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Judith Ross
Ofgem
9 Millbank
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Dear Judith

Response to Targeted Charing Review: a consultation

Thank you for the opportunity to respond to your consultation on a Targeted Charging Review. Citizens Advice has a statutory role to represent the interests of energy consumers in Great Britain. As part of our statutory role we are the consumer representative in the industry code governance framework through which make many of the key decisions around charging and are important for any Review. This includes membership and voting rights on a number of the industry Code modification panels and can raise modifications on most codes. This submission is non-confidential and may be published on your website.

Overall, we welcome and support Ofgem's proposal to initiate this review. We have argued for some time (and most recently in response to the issue of Embedded benefits) that a holistic review of charging is needed in response to transition to dynamic and distributed energy system of the future.

We think that is it important to initiate this this work now in order to tackle the distortions that are currently present. These distortions make the the network less efficient, and prevent benefits of the transition of being realised for energy consumers.

We also think it is important to tackle the issues of charging in a holistic way. Because these are complex arrangements, with many interdependencies only a holistic process, such as a significant code review (SCR), can deliver the strategic changes that are required to make it successful. It is also important to use the SCR process to ensure that the changes are timely, and that these are carried out in an objective manner. In our experience industry codes have an excellent

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track record on delivery of business as usual and incremental change. But when there are vested interests, and incentives do not support strategic change (as illustrated by embedded benefits) strategic change has been poorly delivered.

We think it is vital to consider the impacts of charging regime on consumers (and particularly vulnerable consumers) directly and indirectly. We expect to see these impacts quantified and considered explicitly throughout the SCR process and in any auxiliary work (such as the proposed work on storage or embedded benefits). We also argue that through this review there is an opportunity to reduce the overall bill impacts on vulnerable consumers, which view as a beneficial outcome.

We are pleased to see action being taken now on embedded benefits and on storage, but would encourage these to continue to be considered holistically through the course of the review.

One key risk we envisage is that this review would be happening at what is already due to be a very busy time for the energy industry. The engagement of industry and the delivery of any code modifications would likely to be going alongside a number of other high priority industry changes (half hourly settlement, faster switching, smart roll out). A common feature of all these reforms is that many of the parties involved are the same. This will put resource pressure on all of the parties involved, and so in order to make this review a success Ofgem will need to ensure that the work is ensure tightly planned and coordinated in the wider strategic context.

We are keen to continue to engage with this process at the appropriate level and we would want to involved with the work of the coordination group.

Kind regards,

Stew Horne
Principal Policy Manager, Energy Regulation

Chapter 2 - Why we propose to review residual network charges

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 agree both with the statement that there is potential for residual charges to fall on groups of consumers less able to take action than others, and with the proposal that this is something Ofgem should address.

Ofgem states that “residual charges are intended for revenue recovery, and are not meant to incentivise specific actions by network users”. As time has passed, it has become apparent that this no longer holds true in practice. Types of network users are taking multiple ‘specific actions’, from changing load patterns to providing their own generation, to reduce their exposure to residual network charges. The intent of policy no longer matches with behaviour in the marketplace, so reform is justified and needed.

We are particularly concerned about all situations where customers may face increasing costs but have no ability to control them. Both because of the nature of networks as regulated monopolies, and the characteristics of these particular as difficult for household energy consumers to avoid, they risk having become exposed to an undue proportion of the costs of building and maintaining energy networks, contravening the fundamental basis of monopoly network regulation.

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

See Question 1.

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.

We agree with the proposal to address embedded benefits and storage. We do not have any further suggestions for focus, but we would support a modular approach to any further issues identified through this consultation that would provide benefits to consumer by being addressed earlier in the review.

Chapter 4 - How some network users may respond to the current residual charges

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Question 4: Are there elements of the approaches in other countries that you think could be appropriate for GB residual charges? / Question 5: Are there other approaches that you know about from other jurisdictions, that you think offer relevant lessons for GB?

We do not have comments to make on these examples, instead we have focussed on the approach that we think should be taken for addressing these issues in Great Britain in the sections below. However in each of these cases we think it is important to assess the impact on consumers, especially the vulnerable. We will continue to engage with our partners in BEUC (the European Consumer Organisation) to understand the impacts on consumers of different charging regimes in other members of the European Union.

Chapter 5 - Our proposed principles for assessing options

Overall comments

While certain relevant considerations are described, the three principles suggested are specified with sufficient brevity that no-one could reasonably disagree with them. Moreover, given each principle is capable of multiple interpretations, any decision could be sustained by reference to them. Any reform will create significant contestation given none can avoid winners and losers compared with the current arrangements. We would welcome, in particular, greater detail on how Ofgem perceives the interaction between fairness and proportionality/practical considerations and distortion reduction.

