Your ref:

Our ref: ENERG/E/MC01

Mr Martin Crouch
Director
Distribution
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

18th June 2007

Dear Martin,

Consultation on Use of System Charges to New Electricity Distribution Licensees: WPD and SP Proposals.

Thank you for your letter of 8th May 2007 inviting further comments on the proposals received from Western Power Distribution (WPD) and ScottishPower (SP) to modify their UoS charging methodologies in respect of the charges levied towards IDNO's.

As you are aware, the application of DNO's charging methodologies to IDNO networks has been a contentious issue for a significant period of time. Therefore it was with some cautious optimism that Energetics Electricity welcomed the consultation exercise by both SP and WPD in the hope that there would be some transparency concerning their policies and their general regard to IDNO's.

However, not unsurprisingly, we are disappointed and extremely concerned by the content of these proposals, and in particular the proposal from SP, and regard this as potentially being restrictive in nature and raises the question of market manipulation.

As requested, Energetics has provided responses to the questions posed by Ofgem with respect of the proposed changes from ScottishPower and Western Power Distribution. However, we have also taken the opportunity to draw attention to the scale and variability of capacity and upstream UoS charges and associated practices across all of the DNO's in the expectation that Ofgem will act decisively to address the blatant imbalance currently affecting what could be described as 'margin squeeze' and as such the longevity of IDNO's.

Before moving into the questions raised by Ofgem in your consultation document I wish to draw your attention to the assumptions used in calculating the income and associated charges for LV Network connections (Annex 4.1). The tariff used by each of the DNO's is in fact LVHH and not the non-half hourly stated. We have corrected the figures and these can be viewed in Appendix 1.

Views sought:

- *Does SP's/WPD's modification proposal better achieve the relevant objectives?*
    - *Are the proposals more cost reflective than the current methodology?*
    - *Does SP/WPD demonstrate that their proposals facilitate competition in generation and supply and do not restrict, distort or prevent competition in transmission and distribution?*

a) The absence of cost data in the proposal from both SP and WPD make it impossible to provide comment on whether or not they are in fact more cost reflective than the current methodology. Therefore, we must defer to the Authority to ensure this is in fact the case or to take the necessary action to have these Companies comply with the relevant Licence conditions. We are however perplexed by the use of the term "more cost reflective", it is incumbent on these Companies to ensure that the proposals are in fact cost reflective.
b) Furthermore, we now detect the use of the term "costs avoided". This is not a phrase we recognise in terms of the obligations and as such are concerned that this is a different and indeed lesser test than that imposed by the Authority.
c) In respect of the second point, we are of the opinion that both SP and WPD have failed to demonstrate that their proposals do not prevent competition in distribution. In fact we feel that the examples used do not represent the true position, as detailed in our appendix 2, and as such confuse the issue. We hope that it is abundantly clear to the authority that IDNO's would suffer even less revenues as a direct result of implementing these proposals, which raise the question of "margin squeeze" even stronger than at present.

Energetics firmly objected to the proposal from SP outlined in our response dated 31st January 2007. In the illustration provided by SP, every single example resulted in each of our electricity networks becoming less financially viable. This is worrying in the extreme, especially when you consider that some of the networks we presently own produce negative returns using the existing DNO charging methodologies. The proposals which have been put forward by the respective DNO's threatens the feasibility of owning and operating these networks and poses serious questions regarding the sustainability of IDNOs in general.

LV Network Connections

The corrected illustration provided in Appendix 1 demonstrates in simple terms the issues currently affecting IDNO's. In a scenario where an IDNO is successful in securing the adoption of a development from the incumbent DNO, ScottishPower and Western Power Distribution still manage to retain up to 67% and a staggering 80% respectively of the available income. In addition, this calculation does not take into account the financial effect of boundary metering charges which squeezes the available revenue even further.

It is therefore very alarming that the proposed sets of charges squeezes the margin even further with ScottishPower and Western Power Distribution still managing to retain up to 74% and 85% respectively of any potential income.

Perhaps it is more than coincidence that the DNO's have been pushed hard on the practise of charging capacity for housing developments through the application of the LVHH and HVHH tariffs for IDNO connections when their own charging methodology clearly states that domestic customers will not be charged for capacity. With WPD

and SP (<100kVA only) removing these charges, they then proceed to apply a tariff which not only moves those costs to within the tariff, but also manages to increase them as illustrated in the table below.

