energywatch
your gas and electricity watchdog

Robert Hull
Director of Transmission
Ofgem
9 Millbank
London
SW1P 3GE
robert.hull@ofgem.gov.uk

26 July 2007

Your Ref: Ofgem doc 153/07

Dear Robert

Zonal transmission losses - the Authority's 'minded-to' decisions: consultation

energywatch welcomes the opportunity to respond to the issues raised in the consultation document. This response is non-confidential and we are happy for it to be published on the Ofgem website.

We are disappointed with the Authority's 'minded to' decision to approve one of the various BSC modifications which have been raised to introduce zonal transmission losses, albeit the one most logical to implement. **We do not believe that any of these modifications should be approved**. It appears to us that the Authority has taken a very narrow economic perspective in reaching this 'minded to' decision, despite the attempt to justify this decision in relation to its wider responsibilities as the industry regulator. In our response to the Impact Assessment consultation in April 2007 we highlighted a number of factors which we believe could potentially adversely affect consumers' interests, the protection of which is the Authority's primary duty. We continue to consider there to be valid reasons for rejecting all the modification proposals.

We believe that Ofgem has failed to acknowledge one theme which was highlighted in our response to the Impact Assessment, namely the effect of the zonal allocation of the costs of losses on consumers, large (those directly connected to the transmission grid) and small. Most consumers are passive users of transmission networks and are unable to respond to the pricing signals which zonal losses supposedly provide. They will pay, regardless, for the impact of zonal losses on suppliers, who will probably pass additional costs through to consumers' bills, and on generation sited in northern Britain, which would be reflected in higher wholesale electricity costs. This is a probable consequence of a pure cost reflective approach.

We believe that the following reasons remain valid for rejecting all the modifications:

- the geographical redistribution of costs under a zonal losses scheme will only result in financial windfall gains/losses between northern and southern generators. The additional analysis undertaken by Ofgem does not suggest otherwise. Nor is there firm evidence that there are significant long-term benefits in introducing zonal losses. The benefits dissipate towards the end of the period analysed by Oxera. Simply holding onto the incentives to retain locational balance beyond that time without any further real savings tends to suggest a rather limited period of overall benefit. There is no certainty that southern generators that benefit from lower costs of losses will do other than retain these as profit, whereas there is a real risk that northern generators will pass through their additional costs, increasing wholesale prices to the end consumer;

- the level of increase in onshore and offshore wind and other renewable generation proposed to be built in northern Britain far outstrips any equivalent development in southern Britain. The Seven Year Statement analysis presented by Ofgem bears this out. Geographic and resource factors drive these decisions, as well as other issues such as planning permission and proximity to skilled labour, not necessarily the cost of transmission losses. If Britain is to make best use of its resources to develop a sustainable energy future for the benefit of consumers, then these factors may take more precedence. If some projects fail to be developed due to concerns over zonal transmission losses, there are implications for long-term security of supply as well as for the environment. We fully support the development of more distributed and locally accessible 'green' generation but believe that there still needs to be a balance in terms of incentives to encourage wider deployment of both small- and large-scale generation;

- for the very largest directly connected consumers, there are a number of factors which determine their location on the network, not just the allocation of transmission losses. The zonal allocation of losses will simply add to existing costs based on geography, particularly for those who are already connected and invested in their location under different circumstances, without providing real benefits. There is no real prospect that these consumers would respond to the pricing signals; rather they would just bear those costs and pass them on to their customers. Those adversely impacted may also argue that there is a discriminatory element to the reallocation of costs caused by zonal losses;

- suppliers, particularly small suppliers in the I & C market, are more likely to pass through the additional costs that zonal losses may impose on them. This has two detrimental effects on their customers – the potential for tariff disturbance to take place partway through a contract, and the risk that small suppliers may become less competitive because they cannot absorb these costs like large suppliers. A less competitive market is bad news for consumers;

- there are, or ought to be, sufficient incentives on National Grid as the GB system operator to mitigate the overall level of transmission losses through the SO incentives scheme. We believe that this is a more efficient means of addressing the issue of losses so long as the incentives are transparent and understood by market participants. We would encourage Ofgem to ensure that this approach is reflected in the SO incentives review which it is currently undertaking. Furthermore, National Grid's amendments to the transmission charging arrangements in recent years are already provide locational pricing signals and do not require to be added to through a zonal transmission losses scheme.

We note that, of the responses received on the Impact Assessment, only two parties favour the option which the Authority is minded to approve out of a total of 25, with the majority opposed to any of the options. We believe that Ofgem needs to consider why there is so little support for zonal losses in general. We do not believe that this is because all those opposed are adversely impacted by the introduction of P203 but because there is a sound rationale why the pure cost reflectivity of a zonal losses scheme does not alone provide more effective pricing signals to market participants, whether on the generation or supply side, than already exist. We hope that Ofgem will take full cognisance of these reasons when making a final decision.

Going forward, we will continue to keep these issues under review, particularly the final decision of the Authority, always considering the possible impact on consumers.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs