



Distribution network operators,
generators, independent
distribution network operators,
independent connection
providers, consumers and their
representatives and other
interested parties

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Competition for part funded connections: guidance and summary of responses

1. At present independent companies involved in the electricity connections market are at a disadvantage when competing with distribution network operators (DNO) for 'part funded' connections work. Where a DNO carries out the work it will fund part of the costs using price control revenue, whereas independent connection providers (ICP) and independent distribution network operators (IDNO) can only recover their costs from the connecting customer.
2. Our 'Competition for part funded connections' consultation¹ sought industry views in respect of the issues surrounding the possibility of improving competition by making price control revenue available to independent companies. Having carefully considered the consultation responses it is our view that:
 - DNOs and independent companies should develop detailed proposals for a mechanism through which price control revenue may be made available to ICPs constructing part funded connections, for introduction by **1 April 2012**; and,
 - it is not appropriate to allow IDNOs to adopt assets funded with price control revenue at this stage².
3. The rest of this letter sets out our rationale for taking this view and discusses the issues surrounding making price control revenue available to ICPs. It is intended to help inform discussion at the working group and, where appropriate, provide guidance. We are happy for the group to revisit any of the issues discussed here. A summary of responses is provided in Appendix 1 and responses are published in full online.

Rationale

4. As stated in our consultation document, it is our view that part funding should not in itself prevent independent parties from competing against DNOs to construct or own and operate part funded connection assets. However, the consultation responses have confirmed that there are a number of practical issues in providing price control revenue to ICPs and allowing IDNOs to adopt part funded assets. We have, therefore, considered whether it is likely that benefits of improving competition will outweigh any costs associated with the issues raised.
5. In our view the benefits to improving competition for the construction of part funded connection assets are clear. Extending competition in this area should provide benefits by

¹<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Part%20funded%20connections%20consultation.pdf&refer=Networks/Connectns/CompinConn>

² We will be happy to reconsider the issue of IDNOs being allowed to adopt part funded assets if a tangible benefit to consumers can be demonstrated.

placing further competitive pressure on DNOs' connections businesses in general and perhaps also in encouraging further new entrants to the market. We also consider that allowing an ICP to carry out the work will not be far removed from hiring a contractor, which DNOs do regularly. Therefore, we believe that overcoming the practical issues involved should be reasonably straightforward.

6. We remain to be convinced by the case for IDNOs being able to adopt part funded connection assets. It is not clear that adoption by IDNOs will deliver significant benefits to customers additional to those associated with allowing ICPs to compete to construct the part funded connection. Further, practical issues surrounding DNO customers being reliant on the IDNO network may be complex to resolve.
7. We therefore consider that the working group should focus on developing a mechanism via which price control revenue is made available to ICPs, and, at this stage work should not focus on addressing arrangements to allow IDNOs to adopt part funded assets. As stated above, it is our expectation that the group will bring forward proposal to give ICPs access to price control revenue for part funded connections for introduction by **1 April 2012**.
8. In coming to this conclusion we have taken into account respondents' concerns about a number of issues they consider should be resolved before addressing competition for part funded connections. Our views on these issues are set out below.

Electricity (connection charges) Regulations (as amended) 2002 ('EccR')³

1. Respondents noted that the EccR do not apply to connection assets provided by an ICP and, therefore, DNOs would not be able to recover costs in respect of part funded assets provided by an ICP.
2. We agree that the EccR should be amended so that it covers ICP-constructed connection assets, and will do so if and when the opportunity arises. However, to do so will require changes to legislation and it may be some time before we have such an opportunity. We would not wish to delay the extension of competition while we wait to amend the EccR unless the impact on customers of proceeding without such an amendment would be significant. As far as we are aware the amount of money recovered through the EccR in respect of part funded connections is relatively minor. Therefore, we do not think that this should prevent work to develop competition for part funded connections going ahead.
3. If it is demonstrated that opening part funded connections to competition without amending the EccR is likely to result in a significant loss to DUoS customers, we will be happy to reconsider this position.

Adoption payments

4. SP noted that the ability to make adoption payments gave IDNOs a competitive advantage over DNOs and non-IDNO affiliated ICPs and suggested that addressing this issue should take priority over improving competition for part funded connections work.
5. We are happy to hear further representations on the issue of adoption payments. However, we consider this to be a separate issue and not a reason delay the development competition in this area.

