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Dear Gary

Date: 5 September 03

Electricity Distribution Losses

I write with SSE's response to Ofgem's initial proposals on the above. We have grouped our comments under three main headings for clarity.

Form of Incentive

SSE had advocated an input rather than an output based incentive scheme in previous correspondence on this issue. It is still our view that a change to technical standards to require installation of "low loss" equipment on DNOs' systems would have a growing impact over time, as equipment comes to be replaced, on the physical causes of losses on electricity distribution systems. We are also concerned about the prospect of an incentive scheme for losses that could result in material sums being added or subtracted from the regulated revenue of DNOs, when there are significant issues over the measurement of distribution losses.

We would however agree with Ofgem that one of the principal ways in which DNOs are able to influence distribution losses is through capital expenditure and we therefore welcome Ofgem's signal that efficiently incurred expenditure on loss reduction measures will be included in the RAV. We believe that this should be achieved through the existing price control mechanisms, including anticipated expenditure as part of the business planning process.

Putting these issues aside, as we understand it, the proposed new incentive scheme would involve retaining the actual financial benefit/ penalty arising from a change in losses in a particular year for four further years. However, the new incentive term would include only the incremental change in losses from year to year in the assessment of benefit/loss

under the scheme. Otherwise, an enduring change in losses would trigger a series of benefits or losses, each retained for a five-year period, which would significantly increase the materiality of the incentive scheme. We would welcome clarification that our understanding of the mechanics of the proposed scheme is correct.

If our interpretation of the scheme is correct, we would see some merit in fixing the benchmark or “losses target” for the period of a price control and agree that this should be based on each DNO’s 10 year average, adjusted for an assessment of present levels of distributed generation.

Distributed Generation

We also believe that an adjustment for future distributed generation that will connect during the next price control period will be necessary to reflect that fact that much of this generation will increase, rather than reduce, overall losses on the system. Indeed, we note that Ofgem acknowledge this point in paragraph 3.16.

We do not agree that DNOs are able to influence the specific connection location of distributed generation and, as a consequence, we believe that it would be inappropriate to expose DNOs to the potentially significant risk of additional losses caused by such generation. Indeed, there is a risk that if the higher losses associated with distributed generation are not recognized in the losses incentive term, the proposed new and separate incentive term to encourage investment to accommodate such generation will be undermined.

Against this background, we firmly believe that any new incentive terms for distribution losses should include a potential adjustment mechanism to take account of the adverse effect of distributed generation on losses. We do not envisage a mechanistic formula for achieving this, as we believe that approach would be likely to be overly complicated. However, we would find it difficult to accept an enhanced losses incentive (particularly in the north of Scotland) without a mechanism set out in the licence to allow DNOs to claim an adjustment to the losses “target” in respect of distributed generation. This would also need to be accompanied by a clear policy statement by Ofgem that they would be amenable to accepting claims under this mechanism where the DNO is able to demonstrate that a particular distributed generation scheme or set of schemes has had (other things being equal) a negative effect on losses.

Value of losses

Against the background of uncertainty caused by distributed generation we would not be supportive of a significant step-change in the value of losses figure used in the price control. We would therefore agree that a forward – looking appraisal of electricity cost without an explicit allowance for environmental externalities would be the appropriate approach.

If you would like to discuss this further, please call.

Yours sincerely

Rob McDonald
Director of Regulation