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Further proposals on distributed energy

This is a response to the joint Berr/Ofgem further proposals on distributed energy (DE). I am responding as a stakeholder in the wider sense (participant in industry governance processes and service provider to various market participants, particularly at the smaller end of the market). I have also been a regular participant in the DEWG work-stream and have provided support to the group and Ofgem on both a commercial and a non-commercial basis during the process.

Generally I think the document is a very good one, and it has managed to work through some high-level concepts to produce a practical package of workable proposals. I enclose a copy of a “perspective piece” I have written on the document and progress to date under the DE work-stream as this sets out my fuller impressions.

There are two qualifications I would make to the upbeat tone of the perspective.

First I would personally have liked one area of work developed further, that relating to the virtual private network or VPN. This matter was looked at by a sub-group of the DEWG, which resolved the costs outweighed any benefits though this analysis has not been made more generally available. I think this conclusion premature as a VPN or “super MPAN” approach was not analysed in detail, and any change to the central trading systems invariably involves significant costs. Over the short term the benefits may also be modest because of our present expectations of the likely scale of DE development for which little evaluation work has been conducted.

Over the medium term, however, the netting off of decentralised energy consumption against generation through the supplier services provider or by the local operator in its own right using a variant of the trading unit concept in the balancing and settlement system is fundamental to the decentralised energy business model. Indeed given the ability for many other parties to use netting arrangements under the current arrangements denying this opportunity to smaller players could be argued to be discriminatory given the limited use they

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make of the public system. Elexon should be asked to consider this proposal further and provide clear substantiation of the alleged costs and benefits. The issue could in the first instance be referred to a BSC issues group.

Second the effective roll-out of the measures proposed by Berr/Ofgem presupposes two areas of parallel change. They are:

- the introduction and implementation of cost-reflective distribution network use of system charging that facilitates local trades.

Ofgem has recently indicated it intends to require distributors to have in place a common methodology from April 2010. This initiative is to be applauded in terms of reducing market complexity and simplifying the supply market as well as reducing costs and risk to DE projects, but construction of a suitable charging structure that appropriately reflects costs back to local developers is likely to prove controversial. Nevertheless it is crucial this work-stream is progressed urgently so that regulatory risk to developers flowing from this material variable can be minimised.

- substantive reform of electricity cash-out.

As the further proposals document notes this is a pre-condition to mitigate current unjustifiably high levels of imbalance risk. The additional costs associated with this are likely to flow through to supplier terms for off-take energy and to prices charged under supplier service agreements. However current indications are that change proposals in process (P211 and P217) fall a long way short of creating such conditions and may not (in the case of P217) even have a material effect on imbalance prices.

A longer-term strategy for cash-out that looks beyond immediate change proposals needs to be developed, and this should focus on:

- removing system pollution from energy imbalance charges (energy plus actions including standing reserve effects, as well as transmission constraints);
- addressing the arguments for bringing forward gate closure; and
- moving to a much simpler methodology based on a single price.

Both issues are acknowledged in the further proposals document, but the key point is that progress in other areas is contingent on progress on them and over reasonably short time-scales.

Answer to the specific questions raised in the further proposals consultation are set out in the attachment.

Please let me know if you would like clarification on this response or further comment.

Nigel Cornwall

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 to raise BSC code modifications.

Yes a third party representative should be designated.

Question 2: We welcome expressions of interest from stakeholders interested in having the power to raise code modification proposals on behalf of DE schemes. For those interested parties, please highlight specific reasons why this power should be conferred upon you.

n/a

Question 3: In terms of the length of designation, we believe that a period in line with the Panel's term (e.g. 2 years) may be a suitable period with which to trial this proposal. We would welcome stakeholders views on the period for which designation might last.

Two years should be adequate to test the arrangement, and it should commence as soon as practically possible.

Question 4: We would welcome views on whether the designated party should be obliged to contribute fees to Elexon in order to participate in the BSC change process. If so, how should the level of contribution be determined?

There should be no fee or fees. If anything consideration should be given to helping the designated body with the additional costs it will incur in carrying out this public good role in support of government policy.

Question 5: Should any other codes be examined in relation to lack of DE representation?

