

Ofgem's Targeted Charging Review

Dear Andrew,

Until 2016 I was Senior Partner Networks at Ofgem having previously led Ofgem's work on vulnerable customers. I am now an independent consultant and thought leader on energy regulation with a particular focus on the consumer interest. This response is submitted in a personal capacity.

While recognising the issues that the Targeted Charging Review is trying to address, I am concerned that the domestic consumer perspective and the implications for customers on low incomes has not been given adequate attention. To help address this I produced a report (attached), a draft of which was discussed at a meeting of consumer advocates and others which was hosted by Sustainability First and which Ofgem attended, on 25 January. I have also discussed the report with colleagues at Oxford University, where I am a visiting Fellow, and have looked at the broader issues around network charging as set out in an earlier report for the Oxford Martin School Integrate Programme¹.

These discussions endorsed the main findings of my report (which has since been updated to take account of comments received). There is a clear consensus that:

- The implications for customers on low incomes is a grave concern with the move to recover the costs through a fixed charge typically benefitting richer groups and disadvantaging the poor;
- There is no basis for having a higher charge for Economy 7 customers purely on the grounds of their "line loss factor class", in particular given that these are primarily low-income households. With smart metering this distinction may anyway become irrelevant but either way should be dropped from Ofgem's plans;
- There is less immediate pressure to address distortions in the domestic sector, in particular where doing so would create such significant disadvantage. There is a strong case, for domestic customers in particular, for holding off on a decision until the way forward is clearer on forward-looking charges. The structure of these charges and the potential for the level of the residual to change significantly on distribution makes it very hard to judge whether Ofgem is striking the right balance in its decision on the residual without seeing the whole picture;
- Going more slowly would also allow time for other potentially fairer solutions to be properly explored and debated. These could include an exemption or lower fixed charge for customers on Warm Home Discount; fixed charges linked to council tax band (which academics note would be more progressive and non-distortionary, although consumer groups are less supportive), a hybrid solution where the fixed charge gives an entitlement to a low unit charge essential level of energy; or a separate charge for the right to export (which might run counter to Ofgem's policy of not imposing charges on generation but has the merit of directly tackling what they see as the problem);

¹ <https://www.renewableenergy.ox.ac.uk/wp-content/uploads/sites/4/2018/09/oxford-network-charging-190818.pdf>

- To support proper analysis of the distributional impacts Ofgem should look again at the data sources it can draw on and update the CSE archetypes work. It should also explore techniques such as citizens juries which build on its consumer panel model but would be more effective in exploring complex issues such as this.

While this response focuses on the impacts for domestic customers, I also have a concern that Ofgem is being naïve in assuming that fixed charges will remove any distortions in the non-domestic sector. They assume that the only way to avoid such charges would be for customers to go off grid which they rightly say is unlikely. However, the alternative is for customers to pool supply points through creating a private wire network with a single connection to the grid. Instead of each customer paying a standing charge they would then only pay one between them. This is a perfectly viable response to such a charging structure and one that we have already seen as a basis for avoiding usage related network charges (e.g. in Gateshead on NPG's network). With the projected rise in CHP based district heating systems which can also provide electricity there is an opportunity for such schemes in the domestic sector as well.

I have attached brief responses to the relevant questions in the consultation as well as the full report on "Understanding the Impacts of Ofgem's Targeted Charging Review" which is also available on the Grid Edge Policy website (www.gridedgepolicy.com).

If you would like to discuss any of these points further then please get in touch.

Maxine Frerk

Director Grid Edge Policy

Response to TCR Consultation Questions

1. Do you agree that residual charges should be levied on final demand only?

In principle yes, but that should not rule out options such as a specific export charge if that were a more targeted way of tackling Ofgem's concerns in the domestic sector.

2. Do you agree with how we have assessed the impacts of the changes we have considered against the principles? If you disagree with our assessment, please provide evidence for your reasoning.

As set out in my report, there is a concern with simply relying on RAG ratings as a basis for policy making as it depends on what sub-categories you use and implies they all have equal weight.

I disagree that a fixed charge is "fair". While simplicity, transparency, etc. can all help make a scheme feel fairer, by including them as sub-elements of fairness in its assessment Ofgem is down-weighting the distributional impacts. If you look across the international literature the issue for most countries boils down to how to avoid distortions without creating social disadvantage (and ensuring any scheme is practical). While Ofgem's headline principles reflect that tension in the detail of their assessment, the impacts on low income customers are ultimately given a very low weight which seems out of line with Ofgem's statutory duties and wider commitment to vulnerable customers.

3. For each user, residual charges are currently based on the costs of the voltage level of the network to which a user is connected and the higher voltage levels of the network, but not from lower voltage levels below the user's connection. At this stage, we are not proposing changes to this aspect of the current arrangements. Are there other approaches that would better meet our TCR principles reducing harmful distortions, fairness and proportionality and practical considerations?

No comment

4. As explained in paragraphs 4.41, 4.43, 4.46, 4.49, 4.80, we think we should prioritise equality within charging segments and equity across all segments. Do you agree that it is fair for all users in the same segment to pay the same charge, and the manner in which we have set the segments? If not, do you know of another approach with available data which would address this issue? Please provide evidence to support your answer.

