



To distributors, suppliers,  
customers and other interested  
parties

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17 August 2007

Dear Colleague,

**Consultation on United Utilities modification proposal UU/2008/002.1: Proposal to introduce payments for the adoption of connection assets**

Electricity Distribution Network Operators (DNOs) have licence obligations<sup>1</sup> to have in place as of 1 April 2005 three charging statements: the statement of use of system (UoS) charging methodology, the statement of UoS charges, and the statement of connection charging methodology. The statement of connection charging methodology outlines the method by which distribution connection charges are calculated.

DNOs are required to keep the methodology under review and bring forward proposals to modify the methodology that they consider better achieves the relevant objectives<sup>2</sup>.

Before making modifications to their charging methodologies the DNO must give the Gas and Electricity Markets Authority (the 'Authority')<sup>3</sup> a proposal to modify their methodology stating how the proposal better achieves the relevant objectives. The DNO then makes the modification unless within 28 days the Authority either directs the DNO not to make the modification or notifies the DNO that it intends to consult and then within three months directs the DNO not to make the modification.

The proposal received from United Utilities Electricity Plc (UU) on 14 August 2007 sets out to modify the connection charging methodology by introducing payments for the adoption of newly installed connection assets. None of the DNOs currently pay adoption payments. UU have not consulted with the industry before submitting the modification proposal to Ofgem. Having considered the issues raised by the proposal, based on a proposal submitted

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<sup>1</sup> Standard Licence Conditions (SLC) 4-4B

<sup>2</sup> The relevant objectives for both the connection and use of system charging methodologies, as contained in paragraph 3 of SLC4B and SLC4 of the distribution licence respectively are:

- (a) that compliance with the connection/use of system charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and by this licence;
- (b) that compliance with the connection/use of system 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/use of system charging methodology results in charges which reflect, as far as is 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 connection/use of system charging methodology, as far as reasonably practicable, properly takes account of developments in the licensee's distribution business.

<sup>3</sup> Ofgem is the office of the Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

on 6 July 2006 and subsequently withdrawn, the Authority has decided to consult on the proposed modification, and formally notified UU of this on 15 August 2007.

The introduction of a scheme of adoption payments for connection assets represents a new matter for consideration and for this reason this letter consults on the wider issue of adoption payments to be offered by DNOs as well as on the specific matters related to UU's modification proposal.

### *Background to the modification proposal*

In the Structure of Charges Update paper of April 2004<sup>4</sup> Ofgem proposed removal of Tariff Support Allowances (TSA) from connection charges, starting from April 2005. TSA was a capitalised amount, based on expected UoS revenue generated from the new connection, presented as a credit in the calculation of the connection charge. The proposal aimed to increase the transparency of connection offers and hence promote competition in connections.

The Update paper did not preclude incumbent DNOs or other licensed distributors from making adoption payments where appropriate, provided that transparency about the costs of connection and the TSA credit is ensured and that the level of these payments is reasonable and do not result in any customer being disadvantaged.

At present, none of the DNOs has introduced any specific provision for adoption payments in their charging methodology statements. UU's modification proposal represents the first proposal from any ex-PES distributor to introduce adoption payment since April 2005.

UU note (page 4 of their modification proposal) that it is usual practice for Independent Distribution Network Operators (IDNOs) to grant adoption payments to connecting parties. UU consider that allowing DNOs to make adoption payment would result in a level playing field in the market for network adoption.

### *UU's modification proposal*

UU propose to introduce a methodology for the calculation of asset adoption payments. We invite respondents to refer to the modification report, available on Ofgem website<sup>5</sup>, for further details about the proposed modification.

UU consider that this modification proposal better meets the relevant objectives, in so far as it results in more cost-reflective charges and avoids discrimination between customers that connected before April 2005 (who received TSA) and customers to be connected in the future.

### *Views sought*

The proposed modification is intended to implement a scheme for offering asset adoption payments. UU's proposal raises a range of issues that are of general interest, in addition to key issues that are specific to the Modification. Respondents are invited to provide comments under each perspective, as detailed in Annex 1. We seek views on the following questions:

- Does UU's modification proposal better achieve the relevant objectives? Specifically:
  - Is the proposal more cost reflective than the current methodology?
  - Does UU's proposal restrict, distort or prevent competition in distribution?

