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Dear Rachel,

Response to Ofgem's consultation on the next steps in delivering the electricity structure of charges project

Scottish and Southern Energy (SSE) welcomes the opportunity to comment on the next steps in delivering the structure of charges project.

In our response we provide Ofgem with an alternative to referring the matter to the Competition Commission (CC). This alternative is a variant on one of the options proposed in the consultation document and builds upon the current, very positive progress being made by the Common Methodology Group (CMG). We believe this work will take the structure of charges project forward to a satisfactory conclusion without the need for an expensive and time consuming investigation by the CC.

What we propose is to allow the CMG to maintain its focus on delivering a common methodology for HV/LV for April 2010, via a common Distribution Reinforcement Model (DRM). In addition we believe that the governance working group should be reinstated to investigate the possibility of developing a common governance framework for HV/LV within the same timeframe. This will deliver commonality of charging and governance to the majority (>99%) of customers for the start of the 2010 price control period. We believe that this will address any ongoing concerns over potential barriers to entry, as well as being the best use of scarce industry resource in the immediate future

We also suggest that an industry-wide working group be convened to carry out a fundamental review of EHV charging. This group will need to involve all stakeholders (including customer groups) and have active participation from academics and economic consultants.

The remainder of this letter discusses the options put forward by Ofgem in their 'next steps' consultation and elaborates on our alternative proposals. We have also set out our answers to Ofgem's specific questions in the attached Appendix 1.

However, to provide context to the current consultation, we believe it will be helpful to reiterate our reasons for objecting the recent Collective Licence Modification (CLM) to introduce common use of system charging and governance arrangements. We have therefore provided a brief history of the project and our ongoing concerns with Ofgem's preferred Long Run Incremental Cost (LRIC) approach to EHV charging at Appendix 2.

The main reason for our objection to the proposed CLM was our serious concern with Ofgem's requirement for DNOs to apply a LRIC methodology at EHV. Ofgem recognises these concerns: that the methodology is extremely volatile; and can yield very high or very low prices depending on how close to full capacity the network is, or depending on the rate of the underlying load growth. Furthermore, it can also result in charging volatility if, for example, a new large load changes the capacity loading in a particular part of the network. In an attempt to address the unwanted characteristics of the LRIC model associated with low or negative load growth, Ofgem propose to set a standard load growth for each 5 year price control period and suggested this should be 1% for 2010 – 2015. This arrangement does not satisfactorily resolve the problem of excess charges. Also, LRIC is fundamentally non-cost reflective in nature as it creates reinforcement charges in circumstances where there is no real reinforcement required.

Furthermore, Ofgem have stated in their consultation paper that in electricity transmission there is evidence to suggest that the implementation of cost reflective use of system charges has influenced the siting decisions of power generators. Whilst we again wish to make it clear we are not against the implementation of cost reflective charges, the transmission use of system charging methodology, based on a form of LRIC, has resulted in highly volatile and unstable prices to users. For example, Hadyard Hill windfarm in the South of Scotland saw its charges increase by 130% in one year. We do not believe that transmission charging is a shining example of cost reflective charging, and the one approved EHV charging methodology in distribution based upon a similar methodology has resulted in recent increases of between 18 and 22% in one year. In our view such volatility is unacceptable to users, be they generators or suppliers, who require stability and certainty of charges.

Ofgem have stated that their preference is for a full CC referral. We are fully prepared to defend our view that LRIC is not fit for purpose and should not be mandated as a common methodology for adoption by all DNOs. However, whilst we would welcome the thoroughness this approach would bring, it does mean that the work being carried out by the CMG would need to be put on hold, which would delay implementation of a common approach to HV/LV that will bring significant benefits to the majority of network customers. Furthermore, the costs of a CC referral cannot be justified without first allowing all stakeholders time to carry out their own detailed investigation of the issues with the competing methodologies.

Ofgem have then provided some alternatives to their preferred option, but have made it clear that they do not favour any of these. These alternatives are as follows.

Option 2A, which introduces a CLM for HV/LV and leaves the status quo for EHV. As mentioned above, the work of the CMG is likely to deliver the requirements for a common HV/LV methodology and, possibly, governance. We understand all DNOs are in a position to bring forward individual proposals for EHV charging that Ofgem would then judge on merit. However, Ofgem do not favour this option and do not believe it sufficiently delivers the benefits of commonality or common governance, although it would deliver this for >99% of customers.

