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Att: Andrew Self

YOUR REF./DATE:
Energy Systems

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PLACE/DATE:
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EMBEDDED BENEFITS: CONSULTATION ON CMP264 AND CMP265 MINDED TO DECISION AND DRAFT IMPACT ASSESSMENT– STATKRAFT RESPONSE

Dear Andrew,

Thank you for providing the opportunity to respond to the Consultation on Ofgem's minded to decision for CMP 264 and CMP 265 on embedded benefits.

About Statkraft

Statkraft is a leading company in hydropower internationally and Europe's largest generator of renewable energy. The Group produces hydropower, wind power, gas-fired power and district heating and is a global player in energy market operations. Statkraft has 4200 employees in more than 20 countries.

Statkraft has been a developer and investor in the UK since 2003. We are operating several onshore wind farms in the UK and the Rheidol Hydro power plant. Together with Innogy, we are developing the Triton Knoll offshore wind park, which is located 20 miles off the Lincolnshire coast. Statkraft also have ownership shares in the Sheringham Shoal offshore wind farm and Dudgeon offshore wind farm, which is now under construction.

Statkraft is among the UK's biggest providers of PPAs to developers of renewables and has interests in electricity supply and storage business as well as in biomass supply.

Statkraft's response

We welcome Ofgem's consultation as it reflects a growing concern within the GB electricity sector regarding the disjointed and imbalanced network charging arrangements. However, we are concerned about the potential consequences of the proposed changes currently being developed through the CUSC and BSC modifications process. We are concerned that the scope of these piecemeal modification proposals cannot encompass the full suite of implications of changes and unlikely to result in balanced, well-considered solutions.

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. Of equal importance is to ensure that the scale of revenue collection from the network owners is fair and reasonable for regulated assets. 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
- Further, we consider that the proposed ~95% reduction in value of triad avoidance payment for exporting sites is not fully reflecting the actual value brought to the transmission system from embedded generation. Further assessment should be undertaken to estimate the value of 'x' given the previous informal, narrow assessment previously conducted by National Grid to determine the value of £1.62/kW. Such a review should consider how far network charging should reflect year-round compared to peak network demand
- We strongly urge Ofgem to employ its discretion and delay the implementation of CMP264/265 until after the conclusion of the Targeted Charging Review and considers the reasonableness of the rates of return enjoyed by network owners in GB.
- Implementation after April 2018 is required:
 - To accommodate the outcomes of the wider assessment of charging being undertaken by Ofgem under the targeted charging review.
 - Given the scale of impact, 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 future cost of capital and actual savings by consumers (not suppliers).
 - 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 (value of 'X') by embedded generation to be developed.
- To ensure that residual charges (set to recover revenue of regulated assets) aren't based on excessive returns for the network owners, which currently appear extremely high (average of 10%).
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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 utmost 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.

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.

Reasonable expectation of the benefit

Although large vertically integrated utilities may have some advantage within the marketplace to be able to understand the complex myriad of regulations which form the basis of the energy industry – the reality for many smaller investors or new market entrants is that these issues cannot be foreseen.

Although we agree with Ofgem that there is no legal expectation of receipt of the triad avoidance payments, we do consider that there is an expectation of fair warning regarding fundamental changes to the way that charges are applied.

Impact on investor confidence and cost of capital

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 energy investment in GB.

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 a 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.

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.

We note Ofgem's recent annual report on returns under the RIIO framework which illustrate the Return on Regulated Equity (RoRE). These report show that network operators are making returns that are high 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.

We note that the cost of equity for transmission owners is 7% and for distribution owners is 6% (6.4% for WPD). This seems 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.

Yours sincerely,
for Statkraft UK Ltd.

Knut Dyrstad
Regulatory Affairs Manager
Wind Europe