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<sup>4</sup> <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/6744-April04%20Update%20Document%20SoC%20final.pdf>

<sup>5</sup> [http://www.ofgem.gov.uk/NETWORKS/ELECDIST/POLICY/DISTCHRGMODS/Documents1/UUE%20-%20\(2nd\)%20Modification%20Proposal%20to%20introduce%20Asset%20Adoption%20Payments%20\(UU-2008-002.1\).pdf](http://www.ofgem.gov.uk/NETWORKS/ELECDIST/POLICY/DISTCHRGMODS/Documents1/UUE%20-%20(2nd)%20Modification%20Proposal%20to%20introduce%20Asset%20Adoption%20Payments%20(UU-2008-002.1).pdf)

- Does the methodology proposed by UU provide sufficient clarity and transparency about the calculation and application of adoption payments?
- Have we correctly captured the main issues raised by UU's modification proposal, and more generally by adoption payments, in Annex 1?

*Responses to this consultation letter*

Views are invited from interested parties, including IDNOs, DNOs, suppliers, customers and their representatives.

Views are invited by **Friday 28 September 2007**. Where possible responses should be sent electronically to:

Distribution Policy

Email: [DistributionPolicy@ofgem.gov.uk](mailto:DistributionPolicy@ofgem.gov.uk)

The process associated with modifications to the charging methodologies is detailed within the distribution licence (SLC 4 and 4B). As the Authority's decision is time bound please ensure that your comments are received by the date indicated so that they can be fully considered. It may not be possible to consider responses that are received after this date.

All responses will be held electronically by Ofgem. They will normally be published on the Ofgem website unless they are clearly marked confidential. Consultees should put confidential material in appendices to their responses where possible. Ofgem prefers to receive responses electronically so that they can easily be placed on the website.

Copies of this document are available on the Ofgem website under the distribution charging modifications area of work<sup>6</sup>.

Please contact Alberto Prandini on 0207 901 7281 if you have any queries in relation to the issues raised in this letter.

Yours sincerely,



**Martin Crouch**  
**Director, Distribution**

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

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<sup>6</sup> <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx>

## **Annex 1 – Key issues raised by UU’s proposal**

### Extent of competition

UU considers (page 4 of their modification proposal) that competition for the adoption of connection assets is effective at present and as such it is now time to consider the reintroduction of a TSA-like arrangement.

According to Ofgem’s Connection Industry review 2006/07<sup>7</sup>, IDNOs and DNOs operating out of DSA account for 1.6% of connections in Great Britain reported in the period. In UU’s area, they account for about 3% of connections in the period.

Adoption payments may represent a competitive tool for new entrants, such as IDNOs and DNOs operating out of area, to acquire market shares in the connection adoption market. UU consider that allowing adoption payments to be made by the host DNO would level the playing field in the competitive connections market.

#### *Views invited:*

- Do adoption payments play a role in the development of a competitive market? Is competition now effective? Are adoption payments now appropriate in order to reflect developments in the licensee’s business?

### Effect of average assumptions

UU’s methodology for adoption payments relies on several assumptions of average or typical values to obtain schedules of adoption payments for different assets and customer types. Connection charges, on the contrary, are highly project-specific. In the context of a competitive market for the provision and adoption of connection assets, there is a potential for the methodology to act as a barrier to competition with respect to those sites or projects that deviate from the underlying assumptions. UU submitted that the ADMD and the load factor are representative of the values recorded in their network.

#### *Views invited:*

- Are the assumptions used by UU reasonably representative of the majority of connections?
- What is the impact of the proposed methodology change on customers and competitors whose connections are not closely reflected in the modelled assumptions?
- Does the combination of adoption payments and UoS boundary charges have anti competitive effects?

### Potential for discrimination and double-counting

UU’s modification report (page 3) suggests that connection assets are currently included within UU’s DRM model. UU hence propose to rebate adoption payments to connecting parties as an attempt to eliminate potential double-counting of asset costs that are paid for at the time of connection. It should be noted that the total level of UoS charges is unaffected, since allowed revenue is subject to price-control restrictions.

Other DNOs have taken an alternative approach and excluded those connection assets that are paid for through connection charges from the DRM. This type of model has been in use since the late 70s and has been modified from time to time in order to take into account industry development, such as the introduction of competition in supply, metering and connection activities.

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<sup>7</sup> Forthcoming.

UU contend (page 4) that the proposed modification would terminate the current imbalance between customers who connected before April 2005 and customers to be connected in the future.

*Views invited:*

- Is there currently an issue of potential discrimination in UU's charging methodologies?
- Is there currently an issue of potential double-counting in UU's charging methodologies?
- Is the proposed modification the most appropriate way forward?
- Is there any alternative approach to be considered, that would better meet the relevant objectives?
- Does UU's proposal result in a shift in the connection boundary and, if so, is this appropriate?

Exclusions from the methodology

UU propose (page 11) to exclude some categories of customers and assets from adoption payment. This is aimed to limit adoption payments to cases where the issue of double counting is deemed to arise, as detailed above.

*Views invited:*

- Are the exclusions appropriate and have UU sufficiently justified these?