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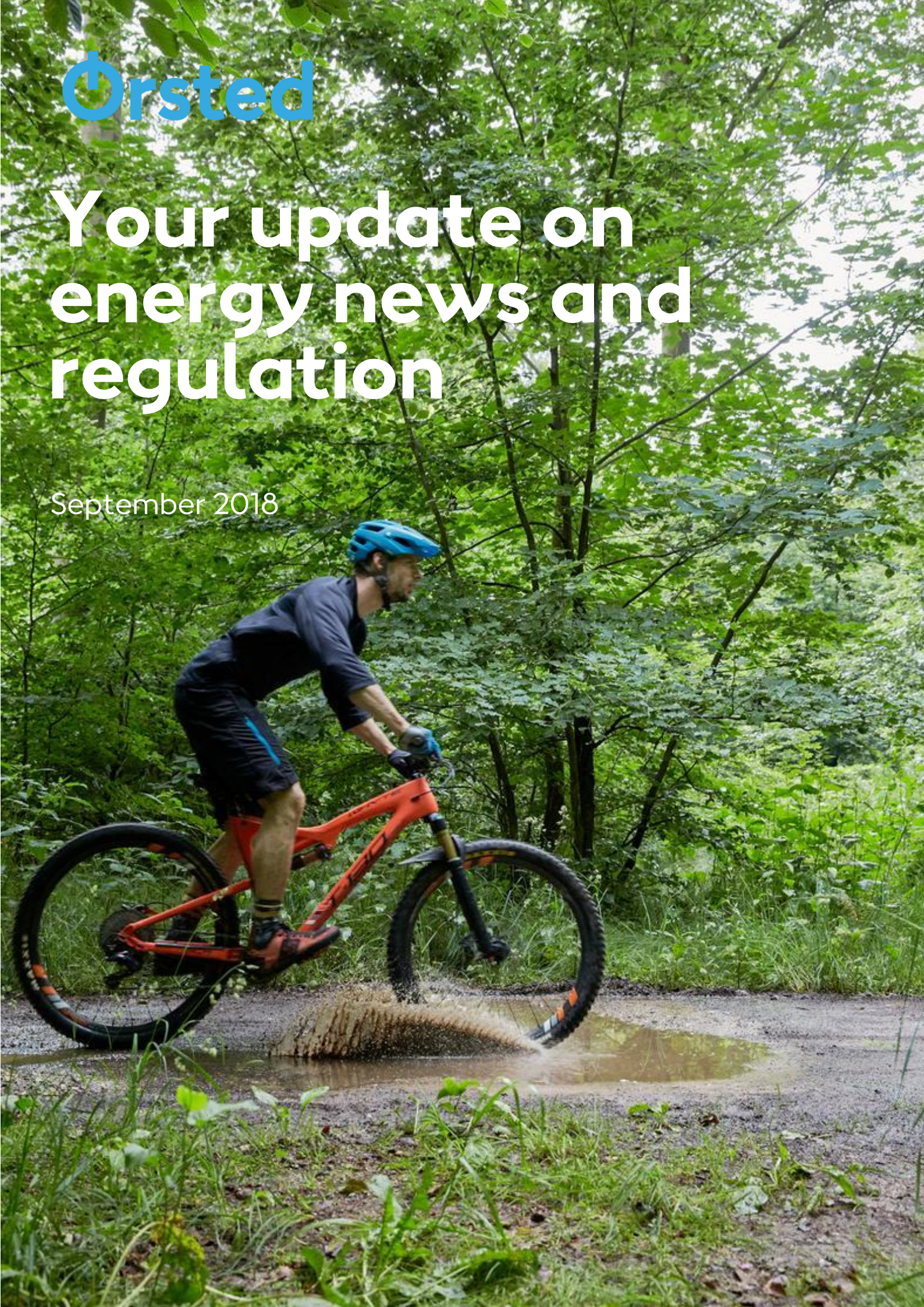
Your update on energy news and regulation

September 2018



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Preparing for EU exit – implications for licences and industry codes

Ofgem has committed to working with the industry in the run-up to Brexit to ensure a seamless transition. It has published its views on what changes may be needed to the industry (available here). This follows principles laid out in the Withdrawal Bill (available here) which assumes, amongst other things, that most EU law will be 'converted' or 'retained' as domestic law on exit day. As a result, it has not identified any provisions which are likely to be legally inoperable on exit day. There are a few areas however that may require modification, which includes references for the requirement that code objectives comply with EU law as well as definitions and terms derived from EU law. Ofgem is expecting to publish more detailed proposals in the autumn, when the details of leaving the EU are better understood.

