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Your Ref: PR-08-001a
Our Ref: RBA/DPC/SOC
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Date: 31 July 2008

Dear Colleague,

Decision in relation to modification proposal PR-008-001a: Amendment of use of system charging methodologies for IDNO networks

On 1 May 2008, ScottishPower EnergyNetworks ("SP") submitted to the Gas and Electricity Markets Authority (the "Authority")¹ a proposal to modify the use of system ("UoS") charging methodology for both the SP Distribution Limited ("SPD") and SP Manweb plc ("SPM") distribution areas. This modification sought to introduce new tariffs for Independent Distribution Network Operators ("IDNOs").

On 1 May 2008 the Authority notified SP of its intention to consult on their proposal. On 6 May 2008 the Authority published its consultation on SP's proposal².

Having carefully considered the proposals made by SP and responses to our consultation, we have decided **to veto** SP's proposals in relation to new IDNO tariffs.

This letter sets out SP's proposal, the views of consultation respondents and the reasons for the Authority's decision.

Background to the proposal

SPM has licence obligations³ to have in place three charging statements: the statement of UoS charging methodology, the statement of UoS charges and statement of connection charging methodology and charges. The statement of UoS charging methodology outlines the method by which distribution UoS charges are calculated. SP has a requirement to keep the methodology under review and bring forward proposals to modify the methodology that it considers better achieves the relevant objectives.⁴

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

² The consultation is available on our website at:
<http://www.ofgem.gov.uk/NETWORKS/ELECDIST/POLICY/DISTCHRGMODS/Documents1/PR-08-001a%20SP%20Consultation%20FINAL.pdf>.

³ Standard licence conditions (SLC) 13 -14.

⁴ The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of SLC 13 of SPM's licences are:

- (a) that compliance with the UoS charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and its licence;
- (b) that compliance with the UoS 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;

The Authority has been encouraging Distribution Network Operators (“DNOs”) to modify their charging methodology to bring forward specific IDNO tariffs which better reflect the costs IDNOs impose on their distribution network. As yet only Western Power Distribution’s (“WPD”) two distribution companies have had IDNO charging proposals not vetoed⁵.

SP’s proposal

SP’s proposal introduces five new IDNO specific tariffs which are calculated on the basis of new demand profiles which closely resemble the profile of a domestic customer. At LV, tariffs are differentiated into four bands according to the distance of the IDNO connection boundary from the local LV substation. SP also propose the introduction of a single tariff for HV IDNO connections.

SP consider that the proposed changes would result in UoS charges to IDNOs, which more accurately represent its avoided network costs compared to existing charging arrangements. These arrangements were developed on the basis of the characteristics of SP’s own end customers: SP state that it is appropriate to develop additional yardsticks for IDNOs as these will generally be different from yardsticks developed for directly connected business customers of a similar size.

SP also propose to charge IDNOs on the basis of a separate day/night unit as they state that this would allow charges to be more cost reflective, as the majority of costs arise from day time use of the network. The day unit rates SP propose for their new IDNO tariffs are higher than their domestic customer unit rates. SP has not explained the rationale for this aspect of their modification proposal. SP do not propose to introduce a commercial IDNO charge. Thus all IDNO sites will be charged on the basis of a domestic profile regardless of the commercial mix within the site. SP state that the average IDNO site is more similar to the domestic profile and that there may be justification in the future to use different profiles for IDNO networks that mainly comprise of commercial customers. However, SP state that it is not possible to create a profile at present for these sites as they are small in number and have been in existence for a limited time.

SP also state that there are some separate billing costs associated with IDNOs connecting to their system. They state that for IDNO connections they do not incur the normal billing costs associated with an LV customer and that subsequently these are omitted from the IDNO tariffs. However, SP state that they use a manual billing process for IDNOs and include the cost of this process in their IDNO tariffs.

We note that SP have capped the level of scaling for their LV IDNO tariffs to the HV level. This avoids the potential allocation of more indirect overhead costs and residual elements to LV IDNO charges than is justified, particularly for those bands further from the LV substation.

Respondent’s views

We invited responses to SP’s proposal in our consultation document of 6 May.⁶ The IDNO responses were generally unsupportive of SP’s proposal, mainly on the grounds that the resulting margins⁷ would fall as a result of this modification proposal. WPD also responded to our consultation and whilst they supported the general principles behind SP’s proposal they were highly critical of the lack of a commercial IDNO tariff.

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- (c) that compliance with the UoS 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 UoS charging methodology, as far as is practicable, properly takes account of developments in the licensee’s distribution business.

⁵ The proposal can be found at:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20uos006%20mod.pdf>

⁶ Consultation responses can be found on Ofgem’s website at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=415&refer=Networks/ElecDist/Policy/DistChrgMods>

⁷ The ‘margin’ refers to the difference in use of system charges between the total all the way charge an IDNO levies on its end customers and the boundary charge the IDNO pays for its upstream use of the network.

Respondents' views also centred on the tariff structure mismatch caused by SP proposing both day and night unit charges for IDNOs, where IDNOs are only able to charge a single unit rate for domestic unrestricted customers. Respondents pointed out that the day unit charge for IDNOs was higher in most cases than the day unit charges to both domestic unrestricted and domestic restricted customers. One respondent also indicated that consequently, the margins available to them would be lower as the day consumption increased.

WPD commented that the new IDNO tariffs should not be used for IDNO sites which mainly supply commercial customers. They went on to enquire if such IDNO tariffs would be used for private networks. They stated that if they were used they would not be cost reflective and if they weren't used then SP may be acting in a discriminatory manner.

The Authority's decision

In coming to our decision we have considered the proposed modification against the relevant objectives and the Authority's wider statutory duties.

