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## **DONG Energy Response to the Provisional Decision on Remedies**

7 April 2016

DONG Energy welcomes the opportunity to respond to the Provisional Decision on Remedies published on 17 March 2016 by the Competition and Markets Authority (CMA). Our response covers our views on your remedies on locational losses.

Our ref. CMA Response - Provisional Remedies

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### *Summary*

We continue to be concerned by the CMA's proposals on locational losses. We have set out previously that we do not think the CMA has sufficiently justified the case for moving to locational losses, and our position has not changed. While we appreciate the additional work the CMA has undertaken, we still do not think the current level of evidence justifies the CMA's proposal. Furthermore, the CMA has now provided certain details of the scheme, their proposed method of implementation, and proposed that losses should be fully levied on generators. We do not think the CMA has considered all of the relevant factors in levying losses fully on generators, and we think that the CMA's proposed method of implementation will place risks and costs on generators that could ultimately be paid for by GB consumers.

### *Justification for locational losses*

We appreciate the work the CMA has undertaken in attempting to quantify the benefits of locational losses. We recognise that trying to calculate the benefits and impacts is not a simple task, especially given the CMA's time constraints. However, in our view the CMA has not made a case for implementing locational losses. We are concerned that the CMA is using their modelling as a justification for implementing locational losses, when any actual locational losses scheme will almost certainly not be aligned with the design of the scheme set out in the CMA's model. The design of the scheme has a significant influence on the distributional impacts of locational losses. In our view, as the distributional impacts of are significant, the impacts of the scheme on stakeholders should be quantified before any decision is made.

We note the CMA has taken steps to look at distributional impacts. For example, Section 4.6 within your commissioned Imperial College/NERA report discusses some of the regional impacts. However, the information in this report is clearly insufficient for stakeholders to engage effectively with the CMA. As one example, under Table 4.8, the CMA's modelling shows that generator margins for independent generators could be £359 million lower under a 45/55 losses scheme, and £268 million lower under a 100/0 losses scheme. This represents a huge potential loss for independent generators, which we do not have any further information on. We view that when a change of this magnitude is being proposed, not only should a decision be based on having considered the potential impact appropriately, but stakeholders should have clear information on both the design, and potential impacts, so that they can respond and provide their view effectively.

Further to our point above, we note that we are the only independent generator/supplier to have consistently responded to the CMA's proposals on locational losses<sup>1</sup>. All of the other respondents have been either Big 6, National Grid, or Ofgem. This is despite these proposals having a material impact across many industry participants. In our view, this is indicative that the timescales the CMA has made their proposals under have limited the ability of industry parties to respond, especially smaller generators and suppliers who do not have the resources and modelling capabilities of larger parties or the capacity to hire external consultants on short notice. We do not think it is fair that these proposals are being justified using work that has not had time to be properly and fairly scrutinised by all industry participants.

We would reiterate our previous position that considering the magnitude and potential impact of locational losses, we think it is more appropriate to instruct Ofgem to look at locational losses, and ensure that a full cost benefit analysis is performed, that the distributional impacts are carefully considered, and that stakeholders have time to provide feedback and input into any analysis.

#### *Levying all losses on generation*

We do not support the CMA's proposal to levy losses fully on generation. We understand the economic theory behind levying charges on parties that are most able to respond. However, we do not think this alone justifies implementing losses fully on all transmission connected generation, nor has the CMA provided sufficient evidence through their modelling. In our view, the CMA has not appropriately considered these factors in their analysis:

- cost reflectivity and fairness
- the impact on trade and competitiveness of UK generators in Europe

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<sup>1</sup> Competition and Markets Authority, Provisional Decision on Remedies Appendix 2.1: Transmission Losses, 17 March 2016. The CMA's summary indicates that Intergen, an independent generator, responded to some of the CMA's locational losses documents but not necessarily all of them.

- the impact on an electricity system with large volumes of inflexible and embedded generation, and Demand Side Response (DSR).

Firstly, we view that the CMA should consider other principles of economic regulation within their thinking on locational losses. Historically, cost reflectivity and fairness have been key principles of GB regulation. Generation and demand both contribute to locational losses, and it is not fair that generators will be paying costs for which they do not contribute to. This was one of the key reasons for having a 45:55 split on losses. This is especially notable for intermittent generators where any additional losses costs they face may not be cost reflective, will not necessarily incentivise dispatch decisions and could in effect only penalise them for operation.

Secondly, we view that the CMA has not fully considered the impact of their proposals on trade with Europe. Levying losses fully on generation could lead to an actual increase in the physical losses on the network. The CMA has proposed that levying losses fully on UK generators would lead to more efficient dispatch by effectively making generators closer to demand cheaper to run. However, levying losses fully on UK generators will lead to them becoming less competitive with continental European generators, and potentially increase imports, leading to increase production from Continental Generators, which are much further away from the centres of UK demand, and could lead to higher physical losses. The CMA has highlighted the issue themselves<sup>2</sup> but has not quantified the impact or done further analysis. Our view is that the CMA should not impose locational losses fully without having undertaken this analysis. Otherwise, the CMA's proposal could have perverse effects from their intended aim, and not lead to an overall increase in system efficiency.

