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Bringing choice and value to customers

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Our Ref: RBA/DPC/SOC/38/2
Direct Dial: 020 7901 7255

cc: Nigel Turvey (by email only)

1 February 2007

Dear Sir/Madam,

Decision in relation to Western Power Distribution's proposal to modify their Electricity Distribution Use of System Charging Model – Ref: WPD/WALES/WEST/UOS002A

On 13 December 2006 Western Power Distribution plc submitted a proposal, reference WPD/WALES/WEST/UOS002A, to the Gas and Electricity Markets Authority (the 'Authority')[1] to modify the Use of System (UoS) charging methodology of Western Power Distribution (South Wales) plc (WPD).

The proposal modifies the UoS charging methodology by introducing a new charging model for the calculation of charges for existing and prospective customers connected to the network at extra high voltage (EHV).

In considering the issues raised by the proposal, the Authority deemed it appropriate to carry out a consultation and set out an impact assessment to help respondents give their views. This was published on 15 December 2006 with responses due back by 19 January 2007.

Having carefully considered the issues raised in the proposal, along with the responses to the consultation, the Authority has decided not to veto the proposed 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

Electricity Distribution Network Operators (DNOs) have licence obligations[2] to have in place as of 1 April 2005 three charging statements: the statement of UoS charging methodology, the statement of UoS charges and the connection charging methodology statement. The statement of the UoS charging methodology outlines the method by which distribution UoS charges are calculated.

[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

The DNOs have a requirement to keep the UoS methodology under review and bring forward proposals to modify the methodology that they consider better achieve the relevant objectives[3].

Before making modifications to their UoS charging methodologies each DNO must give the Authority a report setting out the terms proposed for modification and how the modification would better achieve the relevant objectives. The licensee (DNO) then makes the modification unless within 28 days of receiving the report the Authority either directs the licensee not to make the modification or notifies the licensee that it intends to consult and then within a further three months directs the licensee not to make the modification.

WPD have consulted twice during 2006 on their proposals and these documents can be found on their website[4] along with consultation responses. Since the last consultation, WPD have made a number of changes to their approach taking into consideration responses. In light of this and the important nature of the proposal we issued a consultation on the modification proposal on 15 December 2006.

WPD Modification Proposal

WPD submitted one report to cover proposed changes to both their South Wales and South West licensees. WPD's report is available on our website[5] and therefore the detail of the proposed changes and revised model is not repeated here. In summary:

WPD's proposed revised UoS charging methodologies include a Long Run Incremental Cost (LRIC) model for calculation of charges at the higher voltage networks[6] with a version of the existing Distribution Reinforcement Model (DRM) applying at lower voltages. The new model is a substantial change to the way they currently charge users at EHV.

The LRIC method calculates the brought forward (or deferred) reinforcement cost as a result of the addition of an increment of demand or generation at each network node. The objective is to link the changes in behaviour of a user to an impact on system costs.

An initial AC load flow is used to determine the time it would take for each asset to reach its capacity assuming underlying utilisation levels and growth rates (assumed at 1%). Given these timings, and the future reinforcement costs, a net present value of the future reinforcement costs for the network is calculated using a discount rate equivalent to the cost of capital assessed by Ofgem as part of the price control (currently 6.9%).

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[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 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

(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.

[4] www.westernpowerdistribution.co.uk

[5] www.ofgem.gov.uk

[6] The LRIC model operates at EHV level (in the main 132kV and 33kV)

For each node, an increment (0.1MVA) of demand or generation is added and a new load flow generated. The evaluation of the net present value of the future reinforcement is repeated for the network with this increment present. The difference between the initial and incremental study represents the impact on future reinforcement investment per incremental change in demand or generation. This is represented as an annual £/kVA at each node by multiplying the difference by an annuity factor.

The above analysis is undertaken for both winter loading conditions and summer loading conditions using the appropriate ratings for the season for each branch. The condition that drives the need for reinforcement is used to determine the prices for demand and generation users.

The proposed change predominantly affects charges for parties using WPD's EHV network. Charges for existing EHV demand customers and distributed generation connections at EHV who are liable for UoS charges using the network will be affected. This change will also have an effect on other users of the network mainly due to the impact on revenue scaling.

Respondents' Views

Our consultation on WPD's modification proposal closed on the 19 January 2007. The responses are summarised in **Annex 1** against the main issues raised by the consultation along with views on the impacts, costs and benefits of the proposal.

