

To suppliers, generators, distributors and other interested parties

Promoting choice and value for all customers

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Dear colleague,

Structure of electricity distribution charges: update on progress and next steps

This letter provides an update on the reform of the structure of electricity distribution charges. This update coincides with the setting up of a new industry-led charging methodology forum from May 2007 (see below) and two years operation of new published connection and use of system charging methodologies.

Background

In April 2005, the electricity distributors adopted new, interim charging arrangements. These required publication of approved methodologies, which are kept under review against a series of licence objectives¹. The methodologies are based on "shallowish" connection charges² and ongoing use of system charges³.

The models on which demand use of system charges are based were developed in the 1970s and 1980s and do not cater for distributed generation. Relatively simplistic models have been added on to set charges for new generators.

Ofgem was concerned that these models will not be fit for purpose in the future. We anticipate, over time, increasing development of new sources of distributed generation

¹ The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of standard licence condition 4 of the distribution licence 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.

² Shallow connection charges cover assets required to connect a user to the distribution system plus a proportion of costs associated with any required network reinforcement. The proportion is determined via apportionment rules which are set out in each DNO's connection charging methodology.

³ Generators connected prior to the application of the interim arrangements paid for connections assets plus any required network reinforcement ("deep" charges) and receive a full rebate against any use of system charges until 2010.

and changes to demand patterns and responsiveness. Electricity distributors have an important role in facilitating such changes. The development of networks, generation and demand needs to be considered more holistically. This requires price signals that reflect costs of the networks so that users can internalize those costs in their decisions.

We have therefore encouraged the electricity distributors to understand the impacts of user behaviour on their costs and to develop charging models, where practical, that reflect network costs and benefits to demand customers and generators (in "longer term" methodologies). We commissioned a report from the University of Bath to assess the potential benefits of such models, which indicated they were potentially significant even if only applied to the EHV network⁴. We recognise that the more sophisticated models could not practically be applied throughout the entire network. We also recognise that application of the understanding of costs provided by these models must reflect the importance that users place on transparency and predictability.

Progress to date on the development of longer term charging methodologies

Through 2006 the electricity distributors worked collectively to progress their thoughts on the longer term charging framework. Four workshops were held through 2006 to enable interested industry parties to contribute to the process. These workshops were followed by consultation papers, and a final conclusions paper published in December 2006⁵.

Alongside this work Western Power Distribution (WPD) consulted twice during 2006 on a long-run incremental cost model which reflects the costs and benefits of generation and demand customers at EHV. WPD subsequently made a modification proposal for a new EHV charging model in December 2006. This proposal was not vetoed by us and is being applied to WPD's EHV-connected customers from 1 April 2007.

The remaining electricity distributors are at varying stages of model development but have all indicated their intention to develop their charging models through 2007. We expect the DNOs to ensure that their customers and the wider industry are fully aware of the work going on. This would include consulting with the industry on the principles and detail of their charging models, including illustrative charges.

Company	Initial consultation	Illustrative charges	Target implementation
UU	now (closes 20 April)	Autumn 2007	April 2008 if deemed appropriate
CN, SP, SSE (working together)	April 2007	April 2007	April 2008
EDFE	May 2007	Sept 2007 (SPN)	April 2008 (SPN) and (EPN, LPN) April 2009
CE	Autumn 2007	Spring 2008	April 2009

This project requires extensive development and implementation work. The electricity distributors have indicated their plans as follows:

Implementation in April requires indicative charges to be published by the end of the previous December. For substantive modifications requiring consultation, we have made

⁴ 'Network benefits from introducing an economic methodology for distribution charging: a study by the department of electronic and electrical engineering', University of Bath, December 2005, available from the Ofgem website, <u>www.ofgem.gov.uk</u>.

⁵ This work is on the Regulation pages of Electricity Network Association's website, <u>www.energynetworks.org</u>.

clear to the distribution licensees that we would want to receive their proposals by the previous September.

We have previously noted that it will be preferable to complete this work before the next electricity distribution price review commences, both to provide some early experience of operating the new models and for resourcing reasons. It is disappointing that progress has been delayed by some electricity distributors. We accept that it is important to get the models "right" before making fundamental changes to charges, and that the process has been useful in raising understanding of cost modelling. However we will be more reliant on assumptions at the next price control review than we had anticipated. Nonetheless, it is important that progress is maintained to maximize the benefits from the work to date and we will continue to support the electricity distributors in taking this work forward.

