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By email only

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Shell Energy Europe response to the consultation on Ofgem's minded to decision for the Targeted Charging Review

Dear Andrew

Shell welcomes the opportunity to respond to Ofgem's consultation on its minded to decision for the Targeted Charging Review.

We agree that there is a case for change, to ensure that GB charging arrangements remain fit for purpose, support the energy transition to a more decentralized and low carbon electricity system, and continue to ensure a fair allocation of costs between different groups of consumers.

However, we have several concerns with Ofgem's proposed approach, which we explain below.

Main concerns with the proposed TCR decision

1. Potential impact on investor confidence and costs

In its consideration of charging issues, Ofgem does not pay sufficient regard to the potential impact on investor confidence. To successfully deliver the energy transition, market participants will need to develop and deploy innovative business models and low carbon and flexible generation. The level of uncertainty over network charges that a particular asset or customer will face over the next five to ten years is currently very high which makes navigating the regulatory framework very challenging.

In addition, Ofgem's statement that its proposals may result in cancellation of projects that have been awarded government contracts to support decarbonistion (Contracts for Difference – CfDs), or projects deemed necessary to ensure security of supply (with Capacity Market Agreements), is concerning. In the case of a CfD, a market participant will typically have incurred 10 per cent of its development costs, by the time a CfD is awarded by the Government.

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Given development timelines, it is difficult for market participants to anticipate the impact of these type of changes in modelling the economics of any investment or bidding competitively for capacity market agreements or CfDs. The consequence is that either (i) developers need to build a risk premium into their bids – which leads to additional costs for customers; or (ii) developers will bid for contracts based on the existing rules, with the result that the project will subsequently be terminated, and may create a challenge to achieve the Government's goals of decarbonization and ensuring security of supply.

Even at this late stage in the TCR process – with the additional clarity that the number of preferred options are reduced from five to two, and that Ofgem is proposing to include changes to the Transmission Generation Residual and BSUoS within the scope of the SCR – it is still not possible to forecast *a reasonable range* of network charges that a particular generator or customer should anticipate facing over the next 5-10 years. For example, we have observed that network charges for a particular project could vary by as much as £25 million per year (and account for up to 50% of ongoing costs), depending on different regulatory pathways for transmission charging currently under consideration.

In its impact assessment, Ofgem does not appear to have considered the negative impact its proposals may have on investor confidence and costs. We note that, from its impact assessment, Ofgem anticipates a net benefit to GB consumers of approximately £30 million per year over the next 20 years. While we welcome the consumer benefit, the anticipated benefits seem relatively marginal when compared to the significant disruption that will result from the changes. Ofgem should consider the link with the costs and pace of new developments in its impact assessment to ensure that the anticipated benefits for consumers are not outweighed by other factors.

2. Potentially perverse incentive for I&C customers

Ofgem's preferred options for the recovery of residual charges (fixed charges or agreed capacity charges) will – particularly on the I&C side – reward parties that, to date, have not acted to respond to the economic signals provided by the regulatory and policy framework, and significantly increase network costs for those I&C customers that have. We consider that Ofgem's preferred option will send a perverse signal to this group of customers.

In developing its proposals Ofgem does not appear to have considered the negative impact that significantly increasing network costs for the most active I&C customers (**by over 400%),** while reducing network costs for the least active I&C customers (**by between 30-60%**), will have on I&C customers confidence and willingness to actively engage, and invest in, the GB electricity market based on the economic signals provided by the regulatory framework.

Proactive engagement of industry to respond to the economic signals provided by the regulatory framework, is not the primary focus of industry. However, such engagement will be a critical to achieving the governments climate and energy objectives. In developing its proposals, and in its impact assessment, Ofgem should consider the impact that increasing network costs by over 400% for the most engaged I&C Customers will have on future engagement of industry, and on international competitiveness.

3. Level playing field

We have two main level playing field concerns: first, ensuring a level playing field between small scale distributed generation, demand side response and conventional generation; and, second, ensuring a level playing field is maintained between GB market participants and those in interconnected countries.

In relation to the first concern, we note that there is not currently a level playing field between different types of GB generation, and demand side response, in their ability to access potential revenue streams. For example, balancing markets have not yet been fully opened to the participation of demand side response and small-scale and distributed generation.

