CHARGES FOR PRE-2005 DISTRIBUTED GENERATORS' USE OF DNOs' DISTRIBUTION SYSTEMS

THE RESPONSE FROM CE ELECTRIC UK FUNDING COMPANY, NORTHERN ELECTRIC DISTRIBUTION LIMITED AND YORKSHIRE ELECTRICITY DISTRIBUTION PLC

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PART ONE – ISSUES RAISED WITH RESPECT TO BUNDLING OF COMPENSATION

Compensation and use of system charges: bundled or unbundled

1. In its consultation entitled 'Charges for pre-2005 Distributed Generators' use of DNOs' distribution systems' (the *Consultation*) Ofgem sets out why it sees 'a strong merit' in adopting an unbundled approach to the question of compensation in respect of generation that was connected before 1 April 2005 (pre-2005 DG).

2. We agree with Ofgem that we cannot offer any strong arguments in favour of the bundled approach whereby any compensation due in respect of pre-2005 DG would be expressed in the form of a discount from use of system charges. In addition to all the good reasons advanced by Ofgem at paragraphs 3.4 and 3.5 of the *Consultation*, we would add that a lump-sum compensation payment probably better meets the obligation in standard licence condition 4 (SLC4) of the electricity distribution licence (the licence) that requires that in setting use of system charges;

> 'the licensee must not restrict, distort, or prevent competition in the generation, transmission, distribution, or supply of electricity ….'

   There are parallel obligations under SLC13A, SLC22A, SLC50 and SLC50A.

3. A lump sum payment, accompanied by use of system charges that are determined and applied on the same basis for all generators, irrespective of the vintage of connection, appears to us to be less distorting of competition in generation and to be consistent with Ofgem's clear policy aim of preserving the desired price signals to distributed generation. As a matter of practicality we would also prefer to set charges in future in a way that was not complicated by the calculation and application of customer-specific discounts that reflected the circumstances and history of the connection and the changes in Ofgem policy over time.

4. We, therefore, agree with Ofgem's 'minded to' position that the unbundled approach should be adopted. If the amounts are material for a licensee, it may be necessary for an adjustment to be made to the DPCR5 price control formula so that the licensee does not have to wait until the DPCR6 period to recover the amounts paid in compensation.

PART TWO – PRINCIPLES FOR ASSESSING COMPENSATION

Existing pre-2005 DG contracts

5. The *Consultation* invites views on the description of the contractual position as between distribution network operators (DNOs) and pre-2005 DG. The summary set out in the *Consultation* appears to us to be correct. We have only one Central Volume Allocation (CVA) connection. Our view of that contract is that we would have to agree, or secure by determination, a variation of that contract before we were able to introduce charges for use of system. With respect to the Supplier Volume Allocation (SVA) contracts, we do not believe that changes need to be made to the existing *connection* agreements to allow charges for use of system to be applied to the supplier in respect of the output of the generation plant. However, if any changes are necessary these could be agreed by the parties, or failing that, any necessary variations could be made following a determination by Ofgem.

6. We have seen no evidence to support the view that any commitments, whether express or implied, were given to the effect that any pre-2005 DG should enjoy free use of system in perpetuity.

7. In our view the issue of charging for generators is best understood in terms of Ofgem *policy* rather than in terms of legal obligations. From privatisation to 2005 it was Ofgem policy, confirmed in determinations made pursuant to the licence by the statutory predecessor to the Gas and Electricity Markets Authority (the Authority), that generation should not attract use of system charges. From 2005 it was Ofgem policy that new generation plant should attract a use of system charge but that pre-2005 DG should not, at least for a period of time. It is now Ofgem policy that all generation should attract a use of system charge, irrespective of vintage. During these distinct policy phases, the contracts entered into, the connection charges paid by the connectee, and the use of system charges levied in respect of the output of the generation plant, no doubt reflected the policy that prevailed at the time that the contract was entered into or that the charge was being set. That does not amount to a commitment in perpetuity to any from of charging (or relief from charging). In the absence of any specific contractual commitment, the issue of compensation is similarly best regarded as a matter of regulatory policy, rather than one of legal obligation on the part of the DNO.

However, it would be open to Ofgem to adopt the policy that compensation should be paid only where there was a clear legal obligation that needed to be bought out.

Principles for assessing the efficiency of any compensation paid

> **Question 1**: We welcome views on the criteria that should be applied to determine when it is appropriate to pay compensation.

8. We have set out above why we regard the issue of compensation to be, in the general case, a matter of regulatory policy rather than one of a legal obligation on the part of the DNO.