Ofgem has ruled out launching a Significant Code Review (SCR) for changes that are required, which will mostly be updates to references to external documents. Instead it believes that industry parties (primarily National Grid) are best placed to do this work. You can read Ofgem's consultation response here.

The Department for Business, Energy & Industrial Strategy (BEIS) select committee published a view on the handling of state aid as part of Brexit. During the transition period, it is proposed that the existing structure of EU rules and regulations will still be used, with the Competition and Markets Authority (CMA) best placed to take on the role of State Aid Regulator after exit. You can read the letter here.

CMP 264/265: Judicial review rejects change to payments for smaller generators

A group of smaller generators made a formal application for a judicial review of Ofgem's decision to reduce payments that smaller electricity generators can receive for generating at peak times. These reductions came into effect on 1 April 2018. The basis of the review was that reducing payments to small-scale generation sites would directly impact their financial viability.

Ofgem won the case and it was dismissed on 22 June 2018, so the charging regime as it currently stands will not change. Ofgem's view is that the reduction in this payment will make sure costs are kept as low as possible for consumers. The decision can be found here.

Adoption of existing Smart Meters by the Data Communications Company (DCC)

Most smart meters already installed conform to the Smart Metering Equipment Technical Specification (SMETS1). Suppliers currently communicate with these smart meters using a variety of different service providers, which can make it difficult for consumers to retain smart services when switching suppliers. To address this, it is the intention that all smart meters, regardless of version, will communicate exclusively with the DCC. BEIS has recently started a consultation on when this will happen, and which meters will be supported.

BEIS is proposing that suppliers will be required to enrol all SMETS1 meters with the DCC within six months from the date that the DCC will be able to start supporting these meters. This date is unconfirmed at the moment, but the secretary of state will have powers to set the date in the future. Once the initial transfer has occurred, when a

supplier acquires a non-enrolled SMETS1 meter it must enrol it or replace it within six months. All SMETS1 must be enrolled or replaced by SMETS2 by 31 December 2020 - the designated end of the rollout programme.

BEIS is also consulting on which SMETS1 meters are cost-effective to enrol with the DCC and believes that the following meter types can be enrolled without the costs outweighing the benefits:

- Aclara
- Honeywell Elster
- Itron
- Landis + Gyr

BEIS believes that there is a net societal benefit of £210-£320m, considering the security costs and the technical feasibility of the meters. For two other types, EDMI and Secure Meters, BEIS believes there is not enough information to make an informed judgement and so has committed to a discussion later in the year. You can read the proposal to enrol the cohorts here and the requirement for all SMETS 1 meters to be installed, here.

Ofgem launches latest price control round RIIO-2

Ofgem has started the process of setting prices controls for the gas and electricity transmission and distribution network companies for the period after April 2021. This is called the "Revenue = Incentives + Innovation + Outputs" or RIIO. This is the second time that Ofgem has used this framework (hence RIIO-2) and it's a long-term process with final proposals not expected until December 2020. Any new regime will apply to the gas distribution, gas transmission and electricity transmission networks from April 2021. Though the electricity distribution networks are not due to be reset until April 2023, it is expected that any developments at this stage will be rolled over.

In the framework document, Ofgem identifies issues from the previous price control. It believes that the returns under the current price control are too high, the eight year duration is too long and the revenue incentives too complicated. Also, the business plan incentives were largely ignored. Ofgem has proposed to address these deficiencies in a number of ways.