Future network developments

6. One respondent argued that allowing ICPs to construct part funded connections may prohibit future developments in network design and charging for reinforcement and suggested that a more complete review of charging for network reinforcement should be carried out before addressing this work.

³ The EccR provide for DNOs to recover costs from connecting customers in respect of existing connection assets where those assets have been provided by the DNO to connect another customer.

7. While we are happy to discuss this further, we do not see that opening part funded work to competition will prohibit future developments in this respect. In fact we think that the development of competition could encourage innovation.

Price control settlements

8. One respondent considers that opening part funded connections to competition will have a significant effect on the efficiency assessment of RAV additions and therefore any changes should be postponed until the start of the next price control.
9. We expect that the DNOs' spend will be fairly similar whether the work is carried out by the DNO or an ICP. Therefore, we do not believe this will significantly affect RAV additions.

Some issues for the working group to consider

Calculating the DNO contribution

10. Our consultation set out three potential approaches to calculating the DNOs' contribution towards the cost of the connection⁴. In our view, Option 3⁵ was the best approach to calculating costs. This option shares any cost savings between the connecting customers and DUoS customers, and protects DUoS customers from any increases in cost. However, the consultation responses highlighted a number of potential issues with this approach, and with calculating costs more generally, discussed below. We consider that the working group should attempt to address these issues, before considering other options.
11. **Issue 1:** Options 2 and 3 require the ICP's costs to be known. In order to calculate the amount the DNO would have paid if its costs were the same as the ICP's, you need to know the ICP's costs. Respondents noted that ICPs may be unwilling to make their costs known to their competitors and it is likely to be hard to verify ICP costs.
12. *Potential solution:* the DNOs contribution could be based on price the ICP quotes the customer for the entire job. Option 3 prevents the DNO from contributing more than it would have done if it had done the work, and it is likely that the customer would only accept an ICP's quote where the total charge is less than the DNO's total costs.
13. **Issue 2:** it provides an opportunity for DNOs and ICPs to play the system by shifting costs between the part-funded and fully funded elements of a scheme. A DNO might shift costs from the part funded element to the fully funded element, in order to keep its contribution to the ICP down. ICPs might do the converse.
14. While we acknowledge that these incentives may exist, any incentive for DNOs to shift costs between part funded and fully funded elements will exist whether or not part funded connections work is open to competition. Therefore, our view is that the working group need only consider the incentive on ICPs. (We also note that the incentives may cancel each other out to some extent.)
15. *Potential solution:* the proportion of total costs (part funded and fully funded) could be used, rather than just the proportion of part funded costs. For example, if a DNO connection scheme involves £1000 of part funded work of which the DNO contributes 50%, and £1000 of fully funded work, the DNO's total contribution is 25%. Using this approach removes the opportunity for ICPs to shift costs between the part funded and fully funded elements of a connection.
16. **Issue 3:** For Option 3 it is necessary to know the DNO's costs. Respondents noted that for larger projects DNOs may not be able to provide a firm price until work is under way.

⁴ These options are explained in paragraph 17 of the consultation letter.

⁵ Under Option 3, the DNOs contribution will be the lower of: a) the total amount it would have contributed if it had carried out the work; and b) the amount the DNO would have contributed if its costs had been equal to the ICPs.

Potential solution: the payment could be based on the variable quote or the costs of having a firm quote provided could be subtracted from the DNO's contribution.

17. **Issue 4:** It is not clear which elements of the DNO's costs its contribution should be based on. When charging for a connection DNOs will include the cost of carrying out the work (direct costs, closely associated indirect costs) and costs associated with its overheads (business support costs). The DNO's overheads are fairly fixed and will not vary directly with the volume of connections work it completes.
18. Our initial view is the ICP should only be paid in respect of the work that it delivers instead of the DNO (ie a contribution to its direct costs equivalent to the DNO direct costs it supplants). As the DNO's business support costs will not be significantly affected if the ICP makes the connection it is not clear to us that it should contribute toward the ICP's business support costs as it will not receive any funding for this contribution. The group should consider what work will be carried out by the ICP.

