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14<sup>th</sup> May 2008

Dear Rachel,

### **Delivering the Electricity Distribution Structure of Charges Project**

SSE is extremely concerned that Ofgem are considering imposing a licence obligation on Distribution Network Operators (DNOs) ‘to deliver appropriate charging methodologies ahead of April 2010.’ This would be a disproportionate and inappropriate action by Ofgem which SSE could not support.

We lay out our views on the proposals below. We have provided comments on the five questions raised in the consultation as an Appendix to this letter and attach previous, relevant correspondence.

We believe that Ofgem’s consultation on delivering the electricity distribution structure of charges project is badly timed and misinformed. Whilst it is a fact that the project has met with delays, we totally disagree with Ofgem’s assertion that DNOs are solely responsible for these. The work involved in bringing forward suitable charging methodologies has been complex and difficult at times, but Ofgem’s desire to impose a pure forward looking incremental cost model that is incompatible with its own set of prescriptive charging principles has clearly contributed to the delay.

Notwithstanding this, it is our understanding that all DNOs are currently working on revised charging methodologies that strike the required balance between cost reflectivity, simplicity, transparency and the need to facilitate competition. These are the high level principles that have been agreed between all parties as part of the ongoing project to deliver revised charging methodologies.

We intend to bring forward revised charging methodologies in both our distribution services areas by April 2009. We have been working with both Central Networks and ScottishPower, known as the G3 group, in developing a forward cost pricing (FCP) methodology that we believe mitigates the worst excesses of marginal cost pricing and strikes an appropriate balance between the high level principles. Whilst the FCP methodology does provide a view of future costs, it dampens the volatility of pure incremental cost models and, we believe, provides a more stable and predictable charging regime.

We have consulted stakeholders on our proposals, received in-depth external economic advice and have been in discussions with Ofgem throughout the development of the new methodology. It is our understanding that most, if not all, DNOs are at similar stages of development with their new charging methodologies.

In our view, the main problem with bringing forward changes to DNOs' structure of charges is Ofgem's continued insistence that charging methodologies should be based on a forward looking incremental cost model. We have argued consistently since the start of the structure of charges project that pure forward looking incremental cost models are inappropriate for use of system charging. In our experience these types of models produce unstable and volatile charges. During the course of the project we have provided a number of critiques of this type of pricing model and discussed our concerns with Ofgem. These critiques included one on the report commissioned from the University of Bath that is referenced in the current consultation. We highlighted serious flaws in that report; both with the methodology and with the expected outcomes. We expressed particular concern with Ofgem's use of the £200m of potential benefits that had been severely caveated in the report. Ofgem continue to quote this figure and we continue to be surprised at this. A copy of our critique of the University of Bath report is attached for completeness.

With regard to distribution use of system charging for demand, whilst cost reflective tariffs should, quite correctly, be one of the key building blocks in the design of any charging methodology it is essential to balance this against the needs for stability, simplicity and transparency. Volatility of prices can be damaging to customers, suppliers and network owners. In the short term it leads to inaccurate pricing and potentially inappropriate investment. In the longer term it leads to premium pricing to mitigate risk. As noted above, we have fundamental concerns that pure forward looking marginal cost pricing models tend to produce prices that are extreme, volatile and not reflective of the underlying costs to meet new demands on the system. We believe that the G3 FCP model mitigates the worst of these concerns.

With regard to distribution use of system charging for generation (GDUoS), we are surprised that Ofgem see the imposition of forward looking incremental cost models as the means with which to better facilitate the connection of distributed generation. Ofgem have noted in their initial consultation document for DPCR5 that there is no evidence of distributed generation being unable to connect to the network. This implies that the current connection and use of system charging methodologies are not inhibiting distributed generation, and this is certainly our experience to date. We do not therefore accept that the current GDUoS charges are a barrier to renewables. In fact, generally, micro generation pays no GDUoS charge and the charge for small embedded renewables is minimal. In our experience, the barriers to bringing forward renewable generation centre around local government planning regimes and, in the north of Scotland, transmission access.

However, renewable generators are unlikely to commit to a connection where the charging regime for use of the distribution system cannot be reasonably predicted year-on-year. Furthermore, the whole concept of providing locational signals to distributed generation, certainly via use of system charges, is fundamentally at odds with both government and European policy that is seeking to tilt the playing field in favour of renewable generation.