While we agree with the objective of ensuring a level playing field for charging, doing so in the absence of a clear drive to deliver a level playing field for decentralized and flexible assets to access potential revenue streams, risks tipping the playing field too far in favour of conventional generation assets. We do not consider that this would be in line with the objective of developing a decentralized and flexible energy system. To address this concern Ofgem should continue to work with the Electricity System Operator and market participants to develop systems to enable decentralized and flexible assets to participate in the provision of ancillary services to network operators.

In relation to the second concern, the anticipated increase in cross-border interconnection [with 20GW in planning] means that it will be increasingly important for GB to maintain a level playing field, to ensure an efficient level of investment in generation. The European Commission notice on the withdrawal of the United Kingdom and the Internal Energy Market[1], states that system use fees will be levied on all scheduled imports and exports of electricity from all third countries which have not adopted an agreement to apply Union Law. We note that Ofgem has not provided equivalent clarity on how network charging will be impacted.

It is important that Ofgem maintain a level playing field between GB generators and those connected in neighbouring countries. To achieve this, we consider that Ofgem should (i) maintain (or even lower) the current €2.50/MWh cap on annual average transmission charges for generators [the equivalent cap for most other EU countries is set at €0.50/MWh, five times lower] ; (ii) include Offshore Transmission Operator's (OFTO) local TNUoS charges within the calculation of the cap – to ensure that all GB generators are treated equally; and (iii) consider whether the forward looking locational element of transmission charges should also apply cross-border. Lack of clarity over how Ofgem intend to address such level playing field questions represent one of the biggest uncertainties over the anticipated level of network charging.

4. Link to the Network Access and Forward-Looking Charging - Significant Code Review

Ofgem has taken the view that the collection of residual charges should not impact market participant's decisions on the location and dispatch of generation (or demand response) – and that this should only be impacted by the collection of forward looking charges. However, the collection of residual charges, through the triad charging, has always been explicitly designed to impact decisions on the dispatch and location of generation (or demand response).

[1] https://ec.europa.eu/info/sites/info/files/notice_to_stakeholders_brexit_energy_market_final.pdf

It is not possible to provide a fully informed response to Ofgem's TCR proposals, in the absence of a clear understanding of the proposals that Ofgem will bring forward under its Network Access and Forward Looking Charging Significant Code Review (AFC-SCR). For example, we anticipate that Ofgem will have to replace the existing triad mechanism with an alternative and equivalent incentive for customers to reduce demand during peak periods, to ensure that the proposals do not negatively impact security of supply.

However, the AFC-SCR was launched on the 18 December 2018, and based on Ofgem's timings for the TCR, we anticipate clarity on Ofgem's proposed changes to forward looking charges by the start of 2020 at the earliest. As the forward-looking charges are intended to incentivize decisions on plant location and dispatch, we anticipate that changes proposed under the ACF-SCR will have a bigger impact on the economics of any new development than changes to the residual charges. However, we currently there have limited visibility of what the ACF-SCR changes may entail, and due to the lack of common timing for the two processes, we do not know whether, or how, the existing triad mechanism will be replaced.

In addition, the lack of clearly defined access rights (which we hope will be addressed in the AFC-SCR) appear to have influenced Ofgem's thinking on its two preferred options for collecting residual charges. From a principles-based perspective we see limited differences in principle between Ofgem's two preferred options (fixed charges or access charges) – both represent a different way of allocating customers to specific groups to determine the level of residual network charges that they will face.

The main difference that we see between the two preferred options is that, for the fixed charge approach a potential (albeit obscure) mechanism already exists that could be used to place customers into different charging groups, while for an approach based on access rights, Ofgem will have to have completed the AFC-SCR process (to ensure that access rights are better defined) before this option can be implemented with appropriate considerations of fairness, transparency and efficiency. As Ofgem has not explored in detail how it could potentially place customers into groups based on their access rights, we do not see how Ofgem could have performed its detailed impact assessment to assess the relative merits and distributional impacts of the two approaches

Whatever option Ofgem decides to use to place customers into different groups, it is of primary importance that Ofgem ensures that the industry governance associated with the chosen method is sufficiently robust, transparent and fair, to ensure that the method is implemented and managed in a fair and transparent way, and the scope for regulatory arbitrage is minimised. Ofgem should consider and address any potential governance issues associated with its chosen method now (as part of the SCR), and not leave this as a problem to be dealt with later. It is also incumbent on Ofgem to ensure that the voices of those less able to navigate industry governance process are fully heard, from consumer representatives through to innovators and large-scale system users.

