Going bananas over embedded benefits

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Regular readers of *Energy Spectrum* will know that we have actively engaged with Ofgem over the past year over its approach to reviewing embedded benefits. Most recently we have criticised its 1 March proposal to reduce the transmission triad demand residual (TDR) to less than £2/kW (from in excess of £45/kW), the CMP264/5 "minded-to" decision in support of so-called WACM4.

The effect of WACM4 will be to reduce payments received by operators of several GW of controllable generation, typically depleting revenues by around 20-30%, once the changes are fully implemented. This material loss will have a very significant impact on existing distribution connected operators, but also the large number who successfully applied for Capacity Market contracts in the first two T-4 auctions. This is intentional as Ofgem (echoing BEIS) believes that these payments are distorting the market to the detriment of transmission-connected generators.

Our response was issued on 18 April. This *Energy Perspective* draws on it and a report that we are publishing today critiquing Ofgem's *Impact Assessment*.

Apples and pears

We strongly disagree with Ofgem's minded-to decision on substantive grounds.

Over a year on from its announcement of a review, neither Ofgem nor National Grid (in its role as the CUSC code administrator or as owner of the transmission charging methodology) has produced up-to-date analysis of why it believes that setting the TDR at the Avoided GSP Investment Cost (AGIC) is the correct solution and what that value is today. It has also disregarded various counter-arguments, including several from us, on why a reduction of this magnitude does not appropriately reflect the value of embedded generation to the wider energy system, simply responding that it is "not convinced".

We have also argued without response that there are other offsetting distortions in the market-place. Ofgem has cursorily passed over arguments that the generator residual, which as a negative figure, transmission-connected generators receive should be added back on top of the AGIC. Different approaches to connection charges between transmission- and distribution-connected generation have been ignored, and we have set out why the change will create other market distortions as impacted operators look to recover their costs in other energy markets.

Crucially, the potential impacts for security of supply even at this late stage have simply not been thought through. Ofgem recognises these pressures exist, but argues that these will be largely mitigated by a phased approach to implementation, as this will permit operators to "adjust their despatch and business models", but without saying how. It states boldly that "it is possible that some generators may find options that include significant reduction challenging to their businesses, though we do not expect there to be a major impact on security of supply risk from capacity market non-delivery of these providers, even in the options with the most significant changes", but without substantiation.

Ofgem then reassures us that "[Its consultants'] modelling suggests that the most significant proposed reduction in revenue will not lead to security of supply expectations outside of government parameters". It does not say how any generation coming off the system by winter 2018-19 will be replaced, and it does not comment on how any gap will impact on energy prices and balancing costs ahead of the four-year typical build for the replacement CCGTs even if they do come forward "at the right time", which we doubt.

Raspberry

Last Friday Ofgem belatedly published the minutes of GEMA's February meeting.

The Authority discussion appears far from unanimous, the record noting: "It was a balanced decision [to propose adoption of WACM4], and there was recognition that other options had merit." The minutes continue that "one member of the Senior Leadership Team felt that the level of payment proposed in WACM5 (the Generation Residual in addition to the avoided Grid Supply Point costs) would be better." None of this comes across in the consultation document, which is much more categorical in its support for the proposed decision.

Why none of this pertinent information was included in the consultation and why the draft minutes appeared a month late, after the consultation close, is a matter of conjecture. But the effect has been that material information was not made available to affected parties to help inform their responses.

Oh my gourd

Another matter from the February minutes concerns the Targeted Charging Review (TCR), which Ofgem has since announced. The minutes note: "The Authority considered the TCR and agreed that it should be undertaken to come to a holistic view on the appropriate approach for residual charging across electricity transmission and distribution. The Authority gave a steer that the review should be open minded to different approaches and the language used in the review and the consultation should reflect that".

Against this background, the proposed approach set out in the minded-to decision seems illogical given the TCR and other on-going work on network charges. Ofgem's preferred solution, WACM4, may be introducing new market distortions at a time when its own work programme is being ramped up to consider wider interactions. Ofgem through its various statements and open letters has grudgingly conceded that the decision on CMP264/265 has implications for other elements of network charging, which have a much wider policy dimension, but its approach then disregards those for present purposes.

Against this background, we are perplexed as to why Ofgem is insistent it wishes to take the decision on these code changes in isolation and quickly, especially when other regulatory decisions have rejected such piecemeal approaches. The CMP227 decision is notable in this regard, as it specifically rejected a change to transmission charge allocation on the grounds that more substantive change was likely to quickly follow and that a two-step approach would unnecessarily increase regulatory risk.

Raisin d'être

But our main area of disagreement is around the implications of the proposed decision on investor sentiment. Ofgem seems unconcerned about this. Indeed it advances the argument that investors generally will benefit from the clarity provided by the proposed decision, noting also that delay would increase uncertainty.

