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Dear Nick,

Charges for pre-2005 Distributed Generators' use of DNOs' distribution systems

1. We welcome the publication of this consultation. We have been keen for Ofgem to address the issue of compensation ever since proposals to apply ongoing charges to pre-2005 EHV-connected generators were first proposed. This is the Centrica response to this consultation. This covering letter and Annex B are not confidential; however we also attach two Annexes (A and C) both of which are confidential.
2. We have five generating stations that are affected by these proposals (at Barry, Brigg, King's Lynn, Peterborough and Roosecote). Each of these stations connected to their respective distribution networks prior to 2005, and paid large upfront fees to:
 - connect and use the network;
 - facilitate the operation and maintenance (O&M) of DNO owned assets; and
 - have the right to export power onto the distribution network up to a specific maximum export capacity (in accordance with our connection and use of system agreements).
3. As set out in our response to Chapter 3 of the consultation on 18th August, without full compensation, the application of charges to these affected generation stations would directly conflict with our contractual rights. Contracts were put in place for each of these stations at the time they connected that clearly set out the extent of these rights. None of these contracts make provision for further ongoing charges. In addition, the expectation at the time of contract agreement was that the charges paid at connection were in lieu of any ongoing use of system payments. We have obtained legal opinion from Linklaters that confirms this view, which we attach as confidential Annex A to this response.
4. Were Ofgem to insist on these charges being applied without appropriate compensation being agreed, this would constitute a material increase in regulatory risk, potentially having a damaging effect on investment in new generation (and subsequently on security of supply)¹. Furthermore, increasing regulatory uncertainty for investment in generation would also seem to run counter to the government's policy of encouraging new generation as a fundamental part of its climate change commitments.
5. In the remainder of this letter we set out our views on:
 - the nature of our contractual rights; and

¹ We set out our views on appropriate models for compensation below.

- an appropriate methodology for compensation.
6. In addition, we set out specific responses to each of the questions raised in the consultation document in Annex B, and a quantified analysis of our proposals for compensation in (confidential) Annex C.

Our contractual rights

7. We asked Linklaters to undertake a thorough review of the connection and use of system contracts we have in place for our five affected embedded generation stations. In order to resolve the issue of compensation with you as speedily as possible, we have taken the decision to share this opinion with you (on a confidential basis).
8. This opinion is clear that the agreements we have in place at each of our stations provide ongoing rights to export power onto the relevant distribution systems. Linklaters describes the nature of these rights in paragraph 4 of the opinion provided in Annex A, the relevant extract being:

“...the Generator is entitled to enjoy rights of connection and to export power over the Distribution System for the duration of either the Agreement or the operating life of the relevant station. These rights were granted for, in essence, a single up front payment at the outset of the Agreement.”

9. The opinion also confirms that there are no provisions in any of the agreements for the introduction of further payments for these rights.
10. We believe that the expectation by both the networks and the generating stations at the time of connection was that no additional charge would be payable, beyond that initial large upfront sum. Indeed, this view was reiterated by the network to which Barry Power Station is connected (WPD) 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...”

11. The duration of these rights varies by contract. The agreement we have in place for Barry differs significantly from the other four contracts, in that this includes a reference to duration. Specifically, there is reference to a review of charges (for O&M) to be undertaken after 20 years (i.e. by 2016)². However Linklaters is of the opinion that this provision does not provide a clear basis on which use of system charges could be introduced to the Barry agreement.
12. Finally, Linklaters has also provided opinion on the nature of the variation provisions included in each agreement (and the legal basis on which these could be activated). Linklaters concludes that, as well as overriding the contractual rights of the connectee, requiring an amendment to specific connection agreements may not be lawful for the Authority as this would be inconsistent with its duties.

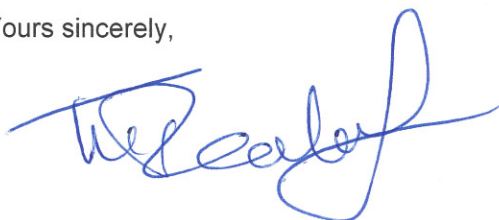
Methodology for compensation

13. The appropriate methodology for setting compensation should be determined by the nature of contractual rights held by each affected plant. As set out above, our legal opinion is clear that our rights are defined in terms of an ability to export power up to a defined maximum level on an ongoing basis.

² Were Ofgem to select a set of agreements that were “representative” for a generic exercise of determining an appropriate method of compensation, we would therefore suggest that those in place at Barry would not be a suitable choice.

