

Ynon Gablinger
Distribution Policy, Local Grids
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Scottish and Southern Energy plc
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400

Facsimile: 01738 456415

email:

Our Reference:

Your Reference:

Date: 26 October 2009

Dear Ynon

Electricity distribution structure of charges project: DNOs' proposals for a common methodology at lower voltages

I am writing in response to the above consultation. In the main, the document seeks views on Ofgem's "minded to" decisions on specific aspects of the proposed common methodology. However, our response is focused on the impact assessment (IA) set out in Appendix 3 of the document and Ofgem's conclusion that it is not appropriate to phase in the consequential charge changes that are indicated to take place from April 2010.

In our view, the IA on implementing the common charging methodology has not properly considered the impact on supply competition. We acknowledge the points that Ofgem has made in respect to cost reflectivity and transparency. However, there are other aspects of competition that, in our view, have not been adequately considered. In particular, we are concerned that for certain sectors of the market the large increases in Distribution Use of System Charges (DUoS) that have been presented by Ofgem in the IA (and updated more recently on 8th October) will, under Ofgem's current "big bang" approach to implementing the new methodology, effectively wipe out a supplier's profitability and distort competition.

Our immediate concern lies with the impact on supply competition in the non-domestic HV sector. As you may be aware, in this sector of the market suppliers' prices are typically fixed for a period on the basis of an expectation of network costs and the supplier hedging its position on the wholesale market. However, the proposed implementation of the charging methodology is resulting in predominantly very large increases in DUoS charges for this sector which suppliers have not been able to adequately predict far enough in advance to factor in to their contractual negotiations. As a rule of thumb, an unexpected 10% increase in DUoS charges has the potential to eliminate a supplier's profit in many contracts. When we look at the forecast increase in DUoS charges for 1st April 2010 for this category of customer a supplier's profitability could be completely compromised depending on the terms of the

contract. Nevertheless, even if costs could be “passed through”, the unexpected increase in charges faced by the end user having entered into a contract would be detrimental to them.

Ofgem has made reference to the impact of the proposed step change in DUoS charges on non-diversified (niche) suppliers, but has concluded that this does not matter. We are surprised about this given that Ofgem is always seeking to promote further supply competition and to remove/reduce barriers to new entrants. Nevertheless, as we have described above, it is not just the niche suppliers that will be affected. Any supplier with contracts that rely on an assumed DUoS charge will be similarly affected and it is therefore most important that Ofgem takes into account the impact on the entire supply market. In doing so, it is also important to understand that although customer numbers may be relatively low in some of these customer groups, the volume of energy they use mean that, proportionately, they have a big part to play in a supplier’s portfolio. Any move that directly impacts a supplier’s ability to compete in the market is clearly not in the longer term interest of consumers.

Turning now to the impact of the charges on other customer groups. The impact of an assumed DUoS charge may not be as acute for a supplier setting its tariffs for domestic customers (as suppliers can more readily change their prices). We do not believe that it is credible to assume that suppliers will automatically absorb the impact of an extreme step change. Therefore, it is likely suppliers will increase their tariffs in response to large increases in DUoS charges. The extent to which this may occur may also depend upon the geographic location of the customers since it is evident that the magnitude of change in DUoS charges varies considerably not only between customer charge groups but also between geographic areas. Therefore differential charging by geographic area is likely to increase going forward.

So far, our discussion in the main has focussed on the step change that a move to the common charging methodology will have in April 2010. However, we are acutely aware of a number of issues that are likely to trigger further changes to DUoS charges once the common methodology has been introduced:

- First, in Table 5 of the consultation document, Ofgem have already identified a further eleven areas of further work required by the DNOs;
- Second, if derogations for some/any aspects of the common methodology are granted to one or more DNOs there is likely to be an impact on the charges applied from 1st April and thereafter once the derogations fall away there will be another change; and
- Third, there are a number of inputs to the common charging methodology which can change/fluctuate that will have an impact on the resulting DUoS charges.

In our view, it is evident from the above discussion that there are two issues that need to be urgently addressed by Ofgem if supply competition in the HH market (and more generally customer charges) are not to be compromised:

1. the impact of the big changes in DUoS charges following the implementation of the common charging methodology on 1st April 2010; and
2. arrangements to ensure that on an enduring basis unpredicted large variations in DUoS charges are avoided.

We have given both of these issues some consideration.

First of all we believe that Ofgem should consider delaying the implementation of the common charging methodology until April 2011. Whilst this may, on the face of it, be unpalatable for Ofgem it would provide significantly more notice of the step change in charges to suppliers to enable them to better factor them in to their pricing policies and decisions. It would also avoid the uncertain impact on DUoS charges for those DNOs that may be granted derogations from the full application of the common charging methodology. Furthermore, it would allow the outstanding issues to be addressed prior to implementation (it would, also, we understand, coincide with the implementation of revised EHV charging methodologies).

However, should Ofgem believe the above proposed delay is unacceptable, we firmly believe that the immediate impact of the move to a common charging methodology should be phased in. This could be achieved by placing an absolute cap on the extent to which a DNO can change DUoS charges to any one customer charging group in a year. The cap could be set at, say, 10% or the "P0" increase associated with the outcome of the price control review, whichever is the larger. Given the uncertainties of the inputs to the charging model and the potential for further changes going forward that could result in subsequent, large incremental charge changes to any one customer group, this cap should not be restricted to the changes taking effect from April 2010 but should also be an enduring cap that applies to subsequent changes in years to come. We do not believe that this would be insurmountable for the DNOs to deliver.

In addition, DNOs should be required to give far greater advanced warning of changes to their charges. As we have articulated, it is not the change in charge itself which is the issue for suppliers it is having adequate warning of it to enable them to factor it in to their pricing and contract decisions. We therefore believe that notice of actual charges (rather than indicative charges) should be far greater than that currently required and a notice period of one year should be considered. However, we acknowledge that this may cause DNOs cash flow issues, so this would also require a relaxation of the current rules about permitted over/under recovery (and the associated penalties).

As you will hopefully appreciate, in our view, this issue is critical to securing ongoing and effective competition in the supply market both in terms of maintaining the depth of competition as it stands as well as ensuring that DUoS charges do not become a barrier to entry.

I hope that Ofgem will give this matter urgent attention and consequently reconsider your position in this respect.

Yours sincerely

Rob McDonald
Director of Regulation