To generators, distributors, suppliers,
customers and other interested parties

Promoting choice and value for all customers

Ref: 104/08
Direct Dial: 020 7901 7194
Email: rachel.fletcher@ofgem.gov.uk

22 July 2008

Dear colleague,

Delivering the electricity distribution structure of charges project: decision on a common methodology for use of system charges from April 2010, consultation on the methodology to be applied across DNOs and consultation on governance arrangements

Summary

This letter provides a decision on the future direction of the structure of use of system charges project following our April 2008 consultation document[1]. Our decision is that a licence obligation to deliver a common charging methodology should be placed on all 14 electricity distribution network operators (DNOs)[2] in Great Britain and that this common approach be reflected in prices from April 2010[3].

Given our decision, this letter consults on how a common methodology will be determined, sets out our initial views on the pros, cons and impacts of the elements of different charging methodologies presented to us to date, and asks industry parties to comment on the relative merits of each method.

Finally, we consider it will be necessary to introduce governance arrangements for the common methodology and this letter consults on possible arrangements.

Background

Our April 2008 document set out two options for taking the structure of charges project forward, either individually by DNOs or via a common charging methodology applicable to all DNOs. Since this consultation closed we have considered responses, have spoken extensively with interested parties and have worked with DNOs to further develop a set of relevant

[1] April 2008 consultation 'Delivering the electricity distribution structure of charges project', ref 36/08, available on our website along with responses to this consultation at http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx. This consultation sets out the background to the structure of charges project and explains the various charging elements involved, i.e. demand and generator charging across EHV/HV/LV plus more detailed issues within tariffs, e.g. IDNO and reactive power charging.
[2] The 14 DNOs are owned by 7 group companies (CE, CN, EDF, ENW, SP, SSE, WPD); for further details see map published at http://www.dcode.org.uk/.
[3] DNOs' price controlled revenue totals about £3.5bn a year. The bulk of this comes from allowed demand revenue with a small proportion coming from allowed generation revenue.

principles designed to provide additional clarity over the charging methods expected of DNOs if we are to achieve the objectives of the project.

Our work with DNOs to develop the relevant principles has been helpful. However, it has also highlighted the difficulty of achieving clarity around what is required of charging methodologies through the relevant principles alone. We recognise a licence condition that requires DNOs to meet the relevant principles may place additional regulatory risk on DNOs. This, along with the strong support for common charging methodologies from suppliers and generators, are some of the reasons for our decision to put a requirement for all DNOs to adopt a particular common methodology for application by April 2010.

Given the range of methodologies being developed across the industry, and the tight deadlines for this project, we consider it necessary that Ofgem makes the final decision on the methodology for common adoption. Our consideration of different charging methodologies to date[4] has revealed issues with all current methodologies and those being developed in terms of the extent to which they meet the relevant principles. Further evolution of the common methodology will be necessary to some degree post April 2010 and for this reason we consider it is important to have appropriate arrangements in place to govern the change process for the methodology. Our further consultation at this stage is designed to seek views on governance and on which methodology should form the industry baseline.

This consultation and way forward

In this letter we ask for views on how best to achieve a common methodology across all DNOs and on what form of governance is appropriate for the methodology. Given our decision to require all DNOs to adopt a common charging methodology, this open letter:

1. explains the reasons for our decision to require a common methodology from April 2010 and consults on how to achieve such commonality;
2. consults on the pros, cons and impacts of the different charging methods developed to date, and asks for views on Ofgem's intention to choose the approach to be applied and developed as the common methodology;
3. consults on governance arrangements associated with a common charging methodology;
4. elaborates on timescales and processes for the project between now, 1 October 2009 submission and 1 April 2010 price changes; and
5. consults on the features required of any licence changes to capture commonality and governance arrangements.

We have considered responses to the April document along with further quantitative and qualitative submissions from DNOs, suppliers and generators on the merits of a common methodology. From this analysis we consider that the benefits of a common charging methodology to suppliers and generators can reasonably be expected to exceed any costs to the industry in delivering it. For example, consistency of charging treatment across GB will eliminate the possibility of siting decisions for parties connecting to the distribution network being made based on differences in approach across DNO areas. A common method will also reduce the complexity of charging, thereby reducing analytical costs across the industry. **Annex 1** to this letter sets out responses to the April consultation and the case underlying our decision for a common methodology.

Annex 2 to this letter sets out our view on the pros and cons of different charging models, our preliminary views of the associated impacts and asks for responses to this. We expect the industry in their responses to identify and quantify impacts and to provide evidence justifying their preference for specific charging assumptions over other assumptions.

[4] See for example our consultations on Western Power Distribution's (WPD) model (December 2006, document ref: 214/06), Scottish Power's model (June 2008, 86/08) and EDF Energy Network's (EDF) model in relation to its south east (SPN) network area (July 2008, 95/08), available on our website at http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx.

It remains our intention to progress the project through a collective licence modification following consideration of responses to this letter. Specifically, we propose to consider responses to annex 2 in determining the methodology for generator and demand charging across all voltage levels including reactive power and IDNO charging. In arriving at that decision we will hold discussions with the industry via a working group. We will follow this with publication of our decision and statutory consultation on the related collective licence modification. Our decision may also highlight shortcomings of the methodology which we would expect industry to address prior to 2010. We recognise that each DNO will face issues in implementing the methodology in their own network area (DSA[5]) and that we expect DNOs will work together on these implementation issues to ensure a common approach as far as possible.

We did not consult on the governance of charging methodologies in April 2008; however a number of responses to the consultation highlighted the need for formal arrangements to enable the new methodology to evolve over time. **Annex 3** to this letter sets out our initial thinking on options for governance arrangements. We believe governance arrangements are required because we would expect any methodology to develop to take account of imperfections. We note that each potential methodology variant set out in annex 2 has not been tested on every DNO network at this point in time and that issues arising will need to be tackled via evolution of the methodology. Without formal governance, each DNO may make changes that may undermine the common approach. We also consider it important that there is a proper process for considering issues raised by parties other than DNOs, for example from suppliers and generators.