The biggest impact on network charges will be the desire to reduce returns. This in turn would lower the percentage allowances given for financing costs and equity return rates. Innovation and efficiency incentives will be more targeted, with competition in the provision of system infrastructure in the distribution networks. There will also be a simplification of the existing number of incentives, with a greater reliance on indexing costs. This will ensure that the networks don't gain windfall benefits from lower than expected running costs.

Ofgem will also shorten the price control to five years. This means it can consider the expected rapid change in network use and technology. There will also be a requirement for customer engagement groups and an independent RIIO-2 challenge group. This is intended to challenge the companies' business plans as well as Ofgem's overall management. Ofgem expects to formally consult in December 2018 on the proposed methodologies to be used for each sector. The framework document can be found here.

Industry pays costs in respect of Co-operative Energy Limited's Last Resort Supply Payment Claim - and Ofgem starts review of the Supplier of Last Resort process

Under the Supplier of Last Resort (SoLR) process, Ofgem can assign customers from a collapsed supplier to any other licenced supplier. Although Ofgem can assign customers to any supplier it sees fit, in practice, it solicits bids from suppliers who are willing to take on the supply. This way, Ofgem is seeking to get the best deal for the industry by reducing any associated costs.

As part of the SoLR process, the assigned supplier can claim for any costs incurred - but in previous SoLR instances, the supplier has been prepared to cover all the costs, so there hasn't been any impact on the rest of the market.

However, when domestic supplier GB Energy Supply collapsed, and Co-Operative Energy Limited was assigned as a supplier, the company made a claim for costs incurred. As a result, Ofgem directed that these should be recovered from transportation charges in 2018/2019; £8.9m from gas customers and £7.7m from electricity customers (domestic and non-domestic). You can read the directions here for electricity and here for gas.

Because of these unexpected costs, Ofgem has started to review the SoLR process, looking at whether the financial requirements for prospective licence holders should be increased and how monitoring and engagement should be increased. The aim is to make sure that consumers are protected through 'appropriate scrutiny and

oversight of suppliers' (which is likely to mean monitoring the financial health of suppliers to ensure that they are viable businesses) without constraining the market. You can read the proposed workplan here.

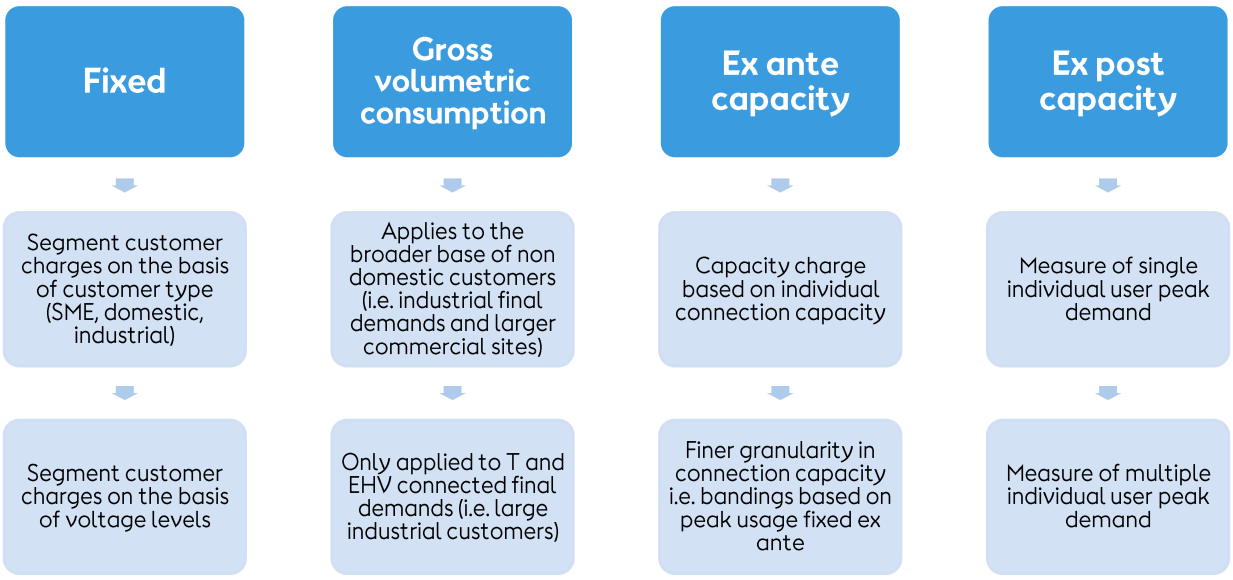
Ofgem has also started updating its SoLR guidance to account for this recent experience. This allows suppliers to claim outstanding credit balances that the customer has with the collapsed supplier, which is likely to increase the size of SoLR claims. This can be found here.