Impact on vulnerable consumers

Regarding how these principles interact, we regard the primary purpose of reducing distortions to be reducing bills (all things being equal) for all consumers. However, this should be subject to how vulnerable consumers will be protected from any reduction in distortions that might increase their bills. Further thought should also be given to how vulnerable consumers will be protected, whether by a) choosing to prioritise distortion reduction options that are more beneficial for vulnerable consumers or b) considering ways to implement rebates for certain categories of vulnerable consumers (e.g. those in receipt of the Warm Home Discount). From first principles, given Ofgem's belief that it will not be possible to eliminate all distortions and that Ofgem will be choosing among many options which may compete in desirability across economic and practical considerations, we suggest that a) be given priority.

However, we suggest going further than merely protecting vulnerable consumers in the proposed principles. We are optimistic that, in practice, most

options under consideration should present opportunities to reduce bill impacts for vulnerable consumers. The current regime for recovering residual charges allows sophisticated consumers in certain profile classes to engage in behaviour that unfairly avoids sunk costs, and given that vulnerable consumers are not within the profile classes that can easily avoid these costs, we recommend that a key principle be whether these reforms reduce vulnerable consumers' bills. We suggest the principal dimension of vulnerability (for these purposes only) should be income/wealth. This should either be treated as a separate principle in itself or be incorporated into the proposed fairness principle. A distributional analysis of reform options should be conducted to estimate the impact of various reform options.

Stability and predictability

Stability and predictability should be captured as a clear subcategory of practical considerations, as Ofgem recognises. Sometimes the consumer benefits of volatility in matching real prices outweigh the benefits of stable and predictable pricing. However, where costs can be stable, this should often be prioritised. For example, BSuoS has recently been volatile year on year and this has caused concerns from some suppliers that their lack of forecastability creates risks that are priced through to consumers. Given impact of the review on a number of areas, for example, the investment cases for different types of generation assets, all of which will typically have multi-decade asset lives, Ofgem would also want to avoid the risk of significant between year flips.

Simplicity

We tend to think that there is a case for the residual to be collected in as simple a mechanism as possible. We think this reduces the opportunities for gaming the charge while increasing the chances of identifying such gaming. This minimises the cross subsidy from those who can't change their behaviour to those who can. We therefore agree that Ofgem should incorporate simplicity into its principles.

Chapter 6 - Some options for setting residual network charges

Who pays?

Ultimately end consumers pay all system costs. We recognise the importance of whether generators or demand users should pay for the network residual charges and our views are not firm at this stage. We expect to develop our view on this point as the Targeted Charging Review develops.

However, we suggest that the scope of the review should indeed include the relative balance of charges applied to demand versus generation. The consultation document highlights (Table 1) that approximately 80% of transmission charges are recouped from demand versus 20% recouped from generation. Embedded generation will be being rewarded (and therefore incentivised) through transmission demand charging, and as a consequence industrial and commercial consumers may be encouraged to modify their behaviour. But domestic consumers are not incentivised to modify their behaviour and in some areas probably never can. The review should consider what types of network user can alter their behaviour, and try to target those users accordingly. This may mean shifting more of the charging from residual charges on domestic consumers to cost reflective charges on generators (whether transmission connected or embedded). Although their aggregate costs would ultimately flow back to households through bills, the sharper signal should in theory reduce that aggregate cost. Any considerations in this area would have to take account of gaming behavior, and existing EU rules around the limits of charges that can be levied on generators.

Ofgem's five options

We strongly support Ofgem maintaining as open a mind as possible at this stage and leaving all options open for detailed consideration. While this is likely to be more resource intensive than a 'whittling down process' implemented this stage, given the complexity and the size of the reforms being considered, it is worth closing the field of options as late as possible in case unconsidered advantages or disadvantages are identified at a later stage.

That said, consistent with our view regarding principles above, we support the aim of a simple charge levied on behaviour that is difficult for network users to change which prioritises the needs of vulnerable consumers.

Comments from our own modelling

While only offering a partial, imperfect answer, we have conducted detailed modelling on various options for reforming distribution charging (*Tackling Tariff Design¹*) and the distributional impacts under certain technological scenarios. It does suggest other options further to those set out here (such as alternative forms of a peak demand charge), though the question of residual recovery is not the principal problem it considers.

1

<https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-policy-research/tackling-tariff-design-the-tariff-transition/>

Our model suggests that technological change is crucial to understanding the impacts of various different tariff options (in this model's case, the take-up of distributed generation by domestic consumers). Our modelling did not suggest perfect solutions and all solutions involve trade-offs. However, under current technological conditions:

- It suggested that reforms which indicated a higher standing charge might increase average costs for lower income consumers by 10%,
- Employing time of use, peak demand and block rate tariffs might reduce the distributional impact on lower income consumers, though block rate tariffs do not enhance cost reflectivity,
- While the average impact on consumers' bills in each income group was small, this masked considerable (sometimes in excess of 100%) variability within each consumer group.

However, crucially, if there is rapid take-up of (in our model's example) rooftop solar, these distributional impacts shift, and a higher standing charge and demand charge become considerably more attractive for lower income consumers. These differential impacts depending on technological uptake reflect the complexity of the challenge. However, we would suggest pursuing reforms that modelling suggests are most **resilient** to technological change. This would necessarily require considering a further range of possible generation scenarios and network impacts.

