EXPLANATORY MEMORANDUM TO THE

THE ELECTRICITY (CLASS EXEMPTIONS FROM THE REQUIREMENT FOR A LICENCE) (AMENDMENT) ORDER 2005

2005 No. 488

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 The Order harmonises certain licence exemption arrangements for electricity generating stations across Great Britain, by extending to Scotland an automatic exemption for a certain class of generating stations that currently only applies in England and Wales.

2.2 Specifically, the Order extends to Scotland the class exemption in Schedule 2 Class C of the Electricity (Class Exemptions from the Requirement for a Licence) Order 2001 for generators not exceeding 100 megawatts.

3. Matters of special interest to the Joint Committee on Statutory Instruments or the Select Committee on Statutory Instruments

3.1 None

4. Legislative Background

4.1 The class exemption is made under the powers conferred upon the Secretary of State by section 5 of the Electricity Act 1989, which is concerned with (among other things) the power to grant exemptions from the requirement to hold licence for generation of electricity. This Order is being made after public consultation, and consultation with the Gas and Electricity Markets Authority, the Scotland Office and the Scottish Executive.

4.2 This power was previously exercised when the Electricity (Class Exemptions from the requirement for a licence) Order 2001 was made on 28th September 2001. This granted an automatic licence exemption to this class of generating station (known as "Class C") in England and Wales. This was not extended to Scotland, as at the time Scotland operated a different and separate electricity market framework.

4.3 The Energy Act 2004 (Part 3, Chapter 1) provided for the introduction of a single electricity trading market across Great Britain. This is expected to go live on 1st April 2005. It would be desirable for the rules governing automatic licence exemption for this class of generating station to be applied uniformly throughout Great Britain at this point, by harmonising the arrangements governing class exemption for generation stations within the category.

4.4 This Order applies the power again to make an amendment to the original class exemption Order that extends the exemption for Class C generating stations to apply to Scotland.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

Not applicable

7. Policy background

7.1 In England and Wales, generating stations that export between 50 and 100MW of electrical power to the transmission and distribution networks, and that were connected to the transmission or distribution networks on or before the 30th September 2000, are automatically licence exempt. This automatic class exemption was defined in an Order made in 2001 under the Electricity Act 1989 (as amended). This automatic class exemption does not extend to Scotland, which currently operates a separate electricity market.

7.2 This issue has arisen as a consequence of the planned introduction of the single electricity market across Great Britain through the British Electricity Trading and Transmission Arrangements (BETTA). It is currently anticipated that this will happen on 1 April 2005. It would be desirable for the rules governing automatic licence exemption to be applied uniformly throughout Great Britain, by harmonising the arrangements governing class exemption for generation stations within the category.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

9. Contact

David Curran at the Department of Trade and Industry, Tel: 02072152779 or e-mail: david.curran@dti.gsi.gov.uk, can answer any queries regarding the instrument.

The Electricity (Class Exemptions from the Requirement for a Licence) (Amendment) Order 2005: Regulatory Impact Assessment

1. Title of Proposal

A Statutory Instrument harmonising certain arrangements for the exemption of electricity generating stations in Scotland capable of exporting 50-100 MW of electricity to the transmission / distribution network and connected on or before 30 September 2000 with current arrangements for such generators in England and Wales.

2. Purpose and intended effect of the measure

(i) The objective

The aim of this Order is to harmonise the positions of electricity generating stations of a certain class (i.e. capable of exporting 50-100 MW to the overall electricity system, and connected on or before 30 September 2000) in Scotland, with the same generating stations in England and Wales, whilst avoiding any potential risk to the safe and secure operation of the electricity system. This is a consequence of the introduction of the British Electricity Trading and Transmission Arrangements (BETTA), which will create a single set of electricity trading and transmission arrangements across Great Britain.

(ii) The background

This issue arose as a consequence of the planned introduction of BETTA – revised wholesale electricity trading and transmission arrangements for Great Britain based upon electricity trading arrangements that currently operate in England and Wales, with some modifications. This is expected to take place on 1 April 2005.

