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Ms Donna Rossall
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14 September 2004

Dear Donna

Regulation of Independent Electricity Distribution Network Operators

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL). This letter represents the response of CE, NEDL and YEDL to Ofgem's publication, on the Regulation of Independent Electricity Distribution Network Operators.

We recognise the need to develop a robust long-term regulatory regime for new independent distribution network operators. We also support Ofgem's view that ex-PES distributors owning or operating distribution networks outside of their distribution services area should have similar charging restrictions as those that will apply to IDNOs. Now that both Independent Power Networks and Laing Energy have been granted distribution licences we believe that an increased level of urgency is required to determine the core principles and resolve key issues.

Our detailed comments are attached as an appendix to this letter. In summary our views are given below.

Contractual Arrangements

- We believe that the contractual arrangements in place for the gas sector are inappropriate for the current electricity trading arrangements.
- We believe that the governance of inter-distributor arrangements should be through a bilateral agreement covering both connection and use of system aspects.
- In principle we believe that metering should be installed at the boundary between distribution systems. However, we acknowledge that in a small number of cases a metered solution may be inappropriate. In such instances there should be a proxy that accurately determines all units transferred across the connection boundary.
- In principle we believe that IIP reporting arrangements requirements and standards of performance arrangements should apply equally to all distributors. However we recognise that in practice further work is required to understand how these might apply.

Charging Arrangements

- The existing arrangements only apply to domestic customers. We believe that this is a weakness and should such arrangements continue, then they should apply to all customer types.

- New distributors will have a different mix of assets and therefore a different cost base. As such, linking a new distributor's price control to the ex-PES DNO is fundamentally flawed. We support simple regulation for small scale distributors; however, as distributors increase in size it is reasonable that regulation should become more closely aligned to that used for ex-PES DNOs.
- We support a tiered approach to charging arrangements with three tiers being in place dependent on the size of the distributor. The threshold for determining what regulatory regime should apply could be determined by market presence.
- Establishing consistency between the charging arrangements in the IDNO and IGT sectors will require complex changes and significant costs with little benefit to end customers. Therefore we believe that this is neither desirable nor appropriate.

Financial Ring Fencing

- The consultation does not identify how the failure of a distributor will be managed. We recognise that disconnection of distributors who default on DUoS payments is something the industry will be keen to avoid; however, the consultation fails to address how such events will be addressed.
- We support the need for financial ring fencing and believe that this should be consistent across all distributors.

We continue to support Ofgem's work in this area and wish to take an active role in future development. To this end we would welcome a meeting with you to share in more detail our views and ideas on the arrangements for IDNOs. Also, we note that in parallel to this consultation Ofgem have held a workshop with ex-PES distributors where a number of issues were identified. Further work will be required to resolve these issues and we will be happy to participate in any industry groups set up with this objective.

We will contact you in the near future with a view to setting up a meeting.

Yours sincerely

MIKE HARDING
Network Agreements

Appendix

CE Electric UK's Detailed comments to Ofgem consultation:
Regulation of Independent Electricity Distribution Network Operators

Contractual arrangements

We believe that the contractual arrangements in place for the gas sector are inappropriate for the current electricity trading arrangements.

1. Under current trading arrangements, the DUoS charge a supplier pays in respect of a customer is dependent on the end customer's connection characteristics and the amount of electricity distributed. Currently, with the exception of EHV charges, there are no locational signals in DUoS charges. The DUoS charge applicable to a particular end customer is identified through the allocation of a line loss factor class (LLFC) to the end customer's MPAN. Under non-half hourly trading arrangements, consumption data is aggregated by LLFC, by distributor for each supplier. Unless distributors use localised network specific LLFCs for their end customers, consumption data will be aggregated by distributor for the GSP group. Limits on the number of available LLFCs mean that the use of localised network specific LLFCs is not possible. Therefore it is not possible to identify and apportion consumption to a particular network node from settlements data and thus identify a supplier's share of the charges in respect of that network. The issue becomes even more complex in circumstances where multiple nesting of distribution network operators occurs.

2. There is no requirement under the BSC for electricity transported across boundaries, between distribution networks operating within the same GSP Group, to be identified by supplier. As such, if suppliers were to be billed separately by each distributor for each component of the network used, then new systems and processes would be required to identify, record and bill charges in respect of each boundary point. This would incur significant additional costs.

