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TARGETED CHARGING REVIEW: MINDED TO DECISION AND DRAFT IMPACT ASSESSMENT

Dear Mr Self,

Statkraft is a leading company in hydropower internationally and Europe's largest generator of renewable energy. The Group produces hydropower, wind power, solar power, gas-fired power and supplies district heating. Statkraft is a global company in energy market operations. Statkraft has 3600 employees in 15 countries.

Statkraft has been active in the UK since 2003. In the UK we develop, own and operate renewable production facilities and are also involved in the trading and origination of power from our own projects and those of third parties.

Since 2006, Statkraft has invested £1.4 billion in the UK's renewable energy infrastructure and facilitated over 6 GW of new-build renewable energy generation through Power Purchase Agreements (PPAs). Statkraft has developed a portfolio in excess of 500 MW of UK generation plant; it is the majority owner and operator of four onshore wind farms and the owner of one large hydropower plant.

With a PPA-portfolio now exceeding 8 TWh of primarily renewable generators, Statkraft is the leading provider of short and long term PPAs in the UK. Statkraft is also active in electricity supply principally to industrial and commercial customers and in related energy services.

Statkraft are pleased to have the opportunity to respond to OFGEM's **Targeted charging review: minded to decision and draft impact assessment** (TCR) consultation. The Statkraft comments are set out below. Answers to specific consultation questions are provided in Appendix A attached to this letter.

BSUoS charges: avoided charges and payments

In the TCR consultation OFGEM proposes to:

- remove the benefit that accrues to suppliers through reduced BSUoS charges as a result of embedded generation volumes being netted of their customer demand (against which BSUoS is charged); and
- charge embedded generators BSUoS to bring them into line with other [transmission connected] generators.

This will have a significant impact on the cost and revenue streams of embedded renewable generators. Suppliers pass nearly all of the benefit they receive to these generators being the source of them, so the overall impact to this group of generators will be double the BSUoS charge level – upwards of £5/MWh on average per annum. This represents a significant share of the revenue a generator of this type will expect to receive (for example 8-10% for generators receiving £50-£60/MWh for generation sales).

If implemented, the proposed changes to the BSUoS arrangements will take effect in a relatively short timeframe - less than two years from the date of OFGEM's decision. In addition to impact on existing generators, it will undoubtedly affect future deployment of small-scale renewable generation as result of the increased costs leading to less profitable investments. The implementation proposal does not fully consider the timescales needed for affected parties to deploy mitigating actions. Many generators will have power sale contracts with three to five (and possible as long as seven) year terms. Because the current proposal provides insufficient notice, many of these will need to be amended mid-term adding additional costs for affected parties.

Statkraft acknowledges the OFGEM suggestion that some generators may be able to achieve additional revenue via the Capacity Market (CM) or Contracts for Difference (CfD) mechanisms. This is however not likely to be the case for small renewable generators connected to the distribution network. They are not able to access these schemes and will be financially worse off. As a result, Statkraft would expect to see some existing schemes becoming financially unviable and close because of these proposed changes. The current standstill on new CfDs for solar PV and onshore wind also means such CfDs cannot be expected to mitigate added costs.

Statkraft notes that OFGEM has initiated a task force (the Balancing Services Charges Task Force)¹ to review the costs of electricity system balancing and in particular to identify, if possible, elements of BSUoS which are forward-looking and those which arise from residual costs. The timing and interaction between the Task Force's work and the TCR process raises significant concern; change implemented as a result of the TCR consultation proposals, followed by the potential for further change is not only challenging for a regulator and the industry at large, but it also creates additional uncertainty which affects investor confidence.

It is Statkraft's view that the Task Force should first be allowed to conclude its work thereby identifying if a real and quantifiable split between forward-looking and residual costs exists; only then should consideration be given to the current BSUoS arrangements.

Proceeding with the proposed changes to the extant BSUoS arrangements before fully evaluating how the overall BSUoS charge is made up (i.e. mix of residual and forward-looking elements) could result in an outcome not fully aligned with the OFGEM policy of recovering residual charges from final demand users only (TCR consultation section 4). It is Statkraft's view that a residual charge is actually being *introduced* for small generators

¹ https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_to_launch_a_balancing_services_charges_taskforce.pdf

via BSUoS. This is another reason for allowing the Task Force to conclude its work before proposing any course of action.