Targeted Charging Review update

Residual charges are used by networks to recover any expected shortfall in allowed revenue that is not recovered from cost related charges (such as new connections). The Targeted Charging Review (TCR): Significant Code Review (SCR) is an Ofgem-led project that assesses how residual electricity network charges should be set and recovered in Great Britain.

It's Ofgem's view that these charges (which are currently levied on both generators and suppliers) should only be recovered from demand. This would reduce potential distortions in generation - and these costs are also easier to recover. In terms of how the charges are defined, there are four scenarios depending on whether the cost is fixed, based on consumption or capacity.

The four scenarios



The diagram above is shown on slide 13 of the Targeted Charging Review, which you can read here.

All options result in potentially quite significant changes to how charges are set (for example the 'Triad' process where capacity charges are based on the three highest settlement periods over the winter is likely to be

scrapped). The work is in its early stages and we anticipate that the next major publication will be in the autumn. You can read the current documents here.

Government ends support for Swansea Bay tidal lagoon project

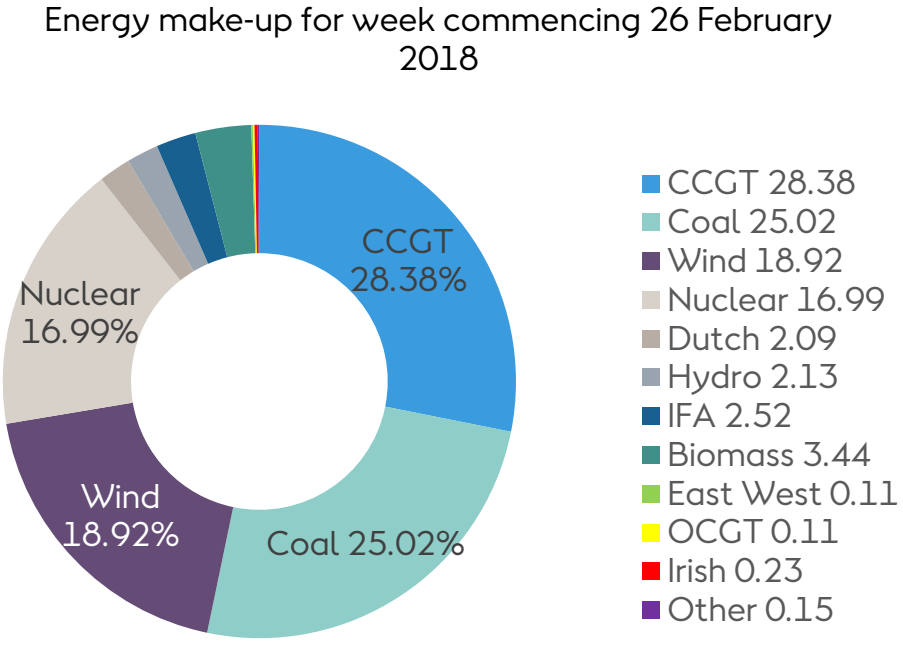
The government has decided to end funding for the proposed tidal lagoon project in Swansea Bay. This is because costs have increased to £50 billion, which compares to an equivalent funding requirement of less than £20 billion for generation from offshore wind farms. The government announcement is here.

