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Dear Donald,

Competition for part funded connections work: consultation document

We welcome the opportunity to respond to Ofgem's recent consultation regarding competition for part funded connections work. We are fully committed to developing competition in the connections area and support in principle the proposal to open up competition to part funded connections work. Our general views on the proposals are set out in this letter; responses to the specific questions in the consultation are given in Appendix I.

The proposal to allow IDNOs to adopt assets constructed by the ICP for a part funded connection is likely to require a number of complex, interlinked considerations, including the issues of safety; licence obligations; and how charging arrangements would work. We therefore consider it appropriate for this to be considered in detail separately at some point in the future after the part funded connections framework has been implemented. Our response is focused on the ICP element of the proposal. Whilst we agree in principle with the proposal, and consider that it could (depending on the framework that is developed) have the potential to benefit customers, it is important not to underestimate the significant amount of work that will be required to achieve this. This is explained in more detail below.

As highlighted in the consultation, there are a number of complex issues that would need to be fully addressed before such a proposal could go ahead. To implement the proposal would require a new charging, commercial and regulatory regime to deal with this new tripartite contractual arrangement. The proposal is particularly complex as it could lead to cases where the new customer is potentially making choices that could impact on costs for both existing

and future customers. Ultimately, the framework needs to be developed to safeguard existing customers against being disadvantaged, i.e. exposed to a higher cost through use of system charges, as a result of an ICP carrying out the part funded connections work. It also needs to be clear that all customers will realise any benefits of competition.

The potential for disputes also needs full consideration. There is significant scope for disputes to arise between an ICP and a DNO in relation to the costs offered by the DNO, the costs claimed by the ICP and, potentially, the works carried out by the ICP. If such disputes were all to be dealt with by Ofgem this would lead to numerous lengthy determinations. In order to minimise the potential for disputes, the framework should be sufficiently detailed on how costs would be calculated and the evidence that would need to be given both from the DNO and the ICP. Our initial view is that the most appropriate way to do this would be to introduce a new section into the DCUSA to deal with ICPs competing for part funded connections.

Given the above, it would seem sensible to set up a working group to examine the implications of the proposal and subsequently develop an appropriate framework. Such a complex issue is likely to take time to resolve, and as such we believe it is realistic to work towards implementation at the next price control review.

If you would like to discuss any of our response further, please be in touch.

Yours sincerely,

Aileen McLeod

Head of Regulation, Networks

Appendix I

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?

Using data from the second half of 2010/11 (September to March), the total number of projects accepted in that period that including an element of reinforcement and value of that element were £0.749m/89 projects for SEPD, and £1.127m/362 projects for SHEPD.

This suggests that approximately 50% of SEPD and 35% of SHEPD part funded works could be carried out contestably, representing approximately £0.8m/90 projects annually for SEPD and £0.8m/250 projects annually for SHEPD that could be deemed to contain a contestable element of part funded work in the case that the methodology were modified.

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, and, if so, what effect would this have on question 1?

Whilst we remain supportive of the move to increase contestable works, we recognise that the issues are complex and that it will therefore take some time and resource to fully consider and develop the changes. As such we believe that it is important that these issues are prioritised such that those with the greatest benefit are addressed first.

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.

We are committed to opening up competition in the connections market; introducing competition for part funded connections work could form an important element of this.

If the proposal to open up competition in part funded connections work is to go ahead, a clear framework around how the financial aspect would be dealt with would be essential. It is

particularly important to ensure that existing customers are not exposed to higher charges as a result of a customer opting for an ICP to complete their connections works.

Whilst option (i) would be the simplest to implement, we are concerned that it could lead to ICPs charging artificially low prices to the end customer, with existing customers effectively subsidising the new customer's connection. This is particularly an issue where the customer is contributing to only a small element of the works. For example, if the DNO's contribution would have been 80% of the total costs, and the ICP is able to undercut this cost, they will potentially then be able to pass this benefit on to the end customer to reduce their connection charge, with the assurance that they will receive more than their cost price for the majority of the works (80% in this example). Whilst this is clearly beneficial for the end customer, it effectively results in existing customers subsidising the connection cost for the new customer; this is clearly inappropriate and not the intent of the proposal. There is less opportunity for this when the customer is contributing to a significant proportion of the costs.

