Donna Rossall
Networks – Distribution
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400
Facsimile: 01738 456415
email:

Our Reference:
Your Reference:

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Dear Donna

Regulation of Independent Electricity Distribution Network Operators (IDNOs)

I write with SSE's response to the recent consultation on the above subject. Our comments are outlined below using Ofgem's different section headings.

Chapter 4: Contractual Framework

Industry Framework

As part of this consultation, Ofgem highlight the fact that the existing contractual framework for the electricity and gas markets are different and notes that this might have an impact on the appropriate form of regulation of independent networks in the two different markets. We agree that the contractual framework is a relevant consideration but we have significant concerns over the suggestion, discussed within this chapter of the document, that arrangements in electricity should be changed to be more similar to the gas market. In particular, it is proposed that electricity suppliers should contract separately with each (I)DNO whose network is used to serve a customer, by analogy with the shipper in gas. The overall implication appears to be that, if this change takes place, the existing approach to independent gas transporter (IGT) regulation can more readily be applied to IDNOs.

We have written to Ofgem on numerous occasions on the subject of the costs to the industry of regulatory initiatives for change and would strongly resist this suggested change to the electricity contractual framework. It would certainly entail changes to

electricity settlement and to supplier billing systems and processes to cater for the possibility of more than one DNO bill for a customer's distribution use of system cost and it would also set up a requirement for DNO/IDNO information flows and reconciliation processes. It is also far from clear how the DNO and the IDNO would apportion the GSP correction to an individual premises. These issues do not arise in the gas market due to the aggregate (rather than premises specific) nature of billing and settlement. We are thus firmly of the view that the contractual framework that has developed in gas is fundamentally inappropriate for electricity and that significant costs and disruption would result if moves were made in this direction. There would be costs for DNOs in changing settlement processes and also for suppliers, all of which would ultimately be passed on to customers. We also see no benefit for customers or in terms of competition from such reforms.

Metering

It is in our view essential for there to be boundary metering between a DNO and an IDNO in order to form the basis for the IDNO's payment of the host DNO's use of system charge although, as Ofgem notes, the metering is outside national settlement system requirements. This metering is also desirable from the point of view of establishing units leaving the host DNO's network for the purposes of its price control. We are aware that such metering is not required for gas IGTs as there is no individual meter point reconciliation in gas for non-daily metered sites, for which actual gas flows would be required. However, as discussed above, the electricity framework is fundamentally different from that in gas and the practice for IGT networks cannot simply be transferred to the IDNO framework.

The economics of an IDNO network requires it to build up towards a reasonable number of individual premises in order to form a charging base that can bear the costs of the host DNO's use of system charge. The cost of the metering and data services associated with a single boundary meter is relatively insignificant when compared to the host use of system charge and spread over all the final customers on the IDNO network. These costs are therefore extremely unlikely to have any bearing on an IDNO's assessment of the economics of potential network investment and thus to have any detrimental effect on competition in distribution. The fact that such metering is required is another opportunity for competitive supply of the relevant metering services. Customers on the IDNO network are also protected by the price control arrangements discussed later in the document.

In conclusion, it is in the interests of both the IDNO and the DNO to establish metering at their contractual boundary and the overall cost to customers (who are in any case protected by price control arrangements) should be minimal. It is unlikely to have any adverse impact on competition in distribution and may have a slightly beneficial effect on competition in metering.

Quality of Service Arrangements

Ofgem is currently reviewing the arrangements for quality of service and standards of performance for DNOs as part of the current distribution price control review. We would expect similar arrangements to apply to IDNOs, as and where appropriate. The data items that Ofgem proposes that IDNOs collect under standard licence condition 5 seem appropriate and we agree that arrangements need to be put in place between IDNO and DNO in order to separately identify interruptions arising from incidents on the IDNO and the upstream DNO network.