	Existing		Proposed		% UoS Increase
	Capacity	UoS	Capacity	UoS	
WPD South West	£1,091	£1,767	NA	£3,098	75%
WPD South Wales	£1,275	£1,763	NA	£3,234	83%
SP Distribution	£654	£2,069	NA	£2,988	44%
SP Manweb	£565	£1,571	NA	£2,410	53%

HV Network Connections

Similar to the LV Network connection example, both SP and WPD have sought ways to protect or, in the case of SP, increase their income from IDNO connections. Taking WPD first; although the available IDNO gross margin is more or less the same under the existing and proposed tariff structure, with the removal of capacity charges for housing developments the increase in UoS charges equating to 141% and 168%, as indicated below, is quite frankly ludicrous and an attempt to maintain and/or improve their current level of income. In addition, in the face of increasing pressure to drop the unfair and anti-competitive capacity charges, they have created the illusion of addressing the issue.

	Existing		Proposed		% UoS Increase
	Capacity	UoS	Capacity	UoS	
WPD South West	£4,073	£2,267	NA	£6,084	168%
WPD South Wales	£3,898	£2,574	NA	£6,216	141%
SP Distribution	£1,183	£6,342	£1,423	£8,802	39%
SP Manweb	£1,292	£5,813	£1,303	£7,197	24%

Turning to the proposals from ScottishPower, two points are relevant: -

1. Their insistence that capacity charges continue to apply for housing developments greater than 100kVA as some form of 'incentive' reflects their dismissive approach to this market. In a like-for-like scenario ScottishPower will not recover capacity charges from either the property developer or the end customers in the event they secure network ownership. However, should an IDNO secure the network then they have to pay SP over 10% of the available income in capacity charges which the IDNO cannot recover from customers under the RPC principle. If we have understood this point, it would appear that SP have unilaterally taken steps to regulate the Electricity Market. It was and remains our understanding that this is the role of the Authority and not SP. Notwithstanding, this action clearly restricts, distorts and prevents competition in the market and as such we feel is unacceptable.
2. Their UoS charges have increased by up to 39% resulting in a gross IDNO margin of £22 and £15 for SP Distribution and SP Manweb respectively. Under the LV network example the respective gross margins were £23 and £19 respectively. This results in IDNO's earning less per connected customer for owning more of the network! I believe this illustrates the point very concisely that SP have not based these proposals on quantative cost reflective data and have singularly failed to justify these additional charges

An accumulation of these issues raise the whole question as to the validity of this consultation exercise and I find it difficult to understand why Ofgem are going through a costly and time consuming process when the evidence of market manipulation is openly available.

Therefore in response to the questions raised, we fundamentally object to these proposals and associated IDNO tariffs and regard them as lacking in transparency in respect of the costs that they are legitimately allowed to recover and regard them as a deliberate attempt to protect the revenue streams at their previous levels thus ensuring that the impact of IDNO networks will not have a material effect on their ongoing returns.

- *Have we correctly captured the main issues raised by WPD and SP's modification proposals?*

In response to this question, we believe the positions taken by WPD and SP raise serious questions on the variability of capacity and upstream UoS charges and also their transparency in meeting the Relevant Objectives. Energetics wish to take this opportunity to request that Ofgem widen the scope of this consultation exercise to look at each and every one of the DNO charging arrangements.

To this end we have included a summarised report in Appendix 2 which illustrates the position across the UK on the two examples used by Ofgem, namely the 45 plot LV Network Connections and the 150 plot HV Network Connection. This sub-report clearly highlights the questionable approach taken by many of the DNO's in setting their Use of System Charges, the wide degree of variability and corresponding net IDNO gross margin available and finally the lack of transparency as to the 'actual' costs that these charges are meant to recover.

Summary
We firmly believe that Ofgem should be conducting an analysis of these charging practices as a matter of urgency to satisfy themselves as to the validity of the resulting figures and from there would expect immediate and decisive action to create a more level market for IDNO's to compete effectively.
Should Ofgem fail to take decisive action then Energetics Electricity may have to embark on a complaint to the Office of Fair Trading to highlight the extent of the market abuse.

