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FAO – Andrew Self
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By email only

27 September 2019

Shell Energy Europe response to the consultation on refined residual charging banding in the Targeted Charging Review

Dear Andrew

Shell welcomes the opportunity to respond to Ofgem's consultation on its refined residual charging banding proposal for the Targeted Charging Review Significant Code Review (TCR SCR).

As explained in our response to the consultation on the minded-to decision, we agree that there is a case for change to ensure that GB charging arrangements remain fit for purpose, support the energy transition to a more decentralized and low carbon electricity system, and continue to ensure a fair allocation of costs between different groups of consumers.

We understand that at this stage of the TCR SCR process three alternative approaches to determine the allocation of transmission residual charges to customers are being considered:

1. Charges based on **fixed charge** for different customer segments
2. Charges based on an **agreed capacity** approach
3. Charges based on **a hybrid approach** based on a combination of line loss factors, agreed capacity and energy consumption

Shell has a strong preference for the recovery of TNUoS residual charges to be based on an agreed capacity approach. We believe that an agreed capacity approach is most likely to meet the TCR SCR objectives of: fairness, reducing harmful distortions and practicality and proportionality, particularly in the longer term. While we understand Ofgem's preference for fixed charges as theoretically the least distortive approach, we do not believe that it will be possible to identify a fair fixed charge method that does not impact customer/supplier behavior resulting in a distortion.

We are concerned that the proposal to use Line Loss Factor Class (LLFC) to determine the level of charging that customers face is driven more by the fact that this categorization already exists, rather than there being any evidence that it is the fairest and most transparent and appropriate approach to

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allocating residual charges. We believe that Ofgem has now recognized that using LLFCs to allocate charges will also (likely) result in distortions, which has resulted in the proposed hybrid approach. Our main concerns with the LLFC approach are the following:

1. the resulting distortions and behavior driven by parties seeking to minimize their exposure to charges based on LLFCs will not correspond with the objective of reducing overall system costs;
2. the existing governance that surrounds the determination and publication of LLFCs is not sufficiently robust, fair and transparent, for LLFCs to be used as the basis for the allocation of transmission residual charges, as this was not the intended purpose of LLFCs;
3. an LLFC approach may be adopted as an interim measure, and then subsequently reviewed once the Access and Forward Looking Charging Significant Code Review (AFC-SCR) proposals have been implemented. This is because one of the core proposals in the AFC-SCR is to provide properly defined access rights for all network users.

It will not be straight forward to implement a fixed charge approach to allocating charges based on LLFCs and, as this may not represent a robust long-term solution, there is a strong risk that (as flagged in Ofgem's open letter) the approach will be subject to subsequent change once the AFC-SCR has been completed. We are keen to avoid the costs and risks to both industry and consumers of multiple changes to network charging, as these rules are both complex and integral to the functioning of the market.

Shell considers that a phased approach to implementing an agreed capacity approach will best meet Ofgem's stated criteria for the TCR SCR process, deliver a long-term solution that is most robust to industry change, and provide the most certainty and clarity to industry to anticipate the impact of any proposal to enable appropriate business planning.

A phased approach would involve: first moving user classes for whom agreed capacity data is available (or could easily be made available) to an agreed capacity approach (larger users); and subsequently moving user classes for whom agreed capacity data is not currently available (smaller users) to an agreed capacity approach once the AFC-SCR proposals have been implemented and agreed capacity date is available.

We would not necessarily support an approach that moves customers for whom data is unavailable onto a deemed capacity approach, as again, this would likely require development of a new methodology that would be complex and costly to implement and would not be enduring. Also, to support the proposal for a phased approach we understand that, at least in the short to medium term, the main distortions that Ofgem are seeking to address are for larger rather than smaller users.

Allocating charges based on agreed capacity approach will result in some distortive behavior, as users may seek to reduce their agreed capacity in order to minimize their exposure to network charges. However, we consider that any method to allocating charges will result in distortive behavior and that an incentive for users to reduce capacity, at a time when the industry is concerned about a lack of network capacity, to be the least harmful distortion.

