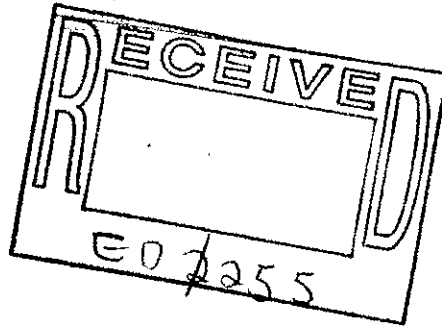


Your ref

Our ref

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11 March 2008

Dear Rachel,

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

I am writing here on behalf of CE Electric UK and its licensed electricity distributors Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

We welcome these proposals, and support the direction you're taking. We agree that strong retail supply competition delivers many benefits to customers, and therefore that distribution licence exemption thresholds (which restrict third party access) should not be raised. We welcome the recognition that distributed energy (DE) schemes can be supported over public licensed distribution networks. In turn, we also recognise that we have some work to do to implement these solutions.

EFFECTIVE MARKETS***Distribution Licensing***

We agree with you that competition remains the most effective form of protection for customers, while recognising that other safeguards in the supply licence are important. Therefore, we also agree that the regulatory framework for DE schemes needs to ensure that competition in the GB electricity market remains vibrant so that distributed energy schemes can grow and thrive within a competitive framework.

The European Court of Justice (ECJ) ruling on Citiworks will provide a clear legal backstop on the issue of third party access. However, we believe that the general philosophical point is more important, that retail supply competition should be promoted where possible because of the customer benefits. Therefore, we support proposals to stimulate DE within the existing market framework rather than take (potentially) large numbers of customers outside that framework.

It follows that we agree that we need not and should not raise the existing distribution licence exemption thresholds. As your consultation paper notes, we can support DE schemes that trade over public licensed distribution networks, and we should retain third party access.

Supply Licensing

The argument not to raise distribution licence exemption limits does not mean that the supply licence exemption limits cannot be reviewed. We are not experts on the issue, but it seems to us that the development of Energy Services Companies (ESCOs) may be stimulated by granting exemption from supply licensing. It may be more appropriate to publish a policy for granting specific exemptions rather than amend the exemption regulations, to allow each case to be taken on its merits.

CE ELECTRIC UK FUNDING COMPANY

Registered Office: Lloyds Court, 78 Grey Street, Newcastle upon Tyne, NE1 6AF
Registered in England and Wales. Registered Number: 3476201

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To focus these derogations on schemes that bring the benefits of both low-carbon energy and retail competition, there is also a case for making any extensions subject to conditions such as:

- being associated with a low-carbon energy source that is itself licence-exempt;
- trading over a public licensed network, so as not to take customers out of the competitive market; and
- accepting the customer service/protection obligations of the supply licence.

We do not support allowing a limited number of new entrant DE Suppliers the option of blocking customer switching for a limited period of time. This is a distribution licensing issue concerning third party access and, as discussed earlier, we agree that competition remains the most effective form of protection for customers and should be retained wherever possible.

As you have noted, fixed installation costs can be recovered alongside the other capital civil costs of the development, and need not be tied to retail energy contracts.

Zero-Carbon Homes

As you note, the potential difference in emphasis between your proposals and the Department for Communities and Local Government (DCLG) policy statement 'Building A Greener Future' needs to be addressed. We appreciate the desire for generation from low/zero carbon sources on site, rather than offsetting consumption by generation at some remote location. However, we do not believe that this requires private wire connections as the initial policy position proposes.

The work you have led summarised in your proposals shows that the zero-carbon requirement for new domestic developments can be delivered over public licensed networks, because any DE scheme can be delivered over public licensed networks.

We suggest that the definition of 'True Zero Carbon Dwelling' (as, for example, in DCLG's Code for Sustainable Homes - Technical Guide) be amended from:

Where net carbon dioxide emissions resulting from ALL energy used in the dwelling are zero or better. This includes the energy consumed in the operation of the space heating/cooling and hot water systems, ventilation, all internal lighting cooking and all electrical appliances. The calculation can take account of contributions from onsite renewable/low carbon installations.