You will have gathered from our response that these issues are causing Energetics Electricity great difficulties in the market. We would like to assure Ofgem that we remain willing to work with the industry and the regulator to create the competitive market place that our customers deserve. The evidence over the last five years has shown that consultation and arbitration with the DNO's has achieved very little. It is now incumbent on Ofgem to lead on this issue and demonstrate their willingness to make the necessary changes to ensure that the market exists and operates to the licence obligations and legislation, all of which will lead to improvements for customers and the industry as a whole.

Yours sincerely

Bill McClymont
Chief Executive Officer

Appendix 1:
Development Connected to DNO LV Network (<100kVA) - Corrected Data

Illustrative Assumptions						
Number of Households		45				
Average Household Consumption		3900	kWh			
Average Household Capacity		2	kVA			
Capacity Diversity Factor		1				
Diversified Site Capacity		90	kVA			
Day Units %		75%				
Night Units %		25%				
Existing DNO Tariffs (April 2007) As per Ofgem Consultation Document	All the way income IDNO collects	IDNO income per plot	Site boundary charge by DNO to IDNO	Site IDNO gross margin	IDNO Margin per plot	% of total all the way charge
WPD South West	£3,686	£82	£2,362	£1,324	£29	36%
WPD South Wales	£3,808	£85	£3,155	£653	£15	17%
SP Distribution	£4,044	£90	£2,767	£1,277	£28	32%
SP Manweb	£3,243	£72	£1,914	£1,329	£30	41%
Existing DNO Tariffs (April 2007) Corrected to reflect LV HH Tariff	All the way income IDNO collects	IDNO income per plot	Site boundary charge by DNO to IDNO	Site IDNO gross margin	IDNO Margin per plot	% of total all the way charge
WPD South West	£3,686	£82	£2,858	£828	£18	22%
WPD South Wales	£3,808	£85	£3,038	£770	£17	20%
SP Distribution	£4,044	£90	£2,723	£1,321	£29	33%
SP Manweb	£3,243	£72	£2,136	£1,107	£25	34%
Modification Proposal Capacity requirement below 100kVA	All the way income IDNO collects	IDNO income per plot	Site boundary charge by DNO to IDNO	Site IDNO gross margin	IDNO Margin per plot	% of total all the way charge
WPD South West	£3,686	£82	£3,098	£588	£13	16%
WPD South Wales	£3,808	£85	£3,234	£574	£13	15%
SP Distribution	£4,044	£90	£2,988	£1,056	£23	26%
SP Manweb	£3,243	£72	£2,410	£833	£19	26%

Appendix 2:
Wider Market Concerns on Charging Statements

Introduction
The questions raised by the WPD and SP consultations have highlighted the somewhat subjective nature of the treatment of capacity charges for residential developments and also the wide range of charges for upstream Use of System. The fundamental challenge that must be posed to all of the DNO's is how they can justify their charging methodologies and statements in the context of meeting the Relevant Objectives.

Firstly, a reminder of the relevant objectives: -

a) that compliance with the Use of System Charging Methodology facilitates the discharge by which the licensee of the obligations imposed on it under the Act and by this licence;
b) that compliance with the Use of System Charging Methodology facilitates competition in the 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 Use of System Charging Methodology results in charges which reflect, as far as reasonably practicable (taking account of implementation costs), the costs incurred by the licensee in its distribution business; and
d) That, so far as is consistent with sub-paragraphs a), b) and c), the Use of System Charging Methodology, as far as reasonably practicable, properly takes account of developments in the licensee's distribution business

This summarised report takes the two network examples used in the WPD/SP consultation and extends the same calculation to determine the IDNO margin after deductions for capacity and upstream UoS for each of the 14 Distribution Network Operators. The output from this analysis can then be used to assess the DNO's against meeting these objectives, particularly b) and c).

LV Network Connections

Using the same data tables as those in the consultation exercise, the table below ranks each of the 14 DNO's against their current Charging Statements (except WPD and SP where their proposed tariffs have been used).

