

## **Introduction**

Energy Power Resources Limited (EPRL) owns and operates five biomass power stations using a range of fuels and technologies. EPRL has a long history of development and operation of biomass power projects, with its five operating plants commissioned between 1992 and 2001. In addition, EPRL is at the early stages of developing a new 40MW biomass fuelled power station, which was submitted for planning approval in January 2010.

As part of the capital costs for its five existing biomass power stations, EPRL paid significant capital connection costs on the basis that these sites were exempt from generator use of system charges. The exemption from generator use of system charges was removed from 1<sup>st</sup> April 2010 for CDCM sites and from 1<sup>st</sup> April 2011 for EDCM sites. Each of EPRL's five power stations will be exposed to generator use of system charges under the proposed EDCM charging mechanism with effect from 1<sup>st</sup> April 2011.

EPRL is part of a larger group (MEIF Renewables) which includes CLP, a business generating renewable energy from landfill gas and operating across 24 sites within the UK. Many of these sites were subject to significant capital connection costs between 1998 and 2009 and since 1<sup>st</sup> April 2010 all are now exposed to the generator use of system charges under the CDCM charging methodology.

## **Executive Summary**

We are party to numerous connection offers and agreements and can confirm that there is limited consistency in respect of the terms of connection and very little transparency in the calculation of the connection costs, some being silent on the subject, some quoting a single figure and others analysing the amount between cost of connection, management fee and maintenance charges. Where maintenance fees are quoted, there is only rarely an indication as to what maintenance period has been used in the calculation and no indication of the discount rate applied in translating the ongoing costs into a one off upfront payment. Where a maintenance period is specified, there is no indication of the charging method to be applied thereafter nor is there a mechanism for agreeing such charges.

Where generators have paid for a connection and such costs included elements which did not relate to the actual cost of connection (e.g. for ongoing operations and maintenance) a compensation payment corresponding to the aforementioned elements is required based upon the criteria of fairness and anti-discrimination and to avoid duplicated charges going forward. . Many connection contracts have either implicit or explicit rights to use of the network. Accordingly compensation is required where such an entitlement will now be subject to a charge brought about by a retrospective change, which in most if not all cases has already been paid for.

We do not believe that compensation should be limit to connections above an arbitrary threshold (10MWs is quoted in the consultation document). We are aware of significant connection costs for connections below this level and compensation should be applied to all DG customers.

An unbundled approach, as suggested by Ofgem, is appropriate. This should be in the form of a cash payment direct to the generator.

The fairest method for calculating compensation would be to repay the unexpired element (as at 1<sup>st</sup> April 2011) of the initial connection cost, excluding the costs purely associated with capital cost of connecting to the network. The resulting amount should be grossed up to reflect the time value of money at 31<sup>st</sup> March 2011. We assume that in calculating a capitalised upfront operations and maintenance payment the DNOs will have discounted this to allow for a one off upfront payment. Such negative discount factor should be applied from the original payment date through to 31<sup>st</sup> March 2011.

There are a number of issues with this (or any other method of calculation) which need to be resolved (none of which is insurmountable):

- The majority of connection offers provided just a single figure and in many cases it will be difficult to calculate the element which related to actual cost of connection to the network (and therefore the balance) in the absence of information to the contrary, a fixed percentage could be applied to the original payment;
- Whilst the start date of a connection will generally be known, to calculate the unexpired element from 1<sup>st</sup> April 2011 to the contract end date needs to be assumed. Whilst some contracts specify a term, this is not always the case. If a term is not specified or is indefinite, an option would be to use a 40 year asset life (not untypical for the network assets); and
- Calculation of the negative discount rate to be used to gross up the relevant non specific connection cost within the upfront payment, this could use historic Bank of England base rates from the date of original payment plus an allowance for risk.

## **Formal Response**

### ***Existing pre-2005 DG contracts***

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

The circumstances noted in this chapter of the consultation document correspond to our experience in respect of connection agreements and connection costs.

Our internal review indicates that there is limited consistency in respect of the terms of connection contracts and very little transparency in the calculation of the connection costs, some being silent on the subject, some quoting a single figure and others analysing the amount between cost of connection, management fee and maintenance charges. Where maintenance fees are quoted, there is only rarely an indication as to what maintenance period has been used in the calculation. Where a maintenance period is specified, there is no indication as to the charging method to be applied thereafter or mechanism for agreeing such charges.

There is no clarity in how connection charges (either in total or the individual elements) have been calculated.

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

Whilst we generally agree with the assessment of the arrangements affecting CVA and SVA customers we do not agree with the assessment of some DNOs that no renegotiations of contracts or payment of compensation is necessary for SVA pre-2005 generators. We believe that compensation payments are due where a pre-2005 generator has paid for a capital connection and will bear the cost of use of system charges going forward, be that generator CVA or SVA.

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

The summary provided is accurate and complete.

### ***Compensation and use of system charges: bundled or unbundled***

Question 1: Have we identified the relevant considerations that influence the decision whether to adopt a bundled or unbundled approach?

Yes.

Question 2: Do you agree with our minded to position to adopt an unbundled approach for the EDCM?

We agree with an unbundled approach.

*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.

The requirement for compensation payments should be considered against three criteria: fairness, discrimination and contractual entitlement.

Fairness – The connection to, in isolation of, the overall network is of little use. When paying for a connection and entering into a connection agreement a DG would implicitly assume that such connection and network would be available either on an “evergreen” basis or as a minimum for the life of its project (up to 40 years) and the project would have use of the system for this period. Whilst this is not always specifically reflected in the connection agreements or connection offers, it is implied. DNOs have charged premium rates for connections, the cost of which pre-2005, either explicitly or implicitly included an allowance for ongoing maintenance cost. From 1<sup>st</sup> April 2011 DNOs will have the opportunity and requirement to separately charge generators for ongoing use of system costs. Pre-2005 generators should not be expected to pay twice for the same element.