Any governance arrangements will take time to develop. We indicate our envisaged timescales and processes for this work, including the development of further licence drafting and the establishment of a governance working group, in **Annex 4**. This annex also steps through proposed timescales for the project as a whole. **Annex 5** provides some indicative licence drafting covering both common charging methodologies and governance arrangements for review and debate. **Annex 6** sets out links to further information regarding the detail of charging arrangements and charging developments.

Interactions

There are various interactions between this and other projects. Delivery of this project is vital in facilitating progress towards meeting government targets on climate change, in ensuring that economic signals are provided to existing and potential users of electricity distribution networks and in enabling the efficient development of the network. We now consider that introducing a common charging methodology in the manner set out in this document will help deliver the project within the desired timeline. April 2010 is the latest possible date for concluding a step change in the cost reflectivity of use of system charges. April 2010 coincides with the start of the next DNO price control period[6] and delivery on the structure of charges project by April 2010 will enable us to consider the price control treatment of generation and demand revenue, provide more certainty that charges support DPCR5 aims of efficient network development, and further enable DNOs' role as facilitators in tackling climate change.

We also note the separate Ofgem review of industry governance arrangements. We will consider responses to this letter prior to concluding whether DNO governance arrangements will be 'fast-tracked' as part of the structure of charges project or whether they will continue to be taken forward as part of the wider review of industry governance arrangements.

In parallel to this project, DNOs have been submitting charging modification proposals to us so we may determine whether any proposal better achieves the relevant objectives set out in the

[5] Distribution services area, DNOs' original 14 network geographical areas.
[6] For price control information see http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/Pages/PriceCntrls.aspx.

licence[7]. Given our decision to implement a common charging methodology we urge DNOs to focus now on common charging arrangements going forward. While we are happy to informally consider different methodologies during this consultation phase and are keen to see the full range of proposals before making a decision on a common methodology, we request that DNOs stop submitting formal modification proposals to us.

Once we have determined a way forward we expect DNOs to put forward their proposals to achieve commonality and we seek views on the best way to achieve this. Our provisional view is that it is for DNOs individually to ensure they accord to a commonality requirement, however it is not sensible for some DNOs to implement changes ahead of other DNOs. That being said, we note the different strands of this project and urge DNOs to consider collectively delivering the project in stages. For example, commonality of charging at lower voltage levels for generation and demand along with IDNO charging could be delivered in advance of changes to charges at higher voltage levels.

Consultation timescales

We recognise that there is a significant amount of work to be done in order to achieve a common approach by DNOs across use of system charging. We are keen to communicate our decision on the specific methodology to be taken forward, subject to DNO approval of a collective licence modification, at the earliest opportunity to give sufficient time for DNOs to deliver against this common approach. This consultation is therefore limited to a 4-week period to give as much time between a licence modification being implemented and the delivery of that methodology to us prior to the revised methodology taking effect from April 2010.

Views sought

We welcome views on this consultation from interested parties, including DNOs, IDNOs, suppliers, customers, generators and their representatives **by 19 August 2008**. Wherever possible, views should be backed up with qualitative and quantitative assessments to justify the position being set out by respondents. Specifically we seek views on:

1. **whether respondents agree that we should specify the common methodology to be applied across DNOs;**
2. **the pros, cons and impacts of each model;**
3. **governance arrangements and the options set out in annex 3;**
4. **the proposed processes set out in annex 4; and**
5. **whether there are any other matters we need to consider in light of our decision on a common charging methodology.**

Responses to this letter

Where possible responses should be sent electronically to Lewis Hodgart at distributionpolicy@ofgem.gov.uk. All responses will be held electronically by Ofgem. They will normally be published on our website unless they are clearly marked confidential. Respondents should put confidential material in appendices to their responses where possible. We prefer to receive responses electronically so that they can easily be placed on our website.

Please contact Lewis Hodgart on 0207 901 7021 or at lewis.hodgart@ofgem.gov.uk if you have any queries in relation to the issues raised in this letter.

A copy of this document is available on our website under the electricity distribution charging area of work[8].

[7] Standard licence condition 13 of the distribution licence includes details of the relevant objectives that apply in respect of DNOs' charging methodologies. See annex 2 below for further details and the electricity distribution licence at http://epr.ofgem.gov.uk/document_fetch.php?documentid=13701.

[8] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx.

Yours faithfully,

Rachel Fletcher
Director, Distribution

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Annex 1 – Decision on licence condition and common methodology obligation

Introduction

This annex provides a summary of the responses received to the April 2008 consultation and sets out our decision that it is necessary to introduce a licence obligation on DNOs to ensure delivery of revised charging methodologies. It also sets out our view that a common methodology obligation is necessary.

Background

In our April 2008 document we consulted on our view that it was necessary to introduce a licence obligation on DNOs to deliver revised use of system charging methodologies that meet the required principles (set out in that document) and licence objectives by 1 October 2009. As a way of delivering this option, we consulted on two different forms that the licence condition could take:

- Option one: Place a licence obligation on each DNO to develop and have in place cost reflective use of system charging methodologies by 1 October 2009. Under this option we would expect commonality across DNOs where appropriate and to the greatest extent possible but without a formal obligation regarding a common methodology; and

- Option two: Place a licence obligation on DNOs to develop and have in place a common distribution use of system charging methodology (i.e. identical charging models across companies) by 1 October 2009.

We stated that in our view the long term benefits of introducing a common methodology would be likely to exceed the shorter term costs of delivering it, and that of the options for introducing the licence condition our preference would be option two – a common charging methodology. We did not prescribe governance arrangements for the new methodology as part of the consultation.

Consultation Responses

<u>DNO Responses</u>

The DNOs did not support the need for a licence obligation to ensure delivery of a revised use of system charging methodology by 1 October 2009. They considered that the introduction of a licence condition was likely to undermine the progress that individual DNOs were making towards delivery of revised methodologies within the existing framework. Some DNOs considered that the licence obligation would create an unnecessary regulatory risk to DNOs on the basis that in their view there was potential uncertainty over what the licence obligation entailed.