On standards of performance, our starting point is that customers on IDNO networks should see the same guaranteed standards of service as customers on all other DNO networks. As in the standards arrangements for IGT networks, it may be appropriate for the reporting of standards information to be annual rather than quarterly. Once arrangements for DNO standards of performance are finalised as part of the price control review, it will be appropriate to consider whether any adjustments need to be made for those applicable to IDNOs. It would not be appropriate or proportionate, in our view, to burden IDNOs with significant levels of standards administration and prospective compensation costs.

When considering application of the IIP quality of service framework, we suggest that the basic data items specified under present IIP arrangements should be feasible for IDNOs to collect. Given that the number of customers on IDNO networks will be relatively smaller than on DNO networks, we expect that manual recording systems will be sufficient. However, it is clear that the wider IIP scheme is becoming increasingly onerous for DNOs in terms of, for example, the detailed reporting and audit requirements. As a consequence, we do not consider that the wholesale adoption of all or some of the IIP scheme (other than some high-level reporting of a few headline data items such as CMLs and CIs) would be proportionate regulation of IDNOs,.

Chapter 5: Charging Arrangements

We have been broadly supportive of the development of the relative price control arrangements for IGTs and the existing interim price control arrangements for IDNOs. We would therefore expect the longer term price control arrangements for IDNOs to have a similar effect to those for IGTs, but not necessarily to be exactly the same.

There are several considerations in developing long term charging arrangements. IDNOs require reasonable certainty about their income level over the life of the assets in which they are investing. Customers need a level of assurance that they will not be significantly worse off being connected to an IDNO network compared to the host DNO network. Finally, suppliers will not wish to see any increase in the complexity of pricing structures due to local variations in distribution charges if IDNO charges begin to differ significantly from those of the host DNO.

We see merit in Ofgem's suggestion of a "two tier" approach to IDNO price control, with relatively simple arrangements applying up to a certain threshold of connected supply

points and a more rigorous methodology above that threshold. We agree that the appropriate threshold might be of the order of 500,000 exit points and suggest that a justification for an appropriate threshold level might be developed by considering the statistical techniques used to model relative efficiency in the distribution price control reviews. Appropriate arrangements above and below such a "breakpoint" are discussed below.

Arrangements below the breakpoint

For "small" IDNO networks, it is desirable to keep regulatory intervention and costs to a minimum. In our view, option B (full RPI-X regulation) is not appropriate due to the amount of regulatory effort involved and the difficulty of obtaining company-specific and comparative IDNO information. The process would also involve significant costs for the IDNOs concerned, relative to the scale of their operation. There are similar disadvantages with option E (rate of return regulation).

Option D (relative price control regulation) is currently used for IGT regulation. While there are merits in the relative price control approach, the detailed arrangements set out under option D would not work without modification in electricity due to the different contractual and charging arrangements compared with the position in gas.

The remaining options use the host DNO charges as a starting point and we agree that this reflects the commercial reality of the competitive processes leading to the establishment of an IDNO network. If the IDNO cannot make a business case for network investment with current host DNO prices as a cap on his own prices, the development is unlikely to proceed. We do not believe it is necessary for the IDNO prices to match each element of the host DNO prices exactly, provided that the overall use of system charge can be shown to be broadly equivalent.

The question then arises as to how the IDNO prices are allowed to move over time. On the face of it, greater certainty for IDNOs is provided by de-linking the IDNO's path of prices from that of the DNO's path of prices, as suggested under option C. However, we can foresee situations where step changes to a DNO's input costs are "passed-through" in allowable revenue and affect the IDNO's costs. An example of this would be a change in NGC's charging methodology (as has recently been proposed) which increased charges to DNOs – part of this is likely to be passed through the DNO's charging methodology to the IDNO. Without a link between the IDNOs allowed prices and the DNOs (which would also be increased in this situation), the IDNO would face an increase in costs that it would have to absorb. There is also the perspective of supplier to consider, as noted above and finally, as Ofgem notes in its analysis of this option, the question arises as to how an appropriate value of "X" would be derived.

