



ScottishPower EnergyNetworks

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Our Ref

Date

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Contact / Extension

Dear Martin,

**Consultation on United Utilities modification proposal UU/2008/002.1:
Proposal to introduce payments for the adoption of connection assets
– Response by ScottishPower EnergyNetworks**

Thank you for giving us the opportunity to comment on the UU modification proposals to introduce adoption payments.

Electricity distribution networks are charged for through a combination of ongoing use of system charges and up front connection charges. In setting use of system charges, assumptions are made as to what costs have been funded through connection charges. Obviously different connections require different amounts of work to connect them to the distribution system. Historically DNOs used tariff support payments to further refine connection charges to reflect assumptions used in setting distribution tariffs. The guidance given by Ofgem in April 2005 for DNOs to remove tariff support payments for their connection charging methodologies removes the ability of DNOs to fine tune their connection charges, and has resulted in less cost reflectivity and potentially some double charging of particular customers. Whilst an element of double charging will always be unavoidable in any pragmatic charging approach, the use of tariff support payments can remove a large element of this. We therefore think that the introduction of adoption payments as proposed by UU will lead to more cost reflective connection charges than their existing approach.

We also see potential for significant distortions in the provisions of new connections driven by an imbalance in regulatory treatment. If a DNO provides the new connection to a housing development (either through a licensed connection or adopting the assets from an Independent Connections Provider) then the capital cost is usually fully funded by the developer. The effect is that, in the long term, there is no net addition to the regulatory asset base and only a small increase in overall revenue allowances for the DNO (through the Composite Scale Variable which is driven by customer numbers, network length, units distributed). This is much less than the DUoS charge

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recovered from the customer. The result is that these new connections tend to reduce the average level of DUoS charges to customers as a whole. There is a similar effect from spreading DNO fixed costs over a larger customer base.

By contrast, if an IDNO provides the new connection to a housing development then, the charges levied to customers overall remain higher than they would have been had the DNO provided or adopted the assets.

It is clear to us that the ability of IDNOs to offer adoption payments and the inability of DNOs to offer the same is distorting competition in electricity distribution and in connections and results in an overall increase in charges to all customers. This is being borne out by the expansion of IDNO connections in SPEN's licensed areas. The degree of market effectiveness and market change experienced to date varies substantially on a regional basis and should be considered in this context rather than against a GB market. For example, in SP Distribution's area there are now 145 live IDNO networks, connected at voltages up to 33 kV.

In our opinion, the current regulatory regime is resulting in higher charges to consumers overall that are funding the adoption payments to developers. This is distorting the connections market. We believe that Ofgem needs to urgently review its whole approach to the regulatory and commercial arrangements for IDNOs. Whilst we recognise that Ofgem need to take account of the Competition Act in determining the regulatory approach, there are also other statutory obligations which we are not convinced are being given adequate consideration in the regulatory decision process, namely

- Section 3A(1) of the Electricity Act (as amended) which states that the Authority's principal objective is to protect the interests of consumers;
- Section 3A(5)(a) of the Electricity Act (as amended) which requires the Authority to promote efficiency and economy on the part of persons authorised by licences; and
- Section 8A(6)(b) of the Electricity Act (as amended) which states that the Authority should not introduce modifications to standard conditions of licences if it unduly disadvantages other licence holders in competing with the holders of such licences.

In response to the detailed questions raised in the paper;-

**Does UU's modification proposal better achieve the relevant objectives?
Specifically:**

- **Is the proposal more cost reflective than the current methodology?**
- **Does UU's proposal restrict, distort or prevent competition in distribution?**
- **Does the methodology proposed by UU provide sufficient clarity and transparency about the calculation and application of adoption payments?**

The approach set out by UU is more cost reflective than their current approach as it provides for adjustment of the connection charge to reflect assumptions that have been used in setting use of system charges. As the proposed charges are more cost reflective we do not believe that the proposals will distort or prevent competition in distribution and may in fact help to reduce a major distortion that current exists with the ability of IDNOs to provide adoption payments. The proposal provides sufficient clarity on the calculation and application of adoption payments.

