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13th October 2008

Dear Rachel,

Collective Licence Modification Proposal ref. 137/08: Delivering the Electricity Distribution Structure of Charges Project

Attached as an Appendix to this letter is our formal rejection of the proposed modification of standard licence condition 13 and introduction of new standard licence condition 50 and 13A.

The decision to reject the collective licence modification (CLM) is not taken lightly. We have expressed our very serious concerns over the proposal to base distribution use of system charging methodologies on a long run incremental cost (LRIC) model on a number of occasions during the course of the project. Unfortunately, nothing in Ofgem's decision document of 1st October 2008 alleviates these concerns. In our view an LRIC based charging methodology will fail to meet the high level principles agreed between Ofgem and DNOs: it will not be cost reflective, transparent, predictable or simple (at point of use). Worse, we do not believe that such a methodology will facilitate competition, particularly with regard to generation.

Furthermore, we were surprised to see in Ofgem's decision document the requirement for DNOs to bring forward proposals for longer term access products to help customers manage the risk of charging volatility. We presume by this Ofgem mean a system of auctioning strips of long term capacity similar to arrangements at gas entry and envisaged for electricity transmission. This topic has never been raised at any point previously during the electricity distribution structure of charges project.

We are also disappointed with the tone of the decision document. As we explained in our letter of 14th May 2008, whilst it is a fact that the project has met with delays, we totally disagree with Ofgem's assertion that DNOs are solely responsible for these. The work involved in bringing forward suitable charging methodologies has been complex and difficult at times, but Ofgem's desire to impose a pure forward looking incremental cost model that is incompatible with its own set of prescriptive charging principles has clearly contributed to the delay.

We do not wish to repeat, again, our arguments against LRIC or the mandating of a common charging methodology. These are laid out in some detail in a number of letters and papers to Ofgem, notably:

- Our letter of 24th February 2006 providing a critique of the Bath University benefit analysis work;
- Our paper and covering e-mail of 7th July 2006 on the treatment of existing DG connections from 2010;
- Our letter of 16th May 2007 reiterating our concerns with forward looking marginal cost pricing models and noting that our work with ScottishPower Networks and Central Networks will result in a SSE distribution charging methodology which will be a balance between cost reflectivity, simplicity, stability and transparency;
- Our letter of 14th May 2008 expressing disappointment at Ofgem's proposal to impose a licence condition on DNOs 'to deliver appropriate charging methodologies ahead of April 2010'. We believed this to be a disproportionate and inappropriate action by Ofgem and that the innovation shown by DNOs to date would be stifled under Ofgem's proposals; and
- Our letter of 19th August 2008 making it clear that whilst we had no objection in principle to Ofgem's proposal for common governance, we certainly could not support a CLM based upon a LRIC methodology which we believe is fundamentally flawed. Our preference was that the starting point should be all DNOs' individual charging methodology proposals.

In many of these letters we have expanded on our concerns over Ofgem's proposals to implement LRIC charges for generators (as well as demand). In our view, the whole concept of providing locational signals to distributed generation, certainly via use of system charges, is fundamentally at odds with both government and European policy that is seeking to tilt the playing field in favour of renewable generation. We are firmly of the view that the imposition of such a charging methodology will have serious, adverse implications for delivery of the renewable generation targets introduced by government.

We have argued strongly that setting all distributed generation charges to zero and relying on locational signals being provided via the existing connection charge regime would be more in line with government and European policy for renewable generation.

Finally, we remain firmly of the view that it would be inappropriate and impractical to charge use of system for those generators connected prior to April 2005. Indeed, so severe are these practical issues that we believe they are a 'show stopper'. For example, in moving to LRIC in transmission the precedent was set that the transmission company reimbursed the deep connection charge (notionally) paid by the generator. Otherwise such generators would be paying twice for use of the system. We do not see how such transfer payments could credibly be calculated for the radial distribution system against the context of a change effecting thousands rather than tens of individual generators. Our paper of 7th July 2006 explains our concerns in some detail, to which we have never received a reply, despite a number of assurances from Ofgem that one would be forthcoming.

In conclusion, I am afraid that we cannot support the imposition of a licence modification that requires DNOs to implement a charging methodology, to Ofgem's satisfaction, where such a methodology is incompatible with the principles prescribed by Ofgem. We therefore have no option but to formally reject the CLM.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Rob McDonald', written in a cursive style.

Rob McDonald
Director of Regulation