Off-site renewable contributions can only be used where these are directly supplied to the dwellings by private wire arrangement.

to:

Where net carbon dioxide emissions resulting from ALL energy used in the dwelling are zero or better. This includes the energy consumed in the operation of the space heating/cooling and hot water systems, ventilation, all internal lighting cooking and all electrical appliances. The calculation can take account of contributions from renewable/low carbon installations which are either on/in the dwelling or elsewhere on the development site.

This would bring the benefits of low-carbon energy and retail competition to new domestic build.

IMPLEMENTATION

Tariffs and Loss Factors

We recognise that there is some work to do further to support DE schemes, in particular developing Distribution Use of System (DUoS) tariffs and Line Loss Factor (LLF) codes that better reflect the impact of DE schemes upon our distribution system. We have engaged Bath University, as employed by WPD, to develop a new charging model for us. This should allow us to propose new DUoS tariffs and LLF codes for DE schemes and inset networks by Christmas 2008.

We are not convinced that tariff volatility is a genuine economic issue, as DUoS tariffs are generally a pass-through that sustains a level playing field between all suppliers. If this is seen to be a major issue, we would readily consider measures to reduce year-on-year changes.

We need to consider the application of short-haul tariffs and loss factors in detail. Our initial conceptual view is to apply standard tariff and loss rates to import MPANs, for simplicity and to facilitate competition in retail supply. New rates for the relevant generator export MPAN would be set to net off against the import to yield an appropriate overall impact.

For example, if the underlying costs of a DE scheme were £10,000 pa and the underlying losses 1GWh pa, but standard import rates yielded revenue of £20,000 pa and allocated losses of 2GWh pa, we would set rates for the associated generator to rebate £10,000 and 1GWh.

This is not the same as a general negative tariff for generators, although it may be possible to justify that separately. This is an arrangement specific to DE schemes where we know the export will be used locally, reducing demand (and losses) on the wider system.

The approach would be consistent with that for 'merchant' generation. The difference would be in establishing a new customer class for generators associated with DE schemes, where we recognise the greater coincidence of the export curve with the demand curve. There would be some inevitable averaging within that customer class, as for all other tariffs, but the general principle of cost reflectivity holds.

We could make these changes within our current loss and tariff allocation methodologies, but suggest that it would be more appropriate to include these issues within the (separate) overhauls of those two processes we plan to execute this calendar year.

Such a solution would work within the scope of these proposals, as there would be a half-hourly MPAN associated with the generation. We note here that something different would be required for microgeneration, where metering arrangements differ.

There is a regulatory challenge here. Allowed income for generation and demand is currently set separately, requiring us to apply different scaling factors to the tariff model to remain within the separate price control constraints. This makes it much harder to align generation and demand tariffs to deliver the results we want. This could be resolved by combining the two price controls, making the current generation charge restriction formula another term in a combined restriction. We could then apply common scaling, retaining the balance between demand and generation tariffs.

We welcome your invitation to build on the Registered Power Zone (RPZ) initiative to come forward with proposals for network trial projects that offer innovative technical and charging solutions for DE. We are already engaged in discussion with potential DE developers in our service area, and hope to bring at least one scheme to fruition this year. I'd value your opinion on whether these trials would allow us to set new short-haul tariffs and loss factors without a formal change of methodology, and addressing the distortions inherent in separate two charge restrictions. Such a derogation would significantly reduce what we see as one of the two key barriers to implementing DE schemes across the public licensed network, the other being access to exempt supplier enabling services.

DE Advocacy

We support your proposal to appoint a DE representative to the Balancing and Settlement Code (BSC) panel. I believe a similar arrangement was in place under the Pool, and we agree that such advocacy is important to facilitate DE under the BSC. We suggest similar advocacy for the Connection and Use of System Code (CUSC) and Transmission Charging Methodology Forum (TCMF), to monitor changes to transmission costs. We also agree that there is a case for DE involvement in developing ER G59 and G75.

We also recognise that funding such representation is a fundamental issue. In the first instance, we expect the relevant DE trade associations, e.g. CHPA, to finance this activity from members' subscriptions. We are not convinced that funding by a wider industry levy would be appropriate.

