Judith Ross
Energy Systems Integration
Ofgem
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

polina.kharchenko@sse.com
01738 512072

5 May 2017

Dear Judith

Targeted Charging Review: a consultation

We welcome the opportunity to provide our views on the Targeted Charging Review consultation. We welcome Ofgem's approach to setting a strategic direction of travel and preferred approach to finding solutions.

We agree with Ofgem's position that charging arrangements should be guided by economic principles in order to deliver the best value to customers over the long term. Given that residual charges are intended for the residual recovery of allowed revenues, and are not meant to incentivise specific actions by network users, it is important to ensure that residual charges are set in a way that is fair and not open to avoidance.

It is our view that the 'net' nature of residual electricity charging arrangements results in a number of market distortions which ultimately lead to higher costs to consumers. These distortions have important implications for Ofgem and BEIS objectives regarding delivering a Smart and Flexible energy system. We believe that both residual charge and embedded benefit distortions need to be addressed as a matter of priority in order to efficiently deliver the economic benefits of smart flexible services from behind demand meters and embedded providers. To this end, we welcome Ofgem's minded to decision regarding CMP264/265 and consider that it is important to extend the same economic principles and approach to the residual elements of other charging elements including TNUoS, DUoS and BSUoS.

While we agree that an SCR approach has its advantages in bringing all interested parties along, there is a risk that more pressing issues, which require immediate consideration, could take too long to address, resulting in prolonged market distortions. It is our view that care, therefore, is needed to ensure that the SCR does not preclude or defer already identified issues and solutions being implemented or result in an unmanageable package of issues.

We are looking forward to working with Ofgem and the rest of the industry on finding optimal solutions to reform the residual charging arrangements so that they reduce distortions and are fair, transparent, proportionate and practical.

Kind regards,

Polina Kharchenko

Regulation Manager

Consultation questions

Chapter 2

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 agree with Ofgem that if the current net charging arrangements remain unchanged, we could reasonably expect residual charges to fall increasingly on groups of consumers who are less able to take action to avoid them. This issue applies to a broad range of charging arrangements including TNUoS, DUoS and BSUoS.

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

We agree with Ofgem's position that charging arrangements should be guided by economic principles in order to deliver the best value to customers over the long term. Given that residual charges are intended for the residual recovery of revenues, and are not meant to incentivise specific actions by network users, it is important to ensure that residual charges are set in a way that is fair and not open to avoidance. For example, whilst demand reduction can be beneficial, it should not be the case that parties can use demand reduction to avoid residual charges, which still need to be met to provide system security for all.

It is our view that both the 'net' nature of residual electricity charging arrangements, and the charging bases they are applied to, result in a number of market distortions which ultimately lead to higher costs for customers. These distortions have important implications for Ofgem and BEIS objectives regarding delivering a Smart and Flexible energy system. We believe both residual charges and embedded benefit distortions need to be addressed as a matter of priority in order to efficiently deliver the economic benefits of smart flexible services from behind demand meters and embedded providers as well as an efficient energy system overall at the best value for customers. We welcome Ofgem's minded to decision regarding CMP264/265 and consider that it is important to extend the review to the residual elements of other charging elements including TNUoS, DUoS, BSUoS and losses.

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 agree that a Significant Code Review (SCR) is an appropriate mechanism to take residual charging reforms forward. The factors and issues related to transmission and distribution charging should be considered in a holistic sense but this should not prevent the adoption of appropriate remedies in either Transmission or Distribution if the need for intervention is required more urgently and an appropriate solution is developed.

For example, it is our view that that it is in the best interest of customers that the charging base for Transmission Demand Residual (TDR) should be addressed as a matter of priority and reforms to transmission and distribution residual charges should not be contingent on one another.

In terms of wider review, we support Ofgem's view that the starting point at least for an assessment of the required changes to any particular element of residual charges should follow a common set of principles and objectives. This will ensure that any options considered and ultimately taken forward in relation to a particular element of residual charges results in a consistent package of residual charging arrangements which reduce distortions and are fair, transparent, proportionate and practical.

Chapter 4

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

The experience of other countries highlights the importance of taking action according to the economic principles identified by Ofgem of fairness, reducing distortions and practicality. The range of options suggested by Ofgem for collecting demand residual payments are all worthy of further consideration, however, there are different advantages and disadvantages associated with each which means there may not be one universal best solution. This situation is reflected in the diverse solutions which other countries have implemented reflecting their starting point, particular energy mix, as well as the particular political, social and regulatory environments of each country. What is clear from the international experience is that it is universally recognised that it is important for the benefit of customers to collect residual elements in a way that is fair, reduces distortions and is practical to implement. It is therefore important that Ofgem considers the choice of options

as well as detailed implementation approaches which would be most appropriate for GB customers.