Discrimination – without compensation, pre-2005 generators will be penalised and discriminated against in respect of connection costs, having to bear additional capital costs compared to a post-2005 generator whilst both will pay ongoing use of system costs. This situation is exacerbated by the EDCM charges which a new entrant is able to factor into its investment decision, which ability an incumbent did not have. Based upon historical connection costs and the indicative charges provided during the EDCM consultation it is clear that the proposed ongoing generator use of system charges (certainly in Eastern Area) are of far greater significance to an investment decision than the initial connection costs. For example, the ongoing illustrative annual costs for two of EPRL's power stations are not dissimilar to original connection cost. This discriminates between customers which are able to make a cost reflective decision and those which cannot, as they have significant sunk costs. This is more for the debate on the EDCM charging methodology but will be exacerbated if compensation is not paid to pre-2005 generators which have already paid an element for ongoing maintenance costs. The consultation document suggests that connection costs were generally a key feature in location decisions. Whilst connection costs would be a factor, of far more relevance would be the availability and cost of land, proximity to fuel (certainly for biomass and landfill gas generators) and available resource pool. Accordingly, we would refute the suggestion that pre-2005 generators avoided reinforcement of the shared network and that deep connection charges were avoided.

Contractual entitlement – many connection contracts have either implicit or explicit rights to use of the network. Accordingly compensation is required where such a right will now be subject to a charge brought about by a retrospective change.

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

We do not believe that compensation should be limited to connections above an arbitrary threshold (10MWs is quoted). We are aware of significant connection costs below this level and compensation should be applied to all DG customers.

The fairest method for calculating compensation would be to repay the unexpired element (as at 1<sup>st</sup> April 2011) of the initial connection cost, excluding the costs purely associated with capital costs of connecting to the network. The resulting amount should be grossed up to reflect the time value of money at 31<sup>st</sup> March 2011. We assume that in calculating a capitalised upfront operations and maintenance payment the DNOs will have discounted this to allow for a one off upfront payment. Such negative discount factor should be applied from the original payment date through to 31<sup>st</sup> March 2011.

However, there are a number of issues with this (or any other method of calculation) which need to be resolved:

- The majority of connection offers provided just a single figure and in many cases it will be difficult to calculate the element which related to actual cost of connection to the network (and therefore the balance) in the absence of information to the contrary, a fixed percentage could be applied to the original payment;
- Whilst the start date of a connection will generally be known, to calculate the unexpired element from 1<sup>st</sup> April 2011 the length of the contract needs to be assumed. Whilst some contracts specify a term, this is not always the case. If a term is not specified or is indefinite, an option would be to use a 40 year asset life (not untypical for the network assets); and
- Calculation of the negative discount rate to be used to gross up the relevant non specific connection cost within the upfront payment, this could use historic Bank of England base rates from the date of original payment plus an allowance for risk.

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.

On the basis of fairness and to avoid discrimination, the contractual right to unilaterally change charging arrangements does not remove the requirement for appropriate 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?

The connection to, in isolation of, the overall network is of little use. When paying for a connection and entering into a connection agreement a DG would implicitly assume that such connection and network would be available either on an “evergreen” basis or as a minimum for the life of its project (up to 40 years) and the project would have use of the system for this period. Whilst this is not always specifically reflected in the connection agreements or connection offers, in most cases it is implied. DNOs have charged premium rates for connections, the cost of which pre-2005, either explicitly or implicitly, included an allowance for ongoing maintenance cost. From 1<sup>st</sup> April 2011 DNOs will have the opportunity and requirement to separately charge generators for ongoing use of system costs. Pre-2005 generators should not be expected to pay twice for the same element.

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.

Yes the same compensation principles should apply.

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?

The provision of compensation to pre-2005 generators is based upon the removal of the exemption from generator use of system charges and the proposed EDCM charging methodology for EHV customers. The latter is on the basis of use of system charges being cost reflective so as to enable more efficient future use of the network. We have already responded to the EDCM consultation issued by the Energy Networks Association but would comment that the illustrative use of system charges do not appear to be cost reflective (particularly in the Eastern Area for generators based upon historic reinforcement expenditure) and they are providing cost signals to customers which realistically are unable to react to them.

One option would be to allow pre-2005 generators to opt into paying use of system charges from 1<sup>st</sup> April 2011 with an appropriate compensation payment in respect of the initial upfront connection payment or opt out. New entrants would pay use of system charges but would be able to base investment and location decisions on connection costs plus the published (cost reflective) use of system charges.

In terms of other points of potential relevance:

It is clear from the EDCM proposals that it is now recognised that in some cases DG projects have resulted in lower reinforcement costs. This reduction in reinforcement costs does not appear to have been recognised in the costs of connection originally paid. There is an argument that where this is the case, relevant DGs should be compensated by DNOs (and ultimately customers) for the period between connection and when this benefit was reflected in use of system credits (either 1<sup>st</sup> April 2010 or 1<sup>st</sup> April 2011).

DGs have generally been charged use of system and standing charges to date in respect of import electricity and connections. These are in respect of the same network and wires used for export (albeit at a lower capacity). Consideration should be given to removing use of system charges for import electricity (where export charges are now being levied) and also compensation for historic import charges where ongoing maintenance was included in the export capital connection charge.

**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.

This is a question best directed at the DNOs once there is more clarity on how compensation is to be calculated as only DNOs have complete information as to the level of connection costs levied on customers.

**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.

Compensation payments should be funded by customers through the price control process.

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

No further comments.