We therefore consider that there is merit in basing long term arrangements for "small" IDNOs on the existing "interim" arrangements, discussed under option A. The following refinements would be needed to these existing arrangements, in our view.

- It should be the overall use of system charge to customers that is restricted by the IDNO price control arrangements, rather than a forced matching of each individual element of a DNO's prices. It may be, for example, that an IDNO wishes to develop a simpler use of system tariff structure than the host DNO.

- To allow for the fact that there may be sudden reductions to the host DNO prices as a result of the price review process (i.e. significant P0 cuts), we advocate a "glidepath" approach, whereby the IDNO's charges are allowed to adjust more gradually to these external shocks. A floor and ceiling on the percentage change required to an IDNO's price cap in any one year, as used in IGT price regulation, is one such mechanism that might be applied.

- It should be feasible, in our view, for Ofgem to carry out "one-off" calculations to establish the floor and ceiling of a glide-path around individual IDNO prices, such as has been achieved in IGT price regulation. The underlying work of the distribution price control might be used for such calculations.

- It may be, to address Ofgem's concerns about the effect of the host DNO's performance under quality of supply incentive schemes feeding through to the IDNO's price cap, that Ofgem might consider making adjustments to the DNO reference price. We are not convinced that this effect will be material, given the other uncertainties affecting DNO prices but it may be that this issue should be reconsidered once the final DNO exposure to such incentive schemes is finalised.

- We also believe that the relative price control mechanism should provide price stability for new network developers over the lifetime of the assets. This has been achieved in the case of independent gas networks by, in effect, fixing the relative price control for 20 years. We believe that a similar mechanism should apply in electricity, perhaps with an option for the IDNO to seek a re-opener after 10 years.

As discussed above, due to the contractual arrangements in electricity, the IDNO has a degree of protection in the linkage under option A between its allowed prices and the use of system charge made to it by the host DNO. Given that Ofgem has a role in approving any changes to DNO charging methodologies, any move by the host DNO to rebalance tariffs to the detriment of the IDNO as suggested in paragraph 5.10 would be subject to regulatory oversight and the chance for representations from IDNOs to be considered.

Above the breakpoint

Once an IDNO has grown above the size threshold, we would favour applying the same type of price control assessment as is used for existing DNOs, as set out in option B. This would promote consistency across the industry and would allow an efficient level of revenue to be assessed in the same way across the electricity distribution industry. While there may need to be some specific factors associated with IDNO operation taken into account in the review process, the general elements should be the same and the IDNO

gradually absorbed into the same cycle of 5 yearly reviews as governs the DNOs' price regulation.

Chapter 6: Financial Ring-Fencing of IDNOs

In this chapter Ofgem confirms its previously stated intention to apply the suite of financial ring-fencing conditions to IDNOs through conditions BA2 to BA6 of the IDNO licence. A further proposal is made in relation to condition BA5 on the credit rating of the licensee. This requires IDNOs with over 500,000 supply points to maintain an investment grade credit rating (or have a "keep-well" agreement with an entity with an investment grade credit rating). For IDNOs with less than 500,000 exit points, a similar "keep-well" agreement is proposed with the IDNO's parent company. If the latter does not have an investment grade credit rating, then cash deposits or third party bonds to the value of at least 6 months operating and asset replacement costs are proposed.

We welcome the further clarity and consistency with DNO arrangements that the proposal for larger IDNOs brings but would still prefer to see no distinction made between credit requirements for IDNOs above the 500,000 threshold and those set out in the standard licence condition applying to DNOs.

Similarly, we welcome the formalisation of what constitutes acceptable credit arrangements for smaller IDNOs. The arrangements proposed appear compatible with the developments in supplier credit arrangements within energy networks. We also support the intention to initiate an orderly process of sale by the parent entity of the IDNO assets if the parent company does not reinstate monies from the escrow account or bond which are drawn down by the IDNO under the "keep well" agreement.

I hope these comments are helpful.

Yours sincerely

Rob McDonald
Director of Regulation