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

We would not at this time suggest any additional approaches currently in place in other jurisdictions which are relevant to the GB market.

Chapter 5

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 agree with the principles outlined by Ofgem in the consultation, such as the principles of reducing distortions, fairness and proportionality and practical considerations.

In our view, it is also prudent to clearly distinguish between charges which are designed to send an economic price signal to incentivise the efficient use of the network, and charges which are intended for revenue collection and are not meant to incentivise specific actions by network users. It is essential that for all types of charging arrangements, each element of any charge should be clearly classed as falling into one or the other category.

Chapter 6

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?

This is an area that warrants further consideration and discussion. At this early stage, our support is for arrangements that provide a level playing field in order to avoid distortions and discrimination.

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?

As per our response to Question 7.

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

Yes, we believe that alternative approaches similar to those adopted by other countries could deliver better outcomes than the current net charging approach to setting residual charges in the GB market.

We support Ofgem's position that the options for reforming residual charges should be assessed against a common set of principles, such as reducing distortions, fairness and practicality, transparency and simplicity:

- The principle of **reducing distortion** must be number one priority because the presence of distortions is by definition not fair.
- The question about **Fairness** is more about the detail of how the option is implemented – There are many different interpretations of what it means to be fair and any of the proposed options can be done in a way that could be describe achieving a fair outcome.
- **Practicality and proportionality** – This should be used to define the bounds of a solution i.e. if a solution is unreasonably expensive, or complicated, then this may limit the range of options which can be taken forward.

Option A, where a charge is linked to net kWh consumption, is susceptible to avoidance, which, as identified by Ofgem, has the potential to result in a less economically efficient energy system, as well as unfairly disadvantage certain groups of consumers. While this approach may be relatively simple to administer, it therefore has its drawbacks.

We think that **Option B,** where a fixed charge is applied, is a potentially good solution which could substantially reduce potential distortions as well as being fair, transparent and relatively simple to implement. If Option B is taken forward, a design of the fixed price charge would need to be carefully developed to ensure a fair treatment of all types of consumers. In particular, care would need to be taken not to disadvantage low consumption vulnerable customers. The key implementation question for this solution is how best to determine the magnitude of fixed charges including how these may be set at a different level for different types of customers because the distributional effects of fixed price charges on different customer groups and types are complex.

Option C proposed by Ofgem, where fixed residual charges are set on the basis of connected capacity, such as maximum demand, may provide a good solution for larger customers

regarding fairness and reducing distortions, however this may be less likely to provide a workable solution at a domestic level.

Option D, where residual charges are based on gross kWh consumption, provides the basis for setting residual charges which may be fair and relatively difficult to avoid. Our view is that, while in theory this approach may tackle a number of issues, it is likely to be very difficult to implement in practice, given that assumptions need to be made about unmetered generation output from behind the meter to arrive at gross consumption figures. Therefore this option may be less likely to meet the test of practicality and proportionality.

Our initial view is that **Option E**, a hybrid approach for setting residual charges, is likely to be the most appropriate mechanism to use across all residual charging elements. A hybrid option could combine a different approach to setting residual charges depending on the class of consumer, for example using a fixed charge (option B) for domestic customers combined with some form of capacity charge (Option C) for large I&C customers. If a hybrid option is carefully designed, it would help reduce distortions and would ensure a fair and transparent treatment of different types of users. However, a hybrid approach introduces a level of complexity which might take time and resources to implement.

As noted earlier, residual charges should not drive avoidance behaviour, therefore, changes to the current residual charging arrangements should ensure that such incentives are removed or minimised. It is clear that all options require further analysis and assessment of the impact of each on various types of consumers. It is also important that any changes to charges should have a sufficient lead implementation time to ensure that a sufficient transition period is given to the affected parties. New residual charging arrangements should avoid, as much as reasonably possible, customers receiving a “shock change” in their tariffs due to a magnitude of the change. In particular, it is important to avoid a tariff shock for domestic customers.

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

We would not at this time suggest any additional approaches for consideration.

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

Option A has been driving avoidance behaviours, which is the very behaviour Ofgem is keen to avoid going forward.

Chapter 7

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')?

