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Dear Paul,

Gas and Electricity Connections Industry Review and Consultation 2007-08

This response is made on behalf of Scottish and Southern Energy (SSE) and Scotia Gas Networks (SGN). We welcome the opportunity to comment on Ofgem's Gas and Electricity Connections Industry Review and Consultation dated 16th October 2008. Our wide experience of operating in both the non-contestable and competitive electricity and gas connections environment has given us a valuable insight to how the markets operate. As such, we believe we are uniquely placed to provide a balanced view on the development of competition and the effectiveness of the current arrangements. We have set out at Appendix 1 our responses to the specific issues raised by Ofgem in the consultation.

Electricity Connections Market

We strongly disagree with Ofgem's general view that there is little evidence of any effective competition and that service standards are relatively poor in the electricity connections market. It is very easy to focus on the headline figures of 58% and 8% of market share in competitive gas and electricity connections respectively and come to the conclusion that the market in electricity connections is not working. This view is far too simple and very misleading.

From our knowledge of Independent Connection Provider (ICP) and Independent Distribution Network Operator (IDNO) connection applications we are certain this will show a rather different picture of the electricity connections market with the independent providers winning a high percentage of the jobs they have competed for. It is therefore important to look behind the headlines to see the true picture, i.e. to identify the number of connections actively competed for and not simply the connections that are won.

While we are aware that improvements can be made in meeting service standards, particularly with regard to unmetered supplies, the number of complaints received by our connections businesses are very small. For example, during 2007/08 we received only two formal complaints from energywatch relating to new connection quotations, both were resolved without the need of escalation to Ofgem. Indeed Ofgem have not had to undertake a formal connections determination in either of our Distribution Service Areas (DSA) since 2005. Furthermore, we are unaware of any ICP or IDNO's concerns about how we provide non-contestable services.

In terms of the early evolution of the gas market, Transco's policy prior to the introduction of competition was to use its own contracting business (Fulcrum) as well as third party contractors to deliver their new connections and reinforcement work. This provided these parties with valuable industry experience and made it easy for them to make the transition to enter the market in their own right. In contrast, most DNOs have always used, and continue to use, their own staff for this type of work. It has therefore been more difficult for ICPs and IDNOs to establish a presence in the electricity market due to their relative inexperience of the industry.

It is clear from our recent experience of providing non-contestable services such as point of connection information and approving network designs that the majority of large developments, i.e. those greater than 10MW, are being awarded to ICPs and IDNOs. This confirms that ICPs and IDNOs have started to gain a strong foothold in our DSAs and are now actively competing for more work. If all other factors remained the same, we would expect to see a significant swing towards the independent operators over the next two or three years. The one dominant factor that could prevent this from happening, and which affects all connection providers, is the current rapid decline of activity in the construction industry. We should therefore not be too surprised to see a period of retrenchment for all parties operating in the connections market. Another view is that with the decline in construction activity the cost of providing connections is becoming paramount. This is to the advantage of the independent providers who benefit from being able to offer better financial arrangements due to the current regulatory framework. Developers are therefore more likely to choose an independent provider for their schemes. This may well be the key driver in the short term for growth in competition.

In practice, both the electricity and gas connection markets are operating in the same way as any other emerging competitive market. The customer base consists mainly of property developers who have a high level of awareness of the choice of service provider. These developers do consider their options before deciding whether to award connection contracts to incumbent DNOs or to select one of the growing numbers of ICPs and IDNOs.

Feedback from developers at our stakeholder meetings confirms that the most important criteria used in the process of selecting a service provider includes: having a single point of contact for network design and construction; the ability to work to the developer's brief and in tandem with their construction programme; a flexible approach to dealing with changes to plan; having confidence in the service provider's professional skills to do a good job; delivering timely and consistently high standards of service; managing the end to end process with the minimum of fuss; and providing all the above at a very fair price. In short, this boils down to reputation, customer service and cost.

Our stakeholders have also commented on our performance by comparing their experience with us to other DNOs, ICPs and IDNOs they have dealt with. They told us that they are generally very satisfied with the service provided by our established connections businesses. They have also highlighted areas where we can make further improvements. In general terms the feedback from these stakeholders has highlighted that our connections businesses are highly regarded in terms of reputation and customer service. Our charges are also seen as being very reasonable but we will always lose out to the independent providers on price when operating in-area due to the constraints of the regulatory arrangements. To us, this makes excellent customer service even more important.

