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*Promoting choice and  
value for all customers*  
Our Ref: RBA/DPC/SOC  
Direct Dial: 020 7901 7255

Date: 12 July 2007

cc: Nigel Turvey (by email only)

Dear Colleague,

**Decision in relation to WPD's modification proposal to the use of system charging methodology: IDNO/DNO charging**

On 8 May, Ofgem<sup>1</sup> published a consultation letter<sup>2</sup> which invited responses in relation to proposals by Western Power Distribution (WPD) and Scottish Power (SP) to introduce new tariffs in relation to use of system (UoS) charges levied on independent distribution network operators (IDNOs)<sup>3</sup>.

Having carefully considered the proposals made by WPD and responses to our consultation we have decided to veto WPD's proposals in relation to new IDNO tariffs.

This letter briefly sets out WPD's proposal, the views of responses to Ofgem's consultation letter and the reasons for the Authority's decision.

*Background to WPD's modification proposal*

WPD's proposal introduces two new IDNO-specific tariffs, one for HV and one for LV connections. The grouping of customers for charging purposes will be set out in WPD's methodology statement which will distinguish IDNOs as a separate group. To qualify in this group more than 50% of a site's maximum demand must be due to domestic customers. The two new tariff groups are:

- Licensed distributor tariff – predominantly domestic LV connected
- Licensed distributor tariff – predominantly domestic HV connected

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<sup>1</sup> Ofgem is the office of the Authority. The terms 'Ofgem', the 'Authority' and 'we' are used interchangeably in this letter.

<sup>2</sup> 'Consultation on use of system charges to new electricity distribution licensees: WPD and SP proposals', 114/07, 8 May 2007, available on our website, [www.ofgem.gov.uk](http://www.ofgem.gov.uk)

<sup>3</sup> SP's distribution licence obliges it to publish three charging statements: the statement of use of system (UoS) charging methodology, the statement of UoS charges and the connection charging methodology. The UoS charging methodology outlines how UoS charges are calculated. SP must keep its methodology under review and propose changes that it believes will better address its licence objectives.

The proposed tariffs are calculated on the basis of new demand profiles and comprise a kWh charge only.

### *Respondents' views – Ofgem consultation*

We received 11 responses to our consultation: from IDNOs, DNOs and energywatch. Overall the responses were generally critical of WPD's proposal. A summary of key points from the responses concerning WPD's proposal is provided in the **Appendix** below.

### *General Observations*

The modification proposal relates to the charges made by a DNO to an IDNO. In general, IDNOs will be competing with DNOs to provide part of the service of distributing electricity. In doing so they will be dependent on services provided, on a monopoly or essential facility basis, by the DNO. In this context, it is vital that the DNO ensures that the charges for such essential services (use of the upstream network) are consistent with the requirements of competition law – such as avoiding "margin squeeze".

Some of the responses noted the importance of DNOs not discriminating between IDNOs and individual customers with the same aggregate load characteristics connected directly to the DNO network. In our view this is desirable but secondary to compliance with competition law requirements.

Further, lack of experience of IDNOs may make it difficult to justify assumptions about costs. In our view, this is no excuse for inaction – DNOs must ensure that in setting charges they do not restrict, distort or prevent competition in distribution. In any event, different IDNO sites are likely to have different cost impacts on DNOs. Overall, this suggests that it is important to recognise the scope for learning from experience and that it is better not to hard-wire arbitrary fixed assumptions into the methodology.

We note that WPD's justification for its proposal and several responses raise issues relating to boundary metering. We consider that boundary metering is outside the scope of this decision.

### *Ofgem's view on WPD's proposal*

We have carefully considered WPD's submission along with responses to our consultation. In coming to our decision we have considered how the proposed modification impacts on WPD's ability to better achieve their relevant objectives<sup>4</sup>, requirements under the Competition Act 1998 and our wider statutory duties.