Commercial terms

19. Respondents had varying views in respect of the timing of payments and concerns about the risk of ICPs being unable to complete the work or not completing the work to the DNO's timescales. Respondents also raised concerns about complications surrounding the need for tripartite contracts between the DNO, the ICP and the customer.
20. We consider that ICPs should be subject to similar commercial terms as DNO contractors. We suggest that the group discuss what these might look like.
21. *Potential solution:* we also note UK Power Networks suggestion that contractual issues may be overcome by making the payment to the customer rather than the ICP. We suggest that the group consider this and the possibility of the DNO contracting the ICP.

Network requirements

22. Where a DNO undertakes part funded connections work it needs to take into account the requirements of the network as well as the requirements of the connecting customer. For example, it may be necessary to complete work to certain timescales to minimise disruption elsewhere on the DNOs network.
23. It is our view that where an ICP wins the work it should accommodate the requirements of both parties. Where it is not able to do so, it should not be able to carry out the work. As discussed under 'Commercial terms', above, we consider that arrangements to ensure these requirements are met should be addressed in the same manner as they are for DNO contractors.

Regulatory Asset Value ('RAV')

24. As stated in our consultation it is our view that money paid to the ICP to provide a connection should enter the RAV in the same manner as it would have if the DNO did the work. To clarify, we consider that where the DNO pays the ICP in respect of something that would have come out of its direct costs if it did the work, it should enter the RAV as a direct cost. For example, if the DNO is paying the ICP in respect of the direct and business support costs, the split between the two would be in the same proportion as it would have if the DNO had completed the work. (As discussed above, the group should consider which costs the DNO is paying the ICP in respect of.)

Proportion of the costs borne by the DNO

25. Our view is that the proportion of funding should not, in itself, affect contestability. While we note the view of most DNOs that there may be a correlation between the proportion of costs borne by the DNO and the risk to existing customers, we do not believe that the correlation is direct. Risks may still exist where customer bears the majority of the costs

and there may be times where the risks associated with connection that are largely funded by the DNO are minimal. As stated above, where risks to existing customers of allowing an ICP to carry out part funded work cannot be mitigated the work should remain non-contestable. We find it unlikely that a set threshold of DNO funding above which a connection is considered non-contestable is the appropriate way to mitigate these risks.

Margins

26. It is our view that if sufficient competition is demonstrated, DNOs should be allowed to earn a margin on the customer funded element of part funded connections work. It will not be possible to understand the level of competition until the market has had time to develop, therefore we consider that group should the work on the basis that the DNO will not be allowed to earn a margin for the time being. We do not consider it would be appropriate to earn a margin on the part funded element as DNOs will earn a return on this element through the RAV.

Dispute resolution process

27. We agree with the majority of respondents that the companies' normal dispute resolution processes followed by determination by the Authority is the appropriate mechanism for resolving disputes under these proposed new arrangements. However, we note that our powers of determination under section 23 of the Act are limited to agreements under sections 16 to 21 and that, depending on the nature of the agreement between the DNO and the ICP, this may not apply to payments from the DNO to an ICP. We therefore suggest that the working group considers the dispute resolution process once further clarity has been established in this respect.

Regulatory arrangements

28. We agree with the majority of respondents that it should be possible to provide a mechanism through which price control revenue is made available to ICPs through changes to the Electricity Distribution Licence, the DNO's connection charging methodologies and the regulatory instructions and guidance (RIGS). We leave it to the working group to develop the detailed changes needed.

EU procurement legislation

29. The working group should consider the relevance of EU procurement legislation to this work.

Next steps

We will contact respondents to our consultation with a view to setting up a working group. Other parties interested in contributing should contact Donald Smith (contact details below). This group should develop and if necessary consult on detailed proposals before bringing them to Ofgem for a decision in time for introduction by 1 April 2012.

If you have any queries please contact Donald Smith on 0141 331 6014 or at donald.smith@ofgem.gov.uk.

Yours faithfully,



Rachel Fletcher
Partner, Distribution

Appendix 1- Summary of responses

This section provides a brief summary of responses. Where appropriate, we have taken the opportunity to respond to points not covered in our letter. The responses are published in full on our website.

We received 14 responses: 6 from DNOs; 5 from independent companies involved in the electricity connections market; and 2 from companies involved in the gas connections market; and 1 one from a gas and electricity supplier. Because our consultation focuses specifically on the electricity connections, we have prioritised responses that relate to the electricity connections market. Responses related to the gas connections market are discussed at the end of this appendix.

