

Judith Ross
Targeted Charging Review
Ofgem
9 Millbank
London, SW1P 3GE

Centrica Plc
Millstream
Maidenhead Rd
Windsor
Berkshire SL4 5GD
www.centrica.com

5th May 2017

Dear Judith

Re: Targeted Charging Review consultation

Thank you for the opportunity to respond to your consultation. This is a non-confidential response on behalf of the Centrica group of companies excluding Centrica Storage.

We believe that the current method of residual charging would benefit from being reviewed. It is important that charging arrangements are well justified to ensure they endure for a reasonable time. This promotes investor confidence and stability of charges for all users, both of which serve the long-term interests of consumers.

Whilst we would expect the review to inform views on the best overall outcome, there are a number of points we would highlight at this stage:

- It would be preferable for the review to be completed as quickly as possible, and be subject to phased or delayed implementation (but not grandfathering) to mitigate impacts on investor confidence of unduly abrupt change.
- Delayed implementation should also allow reform to be implemented alongside other changes required to support the development of flexibility products and services.
- Ofgem's proposed principles are a good basis for assessing any reform.
- It will aid the efficiency of the process to rule out options that obviously fail against the proposed principles. We believe fixed charges should be ruled out for failing on the fairness principle.

Timescales and implementation

Beyond those addressed by the recent minded-to decision on Transmission Demand Residual payments, we have not identified any specific issues that should be expedited. We do, however, believe that the review should be completed as quickly as possible. In order to provide certainty to investors and customers an earlier decision than suggested would be welcome. If clear direction can be provided by Ofgem, assisted by the proposed Charging Coordination Group (CCG), throughout the process then a decision should be possible in less than 18 months.

The review should also be subject to phased or delayed implementation (but not grandfathering), to mitigate impacts on investor confidence of unduly abrupt change.

We would also note that, in practice, current residual arrangements have acted as support for flexibility behind the customer meter. We believe this flexibility is beneficial in the long run with the potential to reduce overall system costs. Whilst we accept that network charges should not be the enduring mechanism for rewarding flexibility, the evidence from the recent DSR auction, which cleared significantly higher than any of the previous capacity market auctions, is that further actions are required for consumers to secure these long-term benefits.

Regulatory efforts are needed to ensure that the value of flexibility services is capable of being fully realised. Our Cornwall LEM¹ project is an example of how this can be explored. There is not clear evidence that alternatives to traditional network reinforcement are given meaningful consideration by network companies in all cases. Ofgem should examine whether measures are needed to ensure flexibility services are given proper consideration going forward. This could include introducing a requirement on network companies to tender for flexibility services.

In summary, it would be appropriate for changes to network residual charges to be implemented alongside other industry changes required to support flexibility.

Proposed principles and reform options

We agree that the proposed principles are appropriate for assessing the options. We agree that it will not be possible to eliminate all distortions and believe that these principles will assist in deciding which distortions are acceptable and support decarbonisation. These principles can be used to assess which aspects of the current arrangements are of most concern. This will allow Ofgem to decide which developments should be prioritised.

Given the potential for a large number of options, and the time it could take to assess them fully, there is merit in ruling out options that obviously fail against Ofgem's proposed principles. We believe that fixed charge options should be ruled out. A simple fixed charge, applied equally to all users, would place significant costs on smaller users. We believe this fails on the fairness principle.

We recognise that there are a number of more sophisticated methods for applying fixed charges which could differentiate between different classes of users. These could reduce, but not eliminate, the movement of costs towards smaller users. However, it is unlikely that any of these would be preferable to a capacity-based or usage-related charge.

Responses to specific consultation questions

Our responses to your specific consultation questions can be found below. Please contact me if you would like to discuss any aspect of our response.

Yours sincerely,

Andy Manning,
Director – Network Regulation, Forecasting & Settlements
07789 575553

¹ Cornwall Local Energy Market trial: <https://www.centrica.com/about-us/what-we-do/distributed-energy-and-power/building-new-energy-future>

Question 1: Do you agree that the potential for residual charges to fall increasingly on groups of consumers who are less able to take action than others who are connected to the system, is something we should address?