Several respondents proposed that implementation of the proposal should be delayed or there should be a form of transition to the new charges so that customers and suppliers had more time to take account of the price changes. Some respondents argued that a delay would allow the other distribution companies to catch up and may provide for a more consistent approach to distribution charging.

Other concerns raised by respondents included the approach WPD had taken to scaling, the growth rate assumptions underlying the model, reactive power charges and the omission of fault levels as a cost driver.

Despite assessing the impacts of the modification in the consultation there was limited consideration or comment by respondees, in particular by those expected to be most affected. There was concern that insufficient lead time to changes in tariffs had been provided, in particular suppliers that focus on certain market segments were more exposed due to the changes and that delay would allow them to factor the changes into their prices to customers. Two responses were also concerned about the use of the Bath University study[7] as the basis for the long term benefits derived from changes to the charging structure. A number of responses also commented that they had concern over volatility of the LRIC model which would provide a detrimental effect on customers and also on both the supply and Distributed Generation (DG) market.

Ofgem's view

Ofgem's views on the main issues raised by the modification and the responses to the consultation are detailed in **Annex 1**.

The Authority must assess the proposal against the relevant objectives and consider whether the proposal is consistent with its principal objective and general duties, and European law.

[7] Bath University benefits analysis report on the long term charging framework (document 12/06).

Relevant Objectives

WPD's proposed modification introduces a UoS methodology which considers forward looking incremental costs in deriving charges. This modification amends WPD's current approach of charges averaged by voltage to a locational or nodal charge at EHV. It better reflects the costs imposed on the network by a change in a customer's behaviour. This improves the cost reflectivity of the model to existing (and future) users of the EHV network without imposing a significant implementation cost either on WPD or users. The implementation costs in the main have been limited through the use of existing charging structures which do not require changes to suppliers' billing systems. Cost reflective charges should facilitate economic development of WPD's network which leads to more effective utilisation and ultimately lower prices to consumers.

The current charging arrangements for DG are overly simplistic providing a non locational average charge to new DG. It is important to ensure that costs are being reflected to the parties effectively allowing for economic development and reducing unnecessary barriers. Although through the retention of a shallowish connection charge DG is still provided with some cost signal, WPD's proposal better reflects the costs and benefits of these parties at EHV on an on-going basis and therefore is a substantial development to their UoS charging methodology.

A number of responses raised concern over the potential volatility of charges derived from the new model. The model will reflect changes in network arrangements which will and should impact on charges. However, the use of a 'fixed adder' approach to revenue scaling the general volatility of the charge is likely to be more limited compared with other scaling options. In addition, by publishing and making available the charging model and publishing the associated tariffs the charging arrangements are likely to be more transparent to suppliers, demand customers and DG parties. Although some level of understanding of the model is required due to its greater complexity, publication of the model coupled with analysis of other available information such as the long term development statements[8] should enable parties to more easily predict their charges going forward. This greater transparency may facilitate greater competition in these markets.

This change also better achieves the relevant objectives by allowing WPD to better discharge its duties under the licence by encouraging economic use of its network.

The Authority's principal objective and general duties

The Authority's principal objective is to protect the interests of consumers, wherever appropriate by promoting effective competition. As noted above, Ofgem considers that the proposal, if implemented, will have a positive impact on both cost reflectivity and competition through greater transparency. By extension Ofgem considers the proposal will therefore be in the interest of consumers now and in the future.

The Authority in making this decision must also be mindful of its obligations under European law, including EU Directive 2003/54. This Directive requires, amongst other things, that the methodology and charges are proportionate and applied in a non-discriminatory way. This proposal only considers charges for EHV connected users meaning that charges for EHV users are calculated in a different manner to

[8] Each licensee is required under standard licence condition 25 to produce a report outlining the current and planned development of their network

HV and LV users. Our view is that this issue is one of proportionality. Indications are that rolling out this modelling to lower voltages is likely to cause an exponential increase in modelling complexity. On this basis Ofgem considers that the difference in treatment is proportional in the circumstance. However, looking forward it will be important for WPD to consider further how they treat connections to HV and LV networks, in particular DG, to ensure that sufficiently robust charging arrangements to these parties are in place which enable WPD to provide non-discriminatory and cost reflective charges.

It is considered that the proposal has a relatively minor effect on the Authority's other statutory duties such as security of supply and environment.

The Authority's decision

The Authority has therefore decided **not to veto** this proposed modification.

Copies of this document are available on the Ofgem website under Electricity Distribution Charges (Modifications) area of work.

