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Dear Judith,

### **Targeted Charging Review: a consultation**

Drax Group is a UK-based energy company with businesses spanning generation, retail and renewable heat. In recent years we have transformed Drax Power Station into the UK's single largest source of renewable power by upgrading its generation units to use compressed wood pellets in place of coal. Alongside our biomass and coal units, our acquisition of open cycle gas turbine (OCGT) development sites is intended to allow us to play an important role in supporting a flexible power system that can reliably support wind and solar power generation.

Our retail businesses, Haven Power and Opus Energy, are actively engaged in helping businesses with their energy needs, improving efficiency and switching to renewable products. In addition, our renewable heat business, Billington Bioenergy, supplies compressed wood pellets to off-grid homes and businesses that would otherwise continue to use fossil fuels.

We welcome this opportunity to provide comments on Ofgem's proposal to launch a Significant Code Review (SCR) into residual charging. This response is submitted on behalf of the above businesses.

Overall, we agree with the general approach outlined in the consultation and support an SCR to address the distortions inherent in the current arrangements. We also agree that Ofgem has identified useful principles and have provided further supporting statements to aid definition.

Our detailed answers to the consultation questions can be found in Appendix 1. However, we take this opportunity to raise the following high level points:

- The outcome of the proposed Significant Code Review (SCR) should be a charging regime that provides proportionate, predictable and justifiable charges that are simple and fair in their application to all parts of the value chain.
- The approach is correctly focused on optimising revenue recovery and avoiding distortion to wider behavioural signals – to this end, the SCR should have tightly defined parameters.
- To aid the objective of the SCR, the Charging Coordination Group may need to consider the wider strategic direction of charging over the longer term, to ensure the new regime remains fit for purpose and avoids a potential duplication of work over the years to come.
- There are highly linked issues that must be considered as part of the SCR, such as the extent to which BSUoS is a residual charge and the current revenue recovery distortion that exists between GB generators and interconnector flows.
- It should be clear that any change aligns with wider industry moves to value flexibility and create opportunities for demand side response, of which transmission costs are currently one of the largest drivers.
- Any changes must be accompanied by robust transitional arrangements, enabling time for potentially complex IT projects and the efficient migration to any new mechanism – failure to do this will have a detrimental effect on consumers.
- Any change needs to be founded on sound economic and pragmatic principles – customers are exposed to numerous overly complex costs that are difficult to explain or understand, therefore exacerbating this position is not desirable.

Please feel free to contact me, should you wish to discuss any aspect of this response.

Yours sincerely,

*Submitted by email*

Paul Youngman  
Regulation Manager

## **Appendix 1: Drax Group response to the questions raised in Ofgem's Targeted Charging Review consultation**

**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?**

Yes – this should be a key focus of the proposed Significant Code Review (SCR).

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

We agree that the current charging arrangements incentivise a proportion of network users to avoid revenue recovery mechanisms. The quasi-signal is likely to continue to strengthen as the total value of revenue recovery increases and the number of applicable users (the charging base) decreases. Without reform, the burden will increasingly shift to those consumers that are less able to respond, including vulnerable customers.

It is important that the regime provides predictable and justifiable charges that are simple and fair in their application. Such charging regimes incentivise investment in physical energy needs and innovation in meeting consumer requirements. Distinguishing between those charges that deliver cost efficiencies by encouraging behavioural change and those that simply recover revenue helps to provide the first step in identifying and rectifying distortions that simply reallocate costs from one category of user to another with no wider social benefit being realised.

In determining an appropriate way forward, Ofgem should also be mindful of complying with EU law and avoid increasing the burden on much needed GB generation investment, relative to its European counterparts. This is especially notable given the increased uncertainty and risk associated with the UK's future status in the internal energy market. A charging structure that facilitates levelling the playing field between transmission connected generation, distribution connected generation and interconnector users is essential to ensure a fair and equitable wholesale market.

**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.**

Those code modifications that are currently progressing via the CUSC governance process should continue outside of the proposed SCR. This includes the embedded benefit work stream, CMP264/265, where the case for reform has been clearly evidenced and any delay to the final decision would only serve to perpetuate the identified distortion.