Company Name ⁶	Business Type
CE Electric UK (CE)	DNO
Electricity North West (ENW)	DNO
UK Power Networks (UKPN)	DNO
SP Energy Networks (SP)	DNO
Scottish and Sothern Energy (SSE)	DNO
Western Power Distribution (WPD)	DNO
GTC	IDNO/ICP
Power On Connections	ICP
Premier Energy Services	Utility Infrastructure Consultants
Sterling Power Group (SPG)	Energy Consultants
British Gas (BG)	Electricity and Gas Supplier
National Grid (NG)	Gas Transmission
Wales and West Utilities (WWU)	Independent Gas Transporter

How much work would become contestable?

Question1: *We welcome respondents' views as to the total value and proportion of part funded work that would be deemed contestable in the case that the methodology is modified to make clear that connections work may be contestable where it is funded by more than one party?*

The majority of DNOs indicated that a significant proportion of part funded work would be opened to competition and independent company's were generally unable to comment or provide an estimate of the total amount of part funded work that would be open to competition.

⁶ One response was confidential.

CE's view is that the proportion of part funded work that can be undertaken is likely to be very small. It highlights our RIIO guidance document which states, in respect of 3rd party delivery of key projects, that this will only be considered as an option where, among other things, the project is significant in scale and cost and that assets are not meshed with existing assets.

Our view: this guidance is in respect of an option for us to directly award price control revenue to third parties in order for them to carry out 'key projects' and is not related to ongoing work to extend contestability in the electricity connections market. Therefore we do not consider that it's relevant to this consultation.

CE also state that the estimated value of part funded connections work over the current price control quoted in our consultation letter, £820m, is based on an 'Ofgem-assumed apportionment figure' of 50% and suggested that this was too high.

Our view: this figure is based on DNO estimates of total part funded connection costs for demand and distributed generation over the DPC 5 period. No 'apportionment figure', Ofgem assumed or otherwise, was involved in its calculation.

SP note that the figures used were 'global' and that in their view as little as 1 in 10 jobs might be part funded.

Question 2: *Do respondents consider that further changes to the rules surrounding contestability should be made in tandem with any move to introduce competition for part funded connections?*

A number of responses did indicate general support for the extension of contestability in other areas. Responses did not highlight specific changes that should be made in tandem with the move to improve competition for part funded work.

Our view: we support and are involved in the extension of contestability in other areas. However, we consider that this work can be progressed independently of other work.

How should payments to ICPs be calculated and made?

Question 3: *We welcome respondents' views on whether arrangements should be established under which DNOs would make price control money available to ICPs, and how the amount of money should be calculated.*

Respondents were generally in favour of introducing a mechanism via which price control revenue is made available to ICPs. There was a variety of responses in respect of how the amount paid to the ICP should be calculated and respondents also highlighted a number of issues that will need to be addressed.

All DNOs preferred Option 3 in our consultation letter, noting that this shared the benefits of any cost savings with DUoS customers and protected DUoS customers from cost increases. The majority of independent companies were in favour of Option 1, noting that option this approach was more straightforward and less open to 'gaming' by either party.

The following issues were raised by respondents:

- In order to calculate the amount to be paid to the ICP under Options 1 and 3 it will be necessary to know what the DNOs costs would have been. SP noted that for larger jobs, they will not normally provide a fixed price, so this won't be known.
- In order to calculate the amount to be paid to the ICP under Options 2 and 3, it is necessary to know the ICPs costs.

- ENW and Power on Connections highlighted opportunities to 'game' under options 2 and 3. The DNO could shift costs from the part funded element to the fully funded element, in order to keep its payment to the ICP down. ICPs could do the converse.

Question 4: *We welcome respondents' views on any commercial issues that might arise if DNOs provided such payments to ICPs. For example, the timing of payment(s) and risks associated with an ICP being unable to complete a project.*

DNOs all considered that payment should be made upon completion. Most also noted that for large projects payments could be staged.

The majority of independent companies considered that payment should be made upfront. Power On Connections noted that DNOs demand upfront payment and that the risk of non-completion was low. GTC also made clear that they did not believe payment should be withheld for warranty.

Sterling Power Group noted that any risk should be no greater than normal contractual risks. It believes the same terms as DNOs apply to their contractors should be used.

CE highlighted that commercial terms would need to comply with EU tendering laws.

Should the proportion of work funded by the DNO affect contestability?

