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Dear Andrew,

Embedded Benefits: Consultation on CMP264 and CMP265 minded to decision and draft Impact Assessment

We welcome Ofgem's open letter as it reflects a growing concern within the GB electricity sector regarding the disjointed and imbalanced network charging arrangements. We welcome Ofgem's focus on protecting consumers, but we are concerned about the potential consequences of the proposed changes.

Highlands and Islands Enterprise (HIE) takes a distinctive approach to regional development – supporting the growth of communities as well as businesses and economic sectors. Operating across a largely rural area that covers half the land mass of Scotland and includes over 100 inhabited islands, the enterprise agency recognises that strong, sustainable communities are critical in supporting economic growth across the region, particularly in remote mainland and island areas. Increasingly this has meant empowering communities to acquire and manage key assets for themselves, including land, infrastructure and energy. The renewable energy sector represents a significant opportunity for the region, noting enviable natural resources, world class infrastructure, and transferable expertise from the oil and gas sector.

HIE along with its local partners - the democratically elected local authorities covering the north of Scotland and the islands; Shetland Islands Council, Orkney Islands Council, Comhairle nan Eilean Siar, Highlands Council and Argyll & Bute Council, make representations to key participants on behalf of industry to influence the way in which regulation of the energy industry is managed in order to ensure the needs and interests of the Highlands and Islands are understood and taken into consideration. HIE also works closely with Scottish Government in relation to regulatory matters.

Summary

We agree with Ofgem's stated principle that the collection of the residual costs for operating the transmission and distribution networks needs to be done in a fair way and that users benefiting from the networks should contribute to the costs of running them. Therefore, we welcome Ofgem's wider consideration of these issues with the new Targeted Charging Review.

However, we do not believe that the process of determining the current proposals recommended by Ofgem under CMP264/265 is appropriate, given the scale of potential impact on industry. Therefore, we urge Ofgem to include this issue under

the Targeted Charging Review, rather than progressing it under the CUSC modification process:

- ➔ To accommodate the outcomes of the wider assessment of charging being undertaken by Ofgem under the targeted charging review.
- ➔ Given the scale of impact (circa £5-10/MWh for embedded wind in the north of Scotland by 2021/22), we consider that a wider impact assessment should be performed to determine the likely economic impact, beyond the scope of the assessment performed by Ofgem, including jobs, industry and future cost of capital, and therefore the actual benefit to the consumer.
- ➔ To mitigate the cumulative impact of both CMP264/265 and BSC P350 being implemented in the same financial year, which is going to have a significant impact in particular on embedded generators in the north of Scotland. We do not believe that this has been appropriately addressed by Ofgem's impact assessment.
- ➔ Given the impact of the change on industry, more notice should be given for such significant changes to charging arrangements to allow time for industry to understand, engage and adjust to the proposed changes.
- ➔ To mitigate the impact on investor confidence and the resulting increase in the cost of capital for future projects and therefore the cost to consumer.
- ➔ To wait for a more detailed analysis of the value brought to the transmission system by embedded generation to be developed.

Revenue collection processes for network owners

We appreciate that network companies must be able to recover sunk costs – this is only reasonable for a regulated business. However, these returns **must not be excessive**.

Ofgem's recent annual report on returns under the RIIO framework which illustrate the Return on Regulated Equity (RoRE) show that returns that are highly excessive for regulated businesses – up to 11.63% and average approximately 10%. This is set against a total equity base of £5.6bn for transmission and £7.6bn for distribution networks. If these businesses collected a rate of return that might be expected for these types of business (circa 5%), then the cost to all network users, including consumers, would reduce by £650M per annum.

We note that the cost of equity for transmission owners is 7% and for distribution owners is 6% (6.4% for WPD). This seems extremely high for heavily regulated business within a mature and stable market like GB, and consider that Ofgem should conduct an investigation into the real cost of equity for these companies to confirm whether current levels of return under the RIIO framework are excessive.

GB consumers are footing the bill for these excessive returns and that this should be the focus of Ofgem's efforts to get better value for money for consumers by reducing the exposure to unreasonable returns posted by network owners.

Total system charging arrangements

We strongly support Ofgem's focus on total system flexibility – moving towards a decentralised energy system, with DNOs actively managing networks and procuring local balancing services. Therefore, the future charging arrangements must be fit for purpose, in this context.

We consider that it should be of upmost importance to properly consider charging issues in the round – covering the whole energy system and the value to the consumer rather than narrow fixes to address perceived issues with particular market frameworks (like the outcome of the capacity market). Therefore, we welcome Ofgem's recent significant code review launched to consider the cross system, multi code changes required – with a particular focus on residual charging.

Proposed minded to decision – introducing new market distortions

As referenced throughout the impact assessment consultation, the immediate priority for Ofgem is considering the Transmission Network Use of System (TNUoS) demand residual payments as it is considered by Ofgem to be distorting investment and dispatch decisions and the outcome of the Capacity Market.

Although the issues within the current charging arrangements are clear, we consider that the minded to decision on CMP264/265 of simply targeting one element of the charging arrangements (demand locational TNUoS tariff) for one type of network user (embedded generation, below 100MW) is likely to result in further market distortion and discrimination between network users.

Further distortion is being introduced by the proposal due to the 'floor at zero' which distorts the locational signal.

Ofgem has stated within its impact assessment consultation that the charging arrangements in GB should be based on clear principles. We fully agree with and support this sentiment, but we consider that these two distortions from the fundamental economic principles of fairness and cost reflectivity undermine the proposed solution.

Behind the meter generation

We are concerned that introducing the proposed change under CMP264/265 is going to distort the market further and push triad avoidance activity behind the meter. The incentive for large demand customers to reduce demand (increase on-site generation) remains unaffected by the proposed outcome of CMP264/265. This distortion will remain in place until a fairer arrangement for revenue collection is implemented.

