



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

Promoting choice and value for all gas and electricity customers

Direct Dial: 020 7901 3064
Email: lawrence.irlam@ofgem.gov.uk

Date: 10 February 2012

Dear colleague

Use of system charges for distributed generators: decision to allow a time-limited exemption for pre-2005 generators

On 21 October 2011 Ofgem published a consultation document entitled 'Distribution use of system charging: a time-limited exemption for pre-2005 generators' (ref 135/11).¹ This document outlined our decision to offer an exemption from use of system (UoS) charges for distributed generators (DGs) that connected to distribution network operators' (DNOs) networks before April 2005. We also outlined our initial thinking that a 20 year exemption would strike an appropriate balance between the interests of DGs and customers, while also achieving our policy objective of having all DGs placed onto a common charging methodology in a timely manner. Our document also canvassed other implementation issues for stakeholder comment, including due process and how the commencement and end dates of exemptions would be determined.

This letter sets out our decision with respect to the duration of the exemption as well as providing further guidance on associated implementation issues. In addition we provide relevant feedback on responses to our October 2011 consultation.¹

Background

Prior to 1 April 2005, DGs paid a 'deep' connection charge which included the full cost of sole use assets, any reinforcement of the shared network and in most cases capitalised operation and maintenance (O&M) payments. DGs did not generally pay UoS charges for energy they exported onto DNOs' networks. On 1 April 2005 Ofgem introduced a 'shallowish' connection charge which covers the full cost of sole use connection assets, but typically only a proportion of any reinforcements of the shared network. UoS charges were also introduced for DGs at this time.

In our DPCR5 decision we set out that, on the introduction of UoS charges, there may be circumstances in which it might be legitimate for DNOs to refund pre-2005 DGs in recognition of the payments they made on connection. In May 2011 we consulted on principles for determining refunds, however in response to stakeholder comments, decided in October to offer instead a time-limited exemption.

Decision

Having considered responses to our consultation, we have decided to provide a time-limited exemption of 25 years to pre-2005 DGs. While this results in some delay in achieving Ofgem's objective of placing pre-2005 DGs on equal footing with post-2005 DGs, the

¹ See

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=763&refer=Networks/ElecDist/Policy/DistChrgs>

additional 5 years is anticipated (based on responses) to remove the risk of some DGs potentially paying twice for costs captured by the UoS charge and the connection charge. In particular, a 25 year exemption aligns with the longest period for which O&M charges were identified in contractual information examined by Ofgem. Our decision is also based on the following considerations:

- We acknowledge the reasoning presented by many respondents that DGs may have based their expectations with respect to UoS cost recovery on the technical life of their generation plant, and perhaps even longer in the case of network assets, however this is not supported by cases of O&M charges being capitalised over matching timeframes.
- A period of 25 years corresponds with the economic lives over which most plant are financed and are expected to earn a return, which is a more appropriate basis for charging arrangements than plant technical lives.
- While some pre-2005 DGs argue they have already paid for UoS costs or did not expect to be charged, we are conscious that UoS payments being made by post-2005 DGs may create a potential competitive disadvantage. Similarly, we have some reservations that other customers are bearing the cost (eg O&M) of assets used by exempt DGs.

The following also form parts of our decision:

- Commencement date for exemptions — as per the suggestion in our consultation paper, the exemption will commence from the date of a DG's connection. Where this cannot be determined, the date of energisation will be used as a proxy. 31 March 2005 is the latest permissible date of connection for the purposes of determining any exemption, regardless of whether the date of connection or energisation is being relied upon.
- Special circumstances — sites that have been subject to changes in capacity since the original connection date will have separate commencement dates that apply for the original and any new installed capacity (as per the method for determining any exemptions that have applied to date).
- Sites with mixed demand/ generation — our decision does not provide for specific treatment of such sites, that is, the generation component of mixed sites (ie export charges) will be subject to exemption provisions as per purely generation customers.
- Eligibility for exemption where DGs currently pay annual O&M charges — where such charges form part of a customer's connection agreement they should continue to be paid regardless of any exemption from UoS charges. This ensures fairness between those that did and did not pay capitalised charges upfront and also protects other customers.
- Decisions to opt into UoS charging arrangements — eligible DGs who choose to continue to be exempt from UoS charges can subsequently opt into UoS charging arrangements at any time in the future. However, once a DG has made this decision it cannot choose to opt out again, regardless of its eligibility for exemption.
- Notification timeframes and default arrangements — DGs eligible for exemption should indicate to their DNO their choice whether to continue with any existing exemptions or to opt into UoS charges by 30 June 2012 with respect to the 2013 charging year, and by 1 November with respect to subsequent charging years. If for any reason a DNO has not been informed otherwise, DGs will default to the following arrangements:

