



To distribution network operators, suppliers, generators and other interested parties

*Promoting choice and value for all gas and electricity customers*

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Dear Colleagues,

### **Charges for Pre-2005 Distributed Generators' use of DNOs' distribution systems - decision on unbundling**

On 21 July 2010, Ofgem published a consultation document entitled 'Charges for pre-2005 Distributed Generators' use of DNOs' distribution systems' (Ref 88/10)<sup>1</sup>. The consultation sought views on the approach that distribution network operators (DNOs) should adopt for introducing use of system (UoS) charges for distributed generators (DGs) who connected on pre-April 2005 connection terms and on the high level principles for determining any compensation that may be due.

One of the issues we consulted on was whether compensation should be bundled with or unbundled from the calculation of UoS charges<sup>2</sup>. This letter sets out our decision on this issue. Consultation on the principles for determining compensation to be funded from price control revenues is still open. We plan to set out draft guidelines for consultation later this Autumn.

A more detailed background and summary of the issues in relation to bundling and pre-2005 DG charging more generally can be found in the July consultation.

### **Summary of responses<sup>3</sup>**

We received 20 responses to our consultation, of which six were marked as being confidential. Eleven respondents agreed with an unbundled approach (three with conditions) and six did not give a clear view on the bundling issue. Three respondents did not agree with our minded to position to adopt an unbundled approach.

Those who supported our minded to position to adopt an unbundled approach to compensation provided the following additional arguments in favour of the approach:

- The proposed extra high voltage distribution charging methodology (EDCM) is already complex and a bundled approach would further complicate it.

<sup>1</sup><http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/Consultation%20on%20charging%20pre-2005%20DG%20for%20UoS%200710%20nr.pdf>

<sup>2</sup> A bundled approach would incorporate the payment of compensation into the calculation of UoS charges within the UoS charging methodology. An unbundled approach would ensure that the payment of compensation is dealt with separately from the UoS charging methodology.

<sup>3</sup> Non-confidential responses that are restricted to the bundling issue have been published on our website. See <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=575&refer=Networks/ElecDist/Policy/DistChrgs>. Responses that commented on the entirety of our consultation will be published after the remainder of the consultation has closed.

- A lump-sum payment (which would only be possible as part of an unbundled approach) would probably better meet obligations in DNOs' licences. For example, standard licence condition 4.1 of the Electricity Distribution licence states that DNOs must at all times manage and operate the Distribution Business in a way that is calculated to ensure that it does not restrict, prevent, or distort competition in the supply of electricity or gas, the shipping of gas, the generation of electricity, or participation in the operation of an Interconnector. Some respondents thought a lump-sum payment made separately from UoS charges would maintain the price signals given by UoS charges and would better achieve the aims of not restricting, preventing, or distorting competition.

Four respondents who supported our position also set out their expectations and conditions to their support. Three respondents supported an unbundled approach on condition that Ofgem provides clear and fair criteria for paying compensation and for logging up efficient costs for inclusion at the next Distribution Price Control Review (DPCR6). The other respondent stated that they supported an unbundled approach on the condition that full settlement of agreed compensation payments are established as a precondition for the application of UoS charges.

Three respondents did not support our minded to position. One considered that a bundled approach would be appropriate, pragmatic, legitimate and straightforward. In particular they considered that evidence to support the calculation of specific amounts of compensation on a case by case basis is likely to not always be available and that a pragmatic solution would be necessary to ensure that, where evidence is missing, DGs are not disadvantaged as a consequence. Furthermore, they argued that deep reinforcement costs and capitalised operation and maintenance (O&M) were arguably the equivalent of today's UoS charges and so it would be appropriate and legitimate to bundle compensation into the charging methodology.

Another respondent who supported a bundled approach considered that the cost of O&M is a distinct cost that is explicit in the EDCM, therefore any explicit refund under the EDCM would not weaken the locational element of the UoS charge. They also considered that customers' payment for O&M is different to a connection cost and that DPCR5 Final Proposals would not explicitly allow compensation for O&M to be logged up as part of DPCR6. Finally, they considered that there may be other circumstances where customers, for example demand customers, may be due compensation for having paid for O&M up front that is not provided for in the proposed DPCR6 logging up mechanism and that a bundled approach could easily resolve this issue.

The final respondent who supported a bundled approach argued that it would ensure due recognition of the contractual rights of pre-2005 DGs and would minimise the impact in terms of stakeholder regulatory risk. They also argued that as a practical matter the approach would ensure that UoS charges and compensation were not "de-coupled". However, the respondent also recognised that a bundled approach might be complex to develop, implement and maintain.

