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Dear Ynon

### **DNOs' proposals for a common methodology at lower voltages**

ESP Electricity Ltd ('ESPE') is a licensed independent distribution network operator which seeks to compete for electricity connections in all areas of Great Britain. DNO tariffs determine the margins available to downstream connected network operators like ESPE. Changes to them, or their structure, have a direct and significant impact on the way in which we are able to conduct our business.

ESPE is generally supportive of the structure and methodology that the proposed CDCM puts in place. However, commonality in structure and methodology cannot in itself address the lack of competition in electricity connections that has been of concern to IDNOs and Ofgem for a number of years. The way in which costs are allocated to the model plays a major role.

ESPE has followed the CDCM closely throughout its development and would like to comment on Ofgem's recent consultation on the final CDCM proposals. We focus specifically on those areas that have a direct bearing on ESPE's business.

#### **Governance of charging methodologies**

It is assumed that the CDCM will leave ESPE better placed to shape the charging methodology in the future, by way of modification via DCUSA. However, as is evident in the current proposal, a charging methodology and tariff structure that may seem generally robust on the outside, may still fail to produce cost-reflective tariffs due to the cost allocation mechanisms that operate 'out of sight' and in a different manner for each DNO.

Currently, ESPE has little confidence that we will be able to use the DCUSA modification route as a mechanism to influence the way in which DNOs allocate costs to the CDCM model, since these rules are not explicitly laid down in the methodology. We are aware that a set of guidelines exists, developed by the DNOs themselves during the CDCM process. ESPE suspects however that these guidelines leave too much room for interpretation, and welcomes Ofgem's indication that they expect this area to be reassessed by DNOs.

#### **Change in available margins**

Ofgem states in the consultation document that the CDCM brings about an overall improvement in the competitive landscape for IDNOs. This, it is claimed, is due to the availability of a positive margin across all DNOs, a certainty and consistency of

margin, along with a general increase in those margins. ESPE is not convinced of this overall improvement, and the reasons for this are discussed below.

Under current tariffs, it has not been possible for ESPE to compete for connections on smaller sites. This makes it difficult to compare the opportunities in the marketplace allowed by CDCM tariffs, since we only have records of those sites which we have at the time considered commercially viable. As such, during 2009, the average size of network that ESPE has provided asset value quotes for is 80 plots at LV and 250 plots at HV.

On this basis, ESPE is right to question whether the market has in fact broadened under CDCM. In particular, Ofgem will be unsurprised to see the information above relating to EDF's distribution service areas. ESPE cannot currently compete, nor will we compete under the CDCM tariffs. In fact, under CDCM sites at LV become viable only when a site has **four** times the number of plots as the figure above (as an average across the three EDF areas).

What is concerning is that based on a reasonably sound assumption that the majority of new sites will be smaller than 50 plots, coupled with the fact that a significant amount of the building of new houses is currently taking place in the South East – EDF's area – it is reasonable to maintain that a disproportionate number of electricity connections will not be subject to competition under the CDCM. Furthermore, at the proposed tariffs, this will still be the case once the issue of boundary metering has been addressed. This situation must be urgently rectified. Considered even more plainly, because networks tend to connect at HV once they reach a certain size, there is absolutely no competition in connections at LV in EDF's DSAs.

Broadly speaking, we see decreasing opportunities on HV sites. This was expected. However, ESPE also expected that there would be an equivalent increase in commercial opportunities at LV. In general this is not the case. The many LV networks that under current tariffs are not commercially viable to ESPE, remain so, despite the availability of a positive margin. They are just 'less unviable' than they were. Only in one or two of the DSAs do we see previously unviable investments turning into viable ones at the smaller end of the market (based on constant assumptions).

IDNOs collectively are looking to undertake an analysis of cost allocations across voltage levels to understand why this is the case. This will allow us to argue constructively what a reasonable level of margin must be. We envisage that the output of this analysis can be used to progress discussion subsequent to Ofgem's decisions on CDCM.