At present, all generating stations in Great Britain that export under 50 MW of electrical power to the transmission or distribution networks and have a declared net capacity of less than 100 MW are exempt from the requirement to possess an electricity licence. In England and Wales, generating stations that export up to 100 MW of electricity and that were connected on or before 30 September 2000 are also automatically licence exempt as a result of Schedule 2, Class C of the Electricity (Class Exemptions from the Requirement for a Licence) Order 2001. Generating stations that meet the criteria for being exempt (i.e. those that are automatically exempt and those that have applied for and received an exemption) are described as *"exemptable"* generating plant for the purposes of the BSC.

Generating stations that could be automatically exempt, but choose to remain part of a licenced business, are able to realise the benefits of being licence exempt even if a licensed generator operates them. These benefits arise primarily, but not wholly, from the fact that exports from embedded exemptable generating plant may be netted off local demand for the purposes of imbalance settlement and certain transmission charges.

Licence exemptable generating stations are not required to be parties to some of the industry codes that govern the functioning of the electricity market (e.g. the BSC) since they can instead embed themselves behind a larger generator who undertakes their duties. Parties to these industry codes are required to meet various costs associated with the administration and development of the codes.

The automatic class exemption for plant capable of exporting up to 100 MW to the total system that was connected on or before 30 September 2000 does not apply to Scotland. The wholesale electricity market in Scotland is currently separate from that in England & Wales, although there has been physical trade between the two markets via the Anglo-Scottish interconnector. In the context of the introduction of the single wholesale electricity market across Great Britain through BETTA, planned for April 2005, it was proposed in the consultation document that the arrangements governing class exemption for stations within this category should be harmonised, by extending the 2001 automatic licence exemption to Scotland.

An essential precondition of a final decision is that DTI wishes to ensure that a robust contractual framework will be in place to ensure the safe and secure operation of the distribution and transmission electricity systems (the reasons underlying this precondition are discussed in further detail in part (iii) of this section).

There are understood to be four generating stations in Scotland that would be directly affected by the proposal. They are all owned by Scottish and Southern Energy (SSE) Generation Ltd, which is a licensed business:

Name	Export (MW)	Type of plant	Year built	Connection method
Errochty	75.0	Hydro electric	1955	Transmission
Clunie	61.2	Hydro electric	1950	Transmission
Fasnakyle	69.0	Hydro electric	1951	Transmission & distribution
Lerwick	67.2	Diesel generator	1953	Distribution

The DTI understands that it is unlikely that any of the generating stations will seek to become licence exempt at BETTA go-live, and that the stations will prefer to derive the benefits that stem from being licence exemptable whilst remaining within the licensed generation business.

(iii) Risk assessment

Potential risks to the stability of the transmission system

The partial regulatory impact assessment noted that extending the exemption to Scotland with no additional requirements would pose certain risks, notably with regard to the safe and secure operation of the electricity network in Scotland. This risk to local security of electricity supply was caused by differences between the characteristics of the electricity transmission and distribution networks in Scotland and those in England and Wales.

When generating stations in England and Wales capable of exporting up to 100 MW to the total system were given an automatic exemption from licensing requirements, it

was considered that stations up to that capacity were small in terms of their influence on the network, and were not used to help manage the integrity of the transmission system.

In contrast, in Scotland the local transmission network generally incorporates lower voltages than in England and Wales, and the nature of the system is different, in that in some areas of Scotland, the system tends to be more radial in nature. Consequently, smaller generators can have more of an impact on the operation of the transmission system. For example, under the existing Grid Codes, while generators capable of exporting up to 100 MW to the total system are classified as "medium" in England and Wales, they are considered to be "large" in Scotland (in fact in SHETL's region of Scotland the definition of "large" extends down to 5MW, whereas the limit is 30MW in SPT's region).

Before extending exemption to such generators in Scotland, the RIA noted that the Government needed to be satisfied that to do so would not have any harmful implications for network security, given the greater impact of such generators on the Scottish network.

Certain provisions would need to be met – and it was believed that these could be met by the EELPS proposals. The proposals, which were the subject of consultation by Ofgem, provided for case-by-case agreements between generating stations and the System Operator, reflecting the level of information and services required from individual generating stations to ensure the safe and secure operation of the system. It was expected that these agreements would contain requirements regarding data that a generating station would be obliged to provide to the System Operator, and services that the generating station would have to be able to provide, on request, to the System Operator to ensure the stability of the network as a whole. The agreements could concern – where necessary - the submission of specified information and data regarding output levels to the System Operator, as well as in some circumstances the provision of certain ancillary services.