Further to our point above, we view that the CMA has also not fully considered the impacts on the dispatch of continental generators within their modelling. The CMA has simplified their modelling of Europe by modelling it exogenously. We fully understand this approach: a full bottom up model of interconnected countries can be difficult and resource intensive. However, we think in this situation the scale of the CMA's proposal arguably requires such a treatment, especially as the CMA assumes an additional 4.4GW of interconnection capacity. The UK could have significantly more interconnection than this, with currently 7.3GW provisionally funded<sup>3</sup> and the Government indicating support for more<sup>4</sup>. We appreciate that the further out a model looks at, the less accurate and meaningful the results are. Nevertheless, we think this exercise needs to be done so that the implications of losses being fully levied on generators can be considered as accurately as possible.

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<sup>2</sup> Competition and Markets Authority, Provisional Decision on Remedies, p69, Para. 2.64

<sup>3</sup> <https://www.ofgem.gov.uk/electricity/transmission-networks/electricity-interconnectors>

<sup>4</sup> <https://www.gov.uk/government/topical-events/budget-2016>

Thirdly, we do not think the CMA has considered the impact of future developments in the electricity system in proposing to levy losses fully on generation. In the future we will see large volumes of intermittent generation, embedded generation and DSR. We think that taking into account these developments the CMA's proposal will not meet its desired aims and could be counterproductive. Levying losses fully on intermittent generation could have little to no effect on their dispatch decisions, and removing losses from embedded generation and DSR could remove their incentive to dispatch efficiently and effectively.

#### *Proposals to adjust the Balancing and Settlement Code (BSC) Formula*

If the CMA decides to implement locational losses we support the CMA's proposal that losses should be changed by adjusting the BSC formula, however we would like to see the CMA be more specific. This is because the CMA's proposal could have a significant impact on generators who hold Contracts for Difference (CFDs). The CFDs are designed to insulate the contract holder from changes to losses and we think the CMA should ensure that if they implement a proposal, it accounts for these provisions as much as is reasonable.

#### *Timing of the CMA's Proposal*

We have concerns over the timing of the CMA's proposal. We do not view that the CMA has proposed a sufficient lead-time for generators to respond effectively and efficiently to its proposals. We think this is especially important for three main reasons:

- The CMA has not finalised the details of a locational losses scheme,
- Conventional generators will need significant advance warning, to make decisions over whether to keep running, and
- With the lack of proposed phasing by the CMA, it is important that generators do not face a step change they cannot reasonably accommodate.

Firstly, the CMA has not finalised the details over how locational losses will be implemented. Notably, the CMA has not specified how zoning, or whether losses should change throughout the year, should be accommodated within a locational losses scheme. If the CMA adheres to its proposals, there will still be a significant amount of work that needs to be taken forward by industry parties, as well as likely code modifications. These processes all need time to ensure they can be carried out appropriately, and once these details have been finalised, industry parties will need significant time to prepare and accommodate these changes. Considering the timescales involved for significant industry changes, and ensuring that industry is given due warning, we think 2020 would be a more appropriate time to start, and may still end up being too early.

Secondly, generators need warning of any changes so they can factor them into investment and operational decisions, as well as to handle any possible administrative, operational and contractual repercussions of any changes. Currently the CMA has set a timetable of 1 October 2017, even though many details have not been decided. This makes it impractical for generators to make decisions currently, and generators may end up with only months of warning based on the current timetable.

Thirdly, the lack of phasing, and the combined impact of losses being both locational and fully levied on generators mean generators, especially those in the North, will face a large step change in the costs they face. We view that it is inefficient and unfair that generators will not have fair, advance warning of charges that could cost them millions of pounds.

#### *Order versus a code modification*

As we have set out previously, we think it is more appropriate the CMA issues an order for Ofgem to look at locational losses, so that a full cost benefit analysis can be performed, and that the detailed of a scheme and implementation can be worked out before a decision is made.

If the CMA adheres to its current position to impose losses, we view that it would be more appropriate to order Ofgem to implement locational losses, and either instruct NGET to raise a modification, and/or impose a licence condition on NGET to implement locational losses. While we have some sympathy with the CMA's view that industry parties have frustrated previous modifications, we view that the CMA needs to recognise that the code modification process can take significant time due to their governance and the specific and tight requirements for a modification to be approved. This process includes multiple consultations, potential Impact Assessments, and opportunities for parties to feed in, such as by being a member of a working group. If the CMA sets out explicitly that NGET and Ofgem must implement locational losses, which will probably be through NGET raising a code modification, we view that it will definitely happen. We recognise that this process could take a significant amount of time, but we think this time is justified and any costs are outweighed significantly by the benefits of going through industry processes. The industry process would ensure that the finer details of any proposal would be discussed considerably and that industry parties had significant sight and transparency over the issues.

#### *Time for parties to respond*

In our view, the CMA has not given stakeholders sufficient time to respond to their provisional remedies. The CMA's proposals are significant and have a wide impact: the provisional remedies document is 800 pages long. The CMA only published their full document on the afternoon of Thursday 17 March, with a deadline for responses by Thursday 7 April. This is equal to 13 working days.

Considering the significant impact of the CMA's proposals, we would have expected and appreciated a longer consultation period. We think this is especially crucial as the CMA themselves has highlighted how important consultation can be, such as on the Contracts for Difference budgets.

Our ref. CMA Response - Provisional Remedies

If you have any questions on our response, please feel free to contact me (020 7811 1055, [almos@dongenergy.co.uk](mailto:almos@dongenergy.co.uk)).

Yours sincerely

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