Shell does not yet have a clear view on whether the agreed capacity approach should be based on large or small charging bands. As the question of banding size will have a fundamental impact on customer behavior, we propose that this is an area that Ofgem considers in more detail – and provides industry with more detailed guidance on – in making its final TCR SCR decision.

Shell does not support the hybrid approach proposed in Ofgem's most recent open letter, as this will overcomplicate the allocation of charges compared to both a fixed or agreed capacity approach. Of the three options being considered the hybrid approach is least likely to meet Ofgem's stated objectives for the TCR SCR. We do support the rationale behind proposing the hybrid approach and the recognition that a fixed approach to allocating charges will also have a distortive impact on behavior. However, the proposed hybrid solution will be significantly more complex and costly to implement and manage than the other options being considered.

Finally, we remain concerned about timing for the implementation of any proposals. As mentioned earlier the rules for charging are both complex and integral to the functioning of the market. While we support the need for change, we are concerned that insufficient notice may be provided for suppliers to adjust their tariffs to the new level of charges. As explained in our previous response suppliers will need three years notice to adjust their tariffs to incorporate any changes to the level of charges to customers.

The annex to this letter provides a summary of our main comments on Ofgem's minded to decision consultation, and more recent consultation on the updated impact assessment.

If you would like to discuss any element of this response further, please do not hesitate to contact me.

Yours sincerely

Olaf Islei
Power Commercial Regulatory Affairs Manager
Shell Energy Europe Limited

Annex 1 – summary of previous responses to the TCR SCR consultation process

We also raised the concerns listed below in relation to the proposed decision. These are explained in more detail in our 4 February 2019 consultation response.

1. **Potential impact on investor confidence and costs:** the level of uncertainty over network charges that a particular generation asset or customer will face over the next five to ten years is very high, which makes navigating the regulatory framework very challenging. This is particularly important as network charges make up a significant proportion of the costs that a generation asset or customer face.

2. **Potentially perverse incentive for I&C customers:** Ofgem's preferred options for the recovery of residual charges (fixed or agreed capacity charges) will significantly increase (by over 400%) network costs for I&C customers that have sought to actively manage and respond to the economic signals provided by the regulatory regime and decrease network costs (by 60%) for those I&C customers that have not sought to invest based on those economic signals. We are concerned that this will have a negative impact on the future engagement of industry in investing in energy efficiency and decarbonization.

3. **Importance of maintaining a level playing field:** with the anticipated increase in GB cross-border interconnection from 5GW today to 15GW in 2025 it will become increasingly important to ensure that there is a level playing field for the purpose of network charging with interconnected markets. We believe that ensuring a level playing field should be explicitly considered, and included as an additional objective, for Ofgem's network charging reform.

4. **Link to network access and forward-looking charging review** (AFC-SCR)**:** we are concerned that the AFC-SCR will also have a material impact on the allocation and recovery of network charges, and that it is not possible for stakeholders or Ofgem to understand or comment on the impact of TCR, in the absence of the other half of the picture. We believe that a least regrets approach for policy makers and the industry would be to align the two processes to enable a holistic understanding and assessment of their impact.

5. **Consistency in application of principles for proposed decision on "other embedded benefits":** in particular, the approach that Ofgem is proposing to take for the treatment of BSUoS, appears to be inconsistent with Ofgem's thinking on the treatment of other residual charges. To address any potential confusion, we would welcome clarification from Ofgem on why it has decided not to take a consistent approach in its TCR process.

In our 4 February consultation response, we also **suggested additional steps that Ofgem should take as part of its review process to address these concerns:**

1. Align the timing of the TCR SCR and AFC-SCR processes so that industry, and the regulator, can consider and develop a holistic and complete set of proposal. It is not possible to provide a fully informed response to the TCR proposals without understanding what changes may be considered as part of the AFC-SCR.

2. Where a solution may result in a significant re-distribution of costs among network users, Ofgem should allow sufficient time for the changes to be implemented so that parties are able to make necessary changes to their business models.

3. Develop a common evidence base which can be used by both industry and Ofgem to assess the case for change and the efficiency of alternative solutions.