The general objective of the EELPS provisions is to ensure that necessary services and information that the generating stations provide to the network operator are provided under BETTA. Ofgem recently announced its conclusions on the EELPS consultation (and launched a consultation on Code changes to implement the provisions)[1]. DTI is of the view that the EELPS provisions satisfy the requirements in the licence exemption consultation document; it is anticipated that EELPS agreements for generating stations that are critical to the safe and secure operation of the system will be completed prior to BETTA go-live.

3. Policy decision

Two options were considered:

Rejected option: The status quo

By not extending Schedule 2, Class C of the Class Exemptions Order to Scotland, any generating stations in that category would have had to apply for individual licence exemption for the affected generating stations, or meet the additional administrative

[1] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9946_treatment.pdf

and financial obligations that would be associated with not being an exempt generating station.

It was noted in the consultation document that the DTI's position is that it is, in general, sympathetic to requests for individual exemption from generators capable of exporting no more than 100 MW to the total system, and, following discussion with interested parties, including the Scottish transmission and distribution operators, it had granted such exemptions to Scottish stations during 2004. It was noted that this option would not pose a threat to the safe and secure operation of the electricity network in Scotland, as the process of granting individual licence exemptions is generally associated with the imposition of conditions.

It was likely that, in the absence of the proposed Order, the distribution-connected generating stations would apply for individual licence exemptions. Applying for individual licence exemptions would place an administrative burden on the part of the operator of the generating stations, but would ultimately lead to a similar result.

Retained option: To extend the class exemption to apply to Scotland, on the basis that suitable agreements are made to apply to relevant generating stations concerning provision of services and information necessary for the safe and secure operation of the electricity system prior to the exemption being granted

The Government considers that suitable assurances relating to the safe and secure operation of the electricity network have been provided by the implementation of recent proposals in relation to Embedded Exemptable Large Power Stations (EELPS), on which Ofgem has consulted[2] and announced its decision[3], and to which these generating stations will be subject.

Among other things, the EELPS proposals will ensure that this class of generating station continues to provide necessary technical compliance, information and, where required, services to the GB System Operator, possibly through the local distribution company. It is intended that these obligations will be broadly similar to existing local obligations imposed on these generating stations prior to the implementation of BETTA.

4. Costs and Benefits

The sector likely to be affected by the proposed regulation is electricity generation in Scotland, and specifically those generators capable of exporting between 50 and 100MW to the total system. At present the Scottish generation market is dominated by two large vertically integrated companies, Scottish Power and Scottish and Southern Energy.

No new benefits would arise from adopting the rejected "do nothing" policy in this instance. This would not make the licensing regime consistent with the DTI's policy of extending competition, which is in the spirit of BETTA, which aims to create a GB wide "playing field".

[2] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9173_25304.pdf
[3] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9946_treatment.pdf

The main advantage of the chosen option is that it harmonises the position between Scotland and England & Wales. Operators of exemptable plant will benefit from the realisation of so-called "embedded benefits", that would not otherwise be available without them having to pay the costs of applying for individual exemptions.

"Embedded benefits" is the name given to the collection of economic benefits that arise from licence-exempt, exemptable and/or distribution-connected generation being treated as negative demand for charging purposes since these stations do not impose costs on the transmission network. Embedded benefits are consequently efficiency gains and may be summarised as the avoidance of:

- Transmission losses – electricity is lost as it is transported along the high voltage transmission network; the cost of this lost electricity is charged to transmission-connected generators and suppliers on the basis of their metered volumes.
- Transmission Network Use of System (TNUoS) charges – all transmission-connected generators and suppliers must pay an annual fee for making use of the transmission network; this fee varies geographically and is based on installed capacity for generators.
- Balancing Services Use of System (BSUoS) charges – all parties to the Balancing and Settlement Code (BSC) must contribute towards the System Operator's costs of balancing the supply of, and demand for, electricity; the cost is recovered as a flat rate fee per MWh of electricity produced/consumed by each party.
- ELEXON costs – ELEXON is the company that administers the balancing and settlement arrangements specified by the BSC; all parties to the BSC must pay for ELEXON's annual running costs.
- Residual Cashflow Reallocation Cashflow (RCRC), also known popularly as the "Beer Fund" – the total amount of money that is left over after the resolution of electricity imbalances have been financially settled; this sum is paid to or recovered from BSC Parties in proportion to their metered volumes.