Please contact myself or Mark Cox on 0207 901 7458 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

Annex 1 – Main Issues: Consultation responses and Ofgem's view

Summary

Ofgem received 14 responses, of which 12 were non-confidential. These were broken down as follows:

Response type	Number
Network Operator	4
Generator trade association	1
Supplier	4
Network / Supplier / Generator	2
Consumer watchdog	1
Energy intensive users	2

EHV charges

The revisions to the UoS methodology predominantly affect EHV charges. There are significant changes for some EHV customers (over 100 % increases in four cases compared to current 06/07 charges). DUoS[9] charges currently make up a minority percentage of an EHV customer's electricity bill. WPD are not proposing to implement any transition to the new prices and therefore unless vetoed these charges would take effect from 1 April 2007.

If this proposal is vetoed WPD's current UoS methodology indicates that current EHV charges will be exposed to an increase of RPI. Vetoing this proposal would also mean some substantial changes in charges for other customer classes due to changes in allowed revenue and changes in inputs in the existing DRM charging model.

Respondents' views

Responses were in the main concerned about the size of the tariff disturbance with no prospect of transition. Most responses supported the need for some transition to allow these customers time to adjust to the increases. Some supplier responses felt that with such a significant change a longer notice period should be provided to allow them time to re-price their contracts to customers. On the counter side a couple of responses supported the lack of transition arguing that the costs should be passed through to the customers.

In addition one response suggested that WPD should consider developing some form of long term fixed products.

Ofgem's view

Ofgem has supported transitions in charges for EHV customers during 2005/06 and 2006/07 to limit any double movement in charges to users in the implementation of enduring charging arrangements. WPD have over this period been developing revised charging arrangements which are now proposed to take effect from 1 April 2007. Ofgem considers that although the changes in charges based on WPD's new charging model are significant to some users, these revised arrangements provide cost reflective charges and we do not see merit in continuing cross subsidy. We have previously indicated that we would look for more robust charging by April 2007 and there has been considerable consultation on the general principles. We agree that more advance notice of new charges would be preferable, although note that the extensive work WPD carried out in the last few months prior to their final proposal was important in resolving issues.

[9] Distribution use of system

The responses received also did not detail what impact the introduction of the new charges would have on the business involved and in fact those parties considered to be most affected by the proposal did not respond.

Scaling to revenue

The scaling requirements for the WPD model are two-fold. Initially the revenue to be recovered is allocated between the LRIC model and the DRM based on the MEA[10] value of the relevant assets. The second element is to scale the individual outputs from both the DRM and LRIC models to the apportioned revenue requirement.

WPD are proposing to scale outputs from the LRIC charging model to their allowed revenue using a 'fixed adder' (£/kVA) approach which is similar to National Grid Electricity Transmission (NGET). This approach minimises the disturbance of the economic signals derived from the model as compared with a percentage scaling approach which is the method used for DRM and that used historically.

In the case of generator charges derived from the LRIC model, WPD intend to use a 'fixed adder' approach so they are better able to adjust the marginal costs to their allowed revenue. Due to the fact that this is a separate revenue stream that at this time is small and growing unpredictably WPD have determined that this is the most appropriate mechanism.

Respondents' views

A number of responses noted the distortion created by separate allowed revenues for demand and generation and argued that this needed to be addressed to allow these charging models to work effectively and avoid perverse outcomes.

Some respondents felt that WPD had not provided a strong justification for a fixed adder approach as compared to percentage scaling while others argued that there were other drivers of WPD's costs that could be identified and captured which would reduce the need for scaling.

Ofgem's view

A fixed adder approach is consistent with economic charging principles. Although relatively simple, it minimises the distortion from marginal costs derived from the model without the need to make assumptions over the elasticity of different customer groups. A fixed adder approach also minimises volatility as it provides a £/kVA amount which forms a relatively stable element of the overall charge to a customer. On this basis we consider that this form of scaling is appropriate for the LRIC model although it is noted that the 10% limit on changes in charges for DG will impact on this approach until 2010 when it is proposed that this safeguard will fall away.

Ofgem recognises that with the introduction of economic charging models the approach to the DNOs' allowed revenue will need to be reconsidered at the next price control.

Generation Tariffs

WPD's proposed method considers the impact of EHV connected generation both in terms of the costs and the benefits and, as can be seen in the WPD's modification report[11] pages 24-44, some of these charges are negative. The model considers the benefits that generation will afford to the network based on the network security

[10] Modern Equivalent Asset value.
[11] As set out above, this report is published on our website.

standard[12]. This means that plant considered more reliable will be given greater credit.

