

Your ref:

Our ref: ENERG/E/MC02

Mr Martin Crouch
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Distribution
The Office of Gas and Electricity Markets
9 Millbank
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26th September 2007

Dear Martin,

Consultation on United Utilities modification proposal UU/2008/002.1.

Thank you for your letter of 17th August 2007 inviting comments on the proposal received from United Utilities (UU) to introduce payments for the adoption of connection assets.

On the initial reading of this document the first question that surfaced was; what has prompted the change? The inference from UU appears to be increasing competition and the assumption that IDNO's are presently offering asset adoption payments. Taking each point in turn, as stated in your letter of 17th August 2007, UU has lost around 3% of connections in their franchise area to IDNO's in the 2006/07 operating year, hardly a significant loss. Furthermore, their current charging methodology serves to ensure there is insufficient net revenue for IDNO's to offer anything substantial to the developers or ICP's.

By far the most concerning aspect of this proposal is the likely impact across the current connections marketplace. Back in April 2005 there were only three licensed IDNO's, namely GUC (now Energetics Electricity), Laing Energy and IPN. Each of the IDNO's were at a very early stage in their development and were not significant threats to any of the DNO's at that time. Small wonder therefore that with the removal of Tariff Support Allowance (TSA) each of the DNO's decided not to offer any asset adoption payments as part of their Connection Charging Methodology. If our understanding is correct, in the face of little or no competition, does the decision not to offer asset adoption payments constitute a breach of competition law?

To summarise on the specific points raised in your letter of 17th August 2007: -

1. Does UU's modification proposal better achieve the relevant objectives?

- *Are the proposals more cost reflective than the current methodology?*
On the understanding that the present charging methodology is not particularly transparent then it's very difficult to assess whether this recent proposal will be more cost reflective. However, the one issue that is abundantly clear is the fact that either the current methodology or the proposed methodology is grossly incorrect. How else can UU justify the proposed sums on the back of

“increasing competition” and “providing transparency” when they, and every other DNO, have not paid asset adoption payments for the last two and a half years?

- *Does UU’s proposal restrict, distort or prevent competition in distribution?*
In short, yes. The statement made by UU that other licensed distribution network operators are offering asset adoption payments is an extreme exaggeration. The fact of the matter is that the current charging methodologies of UU, and many other DNO’s, result in most of the downstream revenue available to an IDNO being paid back in the form of upstream use of system, capacity and boundary metering charges. Should this proposal be accepted in its current form then the existing IDNO’s would not be able to compete for asset ownership in the UU franchise area on the basis that they could not hope to match the payments on offer. The proposal as it currently stands would signal an end to competition for network ownership and with it the continuation of the anti-competitive practises that have blighted the connections market for the last ten years.
- *Does the methodology proposed by UU provide sufficient clarity and transparency about the calculation and application of adoption payments?*
The examples given by UU do in fact show a sufficient breakdown of the fixed and variable cost structure and how this corresponds to an appropriate asset adoption value. The question of whether these apportionments are appropriate cannot be determined on the basis that there is insufficient transparency of the method of evaluation. The figures therefore have to be taken at face value for the purposes of calculating the equivalent adoption payment.

2. Have Ofgem correctly captured the main issues raised by UU’s modification proposal, and more generally by adoption payments, in Annex 1?

- *Extent of Competition*
Notwithstanding the comments raised in point 1 above, the principle of offering adoption payments does play a significant role in the connections marketplace. The key phrase however is a “competitive market” and there can be no doubt that this market is by no means competitive. The 2006/07 annual return from Ofgem has shown that a substantial majority of all electricity connections have been physically installed by the DNO (or their affiliated connections business) and subsequently adopted; a statistic that has barely moved in previous years. In absolute terms, of the 492,309 connections undertaken in the 2006/07 operating year 5,172 (1.1%) were adopted by IDNO’s. Small wonder there are only four IDNO’s across the UK with no real appetite for anyone else to enter the market.
- *Effect of Average Assumptions*
The assumptions offered by UU are generally reflective of the industry and as such Energetics Electricity would not look to challenge the main variables at this stage. The main issue across the industry is the level of upstream use of system charges, boundary metering and, more importantly, the insistence from the DNO’s, including UU, that capacity charges will apply for housing developments. There is no doubt that the DNO’s are taking it upon themselves to regulate the market by stating that the capacity charges are being used to “incentivise” IDNO’s to request only what they require for each specific site thus avoiding the scenario where the IDNO may try to reserve

future capacity. This disparity is blatantly anti-competitive on the understanding that the DNO recovers a significant charge regardless of the IDNO request.

By way of example, using the assumptions in appendix B of the UU document, should an IDNO secure this 200 plot development then the annual capacity charge would be £3,542.40 per annum (which equates to £17.71 per plot) giving a present value to UU of £278.92 per plot.

- *Potential for discrimination and double counting*
There is a potential for double counting in the proposal put forward by UU and arguably Ofgem can ensure that this situation can be avoided through the price control mechanism.
The more alarming concern is the question of discrimination and the statement from UU that the proposal is more cost reflective. This comment is used verbatim by each of the DNO's although very few have gone to print to explain their cost recovery in detail.
- *Exclusions from the methodology*
The only area worth highlighting is speculative developments. By nature these developments result in highly subjective views being taken on the likelihood of the projected loads materialising. The experience of Energetics Electricity when dealing with this type of project is that the host DNO will take a more 'optimistic' view depending on the level of competition. More stringent guidelines would be required to avoid this form of gaming.

It is the view of Energetics Electricity that the timing and potential impact of these proposed changes would have a very disruptive impact across the connections marketplace and we ask that Ofgem considers a wider perspective when evaluating the merits, or otherwise, of this proposal. In summary, until such time that Ofgem addresses the glaring disparities in the current upstream DUOS and capacity charging methodologies that result in miniscule revenues to the adopting IDNO's, the proposal from UU should be vetoed.

Yours sincerely

Bill McClymont
Chief Executive Officer