14. For this reason it would be inappropriate to apply either the “no compensation” or “connection charge compensation” approaches to our affected embedded plant. While the NPV approach would be acceptable (and be consistent with our contractual rights), we have some concerns that this approach would expose our plant to excessively volatile and non-cost reflective charges over the unexpired portion of the contracts we hold. This is particularly the case given the very large swings in estimated charges we have seen in recent months.
15. Instead, we favour an alternative “time-limited discount model”, in which generation stations are refunded UoS charges on an annual basis, in each year for the unexpired portion of the contracts they hold with their respective DNOs. This approach would be consistent with our contractual rights. It would also represent a fair approach to compensation, given the expectation held by both the connecting party and the DNO at time of connection that no further charges would be applied to generators that connected to the EHV network pre-2005.
16. As well as fully respecting our contractual rights, the “time-limited discount” approach would expose generators to correct locational signals at the time they consider whether or not to invest in refurbishing / rebuilding their plant (i.e. as they approach the end of their useful life). Such investment decisions would need to be made significantly ahead of contract-end (therefore the expectation of future application of charges, even if full compensation was payable in the current year, would deliver economically correct investment decisions).
17. It is unclear from the legal opinion what constitutes the unexpired portion of each agreement. However, we believe it would be fair to set the assumed duration of our agreements consistent with what would have seemed reasonable at time of connection. It is reasonable to assume this duration should be the expected plant life (i.e. 25 to 30 years from time of connection).
18. We set out some worked examples of the compensation that we believe would be payable under both the time-limited discount approach, and the NPV approach, using our latest estimates of charges that will apply from 1 October 2011. These are set out in confidential Annex C. We would be happy to discuss this with you in more detail if that would be helpful.
19. I hope that this response has been useful in setting out our views and has made our favoured next steps clear. Please contact me if you would like discuss any of the issues covered in this response further

Yours sincerely,



Tim Dewhurst
Head of Network Regulation and Market Design
British Gas

Annex B: Answers to specific consultation questions

Question 1: We invite respondents to provide further information they have on contractual arrangements and the extent to which the descriptions in this chapter fit their own circumstances.

1. We have obtained an opinion on the nature of the contractual rights we hold at each of our affected plant from Linklaters. This opinion is included in (confidential) Annex A.
2. The contracts at all of our pre-2005 connected generators provide clear and unambiguous rights to export power, on an ongoing basis, onto their respective distribution networks, with no provision for further charge (beyond that paid at connection). DNOs have a reciprocal obligation to accept this power. These rights were secured through the payment of large one-off payments at time of connection.

Question 2: Do respondents agree with our understanding of the arrangements affecting CVA and SVA customers?

3. The relevant part of the consultation document is consistent with our understanding of these arrangements.

Question 3: Do you consider our summary of contractual issues is accurate and complete?

4. If the agreements held by other affected generators are similar to those reviewed by Linklaters, we would disagree with the view that “many connection agreements may not define clearly the extent of the DG’s right to use the distribution system”. Our contracts set out these rights clearly, as described in our covering letter.
5. The summary of issues should also include reference to the expectations that the networks and generators held at the time the agreements were struck. This is an important consideration, as this will have a bearing on the development of a “fair” approach to compensation. From the reference we include in our covering letter, it is clear that WPD believe there was an expectation that no ongoing charges would be paid by pre-2005 EHV-connected plant at the time agreements were struck (beyond the large one-off fee paid at time of connection).

Chapter 4

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

6. We agree that nature and duration of contractual rights held by generators, and fairness are appropriate criteria to consider when determining compensation. Of these two criteria, full consideration of contractual rights is the most critical.
7. Any decision that overturns contractual rights will undermine confidence in the regulatory framework. Increases in regulatory risk, in turn are likely to have a detrimental impact on security of supply, through:
 - a direct impact on existing pre-2005 connected plant, some of which may be forced to close if insufficient compensation is made; and
 - an indirect impact on new generation, as increased regulatory risk will have a detrimental impact on new generation / network infrastructure projects (resulting in higher risk premia demanded for investment in plant and consequently adverse impacts on costs to customers).

8. Furthermore, increasing regulatory uncertainty for investment in generation would also seem to run counter to the government's policy of encouraging new generation (a fundamental part of its climate change commitments).