We believe that the current method of residual charging would benefit from being reviewed. It is important that charging arrangements are well justified to ensure they endure for a reasonable time. This promotes investor confidence and stability of charges for all users, both of which serve the long-term interests of consumers.

Question 2: If so, why do you think, or do not think, action is needed?

We agree that a review would be beneficial. We also agree that deciding what action is necessary requires the balancing of a number of different considerations. The review is needed to decide if action is necessary.

We would also note that, in practice, current residual arrangements have acted as support for flexibility behind the customer meter. We believe this flexibility is beneficial for consumers in the long run with the potential to reduce overall system costs. Whilst we accept that network charges should not be the enduring mechanism for rewarding flexibility, the evidence from the recent DSR auction, which cleared significantly higher than any of the previous capacity market auctions, is that further actions are required for consumers to secure these long-term benefits.

Regulatory efforts are needed to ensure that the value of flexibility services is capable of being fully realised. There is not clear evidence that alternatives to traditional network reinforcement are given meaningful consideration by network companies in all cases. Ofgem should examine whether measures are needed to ensure flexibility services are given proper consideration going forward. This could include introducing a requirement on network companies to tender for flexibility services. Therefore, it would be appropriate for changes to network residual charges to be implemented alongside other industry changes required to support flexibility.

Question 3: We are proposing to look at residual charges in a Significant Code Review. Are there any elements of residual charges that you think should be addressed more urgently? Please say why.

Beyond those addressed by the recent minded-to decision on Transmission Demand Residual payments,, we have not identified any specific issues that should be expedited. We do, however, believe that the review should be completed as quickly as possible. In order to provide certainty to investors and customers an earlier decision than suggested would be welcome. If clear direction can be provided by Ofgem, assisted by the CCG, throughout the process then a decision should be possible in less than 18 months.

The review should also be subject to phased or delayed implementation (but not grandfathering), to mitigate impacts on investor confidence of unduly abrupt change.

Question 4: Are there elements of the approaches in other countries that you think could be appropriate for GB residual charges?

Analysis of experiences in other jurisdictions can assist in identifying options for GB. However, it is important that the differences in circumstance between GB and those jurisdictions are recognised. Specific solutions adopted elsewhere may not be appropriate for GB.

Question 5: Are there other approaches that you know about from other jurisdictions, that you think offer relevant lessons for GB?

Analysis of experiences in other jurisdictions can assist in identifying options for GB. However, it is important that the differences in circumstance between GB and those jurisdictions are recognised. Specific solutions adopted elsewhere may not be appropriate for GB. Solutions adopted for GB should be tailored to and complement arrangements in GB. Some of the key differences between circumstances in GB and the other jurisdictions examined summarised below.

Market structure: The states of Nevada and California have been highlighted as examples of jurisdictions in which steps have been taken to reduce the transfer of costs from users with distributed generation (DG) to non-DG customers. A key difference between these states and GB is the markets in those states are vertically integrated. As such, changes to tariff structures apply to 'end' tariffs and are not targeted at the residual component of network costs.

Charging and revenue recovery arrangements: Spain has been cited as another jurisdiction in which the penetration of renewables has contributed to under-recovery. Though competition exists in the Spanish retail market, 'end' tariffs are regulated. Similar arrangements do not exist in the GB market. Retail tariffs are not regulated in entirety and, therefore, any losses are not guaranteed. Additionally, revenue 'true-up' mechanisms for the regulated sectors in GB provides a means by which regulated companies can recover under-recovery from previous years, subject to certain rules.

Interactions with other funding mechanisms (such as taxation): In the Netherlands, there was also a shift to flat capacity charges over a transitional period. Parallel changes to taxation arrangements were made in order to mitigate the negative distributional effects on some consumers. As such, the overall burden of energy costs on some consumers is similar to before the change was implemented. In Spain, measures to manage the overall financial burden on consumers were adopted. Support mechanisms for some renewable schemes were suspended, remuneration for network operators was reduced and increases in other policy costs were minimised. These tools do not appear to be within the scope of this review.

Also in the Netherlands, customers or DNOs installed smaller fuses and, as such, incurred additional costs so as to minimise the negative financial impact of the changes in charging arrangements. These costs, whether directly or indirectly, are borne by consumers. Changes to the method of residual recovery should not give an incentive for actions that drive additional costs.