A similar facility should be considered with regard to DCUSA and the D-code.

Question 6: We invite stakeholders to identify any good quality information currently available that would be suitable for including in the development of a user friendly information hub on the process of setting up and operating a DE scheme.

I would highlight Box 11.1 from the report prepared by me and Stephen Littlechild reproduced in the annex to this response, which provides a framework for the type of information that should be included. There is a number of existing reports that might help in this task once the framework is identified.

Question 7: Do you agree with the proposed licence amendment to SLC 11.2 (see Appendix 2)? Suppliers – please indicate whether you would accept the proposed license amendment.

Yes. However it is expected that most suppliers will not want to offer reasonable terms to de facto competitors. Therefore it is imperative for Ofgem as an absolute minimum should monitor and where necessary obligate larger supply licence holders, perhaps those with over 50,000 customers, to provide an SSA and intervene to ensure “reasonable terms” are offered to DE suppliers seeking supplier services.

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?

Yes; it is important the criteria are transparent and unambiguous. A size threshold based on MW maximum demand and MWh supplied should be applied. In the case of MWh supplied this should be considerably more

than the current exemption limits for licensed supply. There is an argument that supply to non-domestic customers could be set at a higher threshold than for domestic consumers. A rough calculation suggests that the 50,000 customers corresponds broadly to a 50MW maximum demand and perhaps 200GWh supply.

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

Yes. The industry working group should also develop a standard industry contract.

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

Agreements and disagreements under them should be referable to Ofgem. As noted above, the industry working group should also develop a standard industry contract.

Box 11.1—Information exchange

Potential key functions:

Core information services

- provide Distributed Energy (DE) schemes with contact details for:
 - providers of legal, regulatory, contractual and market advice;
 - providers of “exempt supplier services”;
 - providers of consolidation, broker and agent services;
 - details of auctions where DE electricity can be bought and sold;
 - purchasers of DE electricity
 - distribution network operators
 - providers of DE finance
- provide DE schemes with details of any published prices for:
 - “exempt supplier services”, “high cost, high competency elements of the supply licence”, consolidation services;
- provide DE schemes with details of available benefits, and how to claim them: such as capital grants, tax benefits, Rocs, Lecs, Regos and embedded benefits.

Potential added value services:

- administrative assistance could also be provided;
- helping DE to identify how they can maximise embedded benefits;
- dissemination of standard contract terms and associated guidance;
- share best practice by providing DE case studies.

“Centre of excellence”

- investigate projects that could improve forecasting capability for DE technology, this could possibly be part funded by the agency in partnership with the private sector;
- contribute to the development of technical solutions that will benefit DE, such as virtual private networks;
- liaise with similar organisations in other countries to ensure that best practice is shared globally; and
- act as a DE trade association/ lobby group. Represent the DE community at key events/ on working groups.

Another trip down your way, as decentralised energy package takes shape

Berr and Ofgem's consultation *Distributed energy—further proposals for more flexible market and licensing arrangements* closes on 31 July. In this *Energy perspective* we review the position as we move forward into the end game of this work stream that could have an important impact on local energy markets.

The initiative is a component of the follow-up work signalled in the May 2007 Energy White Paper. The current proposals issued in June follow from a consultation in December last year (*Energy Spectrum 114, p5*), which set out a range of options for reform, some very radical, which in turn emerged out of the Distributed Energy Working Group (DEWG) established last year by Ofgem.

Sizing the problem

Berr/Ofgem said in the June consultation that their preferred proposals “focus on ensuring that the trading arrangements and regulatory regime are proportionate to the size and risk posed by distributed energy schemes in different settings.” While DE is at the heart of the decentralised energy agenda, the problems that have been identified centre on ensuring a better fit with the centralised trading arrangements rather than reinventing those arrangements.

Berr/Ofgem confirmed they are no longer considering the creation of a dedicated trading mechanism or specific agency tasked with providing a route to market for local generators. Berr/Ofgem concluded from this work that the market for small generator output is maturing, and we comment on this further below. They also took account of the views of December consultation respondents. Some argued that a specialist energy trader would stifle innovation, and it should be left to the market to develop this role if it were needed. Concerns about the dedicated DE wholesale market included that there might be insufficient volumes for it to be useful. Further, they considered they might have a detrimental impact on parties who were already offering innovative consolidating and trading services.