An estimate of the value of these benefits for the Fasnakyle and Shetland plants, which are connected to the distribution network, is as follows:

Fasnaklye: Embedded Benefit [4]	£/MWh	£
Transmission Losses (2% of output @ £29/MWh)	0.58	35,400
Benefit of avoiding demand TNUoS charges (20 MW @ £0/kW)[5]	0.00	0
BSUoS charges, net of RCRC (source: SSE)	1.20	73,000
ELEXON Costs & Trading Charges (outside NETA) (Source: SSE)	0.24	15,000
Total	2.02	123,400

[4] The benefits for the Fasnakyle plant are based on an estimated annual output of 61 GWh. In calculating the benefits of avoiding Transmission Losses, it has been estimated that existing E&W losses in England and Wales will increase with the inclusion of the Scottish network losses up to an approximate total of 2%. An estimate of £29 per MWh has been used as it is the current forward baseload price of electricity in 2005/06.

[5] The GB-wide transmission charging regime post-BETTA has yet to be approved. NGC's current proposals are that the demand TNUoS tariff in North Scotland should be £0/kW in 2005/06 (http://www.nationalgrid.com/uk/indinfo/betta/pdfs/0105_GB_Charging_Revised_Conclusions.pdf).

Shetland: Embedded Benefit [6]	£/MWh	£
Transmission Losses (2% @ £29/MWh)	0.58	92,800
Benefit of avoiding demand TNUoS charges (25 MW @ £0/kW)[7]	0.00	0
BSUoS charges, net of RCRC	1.20	192,000
ELEXON Costs & Trading Charges (outside NETA)	0.24	38,000
Total	2.02	322,800

The cost to the transmission-connected stations is more difficult to quantify, and arises from the fact that transmission-connected generating stations that are licence exemptable can aggregate their exports as negative demand (i.e. consumption) for the purposes of energy imbalance settlement.

It should be noted that other users of the system will have to pay for some of these costs – such as ELEXON charge – as the total cost of running the system is approximately constant. However, given that the operator of the affected generating stations would be likely to apply for individual exemptions if the exemption was not extended, and that DTI is generally sympathetic to such requests, it is likely that they would have faced these costs if this option had not been chosen.

The overall economic net benefit of the chosen option is therefore likely to be positive.

5. Equity and Fairness

This is a legislative change affecting the application of licence exempt status to a small number of electricity generating stations in Scotland. It is not expected to have any impact on any particular racial, gender, income, age or disability group. It will be implemented in a way that maintains the safe and secure operation of the electricity network, which is necessary to maintain a reliable supply of electricity in Scotland, which is beneficial to all social groups.

6. The Small Firms' Impact Test

This legislation to be made under the retained option will not have a direct impact on small businesses in the UK. This is because the proposed legislation only affects the status of four electricity generating stations owned by one company, Scottish and Southern Energy Plc (SSE). With just under 10,000 employees, as one of the largest energy companies in the UK, SSE is not a small firm.

As it does not apply to any existing small firms, and would not be applicable to any new firms, this policy will not increase or reduce the regulatory burden on small firms generally. In the light of this, stage one of the Small Firms Impact Test[8] was not implemented. This has been discussed with the Small Business Service, who have agreed this approach.

[6] The benefits for the Shetland plant are based on an estimated annual output of 160 GWh, with the same estimates of transmission losses and forward baseload price s for the Fasnakyle generating station.
[7] See note for Fasnakyle generating station TNUoS charge.
[8] Details of stage one of the Small Firms Impact Test are available at:
http://www.cabinetoffice.gov.uk/regulation/ria-guidance/content/impact-test/index.asp

7. Competition Assessment

Following consultation with potentially affected parties, it is understood that the legislation only affects four relatively small generating stations in Scotland, all of which are owned by one company. Even if one makes the rather extreme assumption that all four stations have 100% load factors, this implies that their total electricity output in any given year is approximately 2.4TWh collectively. This would have been equivalent to just 0.6% of total UK generation in 2003[9].