Option 2B. This is very similar to Option 2A, but refers the LRIC -v- FCP debate to the CC. Once again we would be unable to resource both the CC and the ongoing CMG work. Furthermore, Ofgem believe it may be unwise to implement licence requirements for HV/LV in parallel with a CC reference on EHV charging arrangements as the outcome of the CC would be uncertain, and we would agree. Also, a narrow focus may not deal adequately with the competition and distributed generation issues we and other parties have raised. It is clear to us that a narrow focus will not be possible for any CC referral.

Option 2C. Again similar to Option 2A, but with the exception that this option requires DNOs to choose between Ofgem's proposed version of LRIC and FCP for EHV and that common governance arrangements are also required for EHV.

In assessing these options, it is important to note that network users value price stability above any other attribute. They also want to see certainty going forward. Allowing the CMG to complete its work on a common methodology for 99% of end users will, in our view, provide the stability and certainty that network users are seeking. A CC referral will be costly and time consuming; delaying what will be significant improvements from a network users' perspective. Also, commonality of charging for 99% of end users will address any ongoing concerns over potential barriers to entry that Ofgem have raised due to the 7 different methodologies currently in place.

We believe that much more needs to be done in GB to encourage the same level of investment in renewable generation as is seen elsewhere in Europe. This is particularly important if the UK government is to achieve its challenging and binding targets for CO₂ emission reductions. It is important to recognise that renewable generation will need to be located in those areas where there is an abundance of natural resources, and that these tend to be remote from the main centres of demand. In our view, the whole concept of providing locational signals to DG via the 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 have argued for some time that setting distribution charges to zero for generation will go a long way to encouraging more generators to invest in GB. This practice aligns with the existing charging policies found in many European states. While we fully appreciate the need for locational signals to promote, for example, the siting of generators to balance local demand and to avoid network reinforcement, our view is that this can be accommodated via the current 'shallowish' connection charging methodology.

Our work with Scottish Power and Central Networks has led to the development of an alternative Forward Cost Pricing (FCP) methodology for EHV charges. We remain of the view that the FCP methodology overcomes the worst tendencies of LRIC and provides more transparent and stable charges. We believe the FCP locational signals combined with those produced by connection charges provide the correct strength of signal. We continue to be concerned that LRIC provides the wrong locational signals due to fundamental flaws with the methodology. Furthermore, FCP provides signals that are more transparent and produces more stable charges. These attributes are particularly important for many customers, suppliers and generators. Our preference is that FCP should be developed for demand charges at EHV level and that generation charges should be set to zero. However, we are prepared to commit to a fundamental review of EHV charges and this is discussed further below.

Whilst we have objected to Ofgem's proposal to introduce a CLM that requires all DNOs to introduce LRIC at EHV, we do not object in principle to a common methodology for HV/LV. Indeed, we have continued to work with the other DNOs under the CMG to bring forward a common DRM for HV/LV along with a suite of common tariff structures across all distribution networks by April 2010. Although the timeframe is challenging, the CMG has made good headway and is confident of completing its work in time to publish illustrative tariffs in September 2009. It may also be possible for the CMG to introduce common governance arrangements for the DRM methodology within the same timeframe. In addition, a separate work group established to create a consistent and transparent framework for Independent Distribution Network Operators (IDNOs) is also making good progress and may be in a position to deliver proposals for an interim solution very shortly.

With regard to EHV charging, we continue to believe that there must be a pragmatic balance between cost reflectivity, transparency, simplicity and predictability, along with stability of any charging regime. There is clearly a need to bring the dispute over what form this charging methodology should take to a conclusion. However, we strongly believe that diverting both Ofgem and industry's resources to a CC referral at this stage will be counter-productive. It will mean halting the very positive work being undertaken by the CMG and will delay the introduction of a common HV/LV charging methodology. Maintaining the impetus of the project on this work will bring commonality of charging to >99% of end users. We strongly believe this should be the priority for the project going forward.