Statkraft encourages OFGEM to postpone a decision on whether to implement the TCR consultation proposals until the Task Force has completed its work. Such an approach will allow for OFGEM to put forward a single set of proposals for consultation before deciding on a course of action for any changes to future BSUoS arrangements.

Transmission generation residual payments

The TCR consultation proposes to remove transmission generation residual payments from large generators. These payments are currently negative, and should the change be implemented, such generators will face a cost increase.

OFGEM acknowledges EU regulation (838/2010²) which limiting transmission charges for generators to a €2.50/MWh (annual average), the mechanism to deal with this after the implementation of the TCR proposal is not set out. It is Statkraft's contention that the ESO³ should not "be developing" a modification to address this issue in parallel with the TCR consultation; better it was done in advance of the publication of the TCR consultation proposals and included within the supporting documentation. This would have offered greater transparency of the prospective enduring mechanism to impacted parties. The approach taken has, in Statkraft's view, introduced further unnecessary regulatory risk.

As a matter of urgency, Statkraft strongly encourages OFGEM to direct the ESO to publish their modification proposal to change the generation residual charges. OFGEM could then allow further a further period of consultation once industry parties have all the relevant information before making a decision on any changes.

Transmission and distribution residual import charges

TCR proposals in this area result in all residual charges being levied on final user demand; Statkraft notes that OFGEM's preferred approach is to use the LLFC to classify customers before applying the same charge to everyone in each group.

Statkraft acknowledges the LLFC as readily available, but it is relatively static and customers within each classification will vary significantly in their energy and network use. Statkraft believes further consideration should be given to how the classification and segmentation process for these charges would work when implemented and how it can evolve. This would allow it to remain fit for purpose as the electricity system undergoes transformational change in the next few years, a period where customer behaviours and needs will change significantly.

For the charging mechanism to be efficient, reduce system cost and underpin development of flexibility and energy efficiency, it should reward those embracing new technologies, which are positive for the wider system development. Applying a flat charge based on LLFC could mean that a customer who uses their connection for only a few hours each year pays the same as one with significant general usage; this is hardly balanced or fair.

Statkraft's response to question 9 (see Appendix A), sets out a suggestion to use customer connection capacity as a way of segmenting customers into defined capacity bands. Each

²<https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:250:0005:0011:EN:PDF>

³ESO – electricity system operator

capacity band would have a different charge level. This has a number of advantages over the use of LLFC – it better represents a customers' network requirement for cost recovery, is easier for customers to understand, is common across all network areas and allows customers to move easily between capacity bands as their network need (i.e. capacity) changes up or down over time. Statkraft is prepared to work with OFGEM and other industry parties to develop this idea further or to find alternative more suitable solutions.

Summary

In summary, Statkraft is very concerned that the minded to position relating to the TCR consultation has not been formed from a holistic viewpoint taking into account all available information and ongoing workstreams. OFGEM highlights that the aspiration and intention is to implement a fair solution the way costs are recovered, but this outcome cannot be achieved without the whole picture, which includes considering all non-energy costs faced by final customers and generators.

The other on-going workstreams will undoubtedly bring more change in the near future. Based on the available information, Statkraft is of the view that the extant workstreams could trigger some of the some aspects proposed for implementation here to be significantly changed or even reversed. Statkraft encourages OFGEM to act positively on these points to ensure changes are equitable and transparent, encourage investment, reduce market risks and costs and demonstrate regulatory certainty. This will help in reducing cost to customers.

Statkraft hopes the views expressed will be useful and that OFGEM is able to modify its position in such a way as to allow parties to manage any changes in a manner least likely to engender disruption and cost to consumers.

If you would like to discuss anything in set out in our response or have further questions, please do not hesitate to get in touch.

Yours sincerely,
for Statkraft UK Ltd

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Appendix A – Consultation Questions

The Statkraft answers to specific consultation questions are given below.

1. Do you agree that residual charges should be levied on final demand only?

Policy should be implemented fairly and consistently. In order to achieve this a

1. split between forward-looking and residual charge elements must first be properly established across all charges;
2. mechanism for regular review and amendment of any split needs to be set out and implemented so that the split remains appropriate and fair into the future; and a
3. suitable timeline and transition to any new arrangements must be set out well in advance.

