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cc Tony McEntee (by email only)

Promoting choice and value for all customers

Our Ref: RBA/DPC/SOC
Direct Dial: 020 7901 7255

Date: 12 July 2007

Dear Colleague,

Decision in relation to SP's modification proposal to the use of system charging methodology: IDNO/DNO charging

On 8 May, Ofgem[1] published a consultation letter[2] which invited responses in relation to proposals by Scottish Power (SP) and Western Power Distribution (WPD) to introduce new tariffs in relation to use of system (UoS) charges levied on independent distribution network operators (IDNOs)[3].

Having carefully considered the proposals made by SP and responses to our consultation we have decided to veto SP's proposals in relation to new IDNO tariffs.

This letter briefly sets SP's proposal, the views of responses to Ofgem's consultation letter and the reasons for the Authority's decision.

Background to SP*'s modification proposal*

The modification proposal followed two consultations by SP on the issue of IDNO/DNO charging through 2006. SP propose to add three new tariffs to apply to different types of IDNO connections:

- IDNO sites connected at HV;
- Large IDNO sites connected at LV (with a capacity requirement equal to or higher than 100kVA); and
- Small IDNO sites connected at LV (with a capacity requirement below 100kVA).

These new tariffs are calculated on the basis of domestic demand profiles. Compared to domestic tariffs, the proposed IDNO-specific tariffs entail substantially higher fixed charges (reflecting the additional costs relating to manual billing) and lower unit charges (reflecting the lower costs of SP's provision of network). For all but small (below 100kVA) sites, the proposed tariffs include a capacity charge.

[1] Ofgem is the office of the Authority. The terms 'Ofgem', the 'Authority' and 'we' are used interchangeably in this letter.
[2] 'Consultation on use of system charges to new electricity distribution licensees: WPD and SP proposals', 114/07, 8 May 2007, available on our website, www.ofgem.gov.uk
[3] SP's distribution licence obliges it to publish three charging statements: the statement of use of system (UoS) charging methodology, the statement of UoS charges and the connection charging methodology. The UoS charging methodology outlines how UoS charges are calculated. SP must keep its methodology under review and propose changes that it believes will better address its licence objectives.

Respondents' views – Ofgem consultation

We received 11 responses to our consultation: from IDNOs, DNOs and energywatch. Overall the responses were generally critical of SP's proposal. A summary of key points from the responses concerning SP's proposal is provided in the **Appendix** below.

General Observations

The modification proposal relates to the charges made by a DNO to an IDNO. In general, IDNOs will be competing with DNOs to provide part of the service of distributing electricity. In doing so they will be dependent on services provided, on a monopoly or essential facility basis, by the DNO. In this context, it is vital that the DNO ensures that the charges for such essential services (use of the upstream network) are consistent with the requirements of competition law – such as avoiding "margin squeeze".

Some of the responses noted the importance of DNOs not discriminating between IDNOs and individual customers with the same aggregate load characteristics connected directly to the DNO network. In our view this is desirable but secondary to compliance with competition law requirements.

Further, lack of experience of IDNOs may make it difficult to justify assumptions about costs. In our view, this is no excuse for inaction – DNOs must ensure that in setting charges they do not restrict, distort or prevent competition in distribution. In any event, different IDNO sites are likely to have different cost impacts on DNOs. Overall, this suggests that it is important to recognise the scope for learning from experience and that it is better not to hard-wire arbitrary fixed assumptions into the methodology.

We note that SP's justification for its proposal and several responses raise issues relating to boundary metering. We consider that boundary metering is outside the scope of this decision.

Ofgem's view on SP's proposal

We have carefully considered SP's submission along with responses to our consultation. In coming to our decision we have considered how the proposed modification impacts on SP's ability to better achieve the relevant objectives[4] and our wider statutory duties.

SP indicates that their proposal is more cost reflective than their existing arrangements in terms of better recognising the profile of IDNO demand, network costs saved when an IDNO connects as well as suggesting the reflection in tariffs of additional costs IDNOs cause the DNO via manual billing processes. We note that the evidence provided by SP suggests that domestic demand profiles generally appear more appropriate to apply to IDNOs than other profiles.