The generation market – once BETTA comes into force – will have 12 major participants as well as a number of smaller parties. Only two of the participants (according to the latest available data) have a market share of over 10% and none owns a share of over 20% by volume of electricity generated.

As mentioned above, the only company that is affected by the proposed Order is SSE, the 5th or 6th largest participant, and the affected stations form only a small part of its total electrical output. This proposal is intended to harmonise the position of these generating stations across Great Britain, and ensure a transparent and uniform market structure.

It is not anticipated that the regulation will lead to higher set-up costs for new or potential firms that existing firms do not have to meet as a result of the proposed legislation. Arrangements for plant connected after 30 September 2000 will be different to those for plant connected before this date in Scotland, but only insofar as this will mirror existing changes to arrangements in England and Wales made at this date. The British generation market is essentially competitive, with a focus on increased efficiency of operation, but is not characterised by rapid technological change. The proposed regulation will have no effect on the ability of firms to choose the price, quality, range or location of their products.

The legislation is not expected to have a significant effect on the competitiveness of the electricity generation market, other than assisting the implementation of the wider BETTA proposals. It should be noted that the legislation is not expected to have any material effect on the physical operation of the generating stations in question.

8. Enforcement and Sanctions

Given the nature of the policy (which concerns an exemption from an obligation to comply with various requirements), it is unlikely that any enforcement action would be required. However as indicated in the consultation document, the class exemption in Scotland is being granted on the basis that suitable bilateral agreements will be entered into in order to ensure that the electricity transmission and distribution system can be operated in a safe and secure manner. In the event that this is not possible, the Secretary of State has the option of revoking the license exemption. The Electricity Act 1989 enables the Secretary of State to revoke an exemption if it appears to her inappropriate that the exemption should continue to have effect. The DTI, in its approach to exempting generation, must pay close heed to the safe and secure

[9] Table 5.6, Electricity fuel use, generation and supply, "2004 Digest of UK Energy Statistics".

operation of the total system in England, Wales and Scotland, with the revocation of exemptions an option if that cannot be guaranteed.

9. Monitoring and Review

This proposal concerns an extension of existing secondary legislation in England and Wales. The existing legislation has indefinite effect, with no sunset provision. This consultation document does not propose to amend the terms of the class licence exemption that is already in place in England and Wales, apart from extending the territory to which it applies.

10. Consultation

The introduction of BETTA has been accompanied by an extensive consultation process (details of which can be found at www.dti.gov.uk/energy/consultations, and at www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/betta07). The DTI's Small Generators Conclusion Document, published in May 2004, stated that the Government was examining the position in relation to generating stations that would fall within Class C of the 2001 Order, and the expectation was that the situation in Scotland would be harmonised with that in England and Wales [10].

Informal consultation took place with a range of affected parties prior to the launch of the public consultation concerning the present Order. A partial regulatory impact assessment was developed to accompany and inform the written public consultation, which sought to identify and address any wider policy issues of concern that might arise as a consequence of the proposed Order, as well as to identify and take steps to mitigate any unintended consequences that may arise. All non-confidential responses received have been published on the DTI website. Section 2 of this document reports on the responses received, and addresses any issues raised.

In the light of the consultation, this full regulatory impact assessment has been produced to accompany the laying of the final Order (contained in Section 3 of this document).

11. Summary of costs and benefits for the chosen option

The option chosen, in the light of the public consultation, is to extend the class exemption to apply to Scotland, subject to requirements concerning the safe and secure operation of the electricity system being satisfied.

Costs: None.

Benefits: £445k+ per annum to the affected company in the form of overall efficiency savings associated with embedded generation.

[10] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/6973_9604.pdf

12. Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by

Mike O' Brien

Mike O' Brien
Minister for Energy

Date: **28th February 2005**

13. Contact point:

Dr David Curran
Energy Markets Unit
Department of Trade and Industry
2nd Floor, 1 Victoria Street
London SW1H 0ET