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Consultation on market coupling and Levy Exemption Certificates and call for evidence on wider impacts

Dear Sirs,

SmartestEnergy welcomes the opportunity to respond to Ofgem's Consultation on market coupling and Levy Exemption Certificates and call for evidence on wider impacts.

SmartestEnergy has been an aggregator of embedded generation since 2001 and a supplier in the electricity retail market serving large corporate and group organisations since 2008.

Please note that our response is not confidential.

Overview

In summary, we do not agree in principle with limiting the number of EU LECs entering the country on the grounds that a) it is not possible in practice to determine which EU LECs are legitimate and which are not in an implicitly coupled market and b) it would be an anti-competitive and undue restriction of the EU market. We are also of the view that any arrangements which link implicit trading to interconnector capacity would end up being more restrictive than the status quo and that would be to the disadvantage parties such as SmartestEnergy.

The consultation document states that the Authority need not issue a Levy Exemption Certificate (LEC) unless it is satisfied that it represents electricity that is "consumed or to be consumed" in the UK. However, in 2001 the European Commission decided not to raise objections under the EU State aid rules to the main elements of the UK's Climate Change Levy, the description of which stated that the exemption for electricity generated from some energy sources also applied to imported electricity from the same energy sources. In order to effect any restriction to said import the issue of State Aid would have to be reconsidered by the European Commission. (See "Commission approves tax exemptions from the UK Climate Change Levy," Brussels 28th March 2001, IP/01/455.)

In consideration of the issue generally, however, we have come to the conclusion that the CCL/LEC regime will be unworkable soon because of the number of UK LECs forecast. Since



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further, and more fundamental change will be required there seems little point in addressing the specific issue of EU LECs at this juncture.

If Ofgem does decide to make changes at this stage we believe that sufficient notice should be given. It is important to consider how suppliers are managing their positions and entering into contracts in order to secure LECs that are matched with retail volumes. A sufficient level of notice of change would be needed to ensure a properly managed exit, otherwise there is a significant risk of disruption to the non-domestic supply market.

Below we address the issues contained in the consultation more or less in the order in which they appear.

Questions in the consultation document

Question 1: Where renewable electricity is traded implicitly across coupled markets, is it possible to evidence the electricity is consumed (or to be consumed) in the UK? Please explain your answer.

To a certain extent we do not understand the premise of the question. There is currently no requirement to match electricity generated in Scotland with electricity consumed in England. Indeed, there could easily be trades in both directions which are greater than the capacity of the Scottish interconnectors. Nobody questions whether this is appropriate. Likewise, there is an obligation on Ofgem to accept LECs from other EU countries and the capacity of the interconnectors with Europe should be irrelevant.

Let us assume that at some point in the future, that due to high levels of constraints between Scotland and England, there is a need for market splitting between England and Scotland. In this eventuality, would it be logical to suddenly start insisting on limiting the number of LECs to the value of the interconnector? The answer to this question is no. Just as the European electricity market should not be constrained by national tax arrangements, tax arrangements should not be subdivided on a national level because of internal constraints. For this reason we believe Ofgem are going to have to accept unlimited implicit trading with no physical evidence.

We would suggest that the most that can be expected is that suppliers must demonstrate that their LECs do not exceed supply.

Question 2: What evidence might generators use to demonstrate that an overseas LEC represents electricity that is, or is to be, consumed in the UK when that electricity has been traded implicitly across coupled markets?

Again, we do not understand the premise of the question. Let us take another simple example. Suppose at some point in the future a small European company has a renewable generator in France and some industrial consumers in the UK, and no



other business interests. That company will sell its electricity into the market in France and it will buy electricity from the market in the UK. The purpose of the single market is that the company will be neutral to this double trade if there is no constraint on the interconnector, but that if there is a constraint it will end up paying (or being paid) the difference between the two market prices. The company has, however, and most importantly, not been restricted in its activities. It will also quite reasonably expect that it can use the LECs from its French generation to offset its CCL liabilities in the UK. Even if the volumes are in excess of the interconnector capacity, there is no denying that as a single entity in a single market the company has supplied its customers with its own generation.

It may be argued that generators could be asked to provide proof of a contract with a UK supplier. However, such an audit trail would not be practical. Whilst generators sell their electricity with their LECs, once this first trade has taken place, any further trading can split the LECs and the power. Any further evidence of LECs being associated with the power would be "reconstructed" and ultimately meaningless. An obligation to provide an audit trail which genuinely proves the original source would mean that companies which do not currently trade in Europe or have PPAs directly with European generators would be significantly disadvantaged compared with those which do.