3. Under the existing arrangements, each distributor bills the downstream distributor for use of system, with the distributor connecting the end customer then billing the supplier for DUoS. These arrangements offer a robust and pragmatic solution, causing the least disturbance to existing systems and processes. This mechanism is already in place to manage NEDL's connection to another licensed distribution network within the northern GSP. It also mirrors the arrangements that are in place for inter-distributor connections to networks operating in different GSP groups.

We believe that the governance of inter-distributor arrangements should be through a bilateral agreement covering both connection and use of system aspects.

4. There is a fundamental difference between connections to end customers (or to licence exempt distributors) and connections to licensed distributors. In the case of connections to end customers (and to licence exempt distributors), contractual terms are covered through a connection agreement between the distributor and the end customer and through a use of system agreement with the supplier appointed to the exit point. Under the current arrangements (identified in 3 above), the host DNO has a contractual relationship with a licensed distributor for both connection and use of system. We believe that the governance of inter-distributor arrangements should be through a single bilateral agreement covering both connection and use of system aspects.

5. Agreements covering both connection and use of system have already been developed and, whilst it is acknowledged that further refinement is required, they do provide a template to facilitate the prompt development of a model framework. Such work could include producing model generic agreements for use between distributors operating with separate subsidiary connection specific bilateral agreements. The subsidiary bilateral agreements would cover the specific operational aspects of each connection e.g. maximum power, voltage characteristics and operational boundaries.

In principle we believe that metering should be installed at the boundary between distribution systems. However, we acknowledge that in a small number of cases a metered solution may be inappropriate. In such instances there should be a proxy that accurately determines all units transferred across the connection boundary.

6. In their distribution service area the income that an ex-PES distributor can make in operating their network is regulated through determining the total number of units entering the distribution system and the total number of units leaving the distribution system. Also, under the price control formula there is an incentive for distributors to reduce system losses. The failure to correctly quantify units transported to or from other distribution networks could result in a distributor being penalised through increased system losses. We believe metering represents the most effective way of identifying units being transported across a boundary between distributors.

7. We understand that in a number of limited cases IDNOs may consider that a metered solution is inappropriate, potentially on the grounds of cost. An example of this could be in the case of connections between low voltage systems where the size of the connection is small (for instance to a few houses). However this needs to put in context. Connections between distributors will require a means for protection from excess current and for cutting off the supply and isolation. Some form of accommodation will be required for this. Therefore the additional cost of fitting metering is marginal.

8. However, it may be possible to use a proxy to determine the amount of electricity transported across a boundary. In principle, such a proxy should achieve the same level of accuracy that would be achieved through metering. Although using settlement data could form part of such a proxy, we remain to be convinced that the levels of accuracy that could be achieved through this approach would compare favourably with those achieved through a metered solution.

In principle we believe that IIP reporting arrangements requirements and standards of performance arrangements should apply equally to all distributors. However we recognise that in practice further work is required to understand how these might apply.

9. From a distributor perspective, connections to licensed distribution networks should be treated no differently than connections to licence exempt networks or connections to end customers. A connection to another distribution network is a connection to a single customer, irrespective of how many customers are connected to the other distribution network.

10. We recognise that further work is required in determining how reporting arrangements and standards of performance apply to embedded or nested networks, particularly where several levels of nesting may occur. One example of this is how notice periods for system outages should be applied.

Charging Arrangements

The existing arrangements only apply to domestic customers. We believe that this is a weakness and should such arrangements continue, then they should apply to all customer types.

11. Although the existing arrangements offer a simple form of price control they only apply to domestic customers and are not necessarily cost reflective. We believe that this form of price control is only appropriate for very small distributors and should be extended to apply to all classes of customer connected to such distributors.

New distributors will have a different mix of assets and therefore a different cost base. As such, linking a new distributor's price control to the ex-PES DNO is fundamentally flawed. We support simple regulation for small scale distributors; however, as distributors increase in size it is reasonable that regulation should become more closely aligned to that used for ex-PES DNOs.

12. In promoting competition in distribution, one would expect that end customers ultimately benefit. It is difficult to understand how under current arrangements this will be achieved. Our experience is that IDNOs and ex-PES distributors operating outside their distribution services area will target developers for the provision of new distribution assets. Such work is more likely to involve high value projects as opposed to small scale projects for individual end customers. For a developer, the dominant factor in selecting a distributor will be the price charged for providing the connection. Savings will not necessarily be passed on to the end customer where developers secure cheaper connection charges since the price of housing and commercial properties is determined by the market place.