On the basis that the DNOs did not support the need for a licence condition, none of the DNOs supported either of Ofgem's options for delivering the licence condition. In general the DNOs were most opposed to the common licence obligation. Opposition to the common obligation largely related to the DNOs view that, having to varying degrees developed separate charging methodologies to date, significant costs would be incurred in having to adopt a new methodology at this stage. Following a request for further information on these costs, Ofgem has learned that they could be in the region of £500k per DNO. The DNOs also opposed commonality on the basis that the potential difficulty in reaching DNO agreement on what a common methodology should look like and that this would make the 1 October 2009 deadline more difficult to achieve. The DNOs do not appear to have a principled opposition to commonality, but they do have a number of practical reservations about it. In the responses

one DNO commented that although they did not support the need for the licence condition they could see advantages in having a common charging methodology across all DNOs.

Non-DNO Responses

There was unanimous agreement among the suppliers, generators, industry groups and IDNOs who responded that it would be appropriate to introduce a licence obligation on DNOs to deliver revised charging methodologies. Each respondent agreed with Ofgem that progress on the project had been limited, and that it was important to prioritise delivery of revised methodologies. IDNOs considered that revised charging methodologies should be implemented with the greatest urgency and ahead of the start of the next price control period. Large suppliers considered that it would be appropriate for the revised charging methodologies to take effect from 1 April 2010. One small supplier considered that since supply contracts were often three years in length, any charging changes resulting from the revised methodologies should be applied with delayed effect.

All of the non-DNO industry respondents considered that a licence obligation on DNOs to develop a common charging methodology would be the most appropriate way to take the project forward. Suppliers and generators considered that a single common methodology would be more accessible and easier to understand. They considered that this would reduce analytical costs, would make charges more predictable, and would make progressing incremental improvements to the methodology more efficient and transparent.

Two large suppliers also considered that the greater predictability and transparency that a single common charging methodology would provide would be likely to reduce the risk premium associated with charging uncertainty which they build into supply contracts. This view was supported by smaller suppliers. Following a request for further information on the extent of this benefit, it has been indicated to us that the benefits could be multiple millions of pounds per large supplier per year.

Small suppliers also considered that a common charging methodology would prevent the seemingly arbitrary impact differences in charging methodologies between different DNOs can have on charges in different DNO distribution services areas. They considered that these impacts can distort competition between small suppliers, and that different charges in different locations should reflect real cost differences rather than variations of methodology. One respondent who supported this view considered that a common methodology would reduce uncertainty and therefore promote investment.

A number of non-DNO respondents also commented on governance arrangements. These respondents considered that the benefits of a common methodology obligation would only be fully realised if the requirement for commonality was preserved on an enduring basis, and that the benefits would erode over time if this was not the case. One supplier commented that consideration should be given to extending industry governance (e.g. DCUSA[9]) to the methodology, so that the new methodology can evolve as appropriate over time. We ask for views on this in annex 3.

Ofgem's view

In our April 2008 consultation we set out our view that given the limited progress made by DNOs in implementing revised charging methodologies to date, and given the importance of ensuring delivery of the structure of charges project with effect from the start of the next price control period, it was necessary to introduce a formal licence obligation with a specific time deadline for delivery. This remains our view. Since the April consultation opened, we have

[9] Distribution Connection and Use of System Agreement (DCUSA). This is a multi-party contract between licensed electricity distributors, suppliers and generators concerning the use of the electricity distribution systems to transport electricity to or from connections to them. Licensed electricity distributors and suppliers are required to become parties to the DCUSA.

received a number of revised charging modification proposals. We acknowledge that this is a sign that the DNOs are serious about revising their charging methodologies, but we note that to date only one revised DNO charging methodology has been given a non-veto decision by the Authority. In our view, the need for a licence condition is a proportionate response to the history of the project, and should not undermine or be seen as incompatible with the efforts the DNOs are now making towards delivery.

We have reviewed the submissions received on whether a common charging methodology obligation should be introduced. On the basis that the consistent view among suppliers, generators, industry groups, IDNOs and one DNO is that the qualitative and quantitative benefits of commonality would be substantive, we consider that introducing a common charging methodology licence obligation to take effect from 1 April 2010 prices[10] is the most appropriate option. We have reached this view for the following reasons:

- A single common charging methodology across all DNOs in GB will make understanding distribution use of system charges simpler and more transparent to industry participants. This will reduce analytical costs, and will allow for a more efficient use of Ofgem and industry resources;
- A common methodology will reduce the complexity of charging for suppliers. This has the potential to reduce the charging risk premium applied by suppliers as part of their pricing structure. In a competitive market we would expect this to provide benefits to consumers running to millions of pounds a year;
- A common methodology will promote connection to particular networks based on sound economic and technical reasons rather than incentives from discrepancies of charging arrangements between DSAs;
- A common methodology will create a stable and consistent framework for IDNO investment. At the moment differences in approach between DNOs is viewed by IDNOs as restricting competition in some distribution networks; and
- A common methodology will permit future charging modifications to be developed in a more efficient, consistent and transparent basis.

In reaching this decision, we have taken on board the DNOs' concerns that commonality will result in wasted resources (where a particular DNO is required to terminate the progress of a charging model developed to date) and will result in increased costs where they have to undertake new work to implement the common methodology.

We recognise that complying with a common charging methodology obligation within the timescale may make these costs significant (although evidence submitted by DNOs to date does not suggest this is the case). However, we do not consider that work spent by the DNOs developing their individual models to date should be considered wasted because we now have a number of methodologies to chose from (including variants amongst similar approaches). In addition, the differences across the range of different methodologies could help the future development of the chosen methodology. In the long run, we consider that the annual benefits which could be realised from having a common charging methodology can very reasonably be expected to outweigh the short run costs DNOs will incur in complying with the commonality requirement.