- The Common Distribution Charging Methodology (CDCM)² applies – UoS charges continue to be levied (as they are expected to receive net credits)
- The Extra-High Voltage Distribution Charging Methodology (EDCM) applies and DG is eligible for exemption from UoS charges – exemption from UoS, up until any decision to opt in or at expiry of their exemption period
- EDCM applies and DG is ineligible for exemption – UoS will begin to be levied from the commencement of the EDCM.

Further details on our reasoning and responses to consultation are contained in annex 1.

Next steps

The table below confirms our expectations of the next stages of implementation, reflecting the general support and specific suggestions provided by several respondents.

² Note that some customers will be affected changes to the boundary for CDCM and EDCM charging that will take effect from 1 April 2013 (in accordance with Ofgem's decision of 20 December 2011) and our expectation that further changes to the EDCM for DG will be approved later this year and implemented from the same date.

Table 1 – steps in due process/ implementation

Task and responsibility	Expected timing
DNOs write to all of their pre-2005 DGs: <ul style="list-style-type: none"> • making them aware of Ofgem’s decision • setting out the default position that will apply to them (ie what will apply if they are eligible for a UoS charging exemption but do not express a preference) • setting out the options (if any) available to the DG and the timeframe in which they can exercise those options • where a DG is eligible for an exemption, setting out the date on which the exemption will end and how this was determined • inviting the DG to submit any further evidence or to correct any inaccuracies that may affect their eligibility for the exemption or the date on which the exemption would end. 	Feb-March 2012
DG responds to the DNOs to either: <ul style="list-style-type: none"> • confirm that they understand that they will either be charged (or continue to be charged) for UoS from a specified date or exempt from UoS charges until a specified date • respond with any further information not identified by the DNO which is relevant to the case. 	April
DNOs consider further evidence put forward by the DG and respond to DG on whether they propose to change their earlier assessment on the eligibility for an exemption and the reasons for this. DNOs provide DGs illustrative charges under amended EDCM (as per that submitted to Ofgem).	By 1 June
DGs to respond to DNOs with their decision to opt into UoS charges	By 30 June
If the DNO and DG cannot agree on particulars of exemption, then either of the parties may consider legitimate alternative dispute resolution.	From July 2012
DGs to indicate their choice to opt into UoS charging arrangements on 1 April in the next charging year.	By 1 November each year

A full summary of responses against issues raised in our consultation paper, and our views on each, is at annex 1. If you have any queries related to this letter please contact Lawrence Irlam on 020 7901 3064 or at lawrence.irlam@ofgem.gov.uk.

Yours faithfully,



Rachel Fletcher
Acting Senior Partner, Smarter Grids & Governance: Distribution

Annex – Summary of responses

Exemption instead of rebate (question 1.1)

There was unanimous support for Ofgem's decision to provide eligible DGs a time-limited exemption from UoS charges rather than have DNOs refund unexpired capitalised O&M costs which were part of most pre-2005 DGs' connection charges. Some stakeholders added that DGs should be aware of the likely charges they would face before deciding to opt for exemption. One respondent considered that exemptions derived from contract terms (where available) should be given precedence over a blanket exemption, while another considered that eligible DGs should not be given the choice regarding the exemption.

Our view is that an exemption for affected DGs rather than specific refund arrangements is a pragmatic solution to avoiding double charging for items covered by UoS charges. Provision for exceptions, including precedence of contractual terms, would be difficult to administer and potentially infeasible for the majority of DGs. We also consider that if such contracts (if they exist and cannot be modified) are not compatible with the regulatory framework as it existed pre-2005 (eg the Knapton determination discussed in our earlier consultations³) then they should not form the basis on which to set the length of an exemption. Offering eligible DGs the choice to opt into paying UoS charges is consistent with our objective to have all DGs facing the same charging arrangements.