As already mentioned, we believe there is now a good deal of evidence of ICPs and IDNOs actively competing for electricity connections work in our DSAs. However, it should be noted that these independent providers tend to focus on particular segments of the market, i.e. on industrial, commercial and large scale domestic developments involving high voltage (HV) and low voltage (LV) connections. We are not aware of any activity in the small scale domestic market (1 to 4 houses) and the niche EHV market is already dominated by established contractors competitively bidding for this highly technical and specialised work.

We believe that ICPs and IDNOs will continue to gain market penetration in electricity connections. The rate at which this grows will depend on the market conditions and how well individual providers perform. The most important factors being reputation, customer service and cost. The independent providers have a distinct advantage over the incumbent DNOs in terms of being able to offer a significantly lower cost for their connections. Companies, like SSE, who have developed their competitive connections businesses on the strength of their reputation and high levels of customer service, will continue to enjoy growth and profitability. Those that do not will almost certainly find it difficult to compete in the very challenging electricity connections market.

Gas Connections Market

We note that only 5% of connections to GDN networks are installed by ICPs, and we believe that the fact that GDNs do not make adoption payments is likely to be a significant reason for this i.e. GDNs get no additional revenue. We do not understand why the consultation document states that adoption payments are not allowable into the RAV, such payments seem reasonable up to the NPV of future transportation revenue from the new customers and would provide some incentive to compete in this sector. IGTs, on the other hand, get additional revenue from each new property connected, and therefore can afford to make adoption payments based on the future income they expect to receive from the connections. Therefore, there is little incentive for ICPs to promote connections with the GDNs.

To improve competition between the IGTs and the DNs in connections to new developments the principle should be that the DNs and the IGTs both get the same additional net income from new developments, after allowing for any costs of reinforcement in the case of the GDNs. This could be achieved by allowing GDNs to make adoption payments to ICPs, and we discuss in the Appendix to this letter a methodology for calculating equitable adoption payments. In principle, adoption payments or direct investment up to the level of the capitalised value of the additional net income would be allowed into the RAV. Because the total allowed into the RAV for reinforcement and connection would not exceed the value of the total capitalised revenue from the project there would be no effect on the level of charges for existing customers.

Summary

We strongly disagree with Ofgem's general view that there is little evidence of any effective competition and that service standards are relatively poor in the electricity connections market. Our DNO national networks business (providing out of area competitive electricity connections) and our IGT business (providing competitive gas connections on a national basis) are good examples of what can be achieved by experienced and well run companies. These two businesses have built their reputation on providing first class customer service. We will continue to grow the scale and scope of these businesses by competing vigorously in the evolving connections markets. Other companies that have adopted the same or similar approach will also be in a position to grow their businesses. Progress is being made to improve performance in unmetered connections and more is being done this year to meet the voluntary standards. Further improvements in the competitive gas connections market can be achieved by levelling the playing field to allow GDNs to make adoption payments to ICPs which are allowed into the RAV. Overall, we expect to see further growth in activity by the independent providers in both the electricity and gas connection markets.

I hope you find these comments helpful. Should you wish to discuss any of the above in more detail, please don't hesitate to contact my colleagues, Paul Hemsley (07817 439881) for gas connections and Ian Bruce (07767 850357) for electricity connections.

Yours sincerely,

Rob McDonald
Director of Regulation

Ofgem Connections Industry Review 2007-08

Appendix 1 - Response to Consultation Questions

Chapter Two

Question 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?

Given the costs and charges summarised by Ofgem are based on information provided by the GDNs and IGT's, we believe they are reflective of, but not directly comparable between, GDNs and IGTs. For example the GDN costs for a domestic connection, normally to an existing property, will normally include the public highway reinstatement costs which the IGT's charges in a new housing development would not need to include.

Question 2: Are adoption payments the main reason why ICPs 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 ICPs?

The fact that GDNs do not make adoption payments is, in our view, likely to be a significant reason why only 5% of connections to GDN networks are installed by ICPs. We do not understand why the consultation document states that adoption payments are not allowable into the RAV, such payments seem reasonable up to the NPV of future transportation revenue from the new customers. This would provide an allowance into the RAV and some incentive to compete in this sector. This principle also underpins the Fuel Poor Networks Extensions initiative introduced in GDPCR.

However, we do recognise that in practice GDNs do not make adoption payments, and get no additional revenue from transporting to new properties. IGTs, on the other hand, get additional revenue from each new property connected, and therefore can afford to make adoption payments based on the future income they expect to receive from the connections. Therefore, there is little incentive for ICPs to promote connections with the GDNs. We note that single services and domestic connections will vest with the DN automatically.

Question 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?