9. If there are any situations where compensation would be due because contractual rights exist which must be bought out, the criteria for assessing the 'efficiency' of the buy out would be that the compensation reflected the most efficient buy out by the DNO of its contractual obligations. In all other cases, since the compensation would be a reflection of regulatory policy, the criteria for assessing the 'efficiency' of the compensation should be that the compensation paid properly reflects Ofgem's policy with respect to compensation for pre-2005 DG. The criteria, therefore, must reflect Ofgem's new policy intent and should be chosen by Ofgem to strike a balance between fairness as between the different vintages of generation and fairness as between demand and generation connectees. Ofgem's policy might well be that no compensation should be paid in the absence of a clear legal obligation.

> **Question 2:** When it is appropriate, what method(s) should be used to calculate the level of compensation?

10. In the absence of a clear legal obligations, we question whether Ofgem would find compelling the case for any compensation to be quantified by reference to the net present value (NPV) of the future use of system charges.

11. By contrast, if it were Ofgem's new policy that some element of compensation should be paid, we can see the merit in a calculation that recognises that there may be cases where the connectee has paid for the reinforcement of the network (i.e. deep connection charges that included an element for reinforcement) and the reasonable life of that

investment in reinforcement has not expired. The lump-sum compensation might reflect a proportion of the unexpired part of the deep connection charge. This approach was signalled by Ofgem in its DPCR5 *Final proposals*. We can see the merit of such an approach, although in the case of NEDL and YEDL we do not believe that there would be many, if any, pre-2005 DG connectees that would qualify for compensation against this test.

12. It would be inappropriate to refund the full amount of the reinforcement cost as this would put the pre-2005 DG connectee in a better position than some post-2005 connectees who may have funded a proportion of the reinforcement under the apportionment rule. However, a retrospective application of the apportionment rule several years after the original connection was made has serious practical difficulties. Ofgem might consider a pragmatic solution whereby, say, half of the unexpired part of any reinforcement charge could be refunded. This would be more practicable to implement as it could be done without the retrospective capacity data that would now be difficult to re-create.

13. In order to ensure that pre-2005 DG customers contributed to the costs of the operation, repair and maintenance (OR&M) of the network they were charged an OR&M fee on either a monthly/annual basis or as a capitalised charge for the anticipated life of the asset. Within NEDL the applied asset life was typically 15 years and within YEDL it was 10 years. Under the new arrangements, customers that had elected to pay the OR&M charge on a monthly or annual basis will no longer be charged these amounts and under a compensation policy based on the unexpired element of the connection charge these customers would not be eligible for any compensation since there is no unexpired element. Customers who elected to pay the full OR&M charge as a capitalised amount could potentially be refunded an amount to reflect the unexpired part of the capitalised OR&M charge. There may be customers who, although having originally elected to pay a capitalised OR&M charge, would not be eligible for any compensation as the anticipated asset life will have expired.

14. In NEDL we have eight sites and all of which have fully expired OR&M due to the age of the connections and so no compensation would be made in respect of these eight sites. Of the fifteen sites in YEDL there are six with fully expired OR&M and we are

unable to calculate the total value of the potential compensation for the remainder in the absence of further customer information.

15. *[Paragraph containing commercially sensitive information omitted.]*

Question 3: Do respondents consider compensation to be appropriate in cases where contracts allow for a variation when charging arrangements change? If so, why? Our understanding is that this is the case for all SVA generators and some CVA connected generators.

16. In general we cannot see why Ofgem might consider compensation appropriate in cases where contracts allow for a variation when charging arrangements change unless the exercise of such a contractual right carried with it, or implied, an obligation to compensate. We see no reason why one class of connectee (i.e. pre-2005 DG) should be given special protection against disadvantageous changes in regulatory policy. Protection has not generally been given to other classes of connectee during the long history of the electricity supply industry in Great Britain.

17. We can see that Ofgem might wish to adopt a policy that recognised that there might be exceptions to the general rule, such as where Ofgem's sense of fairness as between different vintages of generator or as between generators and demand customers led Ofgem to the conclusion that a payment was necessary. We think such cases would be exceptional and would have to be justified on their merits.

Question 4: Where contracts are not explicit that UoS charges are included within the terms of the connection, do pre-2005 DG customers have any rights to compensation based on the value of expected UoS charges? What would be the justification for this?

18. In circumstances where no explicit contractual right has been established we see no reason why pre-2005 DG customers should be regarded as having rights to compensation based on the value of expected use of system charges.

Question 5: We welcome views from respondents as to whether the same compensation principles should apply to HV/LV customers as to EHV customers and whether the same contractual and fairness issues apply.

