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Dear colleague,

Consultation: Transition of Electricity Distribution EHV demand use of system charges

Introduction

From 1 April 2005 distribution network operators ('DNOs') are obliged to produce charging methodologies for both connection and use of their distribution systems which must be approved by the Gas and Electricity Markets Authority ('the Authority'). The methodologies are required under the electricity distribution licence following a collective licence modification made by the Authority on 7 July 2004 to standard licence condition (SLC) 4 of all the electricity distribution licences.

The methodologies are required to set out the principles and methods by which electricity distribution charges will be calculated in order to help provide a robust and predictable charging framework for all network operators and users.

Draft DNO charging methodologies were consulted on with the industry during October 2004¹. DNOs then produced final charging methodology statements and submitted these at the end of November to the Authority for approval.

In reviewing the use of system (UoS) charging methodologies Ofgem has identified that some of the DNOs have proposed to change the method used to calculate EHV demand UoS charges with effect from 1 April 2005. DNOs have indicated that in some cases this causes a significant price disturbance to customers; predominantly these are bilateral arrangements and the impact on these customers will vary. This open letter deals solely with the issue of transition of EHV demand charges in cases where charging methodologies have changed; this consultation does not cover other issues associated with the DNO charging methodology statements.

¹ Structure of electricity distribution charges – proposed DNO charging methodology statements, consultation document 235/04, available from www.ofgem.gov.uk along with all the draft DNO charging methodology statements.

The Authority has considered the transition approaches proposed by the DNOs in cases where there may be significant price disturbance to EHV demand customers and is not minded to approve them as they do not facilitate achievement of the relevant objectives within the licence. Ofgem has considered an alternative approach and seeks industry views on this matter.

This open letter consultation summarises the issue and the DNOs proposed methodologies, it outlines Ofgem's initial view on an alternative approach and seeks views from interested parties. DNOs have also recently been notified of the Authority's proposed decisions on their charging methodologies, and have 28 days to make representations to these notices. Both the responses to this consultation and the DNO representations will be taken into account before final decisions are published.

The DNOs are obliged to give notice 3 months in advance of a change of charges and required to publish final charges with 40 days notice as required by their contracts with suppliers. Assuming that charges will change from 1 April 2005, notice is expected to be given on 1 January 2005, with final charges published around 18 February. Charges to EHV customers form an integral part to the setting of distribution use of system charges (DUoS) and therefore to ensure that the DNOs are able to set charges for all customers it is necessary that this consultation is limited to 28 days.

EHV Demand Use of System Charging

Of the seven DNO groups of companies, six have submitted common methodologies for all their licensed distribution areas. Only Scottish and Southern Energy (SSE) has any significant differences between UoS methodologies for its two areas, hence Southern Electric Power Distribution (SEPD) and Scottish Hydro-Electric Power Distribution (SHEPD) are referred to separately in this letter.

Western Power Distribution (WPD – South West and South Wales areas), United Utilities (UU), CE Electric (CE - YEDL and NEDL areas), Scottish Power (SP – SP Manweb and SP Distribution), SEPD and EDF Energy Networks (EDF – SPN, LPN, EPN areas) calculate site specific EHV charges. SHEPD uses a common method for tariff setting across all voltage levels, and Central Networks (CN – CN West and CN East areas) uses a common EHV tariff for most EHV customers except very unusual loads such as railway traction.

SSE and SP are proposing to continue with their present methods of calculating EHV charges and Ofgem therefore expects a consistent approach to charge setting across all their existing and future customers. CN is proposing to peg the movement in yearly tariffs to the movement in HV tariffs, and does not believe this approach will have a material affect on customers' charges.

CE, WPD, UU and EDF are proposing to change the method by which they calculate EHV demand use of system charges with effect from 1 April 2005. These companies have noted that the change may cause a price disturbance to EHV customers and therefore have proposed

arrangements for movement of EHV DUoS charges from the present levels to the interim regime².

