



The Company Secretary
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*Promoting choice and
value for all customers*

Your Ref: SEPD/06/003A
Our Ref: RBA/DPC/SOC
Direct Dial: 020 7901 7255

CC: (by email only): Malcolm Burns

29 November 2006

Dear Colleague,

Decision in relation to modification proposal to the connection charging methodology: High cost amendment

On 13 November 2006, Scottish & Southern Energy plc submitted to the Gas and Electricity Markets Authority ("the Authority")¹ a proposal on behalf of Scottish HydroElectric Power Distribution Ltd ("SHEPD") to modify its connection charging methodology.

The proposal modifies the connection charging statement by clarifying the circumstances under which any high cost elements of reinforcement are recoverable. The proposal also includes a number of revisions which update the methodology statement.

Having carefully considered the issues raised in the proposal, the Authority has decided not to veto the proposed modification.

This letter sets out the background to the modification proposal, explains briefly the proposed changes and sets out the reason for the Authority's decision.

Background

SHEPD has licence obligations² to have in place as of 1 April 2005 three charging statements: the statement of use of system (UoS) methodology, the statement of UoS charges and the connection charging methodology. The connection charging methodology outlines the method by which connection charges are calculated. SHEPD has a requirement to keep the methodology under review and bring forward the proposals to modify the methodology that it considers better facilitate achievement of the relevant objectives.³

¹ Ofgem is the office of the Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

² Standard licence conditions 4-4B

³ The relevant objectives for the connection charging methodology, as contained in paragraph 3 of standard licence condition 4B of SHEPD's licence are:

- (a) that compliance with the connection charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and by this license;
- (b) that compliance with the connection charging methodology facilitates competition in generation and supply of electricity, and does not restrict, distort or prevent competition in the transmission or distribution of electricity.
- (c) That compliance with the connection charging methodology results in changes which reflect, as far as is reasonably practicable (taking into account of implementation costs), the costs incurred by the licensee and its distribution business; and

SHEPD Modification proposal

SHEPD proposes to clarify its connection charging methodology statement through the following:

- Clarification that the "high cost" element of necessary reinforcement(s) are recoverable from generation schemes only.

In November 2004 Ofgem published its final proposals as part of the Electricity Distribution price control review.⁴ As part of this document Ofgem stated that in some circumstances reinforcement for generation may involve unusually high costs (exceeding £200/kW). These "high costs" are not adequately addressed within the parameters of the main distributed generation ("DG") incentive scheme. In these circumstances Ofgem expects the generator seeking connection (and giving rise to the costs) to fund the required additional investment through connection charges. SHEPD subsequently incorporated this principle into their connection charging methodology. However, the methodology statement did not make it clear that the principle applies solely to reinforcement associated with generation.

- Revisions to the methodology statement in a number of areas:
 - Deletion of a reference to the 25% rule
 - Removal of a reference to a common connection charging boundary for both demand and generation
 - Replacing reference to P2/5 with P2/6
 - Deletion of transitional arrangements in place for connection offers made prior to 1 April 2005
 - Revised narrative of the application of operation and maintenance ("O&M")

SHEPD state these revisions update the methodology statement and thus provide greater clarity and understanding.

The Authority's decision

The Authority has considered the proposal against the relevant objectives and wider statutory duties. The change to the connection charging statement in regard to the "high cost" amendment is in line with recent Ofgem discussions with SHEPD over the clarification of this issue. "High costs" associated with reinforcement (over £200/kW) were only intended to be recoverable through connection charges for generation and not demand connections. These costs were not adequately addressed within the parameters of the main DG incentive scheme and so it was deemed fair for DNOs to recover them through connection charges. However, "high costs" associated with demand driven reinforcement were not intended to be recoverable through connection charges. Any "high costs" which result from demand driven reinforcement should be subject to apportionment as per the apportionment rules⁵. The proposal now makes this clear and thus provides greater clarity and understanding on the matter.

The Authority considers that the proposed revisions also give greater clarity to SHEPD's connection charging statement. The references to the 25% rule, a common connection charging boundary, deep charging regime and transitional arrangements are now superfluous. Their removal avoids any confusion which could arise and provides customers with a clearer understanding of the methods by which charges are calculated. These amendments and the update of security requirements from P2/5 to P2/6 better facilitates achievement of the relevant objectives by allowing SHEPD to better discharge

⁴ Electricity Distribution Price control review – Final proposals, 265/04 November 2004

⁵ As laid out in Structure of distribution charges :update and licence modification 76/04 April 2004

its duties under licence. The revised narrative of the application of "O&M" is in line with the amendment made to "high costs" and thus provides both consistency and clarity.

The Authority has decided not to veto the modification to the connection charging methodology statement.

Please contact Laura Nell on 020 7901 7201 if you have any queries in relation to the issues raised in this letter.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'M. Crouch', written in a cursive style.

Martin Crouch

Director, Distribution

Signed on behalf of the Authority and authorised for that purpose by the Authority