Distribution charging methodologies forum

Now that the principles for the new charging models have been established, the first model has been implemented and the other electricity distributors have established plans to deliver new methodologies, we consider it appropriate to transfer responsibility for the key industry liaison group to the distribution companies. We therefore welcome the establishment of the Distribution Charging Methodologies Forum (DCMF).

The DCMF will be chaired for the first year by Tony McEntee of Scottish Power. Its first meeting is being held on 3 May 2007. The distribution charging methodologies forum (DCMF) will meet every 6 to 12 weeks and will consider and progress policy relating to the network operators' use of system and connection charging methodologies. Further details on the DCMF are available from the Energy Networks Association's website⁶.

At the last ISG⁷ meeting, it was agreed that the DCMF should take forward oversight of the longer term charging methodologies described above; log and, if possible, substantively discuss forthcoming modifications; and co-ordinate and discuss progress of the following issues:

- <u>HV/ LV generator charging</u>: the existing charging models for HV and LV generators are simplistic and the new models developed for EHV cannot readily be extended to cover the full HV or LV network on the same basis. There is therefore a need to extend some of the concepts now being developed to provide more cost- (and benefit-) reflective charging. UU's current consultation considers this issue.
- <u>Charging products and structures</u>: the distribution companies have recognised that there is scope to align definitions of the charging product (e.g. capacity) and their approaches to charging for reactive power. We consider that there is also scope for better reflection of costs of usage at different times and potentially for longer-term or more flexible products. In the medium-term, there appears to be value in developing tariffs reflective of costs at voltage levels rather than by predetermined customer profile/class.
- <u>Methodology statements</u>: it has been suggested that a common format for each of the connection and use of system methodologies could be used by all electricity distributors. Work on the connection methodology will be taken forward in consultation with Ofgem's Electricity Connections Steering Group (ECSG).

⁶ <u>http://www.energynetworks.org/spring/regulation/index.asp</u>.

⁷ Structure of charges implementation steering group, an expert industry group. See details of meetings on our website, <u>www.ofgem.gov.uk</u>, under Networks/ Electricity distribution.

- <u>Charges to IDNOs</u>⁸: current methodologies were generally developed prior to the recent growth of IDNOs and IDNOs have challenged whether these are appropriate. We have emphasised that distribution companies need to comply with their statutory (e.g. Competition Act) and licence obligations. WPD has recently proposed a modification to its methodology in respect of charges to IDNOs. We are likely to consult on this issue.
- Existing generators: as at 31 March 2005, there was 12.9GW of generation capacity connected to distribution networks. These generators connected under a "deep" connection charge regime and are not currently paying use of system charges. However, the decisions they take about future use of network capacity may impact on network costs, including charges to prospective generators. The lack of signalling of these costs does not promote economic efficiency. We have explored various conceptual options⁹ for introducing charges for these generators, with or without compensation. At present, the lack of clarity on the likely magnitude of charges makes it difficult to take this issue forward. We therefore propose to return to this issue when more indicative generation charges under new models have been published likely to be early 2008.

In all of these cases, the distribution companies are responsible for putting forward changes to their charging methodologies. We would expect substantive industry discussion of significant changes, in many cases via the DCMF. In deciding whether to consult on modification proposals we will take account of the extent of discussion at DCMF.

Views invited

While the main purpose of this letter is to update industry parties on developments in electricity distribution charging, we would welcome any comments or views on any of the issues raised in this open letter. If you wish to comment, please do so by 16 May. All non-confidential responses will be published on our website. As such, any confidential responses should be clearly marked as such and confidential issues set out in an appendix to any response.

If you have any questions or comments on this letter please contact Colette Schrier on 0207 901 7239 or Alberto Prandini on 0207 901 7281.

Yours faithfully,

Martin Crouch Director, Electricity Distribution

⁸ There four independent network operators (IDNOs) who own and run smaller networks embedded in distribution services areas.

⁹ Further details of discussions at ISG meetings are available from our website, <u>www.ofgem.gov.uk</u>, under Networks/ Electricity distribution.