

Rachel Fletcher
Director, Distribution
The Office of Gas and Electricity
Markets
9 Millbank
London
SW1P 3GE

Your ref

Our Ref

Date

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Contact / Extension

Jim McOmish
01698 413 407

Dear Rachel,

Next steps in delivering the electricity distribution Structure of Charges project

SP Energy Networks ('SPEN') welcomes the Authority's decision to consult on the next steps in the Structure of Charges (SoC) project. This consultation represents an important opportunity to find a pragmatic and cost-effective way forward, when compared to a Competition Commission (CC) referral that will inevitably prolong the process and is likely to be resource intensive for all parties.

We believe that the most effective way forward for the industry is to introduce a Common Licence Modification (CLM) focused on HV/LV customers, and that EHV charging should be resolved by an industry workgroup involving all parties affected by this debate. In this context it is worth bearing in mind that HV and LV customers represent 99.9% of our customer base.

The reason for our recent decision

SPEN took the decision to object to the recent CLM because it imposed a requirement for DNOs to implement a particular Long Run Incremental Cost (LRIC) methodology for our EHV (33kV and above) customers. We believe that implementation of this methodology would be detrimental to some of our most significant demand and generation customers connected at EHV, resulting in inappropriate and excessive charges and in a number of circumstances leading to even more severe consequences for these businesses in the current economic climate.

A typical example of the problems created by the proposal from Ofgem that we encountered is that of a pharmaceuticals manufacturing facility within our franchise area, which is a major employer in a relatively rural location. This customer has been connected to a highly loaded but low/negative growth part of the network for many years. Under Ofgem's proposals this customer faces a potential 12 times increase in use of system charges associated with network reinforcement which is not forecast to be required many years, if at all.

New Alderston House, Dove Wynd, Strathclyde Business Park, Bellshill, ML4 3FF

Telephone: 01698 413000, Fax: 01698 413053

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The charges for this customer clearly did not meet Ofgem's prime objective of cost-reflectivity and the assumption put forward by the working team at Ofgem that the customer could relocate to avoid them is grossly simplistic, ignoring the impacts on local economies and the other drivers, for example transport links and proximity to materials and skilled workforces, that also drive the decision to locate at a particular site.

There will be similar impacts for EHV connected generators in rural areas where the network is predominantly utilised by generation. These issues would be of concern at any time, but will be of increased concern for customers given the current economic climate and government targets for renewables.

Competition Commission (CC) referral impact on implementation of common HV/LV methodology

We believe that a CC referral would expose the unacceptable properties of the LRIC model. However, we also believe that it would be unfortunate if Ofgem were to choose this route. Given resource constraints on the parties involved in the referral, including Ofgem, it will inevitably result in delays to implementation of a common HV/LV methodology which would cover the majority of our customer base (> 99.9%) and in doing so will also realise the stated benefits for Energy Supply companies.

In the relatively short period of time since Ofgem decided that common methodologies were desirable and laid out their preferred way forward (toward the last half of 2008), the DNOs have demonstrated excellent progress in developing a common HV/LV charging methodology. DNOs currently expect to implement a common methodology for customers by 1 April 2010 and are planning implementation of common governance in the same timescales.

We are confident that with support from Ofgem involving clear, pragmatic and timely decisions that DNOs will deliver the majority of benefits of commonality for Suppliers and customers alike in the proposed timescales.

We note some concern in this regard relating to Ofgem's recent input to the DNOs structure of charges project which falls short of these requirements, but hope that Ofgem will be able to address this concern by clarifying and reinforcing their commitments and obligations in the decision and consultation documents when they have determined their way forward.

Potential benefits from a common EHV locational methodology

We support Ofgem's goals in relation to common charging methodologies but any underlying methodology must send sensible economic signals that match the economic environment in which we are operating. Common HV/LV charges will deliver the majority of available

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benefits for Suppliers from commonality, and an EHV charging model that provides appropriate price signals could yield additional benefits in relieving Distribution companies investment burden by avoiding or deferring network reinforcement.

Ofgem's consultation paper does not demonstrate a clear understanding of DNO's EHV reinforcement requirements and significantly overstates the benefits that locational EHV use of system charges might bring. Ofgem state that between 33% and 50% of load related spend in DPCR5 relates to EHV reinforcement, and assumes benefits of 5% of this (£100-125m), which is both inaccurate and misleading.

The majority of DNO's reinforcement needs, including EHV, are triggered by load changes at HV/LV, >96% of gross load related spend in SPEN for DPCR5¹. Of the remaining 4% associated directly with EHV customers, these customers will actually fund the majority (c.75%) through their connections charges. It is therefore the connection charge that provides the economic signal both in terms of location and highlighting where the network has existing capacity at EHV.

Applying SPEN's proportions to the industry forecasts and taking Ofgem's speculative assumption that 5% of EHV customer load related spend could be avoided would result in a potential saving of between £4-5m for the total industry during DPCR5.

Conclusion

In conclusion we believe that:

- A CC referral will identify many flaws with the proposed EHV LRIC model but do not believe that such a referral is in the best interests of the industry or our customers.
- Ofgem should support DNOs current work to deliver of a common HV/LV methodology and governance for 1 April 2010, through introduction of a revised common licence modification. ***However, these timescales cannot be achieved if a CC referral is initiated.***
- We propose that an industry forum is established concentrating on solutions at the EHV level, including looking at real price elasticity and realistic benefits that can be achieved from a forward-looking locational EHV methodology. This group could first focus on the identified weaknesses of the various methodologies proposed to date.
- We would recommend that this EHV industry forum works to an agreed time bound programme to provide assurance for stakeholders.

¹ Extract from HLFBPQ August 2008

In the interim while the industry is working on deriving the correct solution for EHV charging, DNOs should be allowed to implement a company specific methodology for EHV customers that better meets the relevant objectives.

Finally, given the challenges laid out by Ofgem in the DPCR5 policy document regarding “future proofing” the network and driving further innovation there is clear merit in allowing this debate to conclude before landing on a solution at EHV level.

It is also worth noting that this approach is likely to provide a result that will be consistent with relatively early delivery of the recommendations of the Code Governance Review.

We will forward on shortly an appendix that provides answers to Ofgems specific questions in the consultation and contains some additional background as to why we have formed these opinions.

Yours sincerely

Scott Mathieson,

Regulation & Commercial Director

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