We recognise that a significant disadvantage is that potential difficulty in reaching DNO agreement over what a common charging methodology should look like which could make timely delivering of a common methodology difficult. To address this concern we consider it is appropriate for Ofgem to make the final decision on which of the methodologies developed to

[10] Under the electricity distribution licence (SLC14 paragraph 20) this requires DNOs to provide indicative prices three months ahead of April 2010.

date should be adopted as the common charging methodology. We believe that this approach provides clarity and therefore reduces the regulatory risk DNOs have flagged to us in terms of their uncertainty over whether methodology development work will be approved by the Authority. We also consider that the DNOs are unlikely to be able to agree a common methodology between themselves in a timely manner. Further detail on the methodologies is contained in annex 2. In annex 2 we ask for views on our comparative analysis of the pros, cons and impacts of the models to inform our decision on Ofgem deciding on a methodology going forward.

Having reviewed respondents' views on the merits of an enduring common methodology obligation, we also now propose to consult on whether, having reached the decision that a baseline common methodology obligation is appropriate for delivery by 1 October 2009, it would be appropriate to implement governance arrangements which ensure commonality is preserved in the enduring period. We recognise that this was not consulted on in our April consultation document, and consider that it is appropriate to consult with industry participants now on this issue. Annex 3 contains further detail on options for charging methodology governance going forward and asks for views on these.

Annex 2 – Assessment of the pros, cons and impacts of use of system charging methodologies

Introduction

In light of the Authority's decision that a common use of system charging methodology should be adopted across the 14 DNOs in Great Britain, we now wish to consult on the options for such a methodology. As we set out in our cover letter, given the range of methodologies being developed across the industry, we consider it appropriate that Ofgem selects a methodology.

This annex considers the impacts, benefits and potential limitations of different options for a common distribution use of system charging methodology across all voltage levels. We recognise that each existing or proposed methodology has limitations and seek views on the best methodology, in aggregate, to take forward on a common basis to provide a common baseline. As a means of informing consultation and assessment of the methodologies we have sought to break down each element of the charging methodology into key areas.

These areas are designed to provide a framework to inform the selection of the most appropriate approach at this time for a common use of system charging methodology for each area. As set out in our letter, every variant of the methodology in each appears to have some areas for improvement and development. In considering views on each of these areas we propose to identify areas for development by April 2010 (captured by the licence obligation requiring a common approach) along with areas for development post-2010. The pros, cons and impacts suggested here should not be seen as indicating a firm Ofgem view on any modification proposals currently submitted to us for consideration.

Background to modification and assessment framework

DNOs are required to keep their use of system charging methodologies under review and to bring forward proposals to modify the methodology that they consider better achieve the relevant licence objectives[11]. This has been the primary framework for the development and assessment of use of system charging methodologies[12].

The structure of charges project, started in 2000, to review the structure of charges levied by electricity distribution businesses has also been driven by some wider goals, including:

- to protect the interests of customers by developing robust long-term charging structures to facilitate competition in the generation, distribution and supply of electricity; and

- to ensure that DNOs provide appropriate incentives to their customers to encourage the efficient use of their networks.

Work to date on the project has attempted to identify and develop enduring charging methodologies at all voltage levels (EHV, HV & LV[13]) to better meet the relevant objectives and to address these wider goals. Recent work has focused on the introduction of more cost

[11] The relevant objectives for both the connection and use of system charging methodologies, as contained in paragraph 3 of SLC13 of the distribution license respectively are:
- that compliance with the use of system charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Act and by the licence;
- that compliance with the use of system charging methodology facilitates competition in the generation and supply of electricity, and does not restrict, distort, or prevent competition in the transmission or distribution of electricity;
- that compliance with the use of system charging methodology results in charges which reflect, as far as is reasonably practicable (taking account of implementation costs), the costs incurred by the licensee in its distribution business; and
- that, as far as is consistent with the sub-paragraphs above, the use of system charging methodology, as far as is reasonably practicable, properly takes account of developments in the licensee's distribution business.

[12] The Authority must also assess any proposals in the context of its wider statutory duties.

[13] Extra high voltage, high voltage and low voltage.

reflective charges for EHV-connected customers[14], independent distribution network operators (IDNOs) and generators at HV/LV.

We have previously noted that some changes to the existing distribution reinforcement model (DRM) may be needed to accommodate generator charging. There has been some divergence among DNOs over the application of the DRM since it was introduced in the early 1980s. We also note that the structure of end tariffs differs across DNOs: our April 2007 update letter[15] on the project urged DNOs, amongst other things, to consider charging products and structures.

Principles

The principles for the structure of charges projects are well rehearsed in various documents published on our website in 2000 and from 2003 to 2008[16]. As well as developing methodologies to better meet the relevant objectives under SLC13, Ofgem and the DNOs have identified a set of high-level principles for the project. These principles are: cost reflectivity, simplicity (at point of use), transparency, predictability and facilitation of competition.

Following our April 2008 consultation document, recent discussions between DNOs and Ofgem have sought to develop these principles further to highlight that a charging methodology should:

- include all relevant information;
- apply to both demand and generation;
- reflect all significant cost drivers;
- minimise the distortion of price signals where any adjustment or scaling of charges is necessary to ensure recovery of allowed revenue;
- recognise incremental costs and benefits on a forward-looking basis by virtue of users' use the distribution system;
- ensure that charges for EHV users vary by location and utilise power-flow modelling at the EHV level; and
- be transparent and predictable to allow network users to estimate future charges.

It is agreed that there is an inevitable tension between some of the objectives and principles for use of system charges, and that the development of a use of system charging methodology is a balancing act between a number of competing principles.

Common methodology

The use of system methodology comprises various elements, as set out in table 1[17]. We are consulting to establish respondents' views on the pros, cons and impacts of the various approaches in each of these areas with a view to the Authority determining the most appropriate approach going forward in each case and identifying areas requiring further work prior to 2010.