Option (ii) proposes that the DNO contributes the proportion of the ICP's costs that it would have contributed had it carried out the works, no matter what this cost is. A significant concern with this option is that there is little incentive for the ICP to increase their efficiency, as they are effectively guaranteed to recover their costs, whatever these may be, for part of the works (again this is more of an issue where the customer's contribution is low). It is not appropriate for existing customers to be exposed to any over-spend by the ICP.

By providing the ICP with the proportion of its costs that the DNO would have contributed but capped to the actual cost the DNO would have contributed had the DNO done the work, option (iii) appears the most sensible and proportionate solution. This provides the ICP with the correct incentive, i.e. encourages efficiencies, whilst ensuring that existing customers are not exposed to any over-spend and benefit from any under-spend. This is ultimately the most beneficial for all customers of the options proposed.

We note that these options are not considered in detail in the consultation. It is clear from the above that there are a wide range of practical considerations that need to be taken into account. This detailed assessment should be undertaken before any decisions are made.

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.

From our perspective, the most appropriate option in terms of timing of payments would be to pay the ICP on completion of the works. This would avoid the risk of customers being

exposed to the costs of any incomplete work. However we understand that this could potentially cause cash flow issues for ICPs. An alternative option could be staged payments on completion of key milestones of the project.

Under the current framework, if an ICP fails to complete a project it will be the developer who has chosen the ICP that is affected by and exposed to the cost of the incomplete work. If competition for part funded connections work is to go ahead, there is a clear risk if the DNO has paid up front, albeit through staged payments, that existing customers could be exposed to these costs. This risk would need to be addressed in the contractual arrangement the DNO would have with the ICP. One option to minimise this risk could be to offer staged payments of a certain proportion of the costs of the works completed, e.g. 75% of the works completed at key milestones. This would ensure that ICPs were able to advance with the works without putting undue risk on existing customers.

A further commercial scenario that should be considered is where more than one customer is going to be contributing to the connections work. Who chooses who completes the work in this scenario? How would the commercial arrangements work? This also raises other issues associated with second comers; these are discussed further in our response to Question 13.

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?

We agree in principle that the percentage of the cost of part funded connection assets borne by the DNO should not, in itself, affect an ICP's ability to compete for connections work. However it is important in terms of the financial arrangements to fully consider how the options discussed in the consultation and in our response to Question 3 can significantly differ depending on the proportion that the customer is contributing to the works. This is also likely to impact on ICPs' business models. Please see our response to Question 3 for a more detailed explanation of this.

We note that the previous Ofgem working group on this issue proposed that the partially funded works would be placed with the party that funded the majority of the costs. This appeared to be an equitable arrangement, and was accepted by DNOs and ICPs at the time.

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

We consider that DNOs should be allowed to earn a margin on contestable part funded connections as this is consistent with and likely to encourage the development of competition in this area. It also maintains a fairness and consistency between ICPs/IDNOs and DNOs.

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?

As consistent with Question 6 above we consider that the whole of the contestable part funded connection, both the DNOs and customers funded elements should be allowed to earn a margin as this is consistent with and likely to encourage the development of competition in this area. Again depending on the proportion of the connection which is DNO as opposed to customer funded, applying a margin to all works would encourage competition. It also maintains a fairness and consistency between ICPs/IDNOs and DNOs.

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

The use of price control funds to pay third parties to complete significant amounts of works constitutes a significant change in policy and, whilst it is sensible to consider the proposal and begin to develop a framework now, it would seem appropriate to delay implementation to the next price control review. The biggest issue, in this regard, is around the cost and efficiency assessment of RAV additions and ensuring best value for all customers.

