

19th August 2008

Mr Lewis Hodgart
Commercial Regulation, Distribution, Networks
Ofgem
9 Millbank
London SW1P 3GE

Legal & Regulatory

Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY
t: 01784 874 000
f: 01784 878 719

Dear Lewis

Delivering the electricity distribution structure of charges project: decision on a common methodology for use of system charges from April 2010, Ref 104/08

This is our response to the above consultation. It is not confidential and we are happy for this to be posted on the Ofgem website.

We have organised our response into four main areas, covering:-

- our strong agreement to Ofgem specifying a common methodology across DNOs
- proposed implementation date of April 2010
- governance arrangements, and
- the relative merits of the existing models.

A common methodology applied across DNOs

- 1.1 We strongly support the decision by Ofgem to apply a common methodology across DNOs. A common methodology will lead to a step change improvement in transparency and understanding, allowing suppliers and other industry stakeholders to better predict their costs and reduce uncertainty. The resulting benefits to customers through more effective competition and reduced risk premiums running into multiple £millions per annum will easily outweigh the short term, one-off implementation costs incurred by the DNOs.
- 1.2 The unanimous agreement of the suppliers, generators, industry groups and IDNOs who responded to the consultation is evidence that non-DNO industry stakeholders are frustrated with the slow, fragmented progress we have seen to date. Retaining the status quo and allowing DNOs to submit inconsistent and opaque methodologies under their own timescales would put at risk the changes required to meet the government's objectives for carbon reduction. As Ofgem points out, to date only one revised DNO methodology has achieved a non-veto decision by the Authority despite many years of debate.
- 1.3 Furthermore, from our perspective as one of the industry stakeholders who funds the networks through the price control, we have yet to receive any convincing arguments from DNOs as to why the adoption of up to 14 different methodologies would bring any benefit. Indeed, a common methodology is applied in gas distribution – yet there are no arguments or proposals to start applying different methodologies by region in that arena.

- 1.4 We also agree with Ofgem and other respondents that important geographical location decisions (e.g. on connecting to a particular network) may be distorted if different methodologies apply to different DNO regions. We have seen no evidence that different methodologies would not simply lead to arbitrary differences in cost signals between areas.
- 1.5 We believe that a common methodology would promote effective competition. A common approach would be more accessible, easier to understand and would reduce analytical costs – especially significant for smaller industry stakeholders. The removal of potential cost signal distortions between regions referred to above would also be a factor.
- 1.6 The fact that DNOs cannot currently agree on a methodology is no basis to step back from a common approach. The objective must surely be to produce an outcome which brings maximum benefits to customers, rather than one which effectively rewards the slow progress the DNOs have made in recent years. We recognise that DNOs are unlikely to be able to agree a common methodology between themselves, and for this reason believe that it is appropriate for Ofgem to take the final decision.
- 1.7 The process and timings as outlined in the decision document seem sensible. It is important that Ofgem place themselves at the heart of this process, in particular by ensuring that sensible solutions are reached quickly and effectively rather than allowing entrenched positions to develop. We would hope to play a full and effective role in the process, and believe that Ofgem can facilitate this by actively involving industry stakeholders other than DNOs alone. In order to contribute meaningfully, we would ask for sight of the model at various stages of development.

Proposed implementation date of April 2010

- 2.1 We have always believed that an implementation date of April 2010 is the most appropriate, given the significant interaction between the methodology and the price control. The two areas are inextricably linked, and it makes sense to introduce them in a co-ordinated manner. In particular, the future treatment of generation and demand revenue in the price control could have a significant bearing on the methodologies.
- 2.2 An earlier implementation date would be likely to incur significant additional costs and complexity, as further changes to the methodology would be probable in April 2010 to align with the price control. Additionally, in some instances, certain elements of the methodology would not work effectively without accompanying changes in the price control, so pricing signals would be distorted. Trying to predict not only what an interim methodology might look like, but also how this might change in April 2010 would be extremely difficult and increase levels of uncertainty across the industry.
- 2.3 For this reason, we also believe that all existing live proposals should be withdrawn by the DNOs. The introduction of a new methodology in April 2009 by a handful of networks for just one year (until replacement by a common methodology in April 2010) generates all of the problems referred to above.
- 2.4 We agree with Ofgem that later implementation would not be acceptable, and that April 2010 represents the last possible date for the introduction of a new charging methodology.

Governance arrangements

- 3.1 We welcome Ofgem's recognition that appropriate governance arrangements must be put in place to manage change effectively, and in particular to ensure that the benefits of a common methodology are not diluted over time. As Ofgem note in the decision document, without formal governance there is a risk that each DNO may make changes which undermine the common approach.
- 3.2 We are pleased to note that Ofgem recognise the importance of implementing governance arrangements in which issues raised by parties other than DNOs can be fully and properly considered. This is absolutely the right approach.
- 3.3 For these reasons, we would support industry code governance (option 1), which would result in the current methodology being subsumed into the DCUSA. As well as the advantages set out above, this approach would ensure that there is a transparent process surrounding changes to the common methodology, and would allow other protocols of the existing change process to be adopted.
- 3.4 We believe it is important for Ofgem to have the final decision on any changes to the common methodology (in line with the approach adopted for the delivery process), and for this reason would propose that the changes to DCUSA are included in Part 1.
- 3.5 We recognise that changes to the licence will be required to facilitate the introduction of this additional governance. Whilst we strongly prefer the DCUSA option, as a minimum any licence change should ensure DNOs have obligations to consider and facilitate change proposals submitted by non-DNO industry parties.
- 3.6 We agree with Ofgem that it would be sensible to progress governance arrangements as part of this project, rather than address them through the wider codes governance review.

Relative merits of existing models

- 4.1 Based on the information currently available to us, we do not feel able to provide a detailed analysis of the relative merits of each approach above and beyond those which you have already identified, but would make some general points below which will hopefully provide some useful guidance.
- 4.2 It seems to us that much of the debate over which approach to adopt is driven by the trade off between cost reflectivity and simplicity/ transparency. Where such a conflict arises, we would favour models which are (in relative terms) simple, transparent and predictable. This will enable us to better understand how charges are derived, which in turn allows us to set tariffs to customers with more certainty. Models which claim to be cost reflective but which are not easy for users to understand tend to be self-defeating if users cannot see, understand or manage the charges that they face.
- 4.3 As a general principle, we would also favour a model which is based as far as possible on publicly available information and which minimises the use of judgement in the formulation of charges.

- 4.4 We have been making considerable efforts to engage with the DNOs to improve our prediction of future costs, a recent example being our proposed modification DCP030 to facilitate publication of allowed revenue estimates. In order to maximise the benefits from a common methodology, we will need access to the final model so we can use it to predict future charges and make changes to reflect different scenarios. For this reason, it is important to ensure that we guard against implementing a model which may have certain theoretical advantages, but which is too complex to be used outside of a small population of engineering experts.

Conclusion

- 5.1 It is clear there is an overwhelming case for Ofgem to specify a common methodology to be applied across all DNOs from April 2010. As set out above, the benefits to consumers from a common approach are compelling and there can be no justification for continuing with up to 14 separate versions, with all of the delays, inconsistencies, costs, complexities and uncertainties this would involve.
- 5.2 It is therefore extremely important that Ofgem follow through their proposals robustly to ensure that the benefits are delivered in full, and not diluted in any way. We support Ofgem's efforts to ensure a common approach is implemented along the lines set out in the decision document. If we can be of any further help, please let us know.

Yours sincerely,



 Philip Davies
Director of Regulatory Affairs