

Our Ref 18.0/PM
Your Ref

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Date 7 May 2004

Dear Mark,

STRUCTURE OF ELECTRICITY DISTRIBUTION CHARGES
UPDATE DOCUMENT AND LICENCE MODIFICATIONS

I am writing to you, on behalf of our three licensed distribution companies, regarding the update document recently published by Ofgem on the structure of electricity distribution charges. That document included a statutory notice to initiate a collective licence modification procedure under section 11A of the Electricity Act 1989 in relation to certain standard conditions of the distribution licence.

We are pleased to see continuing strong progress being made by Ofgem, supported by the Implementation Steering Group in this area and that some of our previously voiced concerns have now been incorporated into the above document and draft licence modifications.

We continue to support Ofgem's initiative to separate achievable and required deliverables for 1 April 2005, without compromising the requirement to develop a sustainable longer term use of system charging methodology.

We welcome the opportunity to comment on Ofgem's latest consultation on the development of industry-wide principles and a framework for the future structure of electricity distribution charges. Our detailed comments are set out in an attachment to this letter.

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EDF Energy is generally sympathetic to many of the changes proposed by Ofgem. However we have concerns in two principle areas:

1. Format and drafting of the proposed licence modifications.
 - Whilst we believe the overall structure of the relevant licence conditions has been improved through previous dialogue, the revised layout of the licence conditions, and the incorporation of elements of the Transmission Licence has created some complexity of drafting, which can easily lead to ambiguity, doubt and unnecessary conflict. For the avoidance of doubt, we therefore believe it is necessary to conduct a follow-up review of the form and content of the licence modifications aimed at greater transparency, and certainty to licence holders and to Ofgem's proposed guidelines, which further describe the boundary between connection and use of system charges.
2. Alignment of the financial consequences of the impact of the Structure of Charges Review with that of the DPCR process.
 - We have expressed previously, the importance of aligning the outcome from the structure of charges review with that of the DPCR process, to avoid unnecessary legal inconsistencies and ensure that DNOs are adequately funded in terms of meeting those obligations. An alternative to the approval of both packages at the same time could therefore comprise a re-submission of budgets based upon the new structure. We therefore seek your assurances that this step will be incorporated into the DRPC programme.

On the basis of these two points, please will you therefore take this letter as our conditional acceptance of the proposals contained in the Update Document and a wish to work with Ofgem to satisfy these two areas of our concern, prior to formal acceptance of the licence modifications takes place.

You will also be aware of our previous reservations regarding the implementation of licence changes ahead of the DTI consultation outcome on the EU Directive. It may now be more sensible to more closely align these two processes, in the light of the revised timetable needed to accommodate the other Licence Condition 4 changes discussed in this response. However we understand and accept that the final decision on timing is for you to settle

I hope our comments will be helpful in furthering debate on this review and we will continue to take a full and active part in the forthcoming implementation phase of the project. In particular, there may be value in organising a follow-up meeting to pick up on some of the topics raised in this response.

In the meantime, if you would like to discuss the content of our response, in whole or in part, please do not hesitate to contact me.

Yours sincerely,

Peter Merrick
Head of Regulatory Affairs,
Networks Branch

STRUCTURE OF ELECTRICITY DISTRIBUTION CHARGES UPDATE DOCUMENT AND LICENCE MODIFICATIONS

EDF ENERGY RESPONSE TO OFGEM'S APRIL 2004 PAPER:

Form of this response

Where particular reference is made to parts of the Ofgem Update document, cross references will be provided in the form (1.4), or in respect of the draft licence modifications (Condition 4A, Para. 2)

Licence Modifications

1. Transparency of terminology

We agree with Ofgem the value and benefit of providing greater transparency in the provision of information to potential and current recipients of distribution services. We believe this approach should be extended to the content of the proposed licence modifications.

Whilst we believe the overall structure of the relevant licence conditions has been improved through previous dialogue, the revised layout of the licence conditions, and the incorporation of elements of the Transmission Licence has created some complexity of drafting, which can easily lead to ambiguity, doubt and unnecessary conflict. For the avoidance of doubt, we therefore believe it is necessary to conduct a follow-up review of the form and content of the licence modifications and the Ofgem's related guidelines, which further describe the boundary between connection and use of system charges, with the aim of improving transparency and certainty to licence holders.

In the meantime, we will provide examples of areas of doubt or uncertainty of intent, in the following sections.

