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Dear Ms Kulhavy

Distributed Energy - Initial Proposals for More Flexible Market and Licensing Arrangements: consultation

energywatch welcomes the opportunity to respond to the issues raised by this consultation. This response is non-confidential and we are happy for it to be published on the Ofgem website.

General comments

Consumers expect the delivery of safe, secure and reliable supplies of energy in an efficient and economic manner. Where regulatory barriers stand in the way of these expectations – through current licensing or market arrangements – Ofgem must address these. In the case of medium-sized Distributed Energy (DE) schemes, some consumers may be seeking to achieve localised security of supply by developing infrastructure to complement existing and new large-scale infrastructure required for transporting electricity to most consumers. In doing so, and especially where the schemes address aspects of fuel poverty, improve energy efficiency and reduce carbon emissions, these efforts must not be stifled.

We agree that the development of DE schemes should occur within a competitive market framework where possible. Effective competition on an open, transparent and economic basis can provide consumers with the best form of protection and the cheapest prices. If current arrangements create barriers to a more competitive and flexible energy market, this may suggest that existing market structures need to be reviewed. This is why energywatch supports the enquiries into the competitiveness of GB energy markets being conducted by the BERR Select Committee and Ofgem.

Where it is difficult to accommodate DE schemes effectively, any adverse impact on consumers who may be connected to such schemes should be minimised, especially in terms of the prices they pay for energy supplied to them. These costs should reflect overall market conditions and not be higher simply because the form of connection is different from most other consumers. In the same way, the majority of consumers must not pay excessive costs for the deployment of DE schemes benefiting a few consumers only. DNOs must not discriminate against smaller schemes that may require the development of a private network connected to the public wires rather than a direct connection. While cost reflectivity may be important, some of the significant benefits of certain schemes must not be lost even if there is not full cost reflectivity. There are other benefits such as improved local security of supply, potentially for priority consumers if the scheme is based at a care home or hospital, and the potential for lower carbon emissions which justify the scheme. These schemes need to be considered in terms of the long-term benefits they could provide to the users of these connections, which override short-term considerations of cost reflectivity.

It is critical that the development of individual and regional DE schemes is undertaken within a coordinated strategic framework to optimise the benefits not just of these schemes but also of microgeneration projects aimed at householders. BERR and Ofgem have the ability to set out an overall framework within the context of Government energy policy objectives to reduce carbon emissions, increasing renewable generation output as part of a diverse energy supply, and developing more streamlined planning processes for local and national energy projects. Ofgem must take a leading role in delivering the operational elements of this framework, in line with its duties on sustainable energy, working alongside the industry and the wider stakeholder community.

Licensing issues

The development of DE schemes requires a degree of flexibility that current arrangements may not provide. If DE schemes are to increase significantly, the current exemption schemes that allow certain generators and suppliers to operate without a licence may need to be extended but with adequate monitoring and safeguards for any domestic consumers, particularly vulnerable consumers, who may be connected.

Where the DE scheme is limited to a single industrial plant operated only for own-use purposes, it may be unnecessary for the operator to hold a licence. However, where the impact of the scheme is wider, for instance, supplying a mixed community of users – industrial,

commercial and domestic – licensing should be required to ensure that all those users, but specifically the domestic users, are protected in the same way as all other domestic consumers. Ofgem should therefore consider both **scope** and **purpose**, rather than purely load size, in determining whether particular DE schemes need licences. Existing exemption limits may become irrelevant as there is further innovation and development of different DE schemes.

The **form** or **structure** of DE schemes must also be considered before Ofgem determines whether a licence is required. A single operator of multiple schemes may seek exemption by structuring the schemes in such a way as to avoid licensing. Ofgem should use its monitoring and enforcement remit to prevent any potential abuse, balancing this against the effectiveness of schemes in delivering sustainable energy meeting consumer expectations. That is why existing limits, as opposed to scope and purpose, may be less relevant for the future licensing of DE schemes.

The requirement for a licence should always be a balance of considerations - is it proportionate for the scheme operator, based on the form, scope and purpose of the scheme, to hold a licence? Does the scheme have a wider impact on existing infrastructure which impairs the expectations of consumers in general to obtain safe, secure and reliable electricity supplies in an efficient and economic manner? While we recognise that the requirement to hold a licence creates certain further obligations, such as acceding to and complying with industry codes, we do not believe that this necessarily ought to create barriers to entry for DE scheme operators. The relevant codes themselves may need to be modified and evolve to recognise the development of DE schemes and must operate flexibly to remove potential barriers to entry.

