on initiating a Significant Code Review (SCR).

Introduction

The past 18 months have seen an unprecedented level of activity and interest in network charging and in how the costs of running an expanding and increasingly costly electricity network are recovered from end users. Prompted by a rapidly escalating transmission system cost and a cap on the proportion of charges which transmission connected generators can pay, CMP264 and CMP265 were aimed at addressing market distortions that were the result of the consequential increase in the 'Triad' embedded benefit. Both proposals were necessarily limited in scope and were intended as a stop gap measure to enable OFGEM to consider a wider charging review. Whilst we believe that an SCR should have been launched at the beginning of these CUSC proposals we welcome OFGEM now consulting on an SCR which we believe should be taken forward and that the scope of the SCR should extend beyond the TCR proposed in the consultation.

We believe that the current charging arrangements are clearly not fit for purpose and making incremental changes to a flawed model will simply increase the distortions in the market and ultimately lead to increased cost to the end consumer. There is an underlying assumption

running through the consultation document that residual network charges are simply what is left over once all cost reflective elements of network charging are taken into account. By implication this presumes that the forward looking price signals are correct both in relative and absolute terms. Were this to be the case then it would be correct to focus on recovery of the residual elements in a non discriminatory, non distortive manner.

It is clear from an analysis of the locational element of the TNUoS charging model that the charges are not intended to reflect the absolute costs of connecting to the network but are designed to provide a relative locational signal which provides an approximation for the change in the distance electricity will travel across the network. This is taken to be a proxy for the marginal cost to the system. The existence of negative locational signals (for both generation and demand) imply a saving to the system from locating demand or generation in those zones where the charging model indicates it is desirable to do so. However it is clear that any additional connections to the network, irrespective of location, add to the cost of the transmission system. In Welsh Power's response to the CMP264/265 minded to decision we explored the RIIO incentive mechanism in so far as it relates to the incremental costs of connecting large generation to the network. We do not intend to repeat the evidence here but would encourage OFGEM to cross refer to this separate consultation response.

It is only possible to assert that *'Residual charges are intended for revenue recovery, and are not meant to incentivise specific actions by network users [para 1.14]'* In the circumstance where the forward looking network charges are accurate and complete. The consultation states *'We consider forward-looking network charges to be part of a broader question about how best to incentivise efficient use of the entire electricity system....[para 1.13]'* We do not believe it is possible to separate the two elements and both should be covered in the SCR. If they are to be dealt with separately then the sequencing must be to assess the allocation of costs into the right category before focusing on how to recover the cost categories in the most efficient manner.

Since we do not agree that the locational element of transmission charging is cost reflective, an assertion that underpins the proposed focus on only the residual costs we are strongly of the view that OFGEM should launch an SCR and that this SCR should focus on network charging in the round and should not start from a presumption that the forward looking elements of the charging system provide accurate signals. We believe that the allocation of costs between locational and residual is as important as the method by which these costs are recovered.

SPECIFIC CONSULTATION QUESTIONS

Question 1: Do you agree that the potential for residual charges to fall increasingly on groups of consumers who are less able to take action than others who are connected to the system, is something we should address?

We believe that whatever charging arrangements are put in place there will always be incentives to avoid the network charges and that the higher the charges the greater the incentive to avoid them will be. One interpretation of economic theory and Ramsey pricing consistent with elasticity of demand is that charges should be focused on those that are least able to avoid them. We recognise that this interpretation, whilst recognising the economic

motivation for those parties most impacted by network charges to seek to avoid them, is a matter of policy and from a fairness perspective this is unlikely to be desirable.

Provided that only those costs which are truly unavoidable fall into the residual costs then the recovery of this element should be shared equitably between all those users who benefit from the existence of the electricity networks. We are strongly of the view that a charging system which allocates the significant majority of costs to the non cost reflective residual recovery is unlikely to be fit for purpose and believe that the allocation of costs into the appropriate classification is the correct focus for an SCR.

Question 2: If so, why do you think, or do not think, action is needed?

As above we believe action is needed to ensure the correct allocation of costs between cost reflective and cost recovery is critical to the success of the SCR.

Question 3: We are proposing to look at residual charges in a Significant Code Review. Are there any elements of residual charges that you think should be addressed more urgently? Please say why.

We believe that the CMP264/265 process, having been rushed through with insufficient rigour and analysis should provide a cautionary note to any urgent review of elements of network charging. We believe an holistic SCR should be launched that looks at all elements of network charging to ensure that the methodology is fit for purpose.

Question 4: Are there elements of the approaches in other countries that you think could be appropriate for GB residual charges?

We would refer you to the ongoing work of the CMP271/274 working group which has looked at different methods of charging for network costs.

Question 5: Are there other approaches that you know about from other jurisdictions, that you think offer relevant lessons for GB?

We have no comment on this question

Question 6: Do you agree that our proposed principles for assessing options for residual charges are the right ones? Please suggest any specific changes, or new principles that you think should apply.

Welsh Power agrees with the proposed principles for assessing options for the residual charges but would make the following comments on each:

Reducing distortions – we are concerned that the focus on only the residual charges ignores the problems of cost allocation inherent within the charging models. We believe that the residual costs include elements which could be recovered on a cost reflective basis and that a focus of the SCR should be to correctly identify and separate these costs. We are also concerned that the cap on generator charges is forcing cost reflective charges that should be borne by large generators onto demand customers. As the generator residual turns negative this will inevitably lead to competitive distortions between generators located on the transmission and distribution networks.

