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Dear Rachel

Re: Consultation on proposals from Scottish Power Distribution and Scottish Power Manweb to modify Use of System charges for Independent Distribution Network Operators.

This letter is written for and on behalf of the Electricity Network Company, a subsidiary of GTC and is in response to Ofgem's consultation letter of 6 May 2008 on Scottish Power's revised proposals to introduce IDNO specific tariffs.

In summary our view is that the modification proposal put forward in respect of Scottish Power Distribution (SPD) and Scottish Power Manweb (SPM) (both referred to collectively as SP in this response):

- **does not comply with the requirements of the paragraph 4.6 of Condition 4 of the electricity distribution licence in that, both in respect of the charging structure and in respect of the level of charges, the proposal will have the effect of restricting and distorting competition;**
- **does not comply with competition law in that implementation of the proposal will result in margin or price squeeze (which in some cases will result in a negative margin) and therefore will be insufficient to allow licence holders to finance their activities;**
- **does not treat other distributors in the same way as SP or SPM treats its own downstream business in that the use of LV banding is not applied in respect of its own downstream networks.**

Also the consultation does not capture the key issues of whether the proposed modifications comply with competition law and the validity of using an avoided cost approach. No analysis has been carried out to assess whether the margins available are sufficient for a downstream operator, that is at least as efficient as the DNO's notional downstream business, to make a reasonable profit.

IDNO's compete with DNOs for the provision of networks that are subsequently connected to the upstream network of the same DNO. In operating such networks the IDNO's margin is determined by the difference between the charge levied by the

DNO for the use of its upstream network and the all the way charge that the IDNO can charge under its Relative Price Control (RPC) arrangements.

When considering the charges for the provision of the upstream network the cost of providing and operating metering at the IDNO/DNO boundary must be included. This is because the charges for the fitting of such metering, and for subsequent data collection and data processing, are an unavoidable upstream input cost to the IDNO (irrespective of whether the DNO or an agent acting on behalf IDNO provides the metering). Such costs further erode the margins available to IDNOs. To date all DNOs have insisted that boundary metering be installed.

In their consultation Ofgem has asked respondents to comment on the extent to which the proposals are more cost reflective than the current methodology. For this respondents need to have a detailed understanding of the current and proposed methodology and the basis on which costs have been allocated and calculated. The information provided in this consultation is not sufficient to provide such understanding.

However, if SP's methodology is right then the cost of operating a downstream network in SPD's distribution services area is between 3 and 4 times higher than that in SPM's distribution services area. This is because SPM's proposed charges give a typical margin to IDNOs (excluding boundary metering) of £6 to £8, whereas in the case of SPD, the margin available to IDNOs is in the region of £23 to £27 per annum.

We suspect this cannot be true. The cost of operating similar networks in SPM's and SP's area should be broadly similar. This comparison illustrates that the approach adopted in the current and proposed methodologies is flawed, that the allocation of costs is distorted, and that the outputs result in margin squeeze. The margins available under these proposals do not permit a competing downstream competitor to operate and make a reasonable profit. This problem is especially exacerbated when boundary metering costs are taken into account.

The proposed methodology relies on the length of the DNO network to determine the margin available to the IDNO; yet strangely, the methodology takes no consideration of the length of the downstream network and thus the costs of operation.

Compliance with Competition Law

A more appropriate question to ask would have been on the extent that the proposals allow a competing downstream business to make a margin consistent to that which would be required by the DNO's own notional downstream business in order to make a reasonable profit. This is because the analysis carried out by SP (and by Ofgem in their consultation) totally fails to consider the charges in respect of competition law.

SP has used an 'avoided costs' approach to determine the charges to downstream distributors. Competition law cases have ruled against the use of an avoided costs approach. Such discussions and have been made in the Genzyme case and more recently in the case of Albion Water[1] where the Competition Act Tribunal (the CAT) stated in Paragraph 910:

[1] Case No 1046/2/4/04; Albion Water v Water Services Regulation Authority Neutral citation [2006] CAT 36;;

> "…However, in *Genzyme (remedy)* [2005] CAT 32 the Tribunal did not determine the appropriate margin on the basis of Genzyme's avoided costs, but on the basis of the margin required by a reasonably efficient homecare services provider to supply its services and earn a competitive return (paragraph 249 of that judgment) i.e. an amount sufficient to cover the entrant's total costs. Neither *Napier Brown/British Sugar* nor *Deutsche Telekom,* nor the Guidance issued by the OFT and the Commission, appear to proceed on an "avoided costs" basis. An "avoided cost" approach in our view would not be a satisfactory basis for a margin squeeze test, because it takes no account of the incumbent's fixed costs, takes no account of the entrant's total costs, and requires the entrant to be more efficient than the incumbent, as already shown above. In addition there are the problems of determining "avoided" costs."