National Grid reviews system management tools after 'Beast from the East'

National Grid has published an annual review of its activities during the winter of 2017/18. The previous winter was notable for the impact of the so-called 'Beast from the East' weather front that resulted in very cold weather conditions at the end of February and beginning of March 2018. Temperatures dropped to 9°C lower than the seasonal norm. On 1 March, the gas network had to manage the highest demand for seven years. There were also upstream supply losses, due to gas supply assets being impacted by the sub-zero temperatures. This resulted in the gas system being 47 mcm below the end of day demand level (from around 450 mcm of total network demand) and an unprecedented 100 mcm less than instantaneous demand by 7am. As a result, a Gas Deficit Warning (GDW) was issued and market prices increased.

The impact of the cold weather on the electricity system was less severe. However, system constraints did occur in the South East, as energy was moved to that region to allow export to France which was under severe strain because of plant outages. Gas prices had significantly increased, so coal-fired generation became the most economical plant to run. Wind generation provided significant levels of supply as well.

Because of this extreme weather event, National Grid is reviewing its process for issuing Gas Warning Notices and other balancing tools, as well as reviewing the behaviour of interconnectors, gas storage facilities and local distribution networks during unseasonably cold weather events. You can read the Winter Review and Consultation here. The below diagram is shown on page 43.



New Ofgem Chairman and Non-Executive Directors announced

The Secretary of State Greg Clark has chosen Professor Martin Cave to replace David Gray as the Chair of Ofgem from 1 October 2018. Cave is the former Deputy Chair of the Competition Commission and is Deputy Panel Chair of the Competition and Markets Authority (CMA). He is noted for writing the following dissenting opinion in the recent CMA energy market review, saying that the CMA's 2016 review of the energy market, *"...did not go far enough and a temporary price cap is needed to protect consumers from unfair energy price rises."* This price cap is currently being implemented as primary legislation.

Lynne Embleton and Ann Robinson have also been confirmed as new Non-Executive Directors. Embleton is currently the CEO of IAG Cargo, where she is leading transformation based on infrastructure investment, customer focus, culture and digital technology. Robinson is a noted consumer champion with significant experience in energy and consumer policy, having worked in the Civil Service before becoming Chief Executive of Scope. She also worked with uSwitch after Energy Watch, so may help Ofgem with its work on 'faster and more reliable switching'. The announcement can be found here.

National Grid publishes Electricity Ten Year Statement

National Grid has published its view on what network system demands it will be expected to manage over the next ten years (Electricity Ten Year Statement). It has identified the following issues that need to be resolved:

- Increasing quantities of wind generation connected across the Scottish networks will double north-to-south transfer requirements from Scotland to England within 10 years.
- At times of low wind output, more network capacity could be needed to meet the south-to-north transfer requirements for demand in the north of England and Scotland. Large growth of around 5GW in low carbon generation and interconnectors in the north of England, combined with increased Scottish generation will increase export requirements into the English midlands.
- There will be growth of up to 10GW in generation in the next decade, from offshore wind on the east coast connecting to East Anglia. Transfer of electricity from East Anglia to the south of England will risk stressing this region of the network.
- New interconnections coming into the south east of England will potentially increase stress on the southern English network when these interconnectors export power out of Great Britain.

You can read the electricity Ten Year Statement here.

Alongside this assessment, National Grid has issued some proposals, termed the 'Network Development Roadmap' for how it can improve its network planning tools for the remainder of the existing price control, (RIIO-T1), which runs until April 2021. The high-level goal is to identify whether long term transmission network needs can be met most efficiently through reinforcing the transmission network, or by using non-network solutions. It is proposing this will *'drive greater consumer value and provide new opportunities for customers.'*

National Grid is proposing to expand the Network Options Assessment to look out longer-term, using a whole system approach and considering network stability. You can read this document here.

Future Energy Scenarios

National Grid has published its latest long-term view on a range of scenarios of energy supply and demand for the UK out to 2030 and 2050. There are four basic paths it thinks the market can take:

Community Renewables: The 2050 decarbonisation target (80% reduction in greenhouse gas emissions by 2050, compared to 1990 level) is achieved through a more decentralised energy landscape.

Two Degrees: The decarbonisation target is achieved using larger and more centralised technologies.

Steady Progression: Centralised decarbonisation policies make progress towards, but do not meet, the 2050 decarbonisation target.