2. Consequences of not agreeing methodologies

It is not evident as to the consequences of Ofgem failing to approve DNO methodologies (Condition 4, para 1 a)-c) and Condition 4B, para 1a) and b)). It is clearly not appropriate that failure to approve methodologies should prevent a DNO from being able to recover entitled income, whether deriving from the application of connection or use of system charges. As an example, prior to 1 April 2005, failure to approve generation methodologies should clearly not prevent a DNO from providing and applying generator use of system tariffs. Equally, the Ofgem model requires DNOs to continue to review and improve their methodologies. Such improvements may be focussed on better allocation or recovery of costs between parties, reduced administration arrangements, or improved commercial positions for the DNO. In all cases, the primary DNO requirement must always be to recover entitled income. For the avoidance of doubt it may be more helpful to continue to use the existing licence phrase of "in a form to be agreed" by the Authority to describe the process of agreeing

methodologies and to clarify that charging statements take priority, where methodologies have not been agreed.

We support the arguments raised by Ofgem that requiring each DNO to fully consult with interested parties on each occasion that a change of methodology is considered may cause customer confusion and provide an unnecessary burden of cost with limited value. (Condition 4A, Para. 3 & 4). However, there are equally, limitations and risks of placing the lead decision whether to consult with Ofgem. Therefore we would wish to reserve the right that we may elect to consult directly with interested parties on particular changes prior to submitting our positions to Ofgem, in order to consider a broader range of feedback at first hand.

3. Relevant Objectives

We understand that the description of the “relevant objectives” proposed for distribution licences are based upon the transmission licence. In general terms, we support the argument that charges should take account of those objectives. However we understand that often a balanced position is required in achieving multiple objectives and we believe it is for the DNO to make this judgement. For example, one objective of the DNO is to ensure it has recovered its allowed use of system revenue in an equitable manner across customer groups. Having said that, there is an incentive to retain simple tariff structures, minimising billing system and process costs. At the extreme, cost reflective tariffs could be interpreted as low level, granular, locational tariffs and extensive use of site specific terms. However the implementation costs would be high and if there is little incentive to incur such additional costs, either by the DNO or the supplier, who also appear to prefer simple structures, then simplicity will prevail. Simple tariff structures should enhance competition in supply by making it easier for the supplier to estimate his costs, produce offers to the customer and ease the development of billing systems. Such decisions involve a level of judgement/trade-off and we would wish that they rest with the DNO.

4. Submission of indicative charges

We understand that in developing generator use of system charges, particularly in the interim period before installed generation becomes more widespread and stable, tariff structures, methodologies and charging levels will undoubtedly be more volatile and therefore unpredictable in the short term. We therefore see some benefit in being required, as a part of describing our approach to generator tariffs to indicate, during a period of change, what consequential impact such methodologies would have on charges. The development of aligned demand and generation methodologies will of course bring their own levels of stability and consistency, further reducing non-discriminatory practice.

Therefore in the short term we will support the need to produce indicative rates for generation tariffs and at times of material change to both demand and generation methodologies. However the update document also indicates a requirement this year to produce indicative use of system charges for demand customers, but based upon the present price control allowed revenues (3.4).

EDF Energy intends to continue to make some alignment changes to the methodologies and tariff structures adopted across its three licensed distribution areas. We believe this process is helpful for suppliers and eases our own administrative arrangements. We believe that considerable effort will be needed to produce a set of charges based upon current allowed revenue, followed shortly by new rates based on the DPCR4 outcome, and that publication of these two sets of rates will only create confusion for the recipients of this information.

You will therefore understand our reluctance of taking on this additional burden of work in view of the above ambitions for alignment and the additional confusion it may cause.

5. Adoption of similar approaches by DNOs

We agree with Ofgem that the changes proposed through the structure of charges review will allow, in many areas, a greater alignment of charging principles across DNOs (3.11). We also agree it will be beneficial for DNOs to work together collaboratively to develop statements of charges that have a similar “feel” and structure to them. However you will understand that the commercial and operational drivers in each company will often be quite different and the adoption of common practices may, a) not be in the best commercial interest of individual DNOs, and b) is likely to stifle innovation. Our view is therefore that a balanced position needs to be struck and that it should be allowed to develop over time without unnecessary constraints.

Interim Arrangements including Connection Boundary

1. Connection issues

We continue to have some concerns over Ofgem’s outlook on the proposed connection boundary.

In both the short and the long term, it is important to preserve the principle of applying cost reflective messages that can influence behaviour. It is also in our opinion, important to avoid where practicable, unreasonable discrimination between customer groups.

Our first concern is associated with the mechanism for sharing reinforcement costs caused by a request from a developer, consultant or a new customer for connection (Appendix 2).

