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Your ref

38/09

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Date

26/05/09

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Dear Mark,

Joint consultation on IDNO boundary charging: Consultation on WPD UoS 012 & Consultation on IDNO/DNO working group options for April 2010

SP Energy Networks ('SPEN'), on behalf of SP Distribution and SP Manweb, welcomes the opportunity to comment on the issues raised in this consultation.

As this consultation covers a wide range of issues, and at least three different charging methodologies, we have chosen not to give a response to every question listed in the document, but instead we have concentrated in those issues which we feel are most significant.

1. Comments in relation to WPD's modification proposal UoS 012

General comment

Paragraph 1.2, Appendix 1, of the consultation document states that the so-called "Average Accounting Cost" was advocated by the IDNO/DNO working group (facilitated by Ofgem) s being "a more appropriate basis on which to charge downstream competitors". We believe that this comment needs to be qualified: this was the proposal of the working group for an *interim* solution, to be implemented in April 2009, given the disparate Use of System charging methodologies currently in place across all DNOs. This is not to say that the group endorses this methodology as part of an enduring solution. We will return to this point in our comments in relation to Appendix 2 of the consultation.

Top down vs Incremental

In relation to the questions raised in paragraph 1.20, we have the following comments:

Questions:

Whether WPD's proposal to use a top down AAC avoided cost approach is more cost reflective than their current DRM avoided cost approach?

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Whether it is appropriate and cost reflective to make a distinction between the methods used to calculate charges to IDNOs and end customers?

Whether it is appropriate to use the AAC method to provide a discount on the end customer charge derived from the incremental DRM?

We do not have enough information about the way WPD's DRM model works, in particular in relation to inclusion/exclusion of particular elements such as replacement costs of customer contributed assets, treatment of operating costs, etc. However it is well known that the "traditional" DRM approach does present a number of shortcomings in terms of properly modelling costs which are pertinent to IDNO margins, and therefore it is possible that in this case a "top down" approach is more cost reflective than a traditional DRM method.

It is important to note, however, that this comment does not provide unqualified support for a "top down" approach in comparison to an incremental approach. The Common Distribution Charging Methodology (CDCM) currently being developed by the DNOs for implementation by April 2010 is based on a DRM approach, but it has been developed and enhanced to carry out an allocation of costs which is fully justified by the real usage that IDNOs make of the host DNO, and therefore is consistent with the "notional downstream business" approach sometimes advocated by IDNOs. Therefore, provided that a proper "incremental" approach is in place (i.e. one which fully models and accounts for the appropriate costs), then an incremental approach is clearly more desirable than a "top down" one. An appropriate incremental methodology which uses the same principles to allocate costs and produce tariffs for all of the DNO's customers is not only more cost reflective and fair for all customers, but it also better complies with the principles of non-discrimination amongst customer groups whilst promoting competition by means of allocating margins to IDNOs which allow to recover the appropriate costs.

Further comment in relation to the CDCM is given in our comments to Appendix 2 of the consultation document.

Treatment of Operating costs

In relation to the questions raised in paragraph 1.30, we have the following comments:

Question:

Do respondents agree with WPD's assessment that MEAV is the most appropriate (and cost reflective) cost driver to allocate those operating costs not split within RRP data?

Please justify your answer.

WPD's modification proposal included some analysis showing a correlation between total MEAV and both direct and indirect costs (this analysis is cited in the consultation in paragraph 1.27). However, this analysis simply shows that there is a correlation between the total MEAV and the total direct and indirect costs (one could argue that all it is showing is that the bigger the RAV the bigger the operating expenditure, which is not really an unexpected result). However, the key question is whether the MEAV split by network level is a good proxy for splitting the indirect Operating expenditure into network levels. For this WPD provides no analysis justifying the decision to use MEAV per network level.

We believe that there is not enough evidence to justify a split of indirect costs in proportion to the MEAV of the different voltage levels in the network.

Treatment of pensions and incentive revenue

In relation to the questions raised in paragraph 1.38, we have the following comments:

Question:

Is it appropriate for WPD to exclude pension deficit from allowed revenue before allocating it between network levels?