In the north of Scotland, an area where there is an abundance of renewable energy sources, a forward looking incremental cost model would result in positive use of system charges to such generation as they would, by need, be sited away from the centres of demand. We firmly believe that the imposition of such a charging methodology will have serious, adverse implications for delivery of the renewable generation targets introduced by government.

If Ofgem are concerned that current GDUoS charges are a potential barrier to the development of distributed generation, then this could be addressed quite simply by setting all distributed generation charges to zero and relying on locational signals being provided via the existing shallowish connection charge, rather than imposing an unstable and volatile charging regime based on forward looking costs. We believe that this would be more in line with government and European policy for renewable generation.

Whilst pre April 2005 generation has not been discussed at length in the consultation paper, we remain firmly of the view that it would be inappropriate and impractical to charge use of system for these generators. During DPCR4, Ofgem gave a commitment that, if use of system charges were to be applied to these generators, this would not happen until at least 2010. We are very concerned that Ofgem's proposal to impose a forward looking incremental charging regime on all DNOs by October 2009 goes back on this commitment.

For the avoidance of doubt, our forthcoming modification proposal will revise charges to both demand and generation customers that reflect a balance across the agreed high level principles discussed above. With regard to generation charges, these will be designed to dovetail with the existing price control mechanism and recover GDUoS revenue from post April 2005 connected generation only.

We have previously written to Ofgem identifying a number of serious concerns with the proposal to charge use system to pre April 2005 generators. In particular, we sent a paper to Ofgem on the subject in July 2006, to which we have never had a response. A copy of that paper is enclosed for completeness. We strongly believe that such generation connected under entirely different commercial and regulatory regimes. The introduction of GDUoS charges for these generators is likely to undermine their profitability and could even jeopardise their commercial viability as well as raise issues about property rights and adequate compensation. We are concerned that changing our charging methodology in the way Ofgem desire would therefore put us in the middle of a large volume of complaints from customers and indeed, possibly legal action

Furthermore, imposing use of system charges on to pre April 2005 generators would send perverse signals about regulatory risk for generator investment at a time when such investment is critical. These issues are discussed as part of our response to Question 4 in the Appendix and expanded on in detail in the original paper.

In summary, SSE is strongly opposed to the introduction of a formal licence condition on DNOs to deliver appropriate charging methodologies. The joint G3 project to deliver a revised charging methodology that makes a pragmatic balance between the high level principles of cost reflectivity, simplicity, transparency and facilitating competition is at such an advanced stage it would be reckless to abandon it now. The work we have undertaken as part of the G3 project is nearing completion and we expect to be in a position to submit our new charging methodology proposals for Ofgem's approval in the next few weeks. Our proposed implementation date for the new charging methodologies in both our distribution services areas is April 2009.

We cannot support imposition of a licence modification that requires DNOs to implement a charging methodology, to Ofgem's satisfaction, where such a methodology is incompatible with the principles prescribed by Ofgem. Given the strength of our views, it would be useful to meet to discuss the concerns we have raised.

Yours sincerely,

Malcolm J Burns  
**Regulation Manager**

## **Appendix: SSE Response to Consultation Questions**

### **CHAPTER: One**

**Question 1:** Do you consider that it is necessary to place a licence obligation on DNOs to deliver use of system charging methodologies that meet the required principles and objectives by 1 October 2009?

**SSE Response:** No. We strongly believe placing a licence obligation on DNOs will be counterproductive. It will fail to deliver new charging methodologies ahead of April 2010, will stifle innovation and result in significant wasted work by a number of DNOs who have or are close to bringing forward innovative and cost reflective charging methodologies.

In our view, it is not possible to deliver a cost reflective charging methodology, to Ofgem's satisfaction, when such a methodology is incompatible with the proposed principles. We could therefore not support a licence condition that sought to oblige DNOs 'to deliver appropriate charging methodologies ahead of April 2010' to the set of principles prescribed by Ofgem.

### **CHAPTER: Two**

**Question 2:** Have we considered all the necessary high level principles and objectives for the structure of charges project going forward?

**SSE Response:** The high level principles of cost reflectivity, simplicity, transparency and facilitation of competition are commendable. In practice, any charging methodology must strike a balance between each of these high level principles and also that of price stability, which is a key principle for stakeholders like distributed generation seeking funding to develop and connect to the networks.