The SCR should focus on the principles of residual charging, i.e. how to optimise revenue recovery and avoid distortion to wider behavioural signals. To ensure success, the SCR should have clearly defined and tightly focused parameters. Success should also be monitored post-implementation against a set of criteria identified during the SCR process.

We agree that further reform in relation to electricity storage should be taken forward via the standard code governance process. The treatment of storage is a distinct issue – consideration is required on the most appropriate way to categorise, incentivise and utilise the technology. This needs to take account of the potential for storage to operate on a stand-alone basis or in concert with other co-located generation or demand.

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

The report by Cambridge Economic Policy Associates Ltd (CEPA) and TNEI Services Ltd, "*International Review of Cost Recovery Issues*", provides a useful insight into international models. There are clearly a number of different options that can be taken and, irrespective of the option chosen, the report highlights factors that have influenced the ultimate success or failure of charging reform, in particular we note:

- Predictable and transparent charging arrangements are more readily accepted by consumers.
- Independent impact analysis and cost benefit analysis during the development phase encourages confidence in decision making.
- Clear communication with industry participants and consumers is essential.
- Robust transition arrangements help to mitigate the impacts of value transfer in consumer charges.
- Buy-in from the prevailing government may be required to deliver appropriate transitional arrangements.

It is important that Ofgem, and the SCR workgroup, remains mindful of these factors throughout the SCR process.

In terms of the specific examples provided in the report, we particularly note the models rolled out in the Netherlands and Victoria, Australia. Success in the Netherlands has been attributed to coordinated action between the Government and Distributors by simultaneously modifying the charging and tax regimes to minimise negative impacts on consumers.

Although more recent in application, the Victoria example provides interesting parallels with the current GB arrangements and notes that whilst the solution provided a degree of optionality on the approach taken by network businesses to apply residual charges, they have largely adopted a fixed charge approach (in line with other international models).

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

We have no further approaches to add at this time.

**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.**

We broadly agree with the principles identified by Ofgem. As the proposed SCR will focus on residual charges, we suggest specific criteria to assess success in developing and deploying the final proposals. These criteria support, and clearly define, the high level principles advocated by Ofgem:

- Reducing Distortions
  - Deliver a level the playing field between transmission and distribution connected users
  - Seek to reduce distortion between GB generation and interconnector imports
  - Ensure technology neutrality
  - Align with wider industry desire for flexibility and time of use signals
- Fairness
  - Protect vulnerable consumers from the impact of charging distortions
  - Robust arrangements to enable a smooth transition to the new regime
  - Appropriate communication to ensure all elements of the value chain, including consumers, are aware of potential impacts
  - Avoid exposing industry participants to complex changes and uncertain risks
- Proportionality and practical consideration
  - Aim for simple, transparent solutions that enable ease of communication to consumers
  - Deliver justifiable, predictable and stable charges that better inform decision making processes
  - Consider the full implications for various types of generators, groups of customers and system operation as a whole, including potential unintended consequences
  - Provide independent impact assessment and robust cost benefit analysis to evidence decisions

**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?**

**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?**

The only way to guarantee that residual charges have no impact on behavioural pricing signals, now or in the future, is to place residual charges on demand as a fixed charge that is known in advance. This approach has the following advantages:

1. It addresses the distortion between transmission and distribution connected generation by completely removing the residual charge, thereby removing the ability to avoid transmission costs.
2. It reduces the distortion between transmission connected generation and interconnector flows, thereby helping to aid competition between GB generators and their European counterparts.
3. It lowers the potential for forecasting error, making pricing more predictable and reducing the need for risk premiums.

4. It is simple and transparent, making revenue recovery easier to communicate to consumers – overly complicated frameworks obscure the cost of maintaining and using the electricity network.
5. The approach does not preclude the use of cost-reflective charging that aims to deliver efficient outcomes from behavioural change.