Of the Ofgem's two preferred options, we prefer the recovery of residual charges to be based on defined access rights. We consider that this would, at least partially, address the perverse incentive Ofgem's proposal will create for I&C customers and industry to engage proactively in the energy transition (explained in part 2 of our response above). For this option, and indeed either option, Ofgem should also take into account the needs of suppliers, (and others mediating between the charge-setters and charge-payers depending on business model) that the charges levied must be clear and predictable and certain, to avoid any risk or uncertainty premia being added to retail charges.

5. Consistency in application of principles for proposed decision on "other embedded benefits"

We would welcome further explanation and clarification of Ofgem's thinking in relation to the "other embedded benefits" identified in Chapter 6 of its minded to decision.

We are aware that setting the Transmission Generation Residual to zero may put GB in breach of the €2.50/MWh cap on transmission charges imposed by Regulation (EU) No 838/2010. As a result, we assume that the methodology used to calculate forward transmission charges will have to be adjusted to ensure that GB remains within the cap. However, it is not clear whether Ofgem has considered the necessary adjustment to forward looking charges in developing its proposals or performing its impact assessment. If Ofgem is aware that such an adjustment will have to take place, this should also be explicitly included in its proposed decision and impact assessment.

Will Ofgem direct the necessary changes to the method used to calculate forward looking charges as part of this SCR?

Ofgem have also concluded that BSUoS should be treated as a residual charge. We tend to agree, as seeking to include a forward-looking incentive in BSUoS charges (on top of TNUoS and DUoS) may overcomplicate GB charging arrangements without a clear benefit.

We are concerned that, in contrast to the proposed treatment of the other residual charges, Ofgem is not proposing that BSUoS should be levied on final demand only and has not provided a clear rationale for proposing that BSUoS be treated differently. We consider that Ofgem should apply its principles consistently to all residual charges and set out a clear way forward on BSUoS charging in its final TCR decision. In addition, it is not clear whether Ofgem have assessed the option of BSUoS being levied on final demand in its impact assessment.

We see two possible ways forward, Ofgem should either direct an industry group to develop proposals on BSUoS, or include a clear and evidence-based direction on what reforms should be implemented in the TCR decision. We are concerned that the current approach, moving halfway toward levying BSUoS on demand, and leaving industry to clear up the rest, risks confusion.

6. Elements missing from the draft impact assessment

In setting out our main concerns above, we noted a number of elements that we consider are missing from Ofgem's draft impact assessment. We proposed that Ofgem updates its draft impact assessment to include the following additional elements:

1. The impact that the proposals on investor confidence and costs
2. The impact of the proposals on the incentives on proactive I&C customers to respond to the signals provided by the regulatory framework
3. Explicit assessment of the other changes that will have to be made to the charging regime to ensure that GB transmission charges stay within the €2.50/MWh cap
4. Explicit assessment of the costs and benefits associated with BSUoS being levied on final demand, as we assume that this is Ofgem's ultimate objective

Feedback on Ofgem's proposals and proposed actions to address concerns

1. Minded to decision on Network Residual Charges

We have a strong preference for Ofgem to base the recovery of residual charges on an agreed capacity charge approach. We believe that this would partially mitigate the negative impact that the proposed changes will have on I&C customers incentive to respond to the economic signals provided by the regulatory framework. It is very concerning that the proposals will, according to Ofgem's own analysis, increase the network costs of the most engaged I&C customers by over 400 per cent.

We also consider that the timing of the TCR and ACF-SCR should be aligned so that industry can be presented with, and consider, the impact of a holistic set of proposals. To be able to implement the agreed capacity approach, the AFC-SCR process to develop better defined capacity rights would need to be progressed first. Once capacity rights have been better defined, these could provide a simple, transparent and fair basis to determine the allocation of residual charges to different customer groups.

We are concerned that Ofgem's proposal to use Line Loss Factor Class (LLFC) to determine the level of charging that customers face is driven more by the fact that this categorization already exists, rather than there being any evidence that it is the fairest and most transparent approach to allocating residual charges. We also see a risk that Ofgem may adopt the LLFC approach as an interim measure, and then subsequently review the approach once the AFC-SCR proposals have been developed and implemented. In the absence of better defined capacity rights, we are not convinced that the two preferred options (fixed charges and capacity charges) can be meaningfully assessed.