CE and WPD propose capping any increase in charges resulting from the movement to the new regime to the higher of RPI and the general movement in tariffs. UU propose capping the increases to RPI plus 5 percent. For all these companies, decreases in charges associated with transition would be available in full from 1 April 2005. UU also states that existing bilateral contracts will be honoured, and transition will only begin once the contract expires. EDF suggests that increases may be capped to 10 percent per annum after the application of the price control formula, but also state that calculations will be done individually for site specific charges. EDF envisages that this transition process would be complete within 2 years.

More detail on the DNOs' proposed approaches is set out at Annex 1.

October Consultation

Ofgem consulted on draft DNO charging methodology statements in October 2004 and identified EHV demand use of system charges as a key issue. In particular Ofgem noted a potential price disturbance and raised concerns about the transition approach proposed by the DNOs. In particular Ofgem noted that the proposed transition approach may create a cross-subsidy from other demand users and would not be cost reflective. On this basis Ofgem considered that any transition should be managed over a short period of time and in any case not longer than 5 years.

Three respondents raised concerns about the need for transparency in relation to EHV charges, with one of these stressing the need for charges to be cost reflective and the method of calculation to be clear. Another respondent was concerned over the level of charge disturbance and questioned the classification of assets between connection and use of system. This respondent suggested that it may be better to freeze EHV demand charges until the longer term arrangements are brought in as this would prevent two transitions and the potential for double charging.

Relevant objectives

In considering whether to approve the charging methodologies to take effect from 1 April 2005 the Authority considers the relevant objectives and its wider statutory duties³. The relevant objectives are detailed within the distribution licence, standard licence condition (SLC) 4(3) and 4B(3), but are briefly:

² From 1 April 2005 'interim arrangements' for distribution charges are being established but it is expected that over the next year development on 'longer term arrangements' will continue considering economic pricing models across demand and generation.

³ Ofgem's statutory duties are wider than the matters considered by the relevant objectives and include amongst other things having regard to social and environmental guidance provided to Ofgem by the government.

- a. that compliance with the methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and its licence;
- b. that compliance with the methodology facilitates competition in generation and supply of electricity, and does not restrict, distort, or prevent competition in the transmission and distribution of electricity;
- c. that compliance with the 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
- d. that, so far as is consistent with the above, the methodology as far as reasonably practicable, properly takes account of developments in the licensee's distribution business.

In addition to these criteria the licence specifies that the methodologies must also "enable any person to make a reasonable estimate of the charges to which he would become liable". The statements therefore must be clear and provide sufficient information for parties to be able to estimate charges.

Authority Initial View

This consultation deals solely with the proposed transition for EHV demand UoS charges by CE, EDF, UU and WPD. The Authority, after reviewing the proposed EHV charging methodology of these DNOs and the responses to the October consultation, is minded to approve the underlying charging models effective from 1 April 2005 as they achieve the relevant licence objectives. However, the proposed approaches by these DNOs in relation to transition of EHV charges derived from these models do not achieve the relevant objectives. Ofgem is particularly concerned that the proposed transitions do not meet the licence requirement for charges to be cost reflective and non-discriminatory: phased increases coupled with instant decreases will result in cross-subsidy between those EHV customers whose charges should rise and the HV and LV demand customer base. Ofgem also recognises that limiting changes to RPI may mean that some charges never reach the cost reflective level, and the effective grandfathering of these terms will delay the introduction of a more economic long term charging regime. On this basis the Authority is not minded to approve the DNOs' approaches to transition.

Whilst Ofgem considers it important that charges align with the new methodologies as soon as possible, it is recognised that applying major price changes at short notice may not be practical. Some transition may therefore be necessary, but Ofgem considers that this should take place over as short a period as possible.