In our view, further work should be done on other elements of the charging arrangements for smaller EG, such as BSUoS and losses avoidance. While changes to these elements of charging might not be as urgent as changes to the transmission and distribution residuals due to the smaller scale distortions they create, these elements should be within the scope of any further charging work Ofgem might undertake in the future.

In respect of BSUoS, embedded generators enjoy a double BSUoS benefit from : (i) not paying BSUoS themselves, whilst other parties, including transmission generation and demand, pay this charge; and (ii) the embedded benefit arising from net charging of demand BSUoS which must, in turn, therefore be paid for by other market participants through even higher BSUoS charges.

The situation with respect to transmission losses is similar to BSUoS in that it also provides a double benefit to embedded generators. Firstly, if it is accepted that a purpose of transmission losses is to collect the cost of system losses in a fair way (revenue collection), it may be difficult to justify why the class of generation identified as embedded does not pay a share of transmission losses while all other generators and demand do. Secondly, the treatment of embedded generation as negative demand means that embedded generators get paid for avoiding demand transmission loss charges.

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

Yes, as we stated in our response to Question 12.

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

Please see our response to Question 12. In our view, all embedded benefits should be considered as a matter of priority, including the treatment of losses. We support the

minded-to-decision[1] already published by Ofgem in respect of TNUoS Demand Residual payments.

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?

In our view, there are additional distortions which current charging arrangements are resulting in. As outlined in our response to Ofgem's Open Letter on charging arrangements for embedded generation of 29th July 2016, further consideration should be given to the recovery of low carbon levies and charges paid (or rather, currently, not paid) by interconnectors.

Chapter 8

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

This is an area that requires further discussion and consideration. It is important that the application of demand residual charges should not unfairly disadvantage storage or distort competition compared with other market participants.

We believe it is important not to carve out separate technology-specific provisions – at least not at this early stage. Instead, consistent with creating a level playing field for all, we believe any arrangements need to be capable of applying to all technologies to avoid introducing distortions or being considered discriminatory.

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

Yes, we agree that storage should not pay BSUoS on both demand and generation.

In our view, storage should pay cost-reflective forward looking charges. However, as it currently stands, BSUoS is not a cost reflective price signal, but instead its purpose is for revenue collection. The application of BSUoS as a £/MWh charge creates a large and important distortion for the economically efficient dispatch of transmission connected

[1] https://www.ofgem.gov.uk/publications-and-updates/embedded-benefits-consultation-cmp264-and-cmp265-minded-decision-and-draft-impact-assessment

storage assets, which is much more important than the associated distortion for transmission-connected generation which may tend to simply pass the cost via the wholesale power price. This distortion for transmission-connected storage assets occurs because the BSUoS commodity charge creates a distortion by eroding the genuine economic arbitrage price spread which would otherwise be available on both the import and export directions of a transmission connected storage asset. It is also worth noting that embedded storage obtains a non-cost reflective competitive advantage in this regard because it currently does not pay BSUoS at all and, in addition, receives payments related to the embedded benefit of demand BSUoS avoidance. In this regard, the economic principles identified by Ofgem would be best met if transmission-connected storage did not pay either demand or generation BSUoS, as a charge on either side would skew storage arbitrage dispatch and behaviour.

If there was a future change to BSUoS so that it was collected in a different way which avoided distorting dispatch decisions, only then would it be appropriate for storage to be treated the same as any other generation. In this case then, applying the principles of charging being equitable and difficult to avoid, BSUoS charges should be collected in an equivalent way to the collection of other residual elements of transmission, or distribution, charges. This approach would have the benefit of removing the distortion to dispatch for transmission-connected storage, as well as address the double BSUoS benefit, arising from net charging of demand BSUoS which embedded storage can currently receive.

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

Please refer to our response to Question 17.

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?

As stated in our response to Question 16, we do not believe it is appropriate to develop technology-specific provisions. However, if benefits to customers may be delivered sooner, it may be appropriate to make some changes through the standard code change process.

Chapter 9

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.

In our view, the make up of a CCG should be balanced and include a range of stakeholders, such as distribution and transmission network operators, customers, suppliers and generators. Such a make-up of the group will ensure that views are represented across the market chain and consideration is given to all aspects of a particular issue.

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

We welcome Ofgem's approach to setting a strategic direction of travel and preferred approach to finding solutions.

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?

An SCR approach has its advantages in bringing all interested parties along. However, there is a risk that more pressing issues, which require immediate consideration, could take too long to address, resulting in prolonged market distortions. Care therefore is needed to ensure that the SCR does not preclude or defer already identified issues and solutions being implemented or result in an unmanageable package of issues.