

## **Structure of Electricity Distribution Charges**

### **Ofgem April 2004 Consultation**

#### **Comments made by RWE Innogy plc**

##### ***Introduction***

1. These comments on Ofgem's consultation on its April 2004 proposals for the structure of distribution charges and the accompanying Distribution Licence modifications are made on behalf all RWE Innogy companies including npower Ltd. The comments follow the order of the issues raised in the consultation paper for ease of reference.

##### ***Proposed Licence Modifications***

2. Placing an obligation on distributors to produce a charging methodology statement that must be approved by the Authority is a welcome development in determining distributor charges. However, we are concerned that the timetable<sup>1</sup> proposed for the approval of the methodologies will make it difficult for suppliers to review their pricing policies in a timely way for the April round of contract renewals for the I&C market.
3. The reasons for the protracted nature of the consultation on the initial methodologies are appreciated but it would be helpful if the Authority could indicate its approval for the major principles that will underpin the methodology statements at the beginning of October 2004. This would enable suppliers to make informed judgements about the likely structure of the charges well before the start of the shorter notice period that is now proposed for revisions to DUoS charges likely to coincide with the start of the new price control period.
4. We do not believe it appropriate that Ofgem should exercise its discretion in deciding which methodology changes should be consulted upon<sup>2</sup>. We can envisage that some proposed methodology changes might have consequences that may be difficult to foresee. To ensure that all possible outcomes have been contemplated we would suggest that the views of market participants should be canvassed for all proposed changes. If the review of the methodology statements were to be made annually, albeit with the option for more frequent changes if necessary, then consulting on all proposed changes in a single consultation should not prove any more

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<sup>1</sup> Paragraph 2.4 indicates that Ofgem's current thinking is that the methodologies will not be approved before the end of 2004 thus leaving the distributors only the minimum period of 3 months to advise the new tariff levels that will come into effect from 1 April 2005.

<sup>2</sup> Proposal in paragraph 2.7.

cumbersome than only choosing those matters that Ofgem deem most important.

### ***Electricity Distribution Rebates***

5. We do not share Ofgem's confidence that reducing the notice period for providing indicative distribution charges from 5 to 3 months will enable distributors to react more quickly to external events likely to impact the revenues they are permitted to recover under their price controls<sup>3</sup>. The main influence on a distributor's revenue is likely to be the severity of the winter weather. Since this will not be known until February reducing the notice period for a change that will take effect on 1 April from the end of October to the end of December would not seem to be of much assistance in improving a distributor's forecast of its annual revenue. Certainly it creates significantly larger risks for suppliers who will need to cover these risks in the margins they build into their prices.

### ***Interim Arrangements – Charging Methodologies***

6. As noted above we do not believe it would be appropriate for Ofgem to decide which proposed changes to the charging methodologies should be candidates for consultation. Ofgem's concerns over the efficiency of the process could perhaps be addressed by introducing the idea of primary and secondary issues. Primary issues would be fully consulted upon whilst secondary issues would be automatically adopted or rejected as indicated by Ofgem unless a user responded to the consultation. This would enable housekeeping changes and similar to be incorporated into the methodology statement with a minimum of bureaucracy.
7. Ofgem might also streamline the consultation process by contemplating reducing the number of active Distribution Licences where Licences are held by a single organisation. This would also help ensure a congruence of charging methodologies.

### ***Guidance for DNO methodologies***

8. We should like to develop our comments on the approach proposed in Appendix 2 for guidance on the connection charging boundary rules further through our membership of the ISG. Broadly what is proposed would appear a pragmatic approach in that it seeks to make connection charges shallower, whilst still retaining some semblance of locational signals through the connection charge. The LRIC approach that is contemplated as an enduring solution will presumably seek to replace the locational signals of the connection charges to some extent with nodal use of system charges that provide similar economic siting messages.

