

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

7 June 2007

Dear Mr Crouch,

**Ref: Ofgem consultation on proposed new charge structures for IDNOs from Western Power Distribution and Scottish Power**

Thank you for the opportunity to provide our views on these very important initiatives from two distribution network operators (DNOs) as set out in your open letter of 8th May 2007.

As an IDNO with operational networks we have real experience from dealing in the developing competitive market for electricity distribution services and new connections, and we are at the sharp end of the charging proposals currently being developed by DNOs.

### **Key points**

LORE has been actively engaged in moves to develop distinct distribution use of system charges for IDNOs. This involvement includes responding to both consultations on this issue run by Scottish Power (SP) as part of its development process. Since making those responses, we have also had the opportunity to analyse further the rates and detail of charges proposed by both SP and Western Power Distribution (WPD).

We note Ofgem's desire for responses to the consultation to address whether they believe the charging modifications proposed by the two companies better reflect licence objectives compared with the arrangements currently in place. In summary our views are set out below:

° ***Are the proposals more cost reflective than the current methodology?***

LOE supports the concept of application of an IDNO yardstick as being more cost reflective. However, we struggle to reach a considered answer on this because of the limited information provided by the DNOs about how they have arrived at the actual costs assumed in their proposals. Both DNOs have stated that they have followed similar methodologies with respect to cost reflectivity, but have come up with significantly different proposals leading to a wide disparity in the percentage of all the way costs earned by the IDNO. Neither DNO demonstrate that they have met Competition Act requirements, especially with regard to including all costs avoided whilst allowing for a reasonable margin on capital employed. In the case of SP they appear to include additional fixed costs that we believe are grossly overstated, if they exist at all.

WPD's proposals seem (based on our estimates) to create more viable charges for IDNOs, especially at smaller developments, compared to SP's proposals. The SP proposals, when modelled against our operational networks, would not permit us a sustainable operation.

It would be premature in terms of the information available to say one set of proposals was cost-reflective but the other not. Both proponents place undue emphasis on the transactional costs of dealing with IDNOs, and there has been little substantiation of the avoided costs on their own systems. What we do know is that the costs we see in our business (and which presumably the corresponding DNO would have seen) bear little obvious relationship to the charges they are quoting. Given Ofgem's approach to relative regulation of our own charges, this is creating real and systematic distortions.

° ***Do the companies demonstrate that their proposals facilitate competition in transmission and distribution?***

In both cases from our own analysis the DNOs seem to have structured the charges to load costs towards domestic and smaller mixed developments, which we consider to be anti-competitive if not in purpose then at least in effect.

The use of capacity charging is discriminatory, especially in relation to similar classes of customers on the DNOs networks, and we believe in many cases unnecessary. It also creates a competitive wedge that favours provision of service by its in-house resource given the "margin squeeze" this creates for its competitors. The SP proposal proposes removal of capacity charges only for small scale networks, and the WPD proposal proposes removal of capacity charges for 'predominantly domestic' networks only. The justification for the application of capacity charges is to ensure that excess capacity is not requested. We do not believe this is justified, as IDNOs are licensed distributors and as such have the same obligations under licence condition 9 to regarding network efficiencies as the DNOs.

We consider that in particular SP's approach in retaining capacity charges for most circumstances and the inclusion of unjustifiable additional fixed cost creates barriers to entry and we consider this proposal anti-competitive.

° ***Has Ofgem correctly captured the main issues raised by the modification proposals?***

In terms of the licence objectives, the consultation paper identifies the main issues. However we have real concerns based on recent determinations that undue weight is placed on cost-reflectivity in precedence to the competitive impacts. We also struggle to understand what Ofgem and DNOs mean by cost-reflectivity at a practical level and how this property is assessed and translated into tariff structures in a transparent manner. We would wish to see greater emphasis generally on transparency and simplicity of proposals, and of a consistent approach across the industry.

**Other comments**

Ofgem will be aware of the Inexus proposal to use aggregated data for the purposes of billing, removing the need for boundary metering between IDNO and DNO networks for



However we would not wish consideration of this proposal - which relates to the mechanism for measuring and settling demand - to distract from the importance of resolving these issues concerning the structure of charging. It is pointless worrying about the mechanism for quantifying charges if the diverse and inconsistent proposals being brought forward by DNOs are not evaluated rigorously within a framework that places due weight on competitive outcomes and the further competitive distortions that are arising from charging proposals.


Whilst we welcome the development work to date on IDNO charges, we believe it needs to be much accelerated across all DNOs so that greater consistency can be introduced and that the Inexus proposal can be implemented. The issues we highlight in this letter and in our detailed comments therefore need to be addressed as a matter of priority, and they need to be addressed in a consistent way by all DNOs – not just with regard to the four licensees covered by this consultation - otherwise the competitive pressures IDNOs are able to bring will vary by region, increasing the cost and complexity for IDNOs.