In table 1 below we outline the key features of each of these methodologies followed by the expected impacts, pros and cons from its application as a common use of system charging methodology. As part of this consultation, we welcome views and further evidence on the suitability of each of these models for a common use of system charging methodology for the

[14] We are currently consulting on proposals from EDF concerning EHV charging plus HV/LV generator charging, and SP concerning IDNO charging plus EHV, HV and LV charging for demand and generation customers. See footnote 4.
[15] April 2007 update letter: 'Structure of electricity distribution charges: update on progress and next steps', ref 78/07, available on our website at http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx.
[16] See http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx along with charging modification proposals at http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx.
[17] An asterisk (*) in table 1 denotes where an approach has previously been submitted and has been not vetoed by us. Our comments on DNOs' baseline (April 2005) methodologies are published on our website along with all modification proposals since April 2005. Where there is no asterisk next to an approach, methods are described in terms of our understanding of approaches currently under development.

14 DNOs in Great Britain. Links to further detailed information on charging are provided in annex 6 below.

Table 1: Elements of Use of System Charging Methodologies

Element	Current approaches
Cost models	
EHV models[18]	SSE, SP and CN G3 FCP approach WPD LRIC approach* EDF LRIC approach ENW hybrid LRIC/ICRP approach
HV/LV demand model	DRM[19]* Cost allocation using RRP[20]
HV/LV generation model	G3 approach WPD approach EDF approach ENW approach
Revenue adjustment	
Revenue reconciliation/ cost allocation	Fixed adder approach* Multiplier for DRM* G3 cost allocation plus fixed adder
Tariff structures	
Tariff structures and other detail	End tariff structures vary across all DNOs Some definitions vary across DNOs, e.g. capacity.

Source: Ofgem

Tables 2, 3 and 4 below provide a summary of the expected impacts, pros and cons from the application of each use of system charging methodology model element shown above. We have discussed commonality more generally in annex 1.

We note that the tables are designed to highlight the relative merits and impacts of alternative approaches rather than to be a summary of every issue raised since the start of the structure of charges project. We welcome respondents' views on the pros, cons and impacts considered below along with any further thoughts on the relative merits of each approach.

[18] We note that DNOs have presented models to us containing links between EHV and HV/LV models and that G3's proposal uses the same method for EHV and HV generator charges. See annex 6 for links to further information.
[19] For the methodology to be common going forward we will need to set out a specific DRM approach as DNOs' methods have diverged since the DRM was implemented in the 1980s.
[20] Regulatory reporting pack, disaggregated price control-related information provided to Ofgem annually.

Table 2: Impacts, pros and cons EHV level models

EHV Level Models			
	LRIC (WPD, EDF & CE)	**FCP (G3: SP, SSE, CN)**	**LRIC / ICRP (ENW)**
Pros			
1.	Simple cost reflective method to value spare capacity on the EHV level network	Robust empirical approach to forecast and charge for EHV level costs that are likely to be incurred over next 10 years	Dual pricing approach that relates future reinforcement cost to nodal increments
2.	Enhanced cost reflectivity from utilising power flow modelling	Enhanced cost reflectivity from utilising power flow modelling	Enhanced cost reflectivity from utilising power flow modelling
3.	Flexibility for future development	Extensive use of publicly available information	Potential development to LRIC for modelling the pattern of lump investment
4.	Significantly improved cost reflectivity with strong incentives to promote economic efficiency	Improved cost reflectivity to promote economic efficiency	Nodal charging with clear economic signals
5.	Strong locational message from nodal study	Cost drivers are extensive (include fault levels)	Strong locational message from nodal pricing
6.	Treats demand and generation the same	Potential practical and transparent approach to the uncertainty of DG connections	Treats demand and generation the same
7.	Model implemented in two DSAs	Model developed for six DSAs	
Cons			
1.	Potentially less stable tariffs	Weak forward-looking message	Model still in development and would require significant industry wide evaluation.
2.	Sharp incremental cost signals on low growth / highly utilised network assets	Weak locational message with average pricing within each network group	
3.	Use of an annuity factor	Model considers assets above 87% utilisation only	
4.	Fault level costs are not included	Different approach for generation charging and demand charging	

EHV Level Models			
	LRIC (WPD, EDF & CE)	**FCP (G3: SP, SSE, CN)**	**LRIC / ICRP (ENW)**
Impacts			
1.	*Efficiency of decision making*		
	a) Strong locational signals from nodal charges	a) Weaker locational signals from zonal charges	Similar impacts to LRIC expected
	b) Less tariff stability	b) More tariff stability	
	c) Long term forward cost signals	c) Forward cost message limited to 10 years	
2.	*Competition assessment*		
	a) Positive impacts for competition, particularly for the connection of cost efficient DG, from more cost reflective tariffs		
	b) Potential suppliers / IDNOs / generators provided cost signals on nodal basis	b) Potential suppliers / IDNOs / generators provided cost signals on network group basis	Model in early development so unable to accurately assess impacts
	b) Possible negative impacts on competition from more volatile cost signals	c) More stable long term cost signals	
3.	*Suppliers*		
	a) More cost reflective EHV and lower voltage level tariffs from power flow incremental cost study		
	b) Potential for DUoS charges to change at nodal locations	b) Potential for DUoS charges to change at network group locations	b) Potential for DUoS charges to change at nodal locations
4.	*Generators*		
	a) Potential for negative charges where UoS facilitates the deferral or avoidance of future reinforcement costs		
	b) Valuation of generator costs and benefits consistent with demand	b) Valuation of generator costs and benefits are different to demand. Model assumes different cost drivers are relevant for generators	b) Valuation of generator costs and benefits consistent with demand

Table 3: Impacts, pros and cons HV/LV level demand models

HV / LV demand models		
	DRM	**Historic RRP Cost Data**
Pros		
1.	DRM has been used to calculate lower voltage level charges since the 1980s	A transparent and simple model for network users to understand
	Application as part of a common methodology would maintain the status quo for lower voltage level cost modelling	
2.	Forward looking incremental cost model	Potentially delivers stable and predictable charges that reflect medium-term cost trends
Cons		
1.	Various forms of the DRM are currently used by DNOs	Reliance on historical trends to forecast future network developments
	Application as part of a common methodology would require a single approach to be developed and agreed by DNOs	
2.	Currently less predictable and transparent relative to the proposed use of historical data as based on 500MW increment cost modelling that is unavailable to network users	Potential for fluctuations between yearly RRP data which may lead to volatility
	Users would be able to better understand future charges if there was public access to cost modelling	
Impacts		
1.	Industry wide development of a common DRM	Industry wide revision to how HV / LV demand charges are calculated
2.	No significant developments for competition	
3.	Better understanding of future charges provided public access to cost modelling	Users will potentially be able to estimate future charges provided public access to RRP data and cost modelling

