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Dear Nick,

Charges for pre 2005 distributed generators' use of DNOs' distribution systems – proposed guidance

Thank you for the opportunity to respond to the above consultation. E.ON continues to believe that those generators who connected prior to April 2005 should have their existing use of system rights honoured for a set period beyond their connection date.

We believe that this will be a fairer, more efficient and proportionate solution than has presently been proposed. In particular, it is likely to avoid the significant number of disputes that we anticipate under the process as currently set out. Under our suggested approach adjustments in the price control would not be necessary either.

In this response we also provide our interpretation of the pre 2005 regime which arises from our significant amount of experience of operating distributed generation and statements that have been made in the past by Ofgem as to how the charging arrangements work. Our experience of the regime and evidence that we present indicates that rights to use the system were afforded to generators who paid deep connections charges without the requirement to also pay export use of system charges.

We are therefore concerned that Ofgem's current alternative characterisation of the regime, which differs from previous statements it has made, leads to transitional arrangements which are less proportionate, fair and efficient than the alternative.

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Chapter Three, 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.

For us the key conclusion in the guidance document is the belief that the connection charge which was initially paid by pre 2005 distributed generators was not intended to buy rights to use of system without any further charge. We strongly disagree with this view.

We do not dispute that there may be some agreements between DNOs and generators which indicate that use of system charges existed as a concept in relation to generation connections. Our experience is that this is not very widespread and most agreements refer only to the levying of connection charges to generators in respect of the right to export onto the distribution system. Where the provision exists for a generation use of system charge, it is not clear that it was intended that deep connection costs and use of system charges were to be applied in respect of the same generation connection.

Our experience of dealing with DNO connections was that pre 2005, connections would be accommodated on a deep charging basis and use of system charges would not be applied in these circumstances. This appears to be the general perception too across the industry from the discussions that have taken place in past years on the issue of moving to a shallower regime with use of system charges. For the avoidance of doubt, all investments made by EON up to this point were made on the basis that by paying upfront deep connection charges, this would negate the need for ongoing use of system charges.

This also appears to be the previous opinion of Ofgem. For instance, in December 2000 Ofgem explained that "*Embedded generators presently pay the full capital cost of connection to the local distribution system, including the costs of reinforcement across the system. They do not pay use of system charges on their exports.*"[1]

Similarly, in September of 2001 the following statement was made:

"Embedded generators, unlike demand customers and unlike generators wishing to connect to the transmission system, pay 'deep' connection charges, but no UoS charges."[2] However, it also goes on to say that there is nothing preventing shallower charges being applied in respect of generation connections:

"*Because embedded generators cover all the costs of connection in one, up-front, 'deep' connection charge, they have not been required to pay DUoS charges. However, there is nothing to prevent DNOs from levying DUoS charges on embedded generators. Costs of connection that are not recovered through upfront connection charges could be recovered through some form of DUoS charge.*"[3]

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[1] Para 4.26 "The Structure of Electricity Distribution Charges - Initial Consultation Paper" Ofgem, September 2000

[2] Para 2.2 "Embedded generation: price controls, incentives and connection charging - A preliminary consultation document" Ofgem, September 2001

[3] *Ibid* para 2.8

It is clear from this paragraph that it was not intended that deep charging and use of system charges should coexist in respect of the same generator. This seems to be confirmed with a further statement in the same document which states that one benefit of deep charges is that they "*avoid structuring DUoS charges for generators*"[4]. We absolutely agree that deep charging and use of system charges should not coexist for the same connection. Otherwise, we believe that this would constitute double charging.

We note that the draft guidance refers to a determination made in 1995[5] by the Director General of Electricity Supply (DGES) and issued by the Office of Electricity Supply (OFFER). We were unable to find this initially, but you kindly sent a copy to us. Having studied the determination, unfortunately we do not fully agree with the interpretation provided in the guidance document. As you know, the basis of this dispute was that Scottish Power disagreed with Northern Electric wishing to charge it use of system charges on output from its Knapton power station. Scottish Power didn't believe charges should be levied as Northern Electric's charging statement contained a clause which stated:

"The conditions under which licensed generators connected to Northern Electric's distribution system may use the system are described in Northern Electric's statement of connection charges. In general, no separate charge will be made for use of the system in respect of electricity which the generator exports to the system."

