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Dear Andrew,

Future Charging and Access programme – consultation on refined residual charging banding in the Targeted Charging Review

We welcome the opportunity to respond to Ofgem's open letter of 3rd September regarding refined residual charging bands in the Targeted Charging Review (TCR). We fully support the objectives and principles behind the TCR and agree with Ofgem's position that a fixed charge approach would best meet the objective of "reducing harmful distortions".

Regarding the proposals to reform demand residual charges, we support Ofgem's position that it could better meet the objective of "fairness" by differentiating between different customers which exhibit relevant differences from each other. However, in doing so, care is needed to avoid inadvertently leaving undue distortions which are themselves inherently unfair. We also agree that it is important that any solution should be proportionate and practical and, in particular, does not place undue administrative burden, uncertainty, or risk on suppliers which need to be able to accurately translate charging arrangements into tariffs for their customers. We have responded in more detail to the sections of the open letter below.

1. Refined residual charging proposals

We support Ofgem's reasoning for levying residual charges wholly on final demand. We also welcome Ofgem's proposals to charge the residual "per site" on a pro rata, daily basis and agree that it would be appropriate for industry to consider practical details as part of the industry modification process.

We support the objective of "fairness", which Ofgem's is attempting to achieve by proposing segments for non-domestic users and we agree with Ofgem's application of the TCR principles to its customer segmentation criteria as set out in Figure 1 of Ofgem's open letter. In our view, the move to using agreed capacity levels in order to set bands at the higher voltages could deliver charges which are fairer. We suggest a potential additional step that could be taken to further reduce the risk of market distortions may be to take into account a customer's maximum demand in a year, or over a historical period of time. This could further reduce perverse incentives for customers to invest in behind the meter generation or artificially understate their agreed capacity and pay overrun charges

as a means of moving between bands with the consequence that they avoid paying network residual charges.

We appreciate it may be prudent to consider applying a form of segmentation to domestic users, however this may not be appropriate in practice. We would be concerned segmentation by consumption volume would risk leaving in place excessive market distortions which would result in higher system costs and be unfair for customers who are less able to avoid residual charges. Segmentation by volume could also be inappropriately detrimental for high volume vulnerable customers and potentially customers with electric heating (who may also be vulnerable). We would also be concerned that banding may be too confusing for customers, impractical for suppliers to implement and inconsistent with the Prepayment Meter and Default Tariff Caps. At this stage it is not clear to us what alternative measures could be used for banding domestic customers where capacity data is not currently available.

We agree that Ofgem's proposed use of bands should better meet the objective of reducing market distortions compared with using a continuous measure such as charging the residual directly as a £/kW charge. However, if a continuous measure were to be considered, then it would be important to define it in a way which minimised the risk of market distortions, for example, using the higher of either a site's historical maximum demand, or historical agreed capacity.

In contrast to the proposals relating to capacity, we would be concerned about the proposal for customers on the low voltage network to be segmented based on consumption volume. Segmentation by volume would likely be counterproductive for delivering the TCR objectives because it would be likely to leave in place undue market distortions. This is because it is much easier for customers to take residual avoidance action to reduce their consumption volume to move between consumption bands, than it would be for them to reduce their agreed capacity. Furthermore, this approach would be unlikely to deliver the fairness benefit which Ofgem hopes because electricity consumption volume for LV connected customers may not be well correlated with those customers' profitability and ability to pay higher charges, so would not necessarily be any fairer than using line loss factor class groups. Capacity would be the better measure for defining bands, however, for customers where capacity data is not available, Ofgem's original proposal of using line loss factor class groups may remain more appropriate than consumption volume.

We agree it is important that any residual banding arrangements should be consistent across GB and also consistent across Distribution and Transmission customer charges. It will be important to consider details of implementation which could further reduce the incentive for residual avoidance action, including using a smaller number of bands and a historic measure to classify customers into bands, which could take a similar approach to the TNUoS application of the Annual Load Factor for generation such as a form of rolling historical average. We would also agree with the reasoning for allocating customer bands for an extended period such as the duration of a price control, to further limit opportunities for avoidance action and to provide greater certainty for both suppliers and customers.

Lastly, it would be helpful to make use of existing industry data to define the bands instead of requiring the gathering and distribution of new data. It will be important to ensure the band classification for each customer is available to suppliers with sufficient notice for suppliers to accurately set customer tariffs. Furthermore, to reduce the risk of inappropriate classifications, it

may also be helpful to include a review mechanism for occasions where the use of a site may change and a new customer may exhibit characteristics of a different band.

2) Supplementary renewables modelling

We welcome Ofgem's additional renewables modelling, although it is likely that this still under-estimates the system benefits of the proposed TCR reforms to demand charges and BSUoS regarding the mix of low carbon generation and storage rather than total levels. In this regard, the greatest GB system benefit would be expected to arise from a more level playing field between generators located behind a customer meter and those connected directly to the distribution or transmission networks. Therefore, following these reforms, it should be expected that the energy market should deliver a more economically efficient mix of GB generation technologies, at more efficient scales and voltages of connection at lower cost to customers over the long-term.

We would also suggest that Ofgem's input assumptions in the new sensitivity may not be valid regarding "…the assumption that support payments would be used to incentivise replacement of onshore wind and solar PV with more expensive offshore wind, which has a higher "strike price" for the purpose of this sensitivity." We would highlight that the CfD auction result published on 20th September indicates that efficiencies from economies of scale have contributed to offshore wind now potentially becoming the same, or lower cost than onshore wind and PV

A further aspect which this supplementary analysis does not reflect is the issue of delivering a level playing field between all GB generation compared with generators in interconnected energy markets. In this regard, we would suggest that Ofgem's logic is flawed in its proposal to increase costs for GB transmission connected generators by removing the negative Transmission Generation Residual and also to increase costs for GB distribution connected generators by beginning to charge them BSUoS. By contrast, we would suggest it would be better for GB customers to address the level playing field issue by further reducing the average level of TNUoS charges for all GB generation. With regard to BSUoS, then in as far as BSUoS represents revenue collection, it would be appropriate to apply the TCR principles and collect BSUoS wholly from final demand. The question of how best to reflect potential future DSO congestion management costs should be considered separately.

These improvements to generation TNUoS may be best achieved in combination with Ofgem's Access and Forward Looking Charges reform which proposes to consider changes to the TNUoS Transport model reference node and proposes to provide the same TNUoS price signal to generators connected to the distribution network, as those connected to the transmission network. In this way, Ofgem could better ensure that all GB generators are not unduly disadvantaged compared with interconnected generators which should result in lower costs to GB customers over the long-term.

We would be pleased to discuss any of these issues in more detail, if that would be helpful.

Yours sincerely,

John Tindal
Head of Electricity Economics