In general, we consider that SP's approach of developing charges for IDNOs based on the same model that is used to set charges for end-customers is appropriate. However, we

[4] The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of standard licence condition 4 of SP'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

(d) that, so far as is consistent with sub-paragraphs (a), (b) and (c), the connection charging methodology, as far as is practicable, properly takes account of developments in the licensee's distribution business.

have concerns about specific aspects of SP's approach. In particular, we are concerned about:

1. the lack of specific justification for the level of additional costs applied to IDNOs as against other customers, and for the cost savings as a result of IDNO connections. We note the concerns of some respondents that the additional cost values used are excessive and that cost savings are undervalued;

2. the implications for the level of margins available to IDNO sites under the proposals. In particular, we note that for small IDNO connections with few plots this margin will be negative as the higher fixed charges outweigh the lower usage charges. We also note that SP's proposals appear to give higher gross margins to large IDNO sites with LV points of connection than to similar sites with HV points of connection. We do not consider that SP have provided sufficient justification for these features of their proposals and we are concerned that they may not reflect cost characteristics;

3. the proposed structure of tariffs is different from the structure that SP applies to its own end customers. This gives rise to the potential for inappropriate margins in situations where the load or load shape of end-customers is different from the typical assumptions used in setting tariffs.

Hence, whilst we set merit in some aspects of SP's proposals we are concerned that for some IDNO sites they would result in charges or margins for IDNOs which are not reflective of costs or which distort competition.

Our decision

We have considered this proposal against the licence objectives and wider statutory duties. For the reasons set out above, we consider that certain aspects of SP's proposals in respect of IDNO charging give rise to concerns that the resulting charges would not properly reflect costs and could distort competition in electricity distribution. We have therefore decided to veto the modification to the UoS charging methodology statement.

Comment

We consider that the growth of IDNOs constitutes an important change to SP's distribution business and that there remains a risk that SP's current charging methodology could distort competition. We would therefore urge SP – and all other DNOs – to review their approach to charging IDNOs without delay in the light of this decision letter. We also wish to emphasise that it is the responsibility of each DNO to ensure it complies with the requirements of the Competition Act 1998 as for any other legislation.

Please contact Colette Schrier on 020 7901 7239 if you have any queries relating to issues raised in this letter.

Yours faithfully,

Martin Crouch
Director, Electricity Distribution
Signed on behalf of the Authority and authorised for that purpose by the Authority

Appendix – Key points raised in responses to Ofgem's consultation

Cost reflectivity

All IDNOs are unhappy with SP's proposal, citing lack of data and a lack of linkage of charges with their experience of costs. They say the proposals hinder competition, which is their main concern. One IDNO accepts that a new tariff is needed, including the use of domestic profiles to determine IDNO charges, but feel SP's proposals overall are not cost reflective. Another says the proposals are confusing.

Two DNOs believe that using a dedicated profile for IDNO charging is more cost reflective than current arrangements. One DNO believes that consideration of the modifications requires a more detailed understanding of the DNOs' models with respect to costs. energywatch sets out that further cost reflectivity could mean higher charges to IDNOs and suggests further load research is necessary.

Competition

All IDNO responses are concerned that the proposals have an impact on their margin and are concerned whether the proposals meet requirements under Competition Act 1998 regarding costs avoided and earning a return.

Another respondent says that the use of capacity charging discriminates against similar classes of customers on the DNO's network and notes that SP's proposals would result in significantly higher charges for IDNOs connected at HV.

Two IDNOs are concerned at the negative margin implied for sites below ~10 plots (one says this development size represents more than a quarter of the domestic unrestricted connections market), and state that they cannot recover their operating and financing costs on either HV or LV networks under these proposals.

energywatch is concerned that if IDNO margins reduce this will threaten this competition in connections. One DNO notes the number of assumptions involved in using profiles for tariff calculation determine whether the calculated charge is higher or lower than the equivalent 'normal' tariff. This DNO notes that this is likely to lead to claims of distorted competition by the IDNOs if their margins are reduced.

Avoided costs

One IDNO does not believe that SP's HV IDNO charges take in to account the avoided costs of IDNO activity. One IDNO believes neither proposal substantiates the avoided costs on the system against case law.

One DNO believes SP is correct to incorporate the additional costs of bespoke billing arrangements and auditing as the data received by the DNO will not be received via the normal settlement process.