As a GDN we cannot comment on the IGTs' costs of operation, but using assumptions about connections costs and connections charges based on the Ofgem document and calculating the headroom under the RPC for new CSEPs it appears that relatively high rates of return are possible for CSEPs with more than about 35 properties. These relatively high rates of return may be the reason that the IGTs can afford to make relatively high adoption payments.

Question 4: What factors lead IGTs to charge lower connection charges? Are ICPs/IGTs more efficient at installing the connection or are other factors at play?

SGN do not believe that ICPs/IGTs are more efficient at installing connections, but their lower charges probably do, at least partly, reflect lower overheads and operating costs. IGTs deal solely with plastic pipes and modern jointing technologies, therefore their networks are very reliable. GDNs have much higher operations and maintenance costs associated with their ageing iron mains networks.

ICPs/IGTs are able to "cherry pick" developments to suit their business operation and workload, and therefore normally carry out the less expensive connections, particularly to new housing on new developments where the average cost of connection per property will be relatively low. GDNs on the other hand by default tend to do the more expensive connections to existing properties, and their costs reflect the overheads of running a large network. In addition, IGTs do not require to keep an emergency response presence in their areas, as they procure this service from the host GDN on a transactional basis.

Finally, IGTs may feel able to subsidise the connection charges from the future income they will receive from each connection.

Question 5: What impact does the contrasting nature of GDN and IGT price controls have on competition in gas connections?

The evidence suggests that the contrasting nature of GDN and IGT price controls is detrimental to competition in gas connections. IGTs get additional transportation revenue from each new property connected, and therefore can afford to make adoption payments based on the future income they expect to receive from the connections and also possibly subsidise connection charges. This appears to be particularly true of CSEPs with more than about 35 properties as the headroom per property increases as the number of properties rises above that number.

GDNs on the other hand get no additional transportation revenue for transporting to properties on new developments. They therefore have no incentive to compete for connections to new domestic properties.

To improve competition between the IGTs and the DNs in connections to new developments the principle should be that the DNs and the IGTs both get the same additional net income from new developments, after allowing for any costs of reinforcement in the case of the GDNs.

This could be achieved by allowing GDNs to make adoption payments to ICPs, and we discuss below a methodology for calculating equitable adoption payments. For IGTs the additional income they receive from a new development is based on the “headroom” revenue they receive under RPC. The headroom revenue they receive is effectively the revenue the GDN does not receive because the transportation charges would be to a CSEP rather than to a multiple domestic project. Therefore, for a project being carried out by an ICP the GDN could run the Economic Test in two stages. In the first stage it would assess the revenue it would get if the project were a CSEP (because that is what is likely to happen if the GDN doesn’t make any adoption payments) against the reinforcement costs, and calculate whether any contribution was required. That calculation could remain the same whether the project was adopted by an IGT or by the GDN.

In the second stage the GDN would run the additional revenue it would get if the project were directly connected rather than a CSEP through the Test, net of any additional operating costs (minimal) and this would show how much the GDN could afford to offer in adoption payments. If the first stage of the Test showed that a contribution was required the amount of adoption payments would be reduced accordingly. The same principle could be applied to investing directly in connection infrastructure.

The level of adoption payments or direct investment up to the capitalised value of the additional net income would then be allowed into the RAV. Because the total allowed into the RAV for reinforcement and connection would not exceed the value of the total capitalised revenue from the project there would be no effect on the level of charges for existing customers.

Chapter Three

Question 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 believe the performance standards for GDN’s and IGT’s are as high as reported.

The regulatory framework and network operations in gas are very different to that in electricity. Therefore, not all processes and procedures are easily transferable. Detailed studies would need to be carried out to identify if any of the gas industry arrangements can be applied to electricity connections.

Chapter Four

Question 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:

We believe that Ofgem should seek the views of developers in order to understand why, until very recently, they may have been reluctant to utilise the services of independent providers.

As explained in our covering letter, in terms of the early evolution of the gas market, Transco's policy prior to the introduction of competition was to use its own contracting business (Fulcrum) as well as third party contractors to deliver their new connections and reinforcement work. This provided these parties with valuable industry experience and made it easy for them to make the transition to enter the market in their own right. In contrast, most DNO's have always used, and continue to use, their own staff for this type of work. It has therefore been more difficult for ICPs and IDNOs to establish a presence in the electricity market due to their relative inexperience in the industry.

That is not to say that competitive electricity connections have been slow to develop. Our recent experience confirms that the established independent providers are actively competing for and winning more work, particularly when the connection is provided from a new IDNO network. We would expect this trend to continue as independent providers grow their reputation with developers.

The cost of establishing a connections business in the electricity industry is much higher than in the gas industry due to, for example, the need to pay higher salaries for the higher level of craft and engineering skills and to provide generally more expensive plant, tools and equipment.