Table 4: Impacts, pros and cons HV/LV level generation models

HV / LV level generation models				
	WPD	**EDF**	**ENW**	**G3**
Pros				
1.	Each of the models significantly develops existing methodologies and recognises the contribution that appropriately sized and sited generation can have for system security and the deferral of network reinforcement costs			
2.	All the models apply transparent practical approaches to value the costs and benefits of generators connected at lower voltage levels			
3.	Already some commonality in approach. Different assumptions regarding DG contribution to system security but all three models are based on similar principles relating to offset demand and generator coincidence with system peak			Use of industry standard (P2/6 statement) to assess generator contribution to system security
4.	A simple approach for potential generator connections to assess likely charges (credit)			Extensive use of public documents
Cons				
1.	Simplification of the P2/6 criteria and differences would need to be addressed			Only recognises generator benefits where higher voltage FCP demand costs are not zero
Impacts				
1.	A more broad-brush generic assessment of generator benefit across DSAs relative to use of P2/6 statement			Use the same generation reinforcement model for EHV levels
2.	Generator will receive a yardstick credit where its load factor is greater than 60 per cent	Generator will receive a yardstick credit based on its tariff group coincidence factor. Time band charging is also used for all generator tariff groups	Generator will receive a yardstick credit based on 0.7 (0.3) coincidence factor where a generators load factor is greater (less) than 50 per cent	More extensive assessment of HV generator costs relative to other DNO models

System wide impacts

The choice of models that are used as part of a common use of system charging methodology can be expected to have significant impacts across DSAs in the UK. However, the introduction of revised charging arrangements can also be expected to provide more generic system wide impacts. These impacts are discussed in the subsections below.

Environment

While we have not attempted to quantify the environmental costs and benefits from the proposed elements for a common UoS charging methodology, a qualitative evaluation suggests that charging frameworks which accurately reflect locational costs and a customer coincidence to peak demand encourage high utilisation of the network at all times and at all locations. This in turn would generate benefits to the environment and may also lead to lower fixed losses associated with network equipment.

We note that the G3 FCP model provides weaker locational signals relative to other nodal based EHV models. However, this is balanced against more stable charges provided by the G3 FCP model which may also encourage users to respond to economic signals. Dependent on the relative importance of locational signals and the stability of charges, the long term environmental benefits can be expected to differ for a common UoS charging methodology.

Similarly, more cost reflective charges for generators and the recognition of generation benefit is expected to encourage more distributed generation to come from renewable, low carbon sources.

While the various approaches for generator charging all recognise the benefits from distributed generation, we note that different approaches attribute different benefits to customer groups. For example, EDF propose to use time bands and tariff group coincidence factors to value generator benefit at lower voltage levels. In contrast, G3 propose to attribute costs and benefits to generators at lower voltage levels.

Security of supply

Electricity distribution networks are designed to meet security standard P2/6. Where possible, a common methodology should use P2/6 in the power flow model to both determine reinforcement needs and identify the reinforcement types. Using P2/6 in this way is likely to ensure the charging methodology improves the security of supply.

Health and Safety

We consider that the effects of this proposal have no health and safety implications.

Risks and unintended consequences

Risks can arise if methodologies containing assumptions regarding emerging industry trends are implemented and these trends are subsequently not realised. We note that, where possible, the G3 EHV / HV / LV cost models has based assumptions on industry standards such as P2/6, the LTDS and RRP data. In contrast, other cost models do not make as substantive use of these industry standards.

DNO costs

The industry in general is not expected to incur significant additional costs from implementing a common charging methodology. However, we note that a number of DNOs have already developed use of system charging models that are significantly different.

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The elements of the methodology that are adopted will result in some DNOs incurring costs from development of a common methodology. The G3 model has been developed across six DSAs at all voltage levels while other cost models and tariff structures would need to be developed on a more industry wide basis.

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Annex 3 – Consultation on governance arrangements

Introduction

This annex sets out three high level options for governance of the common charging methodology following its implementation. Each of these options seeks to put in place arrangements which will ensure that a) commonality of approach is not eroded over time by modifications made by individual DNOs; and b) there are processes in place to allow parties other than the DNOs to raise change proposals to the methodology.

In developing these options we have been mindful of the fact Ofgem is currently carrying out a comprehensive review of industry code governance arrangements across the gas and electricity sectors[21]. We have sought to ensure that the options considered as part of this consultation are compatible with the options being reviewed as part of this wider piece of work. To this effect we consider that it is important that the governance arrangements considered take account of the better regulation principles of promoting transparency and better understanding of the development of charging methodologies for users, and promoting accountability among network owners for the methodologies they apply.

We also aim to put in place arrangements that streamline the modification processes and make best use of resources in the industry and Ofgem. We seek views from the industry on possible streamlining, for example the potential for some elements of self governance and consideration at a predefined time of year of modification proposals that have an impact on prices.

We consider that, should common governance be supported by respondents, it would be sensible to develop distribution use of system governance arrangements alongside the structure of charges project. We note that an alternative approach would be for these issues to be addressed through the wider codes governance review.

Options

Option 1 – Industry code governance

In this option, the common use of system charging methodology would be subject to the DCUSA governance arrangements. In a departure from current practice, this would mean that suppliers as well as network operators would be able to raise modification proposals to the methodology. The benefits of this approach would be that it would provide users with greater ability to contribute to the development of the charging methodology, and that it would take account of an existing industry framework with an already established appeals mechanism[22].

To bring the governance of the common charging methodology within the DCUSA regime would require a two stage process; the DNOs' licences would have to be modified to reference the code governance arrangements; and a modification proposal to the DCUSA would have to be raised to install the common methodology governance within the code. Under this option, following installation of a common charging methodology obligation within the DNO licence, we would expect industry parties to meet to develop the detail of the governance arrangements contained in the DCUSA modification proposal. We note that the relevant objectives set out in the licence (SLC13) differ from the DCUSA objectives. We will need to consider this should option 1 be taken forward.