Question 6: Do you agree that our proposed principles for assessing options for residual charges are the right ones? Please suggest any specific changes, or new principles that you think should apply.

We agree that the proposed principles are appropriate for assessing the options. We agree that it will not be possible to eliminate all distortions and believe that these principles will assist in deciding which distortions are acceptable.

We would note that a similar logic to that underpinning these principles, and the TCR in general, was behind our distribution modification (DCP228). Through this we sought to place distribution residual charging on a sustainable footing. The modification reduces distortions by moving residual recovery from peak usage to all usage. Our belief is that this removes the distortion that is likely to have the most impact on behaviour whilst avoiding any significant redistribution of revenue, with the fairness issues this may bring, beyond that required to remove the distortion.

In terms of practical considerations, solutions should seek to use existing industry data and systems as far as possible to avoid additional costs. It is quite possible that future changes to other aspects of the system, including how forward-looking charges are set, will necessitate system changes of their own. Seeking solutions for reforming the recovery of the residual which use existing industry data and systems should therefore protect against the undesirable outcome where the cost of significant system changes are incurred twice – once for reforming residual recovery and again for reforming other aspects of the charging regime. If substantial changes are required this is also likely to extend implementation timescales.

We should look to avoid seeking only ‘smart solutions’. The solution should be capable of working with ‘dumb’ as well as smart meters, acknowledging that 100% deployment of smart meters is unlikely, not least because customers are not obliged to accept a smart meter. Solutions should work with both current and future settlements arrangements.

Question 7: In future, which of these parties should pay the transmission residual charges: generators (transmission- or distribution-connected), storage (transmission- or distribution-connected), and demand, and why? What proportion of these charges should be recovered from each type of user?

It is unclear what logic could be applied to decide on the split of allowed revenue recovery between different types of users. It is likely that any such split would be arbitrary and also open to further change. Such uncertainty would not be in the interests of consumers as both generators and suppliers would need to factor in the risk of an adverse movement in any such arbitrary split, which effectively doubles-up the risk. It would be preferable to decide upon who pays residual charges on a principled basis. This would allow consistent treatment between different charges and, potentially, between different countries. It is reasonable that generators

should only face the marginal (cost-reflective) aspect of charges, and so not pay residual charges.

This reflects the current arrangements in distribution for the majority of generators.

Question 8: In future, which of these parties should pay the distribution residual charges: generators (transmission- or distribution-connected.), storage (transmission- or distribution-connected), and demand, and why? What proportion of these charges should be recovered from each type of user?

It is unclear what logic should be applied to decide on the split of allowed revenue recovery between different types of users. It is likely that any such split would be arbitrary and also open to further change. It would be preferable to decide upon who pays residual charges on a principled basis. This would allow consistent treatment between different charges and, potentially, between different countries. It is reasonable that generators should only face the marginal (cost-reflective) aspect of charges, and so not pay residual charges.

This reflects the current arrangements in distribution for the majority of generators.

Question 9: Do you support any of the five options we have set out for residual charges below, and why?

The 5 options listed all have pros and cons when considered against the principles. When proposing DCP228, which moves distribution residual recovery from peak usage to all usage, we believe we produced a reasonable balance by resolving the main distortion without causing significant other issues. Ofgem has already approved DCP228 for implementation in April 2018 and therefore Option A would involve virtually no implementation issues (in terms of either systems or price shock) at the distribution level.

Question 10: Are there other options for residual charges that you think we should consider, and why?

There are variety of ways of defining a fixed charge and a variety of ways of defining a capacity charge. In particular a genuine capacity charge could be applied to some users, on a pence/kVA basis, rather than as a fixed charge. This should be included under Option C or as an additional option.

Also, the measure of 'connected capacity' could relate to fuse size, contracted capacity, maximum demand or it might also relate to the capacity used by DNOs for network planning purposes e.g. After Diversity Maximum Demand (ADMD) for smaller customers and contractual capacity for larger customers. Therefore, the 'hybrid' approach in practice could be a large number of options.

Question 11: Are there any options that you think we should rule out now? Please say why.

