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Dear Rachel

Consultation on Western Power Distribution's (WPD) modification proposal to introduce changes to its charging methodology at extra high voltage (EHV) level from 1 April 2010

1. Thank you for giving us the opportunity to comment on this important consultation.
2. We have a number of serious concerns relating to WPD's proposals to introduce charges to pre-2005 generation connected to its EHV network. Most significantly, we do not believe that the proposals are consistent with the contractual rights that we hold to export power onto WPD's network, and are therefore unlawful under contract law. Further, we do not believe the proposals will better achieve the relevant objectives as set out in paragraph 3 of Standard Licence Condition 13 of WPD's distribution licence. Consequently we believe that they should be vetoed by Ofgem.
3. Aside from the legality of the proposals, we have fundamental concerns with the way in which charges have been calculated by WPD. Indeed, we do not believe that the methodology that has been used by WPD meets the criteria laid down by Ofgem itself. We understand from previous publications by Ofgem¹ that these include that charges should be cost reflective (so far as is practicable), predictable, transparent and simple. We have commissioned a paper from Frontier Economics (appended to this response) that spells out our concerns in this regard in more detail.
4. We also believe that, when taking into account the proposals of other DNOs, the proposals will have a material negative impact on competition in the generation market from 1 April 2010.

¹ See for example "Structure of electricity distribution charges. Consultation on the longer term charging framework", published by Ofgem in May 2005 that lays down the principles that charging methodologies should incorporate.

5. The issues associated with large users connected to the EHV distribution network such as Barry have not yet been properly considered in the context of the charging methodology debate. Other large embedded generation units are likely to face similar issues when other DNOs produce new methodologies, so the issue requires wider consideration. We believe this can best be achieved through the industry consultation the ENA is currently running for the common methodology that will be applied at EHV level from 1 April 2011.
6. In the remainder of this letter we set out our views in more detail, specifically:
 - the inconsistency of WPD's proposal with the contractual rights set out in our connection and use of system agreement with WPD for Barry power station;
 - our concerns over the methodology used by WPD to derive a use of system (UoS) tariff for Barry;
 - the distortion of competition in the generation market that would result were the proposal approved; and
 - a number of material process concerns we have regarding the way these proposals have been raised and assessed to date.

Consistency with contractual rights

7. In 1997, Barry power station paid a large upfront fee to SWALEC (WPD's predecessor) to:
 - connect to the network;
 - facilitate the operation and maintenance (O&M) of the reinforced assets; and
 - have the right to export power onto the distribution network up to a specific maximum export capacity².
8. No provision for further charges were specified in the contract, and the clear expectation at the time of contract agreement was that the one-off fee in 1997 was in lieu of any further use of system payments. This view was reiterated as recently as September 2009 when WPD stated in its response to Ofgem's DPCR5 Initial Proposals document that:

"...the expectation at the time most pre-2005 generators connected was that they would never pay GDUoS charges..."

² This included an explicit O&M payment covering the first 20 years of operation from 1997.

9. The payment in 1997 therefore represented a “deep connection charge”, specifically designed to cover the costs of Barry power station exporting power onto WPD’s network for the duration of the contract.
10. Despite this, WPD has raised a modification proposal which, if approved, would require Barry power station to pay ongoing use of system charges from 1 April 2010 (without any reciprocal compensation). This directly contradicts the terms of the contractual agreement that we hold with WPD. Moreover, there is no provision in the agreement which contractually allows or entitles WPD to charge us any more than what we paid in 1997. Clearly we will not consent to a new payment obligation given what is said above. We therefore believe that the proposal for us to pay an additional charge beyond that already paid would be inconsistent with our contractual rights, and is unlawful under contract law.
11. WPD has proposed to include a number of modifications to its methodology, partly to reflect the agreement made in 1997. The most significant of these is a proposal to remove a number of assets from the charging model that were specified as being constructed at time of connection.
12. We do not believe that these changes adequately reflect the agreement we signed with WPD in 1997, or the contractual rights we hold to export power onto WPD’s network as a result.
13. In your final proposals document for DPCR5, you signalled that in the event DNOs were able to renegotiate connection agreements, then any compensation paid by DNOs would be permitted to be “logged up” through an adjustment to their RAV³.
14. In principle, we would be happy to agree to the introduction of ongoing charges (and therefore exposure to ongoing “cost reflective” prices) – but only so long as we were fully compensated for such a change. This could be achieved, for example, through an upfront payment of the present value of expected future charges or an annual payment to offset that year’s final GDUoS charge. However, WPD’s proposal contains no such provision for compensation – and therefore is not acceptable given our existing contractual rights.