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

9. The appropriate method of calculating compensation should be entirely driven by the nature of contractual rights held by affected plant. As set out in our answer to Question 1.1, the rights held by our plant are:
 - forward looking, giving us the right to export power onto the network up to a specified maximum export level; and
 - there are no provisions for additional charges.
10. Given the strength of these rights, the compensation methodologies that provide "no" or only partial compensation would be inconsistent with our contractual rights, and are therefore inappropriate.
11. We believe there are two approaches to compensation that are both fair, and consistent with our contractual rights. These are:
 - an alternative "time-limited discount model", in which generation stations are refunded UoS charges on an annual basis, in each year for the unexpired portion of the contracts they hold with their respective DNOs; and
 - the payment of the NPV of expected levels of future UoS charges (for the unexpired portion of the relevant contracts).
12. Both of these approaches would be broadly consistent with our contractual rights. They would also represent fair compensation, given the expectation held by both the connecting party and the DNO at time of connection that no further charges would be applied to generators that connected to the EHV-network pre-2005.
13. Importantly, both approaches would expose generators to the correct locational signals. The "time-limited discount" approach would expose generators to the full locational signal at the time the generator is considering whether or not to invest to refurbish or rebuild ageing plant. Such investment decisions would need to be made significantly ahead of contract-end (therefore the expectation of future application of charges, even if full compensation was payable in the current year, would deliver economically correct investment decisions).
14. The NPV approach would also deliver a similar exposure to ongoing charges, with these signals being particularly relevant at the time the generator is considering whether or not to invest to refurbish / rebuild. However, this approach would expose generators to the risk that actual charges differ from expected charges over the unexpired portion of the relevant contracts. This would increase risk on generators without delivering any benefit to consumers (as efficient signals will only become relevant at the time the investment decision is made at the end of the useful life of the station).
15. Both of these approaches would entail determining what constitutes the unexpired portion of each agreement. We believe it be fair to set this to be consistent with what would have been a reasonable expectation for plant asset life at the time the agreements were struck (i.e. 25 to 30 years).

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. The existence of variation provisions has no bearing on the nature of rights that pre-2005 generators hold through their contracts. It would therefore be wholly inappropriate for the existence of such provisions to have any bearing on the compensation issue.
17. At time of connection, potential connectees viewed variation and dispute resolution clauses as a necessary safeguard against unreasonable terms being imposed upon them by monopoly network providers. There was certainly no expectation at time of connection that such clauses could be used to impose additional charges on connectees. We also note that these clauses were an integral part of the suite of agreements offered by the monopoly network at time of connection (therefore the generators in question had little choice but to accept them).
18. The ongoing rights that our affected plant hold to export power onto their respective networks are clear. In addition, the expectation at the time agreements were struck that no further ongoing charges would be levied for these rights is also clear. It would therefore be contractually inappropriate and inconsistent with the concept of "fairness" for the Authority to use variation provisions as a reason not to allow compensation.

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?

19. Our pre-2005 contracts specified a substantial one-off charge as consideration for ongoing rights to export power onto the network. The expectation of our generating stations, and the networks at time of connection was hence that no ongoing charges would be applied. UoS charges therefore formed part of the large one-off payment made at time of connection (in lieu of ongoing charges).
20. We do not believe that we necessarily have rights to compensation calculated on the specific basis of the value of expected UoS charges. However, given we have the right to export power on an ongoing basis to our respective networks, we believe we have the right to compensation equal to a level that will make us whole, were ongoing charges applied. There are numerous ways that this compensation can be determined, and we set out our favoured approaches to compensation in our answer to Question 4.2, above.

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.

21. Where rights to use the network for no additional ongoing charge are clearly set out in contractual agreements, it is inappropriate for charges to then be applied without full compensation. The integrity of contractual agreements should be fully respected irrespective of the networks to which such connection and use of system agreements relate.

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?

22. We have set out an alternative model for compensation that we believe is both "fair", and fully respects the contractual rights held by our affected plant. We ask Ofgem to consider this model as part of its ongoing policy development.

23. We also believe that Ofgem's policy development in this area to date has not considered to a sufficient degree the linkage between the application of charges, the compensation issue and security of supply. The charges proposed by networks for our embedded generation stations may have resulted in the early closure of many of our affected plant. We do not believe that these early closures have been factored into either Ofgem's analysis for Project Discovery, or government analysis of security of supply (e.g. Electricity Market Assessment).
24. Were the combination of new charges, and inadequate compensation to lead to the closure of some or all of our embedded generation stations, it is highly likely that these relatively efficient CCGTs would be substituted by less efficient plant in the merit order – possibly coal burning plant. Both the potential impact of this issue on security of supply, and carbon emissions are relevant, given Ofgem's duties.

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.

25. We have set out estimates of the level of compensation (and the profile of such compensation) in Annex C.

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.

26. The distinction between "standard" and "special" rights in the consultation is unclear. Given Ofgem's decision to provide compensation where appropriate, the level of compensation (and therefore what is passed on to consumers) should be determined solely by an assessment of the strength of contractual rights.