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Dear Martin

**Consultation on WPD's modification proposals WPD/WALES/WEST/UOS005:
Modification Request on changes to the Use of System Charging Methodology to
incorporate IDNO Networks and consequential changes to the form of the Use of
System Charging Statement**

I write in response to your e-mail dated 14 September 2007. You have sought views on this short cut process. I am concerned that Ofgem has chosen not to provide sufficient time for industry stakeholders to review WPD's new proposal. Future charging arrangements between connected network operators are of fundamental importance to the prospects for our business and it is therefore imperative that we, and all other licensees, have adequate time to consider fully the implications of proposals that could be considered to set a precedent for others to follow. A two week window does not allow the proposals to be considered in detail.

We welcomed Nigel Turvey's oral presentation at the recent DCMF which provided an overview of WPD's ideas. However, there was no supporting material for review at that time and we have had to wait until the publication of the Modification Proposal to get to grips with the fresh workings.

In spite of the short timescales we've endeavoured to review the proposals laid out by WPD and I am able to make some preliminary comments now.

1. Tariff structures

As I understand WPD's argument, they feel the need to redress an imperfection in their current suite of tariffs because their simple structure for LV tariffs increases the risk that charges may not be cost reflective for the likely load shapes of some clearly defined sub-sets of their non-domestic customer base. The particular example that they are seeking to address is an emerging sub-category of customers who are licensed network operators.

We can appreciate that there may be a problem in offering simple tariff structures to all LV customers but we do not believe that introducing new tariffs for particular sub-classes is necessarily the right remedy. We do not face the same problem because our standard non-

domestic tariffs include capacity charges as well as kWh rates. Consequently they are much more robust to variations in customers' load shapes. Having a slightly more sophisticated tariff structure reduces the need for a multiplicity of tariffs. This seems a more appropriate solution and also reduces the risk of challenge for discriminatory behaviour, since we do not select customer groups on the basis of the nature of their business, but only by the characteristics of their electrical requirements.

2. Identification of avoided costs

The essential feature of WPD's proposal is the introduction of a number of tariffs for licensed network operators which are distinguished by the length of WPD LV main between the point of connection and the local substation. The calculation of the adjustments from the standard tariffs appears flawed. The illustrations in Appendix 2 show an average LV main network length of 228 metres and 256 metres for South Wales and West respectively. Yet the note 2 in both calculations indicates that WPD assume that 50% of the capital cost of the LV main is paid for in customer contributions. We acknowledge that it may be right to use the full length in adjusting O&M costs since these will need to be attributed to the full circuit length but the avoided capital values should take account of the treatment of capital costs in the source tariffs. As the unrestricted tariff only contains 50% of the capital costs of the LV main, does this not equate to only 114 metres and 128 metres for South Wales and West respectively? If so then why should an IDNO connecting 130 metres from the substation in either distribution services area receive a 50% reduction on an already reduced (by 50%) LV mains cost? Arguably there are no avoided capital costs as the tariff includes no capital costs at this distance from the substation. We therefore believe the methodology used by WPD fails to deliver the result they are intending.

However, even if these computational flaws were corrected, we still have serious reservations over the proposed approach. If it is right to offer IDNOs (and other distribution network operators) separate tariffs reflecting the distance of their point of connection from the local substation, why is it not also appropriate to offer all other customers the same opportunities? This seems an obvious example of discriminatory pricing that would lead to challenge from all other business customers who were not able to avail themselves of the same range of preferential terms. It would also be interesting to learn how WPD intend to treat an IDNO whose point of connection is more than 256 metres from the local substation. Should they be offered a new, higher tariff to reflect the costs of the clearly revealed additional costs?

It is clearly not for us to propose how WPD deal with problems in their own tariffs, but I hope that I have done enough to demonstrate that the proposals we have seen to date do not represent a model that should be applied in other DNO areas. It would seem sensible to encourage a further period of discussion and reflection on how to ensure future tariff structures are fair, both to new types of customers and to those who are already established users of our networks.

I hope you find these observations helpful. If we can be of any further assistance, please let us know.

Yours sincerely,

Mike Boxall
Regulation Director