They also ruled against changing exemption limits, arguing that their latest proposals made raising thresholds unnecessary. But they did concede that the Class Exemptions Order needed updating and clarifying. They will also consider the implications of the recent ‘Citiworks’ case ruling by the European Court of Justice concerning third party access to distribution networks.

Flexing licences

A key area of the proposals was to the regulatory framework for DE schemes operating as a supplier on a licensed distribution network. Berr/Ofgem have proposed to reduce the cost of becoming licensed by “switching off” the condition in the supply licence to comply with “high-cost and high-competence” industry codes. They found that licensing costs added up to £4.50/MWh to overheads for a small DE scheme of around 5MW. Almost a half of this cost is related to complying with industry code requirements, principally the Master Registration Agreement and the BSC, most of which is not scale-able and incurred regardless of the intended market share of the supplier.

Berr/Ofgem acknowledged that new entrants should be able to develop expertise, procure it or rely on a third party to manage these functions on their behalf. But they also noted there were no standard contracts in the market, and thus the process of negotiating such arrangements could involve significant legal costs and asymmetric contracting.

To achieve this “switching off”, Berr/Ofgem propose to amend the SLC11.2 licence condition so a supplier could seek a direction from the Authority permitting it to have arrangements in place with another licensed supplier that is itself a party to the codes, to discharge the necessary functions on its behalf. They also suggested Ofgem should issue separate guidance on the requirements that the licensee would have to meet including, for example, the process that the regulator would follow and the criteria it would use to assess licensees' requests.

Sharing the burden

The second strand of the proposals was to encourage and facilitate the provision of supplier service agreements. Berr/Ofgem said they expected that formalising a switch off within regulatory instruments would provide a strong signal

for the development of third-party supplier services, possibly with specialist energy companies entering the market, or new branches of existing companies, to provide services to DE developers.

But they remained open to the possibility that other incentives, or possibly even regulation, might be needed to ensure these services come forward. They proposed that the Condition 53 services in the previous supply licence should be a starting point for the types of arrangements, which included top-up and stand-by, meter registration, data collection and processing and settlement of charges including use of system, that DE suppliers would require. Berr/Ofgem have therefore proposed facilitating a good practice guide for these types of agreement, although the proposals' document makes clear there is no intention that Ofgem would either regulate prices or approve the arrangements.

Leaning on distributors

Berr/Ofgem also highlighted as a key proposal the need to accelerate the introduction of cost reflective network use of system charging to ensure economic development on public networks as an alternative to constructing private wires. This move reflected concerns that the current charging regime does not properly reflect the benefits that DE can bring to the local system.

Frustrated at slow progress in this area, the regulator last week separately announced its intention to impose a licence obligation on all 14 electricity distribution companies to deliver a common charging methodology, to be reflected in prices from April 2010 (see *this issue p13*). Ofgem's patience has finally worn out on a process first initiated at the turn of the decade.

But to implement a common methodology in time for the start of the next price control in 2010 will be a tough ask, especially as the DNOs themselves are anything other than wholly enthusiastic. There is a big prize at stake because it is a long-established policy and regulatory priority to ensure that the DNOs facilitate the connection of low carbon technologies to their systems.

Burgeoning markets...

Since the December consultation, Berr/Ofgem have also developed thinking on the market for DE generators for selling power to third parties, such as another generator, supplier or consolidator. At that stage they proposed some initial options for addressing the concerns of some stakeholders about insufficient competition for the output of small-scale generators. As we have noted, these included the introduction of a specialist energy trader into the market to make purchases and sales of zero and low carbon output from small distributed generators, or the establishment of a dedicated wholesale market for DE.

In response to comments about the need for further analysis in response to the December initial proposals, Ofgem commissioned a study, conducted by Professor Stephen Littlechild and Nigel Cornwall, into the experience of small generators in selling output to third parties. The study gathered the views of small generators of various sizes and technologies through questionnaires and follow-up conversations, and also took views from offtake agreement counterparties.