We welcome Ofgem's intention to consider this issue under the targeted charging review, and we consider that this further reinforces our view that both should be addressed together and in line with each other. We are concerned that the decision to implement the minded to decision on CMP264/265 will predicate the outcome of the Targeted Charging Review.

Cumulative impact of changes – CMP264/265 and BSC P350

We believe that the combined impact of the proposed outcome of CMP264/265 along with the recently approved BSC modification proposal P350 in April 2018 is going to have a sudden and significant impact on new developments – particularly in the north of Scotland.

The proposed changes to the charging arrangements under CMP264/265 for embedded export triads are significant. However, these compound changes to the allocation of transmission losses which have been mandated to apply by the Competition and Market Authority. The resulting change proposal to the Balancing

and Settlement Code, P350, is due to come into force on 01 April 2018 – alongside the outcome of CMP264/265. The impact of both of these changes together is very significant for the north of Scotland. By charging year 2021/22, the changes under CMP264/265 will result in a reduction of revenue for a typical embedded wind farm in the north of Scotland of £13-26k per installed MW of capacity (circa £5-10/MWh), based range of wind outputs over triad periods. This is combined with the additional cost of circa £1/MWh associated with BSC P350.

We do not believe that Ofgem has sufficiently taken into account the wider context of regulatory change that is currently ongoing when assessing the impact of CMP264/265.

Ability to respond to the changes

Network users that have already made investment decisions cannot be expected to respond to the proposed changes in charging arrangements.

We agree that charging arrangements should encourage behaviour from system users which reduces overall system costs and minimise costs to the consumer. However, similar to the network businesses, generators and other network users have made investment decisions and have sunk costs, at risk. Once investments are made and steel and concrete has been installed, these projects can no longer reasonably respond to new charging arrangements. For many projects, particularly those currently under construction, the proposed changes are therefore simply punitive.

Scope of economic analysis

We are concerned that Ofgem's minded to decision on CMP264/265 is likely to further damage appetite for private investment in generation capacity within GB, increasing the cost of capital and the slowing the rate at which GB can continue its world leading transition towards a low carbon, digitally enabled, flexible and secure energy future.

We are also concerned that the potential for increased cost of capital has not been reflected in the economic analysis performed by Ofgem and the potential benefit of these changes to the consumer isn't particularly well reflected in the impact assessment.

We are also concerned that the impact assessment is based on the assumption that consumers will realise the savings offered as a result on CMP264/265, but there is no consideration of whether these savings would be passed on from suppliers to consumers. We would like to see more evidence from Ofgem of the reasons that it is confident savings would be passed to the consumer.

CUSC process

Having a clear, consistent and stable regulatory regime is one of the big advantages of the energy system across GB. However, making significant, yet piecemeal changes to charging arrangements (like the proposed 95% reduction in the value of triad avoidance payments, as proposed by Ofgem's minded-to position on CMP264/265), through a relatively terse code change process will weaken the ability for smaller innovators and new market entrants to make investment decisions within the GB market place. Overall, this will increase the cost of operating in the GB market due to increased resource costs and the increased cost of capital associated

with future project development. Ultimately, these costs will be passed on to the consumer.

The CUSC process is not appropriate for implementing such significant change to the charging arrangements. A significant code review is a much more appropriate approach because it gives industry the opportunity to engage and respond to the process – one of the key reasons that the process is going to be significant.

Level playing field between transmission and distribution

The differences between the charging arrangements at transmission and distribution are extremely complex. We agree that Ofgem's efforts to attempt to create a level playing field across parties that have their connection points onto these respective systems. However, the reality is that there are very significant, complicated and long standing differences between transmission and distribution in fundamental ways, including: connection charging, network access rights, network reliability, use of system charging and losses.

For example, distribution users pay high costs up front (per MW of capacity) to connect to the electricity network compared to transmission system parties. Transmission connectees tend to have new network investment (extension or reinforcement) socialised across the entire network customer base. Also, distribution connected parties are required to raise finance to procure these assets rather than being able to rely on the network owner's ability to finance and build these assets. Further, distribution connected projects can also be exposed through the statement of works process to transmission related connection charges (and underwriting for transmission reinforcements). However, transmission connected parties are not exposed to distribution system reinforcements.

Further, distribution parties are exposed to transmission losses (albeit often a credit due to offsetting of transmission network flows) as well as distribution losses. However, on the other hand transmission connected parties are not exposed to distribution losses even though their requirement for (and utilisation of) the distribution network is just as significant to a distribution connected party.

Therefore, we do not believe that there will ever be true equality between transmission and distribution connected customers, therefore any changes to the charging regime must take full account of the reality of the current charging framework, including the investments made across the industry against a stable charging backdrop.

Timing of implementation

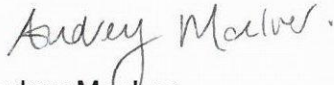
Based on the points raised in this response, we encourage Ofgem to consider carefully the timing of implementing changes to the collection of transmission demand residual component.

We do not consider that the proposed implementation, in April 2018, is a balanced, proportionate position to take on this issue. Therefore, we strongly urge Ofgem to consider delaying a final decision and implementation of this proposal until after the Targeted Charging Review is concluded.

In conclusion, we remain concerned about the scale of impact of the current proposals recommended by Ofgem under CMP264/265, and therefore urge Ofgem to

include this issue under the Targeted Charging Review. We hope you find this response helpful, but please don't hesitate to contact us should have any further queries.

Yours sincerely



Audrey MacIver
Head of Energy

In partnership with:-
Shetland Islands Council
Orkney Islands Council
Comhairle nan Eilean Siar
Highland Council
Argyll & Bute Council