Fairness – we fully support the notion of fairness in network charging but fear that rather than being absolute fairness is often a matter of perspective and therefore subjective. We believe it important that OFGEM determines how it will judge fairness.

Question 7: In future, which of these parties should pay the transmission residual charges: generators (transmission- or distribution-connected), storage (transmission- or distribution-connected), and demand, and why? What proportion of these charges should be recovered from each type of user?

We believe that transmission connected generators should pay a fair proportion of the transmission network costs. Since the costs of connecting generation assets to the transmission system are socialised through TNUoS charges it is important that these generators pay a fair proportion of the costs which they create. Conversely distribution connected generators should not be subject to generator residual charges. These generators pay a deep connection cost to connect and are charged UoS charges by the DNO's. Their use of the transmission system is incidental and not directly related to their operation.

Question 8: In future, which of these parties should pay the distribution residual charges: generators (transmission- or distribution-connected.), storage (transmission- or distribution-connected), and demand, and why? What proportion of these charges should be recovered from each type of user?

We believe the current allocation of costs on the distribution network between generators and demand are appropriate.

Question 9: Do you support any of the five options we have set out for residual charges below, and why?

We believe all options have merits. Provided the allocation of costs between cost reflective and residual are correct then a commodotised (per kwh) or fixed charge (per meter) are both appropriate.

Question 10: Are there other options for residual charges that you think we should consider, and why?

We suggest OFGEM refers to the work of the CMP271/274 working group for guidance on this.

Question 11: Are there any options that you think we should rule out now? Please say why.

At this stage we think it unwise to rule out any options

Question 12: Do you think we should do further work to analyse the potential effects of the charging arrangements for smaller EG (called 'embedded benefits')?

We remain concerned at the focus on EG from the perspective of a level playing field. Questions of market access and competition are clearly evident in other areas of the market yet OFGEM appears to retain a focus on targeting embedded benefits. We would encourage OFGEM to focus on network charging in the first instance to ensure a fit for purpose

charging system is established.

The consultation refers to the growth in EG resulting in *'increased displacement of electricity flows on the transmission network.....electricity that used to flow from the transmission network to that part of the network is now displaced and flows elsewhere. This is similar to the impact of a generator being connected to the transmission system [7.11]'* We believe this statement to be totally inaccurate. The growth in EG is resulting in more demand being met locally and flows on the transmission system being reduced not displaced and flowing elsewhere. This reduction in system flows is leading to a reduction in the rate of growth of the system and in the longer term will lead to a requirement for a smaller transmission system as more demand is served locally. We believe this and similar statements reflect a lack of understanding of the dynamics of the system changes that are occurring and suggests an underlying bias towards preserving flows on the transmission system.

Question 13: Do you think changes are needed to the current charging arrangements for smaller EG, and when should any such changes be implemented?

Given OFGEM's current minded to decision on charging reforms it is difficult to answer this question without repeating our response to the earlier consultation. We believe that OFGEM needs to carry out an holistic review of network charging and that the current processes and pending decisions do not provide an adequate answer

Question 14: Of the embedded benefits listed in our table, do you think that any should be a higher or lower priority?

We believe OFGEM should focus on an SCR into network charging.

Question 15: Do you think there are other aspects of transmission or distribution network charging which put smaller EG, or any other forms of generation or demand, at a material disadvantage?

There are clear differences between the connection charges levied on generators connecting to either the transmission or distribution system. EG pay full deep connection charges, TG pay super shallow charges with the majority of cost being socialised through TNUoS charges. Added to this the level of costs that TG can pay through TNUoS are capped and in the next years are predicted to provide a direct subsidy to TG relative to the cost reflective locational charges that should be levied. These are clear and obvious competitive distortions which OFGEM is not proposing to address.

Question 16: Do you agree with our view that storage should not pay the current demand residual charge, at either transmission or distribution level?

Yes we agree.

Question 17: Do you agree with our view that storage should not pay BSUoS on both demand and generation?

We agree that paying both demand and generation BSUoS is unfair.

Question 18: Which of the BSUoS approaches described is more likely to achieve a level

playing field for storage?

No comment

Question 19: Do you think the changes in this chapter should be made ahead of any wider changes to residual charging that may happen in future? Do you agree with our view that these changes should be implemented by industry through the standard code change process?

No comment

Question 20: We would welcome your thoughts on the potential make-up of a CCG. Please refer to the potential role, structure, prioritisation criteria and assessment criteria.

The CCG needs to reflect on the criticisms that have recently been directed at the CUSC process and ensure that the CCG is truly representative and not unduly influenced by commercial self interest.

Question 21: Do you agree with our proposed delivery model, including its scope?

No comment

Question 22: Do you agree that our proposed SCR process is most appropriate for taking forward the residual charging and other arrangements for smaller EG discussed in this document?

We would strongly encourage OFGEM to expand the scope of the SCR to include the allocation of costs into the residual 'pot'. Without first ensuring that the forward looking charging model is cost reflective and does result in the right quantum of cost being recovered through the residual charges we do not believe that the SCR will result in a robust set of charging arrangements and that it will be inevitable that at a later stage the exercise will need to be repeated to deal with the correct allocation of network costs.

Please do not hesitate to contact me should you have any questions regarding our consultation response.

Yours faithfully



Matthew Tucker
Finance Director