19. It is hard to make a case in principle for differentiating between voltages of connectee. The most that may be said is that, over the years, it has been quite common to treat EHV premises differently in terms of regulation and tariff setting. Ofgem will be aware that HV/LV customers are covered by the Common Distribution Charging Methodology (CDCM). This has already been implemented without refunds.

Question 6: Are there any other proposals or relevant issues that we have not identified in this consultation that you think should inform our policy development going forward?

OR&M and demand customers

20. NEDL and YEDL do not normally charge OR&M on 'demand only' connections and we have no evidence of any EHV demand customers having been charged OR&M, although our connection charging statements contained the option to do this under certain circumstances. For example, OR&M may have been charged in respect of excess assets on a non-refundable basis. We believe such cases to have been very rare.

21. Care should be taken to clearly understand the nature of any OR&M values in the charging models that are related to demand sites. It may be that such values actually relate to OR&M charges applied to sites with import and export MPANs because of the presence of generation rather than OR&M charges applied to pure demand sites. There is a risk that if these charges are misinterpreted they will be double counted and double refunded; firstly, as a potential distributed generation (DG) OR&M refund and secondly, via an adjustment to the demand EDCM models (in relation to the import MPAN). It may be prudent to treat any OR&M charges associated with combined import/export sites as OR&M attributable to the export for DG.

22. We are not aware of any other issues that should inform Ofgem's consideration.

Question 7: We would welcome evidence from respondents that would allow Ofgem to assess the potential magnitude of the compensation that might be due under the different approaches that might be adopted to assessing compensation.

23. Compensation based on the NPV of *all* future use of system charges to both CVA and SVA pre-2005 DG would potentially give rise to payments the sum of which could be very material to NEDL and YEDL. It is hard to estimate a range for this materiality for two reasons. The first is that the charging models are still under development; the second is that the charging models will generate a set of charges for the forthcoming year only. Since the models are dynamic and very sensitive to the pattern and timing of demand on the system it is not possible to predict the charges that will apply in future to derive an NPV of future charges.

24. Determining the value of compensation based on the unexpired part of any deep connection charge paid in relation to any reinforcement is less problematic but it is still difficult to calculate without further information from the connectees and a case-by-case assessment. We estimate that for CE compensation calculated on that basis would be very small for the reasons given in paragraph 25 below.

25. We think that the case-by-case assessment would be likely to lead to a number close to zero because, in practice, the change from a regime of deep connection charges to the current one of 'shallowish' connection charges would in many cases have given rise to no change in the connection charge (because there was little deep reinforcement associated with the connection). EHV connectees generally connected via dedicated feeders where there was spare capacity, so there was no reinforcement element to their connection charge. However, this is an informed guess at this point. Only by a full case-by-case analysis would we find how much less the connectee would have paid under the connection charge policy that Ofgem introduced from April 2005.

26. *[Paragraph containing commercially sensitive information omitted.]*

Question 8: We welcome views and evidence on the approach that should be adopted in the case of special contracts that grant rights in excess of standard rights and whether any compensation due should all be funded by customers through the price control.

27. Provided the DNO, or any of its predecessors in law, acted reasonably (for example to secure the protection of the interests of the generality of customers) any compensation payable should be funded from customers through price controlled revenue. Ofgem may need to be particularly vigilant where such payments would flow from the DNO to an affiliate or related undertaking, but where a DNO has no shareholding or other interest in the pre-2005 DG there is no *prima facie* reason to suppose that the DNO's behaviour may have been influenced by inappropriate considerations.

28. Where compensation is considered payable to return monies paid by any pre-2005 DG, unless the customer contribution was for some reason not reflected in a reduction in the regulatory asset value (RAV), it would be appropriate for customers to fund the compensation paid. After all they will have benefited from the lower charges that would have resulted from the reduction in RAV.

Question 9: We invite any other views and comments about users' contracts that may help us to develop our proposals.

29. Whilst we agree with Ofgem that the calculation of compensation is an exercise for DNOs and pre-2005 DG customers to carry out in the first instance, this can be done only against a clearly defined and articulated regulatory policy. Ofgem needs to set out its policy with respect to compensation and the DNOs should then be expected to apply it. If DNOs apply Ofgem's policy properly, any amounts paid out should be added to RAV and recovered from customers. Only where DNOs depart from Ofgem's policy should there be any question about whether any part of the sum paid out should be added to RAV.

30. Since the three distinct phases of charging – from no charging for distributed generation, through the period of exemption for pre-2005 DG (i.e. from 2005 to 2010),

to the new policy of charging for *all* generation – reflected different regulatory policies, it is hard to see how DNOs can develop their own individual compensation policies. Each DNO should implement Ofgem's new policy on the introduction of charges for pre-2005 DG, including its policy with respect to compensation.