Ofgem considers that DNOs should revert to fully cost reflective charges derived from their models to all customers in a two stage approach with an initial movement from current prices limited to a 50% increase on 1 April 2005. It is estimated that distribution charges make up around 15-20% of an EHV customer's electricity bill, although this will vary between connections, and therefore the change from 1 April 2005 would be limited to approximately 10% of a customer's bill. Customers whose charges derived from the new DNO charging methodology increase by more than 50% would then have the full increase in charge delayed until 1 April 2006. Ofgem notes that in the second year it is expected that DNOs will have further developed economic pricing models which should minimise any further double movement in prices for these customers as the DNOs move towards longer term charging

arrangements. For the cases where the new methodology derives a lower charge than the cost reflective lower charge should be applied immediately, from 1 April 2005, to these customers with no transition as proposed by the DNOs.

This approach would be on the basis that customers will not be paying twice for any particular asset due to historic changes in the connection charging boundary.

Views invited

Although this matter was raised in the October consultation, Ofgem considers it important to consult separately now that DNOs have submitted final proposed methodologies, and that the Authority has reached an initial decision.

Views are sought on Ofgem's initial proposal regarding transition issues for EHV demand UoS charging.

CE, EDF, WPD and UU have been given notice that the Authority is planning to approve their UoS charging methodologies, but intends to apply conditions. One of these conditions requires the DNO to revise their positions on handling changes to EHV charges caused by the move to the new methodologies. Ofgem will consider representations made by the companies and responses to this letter before reaching a decision on final approvals or conditions.

Responses should be received by Friday 14 January 2005 and addressed to Distribution Policy, 9 Millbank, London, SW1P 3GE or distributionpolicy@ofgem.gov.uk. Any queries about the topics in this letter should be addressed to Mark Cox at the address above or on 020 7901 7458.

Yours faithfully,



Martin Crouch
Director, Distribution

ANNEX 1: USE OF SYSTEM

Treatment of EHV

Two methodologies offer tariffs at EHV:

- SHEPD states that a common (non-DRM based) method will be used for tariff setting across all voltage levels. This approach derives yardstick tariff costs by calculating costs based on modern equivalent values for a simulation of the DNO network; and
- CN sets a standard EHV tariff for most customers, apart from exceptional cases such as railway traction or standby import facilities associated with very large generators. The basis for the calculation of this tariff is derived from a DRM approach. From 1 April 2005 existing tariffs will be adjusted in line with movements in HV tariffs which are derived from price control tariff baskets.

The remaining six methodologies set site specific charges for EHV customers:

- EDF and UU state that tariffs will comprise customer related costs, a contribution to the annuitised cost of joint use assets based on a ratio of the authorised supply capacity of the EHV exit point to the network maximum capacity of the joint use assets, operation and maintenance (O&M) costs, NGC exit charges and rates; in the case of UU the asset costs are based on historic prices, while EDF uses modern equivalent asset prices to derive the yardstick prices of the assets used.
- CE set out a similar method, but propose that the asset valuation will be based on a three year rolling average of the estimated capital cost of each individual asset utilised, and O&M costs will be based on a three year rolling average;
- WPD, SEPD and SP again apply a similar approach to recovery of different cost elements but state that while charges are site specific, the tariffs are determined in accordance with the principles of the methodology for lower voltages, based on the regulated demand tariff model. In these cases the yardstick prices for the different voltage levels are used to calculate and from the basis of the individual site tariff.

Transition strategies

CE, WPD, UU and EDF have proposed to change the method by which they calculate EHV demand use of system charges with effect from 1 April 2005, and propose the following strategies for moving charges onto the new regime:

- CE will apply decreases at once, and offer a bespoke migration strategy on increasing charges, which will be frozen in real terms until either their connection assets are changed or their charge reaches the target level;
- WPD will apply decreases immediately and limit annual increases, where possible, to the higher of RPI and general tariff changes;
- UU will apply decreases immediately and cap annual changes to RPI plus 5 percent until the charges reach the required level. The transition will only begin once revised contractual terms have been agreed with each customer bilaterally; and
- EDF will limit changes to 10 percent annual variation after the application of the price control formula, with the expectation that the transition will be complete by the end of 2007/08. EDF note that the calculation will be done individually where charges are site specific. The methodology does not state explicitly whether this applies to increases and decreases alike.