Furthermore, the volatility being experienced with WPD's EHV charging methodology is unacceptable in the long-term and indicates that the current LRIC methodology is not fit for purpose. We therefore recommend that an industry-wide working group be convened to carry out a fundamental review of the methodology to be employed at EHV. The review should start from first principles and should involve all major stakeholders (including customer groups). Active participation from academics and economic consultants will be essential in order to explore how to best balance the principles of cost reflectivity, predictability, transparency and simplicity (at point of use). As noted above, suppliers have also indicated that stability of charges is of primary concern to them, and this should be included as one of the key principles to bear in mind during the review.

In addition, it may be appropriate to allow DNOs to continue working with Ofgem to refine their current proposals, i.e. to bring forward versions of LRIC and FCP methodologies for consideration by the Authority. Indeed, given the volatility exhibited with WPD's LRIC charging methodology we would hope that changes are brought forward sooner rather than later in that instance. Whilst Ofgem have expressed some concern that this may result in uneconomic locational signals being sent, our view is that this is no different than having different charging methodologies at the transmission / distribution boundary or, indeed, simply different tariffs across distribution service areas.

Notwithstanding the above proposals, if Ofgem decide to refer this matter to the CC we consider that it will be necessary to ensure the scope of the investigation includes all issues that were raised as concerns to Ofgem's proposed CLM. Apart from the LRIC -v- FCP debate there needs to be clarification of how competition issues will be dealt with if, for example, an end-user customer challenged the legitimacy of their use of system charges that may have changed significantly year-on-year through the correct application of an approved charging methodology.

Summary

We are working actively with all DNOs and other industry parties in bringing forward a common charging methodology at HV/LV for April 2010. We believe this work could be extended to include common governance within the same timeframe. We are not in principle opposed to a CLM to formally bring this work to conclusion, but we do not believe this will be necessary considering the work now being carried out by the CMG. We also fully support the ongoing work to introduce a revised framework for IDNOs.

In our view the above work will bring about the desired changes to 99% of end users and satisfy the concerns around efficient network investment, climate change and competition raised in Ofgem's consultation paper. For EHV charges, we believe that the volatility experienced with the LRIC model implemented in WPD's distribution services areas confirm there are fundamental problems with this form of charging. Therefore, the most appropriate way to deal with EHV charging and governance is to instigate an industry wide, fundamental review of the methodology to be employed.

We firmly believe that generation should not pay distribution use of system charges. In our view, this would provide the single biggest incentive for renewable, distributed generation to connect to the network and start to bring GB in line with other European states.

However, in the event that the Authority decides that a CC referral is the most appropriate option we will contribute fully to the investigation. We are confident that our objections to Ofgem's proposals for EHV are founded on sound business and economic principles which are in the best interests of the whole industry. We continue to believe that a pragmatic approach must be taken to balancing the key principles of cost reflectivity, predictability, transparency and simplicity (at point of use).

If you have any queries on any of the above, please do not hesitate to call.

Yours sincerely,



RP Rob McDonald
Director of Regulation

Appendix 1: Response to consultation questions

Chapter 2: Drivers for the structure of charges project

Question 1: In this chapter we highlighted the key objectives for the structure of charges project and explain why these objectives are policy priorities for Ofgem. Do you consider that Ofgem is right to prioritise delivery of these objectives?

Ofgem has identified three key objectives for the structure of charges project: ensuring efficient network investment; tackling climate change and; removing potential barriers to competition. We fully support these objectives and agree that Ofgem is right to prioritise delivery. However, we do not support Ofgem's proposed strategy for delivering the objectives. We are, in particular, disappointed that Ofgem continues to promote the introduction of a LRIC methodology for EHV connected customers, which we believe is fundamentally flawed and will actually act against these three objectives.

As explained in the covering letter, it is our long held view that a LRIC based charging methodology will fail to meet the high level principles agreed between Ofgem and the DNOs. We do not believe that a LRIC methodology will facilitate competition in supply and DG. Indeed, our understanding is that this will have the opposite effect due to excessive and inappropriate charges than can result from using such a methodology. On the other hand, the FCP methodology developed by Scottish Power, Central Networks and ourselves overcomes the worst tendencies of LRIC resulting in more transparent and stable charges; attributes which are particularly important for customers, generators and suppliers.

