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Dear Martin,

Structure of Electricity Distribution Charges

SSE welcomes the opportunity to comment on Ofgem's recent update on the reform of the structure of electricity distribution charges.

We note Ofgem's concern that the current industry models are not fit for purpose in the future due to the increasing development of new sources of distributed generation and changes in demand patterns and responsiveness.

In our view, there is a balance to be struck between cost reflectivity, stability, simplicity and transparency in developing any charging structure. In our experience forward looking, marginal cost pricing models produce instability and volatility of charges. Whilst cost reflective tariffs should, quite correctly, be one of the key building blocks in the design of any charging methodology it is essential to balance this against the needs for stability, simplicity and transparency. Volatility of prices can be damaging to customers, suppliers and network owners. In the short term it leads to inaccurate pricing and potentially inappropriate investment. In the longer term it leads to premium pricing to mitigate risk. We have fundamental concerns that forward looking marginal cost pricing models tend to produce prices that are extreme, volatile and not reflective of the underlying costs to meet new demands on the system.

We have discussed these concerns with Ofgem at length on many occasions. We have also provided a detailed critique of the report you commissioned from the University of Bath where we highlighted serious flaws both with the methodology and with the expected outcomes. We attach a copy of that response for completeness.

Nonetheless, following Ofgem's instruction, we are working with both ScottishPower Networks and Central Networks in developing a potential use of system model that uses a form of forward cost pricing. We are hopeful that the methodology employed will minimise the volatility and instability inherent in marginal cost pricing models (i.e. ICRP) but at this stage we are still assessing both the model and the scaling required to recover allowed revenue. Whilst we

intend to consult on the proposed methodology in the near future, further work is necessary to confirm that the output charges are cost reflective and consistent with our licence obligations. The final design of any future SSE distribution charging methodology will be a balance between cost reflectivity, simplicity, stability and transparency.

With regard to the Distribution Charging Methodologies Forum (DCMF), whilst we welcome the establishment of this group, and intend to be an active participant on it, we do not believe that it is the correct forum to decide fundamental policy issues. For example, the issue of whether or not existing generators should be charged for use of system must, in our view, be addressed by Ofgem. We do not believe that it is appropriate for Ofgem to await the development of new generation charging models before providing clarity on this fundamental issue. Such models cannot be developed without understanding whether or not existing generators will form part of the charging base. Therefore, in order to move this policy issue forward, we believe that it would be helpful for Ofgem to publish a consultation paper on the various conceptual options discussed at the structure of charges implementation steering group meetings.

If you have any queries on the above please do not hesitate to contact me.

Yours sincerely,

Rob McDonald
Director of Regulation