WPD indicates that the proposal is more cost reflective than their existing arrangements in terms of better recognising the profile of IDNO demand and network costs saved when an IDNO connects. WPD also believes that by removing capacity charges for

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<sup>4</sup> The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of standard licence condition 4 of SP's licence are:

- (a) that compliance with the connection charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and by this license;
- (b) that compliance with the connection charging methodology facilitates competition in generation and supply of electricity, and does not restrict, distort or prevent competition in the transmission or distribution of electricity.
- (c) that compliance with the connection charging methodology results in changes which reflect, as far as is reasonably practicable (taking into account of implementation costs), the costs incurred by the licensee and its distribution business; and
- (d) that, so far as is consistent with sub-paragraphs (a), (b) and (c), the connection charging methodology, as far as is practicable, properly takes account of developments in the licensee's distribution business.

predominantly domestic sites and providing constant margins across all sizes of site it is not restricting competition.

In general, we consider that WPD's approach of developing charges for IDNOs based on the same model that is used to set charges for end-customers is appropriate. We consider that WPD's approach of using the same structure of tariffs for IDNOs as for end-customers reduces the risk of distorting competition. However, we have concerns about specific aspects of WPD's approach. In particular, we are concerned about:

1. The fixed assumption as a matter of methodology that 50% of the cost of the LV system is not attributable to the IDNO in its proposed LV tariff. No justification has been presented for this figure and we consider that this assumption may be too high or low in any specific case.
2. The restriction of eligibility for the new tariffs to be where domestic customers make up 50% or more of an IDNO site's maximum demand. While many IDNO sites may be wholly domestic or wholly non-domestic, it is not clear that the proposed approach would be appropriate for sites falling just either side of the 50% mark.

Hence, whilst we set merit in much of WPD's proposals we are concerned that for some IDNO sites they would result in charges or margins for IDNOs which are not reflective of costs or which distort competition.

#### *Our decision*

We have considered this proposal against the licence objectives and wider statutory duties. For the reasons set out above, we are concerned that WPD's proposals in respect of IDNO charging would in some cases result in charges which do not reflect WPD's costs and could distort competition in electricity distribution. We have therefore decided to veto the modification to the UoS charging methodology statement.

#### *Comment*

We consider that the growth of IDNOs constitutes an important change to WPD's distribution business and that there remains a risk that WPD's current charging methodology could distort competition. We would therefore urge WPD – and all other DNOs – to review their approach to charging IDNOs without delay in the light of this decision letter. We also wish to emphasise that it is the responsibility of each DNO to ensure it complies with the requirements of the Competition Act 1998 as for any other legislation.

Please contact Colette Schrier on 020 7901 7239 if you have any queries relating to issues raised in this letter.

Yours faithfully,



Martin Crouch  
Director, Distribution

Signed on behalf of the Authority and authorised for that purpose by the Authority

## **Appendix – Key points raised in responses to Ofgem’s consultation**

### Cost reflectivity

IDNOs are unhappy with the cost reflectivity of WPD’s proposal, concerned with a lack of data. One IDNO argues that WPD’s proposal produces less cost reflective IDNO margins than their existing tariffs, reducing current IDNO margins on all sites and thereby restricting the growth of the IDNO connections market. This IDNO questions whether WPD understands their costs.

Two DNOs believe that using a dedicated profile for IDNO charging is more cost reflective than current arrangements. One DNO believes that consideration of the modifications requires a more detailed understanding of the DNOs’ models with respect to costs. energywatch sets out that further cost reflectivity could mean higher charges to IDNOs and suggests further load research is necessary.

### Competition

All IDNO responses are concerned that the proposals have an impact on their margin and are concerned whether the proposals meet requirements under Competition Act 1998 regarding costs avoided and earning a return.

One IDNO is concerned that it will continue to be disadvantaged on sites that are predominantly non domestic. WPD’s current modification proposals do not cover this point.

energywatch is concerned that if IDNO margins reduce this will threaten this competition in connections. One DNO notes the number of assumptions involved in using profiles for tariff calculation determine whether the calculated charge is higher or lower than the equivalent ‘normal’ tariff. This DNO notes that this is likely to lead to claims of distorted competition by the IDNOs if their margins are reduced.