As set out in my report – and supported by the consumer groups with whom it was discussed – the equality principle should not be viewed as fair in the domestic sector where affordability of energy – in particular for those on low incomes – should be a central consideration in the context of an essential service. This proposal would result overall in low income customers on average paying more while those on high incomes pay less, in some cases significantly so. Full details are set out in my report.

I also disagree with the idea that Economy 7 should be treated as a separate segment. There is no basis for this (other than that they happen to be in a different line loss group) and these are predominantly low income customers with above average usage who would otherwise stand to gain from this change. When challenged Ofgem's only argument for including them separately was that they typically used more energy but this is inconsistent with its general approach of charges being set independent of usage.

5. Do you agree that similar customers with and without on-site generation should pay the same residual charges? Should both types of users face the same residual charge for their Line Loss Factor Class (LLFC)?

It is not immediately clear why this should be the case. A charge for the right to export would not seem unreasonable and in the domestic sector could provide a more targeted response to the problem Ofgem identifies. What is proportionate will depend how this is handled in the forward looking charges, given that there will be additional costs to the distribution networks in being able to cope with high levels of export at particular times and from managing bi-directional flows which should be recovered somehow.

6. Do you know of any reasons why the expected consumer benefits from our leading options might not materialise?

Ofgem are potentially being naïve in assuming that there would be no distortions with a fixed charge as a basis for recovering residual charges. Although customers are unlikely to go fully off grid, having a fixed charge per meter point creates an incentive to pool meter points through creation of private wire systems. This has already been an issue on NPG's network at Gateshead, for example, where a private wire network was created alongside a CHP district heating scheme duplicating existing networks. While this was driven by the desire to avoid usage based network charges the same incentives would seem to exist with a per meter point charge.

7. Do you agree that our leading options will be more practical to implement than other options?

Probably but this should not be a primary consideration – options should only be excluded if they are impractical or disproportionately costly.

8. Do you agree with the approaches set out for banding (either LLFC or demanding for agreed capacity)? If not please provide evidence as why different approaches to banding would better facilitate the TCR principles.

As noted above I disagree with treating Economy 7 as a separate category (because of its LLFC). Otherwise the banding seems reasonable.

9. Do you agree that LLFCs are a sensible way to segment residual charges? If not, are there other existing classifications that should be considered in more detail?

Economy 7 should just be grouped with other domestic.

10. Do you agree with the conclusions we have drawn from our assessment of the following? a) distributional modelling b) the distributional impacts of the options c) our wider system modelling d) how we have interpreted the wider system modelling? Please be specific which assessment you agree/disagree with.

I disagree with the conclusions of your assessment of the distributional impacts on different groups of domestic customers. Ofgem conclude that there are winners and losers in each category and hence implicitly that there is no issue. This ignores the very clear pattern of low income customers on average losing while high income customers gain. The analysis of the impacts on fuel poverty is superficial and the impacts on Economy 7 customers is misleading as Ofgem just presents upper quartile figures. The conclusion that on average these customers would benefit is not supported by the data.

My report attempts to fill some of these gaps, but I would urge Ofgem to carry out more detailed analysis than I was able to with limited resources. In particular Ofgem should look at updating the CSE archetypes which were commissioned by Ofgem a few years ago explicitly to help in assessing these sorts of issues but are not referenced in its analysis.

11. Do you agree with our proposed approach to the reform of the remaining non-locational Embedded Benefits?

No comment

12. Do you agree with our proposal not to address any other remaining Embedded Benefits at this stage? Which of the embedded benefits do you think should be removed as outlined in xx? Please state your reasoning and provide evidence to support your answer.

No comment

13. Are there any reasons we have not included that mean that the remaining Embedded Benefits should be maintained?

No comment

14. Do you agree with our proposed approach to transitional arrangements for reforms to: a) transmission and distribution residual charges b) non-locational Embedded Benefits? Please provide evidence to indicate why different arrangements would be more appropriate.

Given the significant impacts on many low income customers, it is important that Ofgem thinks about how to mitigate these impacts. Suggestions like changes to the Warm Homes Discount would help but there is no basis for seeing them as transitional changes – if energy ceases to be affordable for these customers then that is an enduring problem not a transitional matter. The major concern here is that changes to Warm Homes Discount are not in Ofgem's gift. It is therefore imperative that BEIS is fully engaged and understands the impacts of these changes and is prepared to support mitigating action. Alternatively Ofgem could seek to identify options that would put more emphasis on fairness in the first place – for example setting a lower fixed charge for Warm Home Discount customers.

15. Do you agree with our minded to decision set out? If not, please state your reasoning and provide evidence to support your answer.

No. I believe that there are fairer ways of recovering the residual charges than through a fixed charge which will hit low income customers particularly hard. A capacity charge would be preferable in terms of distributional impacts but Ofgem should explore other options too (such as a charge linked to council tax band, a lower charge for customers on particular benefits or a hybrid scheme combining a fixed charge and a usage charge for consumption above a certain level).

Economy 7 should not be a separate category and mitigation needs to be clearly set out.

The decision should be delayed until the Forward Looking Charges work has progressed further, so the impacts can be judged in the round.

16. For our preferred option do you think there are practical consideration or difficulties that we have not taken account of? Please provide evidence to support your answer.

Economy 7 will likely not exist as a separate category once smart meters are rolled out.

It is unclear how different models would work in a multi-supplier context (as envisaged in the supplier hub work).

It is assumed that this structure of charges would in effect be mandated under a price cap (assuming it still exists at that point).