Given the potential for a large number of options, and the time it could take to assess them fully, there is merit in ruling out options at this stage. We believe that fixed charge options (option B) should be ruled out. A simple fixed charge, applied equally to all users, would place significant costs on smaller users – we estimate it could add c. 50% to the network costs of a domestic user. We believe this fails on the fairness principle and could have particularly adverse impacts on vulnerable customers.

We recognise that there are a number of more sophisticated methods for applying fixed charges which could recognise the differing nature of users. However, any fixed charge approach, even one that differentiates between classes of customers, will always disadvantage low consuming users within a class. This includes fixed charges derived on a capacity basis. It is unlikely that any of these would be preferable than a capacity (kVA-based) or usage-related (kWh) charge. These seem more justifiable methods of deciding what proportion of network charges it is fair for a type of user to pay.

Question 12: Do you think we should do further work to analyse the potential effects of the charging arrangements for smaller EG (called ‘embedded benefits’)?

We agree there is a case for further work by Ofgem on the potential effects of BSUoS charging arrangements for smaller EG. We note Ofgem has also listed avoidance of the TGR² and the effective receipt of the TDR as embedded benefits that could be subject to further analysis³. Ofgem’s minded to decision on CMP264/5 would end the effective receipt of the TDR⁴ by EG, and, depending on the reform option chosen, may also expose EG to the TGR. We assume that, if Ofgem’s minded to decision on CMP264/5 is confirmed, further work on the effects of EG receiving the TDR would be redundant and Ofgem’s near term work would instead focus on BSUoS arrangements for EG (and potentially the TGR if a CMP264/5 WACM that excludes the TGR is approved).

Question 13: Do you think changes are needed to the current charging arrangements for smaller EG, and when should any such changes be implemented?

We believe the effective receipt by EG of the TDR is the area most in need of reform. We have set out our preferred reform options in our response to your CMP264/5 “minded to” decision⁵. We believe the case for any changes to BSUoS arrangements for EG should be made in a future consultation, informed by Ofgem’s further work.

Question 14: Of the embedded benefits listed in our table, do you think that any should be a higher or lower priority?

² Transmission Generation Residual

³ We understand from Ofgem’s comments that the relatively minor differences in locational TNUoS charges for EG and TG are not in scope for immediate analysis.

⁴ Transmission Demand Residual

⁵ We favour implementation of either WACM 2, 4 or 5 from 2019/20 (rather than 2018/19 as Ofgem proposes)

We believe the issues listed in Ofgem's table should be prioritised as follows:

- BSUoS arrangements for EG merit further work and analysis by Ofgem. Any changes should be proposed in the light of that analysis and subject to consultation.
- We do not believe the differences between EG and TG locational tariffs are an immediate priority.
- Ofgem has the opportunity to end the effective receipt of the TDR by EG and expose EG to the TGR under CMP264/5. The need for further work by Ofgem on the exposure of EG to the TDR and TGR may fall away following Ofgem's final decision on CMP264/5, as Ofgem will need to opine on these issues in making the CMP264/5 decision.

Question 15: Do you think there are other aspects of transmission or distribution network charging which put smaller EG, or any other forms of generation or demand, at a material disadvantage?

See our comments on question 16 below.

Question 16: Do you agree with our view that storage should not pay the current demand residual charge, at either transmission or distribution level?

We recognise that applying demand residual charges to storage raises storage import costs for non-cost reflective reasons, which could prevent economic cycling of storage assets. There may therefore be a case for rule changes to remove residual charges from storage imports.

However, we believe a number of issues need further consideration before demand residual charges are "disapplied" from storage. First, we note that exposure to two sets of residual transmission charges (the TGR and TDR) is not unique to licensable and transmission connected storage. All licensable and transmission connected generation (TG) is subject to both the TGR and TDR⁶, so TDR relief for storage could be viewed as discriminating against TG that is not classed as storage. We further note that if the period over which the TDR is recovered ceases to be the TRIAD periods, the likelihood that TG incurs TDR charges could increase materially in future. Again, this raises issues of potential competitive disadvantage to TG that is not classed as storage. We also believe consideration may be required of storage located on demand sites and how the relief from demand residual charges could be applied appropriately (where there is a mixture of final consumption import and storage import intended for re-export).