In relation to point 2, Statkraft notes that TCR proposals on BSUoS have not been demonstrated to comply with OFGEM's policy of recovering residual charges from final demand only. A split between forward-looking and residual elements has not been properly established and work to do this is currently on-going. Recovering BSUoS from smaller generators as set out is not in line (as it will include residual costs) with OFGEM's policy and Statkraft does not understand why OFGEM is intent on making this change now. To meet policy objectives, further changes to reverse elements of this this is likely to be needed. This approach is not sensible and leaves a big group of generators (many of which are renewable) facing uncertainty which could be avoided.

The timeline for implementation of the TCR proposals is short and changes will be abrupt, i.e. full changes take effect immediately. In order to allow affected generators time to put in place mitigating actions, both a longer notice period and a phased approach to introducing the changes is needed (see question 14 below).

Until a clear picture across all aspects of charging is presented with fair and proportionate timelines / transitional arrangements for affected parties, it is not possible to comment on whether residual charges, regardless of their origin, should be levied on final demand or not.

2. Do you agree with how we have assessed the impacts of the changes we have considered against the principles? If you disagree with our assessment, please provide evidence for your reasoning.

Although OFGEM has set out a framework for assessing the proposed changes against a number of principles this has been done without reference to other workstreams which are reviewing different but nonetheless very closely related aspects of charging. By not adopting a holistic approach and considering all areas together, changes made separately in different timeframes will likely introduce harmful distortions that have not been considered at this stage. They may not be practical or proportionate when considered with other changes.

With regard to the framework used, Statkraft is concerned that some aspects are open to interpretation and are subjective / ambiguous to the extent that almost any single outcome can be argued from them. For example, a fixed residual charge for a group of similar customers may be fair to the extent that all customers pay the same, but it may be unfair to those that have invested in technology and equipment that allows them to

proactively reduce consumption. Charging regimes must not counteract positive developments like the use of new technology for flexibility, increased energy efficiency, and sustainability. We must avoid incentives that mean customers will not act in a way that better the system for everyone. The assessment principles and framework need to capture this in a quantifiable way whilst avoiding significant ambiguity.

Finally, TCR proposals may not be well in line with stated policies. For example, if the Balancing Services Charges Task Force finds BSUoS contains no forward-looking elements, the introduction of a BSUoS charge for embedded generation would be contra to OFGEM's policy of not recovering residual charges from generators.

- 3. For each user, residual charges are currently based on the costs of the voltage level of the network to which a user is connected and the higher voltage levels of the network, but not from lower voltage levels below the user's connection. At this stage, we are not proposing changes to this aspect of the current arrangements. Are there other approaches that would better meet our TCR principles reducing harmful distortions, fairness and proportionality and practical considerations?**

Statkraft has no comments in relation to this question.

- 4. As explained in paragraphs 4.41, 4.43, 4.46, 4.49, 4.80, we think we should prioritise equality within charging segments and equity across all segments. Do you agree that it is fair for all users in the same segment to pay the same charge, and the manner in which we have set the segments? If not, do you know of another approach with available data which would address this issue? Please provide evidence to support your answer.**

For reasons set out in the response to question 5 below relating to the use of the LLFC as a mechanism for segmenting customers, Statkraft does not think it fair that all customers in the segment should pay the same charge.

Segmentation or classification needs to take account of how much the network is used as well as what the usage requirements are. It also needs to contain a mechanism to allow customers to move segment as their usage changes, whether this is driven by opportunities that arise as the electricity system evolves or any other reason.

- 5. Do you agree that similar customers with and without on-site generation should pay the same residual charges? Should both types of users face the same residual charge for their Line Loss Factor Class (LLFC)?**

Statkraft does not agree that this group of customers should face the same residual charges as this does not fairly reflect the reduced use of system by those that have invested in on-site generation once this becomes operational.

Consider two customers with the same LLFC and similar network needs measured e.g. as maximum import capacity. Before the investment in an on-site generator, both are likely to need their network requirements for similar durations, typically 9am-5pm daily. The investment in and introduction of the on-site generation asset reduces one customer's network time and duration of use.