It is important to note that our decision letter relates to the methodology rather than the quantification of elements produced by the methodology.

The reasons for the Authority's decisions are set out below.

Cost reflectivity and competition

We believe that SP's proposal contains some benefits and these are outlined below:

- A domestic profile is used rather than a commercial one;
- The IDNO tariffs strip out capacity charges levied on IDNOs; and
- Specific IDNO yardsticks take account of some of the avoided costs involved in distributing units of electricity to the IDNO boundary rather than the end customer.

We welcome these developments in SP's approach to IDNO charging. However, we have three concerns with SP's proposal which we consider outweigh these benefits. Combined, these three features of the methodology lead to further issues with the manner in which SP charges IDNOs connected to their distribution system.

1. LV capital in avoided costs

We note that the IDNO yardsticks use a distance related banding approach, based on the avoided costs involved in distributing units to the IDNO boundary rather than all the way to the end customer. There are therefore avoided costs associated with the provision of less LV network, less operation & maintenance and potential savings in billing costs. SP's IDNO tariff calculation indicates that 100% of the LV capital costs are included in the up front connection charge to the customer. None of these costs are included in the UoS charge and SP does not consider that it avoids these costs through the IDNO activity. Consequently the avoided costs in the IDNO yardsticks are limited to those operation and maintenance costs associated with the LV network and any avoided billing costs.

We consider that in some cases connections to the LV network will utilise a share of the existing LV network. To assume that all LV connectees fully contribute to the capital cost of the LV network they use may not be cost reflective. This is particularly true for smaller LV connections. Given this, it is likely SP may avoid some costs associated with LV capital when an IDNO connects. The benefit derived from this avoided cost should be reflected in the IDNO tariff yardsticks. SP's existing methodology does not appear to recognise the fact that shared LV capital is recovered through UoS charges, therefore the IDNO tariffs will not reflect this either. In this respect the proposal does not better meet the relevant objectives,

in particular the requirement to have charges which reflect the costs incurred by SP in its distribution business, as it is based on the same assumption as the existing methodology.

We appreciate that this is an issue over the interaction between the existing methodology and the IDNO charging proposal. However, we believe that this is a crucial point which SP has failed to address.

2. Day and night tariff mismatch

SP propose to structure their IDNO tariffs by having a fixed charge, a day unit charge and a night unit charge. IDNOs will have some developments where customers are on an unrestricted tariff comprising a single unit charge. If SP were distributing units to this development rather than the IDNO they would charge on the basis of a single unit charge which they state is cost reflective. Consequently, it is not clear why it is cost reflective to charge IDNOs who supply the same kind of development on the basis of both a day and night unit charge in all cases. SP's own analysis indicates that the margins available to IDNOs are roughly a third lower when the development is on an unrestricted tariff as compared to when it is on a restricted tariff.⁸ We are also concerned that the higher day unit rates for IDNOs relative to non-IDNOs reflects a change in the balance between fixed and unit rates.

We note that SP's modification report does not provide any clarity over this matter. We do not consider that the proposal to have both day and night unit charges to IDNOs better achieves the relevant objectives. In particular, we are of the view that the proposal could restrict, distort or prevent competition in the distribution of electricity, where a housing development was on an unrestricted unit tariff, due to the higher day unit charge for IDNOs. We consider that the mismatch in tariff structure and potential negative margin with regard to the day unit could foreclose IDNOs from competing to operate such developments which are on an unrestricted tariff.

3. Lack of a commercial tariff

In addition to the two key points above, we note that SP state that they do not offer a commercial IDNO tariff as the average IDNO connection is most similar to their domestic profile and that they only have a very small number of commercial IDNO sites. SP state that as and when more IDNO commercial sites arise that they will consider developing a specific IDNO commercial tariff.

Whilst SP may not have widespread data in order to devise and develop IDNO commercial tariffs, they have indicated that they currently have IDNO sites connected to their network which are predominantly commercial in nature. It appears that these commercial IDNO sites will pay the same tariffs as domestic sites. This treatment does not appear to accurately reflect the costs that the commercial site places on SP's distribution system.

The fact that SP may develop alternative commercial tariffs in the future provides no certainty within the market. This uncertainty could deter IDNOs from competing to build and operate commercial developments. Therefore we do not consider that SP's proposal better achieves the relevant objectives because the proposal could restrict distort or prevent competition in the distribution of electricity. We also consider that the lack of a commercial tariff fails to better meet the relevant objectives as it indicates that SP are not taking account of developments in their distribution business.

Our decision

These concerns set out above have prompted our decision to veto this modification.

⁸ This figure is based on the graphs SP provide on pages 19 and 21 of their modification report. This report is available on Ofgem's website at:
<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/SP%20Modification%20Report%20IDNO%20charging%201%20May%2008.pdf>

We consider that some aspects of the proposed changes in SP's methodology have benefits. However, as we have outlined, we have some concerns with this proposal which marginally outweigh these benefits. Overall we do not consider that the proposal better meets the relevant objectives.

The Authority has decided **to veto** the modification to the UoS charging methodology statement.

If you have any questions relating to the issues discussed in this letter please contact Mark Askew at mark.askew@ofgem.gov.uk or on 0207 901 7022.

Comments

Notwithstanding this decision, we welcome the constructive approach taken by SP in developing these proposals and urge other DNOs to consider their own IDNO charging proposals and fully engage with both ourselves, other DNOs and IDNOs in developing their thinking on these. We would like to point out that this decision was very finely balanced in weighing the benefits of the proposal against the new concerns it raises.

This letter constitutes notice pursuant to section 49A of the Electricity Act 1989.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is positioned above the printed name.

Rachel Fletcher,
Director, Distribution