Question 5: *We welcome respondents' views in respect of whether the percentage of costs borne by the DNO should affect whether the part funded work is considered to be contestable?*

All independent companies took the view that the proportion of the costs borne by the DNO should not affect contestability.

The DNOs responses were more varied. The majority considered that some threshold would be appropriate. Some noted that the effect on other customers of non-completion will tend to be more acute in cases where the DNO bears a larger proportion of the costs.

Should margins be applied to part funded connections?

Question 6: *Do respondents consider that DNOs should be allowed to earn a margin on contestable part funded connections?*

With the exception of WPD/CN, all respondents consider that DNOs should be able to earn a margin on part funded work that is contestable.

Question 7: *Do respondents consider that the margin should be applied to the whole connection or restricted to the customer funded element of the connection?*

Respondents were evenly split between those in favour of a margin being allowed on the DUoS and customer funded elements and those of the view that a margin should only apply to the customer funded element.

Respondents in favour of allowing a margin on all the works noted that this would most closely reflect a competitive market. Respondents that considered a margin should only be earned on the customer funded element noted that the DNO will earn a return on the DUoS funded element through the RAV.

How will part funded work enter the RAV?

Question 8: *We welcome respondents' views as to whether the introduction of competition would have any effect in respect of the RAV?*

Respondents generally agreed that money paid to an ICP should enter the RAV in a similar way as if the DNO had carried out the work.

SP and SSE indicated that allowing ICPs to carry out part funded work may have a significant impact on the DNOs total RAV and it may be necessary to revisit the DPCR 5 price control allowances or delay implementation until the next price control.

Should IDNOs be able to adopt part funded assets?

Question 9: *We welcome respondents' views on whether and, if so, under what circumstances, IDNOs should be able to adopt part funded network assets?*

All DNOs considered that it was not appropriate for IDNOs to be able to adopt part funded assets. They cited a number of reasons why it would not be practical to allow this. Including that DNO customers would, in the case of part funded reinforcement, be reliant on the IDNO.

Three independent companies considered that IDNOs should be able to adopt part funded assets downstream of the point of connection.

Regulatory arrangements

Question 10: *Do respondents consider there is any reason why such provisions cannot be included within the current regulatory arrangements?*

Question 11: *We welcome respondents' views on the appropriate nature and location of such provisions?*

The majority of respondents considered that a mechanism via which price control revenue is made available to ICP may be accommodated within the Electricity Distribution Licence, the DNOs' Connection Charging Methodologies and the Regulatory Instructions and Guidance (RIGs).

One respondent considered that most issues might be dealt with via bilateral contracts between the parties.

Dispute resolution

Question 12: *We welcome respondents' views on the need for and the appropriate nature of a dispute resolution process?*

Respondents were generally in favour of a dispute resolution process similar to that in place for connections at present – ie via the DNOs' internal dispute resolution processes followed by determination by Ofgem.

Further comments

Question 13: *Do respondents have any views on any issues not covered above?*

SP consider that the current arrangements do not disadvantage ICPs because the customers charge for part funded work will be the same, whether an ICP or them carry out the fully funded element.

Our view: we have discussed this view with SP and understand that its interpretation of our consultation letter was that we felt ICPs were disadvantaged in competing for the fully funded element of a connection that contained both part funded and fully funded work. For clarity, our view is that ICP is disadvantaged in competing to carry out the part funded element of such a connection.

SP also noted that the ability to make adoption payments gives IDNOs and IDNO affiliated ICPs a competitive advantage over DNOs and non IDNO affiliated ICPs.

ENW consider that a full review of the current connection charging boundary should take place. It notes that extending competition for part funded connections to include ICPs may inhibit long term development of new approaches to reinforcement and charging. They site demand side response as an example of something that may require new approaches to reinforcement and reinforcement charging.

A number of respondents highlighted issues related to the EccR. In particular, DNOs highlighted that they would be unable to recover costs from 'second comers' using spare capacity on ICP constructed assets.

UKPN have suggested that the working group's proposals be consulted on prior to their introduction.

Sterling Power called for a wider review of competition in connections.

Our view: the arrangements in place requiring DNOs to pass competition tests and ongoing work to extend contestability in other areas should be sufficient to develop competition. As mentioned above, this consultation and the working group should focus on developing competition for part funded connections.

Gas responses

The two responses that relate specifically to the gas connections market stated that they would not support the extension of this work to the gas connections market.

Our view: we have no plans to do so.