In the following example, a new customer has a maximum power requirement of 300kVA. The lowest cost solution requires reinforcement of a fully utilised 500kVA distribution transformer. In Ofgem’s proposal, the new customer would be required to pay 3/8th of the cost of the reinforcement works. All customers would have to pay the remaining 5/8th of costs through ongoing use of system charges. Existing customers gain no additional capacity benefit from the

scheme, albeit they have access to some newer assets. We are concerned as to whether this model creates some form of cross subsidy.

In the previously proposed EDF Energy model, the contribution made by the new customer would be in relation to additional (or perhaps spare) capacity, which in this instance would amount to the full cost.

We have made an indicative assessment of the scale of the differences between the two methodologies and across our three licences this could further increase costs of contribution to network reinforcement, to the generality of existing customers, by of the order of 25%.

In order to support such a proposition, we would clearly need confirmation from Ofgem that its proposal does not represent discriminatory practice between different customer groups and that we receive the appropriate capital expenditure and financing incentives through the outcome of the DPCR4 process. However, we also find it interesting, that in respect of “buy-back” of extension assets, Ofgem provides a vehicle for greater individual decisions to be made by licensed distributors. We therefore believe it to be more equitable, that where a distributor, can provide appropriate justification through its own charging methodology statements of variants of the capacity sharing mechanism, that Ofgem would be minded to give them fair consideration.

In addition we are also have some concern that a model based on lower connection charges may incentivise developers or consultants to contract for more capacity than they may really need, causing us to reinforce the network on occasions when it is not needed, in order to accommodate their requested power requirements. The matter may also be further exacerbated in the medium term with Ofgem’s stated position of transferring all customer contributions towards reinforcement costs into the RAB, for recovery from ongoing use of system charges. A method of managing this risk and at the same time, preserving the locational signal, for customers where a capacity charge is included in the tariff would be to require the connected customer to make ongoing service capacity payments for a defined period, (say from five to seven years). This will also reduce the impact of cross subsidies otherwise occurring and continue to incentivise efficient network design against challenges from developers or consultants.

We would also like to exclude from the sharing mechanism, those situations when either the characteristics of the connection or the customer’s requirements prevent the utilisation of the “spare” capacity for other customers. Examples of such situations would be:

- “dirty loads” such as supplies to welders or to customers with large motor loads;
- where the customer requires “clean feeders” or the enhanced supply is required for his sole use

In regard to a requirement of “second comers” to make a capacity related payment for “existing” reinforcement costs, we support Ofgem’s position (Appendix 2, para 2.8). Without such a mechanism, second comers could easily free-ride on the back of the generality of customers. However, this issue clearly reinforces the need to levy consistent connection charges on both categories of customers corresponding to their take up of the “spare” capacity relative to the original costs. In supporting Ofgem’s position that second comers should make a contribution towards these reinforcement costs, the process must clearly be workable. We continue to argue that the current Connection Charge Regulations, as applied to extension assets for use by connected customers, are currently unworkable. We believe that those regulations will require amendment to explicitly include similar arrangements for reinforcement assets. If however it is Ofgem’s opinion that, in their present form, the regulations are fit for purpose, we clearly require that statement to be put into writing so as to ensure that we have the comfort of knowing that our regulator does not believe that the regulations are in conflict with licence conditions.

Introduction of capacity sharing of reinforcement costs, whilst preferable over the existing 25% rule, clearly introduces new complexities of operation. It is therefore clearly sensible for DNOs to have flexibility to be able to introduce appropriate de-minimus rules for the application of these changed charging arrangements.

Notwithstanding the above issues associated with an appropriate level of “standardisation” of approaches across DNO areas, it is reassuring that Ofgem notes the importance that such “normal” arrangements should not be so constrained to apply in all instances, since that would limit the flexibility of distributors from being able to offer terms necessary to satisfy customer/developer requirements. We are pleased that Ofgem has recognised this issue by, for example, agreeing that connection terms offered under Section 22 of the Electricity Act do not need to be included in the published statements (3.25). It is helpful to allow this form of flexibility to support the further development of competition in connections, particularly for larger works, including re-generation and infrastructure projects. We recognise that by including this facility, distributors would need to apply methodologies that do not conflict with the price control terms of the licence.

