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Dear Colleague,

Decision Letter on Electricity Distribution Use of System Charging Modification Proposal: Central Networks West- Excess Capacity Charges

On 15 of December 2005 Ofgem¹ published a consultation letter² which invited responses in relation to proposals by Central Networks West (CN) to modify their excess capacity UoS charges.

Having carefully considered the proposals made by CN and the responses to the consultation we have decided to veto CN's modification proposals in relation to excess capacity charges.

This letter reports on the views of respondents to Ofgem's consultation and sets out the reasons for the Authority's decision. A glossary of terms used in this decision letter is provided in Annex 1.

Respondents' views – Ofgem consultation

In all we received nine responses to the consultation: four from DNOs, two from generators, one from an electricity supplier, one from an IDNO and one from another interested party.

All of the responses agreed that occurrences of network users demand exceeding their authorised supply capacity increased network costs. Five of the respondents spelt out explicitly what they thought that the causes of these increased costs were. The fact that the network has to be designed and constructed with allowances for random occurrences of users exceeding their ASC was cited by four respondents as a cause of increased network costs. Two respondents suggested that users exceeding their ASC lead to

¹ Ofgem is the administrative offices of the Authority. The terms 'Ofgem' and 'Authority' are used interchangeably in this letter

² Consultation on Electricity Distribution Use of System Charging Modification Proposal: Central Networks – Excess Capacity Charges

increased deterioration of and/or damage to the network and that this was a cause of increased network costs.

Of the responses received to the consultation six of them indicated that they thought that CN's proposals were cost reflective, however, two of these responses contained a clarification of this view. One of the clarifications was related to a concern that it was incumbent on CN to make it clear to affected users why the charges would be occurring. The other clarification was that insufficient detail was provided to be certain as to whether or not this proposed modification would be cost reflective.

Two of the respondents did not consider CN's proposals to be cost reflective the reasons were as follows:

- A tariff based charge cannot adequately reflect that costs that occur as a result of customers exceeding their capacity. Customers who exceed their ASC are breaching their contractual arrangement and it is through bilateral discussion between the DNO and the customer that the extent of the resulting liability should be determined.
- The method used by CN relies on historic data and because there is no historic data available in relation to IDNOs the resulting charges cannot be cost reflective for IDNOs.

A further respondent stated that they have sympathy with the modification proposal, however, they had concerns that the signals that the new charges were intended to convey would only be effective if they could be passed on to customers. In particular this respondent was concerned that contractual arrangements with HH metered customers would make direct cost pass through of these charges (and hence the intended signal) from suppliers to end users difficult. A similar point with regard to the signals that would be sent to customers was also made by another respondent. In this other instance the fact that an IDNO would be liable for CN's excess capacity charges but under the proposed price control mechanism for IDNOs they would not be able to pass them onto their customers was considered a problem.

The general view of the respondents towards the fact that CN's proposed approach to charging customers for exceeding their ASC was that whilst consistency of charging was desirable, especially in the longer term, it was not necessary. One respondent compared CN's proposal unfavourably with an approach to excess capacity charging that is currently used by a number of other DNOs. This alternative approach is to charge a customer who exceeds their ASC as if their ASC was equal to the level of demand that occurred when the customer exceeded their capacity. The increased level of charges is applied for a period of twelve months. The respondent in question suggested that the approach used by other DNOs aims to apply normal capacity charges fairly to all users whilst the approach proposed by CN may allow one customer to 'game' a lower charge than an equivalent customer.

Ofgem's view

We have carefully considered the submission of CN along with the responses to the consultation. Ofgem has also engaged in a dialogue with CN in order to clarify the methodology that they use to calculate their modified excess capacity charges. In coming to our decision we have considered how the proposed modification impacts on CN's ability to achieve their relevant objectives³ and Ofgem's wider statutory duties.