Exemption on ex ante terms (question 2.1)

All respondents supported an ex ante approach. One respondent commented that where a DG's connection agreement specifies any trigger events that affect changes to charges that this should be preserved.

We confirm our view that exemptions on ex ante terms will provide clarity and certainty for stakeholders, and also be cost effective to administer. The preservation of any contractual provisions, subject to the exemption from UoS charges, would be for parties to consider as part of any contract renegotiations but we would expect these to be consistent with the regulatory framework.

Commencement and end dates for exemption (questions 2.2, 3.4 and 3.6)

There was mixed support for defining the exemption commencement date as the date of connection or the date of energisation. Some respondents that supported the connection date considered that the date of energisation should be used as a proxy if the connection date could not be determined. Three respondents considered that the date the DG first exported/ had opportunity to export onto the network should be used. One respondent supported Ofgem's suggested 20 year exemption on the proviso that all exemptions commence from 1 April 2005. All respondents supported the introduction of UoS charges from the beginning of the charging year after the date on which exemptions end, with some noting this reduced the materiality of correctly determining the commencement date.

Several respondents questioned how the appropriate commencement date would be determined for sites where original connection arrangements had been modified, for example to accommodate greater export capacity.

³ See for example, page 18 of our 9 May 2011 consultation document "Charges for pre-2005 distributed generators' use of DNOs' distribution systems – proposed guidance".

We confirm our view that the exemption should commence from the date of connection, and where this cannot be determined the date of energisation should be used as a proxy. To avoid mid year changes in a DG's charges, the exemption will expire at the end of the relevant charging year, rather than on the exact date on which the exemption expires.

In circumstances where a DG's connection arrangements have changed since the date of its original connection, Ofgem's understanding is that DNOs have applied separate charging arrangements with respect to each expansion in connection capacity. In such instances different commencement dates exist for particular increments in capacity which have been used to determine whether such capacity subject to or is exempt from UoS charges. For the sake of consistency these dates for each increment of capacity should also be used as commencement dates for any exemptions under Ofgem's decision. For the purpose of this decision, 31 March 2005 will be the latest possible commencement date for exemptions, regardless of whether the connection or energisation date is being used.

Determining the exemption length (questions 2.3 – 2.5)

The majority of respondents advocated an exemption duration of longer than 20 years. Many considered that the life of generation investments (Ofgem's option 2) should form the basis of this decision, reflecting the investment expectations of DGs at the time of connection, and by implication the contribution they may have anticipated to make (if any) to UoS costs.

Several respondents referred to the lives set out in table 2.3 (replicated below), noting that 20 years was the minimum possible duration that could be derived from these data. Some respondents also highlighted that hydro generation was not listed.

Table 2.3 – average investment and economic lives by technology type

Technology type	Redpoint Energy: investment life (years)	Mott Macdonald: economic life (years)
CCGT	20	35
Coal (ASC)	25	45
Coal (IGCC)	25	35
Coal (ASC) + CCS	25	40
Coal (IGCC) + CCS	25	n/a
Onshore wind	20	25
Offshore wind	20	25
Biomass	20	30
CHP	20	n/a
Marine	25	n/a
OCGT	20	30
Gas engines	n/a	20

Our suggestion of a 20 year exemption duration was not tied to any particular data source. Instead it was intended to be a pragmatic solution given the limited contractual information available, particularly where such information would have otherwise facilitated specific refund arrangements, and was regarded as striking an appropriate balance between the interests of pre-2005 DGs (and their argument that they did not expect to pay UoS costs) and of other customers (who would have to pay for the costs that these DGs impose on the networks during their exemptions).

Our decision to provide for a 25 year exemption reflects the preference for a longer duration expressed by the majority of respondents and is intended to remove the risk of DGs potentially paying twice for UoS (ie instances where payments for O&M were capitalised over periods longer than 20 years).

Eligibility for exemption from UoS charges and existing annual O&M charges (question 2.6)

Almost all respondents considered that if an eligible pre-2005 DG is currently paying annual O&M charges, these should continue to be paid regardless of any UoS exemption.