LORE consider that in the round Ofgem needs to adopt a much more interrogative approach to DNO charge proposals and how they impact on IDNOs. This is an obvious area where the work of the ENA could be extended with a view to development of a common model to assess consistently the impacts of adopting an IDNO-specific yardstick and what should be in it. We would go as far as saying that the current largely hands-off approach adopted by Ofgem is leading to a position where the industry is drifting down a road that is destined to achieve business failure by IDNOs. It is not too extreme in our view to say this lack of a coherent strategy will result in an end to its attempts to bring about competition in electricity distribution provision by IDNOs.

There have been encouraging signs of a more rigorous approach by Ofgem to performance issues by DNOs recently, mainly through the competition in connections workstream, and we applaud its efforts. However much of this work is likely to be nugatory if it cannot or will not take a similarly robust line with DNOs on charging issues.

I hope these comments are helpful and look forward to discussing them with you when we meet in July, at which I will provide details of the charging assessments across each of the GSP areas.

Yours sincerely,



**Darren Grundy**

**Darren Grundy**  
Business Leader  
For Laing O'Rourke Energy Ltd

### Detailed comments

We have grouped our further comments below by the four main issues highlighted in Annex 2 of your letter, specifically:

- specific yardsticks for IDNOs;
- avoided costs;
- tariff design and capacity charging; and
- reactive power charging.

We have reviewed the proposed IDNO charges tabled by both companies and compared them with the rates currently in place – typically the monthly-billed schedules. We have evaluated them according to sample demand profiles based on our operational experience. Crucially our analysis leads us to believe there are a number of differences and inconsistencies between the illustrative numbers shown by Ofgem at annex 4 and our own assessment, particularly when considering the impact on electrically heated developments.

There are also important differences between the two proposals which lead to significant differences in the percentage of all the way income that can be earned by IDNOs, and it is difficult to see that both proposals can be cost reflective across two areas that border each other for example (WPD Wales and SP Manweb). Ultimately, however, it is not possible to evaluate whether the proposals reflect the actual costs incurred by either DNO. We urge Ofgem to ensure a much more harmonised and transparent approach is adopted as far as possible by DNOs in this area.

Structurally the tariffs contain important differences, which given the stated approach of producing a consistent approach to charging is illogical. In particular we note:

- SP proposes two different mechanisms for LV customers, WPD one;
- SP retains capacity charges for all but small LV networks
- WPD retains capacity charges for networks that are not 'predominantly domestic'
- different assumptions are used with regard to sample size and load characteristics in constructing the proposed tariffs.

Furthermore the process of leading with a theoretical discussion and only concluding with proposed charges is unhelpful. At a high level parties can agree in principle that distinct charges for IDNOs would be useful. Only when the real impact can be seen with actual charges can commercial decisions be made on what the charges mean in practice. We think there is a real danger that regulatory oversight will stop at the theoretical level leaving the DNOs with largely a free hand to implement new arrangements as they see fit and usually to their own commercial advantage.

From our perspective the charges do not seem to be reflective of the costs that we assess and see in our own businesses, and this disparity can only hinder competition. Added to this the test of what is cost reflective is not well-defined, and it is clear that competitive



impacts are very much a second order consideration and are scarcely touched on by the DNOs. Even where they are given emphasis, the effect on IDNOs seems not to be an important consideration.

### **Specific yardsticks for IDNOs**

From our evaluation of the charge schedules, we believe significantly higher charges would result to IDNOs connected at high voltage in the Scottish Power and Scottish Power Manweb areas from the proposed high voltage IDNO rates than the current half hourly metered. In the first instance this is counterintuitive, as the only reason we can discern which may have an impact is a reference by Scottish Power to increased billing costs for IDNOs because these users are billed manually.

We question the cost reflectivity of the approaches adopted by both companies in calculating the yardstick, especially when the two DNOs have adopted differing assumptions in identifying costs. The proposed tariffs give significantly different percentages of all the way charges earned by the IDNOs. For example, using the Ofgem comparison data, for a HV network in South Wales (WPD) the % earned by the IDNO would be 51% of the total all the way charges, whilst in North Wales (SP Manweb) the % earned would be 21%.

In addition we have had great difficulty in replicating the examples contained in the SP Modification Report of cost difference per end customer and percentage of all the way charges earned by the IDNO. In all cases our calculations show a worse position for the IDNOs than SPs, with in particular the position on electrical heated developments being significantly worse than SP's examples.