³ The relevant objectives for both the connection and use of system charging methodologies, as contained in paragraph 3 of SLC4B and SLC4 of the distribution licence respectively are:

(a) that compliance with the use of system charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and by this licence;

CN argues that their proposed modification is more cost reflective than their existing arrangements. Their reasoning behind this is that the new method is intended to calculate the average level of excess capacity that the network must accommodate and then shares the cost of providing this capacity between those customers who exceed their ASC. CN's methodology calculates a multiplier which they then use to scale the charges for excess capacity relative to their normal capacity charges. This multiplier is the ratio of the estimated average additional capacity required in order deal with excess demand divided by the forecast level of excess demand. CN provided indicative numbers for this multiplier of 2.1.

Ofgem does not consider that the modification proposed by CN is more cost reflective than their existing charging arrangements. We have the following concerns as to the cost reflectivity of CN's proposal:

- The method that CN uses for calculating the 'average percentage excess demand of all half-hourly metered customers' appears on closer examination to be the average percentage excess demand of only those HH customers who exceed their authorised supply capacity. CN's method assumes that all customers have the potential to exceed their ASC by the average level of those customers who currently exceed their ASC. This assumption ignores the fact that there will be a significant proportion of network customers who do not currently exceed their ASC, have never exceeded their ASC and are not likely to exceed their ASC in the future. The consequence of this assumption is that CN's proposed methodology is likely to result in an overestimation of the additional capacity required to cope with customers who exceed their ASC.
- CN's method is intended to apportion the long run incremental costs of providing a network that can cope with random instances of excess demand (compared with one that cannot) to those users who exceed their ASC. In order to achieve this aim the method should provide an accurate assessment of the amount of additional network capacity that will be required now and into the future to cope with excess demand. CN's estimated amount of additional capacity required is based on the behaviour of network users in the previous year. The use of one year of historic data to predict the long run incremental cost of providing additional capacity to cope with random occurrences of excess demand could lead to significant fluctuations in this estimate. In the long run the amount of additional capacity that will be required in order to cope with users exceed in their ASC is unlikely to vary to the extent implied by CN's methodology. As a result the charge that the method produces is unlikely to reflect the long run incremental cost caused by random instances of excess demand.
- It is possible from CN's methodology that the multiplier could take an extreme value. This could occur for example in a situation whereby the number of users exceeding their ASC is small but that the percentage that these users exceed their ASC by is large. In such a situation CN's proposed method would produce a large value for the multiplier. The fact that the method would produce an extreme value for the multiplier is indicative that

(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.

- it does not calculate an accurate reflection of the amount of additional capacity required in order to cope with the risk of users exceeding their ASC.
- o From the modification report submitted by CN and further correspondence with them it is clear that CN argue that charging a multiple over and above standard capacity charges for units of excess demand will send appropriate economic signals to customers. CN cite as evidence for this that the average amount of kVA that users exceed their ASC by per incidence of exceeding fell during a period when this multiple was set for its incentive effect and proportionality rather than its cost reflectivity at 3. Their argument is that this charge incentivised customers to reduce their levels of excess demand. However, if the charge exceeds cost reflective levels then the message that is being sent to customer is not an economic signal (i.e. that you are imposing an additional cost of the network you can either pay these costs or modify your behaviour in order to avoid them) but a penalty (i.e. this behaviour is undesirable we will charge you so that you stop it).

Ofgem recognises that instances of users exceeding their ASC will lead to higher network costs than would be the case than if no customers exceeded their ASC. Furthermore, we consider it appropriate that these additional costs be allocated to those users who have caused them. However, in the opinion of the Authority the method proposed by CN does not achieve this.

The Authority's decision

For the reasons explained above we do not consider that the proposed modification to excess capacity charging proposed by CN is cost reflective. For this reason we do not believe that the proposed modification helps CN better achieve their relevant objectives and, therefore, Ofgem has decided to veto this UoS charging modification.

Please contact Mark Cox on 0207 901 7458 or Colette Schrier on 0207 901 7239 if you have any queries in relation to the issues raised in this letter.

Yours sincerely,



Martin Crouch
Director, Distribution

Annex 2: Glossary

ASC	Authorised Supply Capacity
DNO	Electricity Distribution Network Operator
DRM	Distribution Reinforcement Model
IDNO	Independent distribution network operator
HH	Half Hourly metered
UoS	Use of System