ScottishPower

energy management

Mark Cox
Distribution Policy
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

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0141 568 4469

Dear Mark,

Structure of electricity distribution charges
Consultation on the longer term charging framework
May 2005

Thank you for the opportunity to respond to this consultation. This response is submitted on behalf of ScottishPower UK Division, which includes the UK energy businesses of ScottishPower, namely ScottishPower Energy Management Ltd, ScottishPower Generation Ltd and ScottishPower Energy Retail Ltd.

Aside from our views on the thrust of the consultation we are concerned that Ofgem has not carried out an impact assessment to establish the benefits and costs which would arise were their views on the structure of distribution charges to be put into practice by DNOs. We believe that it is imperative that Ofgem undertakes such an industry wide impact assessment of the whole programme in order to justify the effort which the industry will need to put into this work.

I hope that you find these comments useful. Should you have any queries on the points raised, please feel free to contact us.

Yours sincerely,

Mike Harrison
Commercial Manager, Trading Arrangements
ScottishPower Energy Management Limited

STRUCTURE OF ELECTRICITY DISTRIBUTION CHARGES:

CONSULTATION ON THE LONGER TERM CHARGING FRAMEWORK

SCOTTISHPOWER UK DIVISION COMMENTS

1 Summary

1.1 ScottishPower UK Division ('SP') supports simple, transparent, stable and cost reflective network pricing. However, we do not support the introduction of locational pricing for use of distribution networks.

1.2 We have a number of philosophical objections to the ideas being proposed by Ofgem in this consultation paper, some of which reflect our experience of locational pricing for use of the GB transmission network. These objections are detailed below.

1.3 We are concerned that the introduction into the market of further uncertainty of charges, both pre and post 2010, will seriously impact investor confidence. This will adversely impact development of and investment in renewable generation and jeopardise achievement of the Government's renewable energy targets.

1.4 We do not believe that sufficient thought has been given to the overall commercial framework within which embedded generation will operate, and that it is premature to change the regime in the absence of a suitable framework.

1.5 The practical impact on suppliers and generators of a multiplicity of different DNO charging methodologies, each under constant review, must be considered.

1.6 The overall costs and benefits of this project must be assessed by Ofgem before the industry carries out any more development work.

2 Philosophical issues

2.1 SP fully supports the high level charging principles[1] identified by the ISG of cost reflectivity, simplicity, transparency, predictability and facilitation of competition. To these we would add stability of charges as an important contributor to the facilitation of competition.

2.2 However, we do not support the introduction of locational pricing methodologies to distribution networks. We believe that all users cause costs to be incurred on the network and that to make payments to users based on notional benefits which they are deemed to bring to the network constitutes a cross subsidy which increases charges to other users and distorts competition.. The immediate impact of the user's connection has previously been reflected in a site-specific connection charge. Replacing this by a shallow connection charge and locational DUoS removes a clear locational signal based on actual cost information and replaces it by uncertain future costs derived from a mathematical model which we believe,

[1] Paragraph 3.13

based on our experience of the NGC ICRP methodology, is unlikely to be a true reflection of costs.

2.3 It seems particularly inappropriate to be discussing how locational charges might be determined when it has not yet been established what the drivers of distribution network investment are. It is not clear that generation and demand can be considered to be symmetrical for investment purposes, nor that distance or system peak demand are the significant drivers of costs. The NGC ICRP model therefore seems to be particularly inappropriate. More information on the actual cost drivers is required before the structure of charges can be determined.

2.4 We note in particular the academic discussion of the difference between marginal and incremental costs and Ofgem's wish to reflect in the charges the benefits which a user might bring to the network. However, as Turvey has noted,[2] downward cost messages are particularly difficult to deal with given that the DNO does not actually save any significant costs when the utilisation of existing assets is reduced. We have consistently argued that NGC's GB TNUoS charging methodology is particularly deficient in this regard. Nor is the lumpiness of network investment readily modelled. Some users may be able to connect within existing capacity without triggering investment, others may not. It is questionable whether a locational DUoS methodology can reflect this better than deep connection charges.