Our experience of managing the IDNO/DNO interface, both in and out of area, shows how important it is to have highly trained and competent staff with a thorough understanding of the industry agreed procedures and standards in order to achieve smooth progress of individual schemes. We believe that many of the problems experienced by the independent providers are due, in part, to the relative inexperience of their staff who are managing the interface with the DNOs. This view is supported by the fact that we do not experience the same number of issues with the other DNOs when we operate out of area.

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

Yes, we believe this is the case.

Also, many of the DNOs are actively competing with ICPs and IDNOs for electricity connections, whereas this may not always be the case with GDNs in the equivalent gas market.

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

We do not agree that there are significant barriers to competition in electricity connections. Our experience as a DNO operating out of area is a good example of what can be achieved. We have found that, overall, most of the DNOs provide satisfactory non-contestable services to independent providers. We have, however, experienced some difficulty in a number of DSAs. This generally relates to differences in interpretation of the requirements of the Electricity Act, DNO Connection Charging Methodologies and of G88 – the ENA's Principles for the Planning, Connection and Operation of Electricity Distribution Networks at the interface between DNOs and IDNOs. We believe it is crucial to have a common understanding and consistent application of the legislation and requirements for the provision of competitive connections. One recent example of a difference of opinion in the interpretation and application of the connection requirements is where an IDNO or DNO operating out of area is required to install sequential circuit breakers at the DNO/IDNO network boundary, whereas this is not a requirement when the DNO is building a network where they retain ownership. Apart from the additional cost of the plant to the IDNO, it also 'pushes' the boundary further downstream which can result in lower tariff margins for the IDNO. In this example the IDNO is at a disadvantage in the competitive market.

We understand that some ICPs and IDNOs may be struggling to find the skilled resources, especially craftsmen and engineers, required for the construction of electricity networks, particularly HV and EHV connections where specialist technical knowledge and operational experience are in short supply. In contrast it is generally regarded that the level of knowledge and skills required for the construction of gas networks is much lower and that skilled resources are much less of an issue.

Chapter Five

Question 1: Why has there been limited reporting against the SLA 15 performance standards, and what measures should be taken to address this issue?

ICPs and IDNOs are still routinely making bundled applications and rarely make applications for non-contestable works only. One solution is to require ICPs and IDNOs to always separate out their connection applications.

Question 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).

Although service standards are appropriate for the straightforward connections, the more complex connections are so variable in content and design requirements that to apply a service standard that will cover them all will be unworkable. Also, there are often too many factors outside of the DNOs control. This would result in all parties involved having to keep very detailed records of all their activities in order to defend their position in the event of failing a standard or in the case of a dispute. This would put an enormous burden on DNOs, ICPs and IDNOs and is unlikely to add any value to the process.

Question 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, ICPs and IDNOs. Why is there an apparent inconsistency between reported standards, and the level of complaints received? How should this issue be addressed?

Ofgem's comments regarding receiving significant numbers of complaints is difficult to assess without details of the supporting evidence. It is therefore difficult to provide a considered response to this question. It is our view that what might appear in the first instance as a complaint is quite simply a misunderstanding of the competitive connections arrangements. Genuine complaints do need to be investigated and resolved by the parties involved. The existing arrangements for the resolution of disputes appear to us to be satisfactory in the majority of cases.

It is important to point out that the number of complaints received by our connections businesses are very small. For example, during 2007/08 we received only two formal complaints from energywatch relating to new connection quotations, both were resolved without the need of escalation to Ofgem. Indeed Ofgem have not had to undertake a formal connections determination in either of our Distribution Service Areas (DSA) since 2005. Furthermore, we are unaware of any ICP or IDNO's concerns about how we provide non-contestable services.

Chapter Six

Question 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.

We agree with Ofgem that the current performance in the delivery of unmetered connections and fault repairs needs to be improved in order to meet the service standards. We have already identified weaknesses in the management and operational activities associated with this work and arrangements are in place to rectify the problems. We expect to see an ongoing improvement in our performance throughout 2008/09 as the implementation of the revised working arrangements become effective. Our view is to allow DNOs the opportunity this year to improve their performance under the voluntary arrangements before considering further measures.

Chapter Seven

Question 1: In the light of experience, did Ofgem's Good Practice Review target the appropriate areas?

Yes. We believe Ofgem was correct to focus on the key areas of customer service and awareness, streamlining the application process and dispute resolution. We have reviewed our arrangements in all these areas and, where necessary, introduced changes to improve our procedures.

Question 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.)

We believe the results are an accurate reflection of the current position.