

OfGEM

**Distributed Energy-
Further Proposals for a
More Flexible Market
and Licensing
Arrangement**

Arup Response to
Consultation

Final

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Summary

We do not believe that these Further Proposals adequately support the transformation of the DE market required by, amongst other things, the Renewable Energy Strategy.

We contend that the market for small generator output is not functioning in support of the UK government strategy for the increased uptake of local renewable energy. The use of renewables described in the Renewable Energy Strategy requires greatly increased penetration for a range of technologies that at present are not widely understood in the market. We make this assertion based on our considerable experience of assisting our clients to bring such opportunities to market and the weak responses has been provided to them.

There appears to be a fundamental inertia in the market for DE output that makes it incompatible with the wider strategy for renewables and we contend that this is not simply a matter of commodity price subsidy, such as use of a feed-in tariff. We urge BERR to reconsider these further proposals in order to selectively align licence requirements more appropriately with the scale of DE operators. We recommend that OfGEM and BERR focus on the barriers to entry faced by new and innovative DE suppliers that will be required in order to deliver the Renewable Energy Strategy.

1 Responses to Consultation Proposals

1.1 The Role of Licence Exemptions in the Future Development of DE

We are in agreement with the proposal that licence exemption limits should not be raised, but find the lack of clarity in the Class Exemption Order to be extremely disruptive in planning new DE schemes, and in urgent need of resolution. The Citiworks case has focused attention on the issue of 3rd party access to 'private wires', rather than the legitimacy of private wire networks and licence exemption per-se, yet these issues are intertwined. We contend that exemption from appropriate regulation is generally undesirable and counterproductive and may be ultimately self defeating. What is required is a balanced and proportionate licensing regime that extends across all market areas, especially the emergent and important DE market.

1.2 Wholesale Market Trading

Question 1: We welcome views on whether the Authority should exercise its power as provided for under the BSC to designate a third party representative with DE interests or expertise to raise BSC code modifications.

As with our response to the previous consultation, we believe that increased consideration of DE within the operation of the BSC would be beneficial. We believe this to be a second-order issue however, since the fundamental asymmetry of the regulatory environment will not be addressed by this means alone.

1.3 Selling to Third Parties

We dispute the conclusions offered in this section that the market for DE output is not exhibiting symptoms of failure. Whereas it may be true that existing market participants have evolved to a position of relative commercial equality, it is evident that both the growth in new DE capacity and the availability of commercial services at DE scale are well short of providing a major contribution to the delivery of the UK's renewable energy aspirations. This finding is based on our own extensive experience of offering assistance to clients who have aspirations to enter the DE market. We contend that the analysis undertaken by OfGEM does not support the conclusions within this latest set of proposals for two principal reasons:

Firstly, the research concentrates on the electricity prices currently being achieved by DE generators and is therefore subject to a high degree of survivorship bias. The very fact that a contract price has been agreed is indicative of that price being within a degree of tolerance, fair to both parties. Of greater strategic significance we believe, are the many potential DE schemes which are unable to obtain satisfactory export prices, a factor which is

critical to the viability of a DE business. Consequently, in our experience many such ventures fail to obtain funding, are aborted and therefore do not feature in the data that are sampled in the OfGEM review. We accept that many of those schemes may not otherwise have proceeded for reasons other than the weak export power price and that this may be in part due to a mismatch in expectations. However our experience across a large number of proposed schemes is that current constraints on electricity pricing constitute a barrier to entry into the DE market for many potential scheme developers.

Secondly and more fundamentally, we believe that because concentrating solely on the pricing of electricity fails to address the holistic nature of the business viability of DE. The terms of reference for the report by Littlechild & Cornwall show worrying inconsistencies between the concepts of Distributed Energy (which should logically include heat, as it does in the BERR Renewable Energy Strategy 2008) and Distributed Generation. Indeed, the two terms seem to be used interchangeably.

In the current regulatory environment, new demand for DE is to a great extent driven by the property development industry. Building Regulations and Planning are increasingly requiring new buildings to be equipped with onsite generation as part of the Government's carbon abatement strategy. In these instances, the primary economic driver for DE is the realisation of development rights and subsequently land value, with both heat and power being considered by-products. At present, the property development industry is at best ambivalent to those benefits, since developers are not equipped to engage with the long-term supply of energy services and are principally searching for energy partners to take on the task. In our experience, it is the difficulties faced by DE energy companies that represent the principal avoidable barrier to the delivery of efficient carbon abatement from DE in the UK.

Further, the transaction costs associated with small schemes are disproportionately large, particularly for new market entrants. The Littlechild & Cornwall report concentrates on the marginal economics of DE rather than the total cost of establishing and operating a multi-commodity DE business. We agree with their suggestion that information is made available to new market entrants in order to reduce transaction costs but would go farther and contend that it is incentives, rather than information, that is critical to the success of DE. We do not agree that the availability of standard contracts from major suppliers constitutes an effective removal of this barrier to entry, since such asymmetric contracting arrangements could prove inflexible and unsuitable for many potential DE operators.

In the absence of a regulatory framework for heat, these interdependencies limit the impact of the regulation of export power on the business viability of DE and as such we believe that these proposals leave the most significant commercial issues associated with the encouragement of DE unresolved. We urgently request BERR to consider the issues of heat and power regulation in conjunction.

1.4 Operating as an Exempt Supplier on the Licensed Distribution Network

Question 8: Should Ofgem issue guidance on eligibility criteria for switching off the code compliance licence condition? If so, what should the main criteria be?

As we stated in our response to the initial proposals, we believe that the criteria for allowing such flexibility should derive from an assessment of environmental benefits, such as carbon abatement. The detail of such an incentive lies beyond this consultation however.

Question 9: Should Ofgem establish an industry working group to develop a good practice guide on supplier services agreements?

This would appear to be a positive step, since an appropriately regulated suite of commercial tools should reduce the high transaction costs of setting up DE schemes. We believe however, that the effectiveness of supplier service agreements will depend on the commercial terms on which they are offered and the enforcement (or threat thereof) of minimum standards for the same. Hence we contend that a best practice guide will only be effective if it is backed up by a clearly stated resolve by OfGEM to intervene more forcefully if this approach proves ineffective.

This will require OfGEM to give careful and timely consideration to how it might manage such an intervention and to openly put plans for its execution into place. Without such leadership, we believe that the negotiation of supplier services agreements will become another source of unnecessary transaction costs that will deter entry for new DE participants.

Question 10: How should the risks of a breakdown in the DE-Agent relationship be mitigated?

We believe that the Supplier of Last Resort provision is a sensible suggestion. We believe that the DE consumers 'belong to' the DE Company and not the 3rd party Licensee.