CE Electric UK

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Dear Nicholas,

Consultation response: Charges for pre-2005 distributed generators' use of DNOs' distribution systems - proposed guidance

1. CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

2. We are writing to provide our response to the above consultation, which seeks views on whether refunds paid by distribution network operators (DNOs) to distributed generators (DG) connected prior to April 2005 (pre-2005 DG) should be funded through the DNOs' price controls. The detailed answers to your specific questions in the consultation are provided in the appendix to this letter.

3. Whilst we welcome Ofgem's initial guidance regarding the payment of compensation, we are concerned that Ofgem's proposed approach may not take sufficient account of the regulatory policy that was operating at the time when DNOs (or their predecessors in law) entered into agreements with DG. This is relevant to the matters both of whether compensation should be paid and, if it is, whether it should be recoverable from customers generally.

4. This issue is best understood in terms of regulatory policy rather than in terms of legal obligations. Prior to privatisation the concept of use of system was unknown in Britain and the commercial arrangements that area boards entered into reflected the policy environment and legal framework that prevailed during that era. From privatisation to 2005 it was Ofgem policy that generation should not generally attract use of system charges. This was confirmed in the approval of the use of system charging statements prepared by DNOs (and their predecessors, public electricity suppliers (PESs)), and in determinations made pursuant to their licences by the Gas and Electricity Markets Authority (and its predecessor, the Director General of Electricity Supply (DGES)). It is clear from this evidence that there was a general presumption that DG should not pay use of system charges. The circumstances referred to in passing by the DGES in the Knapton determination - i.e. where the licensee's costs would increase as a consequence of the altered electrical flows resulting from the connection – were evidently not regarded by the DGES as the norm. We do not think that Ofgem's presentation of regulatory policy before 2005 gives sufficient emphasis to the established policy that DG should generally not pay use of system charges.

5. Policy has changed twice since then. 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 four 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, will naturally have reflected the policy that prevailed at the time that the contract was entered into or that the charge was being set.

6. It may be reasonable to determine that a DNO should not be entitled to recover compensation where it entered into contracts that were inconsistent with regulatory policy. However, in making such an assessment, it must be recognised that such regulatory policy (and, before privatisation, government policy) has changed over time. If there are any situations where a DNO must pay compensation because it has granted *contractual* rights that it must compromise or 'buy out', the criteria for assessing the 'efficiency' of the buy-out should simply reflect the lowest-cost means by which the DNO can extinguish its contractual obligation.

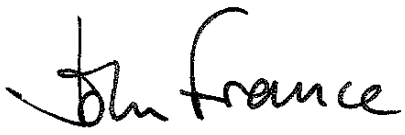
7. We should make clear that we have seen no evidence that any contractual commitments, whether express or implied, were given that had the effect of granting any pre-2005 DG connected to the NEDL and YEDL networks free use of system in perpetuity.

8. In the case of compensation to avoid double charging, since the compensation would be a reflection of a change in regulatory policy, the criteria for assessing the 'efficiency' of the compensation should be that the compensation paid should properly reflect the double charging inherent in the new policy. In other words, the compensation should reflect that element of the new charges for which payment has already been made, which may not necessarily be the same as reimbursing charges made under a previous regime.

9. Finally, we believe that, in assessing whether compensation for double charging should be recoverable by a DNO, there may be circumstances where Ofgem should take into account the manner in which the DNO treated the payments it received from the DG. For example, if the DNO deducted such payments from its regulatory asset value (RAV) then customers will have fully benefited from the payments received, and therefore it would seem inequitable to make the DNO bear the cost should it be determined that the connectee is now entitled to compensation.

10. I hope you find our comments and answers to your questions helpful in coming to a decision on this subject. If you would like further clarification of any aspects of our response, please contact me so that we can arrange to discuss these.

Yours sincerely



John France
Regulation Director

Appendix 1 – Ofgem consultation questions and CE response

Chapter 3. Principles and circumstances for refunding pre-2005 DG

Question 1: *Is our description and interpretation of historical charging arrangements (including connection and use of system agreements, charging statements, determinations, regulatory precedents) complete and accurate? If not, please provide supporting evidence setting out any issues that you identify.*

Answer: In general the description and interpretation of the historical charging arrangements are accurate: however, it is worth noting that some pre-2005 DG may have been connected before the concept of use of system was created and therefore contractual and payment arrangements that may seem unusual now may have been in line with regulatory or government policy or with the obligations of the network entity at the time. We would not expect Ofgem to deem such contractual arrangements to be unjustified or inefficient.