13. Distributors could offer cheaper connection charges by recovering some of the costs through DUoS charges. This tariff support is in effect a cross subsidy from the end customer to the developer. Significant work has been undertaken through Ofgem's review of the structure of electricity distribution charges. We believe that the principles developed under this framework should apply equally to all distributors, particularly in respect of the application of deep and shallow charging principles and the removal of tariff support.

14. Under the current arrangements, DUoS charges to domestic customers are capped to the level offered by the ex-PES host distributor. Typically, unit costs associated with providing distribution networks in urban high load density and high population areas are lower than those incurred in providing connections in more sparsely populated rural areas. However, ex-PES distributor charges will be an average for the whole of the distribution service area. Therefore, in general, an IDNO (or out-of-area DNO) providing connections to urban development, in matching the ex-PES distributor's DUoS charges, will receive a higher rate of return on the assets provided. Since there is no cap on DUoS charges in respect of non-domestic customers they potentially face greater distortions in DUoS charges.

We support a tiered approach to charging arrangements with three tiers being in place dependent on the size of the distributor. The threshold for determining what regulatory regime should apply could be determined by market presence.

15. We recognise the need for efficient and effective regulation and that for small distributors, price control needs to be simple in order to be cost effective. However as IDNOs increase in size (or ex-PES DNOs increase their out-of-area networks) the method of price control should approach that used to regulate ex-PES DNOs. We

believe that a multi-tiered approach to the charging arrangements should be adopted.

16. In terms of small distributors, despite its imperfections, we support Option A: that DUoS charges should be capped by the level of the ex-PES DNO's charges. However, this should be extended to include charges to non-domestic customers. We believe the threshold for applying this should be based on market presence and the impact that new distributors will have in the market place. For instance, 10,000 to 20,000 domestic connection points equates to a diversified demand of 20 MVA and a potential DUoS income of circa £1 million.

17. Between this level and 500,000 metering points, price control based on rate of return regulation offers a fairly simple pragmatic form of regulation whilst restricting excessive profits. We note Ofgem's comment on the inherent weaknesses in that this offers little incentive for cost reduction. However we believe that such an incentive could be built in to such a price control (in the same way that an incentive for reducing losses is built into the price control for ex-PES distributors). Where a distributor has more than 500,000 connection points it will be of the same order of magnitude as an ex-PES distributor. We therefore believe that the method of price control should be identical to that used for ex-PES distributors.

Establishing consistency between the charging arrangements in the IDNO and IGT sectors will require complex changes and significant costs with little benefit to end customers. Therefore we believe that this is neither desirable nor appropriate.

18. We believe the arrangements and industry structures for gas and electricity are fundamentally different and at this time can see little benefit to end customers in having consistency between charging arrangements in the IGT and IDNO sectors. As discussed above we believe that the cost base of IDNOs will be fundamentally different from that of ex-PES DNOs and as such the use of relative price control would be flawed.

Financial Ring Fencing

The consultation does not identify how the failure of a distributor will be managed. We recognise that disconnection of distributors who default on DUoS payments is something the industry will be keen to avoid; however, the consultation fails to address how such events will be addressed.

19. We support the need to ensure the long-term financial stability of all distributors, including IDNOs. We believe that that in principle the criteria that should apply should not unduly discriminate between different 'classes' of distributor. Whilst the use of investment grade credit ratings may provide some comfort, as recent history demonstrates, such a credit rating provides no guarantee. We therefore believe that it is important to explore the arrangements that should be in place should a distributor fail. Other distributors are under no obligation to take over the networks of a failing distributor. It is therefore important that appropriate commercial incentives and mechanisms be established for other distributors to either operate or adopt networks in circumstances where a distributor fails.

We support the need for financial ring fencing and believe that this should be consistent across all distributors.

20. We note that Ofgem's proposal is that for small distributors, any keep well agreement must be with a parent whereas for larger distributors, such an agreement may be

with any entity possessing an investment grade credit rating. We have difficulty in understanding why there should be such discrimination.

21. We also note that smaller distributors will have the option of providing a bond where they cannot secure a keep well guarantee from a parent with an investment grade credit rating. We believe that larger distributors should also be allowed to provide a bond. This would provide an alternative mechanism if a larger distributor's credit rating (or guarantor's credit rating) fell below that required to qualify as an investment grade.