Ruling out options

As stated above, we do not think there are options Ofgem should rule out at this stage. However, we have greater first principles scepticism about certain options. Charges based on net consumption strike us as extremely likely to be even more susceptible to the behind-the-meter generation problems we identify in Tackling Tariff Design. If the aim is to reduce distortions, careful thought will be needed regarding how this option can succeed in eliminating the incentive to install behind-the-meter generation as such generation becomes evermore economically plausible - and desirable - on non-sunk cost avoiding, justifiable grounds. Similarly, a gross consumption charge would need a way of avoiding this problem.

We recognise that attractions of a standing charge approach from the perspective of economic theory are considerable. However, consideration of such an approach should pay exceptional attention to distributional impacts under different generation scenarios, as we highlight above.

In this regard, we noted the MIT [Utility of the Future](http://energy.mit.edu/research/utility-future-study/)² report (2016) with interest, which specified the possibility of rendering this charge on a property value or size basis. If the attractions of a standing charge approach are significant, we would encourage Ofgem to explore options of levying it in an egalitarian fashion to reduce distributional concerns. One possibility to explore would be using existing council tax/business rate classifications as a proxy (albeit an imperfect one).

Finally, we would be somewhat sceptical about the benefits of a hybrid option, on the grounds of simplicity and non-gameability we set out above. However, none of our views here are sufficiently strong to recommend ruling out options at this stage.

Considering impacts on the wider energy system

It would be useful to understand how any changes to residual charging relating to generation charging interact with change of law provisions captured within Contracts for Difference (CfDs). In general terms, CfDs are supposed to protect investors from any risks associated from regulatory changes, so it would be important to understand if any changes in incentive would affect all generators, or only some.

Chapter 7 Benefits for smaller embedded generation, relative to other generation

Our view is that some level of benefit is appropriate for embedded generation, where it encourages an efficient reduction in investment in locationally more expensive parts of the transmission network. We remain supportive of continuing further work to analyse the potential size of effects and therefore the appropriate size of benefit. We also continue to agree with Ofgem that removing the distortion that is currently provided to sub-100MW embedded generators through their avoidance of the demand residual is an appropriate course of action. We suggest that embedded benefits are considered holistically during this Targeted Charging Review.

As specified in our response to the consultation regarding CMP264/265, we recommend that Ofgem give due regard to the impact its decision will have on regulatory certainty for both investors in embedded generation and investors as a wider class and give due regard to the prospect of wasted capital, in the form of closed or unbuilt plants, that its decision could have. We expect that these

² <http://energy.mit.edu/research/utility-future-study/>

points should be considered within the Targeted Charging Review, rather than delaying the interim implementation of removing the demand residual distortion.

Chapter 8. Our views on residual and BSUoS charging for storage

In line with Ofgem's commitment to all network users being on a level playing field, we agree that storage network users should not be facing higher residual costs when compared to other users. Storage network users facing a double residual cost for demand and generation is as plain a distortion as one can imagine. It strikes us as sensible from the perspective of simplicity that they should pay their residual costs in one category, though we do not take a specific view as to which category is most appropriate. Similarly, BSUOS should not be levied on both demand and generation.

We also agree that these changes should be made ahead of any wider changes to residual charges given the anti-competitive nature of the distortion. It seems a strong possibility that storage will become rapidly more viable and rapid action should be taken to remove any undue regulatory barriers to its competitiveness. We hope this will unlock both direct benefits for consumers and aid more technical network management issues.

Chapter 9: Our approach to taking these changes forward

Charging Coordination Group

In Tackling Tariff Design (referenced above) we recommend the establishment of a similar group and have had positive conversations with the Energy Networks Association about its desirability. An effective and considered transition plan will be essential. Alongside the content of reforms, it should consider:

- The agreement of clear protocols and plans for tariff design,
- The appropriate phasing in arrangements to give consumers opportunity to adapt to a new pricing structure,
- Clear plans for supporting consumers (particularly vulnerable consumers) who experience significant bill changes as a result. Our modelling suggests (in terms of percentage change in network bill) this will always contain a significant number,
- Consider how any plans will affect supplier pass through of cost. Where possible, reforms should strive to achieve consistent pass through across suppliers.

We would be happy to be involved in the work of the Coordination group, and we would welcome further conversations about how the consumer voice can feed into this group.

Proposed delivery model and scope

While we recognise the attractiveness of SCRs in principle, they have taken in excess of four years so far. Therefore, we support, *wherever possible*, Ofgem taking a modular approach, whereby if they identify 'easy wins', these can be unbundled from the review and separately progressed. We would therefore recommend that Ofgem does not tie its hands regarding which elements are within the SCR and which are not. For example, if faster arrangements for embedded generation are identified, we would encourage Ofgem to build in the flexibility to pursue these in a more time efficient manner, using its powers to specifically exempt modifications that cover similar ground to the SCR where appropriate.

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