The Company Secretary
Northern Electric Distribution Limited
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cc: Andy Jenkins (by email only)
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Promoting choice and value for all customers

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19 October 2006

Dear Sir/Madam,

Use of system charging methodology: conditional approval – charging model

On 11 February 2005 the Gas and Electricity Markets Authority ('the Authority') issued its decision[1] to approve Northern Electric Distribution Limited's ('the Licensee') statement of a use of system (UoS) charging methodology in accordance with standard licence condition ('SLC') 4(9), subject to various conditions. Amongst these was a condition requiring the Licensee to review its UoS charging model and develop an alternative approach by 1 April 2006.

On 31 October 2005, CE Electric, on behalf of the Licensee, wrote to Ofgem seeking approval from the Authority that the Licensee had addressed this outstanding condition. It was Ofgem's view that the proposed UoS charging model would not facilitate the achievement of the relevant objectives[2]. The Authority determined[3] that the Licensee was working towards meeting the condition and the timeframe for fulfilling the condition was extended to 1 April 2007.

This letter deals with this condition to develop and implement an alternative UoS charging model and implement it by 1 April 2007.

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[1] *Authority approval of CE Electric methodologies*, 11 February 2005, 42/05.

[2] The relevant objectives for the UoS charging methodology, as set out in paragraph 3 of standard licence condition 4 (Use of System Charging Methodology) of the distribution licence are:

(a) that compliance with the UoS 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 UoS 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 UoS 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 UoS charging methodology, as far as reasonably practicable, properly takes account of developments in the licensee's distribution business.

[3] *NEDL charging model condition – Authority decision letter*, 20 December 2005

CE Electric's Submission

As required by the condition, the Licensee has provided updates to Ofgem through 2006 on the development of the Licensee's new charging model. CE Electric has also been regularly updating affected suppliers and customers. On 6 October 2006 CE Electric, on behalf of the Licensee, wrote to Ofgem seeking approval from the Authority that it had addressed the condition.

The Licensee proposes to move away from their current approach whereby the previous year's tariff is adjusted for volume changes in the permitted revenue recovery under the price control and implement a model based on a distribution reinforcement model (DRM) (also called the 500MW model). This new model apportions costs from extending the network between customers by reference to their contribution to required capacity. This is a model similar to that used by other distributors in setting charges to customers at lower voltages.

Ofgem's views

Overall, Ofgem considers that the revised approach provides a cost reflective basis and greater transparency for deriving distribution charges. However, Ofgem sought further clarification from CE Electric on a number of issues as part of their submission to assist in understanding the Licensee's revised model and methodology. These are described below.

Connection charges

The Licensee's UoS charging methodology statement states that the representative network model excludes assets paid for by customers via connection charges. We sought to understand how the model took account of this.

The Licensee stated that no low voltage services are included in the representative network model as these assets are paid for by customers. In addition a scaling factor, based on the contributions historically received from customers at the various network levels, is applied to the model to reduce the overall system cost.

Ofgem is satisfied that this approach provides a reasonable approximation such that the outputs of the representative model do not include the costs associated with the assets paid for by customers.

Annualising capital charges

The annualised capital costs resulting from the representative network model are based on a 6.9% rate of return and a 20 year depreciation period. We sought to understand why a more typical asset life such as 40 years was not chosen for the depreciation period, and the likely impact of this assumption on the distribution of scaled income across customer groups.

The Licensee stated that the reason for using a 20 year depreciation period is to reflect their view of the decline in the earning power of the representative network assets as new technologies are developed.

CE Electric undertook an impact analysis for NEDL and Yorkshire Electricity Distribution plc (YEDL), the other distribution licensee in the CE Electric Group, comparing a 20 year and a 40 year depreciation period. The impact analysis shows that the overall variance in the distribution of scaled income recovery between customer groups in both the NEDL and YEDL distribution services areas is 0%, with a maximum variance of 0.5%.

Ofgem considers that CE Electric has not demonstrated a sufficient case to support the use a 20 year depreciation period. However, given the low materiality it is not considered to be a sufficient reason to veto the proposal.

Operating Costs

In their revised methodology statement, the Licensee states that the DRM approach uses the previous years' operating costs as reported to Ofgem as part of the annual price control reporting pack. No scaling factors are applied to the outputs as the Licensee considers that they are already recovering the full annual operating cost.

The Licensee confirmed that they have adopted an approach whereby the fixed charge in the tariff is set to recover the annualised operating costs (excluding exit charges).

It is not clear that the Licensee's approach to operating costs necessarily provides the most cost reflective charges. However, the results of the proposed approach do not significantly diverge from other DNOs. This is therefore not a sufficient reason to veto the proposal.

Authority conclusion

In keeping with its statutory principal objective and general duties, the Authority has considered the proposed approach against the relevant objectives of the licence condition. The Authority considers that the Licensee's revised DRM approach has now established a more transparent UoS charging methodology that derives charges which more accurately reflect the costs of extending the distribution system.

The Authority considers that the Licensee has now met this outstanding condition, and the UoS charging methodology is approved, effective from 1 April 2007. It is expected that the Licensee will comply with all the requirements in the licence, including SLC 4A(5) which requires the Licensee to give not less than three months notice to propose amendments to its use of system charges.

Enduring arrangements

The conditional approval of the UoS charging methodology also required that the Licensee consider other developments in the industry, such as the studies into distribution charging models, when considering a revised model. In addition the Licensee has licence obligations to ensure that their UoS methodology continues to achieve the relevant objectives and make modifications designed to better achieve the relevant objectives.

Although this revised DRM approach may form part of the basis of an enduring charging model it is important that the Licensee should quickly address the recognised, wider shortcomings in their charging arrangements now that this new model has been approved.

Yours faithfully,

Martin Crouch
Director, Distribution

Authorised for that purpose by the Authority