

Anna Kulhavy
Senior Economist – European Strategy and Environment
Ofgem
9 Millbank
London
SW1P 3GE
Anna.kulhavy@ofgem.gov.uk

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Dear Anna

Distributed Energy – Further Proposals for More Flexible Market and Licensing Arrangements

energywatch welcomes the opportunity to comment on Ofgem and BERR's preferred proposals for this important development. This response is not confidential and we are happy for it to be published on the Ofgem website.

In our response to the December 2007 consultation paper, we stated our agreement to the principle that the development of distributed energy (DE) schemes should occur within a competitive market framework where possible. However, we do not hold as sanguine a view of the market and believe that the proposals set out in the Further Proposals document will neither provide adequate protection for consumers nor achieve their policy objectives.

Development of distributed generation is an important part of the government's energy strategy and we are conscious of the desire to reduce barriers to its development.

Obtaining a licence itself is now a straightforward process and we are not aware of this aspect of the regulatory regime being a significant barrier to potential developers. Before any exemption limits were changed, we would expect Ofgem to present evidence from potential developers that demonstrated the scale of the barrier. We therefore support the proposal to continue with the exemption regime in its current form.

We support the intention of reducing the barriers presented to potential DE developers through the industry codes. However, we consider that the evidence presented is such that the merely encouraging the development and provision of alternative arrangements is insufficient.

Industry codes

The most significant issue that needs to be addressed with regard to the industry codes is aligning code objectives with the updated wider statutory framework. Sustainable development needs to be embedded into the codes' objectives and how the codes are managed. In this way, all code panellists will be required to take factors such as the impact on DE developments into account and show how they have done so.

Moving forward in this way will remove any specific need to designate a third party representative with DE interests or expertise to raise BSC code modifications. Such an approach would be no more than a sticking plaster, becoming unnecessary once the revised code objectives are in place, and could be positively detrimental, as it would legitimise some BSC parties not engaging with issues such as sustainable development or facilitating the contribution of DE to wider policy objectives.

We would urge Ofgem to pursue this alignment of objectives as rapidly as possible, including, if necessary, the introduction of these changes in advance of any others that may be an outcome of the industry codes governance review. If urgent introduction of the changes is not possible, we would suggest that Ofgem give prompt notice that such changes are forthcoming and encourage BSC panel members to act as if the change is in effect as soon as possible.

Cash-out Developments

The further analysis on cash-out developments has highlighted three options (mitigating system pollution, revised reverse price and shorter gate closure / extended contract notification) that have potential advantages for intermittent DE generators. The impact of these changes needs to be determined in the wider context of the whole market and we look forward to seeing further work on this.

Relying on Competition is Insufficient

Ofgem note some surprise that DE generators do not benefit from consolidation within a purchaser's existing portfolio relative to direct participation in the wholesale market. We consider this is prima facie evidence of why relying on encouraging competition in the provision of alternative arrangements to signing onto the industry codes is insufficient in the current industry climate.

We interpret the fact that DE generators are not benefiting from consolidation as evidence that there are insufficient competitive pressures in the consolidation market, so that suppliers are able to dictate the terms DE generators receive and capture the entire margin available. Their ability to do this when overall the market is short of renewable generation makes this all the more surprising. This suggests that all the market power that DE should have from being in an undersupplied market is being negated. If DE is going to grow in the competitive market, this imbalance between suppliers and DE generators needs to be addressed.

We are unconvinced by suppliers' arguments that the lack of specialist consolidators

reflects narrow margins that are symptomatic of high levels of competition. As well as the results from the discount analysis, we believe that there is a structural barrier to the establishment of vigorous competition from new consolidators – the legacy portfolio of contracts with customers and with renewable and intermittent generation that the major suppliers have developed. The consequence is that taking on new DE into a portfolio is much less risky for a major supplier than for a new entrant, where the variability of output could have a much greater effect on business performance. Alongside this, we believe that existing suppliers have an information advantage, which would enable them to make more accurate assessments of the discount that a generator should incur.