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<sup>3</sup> Paragraph 2.14

9. The draft guidelines indicate that O&M charges in respect of connection assets would be recovered through use of system charges. If this is intended then the same arrangements should apply to both generation and load to ensure comparable treatment for both types of user.

### ***Initial approval of charging methodologies***

10. As we have noted above it would be helpful if Ofgem could provide provisional approval of the outline proposals for the charging methodologies in October. This would enable suppliers to form a view on how charges are likely to be structured since final approval of the methodologies is unlikely much before the end of calendar 2004. This might also help distributors achieve congruence in their methodologies.

### ***Generation use of system charging***

11. We are not persuaded that the current “deep” connection charging arrangements does create the barrier to entry for embedded generation that Ofgem suggests<sup>4</sup>. If costs are known in advance then generally the financing of schemes will be easier to achieve than if an estimate of future charges must be made against a backcloth of uncertainty in the future structure and level of charges.
12. Predictability of charges, which is suggested as a key criterion<sup>5</sup>, would be possible if distributors were prepared to enter into long term arrangements for use of system charges that moved in a predictable fashion. Of course such an approach would have implications for the price control which would have to be fashioned to accommodate such arrangements.

### ***Billing issues***

13. The present arrangements between embedded generators, their suppliers and the local distributor are currently subject to a number of confusions and inconsistencies. The charging methodologies must clarify these as well as perhaps permitting generator distribution charges to be applied directly to the embedded generator.
14. At present the DUoS charges for the supply made to an embedded generator’s site can include charges that originate under the connection agreement. The connection agreement will generally be primarily concerned with the export of power from a site and thus cover circumstances with which the supplier to the site load is not concerned. The arrangements can become even more confused if the export is purchased by another supplier, or the

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<sup>4</sup> Paragraph 3.26

<sup>5</sup> Paragraph 3.29

NFPA as an intermediary. The distributor's charging methodology will need to be based on a clear understanding of the various contractual rights and obligations that can exist for generators connected to a distribution system.

### ***Power Factor***

15. We agree that connected parties should be encouraged to operate their connections, whether they are for demand or generation, efficiently. However, this does not necessarily mean that it must be at a power factor that is close to unity. The optimal power factor of a connection will depend on the natural reactive gains and losses of the local system. In the case of many loads this may well be for the power factor to be close to unity. In the case of some forms of generation, though, the generation may be capable of compensating the system and thus reducing the overall system costs by operating at power factors away from unity. These considerations generally argue not only for reactive power charges to be based on relevant economic criteria, but also for plant that is capable of providing reactive compensation to be rewarded for the compensation it can offer as an ancillary service.
16. The approach currently taken to framing reactive power charges, to the extent that it is apparent, appears to assume that the system capacity must be increased in order to accommodate the reactive power associated with poor power factors. This is overly simplistic, and if it were appropriate it would indicate that the distributor was not discharging its obligation to develop the system efficiently. Charges for reactive power should reflect the lower of the cost of the capacity of the system that was utilised as a consequence of the poor power factor, or the cost of providing reactive compensation locally. Only when the user is exposed to this price signal will the economic choice be made between taking up unutilised capacity and the provision of local capacitors.

### ***Tariff Support Allowance and O&M***

17. We would support the general principle concerning tariff support in respect of connection charging<sup>6</sup>. We would also welcome greater transparency in this area in respect of competition in connections. Competition in connection can readily be frustrated by the opacity of the associated charging arrangements. The new charging methodology statements should have a section devoted to the treatment of connections provided competitively so that clarity can be brought to what is often a confused situation.

### ***Longer term framework***

18. There is much work to be done to devise models that can be used practically to devise LRIC based tariffs for both generation and demand. The ISG is

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<sup>6</sup> Paragraph 3.39

clearly the forum for this but it might be useful if some preliminary high level concepts could be described before distributors finalise their interim charging methodology statements. This might help mitigate the disruption that might otherwise occur when the transition from an allocation approach to an economic basis is contemplated.