

The Company Secretary
Northern Electric Distribution Ltd
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*Promoting choice and
value for all customers*

Your Ref: Mod 0001/2006
Our Ref: RBA/DPC/SOC
Direct Dial: 020 7901 7255

cc: Harvey Jones (by email only)

10 August 2006

Dear Colleague

Decision in relation to Modification Proposal Mod 0001 to the Use of System Charging Methodology: Clarification of the EHV asset valuation and OR&M calculation for dedicated assets

On 21 July 2006, CE Electric (Northern Electric Distribution Ltd) submitted a proposal (dated 20 July), reference Mod 0001/2006 to the Gas and Electricity Markets Authority (the 'Authority')¹ to modify CE NEDL's use of system (UoS) charging methodology statement.

The proposal modifies the UoS charging methodology by adding additional equations applying to EHV customers where sole use assets are used for demand and generation purposes. The changes are designed to provide greater transparency and clarification in the methodology statement on CE Electric's current approach to the EHV asset valuation and OR&M charges.

Having carefully considered the issues raised in the proposal, the Authority has decided to veto this modification.

This letter sets out the background to the modification proposal, explains briefly the proposed changes, and sets out the reasons for the Authority's decision.

Background

CE NEDL has licence obligations² to have in place as of 1 April 2005 three charging statements: the UoS charging methodology statement, the statement of UoS charges and the connection charging methodology statement. The UoS charging methodology statement outlines the method by which distribution UoS charges are calculated. CE NEDL has a requirement to keep the methodology under review and bring forward proposals to modify the methodology that it considers better achieves the relevant objectives³.

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

² Standard Licence Conditions (SLC) 4-4B

³ The relevant objectives for the use of system charging methodology, as contained in paragraph 3 of standard licence condition 4 of CE NEDL's distribution licence 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;

CE NEDL Modification Proposal

CE NEDL proposes to clarify its UoS charging methodology statement in the following ways:

- Insert a second equation in both the asset valuation and OR&M parts of the EHV charges section to take into account dedicated assets used for both demand and generation.

CE NEDL states that the changes provide greater transparency and clarity in CE NEDL's methodology statement of their current approach to EHV charges and in particular provides a fair attribution of the dedicated assets where these are used for both demand and generation.

Currently the methodology specifies that EHV UoS charges will be based on an asset valuation which is apportioned to the customer by taking the customer's agreed capacity as a proportion of the asset rating. This valuation is used in calculating the annual depreciation and rate of return elements of the customer's UoS charge. The current methodology details that sole use assets will not be included as part of this asset valuation.

The proposal says that for dedicated or sole use assets, the asset value will be apportioned between demand and generation requirements in proportion to the ratio of the required demand and generation capacity of the connection. Similarly, the same approach is proposed for determining OR&M costs for sole use assets used for generation and demand. While CE NEDL state that the proposal provides greater clarity, the change appears to bring sole use assets into the calculation of use of system charges.

The modification proposal report submitted by CE Electric can be found on the Ofgem website as an attachment to this document.

The Authority's decision

The changes to the charging methodology require approval from the Authority in line with SLC4. The Authority has considered the proposal against the relevant objectives and wider statutory duties.

We have concluded that the proposal put forward by CE NEDL has not been shown to better achieve the relevant objectives. In particular:

- The current methodology excludes the sole use assets from the calculation. Sole use assets would normally be charged to customers through their connection charge and therefore this modification would appear to be recovering the costs again through the use of system charge which could lead to double counting.
- It is not clear that a simple allocation of costs between a customer's generation and demand capacity will reflect the costs that those parties impose on the distribution network. In effect the cost of the sole use asset may be driven by one or the other such that an allocation between the two would not be cost reflective.

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- (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
 - (d) 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.

- Such an allocation is further complicated as existing customers⁴ are not currently subject to generator use of system charges (GDUoS), hence in most cases where the proposed equation applies, less than 100% of the cost associated with the sole use asset will be recovered from the customer in the demand use of system charge (DUoS), and the shortfall will be recovered by CE NEDL across all other customers.

The proposed changes submitted within this modification are not cost reflective and do not better meet the relevant objectives. The Authority has decided to veto this modification. However, the approach used to charge for dedicated or sole use assets is not clear within the charging methodology and it is recommended that CE NEDL review their approach.

Please contact 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

Signed on behalf of the Authority and authorised for that purpose by the Authority

⁴ Generator use of system charges were introduced for new connections with effect from 1 April 2005 but existing generators connected before this time will receive a full rebate until at least 2010.