As noted above, a sub-option would be to do nothing now and to allow this option to be considered through the wider review of codes governance.

[21] See code governance review at http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx.
[22] BERR has consulted on this (see http://www.berr.gov.uk/files/file40898.pdf) and their document suggests they are minded to designate the DCUSA for the purposes of appeals under the Energy Act, however they are yet to publish their decision on this.

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Option 2: Modify the current DNO licence

SLC13 of the electricity distribution licence sets out the requirement on licensees to establish and review their charging methodologies, and sets out the modification process for making changes to methodologies. Under this option we would seek to modify SLC13 to include within the condition that any modification proposal should apply to the common charging methodology, unless otherwise directed by the Authority. To make this work, DNOs would need to propose collective modification proposals. The licence may need to place an obligation on DNOs to consult with other parties before submitting a formal modification proposal to the Authority. This would be especially useful where DNOs cannot agree a collective approach. To ensure greater industry access to charging methodologies, under this option we would also propose that the modified condition would set out formal obligations on licensees to consider and formally respond to change proposals submitted by non-DNO industry parties, including holding industry forums, carrying out Impact Assessments and bringing forward charging methodology modification proposals where appropriate.

Option 3: New Charging Methodology Code

The governance arrangements envisaged under this option would be delivered via a standard set of modification rules. The potential benefit would be that in developing a new code, the governance arrangements could be tailored to precisely meet the requirements of a common charging methodology. In some ways this is similar to those delivered by putting the governance of the common charging methodology within the DCUSA. The potential downside of this option would be that development and introduction of a new code would have significant cost implications for industry parties and this could be viewed as economically inefficient for the number of modifications reasonably expected to be proposed to the common charging methodology.

We seek views on these options. We note that a potential downside of allowing parties other than DNOs to raise proposals is that, due to the asymmetry of cost information between suppliers and network operators, modification proposals could be brought forward based on inadequate information about cost structures. Negative impacts of potentially inappropriate modification proposals would be mitigated by the Authority's power to veto proposals which do not better meet the relevant methodology objectives set out in SLC13 or relevant code objectives, but if the arrangements promoted the development of number of inadequate modification proposals this could be viewed as an inefficient use of regulatory resources.

A proposed timeline for delivery of each of the options is contained in annex 4 which provides for a working group to consider detailed governance arrangements should respondents back this approach. A discussion of the licence conditions associated with common governance arrangements is contained in annex 5.

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Annex 4 – Timescales and processes

The following table provides an indicative timeline for delivery of a common charging methodology by the DNOs and formal governance arrangements consistent with new charges taking effect from 1 April 2010.

We seek views on the timescales and suggested tasks / processes set out in this table.

Tasks	Date
This consultation closes	19 August 2008
Licence drafting work group	21 August 2008
Licence drafting work group	28 August 2008
Ofgem decision on form of common charging methodology	September 2008
Statutory consultation on licence condition	September 2008
Ofgem to consider responses to statutory licence consultation	September/October 2008
Ofgem to issue licence modification to licensees and implement licence condition	October 2008
Industry to establish common methodology implementation working group, including Ofgem observer	October 2008
Working group to appoint consultants if deemed necessary	October 2008
Industry to establish working group to agree detail of governance arrangements for common methodology	October 2008
DNOs to meet with Ofgem to formally discuss progress in implementing common charging methodology and governance arrangements	February 2009
DNOs to meet with Ofgem to formally discuss progress in implementing common charging methodology and governance arrangements	April 2009
All DNOs to submit modification proposals to Ofgem consistent with common methodology requirement along with full set of illustrative prices	1 October 2009
DNOs publish indicative prices on basis of common methodology	31 December 2009
Implementation of common charging methodology	1 April 2010

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Annex 5 – Suggested features of amendments to the distribution licence

Introduction

In this annex we set out our views on the features of a common methodology obligation in the distribution licence. We also set out the features we anticipate would be required of a governance framework. We welcome views on these features. We will determine our next steps on the most appropriate drafting following consideration of responses to this consultation letter and further development of licence drafting through working groups.

Background

Following the April 2008 consultation the DNOs attended three licence drafting working groups concerning the relevant principles[23]. The relevant principles set out in the April consultation were designed to provide additional guidance and clarity in addition to the relevant objectives set out in SLC13. The licence drafting working group discussed and amended the principles and associated licence drafting. DNOs agreed that should this licence drafting be implemented it should be captured in a new licence condition in section B of the licence. Section B applies to DNOs as Distribution Services Providers and not to IDNOs or DNOs' out of area networks.

We set out below and request views on:

1. the principles for licence drafting required under commonality where the Authority determines the appropriate approach going forward;
2. possible licence drafting on governance will depend on responses to this letter. We have asked for views on this in annex 3 and set out below the principles any licence drafting might take.

In addition, we welcome views on the licence drafting working group's suggested amendments to the relevant objectives in SLC13 paragraph 3 as follows, to:

- reflect the need to incorporate Interconnector arrangements in 13.3(b); and
- reflect that the reference to costs incurred in 13.3(c) of the licence could usefully refer to costs 'which have been incurred, or are reasonably expected to be incurred'.

Suggested features of licence drafting

1. The Authority selects a model that will form the basis for commonality

Under this scenario we envisage the features of the licence would be as follows:

- the Authority will specify the methodology to be applied by reference to the approaches consulted on in annex 2 prior to statutory consultation on amended/new licence conditions;
- a new licence condition, SLC50[24], would need to apply to DNOs such that the selected methodology is in place across DNOs in time for implementation in April 2010 prices. Illustrative timescales for this work are set out in annex 4;
- the licence will need to specify the methodology to be applied by reference to a Authority decision setting out the detail of the methodology;
- each DNO would then need to apply the specified approach in their DNO area. This methodology would become the common use of system charging methodology in place for charges from 1 April 2010;
- the licence would need to recognise that in specific (and previously unforeseen) circumstances a DNO-specific treatment may be appropriate to an area of detail within the specified methodology. DNOs would need to inform us of any such 'tweaks' that have

[23] See Annex 2 to this letter for more detail on the relevant principles.
[24] The distribution licence currently contains standard licence conditions 1 to 49.

