



Charles Hargreaves
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12 April 2016

By email

Dear Mr Hargreaves

Guarantees of Origin (GoOs) for use in small scale Feed-in-Tariff (FIT) annual levelisation – concerns around unintended consequences

On 1 April 2016, we wrote to you setting out our concerns around the potential consequences for energy suppliers - and their customers - of the changes to recognising implicitly imported EU GoOs only for (amongst other things) the FIT annual levelisation process. This letter sets out those concerns on a non-confidential basis.

The changes referred to are those arising from recognising implicitly imported EU GoOs only for (amongst other things) the FIT annual levelisation process, following the Government's decision that Levy Exemption Certifications (**LECs**) could no longer be issued for electricity generated after 1 August 2015 and in light of Ofgem's decision on allowing unconstrained implicit trading as proof of flow of overseas electricity into the UK for the purposes of FIT market share determinations.

As we understand Ofgem E-Serve's 'minded to' decision around allowing unconstrained implicit flows for import of GoOs into the UK from the EU, appropriately audited actual purchases of EU GoOs plus EU electricity delivered in the UK can be used - by way of exemption - effectively to reduce the market share position of suppliers for the purposes of FIT annual levelisation. This decision has seemingly led to a flurry of activity in the GoOs market, as many parties source significant volumes of such implicitly imported GoOs to reduce their market share for FIT levelisation.

We are concerned that this may lead to significant volumes of UK supply becoming exempt from FIT costs, which may materially drive up the cost per unit of unexempted UK supply at FIT levelisation. Although there is no simple way to know for sure given the high opacity of this niche market, we are concerned that smaller industry participants may be more exposed than many others to the eventual FIT levelisation (and material cost) consequences.

In our view, the position reached advantages those players who are "gross bidding" on the day ahead auctions and exchanges (in particular the Big Six). It is entirely possible

that some of these players have substantially or entirely covered off their FIT obligation via the ability to match imported GoOs with an implicit audit trail of power flow enabled via gross bidding. For suppliers without pan-European trading operations, who source bilaterally from a single buyer, this could lead to significant disadvantages as it is essentially much harder to put together the GoO plus power flow into the UK, as the audit trail is far more complex to build. This is not so much a feature of any outstanding uncertainty around the appropriate contractual supply chain "from source to sink". Rather, it is around the perfect storm due to (i) the scale of pan-European trading operations in different suppliers, (ii) the abolition of LECs (which were previously too expensive to be economic to import just for the purposes of FIT market share exemption), (iii) the unexpected advantage in the outcome of exempting implicitly imported GoOs from the market share in the FIT levelisation process, and (iv) the short timescale in which to execute deals to mitigate the risk before the 1 July 2016 deadline.

We think the issue is of wider impact: we believe that Ofgem should be very concerned about what would theoretically happen at annual FIT levelisation for the last 1 MWh that is not exempted - in theory all the circa £800 million in annual FITs costs would be levelised to that single MWh. This cannot be right: it certainly isn't good for customers.

We do not think this unintended consequence of large proportions of the small scale FIT annual scheme costs potentially falling on few customers has been fairly mitigated against in the sudden changes brought about over recent months. These effects are not occurring in the ordinary course of business, including trading, but are being generated as a result of a combination of Government decision (on LECs), the market conditions for GoOs and the different trading positions and capabilities of market participants, leading (we think) to a significant levelisation advantage for those companies who were best placed to act quickly on the changes due to their historic operating model and commercial decisions. This advantage is unexpectedly gained at the expense of other participants, who are at a high risk of very serious adverse cost shocks, potentially of costs doubling versus 'priced in' costs prior to the LEC abolition and the implicit delivered GoOs decision). We cannot see that this outcome is good for competition or for customers.

This letter focuses on the significant risks to 2015-16 levelisation and does not address the position and any potential risks for next year and beyond in light of the cap that has been introduced.



Finally, we note that in our 1 April letter, we requested a meeting with you and the relevant teams at the earliest opportunity to discuss our concerns and what can be done to mitigate them to prevent the likely risk – as we see – of one or a small number of suppliers being left with an entirely unanticipated cost shock which cannot easily be managed for the current period.

Yours sincerely

A handwritten signature in black ink, appearing to read "Darren Braham".

Darren Braham
CFO

Copied to: CCLandREGO@ofgem.gov.uk