We believe it is right that Ofgem should be considering alternative strategies for delivering the structure of charges project. Whilst a CC referral will undoubtedly provide a landing on the outstanding issues, there is no certainty that the outcome will align with Ofgem's proposals. The CC may conclude with an entirely different view, which could result in the industry having to take a completely different approach to use of system charging methodologies. In our view it would be more sensible to 'bank' the existing benefits which have taken a great deal of time and effort to achieve. These benefits, which include a common methodology and open governance at HV/LV, are a significant step forward from the existing arrangements. At the same time further analysis and development can be carried out on both LRIC and FCP methodologies to fully identify and understand the pros and cons of each.

Question 2: Given the potential benefits of delivering the project for electricity customers, generators, distributors and suppliers, do you agree that it would be appropriate for Ofgem to continue to pursue delivery of the project?

Yes, we agree that it would be appropriate for Ofgem to continue to pursue delivery of the project. As explained above, a great deal of time and effort has been invested in the structure of charges project. A huge amount of progress has been made, particularly in the last 12 months. The work currently being carried out by Ofgem and the CMG is likely to deliver many of the required benefits by the key date of April 2010. If the

momentum that has built up over recent months is interrupted, this will jeopardize delivery of these benefits to >99% of network customers.

Chapter 3: next steps in delivering the structure of charges project

Question 1: Do you consider that it would be appropriate for the Authority to refer the package of measures consulted on in our October proposal for a ruling by the CC? On this question we invite generators, suppliers and customer groups to confirm which aspect of our October decision would deliver the greatest benefit to them, and where possible to quantify this benefit.

We do not consider it appropriate for Ofgem to refer the package of measures consulted on in its October proposal for a ruling by the CC. This could have serious consequences for work that has been completed by Ofgem and the DNOs, including the delay of benefits to the majority of network users. There are more appropriate alternative strategies that should be considered before referring this matter to the CC.

The greatest benefits will be achieved from adopting a common DRM methodology for HV/LV connected customers, (i.e. >99% of customers) together with common governance arrangements. This will result in stable, transparent and predictable use of system charges for these customers. The models should also be simple and straightforward for suppliers to understand and use, allowing for better forecasting and reducing uncertainty. This common approach to charging will make it easier to analyse the effects of changes across all distribution service areas and reduce the distortion that currently exists between different areas. Additionally, a common governance arrangement at HV/LV will help ensure the methodology evolves to take account of important developments such as climate change proposals and the introduction of electric vehicles.

Question 2: Do you consider that it would be more appropriate for the Authority to modify the October proposal by excluding the requirement for a common charging methodology at EHV level, and opening a CLM statutory consultation on a modified proposal to deliver commonality at HV/LV level only?

We strongly believe that all DNOs are committed to delivering commonality at HV/LV. Whilst we are not convinced that a CLM is required, we would be prepared to accept one if that provided Ofgem with the certainty of delivery.

Question 3: If you agree that it would be appropriate to consult again on a modified CLM proposal at HV/LV level, do you consider it would be appropriate for Ofgem to refer our October decision to implement a common LRIC methodology at EHV level for a ruling by the CC? If you do not agree that it would be appropriate to refer our LRIC decision to the CC, what option would you recommend to Ofgem to deliver revised charging methodologies at EHV level?

We do not consider it to be appropriate for Ofgem to refer its October decision to implement a common LRIC methodology at EHV level for a ruling by the CC. We

strongly believe that diverting both Ofgem and industry's resources to a CC referral at this stage will be counter-productive. It will mean halting the very positive work being undertaken by the CMG and will delay the introduction of a common HV/LV charging methodology.

In our view, there is clearly a need to bring the dispute over what form this charging methodology should take to a conclusion. However, we strongly believe that diverting both Ofgem and industry's resources to a CC referral at this stage will be counter-productive.

We therefore recommend that an industry-wide working group be convened to carry out a fundamental review of the methodology to be employed at EHV. The review should start from first principles and should involve all major stakeholders (including customer groups). Active participation from academics and economic consultants will be essential in order to explore how to best balance the principles of cost reflectivity, predictability, transparency and simplicity (at point of use). Furthermore, as suppliers have indicated that stability of charges is of primary concern to them, we believe that this should be included as one of the key principles during the review.

