

Wednesday, 10 November 2004

Mark Cox
Networks - Distribution
Ofgem
9 Millbank
London
SW1P 3GE

Dear Mark,

**Consultation Response Paper – Structure of Electricity Distribution Charges
(October 2004 235/04)**

Laing Energy welcomes the opportunity to comment on the above consultation document. Please find attached our response as requested.

We would welcome the opportunity to meet with you in the near future to further expand on our response, and look forward to organising a meeting as a result. I have asked Donna Johnson to call you next week to arrange for a mutually convenient date.

Both electronic and hard copy of this letter (and the response paper) has been sent to you to enable it to be published on the Ofgem library web facility.

Yours sincerely,

P.P. [Signature]

Liam Warren
Business Leader
Laing Energy Limited

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Laing Energy

Consultation Response Paper

**Structure of Electricity Distribution
Charges (October 2004 235/04)**

November 10th 2004

Introduction

Laing Energy Limited (LEL) welcomes the opportunity to comment on the consultation into the structure of charges for DNOs. As an IDNO licence holder and a DNO customer, LEL is interested in ensuring that appropriate incentives are placed on DNOs to facilitate efficient IDNO entry and thereby achieve greater competition. To facilitate this it is important that sufficient information is available to all DNO customers such that tariffs can be observed and challenged in a constructive manner. LEL believes that this is the best way to support the aim of delivering maximum long-term benefits to consumers from improvements in:

- the economic, timely and efficient development and operation of distribution networks;
- quality and reliability of supply; and
- competition in connections, networks and retail supply.

At least two outcomes are necessary for this to be achieved:

- host DNO charging arrangements must be transparent, consistent, predictable, and cost-reflective; and
- IDNOs should not be exposed to levels of risk significantly different than those faced by host DNOs.

The level and structure of DNOs' charges—together with the wider regulatory regime applied to IDNOs themselves—are crucial factors impacting on the sustainability of competition in the provision of distribution networks and related services. There are three policy-related concerns that LEL considers to be central to the future development of acceptable DNO charging structures:

- current proposals do not adequately protect customers from potentially discriminatory charging structures, particularly at EHV;
- customers, including IDNOs, are exposed to the risk of inappropriate allocation of costs by DNOs, potentially resulting in a 'margin squeeze' and/or restricting further market entry by IDNOs; and
- existing proposals do not ensure that DNOs' charges would, in practice, be transparent and it is unclear what charging appeals process, if any, is in place.

Potential discriminatory charging structures

Ofgem's policy is to facilitate non-discriminatory access and competition in electricity distribution by ensuring that the DNOs avoid unduly volatile, unpredictable, or complex use-of-system (UoS) charges.¹ If, as the distribution licence states, a customer is able to make a reasonable estimate of the charges they are likely to face using the methodology and charging statement,² it is likely that Ofgem's policy objective will be achieved.

However, LEL feels that current proposals do not incorporate sufficient transparency and consistency for all customers to be able to make a reasonable estimate of their charges. This is demonstrated in the following table, which summarises the extent of transparency and consistency in existing charging policies for different host DNOs.

¹ Ofgem (2004), 'Structure of Electricity Distribution Charges—Consultation Paper: Proposed DNO Charging Methodology Statements', Ref: 235/04, October, p. 36.

² Electricity Act (2004), Section 11A, Condition 4A and 4B.

DNO	Demand			Generation		
	LV	HV	EHV	LV	HV	EHV
CE—NEDL, YEDL	P	P	SS	P	P	SS
CN—East Midlands	P	P	P, SS ¹	0	P	SS
CN—Midlands	P	P	P, SS ¹	0	0	SS
EDF—EPN, LPN, SPN	P	P	SS	P	P	SS
SP—SPD, Manweb	P	P	SS	0	P	AS, P
SSE—Hydro	P	P	P, SS ²	0	0	P
SSE—Southern	P	P	SS	0	0	P
UU—NWest	P	P	SS	P	P	P
WPD—South Wales	P	P	SS	P	P	P
WPD—South West	P	P	SS	P	P	P

Notes: Site-specific (SS); Area-specific (AS); Published tariff (P); Zero charge (0). ¹ Published tariffs for 'standard' connections, but with site-specific charges for 'non-standard' connections.

² Published tariffs for UoS charges, but with site-specific charges loss-adjustment factors.

Source: DNO UoS and connection-charging methodologies and charging statements, available at: www.ofgem.gov.uk (see 'Electricity Distribution Charges' under area of work).

The key point to note is that the extent of published demand tariffs at EHV is very low. This is significant because IDNO connections would almost exclusively occur at EHV.³ In contrast, DNOs' demand customers at LV and HV are likely to be domestic, industrial, or commercial users. LEL's view is that, as a provider of large network extensions, it could find connection at LV or HV uneconomical, thereby limiting the benefits IDNOs could otherwise bring to end-use consumers through enhanced competition. LEL's view is that the host DNOs should provide access to their networks at EHV on terms equal to those given to other customers.