WPD propose to amend their UoS methodology also to restrict existing generators (not currently paying GDUoS[13] charges) from opting into the new arrangements. WPD propose to resolve arrangements for existing generators as a package rather than having the prospect of generators on negative charging nodes opting in on an ad hoc basis from 1 April 2007.

We note WPD intend to retain the 10% limitation on changes in charges year on year for EHV, HV and LV connected generators but have indicated that this is time limited to 2010 while the new arrangements bed down.

WPD do not intend to amend the basis of charges for HV and LV connected generators as part of this modification proposal.

Respondents' views

In general there was support for WPD's proposals for generation charges. However, one respondent felt that WPD's approach could have gone further, such as developing similar proposals for HV and LV, that it could have included incentives to generate by basing charges on actual generation and noted that WPD had taken the worse case contributions from generation. A number of responses argued that negative charges should only be based on actual generation rather than its theoretical contribution.

Two responses supported the removal of the opt-in for existing generators but pressed for the arrangements for existing generators to be resolved quickly.

Ofgem's view

WPD's proposed modification is a significant development for DG which enables the costs and benefits from the use of the network to be identified. WPD's use of the security standard P2/6 is appropriate in considering the contribution that different plant will make although it is noted that this will provide greater complexity in the applicable charges due to the different contribution factors assigned to forms of generation under P2/6. Ofgem notes responses were in favour of a negative charge based on actual generation (more similar to electricity transmission charging arrangements) rather than a theoretical contribution based on P2/6. On the basis that the model is reflecting the investments that WPD would be required to make on their network to comply with their security standard we agree that this reflects the costs being imposed on WPD. However, we note that DNOs contracting with both demand and generation to manage network constraints may be an area for future development.

Retention of the 10% limitation on movement in charges is appropriate at this time due to the growing nature of the DG allowed revenue and relatively small population. In addition WPD's statement detailing when this arrangement will fall away provides greater clarity to parties.

We agree with WPD's proposal to exclude existing generators from opting into the new arrangements due to difficulties of reconciling revenues and the perverse incentives it could cause. It is preferable to resolve the charging arrangements for existing generators as a package and would expect other DNOs to consider their position in this regard.

We note that this proposal introduces differences between the method used for calculating HV and LV DG charges and EHV. As noted earlier we consider that, at this time, there is justification for such a difference in treatment. Indications are

[12] The network security standard is ER P2/6 and this details contribution factors that different types of plant can be assigned to support the network.
[13] Generator Distribution Use of System

that rolling out this modelling to lower voltages is likely to cause an exponential increase in modelling complexity. On this basis Ofgem considers that the difference in treatment is proportional in the circumstance. However charges for these classes of DG need to be considered further and we would expect WPD to bring forward proposals in due course.

New Connections

WPD intend to base their charging model on the forecast network for the relevant charging year. They intend to include proposed reinforcement to their network but proposed connections will only be included in the model for the relevant charging year if a connection offer has been accepted and all consents have been obtained for the proposed connection. The purpose of this is to minimise the effect on existing users from projects that become delayed.

Respondents' views

There was limited response on this issue. One respondee support WPD's approach.

Ofgem's view

This approach is different to a comparable methodology that NGET utilises: NGET include in their modelling any connections that have signed connection agreements. However, lead times for connections in transmission are greater requiring financial commitments sooner in the connection process. In distribution, lead times for connections are relatively short, e.g. they can be within a year, and therefore there may be relatively little financial commitment to a project proceeding when setting UoS charges for the year. WPD have addressed this by including only connections where all consents for the project have been granted. This is likely then to provide a more reliable connection date and avoid undue volatility in charges. On this basis we agree that a connection that has received all its necessary consents is an appropriate basis for inclusion in the charging model.

Sole use assets / contributions

There are a number of cases where assets have been originally installed for a customer but form part of the network. However, the assets have been sized to connect the original customer load and therefore are likely to be fully utilised. Due to the way LRIC works it will identify these assets as high marginal cost as they will be highly utilised. This will impose a high cost on the existing customer. WPD have revised their approach to the treatment of off-site sole-use assets by removing these assets from the LRIC calculation. This treatment may lead to step changes in charges if new customers connect to these assets and they become shared use. By not including them in the model there is also the risk that the charges will not provide an effective signal through UoS charges to new parties however this is balanced due to the shallowish connection charging boundary.