With regard to the reports commissioned from the three sets of academics in 2005, we have previously provided a detailed critique of the report commissioned from the University of Bath that is referenced in the current consultation. We highlighted serious flaws in the report; both with the methodology and with the expected outcomes (see our letter of 24<sup>th</sup> February 2006 attached). The report itself contains caveats on the interpretation of its findings, including around the brief comments in the report on the level of future benefits being "potentially in the order of £200m". The figure is unsubstantiated and indeed in the report itself it is immediately followed by a caveat that any such extrapolation from the study work "would have little foundation". We do not believe that Ofgem should be quoting such an unsubstantiated figure.

**Question 3:** Has the structure of charges work to date highlighted any objectives set out here that are not appropriate for the project going forward?

**SSE Response:** The structure of charges work carried out by industry to-date has been premised on the need to balance cost reflectivity with simplicity, transparency and the facilitation of competition. We continue to believe that DNOs should be left to develop charging methodologies that strike a balance between these principles.

Ofgem's proposed principles outlined in Appendix 4 of the consultation are prescriptive and counterproductive. As noted in our response to Question 1 above, it will not be possible to develop a methodology that is able to meet all of these principles.

### **CHAPTER: Three**

**Question 4:** We welcome views on the two options presented in this chapter. In particular, we welcome views on the timescales for the various options and how they relate to the forthcoming price control review.

**SSE Response:** We do not believe either option will deliver appropriate revised charging structures before the start of the next price control. Contrary to Ofgem's view, we believe that mandating either of these options will result in a significant amount of current work being dismissed. We also believe that the innovation that has been shown by DNOs to-date will be stifled.

We do not believe Ofgem's preferred approach can succeed. As noted in our response to Questions 1 above, it is not possible to develop a charging methodology that meets the detailed charging principles prescribed by Ofgem.

With regard to stifling innovation, we believe Ofgem's comments regarding the DNOs' ability to create innovative solutions ignore the clear evidence to the contrary. For example, apart from the G3 model we are aware of at least another two sets of charging methodologies that are under development. All of these employ innovative ideas to promote cost reflective price signals and solutions. Further examples of innovation include the work undertaken by DNOs to introduce new methodologies for charging IDNOs and for reactive power.

We intend to submit modification proposals for our two distribution services areas, based upon the FCP methodology developed by the G3 group, in early June 2008 and would expect to implement them for April 2009. Whilst the FCP methodology does provide a view of future costs, it dampens the volatility of pure incremental cost models and, we believe, provides a more stable and predictable charging regime. We have previously provided Ofgem with details of the FCP methodology, along with critiques from two leading economic consultants (Reckon and Frontier Economics).

Our proposed methodology will revise charges to both demand and generation customers that reflect a balance across the agreed high level principles. With regard to generation charges, these will be designed to dovetail with the existing price control mechanism and recover generation use of system revenue from post April 2005 connected generation.

Whilst the current consultation has only briefly discussed pre April 2005 generation, we continue to have a number of serious concerns with the proposal to charge use of system to these generators. Once again, we have discussed this issue at length with Ofgem (see our paper attached, sent under cover of e-mail to Ofgem on 7<sup>th</sup> July 2006). We believe that such generation connected under an entirely different commercial and regulatory regime. The introduction of GDUoS charges for these generators could undermine their profitability and could even jeopardise their commercial viability.

Such a move would send a perverse signal about the regulatory risk of generation investment to the investment community at a time when government policy seeks to maximise the availability of new, and particularly renewable, generation. In addition, Ofgem has previously acknowledged that there are legal issues associated with property rights with any introduction of GDUoS for pre April 2005 generation. These issues have not been satisfactorily addressed; indeed we have never had a response to our July 2006 paper.

Furthermore, Ofgem have previously discussed the influence of locational GDUoS charges on generator siting and decommissioning decisions. However, existing embedded generation cannot change their siting decisions, which were made in a completely different commercial environment. Also, decommissioning of existing embedded generation would run counter to current government and European policy to promote the growth of such generation.

**Question 5:** We welcome views on the approach for implementing the two options. In particular, we welcome views on whether integrating the new licence requirements would be better achieved by amending PLC13 or by inserting a new licence condition into Section B of the Proposed Standard Licence Conditions.

We are fundamentally opposed to the imposition of any such licence condition. We could not accept a collective licence modification that sought to impose a charging methodology to Ofgem's satisfaction when the principles prescribed are unachievable.