Question 3: Are stakeholders aware of any reasons for limiting the issue of overseas LECs to electricity that has been or is to be explicitly traded? Please explain your answer.

No. It is not possible to limit the number of LECs to those which are explicitly traded over the interconnector if the notion of explicit trading disappears. It could be argued that unlimited supply of LECs into the UK is evidence of the competitive EU market working. There is a market incentive to sell LECs into the UK because their value is higher in the UK; LECs are the mechanism through which renewable generators in Europe are receiving the best value as opposed to other schemes that may be available. This should lower bills overall in the UK and is precisely the kind of competitive benefit one would expect from an open and liberal market.

What this situation exposes is the differing treatment of domestic and non-domestic retail markets in national (GB) green policies i.e. the CCL is only applied to non-domestic electricity consumption. Unlimited EU LECs could also undermine the small scale FIT policy because ultimately, all suppliers could provide sufficient LECs to exempt the whole of their consumption.

We note that Poyry's GB Electricity ROC Quarterly Update from Q1 2015 assumes that a large majority of projected electricity imports is LEC eligible; LEC supply is projected to exceed demand before the end of the decade; and even without any contribution from imported LECs, LEC production will meet demand early next decade. Given that the CCL regime will need to be revisited in the relatively near





future, we wonder what the point would be of considering the restriction of imported LECs in isolation.

These are policy matters for DECC (whose schemes would be underfunded) and HMRC (who would recover no tax). These questions go much deeper than Ofgem's remit. Let us be clear, though: the failing is not with EU policy but with national policy interventions.

Question 4: Are stakeholders aware of alternative ways of demonstrating proof of GB supply of overseas electricity that do not involve LECs, and, if so, what are they?

We do not believe that there are alternative ways of demonstrating proof of GB supply of overseas electricity. Any other certificate, such as GOOs, will have similar issues, and a purely contractual route is probably less clear than a certificate trade.

It may be argued that a contractual route could be evidenced by the supplier. However, such an arrangement would favour the Big 6 companies which are largely owned by European corporations. For example, at the moment SmartestEnergy's contracts place an obligation on the generators selling to us that they have booked the capacity on the interconnectors. If, however, we are in an implicit world and we wish to purchase renewable power from a German generator and a contractual route had to be demonstrated we would have to prove that the German generator had sold it to a French or Dutch party who in turn contracted with us.

Question 5: Do stakeholders currently acquire LECs purely for non-CCL purposes?

For Smartest to purchase LECs for Non-CCL purposes the value of the FIT and other exemptions would need to be larger than the value of the CCL exemption. This is not currently the case but is very possible in the future.

Question 6: What do stakeholders foresee as potential impacts if:

6.1 Overseas renewable electricity can be demonstrated as consumed (or to be consumed) in the UK where it has been implicitly traded, and LECs are issued for this accordingly?

It all depends on whether there is a "limit" on the number of LECs. If imports were restricted directly to the physical transfer capacity of the interconnector, rather than accepting the European grid as effectively capable of infinite transfer within itself (as the GB grid is) with constraints managed as part of network operations, then the number of EULECs imported will be similar to 2014/15 until additional interconnectors are operational. However, if the number of EU LECs entering the country is unlimited, then there could potentially be a very large number of EULECs imported. The FIT obligation would be recovered from a decreasing number of customers meaning



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that the effective price per unit would increase for the customers of those suppliers not using the exemptions. The same effect would be seen on CFD recovery.

If DECC/Ofgem did decide to make other changes sufficient notice should be given. It is important to consider how suppliers are managing their positions and entering into contracts in order to secure LECs that are matched with retail volumes. A sufficient level of notice of change would be needed to ensure a properly managed exit, otherwise there is a significant risk of disruption to the non-domestic supply market. 2016 power imports from Europe are already being auctioned. Importing/exporting electricity between nations requires a stable regulatory framework to keep risk premiums low, and the activity is extremely competitive.

6.2 Overseas renewable electricity was only accepted as consumed (or to be consumed) in the UK (and LECs issued accordingly) where there is explicit booking and nomination of interconnector capacity?

This would effectively ban all imports of EULECs from Europe when the interconnectors move to implicit only on the interconnectors. This would be anti-competitive and unfair as it would be more restrictive than the current arrangements, disadvantaging those who currently do not have trading relations in Europe. In addition, we believe this would be against the EU conditions introduced when State Aid was granted and would be challengeable in court.

Ultimately, as our example of the Scottish interconnector shows in our answer to Q1, there is really no alternative but to accept that infinite implicit capacity is assumed or to completely re-think the subsidy mechanisms.

Should you require further clarification on this matter, please do not hesitate to contact me.

Yours sincerely,

Colin Prestwich

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