ESPE therefore urges Ofgem also to revisit the area of cost allocation; and to work with DNOs in an attempt to iron out any inconsistencies in the way in which this is carried out. ESPE are encouraged that this seems to be Ofgem's intention, but would reiterate our uncertainty about IDNOs' ability to tackle this solely via the DCUSA modification process.

Regardless of numbers, at the most basic level, the margin available to the IDNO should represent what the DNO has calculated would be the cost of operating a notional downstream business (plus a reasonable profit). With this in mind, and whilst some variation between DNOs must be expected, it is surely difficult to argue that the margins that are currently on offer are reasonable across the board, both due to the extent/degree of variation between DNO areas (including within group) and the level of margin. The EDF areas are of course an extreme example, but ESPE cannot

accept a claim to be able to operate a standalone IDNO business for around £11 per supply point per year.

Of course, the situation is made worse because IDNOs are expected to incur the full cost of boundary metering. Therefore any claim that a positive margin for all sites now allows ESPE to compete for sites at the very small end of the market is without foundation. We do however hope that the issue of boundary metering will be resolved in the near future as alternative industry practices are put in place.

## **Summary**

It is clear that Ofgem is approaching the proposed CDCM with a degree of pragmatism. In looking to secure the introduction of the new methodology and tariff structure, they concede that a number of areas will require further attention in advance of and after April 1<sup>st</sup> next year. ESPE can see merit in this approach. However, it should be no surprise that for ESPE and the IDNO community some serious concerns remain in relation to our ability to operate under the CDCM in large parts of the market for new electricity connections.

It has been an IDNO concern for some time that DNOs would propose a methodology which, whilst delivering the relevant licence objectives, fails to satisfy IDNO requirements for a sustainable and reasonable margin. This concern has been borne out in the CDCM proposal, and as such it is frustrating that we seem to be as far from our objectives as we were 18 months ago, despite the great deal of commitment shown by IDNOs to the CDCM development process.

Our message could not be clearer then: there is still much work to do here. ESPE will be looking for commitment from Ofgem to full involvement until such a point as the cost allocation has been adjusted to allow for sensible positive margins across the board. We believe that this commitment must also include publishing a timetable, against which progress can be measured. Otherwise, ESPE may need to look for alternative assurances to prevent us being shut out of certain parts of the market any longer.

We have provided short responses to the four consultation questions below, and hope that you find our comments useful.

Yours sincerely



David Speake

ESP Electricity Ltd

Annexe

### **Consultation questions**

Question 1: Do you agree with our minded to positions given the arguments/analysis presented here and in the Impact Assessment in Appendix 3? If not, why not?

ESPE can support Ofgem's minded to positions and is encouraged by their suggestions that DNOs, and in particular EDF, must revisit their cost allocation methods, and reconsider the HV/LV split. ESPE finds it difficult to provide a detailed critique of the CDCM tariffs due to a lack of visibility of the way in which costs are allocated between buckets and voltage tiers.

Question 2: Do you consider any additional areas should be conditionally approved?

No.

Question 3: Do you consider any element of the methodology would warrant an overall vetoing of the DNOs' common methodology submission?

ESPE is disappointed that the proposed methodology does not, in our view, fully address the competition issues that exist in the current charging arrangements. Without a firm commitment by Ofgem to lead in addressing the irregularities in cost allocation that ESPE suspects exist, we would certainly consider that deficiencies in this area would warrant a veto of the CDCM. Nevertheless, we realise the importance to the industry of reaching implementation as soon as possible. Therefore, ESPE is hoping for a detailed timetable for addressing our concerns, without which our inability to compete in certain parts of the UK will continue. This must not be allowed.

Question 4: Are there any additional areas you would like to flag as areas you consider warrant further work in the future?

The comments above make it clear that there is still work to be done in the area of cost allocation. We hope that we can secure Ofgem support in maintaining a focus on this, in advance of and following anticipated implementation on 1 April 2010.