Ofgem refers in the consultation to the determination of the DGES in the case of Scottish Power plc and Northern Electric plc with respect to a generation plant at Knapton. The summary of that decision in the recent consultation is incomplete because it fails to point out that in the PESs' charging statements (which had to accord with the PES licence and be presented in a form approved by the DGES) it was made clear that:

> '…in general, no charge will be made to generators for use of system in respect of exports to the system.'

In that determination the DGES said that he 'had to consider whether … it is reasonable for Northern Electric to make an exception to its stated principle in this case.' The DGES concluded that no such exception should be made in that case because the connection at Knapton would not cause Northern Electric plc to increase its costs. Ofgem is correct to point out that that determination stated that, if circumstances changed and additional costs were caused by a change in power flows, the licensee would be able to *propose* a variation to the agreement to enable charges to be made and, in the event of a dispute, to refer that to the DGES for determination. However, Ofgem's most recent consultation paper elides the fact that the regulatory norm at that time was that embedded generation would generally not attract use-of-system charges. This is important because it follows that it would have been entirely reasonable for a PES to have entered into agreements that reflected the prevailing regulatory orthodoxy that was evidently directed towards encouraging new generation to connect to the network. That being the case, it would be unjust for Ofgem to seek to impose on the successor DNO a regime in which it must now (a) impose charges on the generator and (b) pay compensation to the generator (because the DNO cannot otherwise equip itself with the legal right to charge under the existing contract) unless that compensation can be recovered from the generality of users.

Question 2: *Do you agree with our rationale for only allowing refunds for instances of double payment to be funded through the price control?*

Answer: It is reasonable that a refund should be made where there is evidence that there would be a double payment if no refund were to be made. In these circumstances it is also reasonable that the refund should be funded through the price control.

However, for the reasons set out in our answer to question 1 above, we think the same consideration should apply where there may be no risk of double charging but where the DNO is required to buy out a contractual right that was created when a different regulatory policy prevailed.

Moreover, the ability to recover a refund through the price control needs to be clear at the time that it is determined that a refund is merited, in order to minimise the additional risk to the DNO that has arisen as a result of a change in regulatory policy.

Question 3: *Are there any other instances (beyond that of double payment) where refunds should be funded through the price control? If yes, please explain why these instances are appropriate and compatible with the regulatory regime as it has evolved over time.*

Answer: For the reasons set out in our answers to questions 1 and 2 above we believe that it may be appropriate to allow a DNO to recover through the price control the cost of a refund in any circumstances where the DNO cannot now apply use-of-system charges without first compensating the generator in order to compromise an existing contract under which there was an express or implied right to free use of system (assuming that there is no other means of amending the contract). Ofgem has not demonstrated that such contracts would necessarily have been inconsistent with the regulatory regime that prevailed at the time.

Question 4: *Are there any other circumstances beyond capitalised O&M payments that may give rise to instances of double payment that should be reimbursed and funded through the price control? If yes, please explain why these instances are appropriate and compatible with the regulatory regime as it has evolved over time.*

Answer: Generators connected prior to 2005 may have connected under different regulatory regimes (including pre-privatisation) that may have made provision for costs other than capitalised O&M to be recovered under the contract. O&M costs are a prime example of double charging, but Ofgem may consider that the policy of avoiding double charging should apply generally, wherever double charging can be shown. If that is Ofgem's policy intention, it would be useful for this to be made explicit in the guidance to be issued. In all these circumstances, provided the DNO has behaved sensibly, treating the users of its network fairly, it would be appropriate for the DNO to be permitted to recover the costs of any compensation.

Question 5: *Do you agree with our proposed approach to calculating refunds for unexpired capitalised O&M payments? Please suggest any improvements to the approach outlined and reasons for these.*

Answer: The proposed approach to calculating refunds is appropriate although there could be issues to resolve where the DNO and the customer are unable to identify or agree the data concerned. The deadline of April 2012 may be difficult to achieve for both customers and DNOs, given the difficulties that there may be in sourcing all available data, carrying out an analysis and agreeing on a reasonable dataset.

Question 6: *Where DNOs have entered into agreements that are/were inconsistent with regulatory practice (e.g. giving indefinite rights to use of system without further charge or entering into contracts that cannot be freely modified) do you agree that any compensation required by virtue of these contracts should not be funded through the price control?*

Answer: We do agree with the broad policy intent conveyed by this statement. However, for the reasons set out in our answers to questions 1 and 2 above, we would caution Ofgem from taking an overly simplistic view of past regulatory and government policy. It was the norm to allow embedded generators free use of system before April 2005 and we are not aware of any clear regulatory presumption that such contracts should make provision for variation to introduce such charges in future. We recognise that contracts entered into since privatisation usually made provision for either party to propose variations and, if agreement could not be reached, for the matter to be referred to the regulator for determination. However, this is not necessarily the case for contracts entered into prior to privatisation. Neither does it necessarily follow that it would have been bad practice for a PES or DNO to have entered into an agreement that did not contain such provisions for referral of disputes.