WPD's initial position on treatment of contributions to sole use assets was to assume that no assets had been paid for at all. Their revised proposals now assume that all sole use assets have been fully paid which ensures that there is no double charging and the only cost to be incurred by users for these assets will be the annuitised value of the replacement costs. However, such an approach provides a weak signal, certainly at the higher voltages, in deciding whether to replace assets.

Respondents' views

Few respondents commented on this issue but were supportive of WPD's approach. One respondent questioned why WPD do not make adjustments (as they do at lower voltages) for contribution to shared use assets recognising the shallowish connection charging boundary.

Ofgem's view

Off site sole use assets do not sit comfortably within the charging model – in general the assets will have already been paid for by the user at connection and the assets are not being used by other network users. However, there remains the issue of providing suitable cost signals to new parties as these assets are likely to be heavily utilised and there will be a step change in charges to existing users if new parties become users of sole use assets. We consider that the shallowish connection charging arrangements provide a relatively strong cost message to new parties proposing to connect and utilise heavily loaded sole use assets which should mitigate these risks.

The level of contributions that have historically been received is unclear but these assets do not form part of the general network and therefore to assume that they have been fully contributed to, which is in line with current policy, is appropriate. However, by annuitising the value of the future replacement costs into the use of system charge a very weak cost signal will be provided when these assets are due for replacement. For connections at EHV where the replacement costs of sole use assets can be millions of pounds it is important that customers are provided with an effective cost message. Although this proposal does not change WPD's approach to charging for replacement of these assets, further consideration, particularly at EHV, needs to be given to a suitable mechanism.

Capping negative demand charges to zero

In the event that the LRIC model produces negative demand charges, WPD have decided to set these equal to zero. WPD justify this approach on the grounds that these could provide perverse incentives. They also note that the negative demand charges in the main are being driven by existing large generators which are dominating the local area. These generators are not currently paying generation charges and therefore WPD do not think it consistent to levy a negative charge. It is noted that this is not a significant issue at this time as there are no demand charges that are currently capped to zero.

Respondents' views

There were mixed views with a number of respondents arguing that they shouldn't be capped as this would otherwise distort cost reflectivity while others supported capping to avoid perverse incentives.

Ofgem's view

There are no demand charges that are currently capped to zero and, although this does not rule out this being the case in future charge setting years, it is not considered to be a significant issue at this time. Further consideration of the charging arrangements for existing generators may also affect this issue going forward.

Reactive power charges

WPD utilises an AC load flow network model as the basis for the LRIC charging model. This approach considers the cost impacts from both real and reactive elements on future network costs. However, the relationship between the combination of real and reactive increments and network costs is not linear. WPD's approach identifies the marginal cost for the addition of 0.1 MVA at a pre determined power factor but customers may have a different power factor and this may reduce the cost reflectivity of the model. WPD have indicated that this is limited and that by including the reactive element it is likely to be more cost reflective than just having a model based on MW flows.

Respondents' views

In general respondents were supportive of reactive power charges but some noted concern over the trade off against cost reflectivity. Others noted that WPD had provided limited evidence of the relative impacts to quantify the issue.

Ofgem's view

By using an AC model WPD are better able to assess the cost of both real and reactive power flows on their network. However, the non-linearity of this model means that the relativity of the real and reactive power (the power factor) of a user will impact on the cost imposed. The cost impact from adding an increment of 0.1MVA will be subject to the power factor of the increment and therefore such an approach will only provide a proxy for the impact of real and reactive power. WPD assume 0.95 for demand customers and 1 for DG. On the basis that 0.95 is a better approximation for users on their system than 1 (which could be considered to be the underlying assumption for a DC model) then the AC model should better reflect the costs. This is likely to be the case and therefore the AC model is unlikely to reduce the cost reflectivity of the model.

Growth Rate

WPD's model has an assumed growth rate built into it in order to establish when assets will become overloaded. This is set at 1% across their entire network for each licensed area. In WPD's previous consultations this approach has attracted a lot of comment. In particular a number of parties have noted that this may be inaccurate on the grounds that the growth rate may be different depending on location within the DNO's area. WPD note that growth rate is a key assumption of the model but that it is based on a long run average and do not believe that it is workable to have different assumed growth rates for different locations. They also do not intend to regular change it based on its long run nature and to avoid unnecessary volatility.

Respondents' views

A number of respondents were concerned about the use of a global growth rate and argued that this did not reflect the network planning and investment undertaken and would compromise cost reflectivity. Some respondents were concerned that as the growth rate tended to zero the model became increasingly volatile while an increasing growth rate significantly reduced the marginal cost.