In summary, we believe further consideration of the detailed implementation issues is needed before changes to demand residual charges for storage can be made. This may involve expanding relief from (some) demand residual charges to generators more broadly, in order to maintain effective competition. We acknowledge that the default industry modification process(es) may still be the best forum for debating these details, despite our view that Ofgem's initial proposal may need refinement.

⁶ See 14.17 and 14.27 of the CUSC

Question 17: Do you agree with our view that storage should not pay BSUoS on both demand and generation?

Similar to our views on question 16, we recognise that applying BSUoS charges to storage imports and exports could be viewed as non-cost reflective and may prevent economic cycling of storage assets. However, as per the issues identified in question 16, more detailed consideration of the implementation issues and practical effects on competition may be needed. We acknowledge that the default industry modification process(es) may still be the best forum for debating these details, despite our view that Ofgem's initial proposals may need refinement.

Question 18: Which of the BSUoS approaches described is more likely to achieve a level playing field for storage?

At this stage, we are not in a position to give a view on the best way to deal with the potential prevention of economic cycling of storage assets resulting from BSUoS charges on import and export. More detailed consideration of the implementation issues and practical effects on competition is needed. We acknowledge that the default industry modification process(es) may still be the best forum for debating these details, despite our view that Ofgem's initial proposals may need refinement.

Question 19: Do you think the changes in this chapter should be made ahead of any wider changes to residual charging that may happen in future? Do you agree with our view that these changes should be implemented by industry through the standard code change process?

We believe there is a case for a code modification proposal(s) following standard industry governance, which aims to address potential distortions to competition arising from residual charges being levied inappropriately on storage. However, we are not yet convinced that the solution to the issues raised has been found, and a different solution from Ofgem's initial proposals may be needed. We accept that alternatives could be raised under standard industry governance, provided the defect in the original modification is defined appropriately.

Question 20: We would welcome your thoughts on the potential make-up of a CCG. Please refer to the potential role, structure, prioritisation criteria and assessment criteria.

We support the creation of the CCG. We believe this group can provide important assistance to Ofgem on the overall direction of network charging reform. The responsibility for providing guidance to other related reviews should remain with Ofgem but the CCG can have a useful role in informing this. The group needs to focus on network charges and the terms of reference

need to reflect this restricted scope. With regards to the TCR, the CCG should provide, early in the process, some high-level guidance towards the overall approach to network charging. Any developments would need to adhere to this guidance, such as the importance of forward-looking cost signals. This would enable approaches that are unlikely to be capable of being approved, such as cost allocation models, to be ruled out without the need for extensive analysis.

The CCG requires appropriate representation from the industry. This should include, but not necessarily be limited to, suppliers, generators, network companies, BEIS, Ofgem and consumer representatives. It is also important that the group is established with representatives that have the appropriate experience and skills and who can undertake this important role objectively and independently.

Ofgem should provide a detailed candidate specification that outlines the required experience and skills. These should include, but not necessarily be limited to: transmission charging, distribution charging, electricity settlements and price control arrangements. Industry parties, and other expert and interested groups, can then directly nominate representatives for the group. Ofgem can then appoint representatives from those nominations that meet the candidate specification and, overall, provide the appropriate representation.

To be able to prioritise effectively, the group should assess which aspects of the current arrangements are of most concern. This will allow the group to recommend to Ofgem which developments should be prioritised. The group should be able to recommend the scope of other reviews and industry change. In particular we believe:

- Any modifications that relate to residual recovery should be subsumed within the TCR (and any industry meetings halted)
- The scope of the CDCM review (and any other review) should not cover how residual charges are defined

Ofgem should be prepared to offer clear and early guidance, with advice from the CCG, to make the process as efficient as possible.

Question 21: Do you agree with our proposed delivery model, including its scope?

The proposed delivery model does not specify how the industry will engage with detailed policy development (in addition to the strategic CCG). We recognise that this will be an early task for the CCG and assume that all interested parties will have the opportunity to input into this detailed development.

Question 22: Do you agree that our proposed SCR process is most appropriate for taking forward the residual charging and other arrangements for smaller EG discussed in this document?

We are comfortable with Ofgem directing licensees but believe it would be preferable for the direction provided to be specific detailed conclusions.