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been applied. The Authority would then need to approve how each DNO is applying the methodology in its area;
- once the common methodology is delivered, SLC 50 will fall away;
- SLC 13 will need to be amended at the same time as SLC50 coming in to reflect that a common methodology will endure going forward. For example, current references to a 'Use of System Charging Methodology' will be replaced with a 'Common Use of System Charging Methodology' in relation to DNOs; and
- IDNOs may require specific provisions in SLC13 but IDNOs would be expected to have identical use of system methodologies amongst themselves.

2. Common governance arrangements

We are consulting on governance arrangements as detailed in annex 3. There are various options for taking this forward. Features of a licence condition on common governance could be:

- the development of governance arrangements would need to be captured in the licence, potentially in a new licence condition, SLC50 along with SLC13;
- licensees would be required to develop collective governance arrangements by a specified date, say 1 October 2009;
- the licence would specify that the governance arrangements must protect the commonality of charging methodologies across DNOs from 1 April 2010 onwards;
- the arrangements should be acceptable to the Authority and will need to be published, for example in an industry code;
- these arrangements are likely to need to take effect slightly in advance of April 2010;
- they should allow all industry parties to raise modifications and issues for consideration (as consulted on in annex 3);
- they should allow detailed discussion of charging modifications by industry parties prior to formal modification submission. This will enable parties' positions to be clarified prior to any formal modification submissions including whether DNOs hold a collective or individual position on each potential proposal;
- the procedure for DNOs to make modifications to use of system methodologies under SLC 13 will need to change on an enduring basis; and
- any changes to the governance arrangements would need to be agreed by the Authority and/or industry parties.

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Annex 6 – Links to supporting information

This annex sets out links to published supporting information which we consider will be useful for respondents to consider in determining the pros, cons and impacts of the various charging methodologies under discussion.

Ofgem structure of charges documents and consultation responses

Available on our website at:
http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx.

Charging modification proposals

Available on our website at:
http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx.

Ofgem code governance review

Available on our website at:
http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx.

EHV models

- G3 approach (SSE, SP, CN)

SP's modification proposal and past consultation, plus Frontier Economics and Reckon reports:
http://www.scottishpower.com/StructureOfChargesProjectG3.htm.

Our consultation on SP's modification proposal, including detailed step-through of model, impact assessment and issues:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=432&refer=Networks/ElecDist/Policy/DistChrgMods.

- EDF LRIC approach

EDF's third consultation on proposed LRIC model:
http://www.edfenergy.com/hold/regulatory/downloads/edfenergynetworks-consult-uos-chargingmethod-no3.pdf and responses to EDF's third consultation:
http://www.edfenergy.com/hold/regulatory/downloads/edfenergynetworks-conclusion-consultation3-uos-chargingmethod.pdf.

Our consultation on EDF's modification proposal, including detailed step-through of model, impact assessment and issues:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=456&refer=Networks/ElecDist/Policy/DistChrgMods.

- WPD LRIC approach

WPD's LRIC proposal:
http://www.westernpower.co.uk/servercode/showdocument.asp?ID=260.

Our consultation on WPD's LRIC proposal:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=86&refer=Networks/ElecDist/Policy/DistChrgMods.

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Our decision on WPD's LRIC proposal: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/16856-2007.pdf.

- CE LRIC approach

CE has presented updates on its LRIC development work to the distribution charging methodologies forum (DCMF). DCMF slides are available at: http://2008.energynetworks.org/distribution-charging-methodol/. For example, CE presented their approach at the April 2008 DCMF meeting: http://www.energynetworks.org/regulation/PDFS/DCMF/6thDCMF.zip.

- ENW ICRP/LRIC approach

ENW's approach was presented to the 2007 CIRED conference: http://www.cired.be/CIRED07/pdfs/CIRED2007_0336_paper.pdf and at the structure of charges implementation steering group (ISG) and DCMF meetings, for example: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/15357-2%20UU%20ISG%20presentation%205%20Sept%202006.pdf.

HV/LV demand models

- DRM

CE's DRM model proposal including report on DRM by DLT Consulting: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/15818-Methodology%20proposal%20-%20v12.pdf.

Other DNOs' approaches are set out in their use of system charging methodologies. Links to these are provided on our website under 'Further resources' at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx.

- RRP approach

SP's G3 proposal incorporates changes to HV/LV demand charging: see (as above) http://www.scottishpower.com/StructureOfChargesProjectG3.htm and http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=432&refer=Networks/ElecDist/Policy/DistChrgMods.

HV/LV generation models:

- G3 approach (SSE, SP, CN)

As above, see SP's modification proposal and past consultation, plus Frontier Economics and Reckon reports: http://www.scottishpower.com/StructureOfChargesProjectG3.htm plus our consultation on SP's proposal http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=432&refer=Networks/ElecDist/Policy/DistChrgMods.

- EDF approach

See our consultation paper on EDF's modification proposals: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/DCMF%20HV-LV%20Generation%20charging%20workshop%20discussion%20paper%20-%20EDF%20Energy%20Networks.pdf; also see section on HV/LV generator charging in our consultation paper on EDF's modification proposal:

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http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=456&refer=Networks/ElecDist/Policy/DistChrgMods.

- WPD approach

WPD consultation on HV/LV generator charging http://www.westernpower.co.uk/servercode/showdocument.asp?ID=344 and draft modification request for comment: http://www.westernpower.co.uk/servercode/showdocument.asp?ID=343.

- CE approach

CE presented their approach at the April 2008 DCMF meeting: http://www.energynetworks.org/regulation/PDFS/DCMF/6thDCMF.zip.

- ENW approach

ENW's approach is contained within a modification proposal submitted to Ofgem on 17 July 2008: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=467&refer=Networks/ElecDist/Policy/DistChrgMods.

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