The Court of Appeal[2] in their judgement published on the 22 May 2008, discussed the use of avoided costs in relation to margin squeeze in more detail and upheld the original decision of the CAT in this respect. In the original decision and in the decision by the court of appeal the appropriate test for a margin should be whether the margin available would allow a competitor that was at least as efficient as the DNO's downstream business to make a reasonable profit.

This is consistent with the guidance given by the Office of Fair Trading in their draft guidance note OFT 414a and in the guidance note on telecommunications OFT 417. Failure to comply with competition law is not only a breach of DNOs' electricity distribution licences, it is a breach of competition law. We note that Ofgem have on many previous occasions urged distributors to put forward competition law compliant charging methodologies. To date such advice appears to have gone unheeded.

Further considerations on SP proposals.

It is interesting to note the difference in margins available to the IDNO in respect of daytime and night time units. In respect of night units there is always a positive margin available, where as in respect of day units there is never a positive margin available. As Ofgem's own analysis shows the margin available to an IDNO is significantly reduced if the night consumption is reduced. The effect of the negative margin on the daytime component of the tariff is masked by the fixed charge component of the all the way tariff. In SP's all the way tariffs we question what costs the fixed charge component of the tariff is supposed to recover and as a consequence what the objective justification is for a negative margin on the day kWh prices.

In Ofgem's analysis 25% of all units are assumed to be consumed at night. The consumption figure of 4109 kWh is consistent with sites that do not have electric heating. We believe this figure is high and that a more appropriate average night time use is around 17% (based on analysis of profile class 1 data).

In setting charges for their own distribution businesses both SP and SPM consider all domestic customers as being connected to a single network with the charges for LV

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[2] Case Nos: C1/2007/0373 and C1/2007/0374; Albion Water v Water Services Regulation Authority; Neutral Citation Number: (20081 EWCA Civ 536

customers being calculated as an average for the whole GSP group. The notional downstream business of the DNO is charged on an aggregated business by customer class it is not charged on a network by network basis.

The same approach should be adopted for IDNOs. Charges to IDNOs should be made on an aggregated basis for the different customer classes. In this way the mix between I and C properties and domestic properties on different developments becomes irrelevant (from a charging perspective). This approach is entirely consistent with the way DNOs treat their own notional downstream businesses.

Therefore, we do not support the inclusion of a single 'domestic only' tariff. Such an approach fails to recognise that DNOs are substituting the last mile component of the network that would otherwise be provided by the DNO.

These points in this response are made in addition to points raised in our response to the WPD modification proposal. The points raised in that original response are equally valid to this proposed modification.

We will be happy to meet with Ofgem to explain the points raised in this response in more detail.

Yours sincerely

Michael Harding
Regulation and Compliance Manager

Appendix 1 Analysis of Charges

SP Distribution

SP Band 1		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	16.79	16.79	16.79	16.79	16.79	16.79	16.79	16.79	16.79	16.79	16.79	16.79
	Annual kWh Charge £)	£67.15	£335.75	£671.49	£1,007.24	£1,342.99	£2,014.48	£3,357.46	£5,036.20	£6,714.93	£10,072.39	£13,429.86	£20,144.78
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£84	£71	£69	£68	£68	£68	£67	£67	£67	£67	£67	£67
	Charge per dwelling (inc. metering)	£184	£91	£79	£75	£73	£71	£73	£71	£70	£69	£69	£68
IDNO Charges													
	All the way charge (Unrestricted)	£88	£88	£88	£88	£88	£88	£88	£88	£88	£88	£88	£88
	All the way charge (e7)	£95	£95	£95	£95	£95	£95	£95	£95	£95	£95	£95	£95
	margin excluding metering	£4	£18	£19	£20	£20	£21	£21	£21	£21	£21	£21	£21
	Margin per property (Unrestricted and inc. metering)	-£96	-£2	£9	£13	£15	£17	£15	£17	£18	£19	£19	£20
	Margin per property (E7 inc. metering)	-£89	£5	£17	£20	£22	£24	£22	£24	£25	£26	£27	£27