We are also concerned that the governance arrangements for any method adopted needs to be sufficiently robust, fair and transparent. Only then can market participants be confident that the application of charges based on that method will also be appropriately robust, fair and transparent. We consider that Ofgem needs to address any potential governance challenges ahead of adopting a preferred method to minimize the risk of regulatory arbitrage. We are not convinced that the existing governance surrounding LLFCs is appropriately robust if they are to be used to determine the level of residual charges for all customers connected to the network.

As well as aligning the timing of the processes for TCR and ACF-SCR we would also support a phased approach to the implementation of any changes; i.e. from April 2021 to April 2023. This would provide industry with the necessary notice and time to adjust to the anticipated changes in network charging costs and would help to partially mitigate any potential negative impact on investor confidence.

Related to this, of crucial importance is the transparency/simplicity of information, and tools to allow for easy forecasting of the impact of the changes.

2. Minded to decision on "remaining embedded benefits"

We are not convinced that Ofgem has fully considered or explored the implications of its minded to decision on the remaining embedded benefits.

In relation to setting the Transmission Generation Residual to zero, Ofgem does not appear to have considered – or modelled –the impact of changes to the method used to determine forward looking charges necessary to ensure that GB transmission charges remain within the €2.50/MWh cap on transmission charges imposed by Regulation (EU) No 838/2010. We consider that Ofgem should model the impact of all necessary changes in determining whether to set the TGR to zero.

In relation to BSUoS, we consider that Ofgem should either direct an industry group to develop proposals or include a clear and evidence-based direction on what reforms should be implemented in the TCR decision. We are concerned that the current approach, moving halfway toward levying BSUoS on demand, and leaving industry to clear up the rest, creates a risk, but provides no clarity, on whether industry should anticipate further reforms to BSUoS shortly after the TCR process has concluded.

We also propose that the timings of these elements of the proposed TCR decision should be aligned with the AFC-SCR process, and with the timings of any decision and implementation of changes on residual charges. We consider that alignment will be important to ensure that industry (and Ofgem) is able to consider a holistic set of proposals on network charging, understand the potential interactions between the two sets of reforms, and increase the likelihood that we are able to identify important interactions or unintended consequences associated with the proposed changes.

3. Addressing our other concerns

We also encourage the Regulator and Government to explore mitigations to the possible negative impact of uncertainty in network charges on market participants in the reform process. Ofgem should consider the following options to mitigate the anticipated uncertainty:

A. Actions that Ofgem can take in the review process:

- o Align the timing of the TCR and AFC-SCR processes so that industry, and the regulator, can consider and develop a holistic and complete set of proposal. It is not possible to provide a fully informed response to the TCR proposals without understanding what changes may be considered as part of the AFC-SCR.
- o Where a solution may result in a significant re-distribution of costs among network users, Ofgem should allow sufficient time for the changes to be implemented so that parties are able to make necessary changes to their business models.
- o Develop a common evidence base which can be used by both industry and Ofgem to assess the case for change and the efficiency of alternative solutions.

B. Address the outstanding level playing field questions for GB transmission charging

We note that the question of potential changes to network charging arrangements necessary to ensure a level playing field between transmission connected generation in GB and neighbouring interconnected markets is not currently addressed in either the TCR or AFC-SCR processes. We urge Ofgem to address these policy questions as a matter of priority as they have a big impact on the level of transmission charges that generation and demand will face in the future.

C. Investigate other options to address regulatory uncertainty together with the Government.

Currently the route to market for new investment is provided by the Capacity Market and the Contract for Difference (CfD) where parties bid competitively for the level of long-term support considered necessary to achieve an economic return. If the charging regime is subsequently amended, such that the level of support awarded is no longer economic, then the costs fall entirely on the investor.

We note that the CfD already insulates investors from changes in balancing charges. Given the scope of the proposed review, we suggest that the Regulator and Government should explore options to insulate investors from changes in network charges over which they have limited or no control. This would be in line with Ofgem's proposed principle that risks should be allocated to those parties that are best able to manage them

Yours sincerely

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