	All the way income IDNO collects	IDNO income per plot	Site boundary charge by DNO to IDNO		Site IDNO gross margin	IDNO Margin per plot	% of total all the way charge
			Capacity	UoS			
Southern Electric	£3,067	£68	£1,112	£998	£957	£21	31%
			Total	£2,110			
Scottish Hydro	£4,518	£100	£1,782	£1,540	£1,196	£27	26%
			Total	£3,322			
SP Distribution	£4,044	£90		£2,988	£1,056	£23	26%
			Total	£2,988			
SP Manweb	£3,243	£72		£2,410	£833	£19	26%
			Total	£2,410			
United Utilities	£3,077	£68	£1,415	£856	£806	£18	26%
			Total	£2,271			
NEDL	£3,369	£75	£120	£2,459	£790	£18	23%
			Total	£2,579			
WPD South West	£3,686	£82		£3,098	£588	£13	16%
			Total	£3,098			
WPD South Wales	£3,808	£85		£3,234	£574	£13	15%
			Total	£3,234			
EdF London	£2,631	£58	£1,067	£1,447	£117	£3	4%
			Total	£2,514			
YEDL	£2,948	£66	£1,303	£1,699	-£54	-£1	-2%
			Total	£3,002			
Central Networks W	£2,577	£57	£1,830	£861	-£114	-£3	-4%
			Total	£2,691			
EdF SeeBoard	£2,210	£49	£1,892	£609	-£291	-£6	-13%
			Total	£2,501			
Central Networks E	£2,396	£53	£1,718	£1,021	-£343	-£8	-14%
			Total	£2,739			
EdF Eastern	£2,619	£58	£1,814	£1,483	-£678	-£15	-26%
			Total	£3,297			

You will derive from this table: -

1. Under the current Relative Price Control (RPC) methodology, the IDNO gross margin per plot varies across the country to the extent that there is a £51 difference between the highest (Scottish Hydro at £100) and the lowest (EdF SeeBoard at £49). As a consequence, it's accepted that the IDNO margin per plot would also vary from one DNO to the other.
2. The site boundary charge (combination of capacity charge and upstream UoS charge) also varies greatly from a high of £3,322 in Scottish Hydro to a low of £2,111 in Southern Electric
3. The most important observation is the final column which illustrates the percentage of the "all the way income" available to the IDNO to cover boundary metering charges and their own internal costs. The percentage available ranges from 31% down to a staggering negative 26%! Even more alarming is the fact that five of the DNO's leave a negative income to the IDNO.

HV Network Connections

Similar to the LV Network example, the same assumptions were used across the 14 DNO's to show the same breakdown of charges. As before, the proposed tariffs from WPD and SP have been used in this analysis with the other 10 DNO's reflecting their current charging arrangements.

	All the way income IDNO collects	IDNO income per plot	Site boundary charge by DNO to IDNO		Site IDNO gross margin	IDNO Margin per plot	% of total all the way charge
			Capacity	UoS			
WPD South Wales	£12,695	£85		£6,216	£6,479	£43	51%
			Total	£6,216			
WPD South West	£12,285	£82		£6,084	£6,201	£41	50%
			Total	£6,084			
Scottish Hydro	£15,061	£100	£4,788	£3,666	£6,607	£44	44%
			Total	£8,454			
Southern Electric	£10,222	£68	£3,024	£3,141	£4,057	£27	40%
			Total	£6,165			
United Utilities	£10,257	£68	£4,140	£2,323	£3,794	£25	37%
			Total	£6,463			
EdF Eastern	£8,732	£58	£3,348	£2,203	£3,181	£21	36%
			Total	£5,551			
EdF London	£8,770	£58	£3,816	£2,219	£2,735	£18	31%
			Total	£6,035			
SP Distribution	£13,480	£90	£1,424	£8,802	£3,254	£22	24%
			Total	£10,226			
Central Networks W	£8,591	£57	£4,654	£1,983	£1,954	£13	23%
			Total	£6,637			
SP Manweb	£10,810	£72	£1,303	£7,197	£2,310	£15	21%
			Total	£8,500			
EdF SeeBoard	£7,366	£49	£5,152	£925	£1,289	£9	17%
			Total	£6,077			
Central Networks E	£7,986	£53	£4,479	£2,480	£1,027	£7	13%
			Total	£6,959			
NEDL	£11,230	£75	£2,688	£7,422	£1,120	£7	10%
			Total	£10,110			
YEDL	£9,827	£66	£2,903	£6,275	£649	£4	7%
			Total	£9,178			

Key observations from this table: -

1. Once again, the most important output is the final column which illustrates the percentage of the "all the way income" available to the IDNO to cover boundary metering charges and their own internal costs. The percentage available ranges from 51% down to 7%, thereby resulting in a 44% swing.
2. At the lower end of the table we find that the NEDL and YEDL areas can attract a decent starting income with £11,230 and £9,827 respectively. Arguably as a result of their excessive standing charges, they account for two of the highest UoS charges in the industry resulting in IDNO gross margins per plot of less than £10.
3. The range of capacity charges applied is of obvious concern ranging from zero in WPD to an incredulous £5,152 in EdF Seeboard.