Ofgem's view

We note the concerns raised by respondents to the use of an assumed growth rate in the model. However, this is a long run charging model and therefore a long run figure for growth rate is appropriate. WPD have argued that a localised growth rate is likely to be too complex to administer as it would rely on a short run understanding of growth rates in any particular location which is likely to be prone to error. We agree that a global growth rate is an acceptable assumption in light of the modelling required.

Thermal Model

The model only applies to thermal capacity and does not consider fault levels. WPD indicate that their reinforcement costs are in the main driven by thermal requirements and their current UoS methodology does not take account of costs driven by fault level. We would expect WPD to keep this under review and develop arrangements if this becomes a more significant issue.

Respondents' views

A number of respondents argued that the model should consider fault levels and that WPD had not provided evidence to make the cause for a solely thermal model.

Ofgem's view

WPD's current charging model considers costs only driven by the thermal capacity of the network. WPD do not believe that fault levels are a significant cost driver on their network and therefore have not incorporated it into their model. WPD are best placed to understand the cost drivers on their business and have the incentives to put in place charging methodologies to reflect these costs. We would expect WPD to monitor cost drivers over time and include relevant cost drivers in their model where they are a significant determinant of costs.

Chargeable capacity

WPD's modelling assumptions for the capacity of customers connected at EHV is different between demand and generation. For generation connections capacity is taken as the contracted capacity, while for demand customers, capacity is taken as the previous years recorded demand. This difference is on the grounds that demand customers are less responsive to market conditions than generation. This approach may be appropriate but it is important that customers are aware of the charging arrangements as in effect demand customers will be charged for their behaviour post the event.

Respondents' views

One respondent supported WPD's approach on the basis that sole use assets were excluded from the charging model. However, a supplier noted that they may not be aware of the charges to be levied and therefore would bear a risk. This risk would be passed on to end user ultimately.

Ofgem's view

It is not clear that there is a strong basis for this difference in approach between demand and generation users. Although demand users may be less responsive to market conditions than generators, at EHV some of the demand users will be very responsive as electricity may be a large input cost. In general we would expect parties to be charged based on the level of capacity that they have indicated that they need and secured through contract. We would expect all current demand parties to have a contracted amount that could be utilised for charging purposes. We would encourage WPD to give further thought to the product used for charging.

We note that there may be differences between the contracted capacity and the level that has historically been used for charging purposes and therefore it may not be appropriate to align these values in time for implementation. However, there may be a need to move to arrangements where contracts and charging arrangements are more aligned so that customers can purchase the capacity they require to ensure that DNOs are able to develop their network in an economic manner. We do not consider this to be a material issue in itself to veto the proposal.

Other issues raised by respondents

Consistency across DNOs

Two responses favour consistency, and urge delay on WPD implementation. One supplier urges consistent tariff structures across DNOs.

Ofgem's view

We consider WPD's proposal on its merits. Current charging arrangements are different between DNOs and therefore we cannot see a case for delaying implementation until other DNOs are in a position to change their arrangements.

New model is exclusively at EHV

Respondents were concerned that WPD's new model applies at EHV level only with the existing model remaining at HV and LV levels. The current DRM does not derive generator charges, and WPD is not proposing changes to the method for calculating for HV and LV connected DG charges. One supplier notes that this difference is inefficient and sends mixed signals to users and may be discriminatory.

Ofgem's view

This issue is one of proportionality. Early indications on this are that rolling out this modelling to lower voltages is likely to cause an exponential increase in modelling complexity.

Views on impacts, costs and benefits

One supplier noted that the margin on supply is ~5% and notes that prices go down for domestic customers for the new model relative to the existing model whereas they rise for other LV customers. The supplier notes that in the non-domestic market they will be selling at a loss unless they re-price. Given the lack of domestic customers in their customer base they feel they are disproportionately affected by the change and request a longer lead time than 1 April 2007 for the new methodology.

Ofgem's view

The change in charges from 2006/07 to 2007/08 is due to a number of factors:

- Changes in allowed revenue between 2006/07 and 2007/08
- The annual update of inputs within the existing model (DRM) for calculating charges below EHV level
- Impact of the new LRIC model. The split of revenue to EHV customers is lower under the new model than previously, hence customers lower down the network will pick up slightly higher charges to recover WPD's allowed revenue.

For the majority of customers the main impact on charges is driven by changes in allowed revenue and the updated DRM which are unrelated to this modification decision. As noted earlier, we agree that more advance notice of new charges would be preferable.