

5 October 2006

The Company Secretary
Western Power Distribution (South Wales)
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BS2 0TB



Promoting choice and
value for all customers

Your Ref: WPD/Wales/003
Our reference: RBA/DPC/SOC/
Direct Dial: 020 7901 7255

Cc: Tim Hughes (by email only)

Dear Colleague,

Decision in relation to modification proposal to the connection charging methodology: Charges for reinforcement of the existing distribution system including the separation of supply and install elements and the interpretation of 'New WPD Network Capacity'.

On 11 September 2006, Western Power Distribution ("WPD") submitted to the Gas and Electricity Markets Authority ("the Authority")¹ a proposal to modify its connection charging methodology for its South Wales area.

The proposal modifies the connection charging methodology statement in two ways:

- Separating the supply and installation elements of reinforcement, so that customers pay 100 per cent of the installation costs along with an apportioned amount of the supply costs.
- Providing a new interpretation of 'New WPD Network Capacity'. This interpretation states that it is the spare network capacity created that should qualify as new network capacity.

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

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

Background

WPD has licence obligations² to have in place as of 1 April 2005 three charging statements: the statement of use of system ("UoS") charging methodology, the statement of UoS charges and the connection charging methodology. The connection charging methodology outlines the method by which connection charges are calculated. WPD has a requirement to keep the methodology under

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

² Standard licence conditions 4-4B



review and bring forward the proposals to modify the methodology that it considers better facilitate achievement of the relevant objectives.³

WPD Modification proposal

WPD plans to modify the connection charging methodology by:

- Separating the costs associated with supply and installation of reinforcement assets so that the apportionment rules only apply to the supply component. This is proposed on the grounds that the new user is causing the costs to be incurred and that the costs of installation are largely fixed irrespective of the scale of reinforcement required.
- Proposing a new interpretation of 'New WPD network system capacity' to be used in deriving the Cost Apportionment Factor. This proposal alters WPD's definition of new network system capacity to, 'the *spare* network *created* following reinforcement of the relevant assets'. WPD considers that this definition better accounts for the capacity already used by existing customers and that it would be inappropriate for the existing customer base to fund the capacity already being used by them.

WPD considers that both of these proposals will ensure that the application of the apportionment rules is more cost reflective.

The Authority's decision

The Authority has considered the proposal against the relevant objectives and wider statutory duties.

- Separation of Supply and Installation costs

The purpose of the apportionment rules is to apportion the reinforcement costs between existing and new users, recognising the benefit that existing users may receive from such reinforcement. The proposal does not make clear the method by which WPD intends to split the cost of installation and supply in order to only apportion the supply component. The separation of the installation and supply costs of reinforcement adds an extra layer of complexity to the apportionment rules which were introduced in part to provide clarity in this area. It is not clear how WPD's proposal will improve the cost reflectivity of reinforcement charges or how the proposal provides more transparency to existing or future customers. In particular, requirements to reinforce arise when the combination of existing use and new users exceed existing capacity, not solely as a result of new users. It would also lead to different connection boundaries across DNOs.

³ The relevant objectives for the connection charging methodology, as contained in paragraph 3 of standard licence condition 4B of WPD's licence are:

- (a) that compliance with the connection charging methodology facilitates 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 connection 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 connection charging methodology results in changes which reflect, as far as is reasonably practicable (taking into account of implementation costs), the costs incurred by the licensee and its distribution business; and
- (d) that, so far as is consistent with sub-paragraphs (a), (b) and (c), the connection charging methodology, as far as is practicable, properly takes account of developments in the licensee's distribution business.

In addition this proposal would increase the overall level of connection charges. The Authority notes that WPD has not provided any forecast or assessment of the impact of this proposal upon future capital expenditure, or any proposal for offsetting reduction in price control revenues. It would therefore increase total costs to customers and WPD have not explained how this would be in customers' interests.

- Interpretation of 'New WPD network capacity'

WPD's proposal to amend the definition of 'New Network Capacity' represents a significant change to Ofgem's interpretation of the apportionment rules as laid out in the April 2004 document⁴. The Authority considers that the proposal significantly alters the connection charging boundary between new customers connecting and existing users of assets, resulting in increased reinforcement charges to the connecting party.

WPD's proposal suggests that reinforcement provides limited benefit to existing users of assets. The Authority considers that there are some benefits of reinforcement to existing users in terms of the provision of additional load growth and deferring the need for the future replacement of assets. The Authority considers that given these benefits it is reasonable for existing customers to contribute to the reinforcement costs.

The Authority is again concerned that WPD's proposal may increase connection charges with no offsetting reduction in use of system charges. The Authority is also concerned that the proposal would lead to differences between DNOs in the connection charging boundary.

Furthermore, the Authority does not consider that the modification proposal is clear and consistent within some of the worked examples provided. In one instance WPD appears to use the existing load to calculate the new capacity created, whilst on another occasion WPD appear to use the existing secure capacity to calculate the new capacity created. Therefore, the basis of the proposed modification is not clear.

The Authority considers that the proposals do not meet the relevant objectives in terms of the methodology resulting in charges that reflect, as far as is reasonably practical, the costs incurred by the licensee in its distribution business.

The Authority has decided to veto the modification to the connection charging methodology statement.

Please contact Laura Nell on 020 7901 7201 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

⁴ Structure of electricity distribution charges: Update document and licence modifications, April 2004, www.ofgem.gov.uk