Specific yardsticks for IDNOs

One IDNO supports separate yardsticks as more cost reflective whereas two other IDNOs do not see why IDNOs are singled out for a specific tariff, one believing that smaller samples of customers (e.g. in the case of IDNO connections) within the GSP group will have different profiles from the average.

One DNO considers that SP's proposal to introduce three new yardsticks derived from the domestic profile class to be simpler more cost reflective and transparent than WPD's proposed approach. Another DNO argues that a profile based on domestic consumption patterns (SP's approach) is not applicable in all cases: SP argues that its analysis shows that for both small and large LV sites the domestic profile is found to fit much more closely than the small business profile.

A different DNO believes that existing yardsticks continue to provide reasonable and proportionate cost signals, stating that geographic average yardsticks are more appropriate than locationally specific charges for HV and LV connected IDNOs or out of area DNOs. Two other DNOs are unsure whether singling IDNOs out for a special tariff is appropriate. One says it does not believe that the movement away from averaged tariffs would be in the interests of suppliers or end users. This DNO is concerned that more tariff classes may not help competition but brings additional complexity, and that other groups of customers may want separate tariffs as well.

One DNO argues that changes in tariff structure work better than introducing customer type tariffs. Cost reflectivity could be improved by implementing separate tariffs for each profile class 5-8 classification and, for HH metered connections, by having seasonal time of day time bands for unit charges. Another DNO ties in the issue of metering and separate tariff classes, saying that it is unclear whether separate yardsticks are needed for a particular sub-class of customers; this depends on the form of metering used and the detail available on individual load shapes.

Tariff design

IDNOs are generally not in favour of capacity charges. One IDNO believes that applying capacity charges to IDNOs is explicitly discriminatory and states that any proposals to limit IDNO capacity charges are welcome, but SP's proposals do not go far enough. One IDNO believes SP's proposal to have capacity charges for larger sites is anti-competitive as it effectively locks out IDNO competition for developments with more than 50 houses.

The majority of DNO responses stress that much of the cost of providing the network is associated with capacity requirements and that capacity charges are necessary. Some recognise the difficulties this may pose IDNOs where they cannot pass on these capacity charges, for example one DNO notes that for small 'infill' developments it may be more appropriate to apply existing NHH tariffs rather than HH tariffs.

The phasing of capacity is also mentioned in the context of DNO capacity charges. One DNO notes that this is problem not just one for IDNOs but also for other customers whose load is likely to build up gradually (as with a new factory or commercial complex where construction or fitting out is in phases). Two DNOs point out that this is about tariff application rather than tariff design.

Metering

One IDNO objects to boundary meters, and being charged for them, on the basis that available settlement consumption data can be used to calculate flows across the boundary and any losses associated with IDNO systems. It thinks that metering charges are disproportionate especially on small sites; restricting entry and distorting IDNO net incomes.

Another IDNO believes that boundary metering is unnecessary. This IDNO argues that it is unduly discriminatory in that if the DNO was to connect, own and operate the same network it would not require boundary metering. It also considers that the significant billing costs which DNOs say IDNO cause result from the insistence of DNOs to refuse to consider aggregated billing. It says it is not appropriate that IDNOs bear the burden of DNOs' inefficient billing solutions.

DNO responses generally prefer HH metering, else maximum demand metering. Some do not rule out use of settlement data. One questions whether this would be cost effective, stating its belief that using aggregate data would itself require changes to systems. One DNO believes that settlement data should be used for small LV IDNO connections. However, it argues that this data would need be provided on a site by site (rather than aggregate) basis in order to facilitate the needs of system design.

Reactive power charging

DNO responses generally agree that reactive power charging is not appropriate for domestic customers. Some DNOs argue other sites should be charged reactive power charges where they have a poor power factor, although note that this does not appear to be the case at this time. The IDNOs are against reactive power charges where they cannot recover them in their tariffs to downstream customers. One IDNO agrees with SP's proposal not to levy reactive power charges. Another argues that it is not appropriate to charge IDNOs reactive power charges as IDNOs are licensed distributors not consumers. This IDNO considers it appropriate for IDNOs to 'police' power factors of their own customers, in a similar way as DNOs do currently.