As with any change to residual charging, there would need to be a robust transition process to enable IT changes and the efficient pass-through of charges, particularly given supply contracts with end users, and offtake contracts with small generators, are agreed in advance and may cover multiple years. In addition, customers that currently load manage to reduce network charges should be given sufficient notice to accommodate any significant changes. Failure to develop a robust transition approach will result in a detrimental impact on consumers.

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

At this early stage we believe there is merit in exploring the practicality of a wide range of alternative options. On first review, those arrangements based on demand capacity or gross network usage appear to hold the greatest potential for simplicity, predictability and, importantly, driving out revenue recovery cost avoidance. However, further analysis on the potential benefits and impacts of each approach is clearly required.

As demonstrated in the CEPA study, consideration must be given to how consumers can be effectively protected via transitional arrangements, which will require co-ordinated support from distribution network operators, the regulator and, potentially, the government.

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

We have no specific alternative proposal at this time. However, as highlighted in answer to question 7/8, there is a clear opportunity to reduce distortions between transmission connected generators, distribution connected generators and interconnector flows. This should form part of the SCR success criteria.

We also note that in order to deliver a charging regime that is robust to future change, there is merit in the Charging Coordination Group (CCG) considering the principles that will govern the wider strategic direction of charging reform beyond the Targeted Charging Review SCR. Communicating a strategic direction will help protect against an investment hiatus over the intervening period and enable market participants and consumers to prepare for future change.

Furthermore, changes to charging arrangements will require significant IT investment, particularly for supplier billing systems, which will need to be appropriately planned and co-ordinated. Multiple large-scale changes in quick succession, with the potential for overlap or system infrastructure redesign, is likely to be costly and resource intensive. Suppliers are already carrying a significant regulatory-driven change burden – adding to this in an untimely or unstructured way could have unintended consequences on other implementation projects.

A clear vision, or at least a clear direction, may help reduce the burden on market participants and help facilitate the communication to consumers on the objectives and potential impacts of reform. In line with good regulatory practice, a full impact assessment should be conducted before any implementation is taken forward.

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

No, it would be premature to rule out any options at this stage of the consultation.

**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’)?**

If the TNUoS Generation Residual (TGR) is not removed as part of the charging reform, then yes. A distortion will remain between transmission and distribution connected plant, therefore this should be addressed.

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

As highlighted in answer to question 7/8, transmission connected generators attract charges that distribution connected generators and interconnector flows do not face. Such charges should be levelised for all GB generators or analysis should demonstrate why the charging approach does not distort the playing field and delivers behavioural change that leads to an efficient outcome for consumers.

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

Priority should be given to minimising distortions in relation to residual charges prior to tackling locational charges. In terms of the residual charges, TNUoS Demand Residual and TNUoS Generation Residual should be the first priority – we see no problem with addressing each of these issues simultaneously, given the principles on all residual charges should be broadly similar.

We would support a wider examination of the application and underlying rationale of BSUoS charging. The BSUoS charge is volatile, unpredictable and only discovered post event, hence it does not provide a credible signal for behavioural change. There is a strong argument for categorising BSUoS as a residual charge, with future charging being based upon a fixed rate known in advance.

**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?**

As highlighted in answer to question 7/8, transmission connected generators attract charges that embedded generators and interconnector flows do not face. This places transmission connected generation at a competitive disadvantage. Such distortions should be considered together as part of this charging review.

In addition, the role of DNOs is changing and there are wider factors to consider as part of the future generation charging landscape. For example:

- Should there be one System Operator or multiple regional operators (i.e. DSOs)?
- How should regional services be procured?
- How should distribution and transmission-based service providers compete?
- Should DNOs/DSOs be allowed to develop their own capabilities (generation, storage, other) or could this lead to cross-subsidy and/or potentially foreclose the flexibility market?
- Who benefits from such services and, as a result, how should the costs be applied?

We believe in a market approach where competition determines how best to serve the needs of the system. The charging approaches for transmission and distribution connected generation should converge in order to ensure the market provides efficient signals and supports an economically efficient outcome. This must be considered as part of the proposed SCR, otherwise we risk developing an approach to charging with no longevity.