We note the views of these three respondents, however we do not think their arguments suggest that a bundled approach is more appropriate. Our rationale is set out below:

- We think the evidence base required to justify a bundled approach is no different from that required for an unbundled approach - in both cases there is an expectation that money paid in compensation will be recovered from other customers and this must be justified.
- Similarly, we consider that due recognition of DG's rights should be achieved irrespective of whether compensation is bundled or unbundled, since the same issues and evidence base would be considered when calculating the compensation.
- If compensation is bundled then the pre-2005 DG customers will not face the same price signals as other DGs - this goes against our DPCR5 policy decision for all DGs to be charged for UoS in a non-discriminatory manner.

- We do not think that a bundled approach is compatible with the DPCR5 policy intention for there to be a review of any compensation before DNOs can recover the payments through the price control to ensure that it is efficiently incurred. Under a bundled approach other customers' charges would increase to offset the bundled compensation included in charges.
- Furthermore, a bundled approach would be likely to continue past the end of DPCR5, meaning that we would be unable to review the full costs of compensation as part of DPCR6 as envisaged as part of DPCR5 Final Proposals.
- We take on board the comment that DPCR5 Final Proposals did not explicitly reference allowing the recovery of capitalised O&M charges as part of the compensation. However, we do not see how this has any bearing on whether such compensation should be bundled or unbundled. Any compensation must still be well justified and subject to an efficiency review to protect the interests of customers. As part of the principles that we will develop for assessing the efficiency of compensation, we will need to consider whether it is appropriate to allow the recovery of refunded capitalised O&M costs in some cases.
- Because of the complexities involved with developing, implementing and maintaining a bundled approach, we do not think it would be more practical than an unbundled approach.

### **Our decision on unbundling**

Having considered responses to our consultation, we consider that DNOs should be required to unbundle compensation from the calculation of UoS charges.

As stated in our July consultation, Ofgem considers that there is strong merit in adopting an unbundled approach to be reflected in the EDCM for the following reasons:

- UoS price signals are unaffected by any compensation and this meets our aim of facilitating the efficient development and use of the network.
- It allows DNOs to bring forward EDCM proposals, ahead of the detailed approach to compensation having been finalised.
- It would lead to a simpler UoS methodology for DGs.
- It will allow DNOs to make case by case decisions on compensation without having to reflect this in the charging methodology.
- Recording and reporting details of compensation paid is likely to be administratively simpler and less burdensome on the DNOs and Ofgem.
- It is compatible with the approach taken to charging DGs in the CDCM.

By contrast the bundled approach presents the following issues:

- Incorporating compensation into a UoS methodology may not technically be correct, i.e. the methodology is intended to be for the determination of charges for UoS, not compensation.
- It could be challenging to ensure that compensation is paid consistently when a methodology may change over time.
- It will be difficult to track how much compensation has been paid to a particular customer and DNOs may still be exposed to the risk of accusations of undue discrimination.
- The Authority has to approve the charging methodology. This may present complications when Ofgem is also required to determine disputes over compensation.
- It may lead to very complex and detailed charging arrangements for DGs, which are difficult to understand.
- Pre-2005 DGs may receive weaker price signals than those intended by the charging principles that are designed to encourage efficient use of the system and avoid any undue discrimination.

Overall, and having considered responses to our consultation, we think the bundled approach would complicate the EDCM without offering any strong offsetting benefit.

## Next steps

In light of our decision we consider that the DNOs should not develop any additional, substantive elements to their EDCM proposal for delivering compensation to pre-2005 DGs. We have noted the above views of respondents to our consultation. In the Autumn we will issue, for consultation, a set of guidelines for assessing efficient compensation payments. Following consultation we plan to publish these guidelines with the expectation that they will give DNOs clarity on the circumstances in which compensation payments will and will not be eligible for inclusion in price control revenue allowances. These guidelines may be shaped and refined as a result of determinations we may make on this matter.

This decision letter should be read in conjunction with our consultation published today on the timescales for submitting and implementing the EDCM<sup>4</sup>. In particular, that open letter sets out our minded to position to change the submission date of the EDCM to 1 February 2011 in order to allow for further consultation on and development of the methodology.

This decision letter relates to only one of several issues in our consultation on pre-2005 DG charging. Consultation is still open on the appropriateness of compensation and the principles for assessing the efficiency of any such compensation. Responses on that matter should be sent to [distributionpolicy@ofgem.gov.uk](mailto:distributionpolicy@ofgem.gov.uk) by 1 September 2010.

Please contact Nicholas Rubin if you have any questions in relation to this decision letter. He can be contacted either on 020 7901 7176 or by email at [nicholas.rubin@ofgem.gov.uk](mailto:nicholas.rubin@ofgem.gov.uk).

Yours faithfully,



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**Partner, Distribution**

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<sup>4</sup> <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=599&refer=Networks/ElecDist/Policy/DistChrgs>