SP Band 4		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	£16.79	£16.79	£16.79	£16.79	£16.79	£16.79	£16.79	£16.79	£16.79	£16.79	£16.79	£16.79
	Annual kWh Charge £)	£60.12	£300.59	£601.19	£901.78	£1,202.38	£1,803.56	£3,005.94	£4,508.91	£6,011.88	£9,017.82	£12,023.76	£18,035.63
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£77	£63	£62	£61	£61	£61	£60	£60	£60	£60	£60	£60
	Charge per dwelling (inc. metering)	£177	£83	£72	£68	£66	£64	£66	£64	£63	£62	£62	£61
IDNO Charges													
	All the way charge (Unrestricted)	£88	£88	£88	£88	£88	£88	£88	£88	£88	£88	£88	£88
	All the way charge (e7)	£95	£95	£95	£95	£95	£95	£95	£95	£95	£95	£95	£95
	Margin per property (Unrestricted and inc. metering)	-£89	£5	£16	£20	£22	£24	£22	£24	£25	£26	£27	£27
	Margin per property (E7 inc. metering)	-£82	£12	£24	£27	£29	£31	£29	£31	£32	£33	£34	£34

SP Manweb

SP Manweb Band 1		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51
	Annual kWh Charge £)	£72.33	£361.67	£723.35	£1,085.02	£1,446.70	£2,170.05	£3,616.74	£5,425.11	£7,233.48	########	£14,466.97	£21,700.45
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£83	£74	£73	£73	£73	£73	£73	£72	£72	£72	£72	£72
	Charge per dwelling (inc. metering)	£183	£94	£83	£80	£78	£76	£79	£76	£75	£74	£74	£73
IDNO Charges													
	All the way charge (Unrestricted)	£74	£74	£74	£74	£74	£74	£74	£74	£74	£74	£74	£74
	All the way charge (e7)	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75
		-£8	£0	£1	£1	£2	£2	£2	£2	£2	£2	£2	£2
	Margin per property (Unrestricted and inc. metering)	-£108	-£20	-£9	-£5	-£3	-£2	-£4	-£2	-£1	£0	£1	£1
	Margin per property (E7 inc. metering)	-£108	-£20	-£8	-£5	-£3	-£1	-£4	-£2	-£1	£1	£1	£2

SP Manweb Band 4		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51	£10.51
	Annual kWh Charge £)	£60	£301	£601	£902	£1,202	£1,804	£3,006	£4,509	£6,012	£9,018	£12,024	£18,036
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£71	£62	£61	£61	£61	£60	£60	£60	£60	£60	£60	£60
	Charge per dwelling (inc. metering)	£171	£82	£71	£67	£66	£64	£66	£64	£63	£62	£62	£61
IDNO Charges													
	All the way charge (Unrestricted)	£74	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75
	All the way charge (e7)	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75	£75
	Margin per property (Unrestricted and inc. metering)	-£96	-£7	£4	£7	£9	£11	£9	£11	£12	£13	£13	£14
	Margin per property (E7 inc. metering)	-£96	-£7	£4	£7	£9	£11	£9	£11	£12	£13	£13	£14

Data Used in Analysis

IDNO Charges (excluding metering)

SPD	Fixed p/Day	Day (p/kWh)	Night (p/kWh)
LV Band 1	4.6	1.93	0.19
LV Band 2	4.6	1.98	0.19
LV Band 3	4.6	2.03	0.2
LV Band 4	4.6	2.08	0.2
HV Band 5	4.6	1.73	0.16

SP Manweb	Fixed p/Day	Day (p/kWh)	Night (p/kWh)
LV Band 1	2.88	1.75	0.19
LV Band 2	2.88	1.79	0.19
LV Band 3	2.88	1.84	0.2
LV Band 4	2.88	1.89	0.2
HV Band 5	2.88	1.45	0.16

All the Way Charges

SP	Fixed p/Day	Day (p/kWh)	Night (p/kWh)
Unrestricted	5.71	1.64	1.64
E7	7.68	1.86	0.56

SP Manweb	Fixed p/Day	Day (p/kWh)	Night (p/kWh)
Unrestricted	3.63	1.49	1.49
E7	4.17	1.64	0.54

Assumptions

Annual Consumption (kWh)	4109
% night units	17%
metering charge (< than 60 kVA)	100
metering charge (> than 60 kVA)	300
Assumed admd (kVA)	1.5
CT metering boundary (kVA)	60

A notional cost of £100 per annum has been assumed for whole current metering at the boundary
A notional cost of £300 per annum has been assumed for current transformer metering at the boundary