Access to Markets

We agree that access to wholesale markets, and economical interfaces with industry processes, is essential to the future of DE schemes. The specialist energy trader as full consolidator you propose is very close to the exempt supplier enabling arrangement that already exists. We believe that this level of support is required to facilitate DE schemes, whether export-only or ESCOs.

A logical extension of these roles is the agency role discussed in Ofgem's parallel Transmission Arrangements for DG (TADG) workstream. Where a third party is providing DE schemes with the range of services you propose, it seems to us obvious that this should extend to the relationship with GBSO that TADG has examined in detail.

Workshop

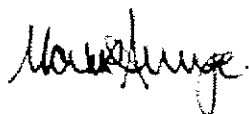
We agree that an industry workshop would be valuable to exchange ideas and stimulate further consideration of the issues in your consultation. Given the breadth of this subject area, I suggest the workshop should consider relatively few issues, specifically gathering the evidence you have requested and discussing implementation of your proposals.

In summary, we:

- agree that sustaining retail competition is a key benefit for customers;
- submit that supply and distribution exemptions can be considered separately;
- agree that DE schemes can and should be facilitated over public licensed networks, so there is no need to raise the distribution licence exemption limit;
- look forward to working with you to address the potential difference in emphasis between your proposals and DCLG policy on zero-carbon homes, bringing the benefits of low-carbon energy and retail competition to new domestic build;
- recognise that we need to reform tariff and loss factor formulation. There are barriers in the structure of the current price control and in the requirements for formal change of methodology. We look forward to bringing forward innovative solutions on a trial basis to address these issues

We look forward to continuing to work with you in this area. Specifically, we would be glad to meet you to discuss these ideas. In the interim, feel free to call either me or Dave Miller (0191 387 7140).

Yours sincerely



Mark Drye
Director of Asset Management

Specific Questions Raised

Question 1: If the exemption limits for supply and distribution to domestic customers were to be raised, what measures would be required to ensure ongoing and effective protection of energy customers, and how would this be enforced or monitored?

We do not believe that ongoing and effective protection of energy customers can be ensured if the exemption limits for distribution to domestic customers were to be raised. These customers must retain access to competitive markets, which means they must be connected to public (licensed) networks

We believe that ongoing and effective protection of energy customers can be ensured if the exemption limits for supply to domestic customers were to be raised, so long as such exemption is made subject to:

- connection to public (licensed) networks, retaining access to competitive markets; and
- customer codes of practice etc. on a similar basis to licensed suppliers

Question 2: Should the existing per company maximum exemption limit be removed allowing one company to develop a number of different sites?

As noted under question 1, any relaxation should apply only to supply exemption, subject to some conditions related to customer protection

Question 4: Do you consider it appropriate to use the provisions of the BSC to increase the representation of DE schemes in BSC governance processes?

Yes, we strongly support working within existing frameworks and creating an advocate for smaller players

Question 5: Do you consider that there is a case for allocating funding for DE representation in BSC governance? If so, do you have views on where the funding should come from?

In the first instance, we expect the relevant DE trade associations, e.g. CHPA, to finance this activity from members' subscriptions

Question 10: Do you think there is a case for a specialist Energy Trader? What are your views on the scope and functions the specialist agency could perform as an interface between DE generators and the current trading arrangements?

The specialist energy trader as full consolidator is very close to the exempt supplier enabling arrangement that already exists. We believe that this level of support is required to facilitate DE schemes, whether export-only or ESCos.

A logical extension of these roles is the agency role discussed in Ofgem's parallel Transmission Arrangements for DG (TADG) workstream. Where a third party is providing DE schemes with the range of services you propose, it seems to us obvious that this should extend to the relationship with GBSO that TADG has examined in detail

Question 20: Is there a case for DE representation at the Energy Network Association working group examining the technical standards for connection? If so, do you have views on how representation might be funded?

As with BSC, we support creating an advocate for smaller players and we expect the relevant DE trade associations to finance this activity from members' subscriptions

Question 22: We welcome views on the proposed options to improve the accessibility of the licensed network to DE schemes, and whether there are any other relevant options we have not considered

We agree with the proposed options to improve the accessibility of the licensed network to DE schemes. While there is much for distributors to do, this is within our grasp. Key points are discussed in more detail in our letter