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Via email

Dear Frances

Re: Open letter: Charging arrangements for embedded generation

Thank you for the opportunity to respond to your [open letter](#). This is a non-confidential response on behalf of the Centrica group of companies, excluding Centrica Storage.

Summary views - current arrangements

- Embedded Benefits are not cost reflective and give undue competitive advantage to exemptable embedded generation (EG) over licensable and transmission connected generation (TG). Ultimately, they increase costs for customers.
- Embedded Benefits arise because some cost recovery mechanisms in GB are charged on the basis of “net demand” (i.e. demand imports net of EG exports). This is also referred to as “net charging”. Cost recovery mechanisms that use “net charging” effectively create revenue streams for EG.
- There is no justification for the current levels of EG revenues arising from “net charging”. These revenues distort competition in generation and inflate the unit cost of levies to end consumers¹.
- As TG does not receive Embedded Benefits, investment and dispatch decisions are skewed in favour of EG under current rules. This distortion will continue – and in all likelihood increase - as long as “net demand” remains the basis for any major cost recovery mechanism in GB.

¹ End consumers pay a higher unit rate under “net charging” because EG reduces the charging base the cost is recovered from. For example, if ~£2,200m is recoverable from Demand TNUoS in 2016/17, recovery from “net demand” creates a demand unit rate of ~£2,200m / ~50GW or ~£44/kW. However, in reality, underlying demand is ~55GW, but ~5GW of EG reduces the denominator to ~50GW. Recovering the ~£2,200m over gross demand and excluding EG from the calc would lower the unit rate for end consumers to ~£2,200m / ~55GW or ~£40/kW.

Preferred way forward

A Significant Code Review (SCR) is unnecessary

- We agree that a Significant Code Review (SCR) is unnecessary at this stage and risks prolonging uncertainty in the market. Industry led reforms (CMP264/5) to the largest Embedded Benefit, Demand TNUoS, are at an advanced stage, enabling an Ofgem decision in the near term. A comprehensive range of alternatives (WACMs) will be available to Ofgem to consider.
- The Capacity Market Supplier Charge (CMSC) is, prospectively, the second largest Embedded Benefit. We anticipate a Government consultation on moving from “net” to “gross” charging in the coming months. This should address the undue competitive advantage to EG that currently arises from the CMSC.
- Taken together, these developments can substantially address the problems of Embedded Benefits and restore effective competition in generation in a timely manner.

Preferred reforms to Demand TNUoS Embedded Benefit

- We favour reforms to Demand TNUoS that create equivalent residual tariffs for TG and EG, in the interests of effective competition in generation. Locational tariffs for EG and TG are broadly equivalent already. The principle of equivalent residual tariffs for TG and EG is embodied in several of the alternatives (WACMs) developed under CMP264/5.
- We do, however, support delayed implementation of reform, in recognition of the four-year-ahead price commitments Capacity Market (CM) participants must make under the CM. If CM participants can have confidence that the *structure* of their TNUoS charges in year t will reflect the structure in place at the $t-4$ auction, risk premia can be avoided in CM bids, reducing costs to consumers. We also believe there are administrative benefits of having a reasonable lead time between a CMP264/5 decision and implementation.
- In practice, this means we support a decision on CMP264/5 as soon as practicable, with implementation in April 2020².

Wider views on incentivising flexibility

- We recognise some participants have argued that Embedded Benefit reforms would stymie the uptake of flexible generation in GB. We believe demand for flexibility services, not Embedded Benefits, should underpin the supply of flexible generation in GB.
- National Grid’s recent tender for Enhanced Frequency Response (EFR) is an excellent example of how flexibility should be incentivised going forward. The tender proved extremely competitive, highlighting the superiority of market based procurement of ancillary services over administrative or monopolistic approaches.
- We support additional EFR tenders in future and hope to see flexibility and network management tenders at distribution level in the near to medium term.

² An Ofgem decision on CMP264/5 before this year’s CM auction with implementation in April 2020 was our preferred solution. However, we recognise the practical limitations of this timeframe on the CMP264/5 process and accept that a decision may now be after the CM auction.

- Ofgem may have a role to play in stimulating the buy side of the flexibility market, at transmission and distribution level, to ensure that competitive tenders for flexibility services are forthcoming and monopolistic approaches to flexibility / network management are avoided.

We trust you find our comments helpful. We would be happy to discuss these issues in more depth at your convenience.

Yours sincerely,

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