Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Mark Cox
Distribution Policy
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Telephone: 01738 456400
Facsimile: 01738 456415

12th September 2005

Dear Mark,

Regulation of Independent Electricity Distribution Network Operators

I am writing in response to the Ofgem final proposals on the appropriate long-term regulatory regime for new independent distribution network operators (IDNOs) and distribution network operators (DNOs) operating out of area.

With regard to the price control arrangements for IDNOs and DNOs operating out of area, we are concerned that the final proposals for relative price control (RPC) regulation have moved from those put forward in the January 2005 initial proposal document. At that time, Ofgem proposed that the floor and ceiling would be set at +/- 5% around the incumbent DNO's charge to equivalent domestic customers at the start of the review period for the first five years, moving to +/- 10% thereafter for the next five years. The final proposals omit this last step, which we regard as important for two reasons:

i) firstly, in the absence of a 'glide path' for IDNO charges, the widening of the floor and ceiling after five years will help to ensure that the IDNO charges continue to follow the incumbent DNO's charges in the longer term unless there are significant changes to prices; and
ii) secondly, it will help mitigate against the problem, identified by Ofgem, of IDNO's 'cherry picking' sites where they will make the highest profits if charges do diverge.

It is our view, therefore, that the floor and ceiling should still be extended to +/- 10% after five years as put forward in the initial proposals document. Without this there is an increased risk of major divergence in prices between the IDNO and incumbent DNO over time.

We understand that in the gas industry, such divergence has already occurred and some IGTs are now able to charge up to twice the transportation charge of Transco/Host DN. We do not believe that this is good for the customer or for competition in general and would urge Ofgem to set the RPC regulation for IDNOs such that it follows the incumbent DNOs' charges unless there is significant change (i.e. >10%) over the period of the price control.

We agree with the proposal to implement similar revisions to licence conditions BA2 to BA6 to those made for ex-PES DNOs as part of the recent price control review. We note that these proposals for financial ring fencing of IDNOs are not applicable to DNOs operating out of area as they are already covered by the aforesaid changes to the ex-PES DNO licences.

With regard to Ofgem's view on the market structure within the electricity industry, we welcome the decision not to change the basic structure of the contractual relationship between upstream DNOs, IDNOs and suppliers.

On the subject of boundary equipment, we welcome the clarification that only one set of isolation equipment, supported with appropriate shared operating procedures should be necessary in many circumstances. With regard to boundary metering, we note Ofgem's view that suitable mechanisms are required to measure the electricity flows at the boundary, and that solutions should be identified for each connection scenario which are both proportionate and least cost. Our view is that in most scenarios the solution will involve appropriate metering at or near the boundary.

We note that with regard to credit cover for IDNOs, the proposal is to use four times their annual sales revenue as a proxy for Regulated Asset Value (RAV). We are not convinced this is appropriate as it is based upon the ratio of sales to RAV for the ex-PES DNOs, whose business structures are unlikely to resemble those of IDNOs. A more appropriate proxy for RAV would be the network asset base of the IDNO.

On the subject of credit cover for upstream DUoS, both alternatives to treating IDNOs on a similar basis to all other counter parties are likely to be even more bureaucratic and costly to the industry. Furthermore, whether or not credit cover would be required if the underlying supplier(s) were contracted directly to the host DNO is not the issue. The IDNO may get into financial difficulties irrespective of the credit worthiness of its own DUoS counter parties. We strongly believe that applying the same best practice credit cover arrangements across the industry is the most appropriate solution which will help to keep the costs of developing what we consider to be already overly-bureaucratic credit cover arrangements to the minimum.

Finally, with regard to the proposed changes to other licence conditions, we note Ofgem's proposals to move standard licence conditions 34, 35 & 48 into section B of the distribution licence via a collective licence modification. Whilst we fully support this proposals, we do have some comments on the draft replacement for licence condition 48 which are attached.

If you have any queries on any of the points raised in this letter please do not hesitate to contact me.

Yours sincerely,

Rob McDonald
Director of Regulation

Attachment: SSE Comments on the draft Standard Licence Condition intended to replace SLC 48

Paragraph 2(a) adds a requirement to increase demand use of system charges within 28 days of receiving a valid claim. No mention of this proposed change, or justification for it, has been provided in the Ofgem proposals. We do not consider it appropriate to require a network operator to modify its use of system charges within such a timescale. Network operators will seek to amend their use of system charges as soon as practicable after a valid claim as a matter of good business practice.

There is a minor typing error at paragraph 4 which should read '… this condition (other than sub-paragraph 7(a) and 7 (b)**)** shall apply separately …'.

We believe that paragraph 7 requires a sub-paragraph similar to sub-paragraph 11(b) of the existing SLC 48 i.e. 'the aggregate amount of its revenue derived from increases in charges in pursuance of paragraph 3'

Finally, there is a minor typing error at sub-paragraph 11(b), we believe it should read '… in charges in pursuance **of** paragraph 5'