4. Include maintaining a level playing field for network charging with interconnected markets as an explicit part of its consideration of, and objective for, GB network charging reform.

5. Investigate other options, together with the Government, to address the regulatory uncertainty associated with network charging reform for example through reform of the Contract for Difference (CfD) or the Capacity Market (CM). In that respect, we note that the CfD already insulates investors from changes to balancing charges.

6. We noted that it will be critically important to ensure that the governance arrangements for preferred option that Ofgem adopts for recovery of residual charges are sufficiently robust, fair and transparent.

In relation to the first two suggestions, we welcome the update from Ofgem on 21 May that it is considering aligning the implementation dates for the TCR and AFC-SCR.

However, to address these concerns, we believe that a least regrets approach for Ofgem, industry and customers, would be to align all elements of the two processes: from deciding on its preferred options, consulting on minded to decisions, assessing the impact to publishing its final decisions.

As the proposed charging reforms represent such a fundamental change, we believe that a worst-case scenario would be rushing through with a limited scope, or having to unpick some of the TCR proposals because of unintended consequences associated with AFC-SCR proposals that are still in the early stages of being developed.

We also believe that there needs to be three years between Ofgem's final decisions, and the implementation date, to provide industry with sufficient time to digest the potential impact and update business plans.

Finally, in setting out our concerns, the 4 February consultation response **also listed a number of elements that we considered missing from Ofgem's draft impact assessment.** We welcome the additional work undertaken by Ofgem to update the impact assessment, as set out in the June update, and consider that further work on the elements listed below, would help minimize uncertainty in industry and ensure an appropriately robust and considered decision:

1. **Transparency and tools for industry to understand the impact:** as part of its impact assessment Ofgem provided detailed information on the expected impact of the TCR proposals on the charges that different categories of customer would face in different regions in GB. We would welcome the publication of information with a similar granularity for different generation types. Currently the information provided on generator impact is based on NPV per generation type, which is a useful signpost, but not sufficiently granular to enable industry to understand the actual impact of the proposed reforms.

2. **Investor confidence and I&C customer incentives:** as explained above, and in more detail in our 4 February consultation response, we expect that Ofgem's proposals will:

    a. result in investors adding a risk premium to projects to seek to account for charging regime uncertainty, or bidding for CfD and CM contracts based on the existing rules,

with the prospect that the projects will subsequently be terminated if it becomes clear that they are no longer economic (as noted by Ofgem in its minded to decision); and

b. result in I&C customers that have previously proactively invested in energy technologies based on the economic incentives provided by the regulatory framework network charges increase significantly, strongly discouraging them from investing in investing in energy efficiency and decarbonization.

We consider that Ofgem should explicitly consider and, at the very least, assess the sensitivity of the results of their impact assessment to the negative impact on investor confidence. To be clear, the concern is that if the process results in higher investment costs, that this will at least partially erode the anticipated consumer benefit, and it is not clear how Ofgem has taken this into account or the steps it is taking to mitigate those costs.

3. While we understand that the scope of the TCR is limited, we consider that **the impact assessment should also check the sensitivity of the results to**:

   a. Other changes that will be made to the charging regime to ensure that there is a level playing field between generators in GB and neighbouring countries for the purpose of network charging;

   b. The emergence of merchant renewable project and new generation technology types such as co-located wind and storage or solar and storage;

   c. Changes that Ofgem plan to make to network access and forward-looking charging arrangements as part of the AFC-SCR, in particular, the definition of network access rights – will (we expect) impact Ofgem's assessment of the merits of its two lead options for reform of residual charging;

4. **Include an assessment of the impact of BSUoS being levied on final demand:** the results of the BSUoS taskforce suggest a preference from industry for BSUoS to be levied entirely on final demand. We understand that Ofgem considers that the scope of the TCR is too restrictive to include this as an additional option for reform – and that industry could propose this in a second and later step. To demonstrate that Ofgem is considering the BSUoS taskforce conclusions we consider that it would be appropriate and timely to assess the impact of BSUoS being levied on final demand, even if the option is outside the scope of TCR.

We understand that Ofgem is still planning to further update the draft impact assessment and request that the points listed above are included as part of that process.