

**Competition for part funded connections work: open letter (1/6/11)**

SP Energy Networks (SPEN) welcomes the opportunity to comment on the issues raised in this open letter.

We do not object in principle to opening up part funded connections work to competition. Competition in connections activities in the Scottish Power distribution services areas is amongst the most vigorous in the UK, and SP Energy Networks and our customers have benefited from the additional flexibility that good Independent Connections Providers bring.

However, there are a number of regulatory and practical issues that would need to be worked through to implement the changes suggested in the consultation. For example, it is important that uncertainty over the legal rights of distributors to recover costs from 'second comers' under the Electricity Act in relation to adopted assets is addressed by Ofgem alongside any implementation of these proposals.

We believe that the proposals fall into two clear categories:

- a) A small number that appear relatively simple to implement, but may still require a number of potentially complex changes, and for which it may possibly be demonstrated that benefits may outweigh the costs;
- b) More far reaching proposals on asset ownership which will clearly need significant regulatory changes, implementation of complex technical interface arrangements and for which it seems highly improbable that the benefits will outweigh the cost of implementation.

By definition, part funded connections work affects customers other than those directly involved in a connection project, and the distributor's obligations to provide secure and reliable supplies to these would need to be taken into account.

We understand that one of the main concerns relating to part funded assets - although this does not fully come out in the letter - is that DNOs are perceived to be able to 'free ride' by being able to utilise spare capacity on system extension assets they adopt that have been constructed by an Independent Connections Provider ('ICP'). Although we recognise this issue, it needs to be remembered that it will only be in a limited and specific set of circumstances outwith the DNO's control that its existing or future customers would be able to use any such spare capacity at no cost to themselves.

We believe that there are more important issues to be addressed in the competitive connections market that would offer more substantive benefits to customers – particularly in the areas of the Electricity Connection Charges Regulations ('ECCR') and also asset value adoption payments made by IDNOs.

In relation to ECCR, the position at present for connection assets adopted by a licensed distributor is that 'second comers' are able to free-ride in relation to the capacity concerned, as there is no mechanism under the ECCR to accommodate payments between second and first comers in such cases.

Additionally, the issue of adoption payments made by IDNOs but not open to DNOs remains an important distortion to the competitive connections regime that needs to be addressed. For example, it significantly affects the ability of independent ICPs as well as DNOs to compete in the connections market. Establishing a value of assets constructed by the ICP through such payments could provide a basis for determining appropriate charges and

payments through the ECCR mechanism, and potentially provide a solution to the associated problem detailed in the preceding paragraph.

We believe that at a minimum both of these areas would need to be addressed alongside any proposals to extend competition to part funded connections,

Assessment of any proposal for IDNOs to be able to adopt part-funded assets must take into account the ability of the DNO to recover from the IDNO its exposure to IIS, distribution losses, Guaranteed Standards of Performance and other incentives where its performance is dependent on network assets over which it had limited if any control. In addition there are many technical and operational issues that would require solutions to be developed. A clear cost benefit justification is required before the industry embarks upon such a fundamental change.

The distributor may need to manage other connections dependent on part funded reinforcement, and to do so in a way consistent with its licence obligations and standards of performance. Where a third party was responsible for delivery of part funded assets, there would need to be a way of ensuring adequate safeguards against knock-on effects on other customers in the event of delays.

There is also the question of how the DUoS funded element should be established for major projects where a firm price may not be quoted at the outset pending tenders being sought by the distributor.

The proposals set out in the attachment to the letter raise further issues that would need to be addressed, such as publication of 'related' projects, and connection and charging arrangements for part funded assets where these are adopted by an IDNO.

Our responses to the detailed questions in the letter are set out below.

**Question 1:** *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?*

We think that as a proportion, the estimate of 26% of connections work involving part-funded reinforcement may be reasonable as an overall average. However, as a global figure this does not take into account that only a limited proportion of jobs – perhaps less than 1 in 10 – are likely to involve part funded reinforcement. A global figure taken in isolation may therefore be somewhat misleading.

**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?*

The existing rule for wholly funded reinforcement that contestability should apply only to assets that are electrically separate from the distributor's existing network should apply also to any part funded work that becomes contestable. Further rules would need to be discussed, agreed and introduced to cover, for example, 'step-in' provisions where a DNO needs to complete works itself for system reasons.