Charging for Network use need to consider when, both for how long and how much of the network is needed as to give appropriate incentives. The customer with the on-site asset should generally be paying less as they are using the network less frequently. The customer with on-site generation is however unlikely to be entirely self-sufficient and will need to use the network during some specific situations (e.g. plant failure) and therefore should make a reasonable contribution to the cost.

6. Do you know of any reasons why the expected consumer benefits from our leading options might not materialise?

If implemented as set out the TCR consultation proposals will adversely affect embedded generators; they will face significant cost increases that they will be unable to replace with alternative revenue streams (e.g. embedded renewable generators cannot access the Capacity Market).

7. Do you agree that our leading options will be more practical to implement than other options?

Leading options presented in the consultation may be “relatively” straightforward to implement from a process perspective, but timeframes are not sufficient to allow affected industry participants to put in place alternative arrangements. Over the medium to long-term, reduced investment in capacity producing cheap and reliable renewable generation may lead to higher overall costs for consumers.

8. Do you agree with the approaches set out for banding (either LLFC or deeming for agreed capacity)? If not please provide evidence as why different approaches to banding would better facilitate the TCR principles.

See response to question 9 below.

9. Do you agree that LLFCs are a sensible way to segment residual charges? If not, are there other existing classifications that should be considered in more detail?

Statkraft does not agree that this is an appropriate segmentation for the recovery of residual charges and little evidence, or reasoning has been presented to support the proposal.

The use of LLFC as a mechanism to group “similar” customers for the purpose of applying a residual network import charge does not provide sufficient recognition of the diverse mix of customers within each LLFC group. Using LLFCs may also result in discrepancies for similar customers connected to different distribution networks.

As users’ network needs alter in the transition to a low carbon smart grid, any mechanism used to group customers for the purposes of cost recovery must allow movement between groups over time, while maintaining overall cost recovery fairly and reflecting network use at the time the charge is recovered.

Statkraft suggests that OFGEM explores the use of connection capacity as a way of segmenting customers into groups or bands. It is Statkraft’s view that this is a better way to segment customers than using LLFC because it

- better reflects customers' network needs;
- allows customers to move between bands easily when they change their network capacity (up or down);
- enables more bands to be easily introduced;
- would be easier for customers to understand; and
- allows proportionate cost to be recovered from customer groups at the time of network use.

Statkraft is prepared to work with OFGEM and other industry parties to develop this idea further or to find alternative more suitable solutions

10. Do you agree with the conclusions we have drawn from our assessment of the following?

- a) **distributional modelling**
- b) **the distributional impacts of the options**
- c) **our wider system modelling**
- d) **how we have interpreted the wider system modelling?**

Please be specific which assessment you agree/disagree with.

Renewable generators will be particularly affected by the proposed changes – they will generally see reduced revenues and increased costs. This will have an effect on the viability of a many projects, but particularly those operating without CfD or ROC support. This will lead to reduced investments and delays in new capacity. Statkraft does not think this aspect has been captured fully in the frontier economics / LCP report⁴ and so the proposals have been derived without fully knowing the impact of the changes on renewable generators. These will be key to the cost-effective delivery of decarbonisation targets.

11. Do you agree with our proposed approach to the reform of the remaining non-locational Embedded Benefits?

Statkraft disagrees with OFGEM's proposed approach as set out in the TCR consultation document.

Statkraft questions the logic and appropriateness of OFGEM's proposal to remove the residual element of charging from transmission connected generators until all details are available including how the change interacts with EU regulation 838/2010⁵ limiting these charges to a €2.50/MWh annual average. OFGEM must set out the whole picture and allow a further period of consultation. A minded to decision at this stage is unhelpful and gives rise to uncertainty that could be avoided.

Any proposals for change to BSUoS arrangements should not be made until the Task Force has reported and a clear understanding of any split in contributions to BSUoS from forward-looking and residual costs is presented. As presented, it is unknown if changes result in an outcome compliant with OFGEM's extant policy (recovery of residual costs from demand only).

⁴ Distribution and wider system impacts of reform to residual charges, November 2018 (https://www.ofgem.gov.uk/system/files/docs/2018/11/distributional_and_wider_system_impacts_of_reform_to_residual_charges.pdf)

⁵ <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:250:0005:0011:EN:PDF>

Again, presenting a minded-to position is unhelpful to industry and like the proposal to remove transmission residual charges, it has created uncertainty that could have been avoided. The area of charging is complex, and it is almost certain that if the TCR proposals are implemented, further change will be needed as a result of work that concludes after changes have been made. This could have been avoided if OFGEM had developed a joined-up approach to the review of charging as a whole.