However, Northern Electric argued that paragraph 11 of its charging statement could be relied on because it believed Knapton was an exceptional case.

"11. Where Northern Electric, after evaluation of the characteristics of the requested use of system, accepts that none of the categories of charges in the attached Schedule is appropriate, or where supplies are provided at EHV, Northern Electric will offer special arrangements."

In its ruling OFFER did not accept that this was an exceptional case as Knapton did not increase flows on the network when it was generating. It said that:

"If circumstances were to change such that, for example, additional embedded generation within the GSP changed the direction of real electrical flows on the relevant parts of its distribution system, it would be open to Northern Electric to argue that this was an exception to the general case. In these circumstances, Northern Electric could seek a variation to its use of system agreement with Scottish Power to reflect this."

This is not to say that this would have automatically led to a levying of use of system charges, just that an application could be made to reflect changing circumstances in the use of system agreement. However, another important conclusion to come out of the determination was the following:

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[4] I*bid* para 5.17

[5] "Determination by the Director General of Electricity Supply of a Dispute Referred to Him Under Condition 8C of the Public Electricity Supply Licence Concerning the Terms of a Connection and Use of System Agreement between Northern Electric and Scottish Power for Knapton Generating Station". OFFER, 27 June 1995

"Scottish Power has expressed concern that the information provided by Northern Electric to justify its proposed use of system charges is inadequate. I agree. It is unsatisfactory that a distribution business should set out a general principle with no express qualifications or explanation of when it will not apply, and then not abide by it. The licence requires that customers should be able to relate their charges to the principles set out in the Condition 8 charging statements."

Therefore, there was a clear message from the DGES/OFFER that if use of system charges were to applied to generation that the condition 8 statements should be explicit about the circumstances in which this would be the case. Unfortunately, we have been unable to access DNO charging statements sufficiently far back to ascertain whether they were generally clear about the circumstances under which generators would be charged use of system charges. Up to this point our assumption, which appears to accord with the rest of the industry, has always been that generators would be charged deep connection charges without a use of system charge.

The guidance also refers to the connection agreements that Ofgem has been able to study and concludes that they provided either no or limited rights to use the distribution system. Again, we disagree. Ofgem's interpretation appears to rest on the fact that many connection agreements require the user to be contracted with a supplier and for that supplier to enter into a use of system agreement with the DNO. This is because the contractual framework which was set up in respect of distribution connections is a tripartite arrangement which has been referred to as "the contractual triangle". Under this arrangement, the customer/generator has a direct relationship with the DNO through a connection agreement. However, in the majority of cases the agreement for use of system is made between the supplier and the DNO on behalf of the relevant customer/generator. The agreements between the suppliers and their contracted customers/generators complete the triangle.

Therefore, it is not surprising that generation connection agreements often do not refer explicitly to use of system rights. In other cases the generator is sufficiently large as to warrant a direct contractual relationship with the DNO for use of system. In other instances the generator contracted with a combined DNO/supplier, the Public Electricity Supplier (PES), and the contractual relationship was combined into one agreement alone. Therefore, there are a wide variation in the exact contractual terms which are used to create these relationships, depending on when the connection occurred and the DNO network to which the connection was made.

The fact that the generator or an associated supplier is required to enter into a specific use of system agreement in respect of a generation site does not imply that the previous regime entailed that deep connection charged generators would be charged generation use of system charges too, or that access to the network would only be provided if a use of system charge was paid. It was simply a feature of how the contractual relationships between the DNOs, the suppliers and their customers (demand and/or generation) were constructed. A generator would not be able to operate without this whole triangle of contracts being in place.

It does not change the fact that the generation sites were connected under a deep

charging policy and as a result no use of system charges were made, either directly by the generator or through their contracted supplier. The fact that we have seen no evidence of use of system charges being levied in respect of pre 2005 generators, however they were contracted, confirms this.