Is it appropriate for WPD to exclude in year incentive income received/deducted from allowed revenue before allocating it between network levels?

Does WPD's proposal to exclude pension deficit and incentive income from allowed revenue better achieve the relevant objectives?

At the moment, we see no justification for excluding these elements from the allowed revenue prior to allocating revenues to IDNO tariffs.

Basis of allocating LV and HV network costs between WPD and IDNOs

In relation to the questions raised in paragraph 1.45, we have the following comments:

Question:

Is it more cost reflective for WPD to use the proportion of direct to indirect costs as a way of identifying the fixed and variable elements of the 'all the way' discount?

Does banding restrict, distort or prevent competition in Distribution? Is it more cost reflective for WPD to differentiate between HV and LV and propose bands solely at LV?

Does WPD's creation of IDNO specific tariffs for non domestic LV IDNO sites and IDNO specific tariffs at HV better achieve the relevant objectives?

Is it cost reflective for WPD to distinguish between HV domestic and HV non domestic in the manner in which they calculate the respective tariffs?

Do WPD strike an appropriate balance between cost reflectivity and not restricting competition in their use of a domestic restrict tariff structure for all domestic IDNO tariffs?

In terms of the methods used to allocate LV costs, we are not convinced that the methodology selected is cost reflective. The "fixed cost" ratio seems to have made proportional to the amount of indirect costs in relation to the total operating costs. There seems to be no rationale or analysis justifying this decision, as there is no justification for then assuming that the "variable" costs are proportional to network distance.

SPEN does not support a banded approach to IDNO charging for two main reasons: 1) we support and agree with the argument put forward by the IDNOs that distance banding is not reflective of the way the DNOs calculate tariffs for their own customers and 2) a combination of a banded approach with a structure of tariffs based on portfolio charging, would introduce a high level of complexity (for billing, settlement flows etc), without clear benefits from a cost reflectivity point of view. Note that this complexity will be experienced mostly by the IDNOs (in setting their LLFC/PC/SSC combinations), and could be seen as a barrier to entry for new entrants.

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2. Comments in relation to Appendix 2 – “IDNO/DNO working group consultation”

General comment

Although Annex 2 describes a number of methods which were and are being considered as part of the “interim” solution (ahead of April 2010), we notice with worry that somehow the extrapolation was made to the methods which might be developed and proposed for the enduring solution (from 2010). The consultation document does not describe or even acknowledge the only method which is being proposed by the CMG as the enduring solution for IDNOs: the CDCM.

In terms of the development of the interim solution, we believe that one of the main reasons for the “failure” to produce a common interim methodology, as was attempted by the working group, is the many different UoS methodologies currently being used by DNOs to calculate the all the way tariffs. Against this background, it is a very difficult task to superimpose any kind of “top down” approach and obtain results which can be justified by the host DNOs as being cost reflective.

The other main problem encountered during the work towards an interim solution was that, given the need for a top down approach due to the differences in methodologies mentioned above, a “top down” accounting approach was chosen as the solution. As the consultation document illustrates quite effectively, the main issue with the so-called AAC is the many different ways that costs can be allocated. There are many different views about drivers for the relevant costs, all of them will have a certain merit and justification. The outcome of the working group is a natural consequence of this situation: one company (WPD) decided not to wait for a consensus to be reached and went ahead with their own view of how costs should be allocated, whereas the majority of other companies (excluding CE, who were restricted in their participation in the working group due to their internal legal advice) have tried to achieve a common view, and to agree this view with IDNOs, but this has not been achieved.

CE’s proposal

We do not support a banding approach based on capacity, for the same reasons given in our response to WPD’s banding approach. Capacity monitoring also introduces a further level of complexity in billing which is not desirable.

In terms of the optional capacity reservation included in the CE approach, we believe that this is not necessary and it has been superseded by the “capacity ramping” modifications recently implemented by the majority of DNOs. Capacity reservation and capacity utilisation is a very important element in network management, but we believe that the best way to manage this area is by means of the connection agreement and bilateral agreement between the parties, and not by producing complex tariffs which are not certain to produce the appropriate cost signals and risk distorting competition in the market.