12. Do you agree with our proposal not to address any other remaining Embedded Benefits at this stage? Which of the embedded benefits do you think should be removed as outlined in xx? Please state your reasoning and provide evidence to support your answer.

Statkraft agrees that OFGEM does not need to consider any other remaining Embedded Benefits. This covers three aspects of charging – Residual Cash flow Reallocation Cash flow, Assistance for Areas with Higher Electricity Distribution costs (AAHEDC) and Statkraft agrees with OFGEM's assessment that the materiality of these is small and is unlikely to influence market participants' behaviour. In addition, it is Statkraft's opinion that RCRC is extremely complex and therefore it is difficult to form a forward-looking picture of its level. A review of this aspect in isolation would be impractical, costly and unlikely to achieve a meaningful outcome that would ultimately lead to value for consumers.

13. Are there any reasons we have not included that mean that the remaining Embedded Benefits should be maintained?

Other workstreams must be allowed to complete their work before you decide to implement any changes. If OFGEM does not allow this to happen, changes may be followed in short order by further changes that either undo or amend hastily implemented changes where the full picture was not available.

14. Do you agree with our proposed approach to transitional arrangements for reforms to: a) transmission and distribution residual charges b) non-locational Embedded Benefits? Please provide evidence to indicate why different arrangements would be more appropriate.

Statkraft does not agree with OFGEM's proposed transitional arrangements for both aspects. There is insufficient time for affected parties to put in place mitigating actions and revisit contractual arrangements.

Statkraft believes OFGEM has not fully considered the actions that parties will need to undertake as a result of the changes or the time necessary to implement them. A longer notice period would allow changes to be incorporated as part of the "business as usual", reducing cost to parties and ultimately consumers.

Without a longer notice of change and a phased approach, there is a real risk in the short-term that some schemes may close as they become unviable overnight. In the long-term these deficiencies in the change process will damage investor confidence because there is not sufficient notice to allow new projects to fully understand the impact of change and factor this into their investment decision. For existing projects, a phased approach would reduce damage to investor confidence; recognition of the conditions under which prior investment decisions were made needs to be factored into

the regulatory process and future changes. It is important to learn from past experiences and not all large changes have been implemented smoothly and without issue (e.g. Project TransmiT).

In the consultation document, OFGEM considers how much power suppliers may have hedged in future years (paragraphs 7.13 and 7.14) and whether this will affect how the benefits are passed on to consumers. Statkraft is concerned that OFGEM appears not to have considered fixed price, fixed term contracts where consumers may have already agreed prices into the future (e.g. three years from next year) or what the position will look like by the time a final decision is made. Generally speaking the notice period required for a change is longer than the one you have set out in the consultation.

15. Do you agree with our minded to decision set out? If not please state your reasoning and provide evidence to support your answer.

Statkraft is disappointed with the lack of coordination that you have applied to the review of charging. Statkraft does not agree with the minded to position as it believes the process followed is flawed and it is likely to generate additional change resulting from on-going workstreams. The timing of workstreams could have been better managed and resulted in a more efficient process, less changes and a better outcome for consumers.

Network access and future charges are being reviewed under a significant code review (SCR) launched in December 2018 (Electricity Network Access and Forward-Looking Charging Review) and the costs of electricity system balancing are being reviewed by the Balancing Services Charges Task Force. Further, some industry change has been stopped whilst other proposed changes have only received a suggestion to discontinue work. Before reaching any minded to position from the TCR work, OFGEM could have harnessed greater industry support through waiting for the outcome of these workstreams concluding in autumn 2020 and May 2019 respectively. If TCR proposals are implemented as set out, is OFGEM confident it is acting in the interests of the consumer having considered all available information and analysis?

In Statkraft's view, the approach will increase regulatory uncertainty that could readily have been avoided. Reduced investor confidence will affect future low-carbon generation schemes and the ability to meet decarbonisation targets and deliver reliable, renewable generation for consumers cheaply.,

16. For our preferred option do you think there are practical consideration or difficulties that we have not taken account of? Please provide evidence to support your answer.

Statkraft has no comments in relation to this question.