2.5 It is also unclear at this stage what benefit embedded generation will be deemed to have brought to the network and against what standard this will be assessed. Without clear security standards dealing with both demand and generation there is a risk that different DNOs would ascribe different security benefits to embedded generation.

2.6 Ofgem have offered no evidence so far of the magnitude of cost differentials which might arise from the application of locational charging methodologies to individual DNO networks, so it is difficult to assess which users might respond to those signals. With the majority of new embedded generation expected to be renewable it can be expected that the main locational drivers will be the availability of resource, consents and grid access. Intra-DNO locational charge differentials are unlikely to be a factor.

2.7 Ofgem, also appear to want inter-DNO locational signals to be visible[3] although it is not clear from Ofgem's discussion why such comparisons are desirable. We do not believe that such a comparison is relevant or practicable. The effect of a user's inter-DNO locational decision will be reflected in the transmission charges paid by that user. If the purpose of the DNO charging methodology is to "...reflect forward looking costs, incentivise efficient usage and development of the system..."[4] then it is only relevant within the context of the particular DNO network being considered and comparison with the tariffs produced by another DNO's methodology on another network is meaningless.

[2] Paragraph 3.25
[3] Paragraph 4.47
[4] Paragraph 3.8

2.8 There are also a number of practical issues which mitigate against inter-DNO comparisons. As Ofgem has noted, the locational charges derived from the model are unlikely to raise the correct amount of revenue and will require to be manipulated in order to do so. It would appear that Ramsey pricing is the only way of doing this which would preserve the inter-DNO locational signal. Implementation of Ramsey pricing requires someone (Ofgem, DNOs?) to decide which classes of users are price elastic and should be exposed to locational prices and which are not and should not. Presumably, those which are will be charged the basic locational price, those which are not will be charged at a rate which includes all the price adjustment which is required to achieve full recovery of the DNO's allowable revenue. Such a system would be the antithesis of cost-reflective pricing.

2.9 Alternatively, if Ramsey pricing is not used, the charges will vary between DNO network areas due to the differences in allowed revenue of the different DNOs. We believe that this is a more cost reflective arrangement.

2.10 It should be noted in any case that comparisons between DNOs located in England and Wales and those located in Scotland will be invalid due to the different valuations which were applied to their assets at the time of flotation and which is now reflected in their allowable revenue.

2.11 Comparisons are further complicated by the classification of the 132kV networks in Scotland as transmission. 132kV costs are therefore not included in the Scottish DNO's cost base (nor tariffs). The difference in charges faced by a potential 132kV network user between a connection in Scotland and a connection in England and Wales highlights the irrelevance of inter-DNO locational charge comparisons.

3 Generator DUoS

3.1 In our response to Ofgem's October 2004 consultation on the proposed DNO charging methodology statements we expressed concern about the uncertainty and volatility being introduced into distribution charging by the change to shallowish connection boundaries and GDUoS. We continue to be concerned that the introduction into the market of further uncertainty of charges, both pre and post 2010, will seriously impact investor confidence. This will adversely impact development of and investment in renewable generation and jeopardise achievement of the Government's renewable energy targets.

3.2 In addition to the philosophical issues detailed above regarding the possible implementation of locational charging methodologies, we are concerned that these developments are being proposed without a clear, consistent and complete commercial framework for the operation of embedded generation.

3.3 For example, nowhere in the consultation paper is there any mention of what product is being purchased by payment of GDUoS. Paragraph 4.12 purports to answer the question "what is being paid for" but in fact only considers the basis on which charges might be levied. Similarly, paragraph 4.32 attempts to value the access right but in fact is trying to value the right not to pay DUoS charges.

3.4 Any change to the generator charging regime for connection to and use of the distribution system must consider the entire commercial framework within which those charges are levied. We would expect this to include clear security standards for generation as well as demand, commercially firm access for generators and mechanisms for the purchase by the DNO of balancing services when required.