We share Ofgem's concerns that domestic consumers connected to certain DE community schemes should not be disadvantaged in seeking the benefits of competitive energy markets. Even with the best intentions of the scheme, it may create its own barriers to domestic consumers from seeking competitively priced supplies. Such schemes should not offer to supply any domestic consumers connected to them on terms which are significantly different from those available in the competitive markets, even taking into account other benefits that consumers may derive from being connected to those schemes, e.g. energy efficiency.

Wholesale market issues

We recognise the many difficulties that DE schemes may face if they are sufficiently large enough to be licensed and therefore are obliged

to play some role in the BSC arrangements. However, there are already some ways under the BSC in which licensed DE schemes can avoid some of the considerable exposure to imbalance cash-out which may occur, such as contracting with consolidators or suppliers (through trading units if they are generators) who can net off their energy flows. If DE schemes are to be encouraged further, greater flexibility achieved through the evolution of the existing arrangements is preferable.

We believe that, while the current cash-out arrangements may be penal to individual schemes, encouragement to new entrants that promotes a collective approach may reduce risk and exposure more effectively. We would encourage greater transparency and engagement with those operating or considering DE schemes which may be affected about how these mechanisms may allow them to hedge some of their exposure.

While we see a superficial attraction in having a DE representative on the BSC Panel, Ofgem itself recognises that many DE schemes will not be affected by the BSC at all. In any case, the BSC Panel operates as an independent and objective body in considering modifications and makes recommendations on the basis of whether these meet the Applicable Objectives. It would be useful to have a DE insight into modifications and the BSC Panel chairman already has the ability to appoint a further industry member of the Panel if current industry representation is deficient. It may be more relevant to consider, as Ofgem intends to do under the industry codes governance review, whether the current BSC Applicable Objectives fully reflect the changing nature of the electricity market and whether a sustainability objective is required in addition to the current Applicable Objectives.

We believe that there is real scope for efficiency and cost reduction through increased engagement by suppliers of the demand side. DE schemes represent the future of scale demand-side management which is critical to sustainable energy objectives. Suppliers should actively seek to offer innovative products and services to scheme operators which effectively manage their demand or purchase electricity from small generation as the case may be. We believe that suppliers should not ignore the potential benefits that amalgamating a number of schemes can offer.

If existing vertical players fail to take up opportunities in assisting DE schemes within the existing trading arrangements, Ofgem must address the barriers to entry that limit the scope for new entrants to take on the role of consolidators. A separate wholesale market for DE schemes may have short-term benefits but could be inconsistent with an integrated open and effective competitive market in the long term. We believe

that improved transparency and the use of standardised terms on offer to DE scheme operators within the existing market may be more beneficial.

Energywatch has already supported BSC modifications seeking to improve information transparency in the wholesale electricity market and would urge Ofgem to speed up the availability of increased information on a single accessible platform to as wide a range of stakeholders as possible to keep up momentum. We believe this will help to bring down some of the barriers that impede the effective deployment of consolidation and similar services which would benefit DE schemes.

Other issues

We note the examples of DE schemes provided in the consultation document. The Aberdeen City Council community-based CHP scheme in particular highlights how fuel poverty can be addressed effectively at a local level if the scheme is well thought out, strategically planned and well delivered. Barriers to these schemes ought to be addressed in the same manner – a strategic identification of where problems lie and an operational plan to address deficiencies.

We believe that flexibility and innovation on the part of existing suppliers, DNOs and new entrants will help to boost the number of DE schemes. If this requires encouragement through licence changes – allowing exempt supply services to be catered for by licensed suppliers or the fairer (not necessarily cost reflective) treatment of private networks connected to DNO networks through DUoS charges – Ofgem should explore these issues in more detail.

We do not believe that consumers connected to private networks should be prevented from seeking competitive electricity prices through limitation of third party access by the developer of the DE scheme. At the very least, the DE scheme should offer electricity prices which are no less competitive than the going market rate. We appreciate that the developer may wish to obtain some return for its investment in the network but domestic consumers should not face unnecessary barriers to switching.

We will continue to engage with Ofgem and the industry on the issues regarding both distributed energy and microgeneration as and when they are raised, always considering the possible impact on consumers, and comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs