

Your ref 143/08

Our ref COp/THS

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Dear Rebecca

CE Electric UK response to Ofgem's consultation on its Gas and Electricity Connections Industry Review 2007-08

I am writing on behalf of CE Electric UK Funding Company (CE), which is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

We have set out our responses to the specific questions posed in the consultation in the attachment to this letter. In addition, we would wish to make a number of overarching comments, as set out below.

We believe that the higher relative number of connections carried out by independent gas transporters (IGTs) and independent connections providers (ICPs) in the gas market when compared to volumes carried out by independent distribution network operators (IDNOs) and ICPs in the electricity sector is probably due to a combination of adoption payments and stronger brand awareness. We perceive that house builders have been much more aware of IGTs and the product they offer in the gas market than they have been of IDNOs and their offering: however, we believe that brand awareness of IDNOs is increasing quickly.

It is also worth noting that ICPs and IDNOs in the electricity distribution sector are essentially multi-utility (common trenching) providers working in the housing market and that this market has slowed considerably of late. We believe this down-turn has adversely affected IDNO and ICP market share as measured by Ofgem relative to the totality of new electricity connections.

In assessing competition in the market for connections Ofgem may need to look further than traditional measures of market share. The traditional metrics, including market share, will show most, if not all, legacy network operators as being dominant. This is not surprising in an industry characterised by a starting point of incumbents with 100% market share and therefore market share data will conflate legacy effects with the ongoing process of competitive choice. These legacy effects may include:

- A natural brand awareness amongst customers of the host distribution network operator (DNO) as a provider of an end-to-end connections service;

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- Inherent economies of scope and optimisation of efficiency in providing a bundle of both the contestable and non-contestable elements of the connections service, which results in lower costs, or better service for a given cost; and
- The current regulatory arrangements, which constrain DNOs to price at cost-reflective levels, without any mark-up, and to recover only those costs that have been reasonably incurred.

We agree with Ofgem that larger sites have proved more viable for new entrants and believe this is exemplified in the number of new entrants offering multi-utility connections to house builders. We note Ofgem's observations on the level of market share being moved to the two leading IGTs. This would appear to be as a result of tariff support in the form of adoption payments being offered by IGTs who are well established in the market.

We believe it is clear to all parties in the connections market that house builders and developers find attractive any form of allowance that has the effect of reducing the initial connection charges that they face. Anecdotal feedback from house builders in our area suggests that they are seeking and receiving adoption payments for electricity assets from IDNOs and the builders see this as a natural extension of the treatment of gas connections by IGTs.

It appears to us that the market move to IDNOs has been slower in electricity due to limited brand awareness of alternatives available to customers and the now resolved technical interface issues, but in recent months we have noted house builders increasingly choosing the IDNO-ICP route for competition rather than employing standalone ICPs to build assets for adoption by us. We perceive there is rapidly increasing brand awareness of IDNOs and ICPs among builders and developers and that the builders are beginning to benefit from adoption payments for the electricity assets.

Ofgem's measure of market share may also benefit from being refined, as simply measuring connections won by IDNOs and ICPs compared to the total of new connections may be inadvertently understating the level of competition. The fact that most ICPs and IDNOs tend only to focus on certain types of development suggests that measuring their success in specific market sectors would be a more appropriate measure of the success penetration. This is because the total of new connections includes one-off connections, modified connections, smaller developments and speculative commercial projects for which new entrants have shown little appetite.

We do not believe that current service standards or the extent of contestability are having an adverse effect on competition in metered connections. CE and some other DNOs are achieving the standards introduced by SLC15 and the connection work required on the vast majority of new development sites is almost all contestable. Given that the standards benefit both ICPs and IDNOs and there is only six months' worth of nationally shared data, we believe it is appropriate to let the new standards run for at least 18 months before reviewing them. However, we are pleased to report that our strong performance in respect of SLC15 has continued throughout 2008 and, as was seen in our 2007/08 SLC15 return, our performance here has been at least comparable to, if not better than, our general performance with section 16 quotations.

Our experience with SLC15 suggests that ICPs do not always use the options open to them and frequently request an exemption from the standard. In the twelve months that SLC15 has been operational, ICPs requested an exemption 76% of the time for low voltage final connections in YEDL and 26% of the time in NEDL. This leads us to believe that, even after 12 months, ICPs choose to opt out in order to achieve a more flexible service delivery in line with the development of their sites.

We believe we are at the forefront of extending contestability in electricity connections, and wish to remain so, and we do not believe that Ofgem's description of activities remaining non-contestable in paragraph 1.16 of appendix 9 is a complete or accurate reflection of the current position. On the vast majority of sites the only physical works remaining non-contestable are the closing joints on to the DNO system. It should be noted that we have been proactive in facilitating live jointing trials and removing the >1m rule for unmetered connections. Furthermore we have already said that in principle ICPs can remove certain elements of our redundant assets as a result of diversions, albeit this would need to be on a contractual basis.

CE has long established relationships with local authorities in our area including the street lighting steering group. We continue to demonstrate good levels of performance on high volumes of new connections and we believe this is clear evidence that voluntary standards are effective when developed through working closely with customers.

We are concerned that Ofgem reports in generic terms that it continues to receive large numbers of complaints about incumbent DNOs from market participants, given our overall approach to the market, our performance against standards and our track record of extending contestability. Written complaints received by CE are reviewed at executive level on a weekly basis and no formal written complaints have been received from any IDNO/ICPs direct, or referred to us from independent industry representatives, during 2008. If Ofgem has had specific concerns raised with it in respect of CE, we would expect to be advised of this and would welcome the opportunity to review any such cases and, where necessary, look towards an improved solution for any substantive issues. It may be that the management of perceptions is an issue here and we are keen to work with Ofgem to explore in detail any complaints received in respect of CE.

I hope that you will find these comments helpful. Should you have any queries, or wish to discuss any of the points in this letter, please contact me on the above number.

Yours sincerely

John Barnett

John Barnett
Director of Customer Operations

Appendix 1 - Consultation responses and questions

1.1 Chapter two

1.1.1 Is the data we have collected reasonably representative of connection charges levied by GDNs and IGTs, and adoption payments made by IGTs and GDNs?

We are not in a position to comment on this.

1.1.2 Are adoption payments the main reason why ICP'S have a much higher market share in connection to IGT networks than GDN networks? Are there other factors that account for the fact that only 5% of connections to GDN networks are installed by ICP'S?

The potential for adoption payments is one factor that explains the market share, since ICPs will see this as an attractive option.

1.1.3 What factors enable IGTs to make adoption payments of these magnitudes? Do they have lower costs of operation, or are other factors at play, such as the degree of headroom in the relative price control?

It is likely that price control and regulation are a major factor in the IGTs' ability to subsidise connections, plus we assume their desire to increase their market share by making attractive offers to enable recovery up-front of investment by builders will be factored into their business plans.

1.1.4 What factors lead IGTs to charge lower connection charges? Are ICP'S/IGTs more efficient at installing the connection or are other factors at play?

IGTs do not have to consider the implications of upstream reinforcement costs and will not need to consider asset replacement or remedial costs in the near future. There are also clear cost benefits associated with multi-utility working, which include economies of scale when considering the high density of connections against infrastructure. Furthermore, these connections are also subsidised by the adoption payments. ICPs/IGTs are able to choose which projects they want to pursue and sites that may be perceived as unattractive will fall to the GDN, e.g. connector of last resort. It is more efficient to be involved with a high density of connections on a large development compared with lower densities on a large number of diverse sites.

1.1.5 What impact does the contrasting nature of GDN and IGT price controls have on competition in gas connections?

It would appear that the IGT price control may create sufficient headroom to enable them to offer very attractive levels of adoption payments that can be passed through to builders (effectively as tariff support). This will help them win market share of gas connections, but also assist in winning electricity connections on multi-utility/common trench sites.

1.2 Chapter three

1.2.1 We seek consultation response on whether stakeholders agree that performance standards are as high as reported, and what lessons can be learnt from the gas connections industry and applied to the electricity connections industry.

We are confident about the accuracy of our performance in this area as our performance is subject to an internal and external audit programme. This is supported by the very low levels of complaints we receive directly. Clearly we are not in a position to comment on others, but we look forward to reviewing the lessons learnt with Ofgem.

1.3 Chapter 4

1.3.1 Why has competition been slow to develop in electricity connections compared to gas, and what measures if any, should be taken to address this issue. In particular, we seek responses on the following theories for the relatively slow growth of competition in electricity connections:

1.3.1.1. The relative price control operating in gas gives IGTs relatively high revenue compared to their underlying operating cost, whereas margins are slimmer for IDNOs?

A higher revenue for IGTs will allow them to target their marketing efforts and increase their brand awareness. In addition the housing sector has a lower growth rate now when compared to recent years, so the growth in electricity competition will also be slower. It is also worth considering that there is a shortage of skilled craftsmen and engineers capable of supplying the new connections market in electricity overall - this does not seem to be the case in gas, as proven by the high take-up.

1.3.1.2 There remain significant barriers to competition in electricity, whether real or perceived, which prevent effective competition from IDNOs and ICP'S. If so, we seek consultation responses on the nature of the barriers, and what measures should be implemented to address them?

In a free market participants have a choice regarding where they will commit their resources and which projects they will pursue. We believe that some of these barriers are actually perceived rather than real as on most development projects over 95% of work elements are contestable and the performance standards in SLC15 have been accommodated within the timescale to plan and build a new housing development. Overcoming these perceived barriers may not be within the capabilities of a DNO and also may not be subject to regulatory intervention. For example, there are certain project types that prove to be unattractive to ICPs/IDNOs, such as one-off connections. Removing these barriers will involve the action of DNOs, ICPs and IDNOs.

1.4 Chapter five

1.4.1 Why has there been limited reporting against the SLA 15 performance standards, and what measures should be taken to address this issue?

We have taken measures to ensure that we report on all relevant categories and do not have any concerns in complying with this requirement. However, in some areas, such as EHV, there has been little activity and, in addition, some ICPs now opt out of SLC15 at their own instigation in order to obtain a more flexible and interactive service from us where the obligations upon the ICP have become inherently too prescriptive. .

1.4.2 There are standards relating to the provision of non-contestable services where the connection is being provided by an alternative provider. However, the vast majority of contestable activity is still carried out by the incumbent and not all of this activity is covered by service standard reporting. Therefore we seek feedback on whether it is appropriate to extend the scope of service standard requirements / reporting to the provision of connections not currently covered, and if so, what form the scope extension should take? For instance, we have 30 and 40 day standards for straightforward connections, but no comparable service standards with regard to non-straightforward connections (i.e. the majority of larger connections).

The experience of SLC15 would lead us to conclude that the introduction of further standards to cover all connection activity would require a similar level of complexity and obligations on the parties involved in order for reasonable exemptions to be recognised and reported. It is important to recognise that any results will reflect our customers' needs with regard to specific projects.

1.4.3 Data generally suggests that standards are being met. However, this is not consistent with the fact that we receive significant numbers of complaints with regard to service quality from end customers, ICP'S and IDNOs. Why is there an apparent inconsistency between reported standards, and the level of complaints received? How should this issue be addressed?

We are concerned that Ofgem continues to report the receipt of significant numbers of complaints from market participants, given our overall approach to the market, our performance against standards and our track record of extending contestability. It may be that the management of perceptions is an issue here and we are keen to work with Ofgem to explore in detail any complaints received in respect of CE.

It is possible that those issues escalated to Ofgem have contributory factors from both DNOs and customers. The issues may allow them to be exempt from failure reporting or are related to activities and disputes outside the scope of SLC15 such as "the apportionment rule". The vast majority of ICPs may actually be getting a service within standard and those events that escalate to complaint may not be typical of the majority. The DNO complaints escalation process under the new redress arrangements should now deal more effectively with complaints at their source and avoid unnecessary escalation to Ofgem while ensuring that there is minimal risk of a standard failure going unreported.

1.5 Chapter six - Unmetered

1.5.1 In the light of generally disappointing performance, Ofgem seeks views from interested parties on whether they believe that it is appropriate to continue with the current voluntary arrangements, or whether Ofgem should seek to introduce either financial incentives (as part of DPCR5) or specific licence conditions with regard to performance standards in unmetered connections.

For many years we have demonstrated that partnership with the public lighting authorities and agreed voluntary standards can work, particularly in our YEDL distribution services area, to deliver improving service and new opportunities such as access to competition. CE has maintained an excellent track record of both reporting and performing against these standards, even though they have been voluntary, and we have established relationships with local authorities in our area as well as actively participating in the street lighting steering group. We have been encouraging similar arrangements with the authorities in the NEDL distribution services area and we are pleased to note recent signals from those authorities of a wish to take up similar arrangements after having witnessed the benefits of partnership working in the south of our geographic area. We continue to demonstrate good levels of performance on high volumes of new connections and we believe this is clear evidence that voluntary standards are effective when developed with customers.

1.6 Chapter seven

1.6.1 In the light of experience, did Ofgem's Good Practice Review target the appropriate areas?

We believe that Ofgem targeted the correct areas in the review and that it has encouraged DNOs to implement best practice.

1.6.2 Do the DNOs' reports of their own performance in implementing the Good Practice measures (as per our checklist) accord with their customers' and other market participants' perceptions of their performance? (See Appendix 10 for details of the checklist items, and the traffic light scores for each checklist item.)

The good practice measures have encouraged DNOs to compare best practice but not in any formal way. We regularly liaise with our customers either directly through key account contacts, or indirectly through our independent market research and mystery shopping to gauge our customers' views and expectations. We would like to

see IDNOs and ICPs offer their own good practice to get a complete picture of the market and expose it to appropriate scrutiny across the entire market sector. We would be happy to work with Ofgem in order to extend the review so that customers let us know the issues that are important to them and what areas they would like to see improved.