3.5 We are also concerned that Ofgem's review[5] of the interaction between transmission and distribution charging could lead to further complexity in the commercial environment within which embedded generation operates and the unwarranted application of transmission charges. We believe that any interaction between the distribution and transmission networks should be dealt with between the DNO and NGC; generators should only need to deal with their host network operator.

3.6 The transition to the new charging regime in 2010 must be arranged in such a way as to avoid existing generators which have paid deep connection charges being disadvantaged in any way. We would urge Ofgem to confirm that generators which entered into connection agreements prior to 1 April 2005 will not be required to transfer to any new charging regime before 2010.

4 Practical issues

4.1 Developments in DUoS charging structures will impact on suppliers both in their contractual and pricing arrangements and in their billing systems. Whilst innovation by DNOs should not be inhibited unduly we do not believe that it will be in the best interests of customers for DNOs to have between eight and fourteen different ways of charging for use of system, plus a few more from IDNOs. We strongly believe that consistency of charging structures between DNOs is the minimum level of harmonisation which is required.

4.2 Ofgem is currently consulting on the regulation of IDNOs. Within the proposals for IDNO charging arrangements Ofgem has proposed a form of Relative Price Control. We would encourage Ofgem not to allow the development of these proposals to deviate from current DUoS charging principles, thus ensuring that the current settlement processes can be applied. RPC arrangements have already been implemented within the Independent Gas Transporter market; however, the model adopted for gas should not be replicated within the electricity market. Removal from the present DUoS charging structure serves no purpose other than to add confusion and uncertainty and risks increasing supplier costs to the detriment of customers.

4.3 It will also be important to avoid producing complex new tariffs which are incompatible with existing metering systems. It is likely that only in a few special circumstances would a change to the metering arrangements be justified by the benefits which would be achieved from a particular new tariff.

4.4 It is also important to ensure that, once decisions have been reached on what the basic structure of DUoS charges should be, sufficient time is allowed for the industry to make the necessary modifications to the billing systems.

[5] Paragraphs 4.49-4.51

4.5 DNOs do not have a good record regarding large and unpredicted changes in DUoS tariffs; we believe that the new charging methodologies should be implemented, and maintained, in a way which minimises tariff shocks to suppliers and customers. Indicative charge levels must be published in good time to allow contractual and pricing arrangements to be changed prior to implementation.

4.6 Consideration needs to be given to the governance framework of the distribution charges and the means by which network users will interact with the methodology development process.

5 Impact assessment, costs and benefits

5.1 We are surprised and disappointed by Ofgem's statements justifying the lack of an impact assessment. This entire work programme is being driven by Ofgem's stated objective[6] that "use of system charges for demand and generation regimes should be fully aligned with UoS charges established via charging models based on forward looking long run incremental costs (LRIC)."

5.2 For Ofgem to claim[7] that an impact assessment is not required because the current consultation document merely "indicates an Ofgem view rather than initiating a project or implementing a policy" is disingenuous at best. Ofgem admits[8] that "the likely response of customers to locational pricing signals is currently unclear" yet the effort which the industry is already committing to this project is considerable.

5.3 It is questionable how the project has been allowed to develop thus far in the absence of clear and quantified benefits which would justify its implementation. Assessment of the impact of individual charging modifications as they are proposed by DNOs[9] will be too little, too late.

5.4 The ISG has recognised that "cost reflectivity....needs to be balanced by evidence of benefits of introducing more complex charging structures." We believe that it is imperative that Ofgem undertakes an industry wide impact assessment of the whole programme in order to justify the effort which the industry will need to put into this work. Benefits in terms of the savings in distribution costs which would be achieved by the use of locational charging models must be accurately assessed and set against the costs which the industry is likely to incur in responding to the proposed changes, both in the immediate transition to the new regime and in the continued need to keep abreast of the status and likely development of multiple charging methodologies.

5.4 Such an impact assessment should be carried out as soon as possible and the industry should not be expected to undertake any further development work until the benefits of locational DUoS charging have been demonstrated clearly to outweigh the costs which the industry will incur to develop and implement these methodologies.

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[6] Paragraph 2.7
[7] Paragraph 5.2
[8] Paragraph 3.69
[9] Paragraph 5.1