Chapter 4. Implementation arrangements

Question 1: *In general are our proposals for implementing the refund arrangements considered by this consultation appropriate? Is the level of detail we have provided sufficient to make our proposals clear and workable? Please outline any areas where you think more clarity/detail is required.*

Answer: The proposals appear to be broadly workable and we agree that a structured approach is required in order to determine what would constitute a valid claim for compensation. However, Ofgem's intention that customers and DNOs should first decide whether compensation is due and that the DNO should then pay it with possible recovery at the price control review is not likely to be sustainable in all cases. A DNO cannot be expected to agree to pay any material amounts of compensation where there is a risk that this may not be recovered through price-controlled income. Where both the entitlement to compensation on the part of the generator and the entitlement to recover that compensation through the price control are clear, there may be few difficulties with the approach outlined by Ofgem. Where either or both of these are in doubt it is likely that the entitlement to compensation will have to be determined by Ofgem before the DNO will agree to pay it. In those circumstances it would be reasonable for Ofgem to state in its determination what the price control treatment of that compensation will be. This is in our view unavoidable.

Question 2*: In the section on "Consistent application of principles", have we appropriately identified who is eligible for a refund? Do we need to provide any further areas of clarification? Which of the two options outlined for mixed sites (demand and generation) are appropriate?*

Answer: We believe that option 1 is the most appropriate as it addresses the circumstances under which O&M was originally incurred and therefore whether a refund is appropriate. We agree that the Ofgem guidelines are clear relating to who is eligible for the refund.

Question 3: *Are the evidence requirements set out in the chapter as necessary to support a case for refunding appropriate? Are they sufficiently robust to prevent ineligible claims for compensation being recovered through the price control? Are there additional or alternative assumptions that could be used for supporting a case for a refund?*

Answer: In principle, the evidence requirements are reasonable. However, it has already been determined that some of the primary documentation may not be available. It needs to be made very clear that the onus should be on the applicant for compensation to substantiate his claim. Both parties should act in good faith, making available the relevant information that each may have. However, if the information has not survived, it will be impossible to substantiate the claim and no compensation should be paid.

Question 4: *Is our approach to due process appropriate? Are there additional or alternative steps that should be incorporated?*

Answer: We agree that the due process appears to be appropriate, but see our comments in response to question 7.

Question 5: *We welcome views on how refunds should be paid and the details of implementation. In particular, should it be a one-off payment, a phased payment or a hybrid of the two? If a refund is not a one off-payment, over what time period should it be paid? Do you agree with our proposals for refunds that are not agreed by 1 April 2012?*

Answer: We consider that the hybrid payment method is better and would suggest a one-off payment up to a threshold of £1m should be the norm. Above that there should be phased payments that would depend on the size of the refund concerned.

Question 6: *Do you agree with the mechanics for allowing DNOs to recover refunds through the price control?*

Answer: We agree with the principle of allowing refunds to be recovered through the price control, though under the arrangements proposed by Ofgem there would be an unacceptable risk to the DNO in providing a refund without any certainty that it can recover the amount through future price controls. To control that risk it is likely that DNOs will (where possible) refer requests for refunds to Ofgem for determination.

Question 7: *Do you agree with our proposals for dispute resolution where DNOs and DGs cannot reach a settlement by 1 April 2012? How can we encourage DNOs and DGs to reach a timely settlement? In particular, should use of system charges in respect of the DG be logged up and back-billed once a refund has been settled on? If these DGs do not have these charges back-billed, how should these charges be recovered by the DNO from other customers?*

Answer: We agree that timely resolution is desirable. However, it is not clear to us that either of Ofgem or the DNO can impose a date by which matters must be resolved (certainly in the case of contractual rights that may exist). The approach of 'logging-up' use-of-system charges in cases of dispute would appear to present a number of challenges, not least because these charges will ordinarily be payable by the licensed supplier that has contracted with the generator. It would seem far simpler to charge the use-of-system charges from April 2012, notwithstanding that compensation may subsequently be determined to be payable. This approach is also likely to encourage the parties to resolve any dispute regarding compensation as quickly as possible.