Consumer Evolution: More decentralised policies which makes progress towards the decarbonisation target but fails to achieve the 80% reduction by 2050.

You can read more information on these scenarios on page 3 of National Grid's publication 'Future Energy Scenarios in 5 minutes here.

In addition to these four high level scenarios, National Grid looked at the speed of decarbonisation and decentralisation. For decarbonisation, for the two scenarios where the 2050 target is met (Community Renewables and Two Degrees), this is achieved through a large shift to electrical heating and the almost complete substitution of internal combustion engines by electric vehicles, as well as further improvements in energy efficiency in households. Decentralisation is where the proportion of transmission connection generation drops and a move to small scale and distribution generation occurs. In all scenarios, National Grid believes that there will need to be more active management of local distribution networks.

Electricity demand is expected to increase from around 297TWh to around 400TWh in 2050, though increases are not expected to occur for another decade. Along with the move to electric vehicles, this increase will be caused by the move to electric heating, which will cause a drop in gas demand from 810TWh today to around 600TWh, though possibly dropping to 230TWh by 2050. A role for gas-fired generation to deal with variable generation issues from renewables is assumed in all scenarios.

Electricity supply is forecast to grow to over 250GW with peak demand being around 80GW. Renewables are set to grow - particularly solar, with forecasts showing up to 60GW of solar capacity compared to just over 10GW of capacity today. As this means excess supply on some days, electricity storage will have an increasing role (up to 20GW of such storage is assumed) and interconnectors will also have a role to play. In terms of gas supply, National Grid is forecasting several scenarios, including the complete exhaustion of North Sea supplies before 2050, and an associated reduction in gas supplies from Norway. The main uncertainty in terms of gas supply is whether shale gas will come on stream, with National Grid forecasting no shale production up to a complete replacement of current North Sea gas production.

You can read the full document and supporting information here.

Proposed closure of the Feed-in Tariff scheme to new applications after 31 March 2019

BEIS has published proposals to close the Feed-in Tariff (FiT) scheme to all new applications from 31 March 2019. BEIS's view is that it doesn't represent value for money, with the export tariff significantly exceeding current wholesale prices, costing customers over £1.6bn a year. BEIS contends there is insufficient value in rebasing the current prices, and the whole scheme is to be closed on 31 March 2019. Community and school installations will have a little longer to finish applying for accreditation (up to 31 March 2020 depending on the nature of the application).

BEIS is also asking for evidence on how replacement installations should be treated (i.e. whether the original support tariffs be maintained or altered). The consultation can be found here.

Ofgem's consultation on reforming access to the electricity network and forward-looking charges

Ofgem has published its consultation document, setting out its emerging thinking on possible changes to the GB power access regime and the structure of forward looking charges (charges that seek to recover costs from future development and connections, as opposed to charges that recover costs of the current network). Ofgem wishes to manage growth in demand, particularly from Low Carbon Technologies (LCTs) and localised generation. At the same time, it recognises the need to manage constraints on the system and ensure new connections are made where it is efficient to do so, rather than to take advantage of differing access and charging arrangements run by the transmission and distribution networks. For the access regime, Ofgem will look to clarify access rights and improve choices for small users (including households) as choices are currently poorly-defined and don't fully consider the needs of such customers (such as to power electric vehicles at off-peak times). For large users there is inconsistency between the rights consumers have depending on whether the site is connecting to the transmission or distribution network. It also doesn't fully consider the needs of sites that want short-term connections. For forward looking charges, Ofgem will be reviewing the charges levied for using the distribution and transmission networks. It will also be considering whether connection charges for new connections should include the costs of any system reinforcements. It is expected that the work being done will result in some firm proposals by the end of 2019. You can read the document here.

Widening eligibility for renewable electricity cost relief schemes

There are policies in place in the UK to drive renewable growth and help the UK meet carbon reduction targets. The schemes associated with these policies are typically funded by electricity consumers, through invoices. These schemes have led to an increase in the cost of electricity. The government introduced the EII exemption scheme in 2016, to exempt eligible large industrial electricity users instead of providing compensation after paying the costs as per the previous scheme. They did this to make sure that these businesses could stay competitive with companies in Europe. Eligibility is based on whether the user is within the eligible region and currently requires that electricity costs are at least 20% of its Gross Value Added (GVA).