There are a number of reasons why DNOs would need a use of system agreement in place, which are not associated with the notion of charging for generation use of system. DNOs need to ensure that there is a supplier associated with an embedded customer/generator so that they are registered in the central trading arrangements and can be responsible for imports and exports from the relevant site. DNOs have a licence requirement to facilitate these meter point administration services and they require a trading party to be registered as responsible for each energised metering point at any time. This ensures that accurate metered volume data is made available to the central settlement systems; information which the DNOs also rely on for billing purposes. All export sites also have an import capacity associated with them. The distribution business would be keen to ensure that there is always a supplier in place to ensure that import distribution use of system charges can be levied.

A common clause which also may have confused the perception of the previous regime refers to users not actually having rights to use the distribution system at all. The context of this from our understanding is that this was to ensure that DNOs were not liable to pay compensation were the network to become unavailable. For instance, one example we came across was the following:

"*This Agreement shall not give the Customer any right to a supply of electricity or to use the Distribution System, and the Company therefore makes no warranty to the Customer in relation thereto. Without prejudice to the foregoing, but subject to the provisions of the Distribution Code, the Company shall be entitled to plan and execute outages of the Distribution System and the Company's Equipment at any time and from time to time.*"

This has been subject of some contention over a number of years especially as firmer rights are afforded to transmission connections. However, the generators were still clearly granted a right to use the distribution system, however non-firm that right may be, as they have been allowed to generate under these agreements.

The evidence appears to be clear that these generators who paid deep connection charges were granted rights to use the distribution system. It is also clear that they were, as a result of paying deep charges, not required to pay use of system charges for export as well. As a further example, in the Ofgem guidance document reference is made in section 3.5 to a common statement that existed in DNOs' UoS charging statements that "*In general, no separate charge will be made for UoS in respect of electricity which the generator exports to the system*". Given this clear and explicit statement of the previous general policy, which has been backed up by statements that Ofgem has made in the past as to how deep connection charging works, we are uncertain why it is necessary to undertake an assessment of the detailed terms associated with specific agreements in order to infer that a contrary position existed instead.

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

We do not. We continue to believe that generators who connected under the deep charging regime should be granted continued access to the distribution system under the same terms for a set period of time. As we mentioned in our previous response on this issue, we consider that this would mean extending these terms for such generators for a set period after the connection date of each generator, say to equate to a 25 year access right. For example, a generator connecting in 1995 would remain on its existing terms for a further 9 years until 2020. However, those with agreements from prior to 1987 would go straight onto the new regime from next April.

The benefit of this approach is that DNOs simply require a list of generators and associated dates on which they will be brought into the use of system charging base. There would be no requirement for Ofgem to allow additional money through the price control, unlike under the unbundled refund approach. It would also remove the requirement for lawyers from both generation companies and DNOs to scrutinise the terms of each connection and use of agreement, along with the past charging statements covering the relevant period, plus any correspondence associated with the construction and negotiation of each connection, to ascertain the exact level of compensation which is applicable. Our approach would be a pragmatic and proportionate way of addressing this issue which would save considerable time, effort and money.

Chapter Three, 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.

Our response to this question does not relate to funding explicit refunds under the price control as we do not believe that this is the correct approach. However, should our proposed approach be implemented, we would recommend that it is carried out for all connections, regardless of whether or not up front charges were made for reinforcing the network or for Repair and Maintenance. If a generator connected to a beneficial part of the network for the DNO, in response to the deep locational charge which existed, it should not be treated differently under our preferred approach of honouring the access right simply because no money was payable at the time as a result. In other words, it should not be discriminated against simply because it reacted correctly to a pricing signal.

Chapter Three, 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.

We are unclear as to why capital payments which were made to reinforce the network have been excluded from those payments that are eligible to be compensated. The argument made in the guidance document is that these costs have not been included in

the regulatory asset value for the DNO which is recovered through use of system charges and therefore if the generator is charged use of system this would not constitute double charging.

However, the fact that these costs do not form part of the overall allowable revenue of the DNO does not detract from the fact that, if the generator has paid up front for its access to the network, if it is then also charged a use of system tariff this represents a double charge for the same service. Not recovering the cost twice from users as a whole is a completely different issue from charging a specific user twice for providing its access to the network.