Additionally, DNOs are also under some pressure to develop (and sometimes fund) certain infrastructure projects, “in advance of need”. These are required to stimulate the financial recovery of certain geographic areas as a result of pressure, or potential investment by national government agencies, the Office of the Deputy Prime Minister, local government and other organisations. We now believe this model is not dissimilar to the principles Ofgem has introduced for payment of extension of networks assets discussed later in this response. We believe it is therefore important to have confirmation from Ofgem that, where a DNO agrees to support such re-generation schemes, particularly where required to contribute to the funding arrangements, that the Authority will allow that efficiently incurred costs can be added to the RAB in the same manner that spare capacity is also funded and recovered through the generality of use of system charges until such time as customers connect to the network.

In regard to charging statements (3.3), the document suggests that in addition to providing sufficient detail to enable a customer to make a reasonable estimate of his connection charges, the statement should include worked examples where practicable. However, all connections tend to be unique by their nature. To provide “average” charges could be very misleading as any customer who receives a quotation greater than the average will complain, either to the DNO, to energywatch, or more likely to Ofgem.

In paragraph 3.21, the document discusses application of a share of reinforcement costs triggered by fault level reasons to the affected (normally) generator. Whilst this approach may be sensible and consistent with the general principles of sharing reinforcement costs for that customer, we have strong concerns as to what happens with the balance of fault level related reinforcement costs. Are these to be spread across all (new since 1 April 2005) generators and included in the generator RAV, or included in the demand RAV. If the former, Ofgem will need to explain the mechanics of how these allowances are to be covered? If the latter, then this approach is arguably discriminatory and Ofgem may need to reconsider it’s handling. In either situation, urgent answers are required from Ofgem to enable distributed generation tariff methodologies to be further refined.

2. Appendix 2 – Connection Charging Guidelines

We believe further work is needed to the definitions. For example, in 2.1 a reader could interpret that by paying for the provision of assets, they may become the property of that connectee, which obviously is not the case. In 2.3 there is reference to design capacity. It has been suggested previously to Ofgem that it would be more sensible to use the existing description in Section 16 of the Electricity Act, namely maximum power requirement, as this is better understood by industry parties.

3. Payment for adoption of assets installed by Independent Connection Providers

Ofgem introduces the “separate” (from connection charging methodologies) subject of payment for adopted assets (3.40 and 3.41). This is a new but significant departure from previous consultations under the structure of charges review. As such this step clearly influences the net value of connection charges applied or levied by parties. It would certainly seem to be sensible to incorporate the consequences of these arrangements under the connection charging methodologies and this would also have the effect of providing a more structured framework.

This topic introduces the following interesting situations/consequences:

- An ICP may offer a very attractive bid to the customer, in order to gain the business, anticipating that he will also be able to recover an “agreed” payment from the licensed distributor, adopting those assets.

That could create a situation where the connecting customer pays for the assets and over time, so does the generality of customers. Firstly it is important to understand who initially has rights on those assets and secondly that at each financial exchange fair prices are paid. As a consequence it would then only be equitable for the ICP to receive from the licensed distributor, the net value of assets not paid for by the customer requesting the connection. This would overcome the potential for the ICP to be paid twice.

- Equally, in order to compete on a level playing field would require DNOs to also be able to “buy-back” assets that they have installed themselves and we assume this is also Ofgem’s intent. We understand, of course that this decision would be taken on a discretionary basis and by each individual DNO.
- Where a DNO has decided to “buy-back” the assets, it is assumed that the efficiently incurred rates would be placed into the RAB and the price control formulae would enable their corresponding recovery through ongoing use of system charges.
- Clearly, appropriate allowances will therefore need to be catered for in the price control process.

4. Distribution rebates and notice periods required for tariff changes

We confirm our support for the changes (2.10 – 2.15) introduced through the previous and separate consultation. In particular we are pleased that Ofgem agrees with EDF Energy that it is sensible to introduce the three month notice period for tariffs applying on 1 April 2005, to align not only with the significant changes introduced and yet to be finalised from the structure of charges review, but also as a consequence of the forthcoming outcome of the DPCR4 process.

5. Generator use of system

Initial generator use of system tariffs will be set to be closely aligned with the separate, generator, allowed revenue formula, proposed by Ofgem. Until such time as demand and generation allowed revenues are aligned, it is envisaged that truly cost reflective tariffs will be difficult to realise. Initial thinking suggests that tariffs will vary with voltage and billing arrangements and with metering type. Site specific charges will apply to generators connected at EHV, and locational use of system regimes will not be implemented until equal consideration is given to demand customers, and identifiable benefits can be realised and costs of development and billing met. Until enduring combined methodologies are defined and agreed, it is unlikely that the full range of costs and benefits that demand and generation parties could enjoy can be successfully introduced into tariff charging arrangements. In the short term the generator tariff structure will also be heavily influenced by billing constraints and the size of anticipated charges.