### Avoided costs

One DNO thinks that DNOs’ tariffs already largely avoid including any of the costs of the service cable and parts of the mains cable as these assets are paid for via connection charges. This DNO therefore believes that WPD’s exclusion of 50% of the LV network costs in the tariff calculation seems high. One IDNO believes the proposal does not substantiate the avoided costs on the system.

### Specific yardsticks for IDNOs

Two DNOs see WPD’s proposal to apply specific IDNO yardsticks to ‘predominantly’ domestic customers as arbitrary, and leaves the host DNO open to disputes over what constitutes ‘predominantly domestic’.

One IDNO supports separate yardsticks as more cost reflective whereas two other IDNOs do not see why IDNOs are singled out for a specific tariff, one believing that smaller samples of customers (e.g. in the case of IDNO connections) within the GSP group will have different profiles from the average.

One DNO considers that SP’s proposal to introduce three new yardsticks derived from the domestic profile class to be simpler more cost reflective and transparent than WPD’s proposed approach.

A different DNO believes that existing yardsticks continue to provide reasonable and proportionate cost signals, stating that geographic average yardsticks are more appropriate than locationally specific charges for HV and LV connected IDNOs or out of area DNOs. Two other DNOs are unsure whether singling IDNOs out for a special tariff is appropriate. One says it does not believe that the movement away from averaged tariffs would be in the interests of suppliers or end users. This DNO is concerned that more tariff classes may not help competition but brings additional complexity, and that other groups of customers may want separate tariffs as well.

One DNO argues that changes in tariff structure work better than introducing customer type tariffs. Cost reflectivity could be improved by implementing separate tariffs for each profile class 5-8 classification and, for HH metered connections, by having seasonal time of day time bands for unit charges. Another DNO ties in the issue of metering and separate tariff classes, saying that it is unclear whether separate yardsticks are needed for a particular sub-class of customers; this depends on the form of metering used and the detail available on individual load shapes.

### Tariff design

An IDNO and a DNO suggest that WPD's 50% non-domestic threshold test is not representative of its own tariff setting costs. The IDNO states that this 50% assumption should be removed as it is unenforceable as relative use may vary according to local demand and changes in commercial customer's requirement.

### Metering

One IDNO objects to boundary meters, and being charged for them, on the basis that available settlement consumption data can be used to calculate flows across the boundary and any losses associated with IDNO systems. It thinks that metering charges are disproportionate especially on small sites; restricting entry and distorting IDNO net incomes.

Another IDNO believes that boundary metering is unnecessary. This IDNO argues that it is unduly discriminatory in that if the DNO was to connect, own and operate the same network it would not require boundary metering. It also considers that the significant billing costs which DNOs say IDNO cause result from the insistence of DNOs to refuse to consider aggregated billing. It says it is not appropriate that IDNOs bear the burden of DNOs' inefficient billing solutions.

DNO responses generally prefer HH metering, else maximum demand metering. Some do not rule out use of settlement data. One questions whether this would be cost effective, stating its belief that using aggregate data would itself require changes to systems. One DNO believes that settlement data should be used for small LV IDNO connections. However, it argues that this data would need to be provided on a site by site (rather than aggregate) basis in order to facilitate the needs of system design.

### Reactive power charging

DNO responses generally agree that reactive power charging is not appropriate for domestic customers. Some DNOs argue other sites should be charged reactive power charges where they have a poor power factor, although note that this does not appear to be the case at this time. The IDNOs are against reactive power charges where they cannot recover them in their tariffs to downstream customers. One IDNO agrees with SP's proposal not to levy reactive power charges. Another argues that it is not appropriate to charge IDNOs reactive power charges as IDNOs are licensed distributors not consumers. This IDNO considers it appropriate for IDNOs to 'police' power factors of their own customers, in a similar way as DNOs do currently.