At a more general level, we are also surprised that Ofgem is willing to rely so strongly on the goodwill of the major suppliers to develop competition in this ancillary area, when there has been a need to investigate whether the same organisations are competing vigorously to supply their core product.

Rather than the market for small generator output being competitive and diverse, we are concerned that the DE developers should be capturing more value for their output and that leaving the development of arrangements such as supplier services agreements solely to competition will create further barriers to the growth of DE.

We are also disappointed that, when faced with suppliers saying they had not been asked to provide Exempt Supplier Services and DE proponents describing difficulty in obtaining these services, Ofgem appear to have ignored the difficulty. This pushes developers toward avoiding operating on the public network, relying on exemptions and so indirectly constraining the size of DE schemes. It is no surprise that suppliers have objected to imposing an obligation on them. However DE operators need such services if they are to switch off the code compliance requirements or to develop larger schemes anticipated from, for example, zero carbon homes. In the absence of evidence to the contrary, namely suppliers positively offering such services, and improvements in the consolidation market, we believe it is proportionate for Ofgem to employ more direct regulation as a backstop, albeit one that can be removed once effective competition in this area can be observed.

We note the recommendations of the Selling Output study and strongly support the developments outlined for more within year trading; better information on entry options and requirements and available support for DE schemes; more standard terms and conditions for smaller power parcels; and set tariffs for smaller parcels of output. Developments that improve the information available to prospective DE operators and simplify the market, particularly for smaller amounts of DE, should be pursued urgently as part of establishing effective competition.

Distribution Issues

If DE is to make a significant contribution to the country's energy requirements, the scale of activity will need to increase. We agree with retaining the existing licensing and exemptions regime, but without other measures we believe this could become a constraint on DE development. Exempt Supply Services, mentioned above, is one area for action, but we also believe that distribution charges competition systems

requirements could also drive developers to stay within unlicensed private networks.

We do not agree with the statement that the outcomes for DE will depend to some extent on DNOs' vision around taking forward new business areas. Instead, we believe it should be for the DNOs to facilitate the development of DE as part of the service of providing safe, secure and reliable energy supplies. We agree that the structure of charges will be important and look forward to seeing further developments in this area.

We also consider that there should be further work on the virtual private network concept. This appears analogous to arrangements that apply in the gas industry and would also appear complementary to the development of innovative supplier services that would be expected in a market with effective competition.

Implementing the Proposals

Subject to our earlier comments about backstop obligations for the provision of exempt supply services and supplier services agreements, we support using the collective licence modification process and subsequent directions to implement these proposals. Providing guidance on the requirements is also supported. The guidance should clearly stipulate the contingent nature of any direction and, as well as the information requested, an obligation to advise promptly of any changes to the information.

We believe that eligibility criteria should follow those already established for licence exemptions; i.e., scheme capacity and commercial characteristics, as this provides simplicity for developers considering schemes of different sizes.

For these proposals to work there will need to be vigorous competition between suppliers to provide the supplier services. We are sceptical this will exist initially and are concerned that Ofgem are not proposing to regulate the prices of these arrangements. This is likely to leave developers and their consumers exposed to whatever costs the supplier chooses with only limited recourse available under competition law. The essential nature of these services for DE developers makes this imbalance unacceptable. To protect consumers, Ofgem should stipulate a minimum set of services that should be provided and a requirement that the costs of these services should include only a reasonable level of profit and be published. Developers could negotiate for additional services over and above the core elements.

With regard to the breakdown of a relationship between a licensed third party and the DE supplier, we can see no reason why these consumers should ultimately belong to anyone other than the DE supplier. However, two further elements will be required to cover the breakdown of the relationship. If the breakdown follows the business failure of the DE supplier, then the agreement should require the third party to adopt the customers as its own, effectively using a supplier of last resort mechanism. If the breakdown is due to the failure of the third party, then a third party of last resort arrangement is required.

Going forward, we will continue to keep these issues under review as and when they are raised, always considering the possible impact on consumers. If you wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs