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*Promoting choice and
value for all customers*

Your Ref: UU-2008-002.1
Our Ref: RBA/DPC/SOC
Direct Dial: 020 7901 7255

25 October 2007

Dear Colleague,

Decision in relation to proposal UU/2008/002.1 to modify the connection charging methodology: introduction of asset adoption payments

On 14 August 2007 United Utilities Electricity PLC ("UU") submitted proposal (UU/2008/002.1) to the Gas and Electricity Markets Authority ("the Authority")¹ to modify its connection charging methodology. This followed the submission of a proposal (UU/2008/002) on 6 July 2007, which was subsequently withdrawn.

We notified UU of our intention to consult on the specifics of the proposal as well as the wider issue of adoption payments². The consultation closed on 28 September 2007. A summary of responses is provided in **Annex 1** of this letter.

UU proposes to introduce an asset adoption payment scheme, which would provide a credit to a connecting customer or an independent connection provider (ICP)/developer, based on the future revenue stream of a new connection from use of system costs over the life of the asset, adjusted by a risk factor.

Having carefully considered the issues raised in the proposal, the Authority has decided to veto the proposed modification.

This letter sets out the background to the modification proposal, summarises the proposed changes and explains our decision.

Background

UU has licence obligations³ in place since 1 April 2005 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 connection charging methodology outlines how connection charges are calculated. UU have a requirement to keep this methodology under review and propose changes that it considers would better achieve the relevant licence objectives.⁴

¹ Ofgem is the office of the Authority. The terms 'Ofgem', the 'Authority' and 'we' are used interchangeably in this letter.

² Ofgem document 213/07 - Consultation on UU/2008/002.1: proposal to introduce payments for the adoption of connection assets. Available on the Ofgem website:
<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx>

³ Standard licence conditions 4-4B

⁴ The relevant objectives for the connection charging methodology, as contained in paragraph 3 of standard licence condition 4B of United Utilities' licence are:

In the Structure of Charges Update paper of April 2004⁵ 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 does not result in any customer being disadvantaged.

At present, none of the DNOs have 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 notes (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 considers that allowing DNOs to make adoption payments would result in a level playing field in the market for network adoption.

UU modification proposal

UU proposes to introduce an asset adoption payment scheme that recognises the value of each newly installed connection asset to be connected to its electricity distribution network.

This value would be based on the future revenue stream expected from the new assets, calculated as the net present value of the estimated network capital cost component of use of system charges received over the lifetime of the asset (nominally forty years, but reduced by a risk factor as appropriate).

The adoption payment value would be presented as a separate component within the connection charge calculation, where UU are asked to quote for providing a new connection, or be indicated to an ICP/developer, when they ask for a point of connection. In cases where contestable works are undertaken by an Independent Connection Provider (ICP), UU would pay the adoption valuation to the developer/installer at the time of transfer of ownership to UU of the new connection assets.

The Authority's decision

We have considered this proposal against the relevant licence objectives and wider statutory duties. The remainder of this section sets out the main issues raised by UU's proposal to introduce adoption payments.

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- (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 licence;
 - (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.

⁵ <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/6744-April04%20Update%20Document%20SoC%20final.pdf>

UU proposes that adoption payments would be financed by adding their value to the regulatory asset value (RAV), hence increasing the relative proportion of costs recovered through UoS charges. We consider that this would effectively make the connection boundary shallower. This could alter the signal provided by connection charges regarding the relative costs of connecting at different voltages. It would also, over time, tend to increase UoS charges.

We also note that the assumed load characteristics, scaling approaches and risk factors used to derive adoption payments vary according to different customer groups. For example Appendix B of the proposal shows significant differences between the £/kW value for the domestic unrestricted tariff and the £/kVA value for the low voltage maximum demand tariff at the same voltage level. We are concerned that the scale of these differences has not been fully explained and may negatively impact on competition, for example, at sites which differ from the average assumptions used. We are therefore concerned that UU have not demonstrated that its approach will avoid margin squeeze in relation to IDNOs.

We acknowledge UU's view that adoption payments may create a more level playing field. Both DNOs and IDNOs commented that adoption payments constitute an important competitive tool in the market for adoption of distribution assets. UU are the only DNO that have proposed to introduce adoption payments. This would result in customers being treated inconsistently across distribution service areas, and we note the concern expressed that this would distort competition between different DNO areas.

We have therefore decided to veto the modification to the connection charging methodology statement.

Comments

Responses to the consultation suggested that UU's existing charging model may involve double-counting, since assets paid for through connection charges were included in the charging model. In the light of this, we expect UU to review its charging methodology, and note that UU's service model used for their unmetered supplies tariff does not double-count connection assets.

The consultation has highlighted that adoption payments play an important role in the development of competition in distribution. We will consider this issue further in reviewing the methodologies proposed by IDNOs.

Please contact Alberto Prandini on 020 7902 2781 or alberto.prandini@ofgem.gov.uk if you have any queries relating to issues raised in this letter.

Yours faithfully,



Martin Crouch
Director, Distribution

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

Appendix 1 – summary of consultation responses

We received 15 responses, 2 of which were confidential. Non-confidential respondents include 7 DNOs, 2 IDNOs, 1 ICP, 1 connection customer, 1 customer agent and 1 representative organisation.

Competition

1.1. The majority of DNO responses did not consider that the proposal would restrict, distort or prevent competition. These DNOs tended to agree that competition in connections is now effective and that a more level playing field was needed since some other distribution companies offer adoption payments. Two DNOs disagreed, noting that there would be distortions in competition if only some DNOs offered such payments. One contended that the proposal would reduce transparency and dilute locational signals.

1.2. One IDNO suggested that competition is not currently effective and would be further hindered by the proposal. One IDNO commented that adoption payments are one of many measures DNOs may use to protect their market share and frustrate competition.

1.3. Most DNO responses denied that combining adoption payments and UoS boundary charges produce anti-competitive effects. One DNO added that the proposal seeks to minimise the risk of excessive payments. However, one DNO claimed that the resulting shallower connection charge reduced the scope for competitive connections.

Cost reflectivity

1.4. All DNO responses agreed that the proposal improves cost reflectivity. Various reasons were cited, including a flexible boundary between UoS and connection charges and removal of duplication where customers may pay up-front and UoS charges. One DNO suggested however that the proposal does not state how it is more cost reflective.

1.5. Two IDNOs warned that the proposal was not cost reflective, and one commented that the present charging methodology is not particularly transparent, making it difficult to assess whether the proposal will be more cost reflective.

1.6. Several respondents believe that the connection boundary would become shallower, which may reduce the scope for competition in connections.

Clarity and transparency

1.7. Four DNOs thought that the calculation and application of adoption payments is sufficiently clear and transparent; one commented that payments are published and criteria are transparent, and worked examples add further clarity.

1.8. One IDNO countered that the proposal does not provide sufficient clarity or transparency about the calculation of charges.

Reflective of developments in licensee's distribution business

1.9. Two DNOs see adoption payments as an appropriate reflection of developments. One commented that it removes overlap between connection and UoS charges, and the other pointed to the lag from acceptance to completion which means it is more appropriate to consider contracts presently being won rather than the physical connections being delivered.

Assumptions

1.10. Four DNOs, an IDNO and a customer service company believe that UU's assumptions are representative of the majority of connections.

Potential for discrimination and double counting

1.11. Two DNOs commented that the proposal addresses discrimination between customers who connected before and after April 2005. They argued that the overall effect consists in tariffs realignment between different customer groups rather than over-recovery.

1.12. Two DNOs and one IDNO expressed concerns that discrimination was possible. Two respondents commented that the proposal lacked sufficient explanation, and others complained that the proposal created distortions, perverse incentives and seeks to use a dominant commercial position to disadvantage or exclude competitors.

1.13. One DNO commented that the proposal was similar to the TSA arrangements prior to April 2005, but lacked an uplift charge. For this reason the proposal would not correct potential discrimination between pre- and post- April 2005 customers.

1.14. Seven respondents indicated that double counting is possible; however three respondents believed that the proposal addresses this potential issue. One IDNO suggested that Ofgem could guard against this via the price control mechanism. One IDNO warned that cost reflectivity was being assessed on a piecemeal basis rather than being reconciled with published accounting statements, and another commented that UU may be overcharging currently, and applying its current methodology incorrectly. One DNO suggested that the issue is around cross-subsidy rather than double counting.

Alternative options

1.15. Three DNOs commented that this question is irrelevant provided that the proposal better meets UU's licence objectives. A DNO and customer service company see asset adoption payments as a positive step as they protect customers' interests by removing discrimination and providing greater transparency and cost reflectivity. One IDNO disagreed with this view. A DNO suggested that connection assets should be left out of the DRM. Another DNO emphasised the importance of consistency across distribution licence holders.

Exclusions

1.16. Three DNOs and one customer service company felt the exclusions to be generally appropriate, and an IDNO felt that they are not. One DNO suggested that service alterations should be included as theses do not provide any additional UoS income.

1.17. Two respondents commented on speculative developments, arguing that more stringent guidelines are needed to avoid strategic implementation of adoption payment schemes by the host DNO.