Concerns regarding WPD’s methodology

³ Page 25 of the Incentives and Obligations document, which states, “Where DNOs are successful in negotiating such changes to the contractual arrangements, and can demonstrate that it was appropriate to provide the DG with a refund on the connection charge, we propose to allow them to log up the compensation.”

15. In addition to the issue of whether WPD has a legal right to apply charges to Barry, we also have concerns about the way in which the proposed charges have been calculated. Most significantly, the methodology selected for use by WPD appears fundamentally inappropriate for the calculation of cost reflective charges for large power stations connected to networks that have been sized predominantly for their own use.
16. We have commissioned a paper from Frontier Economics that sets out in detail the reasons why WPD's proposal is flawed in its application to Barry. This paper is appended to this response for reference.
17. WPD has selected the Long Run Incremental Cost (LRIC) model as the basis for the charges proposed for Barry. This methodology calculates charges by analysing the impact on the network of small increments of demand and generation, by node. In those parts of the network where there is little spare capacity, increments of generation tend to trigger significant charges.
18. Barry triggered (and indeed paid for) significant reinforcement at the time of connection. The immediate part of the WPD network to which Barry is connected has therefore been sized to allow Barry to export an amount of power equal to the maximum set out in the connection and use of system agreement. Understandably, there is therefore little spare capacity in that part of the network at present (or at any time since connection). This results in a unit charge (set on a £/kVA basis) for a small (0.1MW) increment in the generation capacity at the Sully node that is very high.
19. If we could opt to operate in 0.1MW capacity "steps" this would indeed be a cost reflective signal to send Barry power station. However, in practice, the economics of the plant are such that we face the binary decision of keeping the plant open at its registered capacity or complete closure. As a result of this, and as the Frontier report demonstrates, extending the cost signal derived from incrementing a 0.1MW of generation across the entire 230 MW capacity of the plant results in a signal that hugely overstates the costs that Barry imposes on the network.
20. A second concern identified in the Frontier report relates to the assumptions used by WPD in the methodology itself. Embedded within the heart of the methodology is a critical assumption that network usage will grow at 1% per annum in perpetuity. This applies to both growth in demand and growth in generation. This "exogenous" 1% growth assumption is required as the methodology breaks down if growth is very low (as derived tariffs tend to infinity as the growth rate tends to zero).

21. There might be some sense in assuming a 1% growth rate on the demand side – for example this could reflect the underlying growth in the demand on the HV and LV networks (although even here we would question this given that we now understand that there is expected to be a reduction in demand) However, the lumpy nature of generation growth (particularly on the EHV network) means that the use of a smooth 1% growth rate is wholly inappropriate – and significantly reduces the cost reflectivity of the tariffs that are derived.
22. To be truly cost reflective, use of system charges should distinguish between areas of the network where high growth is expected (and therefore spare capacity is likely to be limited) and areas where low growth is expected (and therefore tariffs should indicate that there is likely to be more spare capacity in this area of the network). However WPD's methodology does not allow the use of the most accurate "forward looking" assumptions (such as those set out in the long term development statement) and as a consequence, distorts the locational signals that the methodology purports to derive.
23. As well as lacking cost reflectivity, WPD's methodology produces tariffs that are hugely volatile in the case of Barry and materially influenced by subjective engineering assessments. We understand that the 2009/10 charge for Barry as calculated by the methodology would have been £4.2m whereas the tariff calculated on a like-for-like basis for 2010/11 would have been £2.2m – nearly 50% lower. Given such a large change one would expect to have seen a very significant change in the demand-supply fundamentals in the Barry area – for example a large source of demand might have connected in the region. However, WPD explained this £2m swing in charges resulted from a small change in the demand assumptions in one part of the network and by a change in the engineering assessment of line rating of one of the lines serving Barry. This is further evidence that the methodology lacks both transparency and predictability; key principles for charging methodologies that Ofgem has itself laid down.
24. Partly in recognition of the deficiencies of the methodology when applied to large generators, WPD has proposed the application of a number of "fixes" – notably capping charges at branch level and removing sole use assets. While welcome in the sense that these attempt to undo the worst excesses of the methodology itself, it merely demonstrates the fact that the charges derived are not cost reflective when applied to a large plant and that there is no reason to believe that this proposed fix is any more or less cost reflective than the current charge paid by Barry.

25. As WPD's methodology produces tariffs that are neither cost reflective, predictable, or transparent when levied on large generators, we believe it would be wholly inappropriate for Ofgem to approve WPD's proposal. Instead, the issue should be considered and properly consulted-on through the ENA's ongoing work to specify a common charging methodology for EHV-connected generation from 2011.