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

Further work is required to answer this question. Storage acts as both an off-taker and a supplier of electricity. As such, there are valid arguments to apply network charges as either a demand user or a generator. However, we agree that storage should only be subject to one set of network charges if it only has one connection.

The nature of the charges applied, however, should depend on how an asset is expected to use the network. If the provider is a net exporter (e.g. storage only forms part of a wider set of electricity delivery assets), then its charges should be based on generation charging principles. However, if the assets are typically a net importer (e.g. due to equipment efficiencies or the technology acts as net consumption, such as a car battery), then its charges should be based on demand charging principles.

It is not clear that a one size fits all approach is appropriate for storage. Further consideration should be given to this as part of the dedicated storage work stream.

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

No. Storage can act as both an off-taker and a supplier to the system. These activities are likely to occur in different charging periods and contribute to the actions on the system in that Settlement Period. As such, its actions do not net and the operator should be liable for charges recouped on a MWh usage basis.

**Question 18: Which of the BSUoS approaches described is more likely to achieve a level playing field for storage?**

As noted above, storage can act in both an off-take and delivery capacity. These activities are likely to occur in different charging periods and, as such, do not “net”. On that basis, BSUoS should be levied on a gross per MWh basis to deliver a level playing field between storage and other users of the system.

However, as noted in relation to question 14, we believe that BSUoS charges need to be examined in the round. The BSUoS charge is volatile, unpredictable and only discovered post event, hence it does not provide a credible signal for behavioural change. There is a strong argument for categorising BSUoS as a residual charge, with charges based upon a fixed rate known in advance.

**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?**

We agree that changes should be progressed through the standard code governance process.

**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.**

It is clear that a number of industry bodies have been progressing proposals for charging reform independently. It is reassuring that Ofgem has engaged in National Grid’s review of transmission charging, the Distribution Charging Methodologies Forum work and the ENA’s charging workgroup to date. It is important, however, that Ofgem engages with a wider community of market participants to progress the Targeted Charging Review.

We agree that a centralised Charging Coordination Group (CCG) should be formed, with Ofgem chairing the group and membership consisting of expertise from across the industry. It is critical, however, that the CCG is appropriately resourced to ensure strong leadership and enable the formation of a coherent strategic direction on charging reform. If this is not facilitated, then it risks becoming little more than a talking shop. We strongly recommend a visible senior leadership commitment from Ofgem in terms of its attendance/membership of the group.

The CCG must also provide a leadership role in ensuring efforts internal and external to the Targeted Charging Reform are more widely socialised and better coordinated. Furthermore, appropriate channels must be developed to ensure all stakeholders can continue to contribute to the debate as the work-stream develops.

In terms of prioritisation criteria, the focus should be placed on ensuring distortions are minimised and that proposed charging reform promotes a transparent, stable and predictable charging regime. In terms of the assessment criteria, please see our answer to questions 6, 7/8 and 14 above.

In addition, with regard to the proposed implementation, there should be consideration of the impact on generators, suppliers and customers, with a corresponding requirement to provide clear communication and sufficient notice of any changes.

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

We welcome the use of the SCR route. We believe the scope of the SCR must be very clear from the offset. As noted above, we believe the scope of reform may need finessing, particularly in terms of levelling the playing field between transmission connected generation, distribution connected generation and interconnector flows. In addition, consideration should be given to the residual nature of BSUoS charging.

We are conscious that there are a number of other pressing charging issues that need to be considered in parallel, namely:

- Consideration of how behind the meter generation and “demand turn up” are charged in the future
- Storage charges
- Connection charges and foreclosure of capacity on distribution networks
- Review of Triad charging
- Cost reflective network charging

In determining the scope of the SCR, clear signals should be provided on how the other issues noted above will be tackled and the likely timescales.

**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?**

Yes. We also believe that other charging issues can and should be pursued in parallel to the SCR. We would not expect foreclosure of other charging issues that can be progressed in parallel via the standard code governance route. Additionally, where some issues covered by the SCR can be progressed more swiftly than others, then the process should facilitate this.