**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.*

For major projects involving EHV assets SPEN does not normally quote a fixed price at the outset pending a tender process being carried out. The final cost for the works involved would not be known until the tender process is complete. This process is intended to help ensure efficiently incurred investment expenditure for major projects, but it would not take

place where an ICP was seeking to carry out the works concerned. It is important that any method of calculation avoids the risk of DNO customers funding inefficient investment by ICPs.

Perhaps ICPs could competitively tender for these activities where the DNO's contractual arrangements allow and the part funding is greater than a reasonable defined threshold.

**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.*

For large projects, SPEN will normally require milestone payments in order to ensure as far as possible that it is cash positive. Similar principles could apply where an ICP was carrying out a project that was part funded (in respect of the DUoS funded element), subject to a satisfactory process for establishing the total cost involved. For other projects, payments by the DNO should be made only once all works have been completed and the assets adopted, as up to that point, the risk should lie with the ICP installing the assets concerned. It is important that the risk of upfront payments to ICPs for work that is not carried out (e.g. due to changes in the customer's requirements or circumstances) is addressed.

**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?*

Where a large proportion of costs are borne by the DNO (reflecting its share of the new capacity to be provided), there is a greater risk that it may need to step in if the work becomes necessary for system-related reasons. In addition, there could be difficulties if the ICP was unable to complete contestable part funded connections work that was largely driven by the DNO's capacity requirements. For these reasons, we do not think that contestability is likely to be appropriate where the proportion borne by the DNO is above 50%.

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

As with other contestable work, the DNO should be able to charge a margin if part funded connections become 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?*

The DNO should be able to charge a margin on contestable work it is carrying out. By the same token a margin should apply in respect of the DUoS funded element if an ICP carries out this work.

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

In principle the DUoS funded element of part-funded reinforcement should be eligible to be included in the RAV whether or not the DNO or an ICP carries out the work, so long as it is adopted by the DNO. However, there needs to be a means of ensuring that the DNO does not provide funding for inefficient investment by a third party.

As detailed in the opening section of our response there is a need for guidance on DNOs' rights to recover costs under the Electricity Act from second comers in relation to adopted assets under each of the proposals. If this is not provided it may be that a proposal is implemented that does not align with DNOs' rights in this regard and this could require increases to DNOs' RAVs and funding by DNOs' customers, when some of these costs should reasonably be recovered from second comers.

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

We do not think that DNO customers should be connected via third party-owned assets outwith the DNO's control. Under no circumstances should an IDNO be able to adopt part-funded assets that are embedded within the DNO's network. This could compromise a DNO's ability to operate its network safely and efficiently, carry out planned works, and ensure secure and reliable supplies to its customers. The DNO's exposure to the IIS, losses and other incentives, and to Guaranteed Standards of performance would also need to be taken into account. We are also not aware of any provision in the Act that provides for third party assets to be interposed between a distribution network and its connected customers.

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

As set out under (9) above we do not think that adoption by an IDNO of part funded assets is appropriate where DNO customers are supplied via the IDNO's assets.

As detailed in the opening section of our response there is a requirement for guidance on the legality of DNOs' rights to recover costs under the Electricity Act in relation to each of the proposals.

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

Please see our response to (10) above.

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

The DNO should be able to step in and complete a project where necessary where it has reasonable grounds for doing so to protect existing customers. Existing procedures for dispute resolution should apply.

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

We do not accept the statement in paragraph 2 of the letter that DNOs have a significant advantage over ICPs in competing to construct part-funded connections as the ICP 'can only recover its costs from the connecting customer.' The apportionment of costs by the DNO where there are part-funded connections applies whether or not an ICP is bidding for the contestable work. We accept that in certain cases the DNO's future customers may be able to utilise spare capacity of extension assets constructed by an ICP, but in our view this reflects a gap in the ECCR regime rather than implying a need to change the contestability boundary. Addressing the ECCR so that charges to second comers in respect of adopted assets can be made would address a range of issues in the competitive connections market beyond that of part funded connection assets.

As we set out in the opening section of this response, the issue of adoption payments should also be addressed as these represent a significant distortion to the connections market.

The strawman attached to the open letter raises a number of issues on, for example, publicising details of connection applications that are or may involve part-funded reinforcement that would also require to be addressed.