Critique of Appendix 14 – Initial impact assessment on proposed treatment of DG connected pre-2005

Introduction

As Ofgem is aware, SSE remains extremely concerned about the proposal to bring long-standing, existing DG within the charging base for distribution use of system charges from 2012. We have consistently argued that such generation connected under an entirely different commercial and regulatory regime and that the imposition of generation use of system charges (GDUoS) could undermine the profitability and jeopardise the commercial viability of a significant number of existing renewable generation.

We note that at this stage only an outline impact assessment has been possible. Given the very high level nature of such an impact assessment, we are very surprised that Ofgem has already decided on Option 2: mandate revised charging arrangements. In our view, until the full costs / benefits of either option are understood, then Ofgem should keep an open mind as to the best way forward.

Key Issues and Objectives

The outline impact assessment notes that a substantial amount of DG (almost 13GW) is currently not exposed to economic signals for ongoing use of system. This is true. However, it is an extremely misleading statement. All such DG connected under a commercial regime when 'deep' connection charges were applied. Under such a policy, when no GDUoS was applied, such generators must be considered to have paid for the ongoing right to connect and use the system. In our view there can be no other interpretation.

We are therefore very surprised with the view expressed in Ofgem's letter of 17th October 2008 that a suitable cut-off point for access rights might be a typical financing period, i.e. 20 years. In our view, such generators would expect these access rights for the life of the asset not its financing period (which in any case is arbitrary and different for the different types and sizes of generation).

Given that pre-2005 generators have paid for ongoing access and use of the system, it is neither appropriate nor desirable to expose such generation to ongoing use of system signals. This is the conclusion we came to in our July 2006 paper to Ofgem.

The second 'key issue' considered is that revised charging arrangements for all DG shall recognise the different treatment of reinforcement costs before and after 1st April 2005, due to the shift in the connection boundary from deep to shallowish. In our view, this means that compensation payments will have to be assessed, on a case by case basis, for well over 3000 effected generators. We do not agree with the view expressed in Ofgem's letter of 17th October 2008 that much of the information required for the compensation exercise can be expected to be available as a matter of good commercial practice. Indeed, we have previously explained (in our July 2006 paper) that identifying this information will take significant man-hours.

Furthermore, we are surprised that Ofgem consider (in their 17th October 2008 letter) that whilst a number of DG sites may in principle be eligible for compensation, this was expected to be relatively uncontroversial. Whilst the age profile of existing DG may be skewed to 'less than 20 years old', it does not follow that complete or accurate information is available for all such connections. Indeed, over the last 20 years (since privatisation) the electricity industry has seen significant reorganisation which will inevitably mean that access to historic documents will be difficult, if not impossible.

Therefore, we expect most cases to involve extremely cumbersome administrative work. We remain of the view that the vast majority of generators who connected under a deep connection regime will expect compensation if GDUoS is mandated on all generators from 2012.

Options

We agree that there are two options: do nothing or mandate revised charging methodologies. However, we do not believe that the benefits of the 'do nothing' option have been explored in the outline impact assessment. This option is simple and transparent, raises no issue of regulatory risk and recognises that existing DG made investment decisions in a commercial framework that did not include GDUoS. Our understanding from the recent DPCR5 stakeholder workshops is that many (if not most) stakeholders believe this is a pragmatic and practical solution.

Simply because pre-2005 DG paid deep up-front connection charges, we do not believe it follows that they fail to take the costs or benefits they impose on the network into account in their operating decisions. The deep connection charge they paid is part of their overall costs and will impact on their on-going operating decisions. Even though a proportion of DG does not pay GDUoS it does not follow that post-2005 DG could receive distorted signals.

Furthermore, we are surprised that Ofgem suggest that the value of network capacity is not reflected to pre-2005 connected DG. Such DG paid for the network capacity via their up-front deep connection charges. We do not therefore believe that new DG is likely to be exposed to an inefficient level of network reinforcement costs.

We are surprised by the implication that efficient, renewable DG (such as the north of Scotland hydro generators) who have paid up-front deep connection charges should close in favour of new plant.

Impact on Consumers

In our view, option 1 will be good for consumers as it avoids any increased perception of regulatory risk in the generator sector feeding through to increased prices seen by end-customers.

As Ofgem is aware, we believe that the most efficient use of system would best be promoted by charging demand side fully for the energy they require from the network. As argued previously, this will further help to achieve the government's very challenging 2020 carbon targets.

We are therefore surprised that the outline impact assessment suggests that the principle of efficient use of system promoted by exposure to cost reflective use of system charges which reduces overall costs to customers only applies to option 2. If GDUoS is charged, under option 1, to all new DG it will provide the same signals and benefits as option 2.

Impact on Competition

It is important to understand that pre-2005 generation connected under an entirely different commercial and regulatory regime than those connected post-2005. To argue that competition in generation is best promoted when all generators face a common charging framework is perhaps commendable, but clearly not practical in such circumstances. Indeed, the one way that would allow a common charging framework to apply would be to set GDUoS to zero (G=0) as we have long argued.

We are surprised that Ofgem has not provided an estimate of the costs and timescales that will be required for DNOs to 'develop appropriate compensation arrangements …'. As laid out in our July 2006 paper, we believe this to be a significant cost and would expect the final, full impact assessment to include this important area or work.

Ofgem appears to be conflating connection and use of system charging arrangements when arguing that the continuation of differentiated charging arrangements under option 1 would not be as effective as a common UoS framework under option 2. As noted, option 1 could still include a common UoS framework, and option 2 will still require connection charges.

Impact on Sustainable Development

Pre-2005 DG has already been exposed to the correct economic signal for siting, connecting and using the network via their up-front deep connection charge.

Furthermore, we are not convinced that it is only option 2 that could result in reduced losses 'because of better economic signals'. Incentives to develop commercial arrangements to reduce losses at certain times can be developed within a flexible innovation incentive arrangement.

Risks and Unintended Consequences

Ofgem has previously acknowledged that legal issues associated with property rights exist, but we are disappointed that the impact assessment simply notes that 'under option 2, DNOs shall develop appropriate compensation arrangements …' without assessing the costs, timescales and very likely legal challenges from such pre-existing generation.

Other Impacts, Costs and Benefits

As noted above, the costs and timescales of developing compensation arrangements must be factored in to the final, full impact assessment. Whilst it is clear that this will vary across DNOs, given the different volume of DG connected in each distribution services area (DSA), we have provided a detailed estimate of the likely man-hours required for our DSAs in our July 2006 paper.