Distortion of competition in generation

26. In addition to the major concerns we have over the legality and cost reflective nature of WPD's charging proposal, it is clear that, if implemented, the charges would lead to a material distortion in the generation market.

27. In particular, since Barry has paid for connection on a long term basis decisions about the siting, scale and investment in the Barry Plant have been taken on that basis. To impose new costs on Barry now would inevitably affect its position in the generation market.

28. At present there is general confusion across the DNOs regarding the way in which they intend to treat pre-2005 connected generation from 1 April 2010. However, it seems likely that widely varying approaches will be adopted by different DNOs. These range from the very high charges proposed by WPD, to zero charges (that we understand will be applied across EdF's regions).

29. These wildly different levels of cost place Barry at a significant competitive disadvantage to comparable generators across the networks. This will distort competition in the generation market and would be inconsistent with the relevant objectives as set out in WPD's distribution licence.

Process issues

30. Finally, we do not believe that the application of charges to pre-2005 generators from 1 April 2010 has been properly assessed. In the case of Barry, we have seen no evidence of any benefits that applying the charge would bring to customers (aside from a passing reference to a reduction in administrative costs in Ofgem's consultation document). However, we believe that the proposal will attract significant costs in terms of:

- increased regulatory risk, resulting from the challenge to bilaterally agreed property rights;

- reduced cost reflectivity of network charges, given the application of a volatile and inappropriate charging methodology to WPD's network; and
 - a negative impact on competition in the generation market, given the inconsistent way that Ofgem's decision to apply charges to pre-2005 generators connected to the EHV network is being applied across GB.
31. We believe that a proposal such as this warrants an impact assessment – particularly given that the materiality of charges that have been produced only became apparent recently (with the publication of WPD's proposal in early January). We recognise that WPD has historically published the tariff that would apply to Barry were charges to be applied. However the WPD statement of charges for 2009 stated the charge at the node which Barry offtakes would be zero (although we now understand that this was a misprint)⁴. This meant we had no way of knowing what the materiality of any potential charge would be prior to January 2010.
32. For the avoidance of doubt, we do not believe that the benefits of WPD's proposals outweigh the significant costs that will result. We therefore suggest that WPD's proposals should not be approved until a full impact assessment has been undertaken.
33. We also note more generally that there has been significant uncertainty and movement in the timetable for implementing these charges. We originally understood that the charges were to be implemented from 1 April 2011 to facilitate development of the charges and full industry consultation. However this has now been fast tracked to 1 April 2010 without the industry being able fully to assess and engage in the development of these new charges.

Conclusion

34. In summary, we believe Ofgem should reject WPD's proposal on the grounds that the proposal:
- does not respect the contractual rights held by Barry, and therefore cannot be implemented legally under contract law;
 - is not cost reflective, and leads to highly volatile charges;
 - will lead to a material distortion of competition in the generation market; and

⁴ Indeed, there is a similar misprint in the indicative statement of charges for 2010 that also states that the charge at the Sully 132kv node would be zero. Recent communication with WPD has also revealed that this is an error.

- should be subject to an impact assessment, given the large new charges it proposes to apply to Barry.

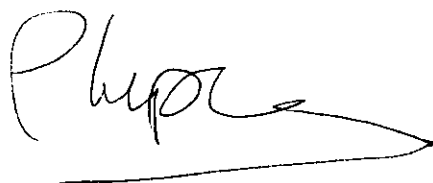
35. We therefore believe that Ofgem should:

- veto WPD's proposal;
- undertake an impact assessment on the introduction of charges to pre-2005 EHV-connected distributed generation; and
- ensure that the outcome of this is factored into the ENA's ongoing consultation into arrangements that will apply from April 2011.

36. In the event that Ofgem ultimately concludes that it is appropriate to levy ongoing charges on pre-2005 connected plant (in order to expose these generators to marginal price signals), then we ask for agreement from Ofgem that affected parties should be appropriately compensated for such a change (commensurate with their contractual rights). We believe that to be consistent with our contractual rights the level of compensation would need to reflect the full current value of these rights. This may also require Ofgem providing WPD (and other networks as appropriate) with assurance that the compensation they provide under subsequent revised proposals will be capable of being entered into their RAVs.

37. I hope that this response helps in clearly setting out the extent of our concerns over WPD's proposal. I also hope that our favoured next steps are clear. Please do contact me if you would like to discuss any of the issues raised in this response in more detail.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Philip', with a long, sweeping horizontal stroke extending to the right.

Philip Davies
Director, Regulatory Affairs