Comparison between HV & LV Network Connections

Each of the DNO's state clearly in their Use of System Charging Methodology that their charges meet the relevant objectives and in particular;

- …does not restrict, distort, or prevent competition in the transmission or distribution of electricity and;
- … results in charges which reflect, as far as reasonably practicable (taking account of implementation costs), the costs incurred by the licensee in its distribution business

The table below compares the available IDNO gross margin per plot for HV and LV network connections in order to assess their compliance with the Charging Methodologies.

	HV IDNO Margin per plot	LV IDNO Margin per plot	Difference HV less LV
EdF Eastern	£21	-£15	£36
WPD South Wales	£43	£13	£30
WPD South West	£41	£13	£28
Scottish Hydro	£44	£27	£17
Central Networks W	£13	-£3	£16
EdF London	£18	£3	£15
EdF SeeBoard	£9	-£6	£15
Central Networks E	£7	-£8	£15
United Utilities	£25	£18	£7
Southern Electric	£27	£21	£6
YEDL	£4	-£1	£5
SP Distribution	£22	£23	-£1
SP Manweb	£15	£19	-£4
NEDL	£7	£18	-£11

Once again a number of important points arise from this analysis: -

1. Although EdF Eastern shows the largest income increase from LV to HV, the fact that the LV margin per plot is so negative does not bring any comfort to the IDNO marketplace.
2. Both WPD companies show a more consistent position with circa £30 of a difference reflecting the fact that they have less of the network to manage at HV.
3. The fact that SP Distribution, SP Manweb and NEDL can justify reducing the margin per plot for HV connections is incredulous! Whatever the reasons, this must be viewed by Ofgem as a clear indication that their charging methodologies are not designed to meet the relevant objectives.
4. On a similar note, companies such as YEDL, Central Networks East and EdF Seeboard must be taken to task on the fact that the gross margin on LV networks is negative and the step up to HV results in a gross margin of less than £10.

Summary
The most recent Gas & Electricity Connections Industry Review Results were published in August 2006 and covered the 2005/06 operating year. The published figures showed that of the new domestic electricity connections completed that year (322,323), less than 5% were connected by Independent Connections Providers compared to 70% in the gas sector. Twelve years after the market was opened to competition, this must been seen as a regulatory failure.

In an attempt to overcome the many technical and commercial obstacles posed by the DNO's, a few organisations ventured down the IDNO route only to be met with charging methodologies which effectively left many of the new developments uneconomic. The situation for IDNO's is fast approaching the point where investors will withdraw funding to secure new developments due to the fact that there are many areas of the UK where the net annual returns are negative.

The key issues that must be addressed as a matter of urgency are: -

1. The practice of charging IDNO's for capacity on housing developments when each and every one of the DNO's state that domestic customers will not be charged for capacity should they adopt the network. WPD have stated that they will withdraw capacity charges but what about the other DNO's? More importantly, what does Ofgem intend to do about this anti-competitive practice?
2. The random nature of UoS charges has resulted in many of the monopoly licenced areas being free from competition in network ownership. It's acknowledged that Ofgem would not wish to embark on a 'cost plus' margin recovery for IDNO's on the understanding that this could lead to a similar situation in the early days of the Independent Gas Transporters where customers of independently owned networks paid more for their transportation charge. However, there must be some form of mechanism that results in a set percentage of available income for IDNO's rather than allow the current situation to continue. The mere fact that the percentage of available income can vary so dramatically across the DNO's point very clearly to a failure in the market.
3. The situation whereby a handful of the DNO's earn more revenue by losing the network to an IDNO should be viewed with some embarrassment by these companies and indeed by Ofgem.
4. The lack of cost transparency from the DNO's in justifying their respective positions must be challenged. It's clear that Ofgem only approve the Methodology Statements year-on-year, however, it's absolutely essential that Ofgem takes responsibility for monitoring the price changes from each of the DNO's to ensure that the obligations are being met.
5. Lastly, although the application of boundary metering has not been addressed in this analysis, this is another area that can have a considerable impact on IDNO revenue streams. Typical annual charges can average £500 per development which of course is a significant sum, particularly for the LV network connections. Again, this is causing distortion in the market