Question 4: Are there options we have not considered for ensuring delivery of the structure of charges project, if so what are they?

As noted in our responses above, we believe that allowing the CMG to complete its work on a common methodology for HV/LV will provide the most benefit to users of our networks. Completion of this work, along with the development of a common governance regime will bring about the desired changes to 99% of end users and satisfy the concerns around efficient network investment, climate change and competition raised in Ofgem's consultation paper.

The volatility experienced with WPD's LRIC model confirms there are fundamental problems with this form of charging. Therefore, the most appropriate way to deal with EHV charging and governance is to instigate an industry wide, fundamental review of the methodology to be employed.

Appendix 2: Background to SSE's rejection of the proposed CLM

SSE supports the concepts of cost reflective charging via a common methodology and common governance arrangements. Our decision to reject the CLM was not taken lightly. We could not 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 had no option but to formally reject the CLM.

We agree with Ofgem's key drivers for the structure of charges project: tackling climate change; facilitating competition in generation, supply and independent distribution; and efficient network investment. These high level principles are not in dispute. What we do dispute is Ofgem's continuing requirement to base EHV use of system charges on a LRIC methodology that is fundamentally flawed and would inhibit competition and the growth of renewable generation.

It is our long-held view that a LRIC based charging methodology will fail to meet the high level principles agreed between Ofgem and the DNOs: it will not be cost reflective, transparent, predictable or simple (at point of use). A LRIC methodology would inhibit competition in supply or generation. Implementation of such a methodology will be detrimental to many EHV customers, demand and generation alike, resulting in excessive and inappropriate charges in a number of circumstances. We argue strongly that users of the network should not be faced with unpredictable, extreme, non cost-reflective and unjustifiable charges. Our critique of LRIC is well known and has been spelt out in previous correspondence to Ofgem. Our formal rejection of the CLM referenced the key background documents that underpin our argument against LRIC.

One of the most important factors in deciding to object to the CLM is the disproportionate effect that the proposal will have on some customers connected to our distribution networks. Our two networks, located either end of the country, have very different engineering and operational characteristics. These range from the highly utilised network in central southern England where low growth rates are a current feature, to the lower utilisation of the radial circuits found in the north of Scotland where greater volumes of distributed generation is more common. As Ofgem recognise, the shortcomings of the proposed LRIC methodology will have a number of significant impacts on customers according to their pattern of use, the type of network they are connected to and their location on that network. This can cause unexpected and volatile charges, which can vary significantly year on year.

Ofgem recognises that its preferred model can yield very high or very low prices depending on how close to full capacity the network is, or depending on the rate of the underlying load growth. They acknowledge that LRIC can also result in charging volatility if, for example, a new large load changes the capacity loading in a particular part of the network. In an attempt to address the unwanted characteristics of the LRIC model associated with low or negative load growth, Ofgem proposed to set a standard load growth for each 5-year price control period and suggested this should be 1% for

2010-2015. This arrangement does not satisfactorily resolve the problem of excess charges. Furthermore, it is fundamentally non-cost reflective in nature as it creates reinforcement charges in circumstances where there is no real reinforcement need.

While some mitigation of the problems may be available, this is conditional on Ofgem and other industry parties. However, Ofgem's obligations in this regard are not defined and neither are the circumstances in which derogations will be deemed appropriate. These matters must be clearly addressed to provide assurance and clarity to DNOs that customers will be treated appropriately.

Predictable and stable charges are essential if renewable generation in particular is to commit to connection to the distribution network. Uncertainty of prices will adversely impact a generator's ability to raise capital. We believe a LRIC based common methodology will send entirely the wrong signals at a time when the drive is to encourage DG. Furthermore, renewable energy sources tend by their very nature to be remote from centres of demand. Hence overly strong, volatile locational signals are inappropriate. What are required is predictable and stable tariffs, with stable long term cost signals. Whilst we are prepared to accept that a common DRM may provide positive or negative charges for HV/LV connected generation, our preferred option is to set use of system charges for all DG to zero. This issue should, we believe be discussed and resolved as part of our proposed industry wide working group on EHV charging.