The regulator adds, rather gratuitously, that "investors in smaller embedded generators can reasonably expect to bear the risk of changes to charging arrangements and to develop their business accordingly", pointing out that "changes in levels of charges are foreseeable to a prudent and informed investor who understands the network charging objectives and arrangements". Its decision will allow industry time to adjust to the proposed changes.

This, of course, is nonsense given the level of revenue at risk and the impact its removal will have on the viability on operators. As a minimum, and as we have noted already, the proposed decision will result in some plant being withdrawn early from the market, and the likelihood is that recently committed plant that won contracts the first two T-4 capacity market auctions will not proceed. The decision might also delay larger (and longer-term) investments in CCGTs at a critical time of significant market change.

Even today National Grid is issuing forecasts of the TDR to the market that show a continuing acceleration in the value. None of this was foreseeable at all until July last year when Ofgem shocked the market with its open letter indicating it wished to see change. Since Project Transmit the market had been led to expect by the regulator and the transmission operators that the only necessary change in this area was a modest change to introduce a surcharge for exporting grid supply points.

Indeed at no point over the past 25 years has National Grid indicated that it was contemplating a fundamental shift in its charging methodology from incentivising peak demand reduction at the distribution level. Quite the opposite the redesign of local electricity network charging that has taken place 2010 (itself 10 years in gestation and a by-product of the regulatory agenda) was predicating on supporting those incentives. Where this change of direction sits in the wider context of the move to a smarter, decentralised network is anyone's guess.

Against this background it is unclear from the consultation why Ofgem and its consultants have not addressed this issue of existing operator and developer impacts in depth and engaged with the market on it. This omission needs to be rectified urgently: it would not be going too far to say that we think that the change if implemented will be less a patch for the current Capacity Market than, because of the serious unintended consequences, a catalyst for a rethink on the GB market's approach to capacity support. This, of course, is the very opposite of what officials seem to be trying to achieve.

The difference with its approach in its recent RIIO T1 Mid Period Review (MPR) decision, where it decided to do nothing because of the impact on investor confidence, is striking. It is hard to avoid the impression that Ofgem quantifies impacts on investor confidence when it wants to justify not to do something, but underplays it (as in this instance) where it wishes to push through change.

Plum assignment

We have prepared a fuller critique of the minded-to decision and the *Impact Assessment* for a number of embedded generators and two trade associations. Notwithstanding financial support we received for it, it is our own independent view.

It sets out why we believe:

- The Ofgem *Impact Assessment* supporting the minded-to decision on CMP264/265 has several material flaws and gaps
- The benefits of change for an immediate and worst case reduction of TDR are greatly overstated. Notably, no account is taken of impact on increased cost of capital and credible impacts on investor confidence
- Wholesale prices, Capacity Market costs and balancing costs will all be materially higher than Ofgem has estimated as several increased costs have been left out
- These cost increases arise because WACM4, if implemented, will lead to a higher level of new embedded projects not proceeding, and there being a much less orderly process for new CCGTs filling the capacity gap
- Indeed we believe the market will still seek to build smaller reciprocating engines for a combination of reasons, and
- The increased costs almost outweigh the claimed benefits, and many of these can be realised by an immediate cap on the TDR.

Our response and the report can be found **here.**

Bitter lemon

A more defensible decision, if an urgent decision really is required, would be to accept one of the alternatives that does not move to a worst-case outcome before the TCR and other reviews are complete.

Options are available to Ofgem from the change process to cap the TDR to ensure the current position is not aggravated, but these are rejected without proper explanation. But any of the scenario 2 WACMs would in our view be superior to the minded to decision, with WACM7 being our preference.

Peachy keen

The process for reaching the minded-to decision has been seriously flawed. There has been a rushed code change process, one that has all the hall-marks of the regulator setting the agenda to meet government pressure. It has given too little time for all participants to properly engage, despite the acknowledged impacts for generators and developers.

Ofgem has stated previously that it will apply a three-month consultation period for matters that have a wide significance, but its approach here has been contrary to that policy. The original five-week deadline has not been extended meaningfully despite impact assessment corrections and important supporting documentation being published as late as 15 March, with Ofgem allowing only a further week for responses, which happened to be Easter week. And, even allowing for the revised response deadline of 9.00am 18 April, Ofgem had on its website over the Easter weekend that the consultation was "closed" and "awaiting decision".

Since the start of the process, and throughout last year, the regulator has given explicit steers to the market to expect a worst-case outcome, and actively solicited proposals that went far beyond the two change proposals brought forward by Scottish Power and EDF Energy. Ofgem has acted as judge and jury, if not yet as executioner. `This is not an appropriate way to proceed for the arbiter of the eventual decision on a major change within ordinary code governance.

Let's hope it is not too late and Ofgem has a rethink and does not slip up on this particular banana skin.

"Oh, sure, it gets the creative juices going, but is it worth the cost?"