Our view is that DGs eligible for a UoS exemption that currently pay annual O&M charges should continue to do so, on the basis that this reflects their contribution to UoS costs in a manner intended by the previous and current charging regimes. This is consistent with the intention of our decision that DGs who paid for such O&M charges upfront should now be exempted for an appropriate period of time.

For the purpose of clarity (including with respect to respondents' questions about other contractual provisions) our decision is not intended to modify the terms of existing arrangements, but should simply determine the maximum length of time for which existing exemptions can continue to apply.

Implementation and dispute resolution process (questions 3.1 – 3.3)

Most respondents agreed with the due process outlined in our October consultation paper. Respondents highlighted that indicative tariffs should be provided to DGs to better enable them to opt for an exemption, suggesting time periods of between 6 to 18 months for DGs and DNOs to confirm (including through dispute resolution) the conditions on which a DG would be exempted. Respondents considered that any disputes arising between eligible DGs and DNOs should be resolved via the Electricity Arbitration Association rather than Ofgem.

Many respondents expressed concerns over the ability of DNOs and DGs to effectively correspond with one another and ensure that DGs were furnished with all relevant information in a timely manner and so suggested Ofgem take a role in facilitating this process. Several respondents requested further detail on the process, including clarity on evidence requirements, who would bear the cost of dispute resolution, and any default position in the event one party failed to contact the other.

Table 1 of this letter confirms our expectations regarding due process, including expected timeframes for notification and dispute resolution. From the date of this decision letter, DNOs and DGs will contact one another regarding their eligibility and decision to opt out of UoS charges. We consider it appropriate that DNOs use best endeavours to contact DGs, including contacting relevant Suppliers. It would be useful for DGs (including through representative agencies) to contact DNOs and Suppliers to ensure their contact details are correct. In the event parties fail to contact one another, the default position is that DGs under the EDCM continue to be exempt (on the presumption they would otherwise face positive UoS charges) while those under the CDCM continue to be charged (where they will likely receive net credits).

We consider that DGs should not be provided an open ended ability to opt for exemption, and that they must confirm their choice with DNOs sufficiently prior to the commencement of the 2013 charging year (including allowance for any potential disputes to be resolved). Consistent with our intention that all DGs should be covered under the EDCM, DGs will have the ability to opt into UoS charging arrangements at any time, provided sufficient notice is given to the DNO (we suggest at least 5 months prior to the commencement of the next charging year to allow DNOs sufficient time to calculate indicative tariffs). For the charging

year commencing in April 2013, given parallel changes to the EDCM underway, DNOs should provide illustrative charges to DGs by 1 June (coinciding with their EDCM methodology submission to Ofgem under their amended licence conditions) to help inform their decision to continue with any existing exemption. We suggest that DNOs provide indicative EDCM tariffs on the following basis:

- site specific sole use asset charges (unaffected by other DGs' decisions to opt in to charging)
- site specific credits (unaffected by other DGs' decisions to opt in to charging)
- with respect to capacity charges, DNOs should consider providing estimates of the maximum and minimum charges likely to be faced by DGs, which will depend on assumptions around whether eligible DGs will choose to opt in to UoS charges.⁴

With respect to dispute resolution, we note respondents' views regarding the Electricity Arbitration Association. As outlined in our October consultation paper, Ofgem may consider disputes over the proposed terms of a new or amended connection of UoS agreement when requested to do so and where it has the vires to do so.

We reiterate our view that evidence requirements should be kept simple. Given our decision has been to provide for a generic 25 year exemption, evidence requirements should be limited to determining the appropriate commencement date, namely the date of the connection agreement (including that applicable for any additional capacity that has since been installed) or otherwise the energisation date. Where a specific date is not supported by evidence, we consider that 1 April of the relevant year should be used.

Treatment of sites with mix of import and export (question 3.5)

In line with the views of respondents, we reiterate our view that sites with both demand and generation characteristics should not be treated any differently with respect to their generation charging arrangements, including eligibility for exemption.

⁴ This assumes that the methodology will give all DGs the same capacity charge (£/kVA), ie that it will use a fixed adder to allocate these costs, which would be compatible with the view set out in our letter of 2 February 2012 "Distribution use of system charging – decision and further guidance on higher voltage generation charging".