As a minimum there needs to be much greater visibility and consistency of the yardstick calculations and we urge Ofgem to seek full disclosure by the companies of this information. This information should then be compared and contrasted for consistency given the competitive impacts differences have. Furthermore as they stand we believe both companies' proposed charges will harm and rather than facilitate competition because they are loading costs onto IDNOs that they would not charge corresponding classes of customer in their own business.

### **Avoided costs**

We do not believe that the Scottish Power HV IDNO charges take into account the avoided costs of an IDNO's activity. SP's proposed HV IDNO charges cannot be more cost reflective than the standard HH monthly HV charges already in place – because the extra costs they propose to impose exceed any extra billing costs it may incur. Furthermore, we believe we can provide data from D0036 flows which would help Scottish Power and other DNOs automate their billing of IDNOs thus removing any extra billing cost. This point has been made to them by IDNOs but it has been ignored.

As a minimum we therefore wish to see fuller information on this issue from both WPD and SP on the costs IDNOs help them avoid as well as the extra costs they may incur so we can make our own evaluation, and we recommend that Ofgem undertakes its own more thorough review.

### Tariff design and capacity charging

The use of capacity charging by DNOs in their charges to IDNOs is common place and puts independent operators at a significant disadvantage through "margin squeeze". DNO charges to domestic users and small business users do not incorporate capacity charge elements, and the practice of applying such charges to such customers through IDNO rates is explicitly discriminatory and seems designed to distort the competitive process in their favour.

We therefore welcome, such as they are, the proposals by both companies to limit their use of capacity charges in new IDNO structures. However, we feel that both companies need to do more if they are to demonstrate that their proposals facilitate competition. We believe as currently structured the practical impact of both sets of proposals would still be to hinder competition by deterring IDNO activity in those market sectors where IDNO tariffs with capacity charges would apply:

- Scottish Power's proposed use of a capacity charge in the HV IDNO tariff is anti-competitive as it effectively locks out IDNO competition from any other than small scale domestic developments. By way of context we estimate that capacity charges would apply for developments of more than around 50 houses with gas heating, and 20-25 houses/flats if electrically heated;
- WPD's decision to limit IDNO tariffs to predominantly domestic developments is arbitrary and unsubstantiated. We do not believe the 50% non-domestic threshold test is representative of WPD's own costs in setting its tariffs and believe it should be removed, or other specific IDNO tariffs introduced. Again the effect of this decision by WPD is to restrict access a significant segment of the market – in this case business and mixed (business and domestic) developments - and this is also anti-competitive. We suggest that the 50% ruling is unenforceable in any case as developments may well emerge where relative usage varies about this level depending on local demand conditions and changes in commercial customer's requirements. Would an IDNO network qualify one year and not the next because the share of non-domestic usage had altered from 49.9% to 50.1%?

The SP proposal states that capacity charges are required to ensure that users only "request the capacity they need." Whilst this may be appropriate for general users, IDNOs are licensed distributors and as such have the same obligations under licence condition 9 regarding network efficiencies as the DNOs do. If we are not operating in a responsible manner and are requesting higher than required capacities, then we would be under threat of sanction by the regulator, as would a DNO. We therefore believe IDNO tariffs do not need to contain provisions designed to force IDNOs to a DNO's vision of their behaviour. We would suggest this has more to do with enforcing its commercial priorities than licence compliance.

We note the provision proposed by SP for reduced capacity charges to apply where the peak occurs at night, which highlights the wider diversity DNOs enjoy across their system and undermines the basic argument against the use of capacity charges. On a practical level, it is our experience that developers are moving away from storage heater type



installations and onto alternative types of heating. Where electric heating is still being installed it is more likely to be smart thermostatically controlled systems such as under floor heating. These systems will not necessarily have a night-time peak and as such would gain no benefit from this proposal. As a consequence the approach proposed would seem to inhibit innovation.

We would also like to see more clarity on the SP proposal related to phasing of capacity requirements. Again this is a principle that may be worth developing, but it is currently unclear from the wording of the proposal whether the fully developed maximum capacity would be allocated to the IDNO throughout the build-out phase, or whether network availability would only be checked as the capacity requirement increased. If it is the latter, then this would mean that at the start of a development there would be no way of estimating the overall cost of the development as significant, and as yet undefined, costs may be required for network reinforcement at some future time. It would also give an unacceptable risk to availability of power if a network upgrade was required part way through a build-out sequence. The proposal therefore needs to be clarified. If the situation is that the maximum capacity would not be in effect reserved, then in our view this would not be an improvement on the current situation.

### **Reactive power**

We believe that it is not appropriate to charge IDNOs reactive power charges, as IDNOs are licensed network operators not consumers. IDNOs should 'police' the power factors of customers on their own networks in much the same way as DNOs do currently. IDNO tariffs which remove reactive power charges as proposed by both DNOs are therefore welcome.