In terms of the approach used for banding, based on capacity, it is not clear what analysis has been undertaken to prove that capacity requirements are inversely correlated to the use of the network. It is not clear on what basis “use of the network” is being measured in this context, but it

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appears that the approach seeks to reflect the fact that larger users tend to locate nearer the substations, in a way which acts as a proxy for network length. We believe it is a much more transparent and cost reflective approach to use network length directly, albeit not in a banded way, as mentioned earlier.

Comparative analysis

In relation to the questions raised in paragraph 2.49, we have the following comments:

Is it more appropriate for an enduring solution to IDNO charging to be based on a ‘top down’ AAC allocation approach or a scaled incremental cost approach such as the one based on the DRM?

As mentioned above as part of the response to WPD’s method, we believe that the CDCM is the best available approach to determine IDNO charges. An incremental method which does not rely on subjective conclusions about costs and cost drivers is clearly more desirable than a “top down” method which can easily be challenged and which would be very difficult to justify in the basis of costs, in particular if price control forecasts are used to determine the different allocations.

Although the CDCM is based on a DRM model, it has been developed to properly model and allocate a proportion of costs related to the mains at the voltage level at which the IDNO is connected (in relation both to replacement and Operating expenditure). It also separately models service assets in order to ensure that these costs are not recovered from IDNOs as they fall wholly on the IDNO operator and therefore it is inappropriate to include them in the IDNO tariffs.

In relation to other criticisms of the “traditional” DRM costs, the CDCM is proposing to explicitly model replacement of assets which are fully customer contributed, since it recognises that these are costs that the network operator needs to finance in the future. This has a direct impact on the cost reflectivity of IDNO tariffs, as replacement costs are genuine costs that the IDNO must fund and therefore a provision for them should exist in their income.

Does the answer to the above depend to any extent on the way that scaling is applied?

In terms of revenue matching, the CDCM is proposing to use an allocation method which does not drive costs unjustifiably to the higher levels of the network.

Allocation of LV and HV network costs between transformer and the point of connection

In relation to the questions raised in paragraph 2.49, we have the following comments:

Do respondents consider that it is appropriate to reflect partial use made of the network level to which the IDNO connects in boundary charges? If yes, should boundary charges reflect site specific details or be set on an average basis? And if on a site specific basis what is the appropriate cost driver?

Do the WPD and CE approaches result in appropriate changes in boundary charges to reflect the costs of partial use of the network?

Which method of allocating LV & HV costs between DNO and IDNO do respondents consider is the most cost reflective?

Are there aspects of the different approaches which respondents consider could be used for the enduring IDNO charging methodology? Please justify your answer in terms of cost reflectivity and not restricting competition

We would also invite respondents to evaluate all of the approaches outlined above and the extent to which they are appropriate for an enduring IDNO charging methodology.

SPEN support a portfolio based tariff structure. We believe it is necessary for IDNO tariffs to mirror the ATW tariffs that IDNOs are able to charge to their own customers, as there is a risk of negative or unjustified margins when the tariff structures are different. For instance, NHH profiles for end customers might conflict with the aggregate boundary flow on a site by site basis and therefore create negative margins in certain time bands or windfall gains in others.

Furthermore, portfolio tariffs could simplify the billing process for IDNOs and DNOs, with the option of a fully automated settlement based position to be implemented in the future. This is obviously an attractive option if IDNOs are to continue their growth in market share. We believe that the portfolio structure of charges for IDNOs is fully justified by the objective of not distorting competition (by not exposing IDNOs to the cashflow risks associated with settlement profiling) without affecting the cost reflectivity of the charges.

SPEN also believes that is appropriate to reflect partial use of the network at the voltage of connection, based on the ratio of average length of LV mains cable provided by DNO per IDNO end user as proportion of average length of LV mains cable per DNO end user. We propose to use one single allocation percentage per network level and not a banding approach, as mentioned above.

We hope that you find these comments useful. Please do not hesitate to contact me if you have any queries.

Yours sincerely

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