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

There are a great number of complexities to this issue which have not been explored in previous work. We strongly consider it is something that should be looked at in the future. A number of the issues are noted in the consultation. In addition to these we would need to consider: how use of system charges would be calculated; how the licence obligations would apply; and the balance of risks and benefits between the DNO and the IDNO.

The first logical step is to open up part funded connections work to ICPs. Once the principles of this are established, a framework policy is implemented and any lessons have been learned, it would then be appropriate to consider whether IDNOs could be able to adopt these assets.

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

As explained in our response to Question 9, we do not consider that IDNO arrangements should be considered at this time. In terms of the ICP proposals, as noted in our cover letter, significant changes to the existing charging, commercial and regulatory regime would be required to implement this.

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

We consider that the DCUSA would be the most appropriate location for the requirements regarding part funded connections. This should include detailed provisions such as how ICP and DNO costs should be evidenced; liability for incomplete or incompetent works; and how the commercial / contractual arrangements should work.

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

Whilst we hope to continue to work well with ICPs and IDNOs, there is significant scope for dispute if the proposal was to go ahead. Due consideration to the issues discussed in the consultation and in responses to the consultation when developing the policy framework, together with ensuring that the framework is sufficiently detailed, should go a long way towards minimising the potential for any dispute.

Ultimately such disputes should be referable to Ofgem for determination.

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

There are a number of issues that we do not consider are fully addressed in the consultation. More detail on these is given below.

Second comers

Whilst in cases there is a single applicant on the relevant part of the network, the proposed principles will be straightforward, the contractual issues that may exist with multiple customers applying for connection on the same part of the network need to be carefully considered.

First is the scenario where a customer requiring reinforcement works has requested that an ICP complete the works. A further customer could then apply for a connection requiring use of the same reinforced line. Is the second customer tied in to using the ICP nominated by the first user even if works are yet to commence? It is also possible that the previous applicant may not need or wish to complete his reinforcement works in the timescales required for the second applicant. There may also be further contractual complications in cases where a reinforcement planned to cater for an initial reinforcement (to be carried out by the ICP) needs to be radically changed as a result of a second or subsequent applicant also seeking to connect to that part of the network.

A second scenario occurs where the first customer has opted for an ICP to carry out the works, paid the cost and the works have been completed. In this instance a second customer would be required to pay a sum to the DNO under the Electricity (Connection Charges) Regulations 2001. How this sum is calculated would differ depending on which of the 3 options discussed in our response to Question 3 is opted for.

In both of these scenarios, whilst opening up competition would benefit the first customer, it is important to also consider the impacts on existing and subsequent customers. As such, we believe that the contractual arrangements for the reinforcement and sole use works need to be fully considered and the various scenarios scoped out.

Liability

More generally, a typical connection project may have sole use works (completed by an ICP), partially funded reinforcement works (completed by an ICP) and partially funded reinforcement works on existing assets (completed by the DNO). It is important in case of non-completion of the proposed development, or of the proposed load not materialising, that existing customers are not exposed to any cost and that the liability for payment for all customer funded works lies with the developer.

Independent Company's Proposal

We consider that, in general, the questions raised in the consultation are the relevant ones. We will therefore not respond in detail on the independent company's proposal itself. However, there is a general principle in the proposal that we are opposed to; more detail is given below.

The proposal suggests that the onus should be on the DNOs to inform ICPs of part funded connections work that has been quoted for. We do not consider this appropriate as this is confidential information and it cannot be presumed that customers wish to receive alternative

quotations. An important element of competition is customers' awareness of the alternative options available to them. This is something we are already committed to for existing contestable connections work. A clear explanation that ICPs or IDNOs are able to undertake some of the works is given in our quotation letters. Moreover, we recently undertook a survey on this issue, the results of which showed that the majority of the customers surveyed were aware that other parties could carry out elements of the connections work. The most appropriate way to open up competition for part funded connections work would therefore be to include a section up front in relevant quotations explaining that ICPs or IDNOs are also able to undertake this work and providing a link to a list of the relevant parties.