

Martin Crouch
Director, Electricity Distribution
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE



28 September 2007

Dear Martin

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

UU's proposals raise important and profound questions about the best way to structure the boundary between Distribution Use of System (DUoS) charges and connection charges in the context of licence requirements for cost reflectivity and for DNOs not to restrict, distort, or prevent competition in distribution.

The main area of challenge concerns the treatment of the boundary between long run average costs (recovered through DUoS), site specific costs (recovered through connection charges/adoption payments), and the role that Tariff Support Allowances (TSAs) can play in allowing for a more flexible delineation between the two.

The debate that UU has created through its proposals is welcome, and one that was perhaps incomplete at the time Ofgem required DNOs to discontinue the use of TSAs.

Cost reflectivity

A DNO's charging model must be scaled to reflect price controlled revenues. Overall this will reflect a mix of current and historic boundaries between connection and use of system charges. However, at an individual connectee level, there is typically a mismatch between generic DUoS cost assumptions and the location specific connection costs. This means there is potential for some customers to pay too much, and for others to pay too little, depending on whether the costs of their connection are, respectively, higher (i.e. deeper) or lower (i.e. shallower) than those assumed in DUoS prices.

The pre-vesting pricing arrangements put in place by the Electricity Council recognised this problem by including TSA, which had the effect of allowing the financial boundary between system and connection to flex on a site by site basis.

With regard to each connection, the effect of TSA is to bring the balance of future DUoS charges and connection charges for the site closer to those assumed in DUoS prices (after scaling). This may have some effect on the current financial boundary between DUoS and connection charges because connection costs tend to be higher than the minimum amounts assumed in DUoS prices.

Given the role of TSAs described above, the reintroduction of them, by allowing for a flexible financial boundary between DUoS and connection charges/adoption payments, clearly meets the licence test of better achieving cost reflectivity.

We have no specific comments to make at this time in relation to the details, clarity and transparency of the UU model.

Competition

Pricing structures, including the potential use of TSAs, should not be used to prevent the incumbent from competing on a level playing field, irrespective of the market share of entrants. The fact that adoption payments are a tool used by new entrants is not a valid reason for preventing the incumbent from also using them. The aim of regulation in this area should be, as is prescribed in the DNO licence, to ensure that the incumbent's charging arrangements do "not restrict, distort or prevent" competition in distribution, and not to promote competition, as Ofgem appears to imply in its consultation letter.

UU states that IDNOs operating in its area regularly offer adoption payments and, in order to be able to compete with them, UU proposes that it should be able to do likewise.

The relevant test for modifications to UU's connection charging methodology is that it does not restrict, distort, or prevent competition in the transmission or distribution of electricity. UU's proposal passes this test since it removes a distortion (it cannot offer adoption payments which competing IDNOs can).

We also believe that a wider debate (i.e. beyond the scope of UU's proposed modification) is required as regards the development of IDNO commercial arrangements.

Competition can only be an appropriate goal where it leads to benefits for society. Indeed, from Ofgem's perspective, competition should only be the goal where it will be in consumers' interests (Ofgem's Electricity Act primary duty), or will be in the public interest (implied by the competition legislation). So, in allowing UU to mimic (to an extent) the practices of IDNOs, Ofgem will need to examine whether the commercial arrangements used by IDNOs meet either criterion.

Ofgem has already recognised the potential for adverse affect on consumers when it introduced a relative price cap on domestic IDNO DUoS revenues – which, in the case of these customers, means that at least competition will leave them no worse off compared to the incumbent DNO's charges. However, such protection is not available to other non-domestic customers.

It is also of great concern that no IDNO has published an approved charging methodology. This must be addressed as a matter of urgency by Ofgem – and if there are difficult issues to be address, which are clearly implied by the time Ofgem is taking to approve the draft methodologies (so we understand), these issues should be put out to general consultation, as they have been in the case of UU's modification.

Conclusion

We believe that UU's proposal better achieves the relevant objectives and that Ofgem has no grounds for vetoing them. Separately, outside the scope of the modification, we believe that Ofgem should carry out work to understand the operation of the IDNO market with a view to establishing what if any consumer or public interest is being achieved. Lastly, any disturbance to the balance between use of system and connection charges will need to be allowed as part of the next price control review.

Yours sincerely

Paul Delamare
Head of Regulation and Compliance