IDNO-specific risks under current charging arrangements

The lack of transparency, consistency, and specific data for calculating DNOs' DUoS charges makes it difficult for an EHV customer to determine beforehand efficient network extensions, both in terms the location and voltage level. This gives rise to at least three important risks to IDNOs in particular, with a potentially detrimental impact on competition in distribution:

- *Potential margin squeeze due to uncertain up- and down-stream balancing of costs*—IDNO revenues are based on the difference between the exit point DUoS and the upstream DUoS. IDNOs are potentially exposed to the risk of the host DNO adjusting the pricing between the exit point and higher voltages in order to restrict entry of IDNOs.
- *Higher operational risks due to an inappropriate and uncertain balance between standing and variable charges*—the balance between (high) standing and (low) variable charges at each exit point on the network will affect the IDNO by potentially making upstream costs relatively fixed, whilst making downstream costs—on which IDNO revenue is based—more sensitive to price changes. In addition, an IDNO's costs may be based on the

³ EHV connections are defined in Special Condition Part B of the Electricity Distribution Licence, as occurring at a voltage of higher than 22kV or at a substation with a primary voltage of 66kV or above. In practice, this means sites with exit points at 132kV, 66kV, 33kV, and 22kV or at a 132/11kV or 66/11kV substations.

average DNO end-use consumer demand profile, but its revenues may be based on a particular subset of those consumers who are actually connected to its network (eg, domestic consumers), making competition in distribution services infeasible for some customer groups.

- *Unduly limited opportunities for market entry*—the lack of published tariffs at EHV increases the difficulty for IDNOs to recover search costs, thereby incurring greater sunk costs and resulting in a first-mover disadvantage. Higher sunk (search) costs raises a barrier to new entrants relative to second-movers who would not incur the initial ‘prospecting fee’ associated with the initial negotiations with DNOs. Second-movers would be able to see the existence of IDNO entry before them as a signal of viable competitive opportunities. In the long run this would act to limit competitive entry by IDNOs.

Clearly, these risks may further increase the required rate of return for IDNOs, unduly restricting the development of competition. For example, where a host DNO has very high standing charges, this will increase the operational gearing of IDNO operations, thus increasing the required rate of return still further.

The lack of published tariffs for EHV DUoS (shown in the table above) means that the above risks to IDNOs’ operations are acute. Given that generation UoS charges are published by some DNOs, it should be possible to have demand UoS charges available.

The implications for the wider development of distribution networks are also highly significant.

- To the extent that there are different levels of transparency between DNOs’ charges, IDNOs’ business risk will increase, thereby potentially reducing the overall level of IDNO penetration.
- The degree of inconsistency between DNOs is also likely to have a significant negative impact on the ability of IDNOs to identify competitive niches, resulting in variable levels of competitive entry by IDNOs across host DNO areas, implying uneven end-user benefits.
- Alternatively, where competitive entry does take place, the lack of a transparent and consistent charging policy for different types of network extension and at different voltages is likely to result in inefficient connections or extensions reducing end-user benefits still further.

Requirements for transparent and consistent charging structures

Full transparency would imply that a customer is able to determine what its charges are going to be for a particular voltage level in any host DNO area over a defined period of time. Together with greater consistency in the *structure* of charges across host DNOs, this would help to overcome a number of obstacles to greater competition in distribution highlighted above.

LEL believes that Ofgem should address the problems with existing charging proposals by implementing policies in three key areas:

- *Ensuring that published tariffs at EHV are available from all DNOs*—Ofgem should require all DNOs to publish DUoS charges at EHV in order to allow transparent access by all customers, including IDNOs. This would be achieved by the publication of a matrix of indicative tariffs at the various EHV voltages (ie, 132kV, 66kV, 33kV, and 22kV), as well as the published tariffs at LV and HV as currently is available. LEL understand that there

are likely to be some site-specific elements of tariffs at EHV level, but a clear statement of indicative tariffs would provide a starting point for any negotiations between DNOs and IDNOs.

In this way, the benefit of greater transparency would be to mitigate the problem of identifying opportunities for efficient entry, both in terms of geographical location and voltage level. It would also help to determine the actual size of the market for independent networks.

- *Increasing the requirement for reporting of costs and apportionment methodologies*—more detailed reporting of costs and the mechanisms for allocating costs between different end-user consumer groups, and at different voltages, should be implemented. O&M costs should be reported to allow customers to identify what proportion of each cost category an individual customer's DUoS charges are contributing to. In addition, the reporting of which network assets are used in the provision of EHV (by network voltage level as mentioned in the above bullet), HV, and LV connections and services should be mandatory to allow capital charges to be appropriately reflected in DUoS charges. The approach to the apportionment of O&M and capital charges should also be required to be included in the DNOs' charging methodology statements.

By implementing the above reporting requirements, IDNOs would be able to ascertain whether charges are cost-reflective and if the basis for fixed-cost allocation is appropriate. This would help mitigate the risk of margin squeeze referred to earlier, and allow IDNOs to evaluate the degree of additional operational gearing borne by IDNOs. In addition, the long-term nature of any investments to develop independent distribution networks means that transparency in the charging methodology is necessary to allow IDNOs to estimate the trajectory of DNOs' charges in the future.

- *Implementing procedures for dispute resolution between DNOs and their customers*—as well as providing an opportunity for DNO customers—including IDNOs—to challenge the level of published, indicative charges, Ofgem should consider developing a forum for the resolution of disputes between DNOs and their customers over the level of DUoS and connection charges. Guidelines for such a forum should ensure that any divergence from the indicative tariffs (either in favour of the DNO or IDNO) should be supported by reasonable compensation for site-specific factors.

This is likely to have at least three desirable effects. First, it would ensure that a consistent interpretation of cost-reflective charging principles is adopted across all networks. Second, it would provide a strong competitive discipline for DNOs in the current initial period of nascent IDNO competition. Third, it would give IDNOs some degree of certainty in their financial planning, thereby facilitating the development of effective competition in the development of distribution networks.

Taken together, these measures would increase transparency and consistency in DNOs' charging methodologies and would ensure that inefficient cost risks on IDNO operations would be mitigated. This would enable LEL and other IDNOs to invest efficiently in network expansion and ensure consumers get the maximum benefit from network competition.