Therefore, pre 2005 generators would be required to pay up front for their access and then be subject to the same charges as those generators who subsequently connected under the new "pay as you go" regime. As an energy supplier, we do not believe that Ofgem would take a similar view if we adopted a similar pricing policy in respect of our energy customers, and rightly so. Therefore, we do find it difficult to understand why it is being proposed as the way monopoly network companies should treat their customers.

Chapter Three, 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.

As mentioned above, we do not support the approach and believe that honouring existing access rights for a specified period is the most appropriate solution.

Chapter Three, Question 6: Where DNOs have entered into agreements that are/were inconsistent with regulatory practice (eg 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 controls.

We do not agree with the interpretation of what was regulatory practice at the time and believe that this interpretation diverges from the previously stated position of Ofgem too. The problem with the transition arrangements set out in the guidance for moving onto the new charging regime is that they create a confrontational position between the DNOs and generators, whereas a cooperative approach would be more efficient and constructive. The path set out at present means that generators will have to expend a significant amount of effort to build up a "legal" case to persuade DNOs to pay out refunds, whereas the DNOs will be reluctant to do so as this would expose them to significant losses if the revenue is not allowed in the price control.

As we mention above, our approach of honouring existing rights for a set period would avoid a great deal of this confrontation and would not need an adjustment in the price control at all.

Chapter Four, 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.

As we have mentioned above, the DNOs will be extremely reluctant to pay out compensation as this may subsequently be disallowed as part of the reconciliation undertaken in the next price control review. This approach is unnecessary when the existing rights can be honoured instead.

All that needs to take place for this alternative process is for a list of sites to be compiled along with the dates when they transfer onto the new arrangements. This would not require an adjustment to the price controls. All that would happen is that the charging base over which allowed revenue is recovered would increase whenever another tranche of pre 2005 generators' existing rights expire and they go onto the new regime. A process would be required to agree the length of the rights for each generator. Providing the length is not unrealistic then the potential for dispute would be reduced.

Chapter Four, 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?

The consistent application principles appear correct, even if we disagree with the refund approach.

Chapter Four, 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?

We believe this element is unnecessary. Under our suggested approach the only evidence required is the connection date of the relevant generator and the deemed length of the access right.

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

As we mention above, we believe the process is unnecessary. However, we would point out that if Ofgem maintains that an explicit compensation process should be followed, then resolving all of the sites in time for April 2012 is an unrealistic target. We believe that that there is a risk that the approach being pursued at present will result in a significant amount of legal disputes.

Chapter Four, 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?

Although this issue could be avoided by following our suggested approach, it would be unrealistic to put a licence condition on DNOs to resolve all refunds by April 2012. This would increase the pressure on DNOs which is likely to result in even more difficulties in agreeing compensation claims.

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

As we mention above, we believe the process as set out will make the DNOs extremely risk averse and therefore make it extremely difficult for generators to seek compensation.

Chapter Four, 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?

The dispute process set out in the guidance appears to be an opinion that disputes would fall under existing provisions for resolving disagreements over proposed amendments to agreements. As such it doesn't appear to be a proposal as such. Each case would presumably have to be considered in isolation and we assume that nothing in the guidance itself would remove the rights of parties to seek redress through whatever avenue was applicable and open to them in the particular circumstances.

Summary

We have set out above how we believe that:

- Under the pre 2005 regime, generators were afforded access rights by paying deep connection charges and it was not anticipated by the industry or Ofgem that these generators would also pay use of system charges.

- That to charge these generators use of system would be to double charge them for the same service, even if cost recovery through the price control is not duplicated.

- That honouring these existing rights for a set period would be a fairer and more proportionate solution, that would help reduce the potential for legal disputes and avoid the price control reopeners presented by the current proposed solution.

We would therefore urge you to reconsider your position on this issue.

I hope that the above proves helpful. Please call me on the above number should you wish to discuss this further.

Yours sincerely

Paul Jones
Trading Arrangements