Care is clearly needed to strive to limit the effects of significant charge disturbances year on year and during transitional periods. The impact of this issue is difficult to predict at this time. EDF Energy currently has some concern over the application of tariff caps. Whilst during the period of the cap the

generator may gain some level of comfort, we believe it to be more desirable to move to the enduring solution as soon as practicable to limit the number of generators to which the short term arrangements will apply and the disturbance effect at the cut-over. There may also be an argument that too long a transitional period could encourage generation connections that may not be viable in the longer term.

We have therefore concluded that a pragmatic solution in the short term, whilst generator take up is judged to be small relative to the size of the demand customer community, could comprise the following arrangements. Generator tariff rate adjustments will be constrained through a sensible year on year cap and collar outside published, indicative, forward rates. Any difference in monies to that allowed under the generator allowed revenue formula will be taken into adjustments in demand tariffs. In other words, it will be acceptable to have an over recovery in one category with an under recovery in the other, without financial penalty to the DNO. Over time such adjustments should be targeted to balance out. This model will therefore act to average the consequence of what would otherwise be oscillations and corresponding disturbance effects, whilst ensuring the DNO can continue to recover aggregate allowed revenue, without overall cross subsidies between the two groups. This methodology may also ease the route to implementing the enduring methodology solutions earlier than otherwise possible.

There has been much debate as to whether generators can contract direct with DNO for use of system services. This model is obviously quite different from the supplier hub model supported by Ofgem and developed by the industry. To adopt Ofgem's latest proposals would undoubtedly require some re-working of the hub-model, may impact dataflows and IT systems and would require the development of new forms of agreement that currently are likely to be beyond the short term scope of the Distribution Commercial Forum. It is unclear how these additional costs will be funded. It is also unclear, in the absence of Ofgem providing substantive guidance on credit cover, how such financial risks would be managed by DNOs. Until full consideration has been given to these and other relevant issues, it would not seem to be prudent to move away from the supplier hub model in the meantime.

There has also been some limited debate on the subject of the application of reactive power charges (3.35 – 3.36). EDF Energy's present view is to apply similar techniques to generator connections, as are presently in place for demand customers. Reactive charges would apply to half hourly metered connections where suitable metering is in place. We seek to incentivise customers to maintain their power factor around unity, such that customers generally provide equal effect and cost onto the network. Our preferred intent would then be to continue to levy charges on those customers who, for whatever reasons, cannot or choose not to manage their requirements within an acceptable range. Whilst it is an obvious statement, there is absolutely little value in a DNO charging discrete reactive charges to a supplier for specific customers, if the supplier has no obligation to pass on such charges to the affected customer. It is for Ofgem to consider whether suppliers should be required to assist us in seeking to price incentivise customer behaviour.

Longer Term Framework

There is still considerable work to be completed by DNOs, Ofgem and other parties in developing the enduring solution. We are keen to support and work with Ofgem and other parties in seeking to achieve their ambitious timetable. We believe it is imperative at this time not to put too many restrictions in the way of DNOs from developing practical and yet innovative solutions. We have some concerns that there appears too much overarching pressure towards the development of common methodologies. Whilst that is undoubtedly cost efficient to the DNOs and simpler to parties receiving such services, it needs to be carefully weighed against the benefits of consideration of alternate approaches.

Implementation Issues

We understand the basis behind Ofgem's proposed timetable, particularly for the interim arrangements being geared towards readiness for 1 April 2005. Many of the deliverables are therefore sensible with that date in mind.

We currently have some concerns with two particular deliverables on the plan:

- Firstly, the need to provide indicative demand, use of system charges later this year using the current price review period allowed revenues as the basis.
- Secondly to require initial draft methodology statements to be provided to Ofgem in July. There is still some uncertainty exactly as to the form of the outcome of the DTI consultation on EC Directive and to reach agreement on the detail of connection boundary issues and to understand the process and content of any review of the Connection Charge Regulations. In the meantime, we agree it is sensible and valuable to use the ISG as a means for furthering debate of the methodologies to be used and the likely levels of interim generator use of system charges and we will continue to actively support that process.

There is also further work to be considered in regard to transitional arrangements. We have started to develop positions in regard to O&M and TSA. However work is also required as to how we migrate from applying the 25% rule to capacity contributions, changes to second comer rules and the introduction of GDUoS. Whilst it is feasible for each DNO to develop its own position on these points, we believe there is real value in Ofgem, potentially through the Implementation Steering Group, coordinating more consistent timings of the roll out of change across the industry.