Bringing choice and value to customers

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20 December 2005

cc: Andy Jenkins (by email only)

Dear Sir/Madam,

Use of system charging methodology: conditional approval – charging model[1]

On 11 February 2005 the Gas and Electricity Markets Authority (the 'Authority')[2] issued its decision to approve Yorkshire Electricity Distribution Plc's (YEDL) use of system (UoS) charging methodology in accordance with standard licence condition (SLC) 4(9), subject to various conditions. Amongst these was the following condition requiring YEDL to:

- Review its use of system charging model and develop an alternative approach by 1 April 2006.

DNO Proposal

On 31 October 2005, CE Electric, on behalf of YEDL, wrote to Ofgem seeking approval from the Authority that it had addressed this outstanding condition.

CE Electric proposed a revised UoS charging model based on an income allocation model whereby historic and forecast investment costs at the different network voltage levels are assessed along with capacities of different customer groups at these voltage levels. The relationship between these investments and the capacities taken by customer groups using the network is used to determine the income that should be recovered from each customer group. This income forms the basis of charges to these customer groups.

In addition CE Electric's proposal included a normalisation of the outputs from the new model by weighting these with their existing tariff allocation. The proposal attributes 20% of the weighting to the new model and 80% to the existing tariffs.

[1] This letter is only in reference to the charging model condition. Decisions on other CE Electric proposals have already been distributed separately.
[2] Ofgem is the office of the Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

CE Electric considers that this proposal facilitates achievement of the relevant objectives[3] by being cost reflective, considering the cost drivers on the network, and allocating revenues based on capacity. CE Electric considers that this proposed method is simple and transparent.

Ofgem views

Ofgem has considered the proposed approach against the relevant objectives and its statutory duties.

The approach proposed by CE Electric does consider an assessment of the potential, future areas of investment on the network going forward, however, it also considers past investments that have been made on the network in setting network charges. Ofgem notes that it is only future costs that are relevant in influencing economic development of the network.

It is also important to consider the time horizon going forward as the investments being made on the distribution network are generally long term investments, i.e. 20 - 40 years, and tend to be 'lumpy'. The forward looking element of the model proposed implies investment costs looking at the next five years which may not be long enough to reflect effectively the potential costs due to the discrete and long run nature of investment.

Further, although CE Electric's approach reflects expenditure on the actual network, the model does not consider the incremental cost of changes in network capacity. Instead it uses averaged, projected future (and past) investment pro-rated by capacity shares to allocate revenue to customer groups. In addition, the costs are averaged by each voltage level meaning any locational difference is lost.

The proposed normalisation blends charges from the previous charging model with this new approach. The Authority did not approve the previous charging model as CE Electric did not demonstrate that this model was cost reflective. No further evidence has been presented that the current model is cost reflective and Ofgem does not consider that the case for normalising the outputs by weighting them with charges from the current model has been made. Ofgem accepts that it is important to consider significant price disturbance to users when amending charging arrangements but in this case, Ofgem considers that the case for normalisation has not been justified.

It is Ofgem's view that the proposed UoS charging model does not facilitate achievement of the relevant objectives.

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[3] The relevant objectives for the use of system charging methodology, as contained in paragraph 3 of standard licence condition 4 of YEDL's distribution licence are:

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

Authority conclusion

The Authority considers that CE Electric's proposed new income allocation model including the normalisation approach does not facilitate achievement of the relevant objectives. CE Electric has not demonstrated that the charging model is cost reflective.

This condition imposed on YEDL in accordance with SLC4 (9) requires the licensee to take action in line with the terms of the condition to ensure that their charging methodology is unconditionally approved by the Authority. The Authority considers that YEDL has not met the condition on them to review their UoS charging model and develop an alternative approach by 1 April 2006.

The more recent actions that CE Electric has undertaken in developing a revised approach indicates that CE Electric has worked towards meeting the condition and on this basis the Authority has determined that the condition on YEDL's UoS charging methodology should be extended as follows:

- Charges applicable from 1 April 2006[4] should be set using the current model rather than the revised approach;
- YEDL should progress with urgency the development of a revised charging model based around the comments and views provided in this letter to ensure that any revised model achieves the relevant objectives;
- Due to the extension of timescales for completion of this condition YEDL should also consider other developments in the industry, such as the studies into electricity distribution charging models during the course of this year, when considering a revised model;
- YEDL should develop a revised UoS charging model to be approved and in place by 1 April 2007.

In order to achieve this, it is proposed that YEDL submit to Ofgem regular updates (quarterly) on progress towards satisfying this condition. It is suggested that we meet to discuss this matter further and agree appropriate milestones to ensure compliance with this extended condition in the New Year.

Please contact Mark Cox 020 7901 7458 or Colette Schrier 020 7901 7239 if you have any queries in relation to the issues raised in this letter.

Yours faithfully,

Martin Crouch
Director, Distribution
Signed on behalf of the Authority and authorised for that purpose by the Authority

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[4] This condition excludes EHV customers whose charges have been determined and the approach approved by the Authority – decision letters of 7 December 2005.