It found that overall the market for small generator output seemed to be competitive and diverse, with all the major suppliers active, usually nationally. Smaller suppliers were also becoming increasingly involved and competing aggressively. Better understanding of the revised trading arrangements introduced with Neta and Beta and the operational environment, and growing familiarity with technologies like wind and biomass, had led to an improvement in prices, more flexibility on contract duration and structure and better sharing of benefits in favour of the DE schemes. Demand had also been stimulated by the surging business market for green power.¹

...which could flourish further

But respondents to the study raised a number of concerns. These included: difficulty in getting a route to market for some new entrants combined with a lack of information on the options available; disappointment over the prices offered, with acknowledgement that this may be a result of lack of information and unrealistic expectations rather than market failure; a lack of interest from some larger suppliers or an inflexible approach; and credit issues and physical issues with the distributor for new sites.

¹ I would add now that there is a risk that this evaluation could come to signify a high water mark as Defra's new guidance on carbon emissions reporting by business may well change the baseline for businesses so they simply do not value electricity from climate change levy exempt sources to the same degree any more.

Consequently Berr/Ofgem concluded that proposals suggested in the study could improve accessibility to the offtake market and further improve the state of competition and ease of access into the market. These included:

- better information should be offered on entry options and requirements and available support for DE schemes, possibly through an open access web information exchange, which would bring together information, including on market access and related market information. Berr has, as part of the renewable energy strategy consultation issued last month, also proposed that the government establishes an online distributed energy information hub under the 'Act on CO2' brand, which ties in nicely with the thrust of our recommendations;
- introduction of more standard terms and contracts for smaller power parcels, to help smaller distributed generators as a starting point for negotiation, with standard terms supported by guidance explaining industry structures and terminology; and
- encouragement of more within-year trading of power and Rocs. Some participants found the current options were inflexible and that the issue was likely to become more significant as increasing volumes come to market when NFFO projects and contracts reach maturity.



Additionally Berr/Ofgem recommended that tariffs could be set for smaller parcels of output.

Opening up governance

In respect of wholesale market trading Berr/Ofgem's December proposals focused on representation within the BSC as a means of influencing the development of the code, including cash-out. They have now noted that future developments in cash-out could have a material impact on DE generators. This was from the perspective of those directly trading in wholesale markets but also those that are affected indirectly through the terms offered to DE schemes by intermediaries in bilateral offtake agreements. This is an argument with which we have much sympathy.

But Berr/Ofgem have concluded that appointing a DE representative to the BSC Panel would be undesirable—the word used is disproportionate—for a number of reasons. These included a lack of stakeholder support, the limited ability of panel members to raise modifications and the current low status of DE in the energy mix, with the corresponding small number of DE relevant modifications. They also cited lack of funding as a stumbling block. Instead they have proposed to designate a third party to have the power to raise modifications, which could include anyone who has DE interests or expertise. This change would create a channel through which DE players could address issues in the wholesale regime and enable DE to “find its feet” in the BSC process, given the likely increase of DE in the UK energy mix.

Striking a balance

Overall we think Berr and Ofgem are treading a sensible path with these further proposals. They have carried out on-the-ground analysis and discovered—perhaps surprisingly given the dominant position of a few players in controlling routes to market—that the offtake market is reasonably healthy and smaller suppliers are now aggressively participating in it. Because of Ofgem's grasp of detail, it has been able to jettison some of its more radical thoughts, which were probably included in the December documents against its better judgment.

The package on offer is a pragmatic one that focuses on practical measures that should nevertheless make a difference, opening up options to smaller developers and tackling recognised distortions that flow from the heavily centralised and (from the local operator's point of view) costly central trading arrangements.

But we continue to believe there are two pre-conditions on which real progress will be contingent:

- alignment and rationalisation of distribution charging; and
- cash-out reform.

The regulator has just indicated it intends to take a robust (if long overdue) position on distribution charging. Let's hope it is similarly minded to follow-through energetically on cash-out reform. In this context the challenge will be to identify a meaningful development path that goes somewhat beyond the very modest proposals it currently has before it.