Have Ofgem correctly captured the main issues raised by UU's modification proposal, and more generally by adoption payments, in Annex1?

Annex 1 generally covers the issues raised by UU's modification proposal. However, it does not cover the wider regulatory issues surrounding IDNO regulation that has led UU to put forward this modification.

Extent of competition

- **Do adoption payments play a role in the development of a competitive market?**
- **Is competition now effective? Are adoption payments now appropriate in order to reflect developments in the licensee's business?**

New build developments have an inherent lag from acceptance to connection, with some larger developments being completed over several years. To understand the current state of the market it is more appropriate to consider the contracts that are presently being won rather than the physical connections that are being delivered.

The currently regulatory framework and the inability of DNOs to offer adoption payments is distorting competition.

Effect of average assumptions

- **Are the assumptions used by UU reasonably representative of the majority of connections?**
- **What is the impact of the proposed methodology change on customers and competitors whose connections are not closely reflected in the modelled assumptions?**
- **Does the combination of adoption payments and UoS boundary charges have an anti-competitive effects?**

A weakness of the UU proposal is that it appears that, in constructing their use of system charging methodology, they have not reflected the change in the connection boundary that came into effect in April 2005. Their argument appears to be that they have retained the old boundary to reflect the fact that previously connected customers were given tariff support. We do not believe that this should be the assumption in setting charges and UU should take a forward-looking view in setting use of system charges. This weakness, however, does not negate the advantages of this approach but will affect the

levels of adoption payments when the tariff model is revisited. The assumptions used by UU appear representative and the benefit of the UU proposal assists in more cost reflective charges in situations where customers whose connection characteristics differ from the assumptions used in setting charges by providing further refinement to the connection charge. This assists in addressing the distortions of the current regulatory approach.

Potential for discrimination and double counting

- **Is there currently an issue of potential discrimination in UU's charging methodologies?**
- **Is there currently an issue of potential double counting in UU's charging methodologies?**
- **Is the proposed modification the most appropriate way forward?**
- **Is there any other alternative approach to be considered, that would better meet the relevant objectives?**
- **Does UU's proposal result in a shift in the connection boundary and, if so, is this appropriate?**

We do not believe there is any discrimination in UU's proposal and it helps in removing the current discrimination against DNOs and possibly some Independent Connections Providers. There will always be an element of double counting with connection and use of system charges which tariff support addressed to a large extent. The UU proposal goes some way to getting to the same position that existed prior to Ofgem's guidance to remove tariff support.

There are alternative ways forward to that proposed by UU. One such approach is for Ofgem to apply rules consistently across distribution licence holders, as it is the inconsistency that is causing the issue and is not in the best interests of consumers. UU do not have to propose the best approach, they merely need to demonstrate that what they are proposing better meets the objective than what they do now.

The proposal does not result in a shift in the connection boundary but we believe that UU should adjust their use of system charging model to reflect this connection boundary also.

Exclusions from the methodology

- **Are the exclusions appropriate and have UU sufficiently justified these?**

We do not believe the exclusions proposed by UU are all appropriate. If a customer funds reinforcement through the apportionment rules set out in their connection charging methodology, but this reinforcement is also funded through ongoing use of system charges as a result of their charge setting assumption, then it is difficult to justify why the same adoption payments do not apply. The same is true for unmetered connections. We agree with the other exclusions proposed by UU.

In summary, we support the principle of adoption payments put forward by UU. The primary driver for this modification, however, is the discriminatory nature of the current regulatory regime between distribution licence holders. Should Ofgem choose to veto this proposal, or any other proposal along similar lines, we would expect Ofgem to justify this decision against the provisions of the licence and its wider statutory duties, not merely its interpretation of the Competition Act.

Yours sincerely,

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