The government is considering widening eligibility for the EII exemption and is inviting views from electricity consumers. To express your view, complete the online form here or email energyintensiveindustries@beis.gov.uk You can read the full government consultation document here. The consultation closes at 11:45pm on 7 September 2018.

The government has recognised that companies who qualify for current EII exemption could have a competitive advantage over those UK businesses within the same sector who don't qualify. High electricity prices attributed to renewal policy costs may also lead to industrial businesses investing outside the UK.

The government is proposing that the intensity threshold is reduced from 20% to 17%, 15% or 10%. The lower the threshold, the more businesses can become eligible. The government is also considering whether to lower the exemption available, which is currently 85% of policy costs. This percentage may vary - for example businesses with a lower intensity would receive a lower exemption percentage. The change could save some businesses around £2.8m per year.

Domestic users and small businesses: By allowing more businesses to become eligible, non-eligible consumers will be charged more. This means that small businesses and domestic consumers will see an increase in their electricity bills. The proposal to lower the exemption percentage available for lower intensity businesses would help reduce this impact.

Large electricity users (below current 20% intensity threshold): Businesses in certain sectors whose electricity costs meet a 10%, 15% or 17% intensity threshold may become eligible for the exemption. A business can work out their electricity intensity percentage by calculating electricity costs as a proportion of Gross Value Added (GVA).

Large electricity users who are currently eligible for the exemption: These businesses will still be exempt from paying the renewable policy cost, and the exemption remains at 85%. However, widening the exemption to include more businesses would mean that the remaining 15% would increase. The below table shows estimated figures provided by the government, to demonstrate the changes to consumer bills.

Threshold	Impact on households	Impact on small energy users	Impact on medium energy users	Impact on large non-exempt users	Impact on large exempt users
20% (current)	£4	£300	£11,000	£100,000	-£2.8m
17%	£5 (0.2%)	£400 (0.2%)	£14,000 (0.2%)	£130,000 (0.3%)	-£2.8m (0.1%)
15%	£6 (0.3%)	£400 (0.4%)	£17,000 (0.4%)	£150,000 (0.5%)	-£2.8m (0.1%)
10%	£8 (0.7%)	£600 (0.8%)	£23,000 (0.9%)	£210,000 (1%)	-£2.8m (0.2%)

The monetary values in the table represent the total bill impacts of the scheme under the different thresholds, rather than additional impact of moving from the 20% eligibility threshold to a lower threshold. The percentages in brackets represent the additional impact of moving from the current threshold to a lower threshold.

Further changes to the Smart Meter Rollout Programme

In June, BEIS confirmed that SME customers can choose a Smart Meter or an Automated Meter Reader (AMR) as part of the Smart Metering Rollout Programme. (SME is defined in the legislation as 'any customer that is not a microbusiness customer'). This is to allow customers to use a single communications provider, as the DCC will only be supporting Smart Meter communications.

This flexibility will be maintained beyond the end of the Smart Meter Rollout programme (31 December 2020) so SME customers can keep using solely AMR devices at all their sites indefinitely. They will be allowed to replace any Smart Meters with AMR meters that have been installed in their premises if they wish. The decision can be found here.

When suppliers are arranging the meter installation at a SME customer's premises, they must provide 'accurate, comprehensive and not misleading' information as to the advantages and disadvantages of having an AMR or smart metering device at their premises.

Up to the 'exemption deadline', (5 October 2018) an AMR device can also be installed at a microbusiness customer's premises and count towards the 2020 target. After this date, suppliers can only install Smart Meters that comply with version 2 of the Smart Metering Technical Specifications document (SMETS2). BEIS is proposing to extend the deadline to 5 December 2018 for AMR and earlier version Smart Meters (SMEST1) considering the lack of availability of SMETS2 meters in the market. The proposals are here.