

Your Ref

Our Ref Ofgem/WPD/SP consultation

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Dear Colette

**Consultation on use of system charges to new electricity distribution licensees:
WPD and SP proposals**

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

I am writing in response to your consultation regarding use of system charges to new electricity distribution licensees: WPD and SP proposals. Your initiative is welcome in this area. CE has been actively involved in consulting with new electricity licensees on the issues of tariffs and metering.

We believe that, given the changing market, there are still some very complex issues to be addressed and the concerns of the independent distribution network operators (IDNOs) is one of those.

Whilst we recognise that IDNOs and distribution network operators (DNOs) operating out of area are subject to a price cap under distribution licence condition BA1 and special licence condition G1, which caps end-user charges for providing use of system to domestic customers to those of the host DNO, we must set tariffs in accordance with (i) the overall income allowance given in the price control, and (ii) the methodology, approved by Ofgem, drawn up under (and in accordance with) the licence condition on use of system charging.

We are currently carrying out our own analysis and are actively reviewing our charging methodology and tariff structure and, if we feel improvements can be made to better achieve the relevant objectives¹, we shall bring forward charging modification proposals to address these. This work has progressed substantially but we have not as yet completed our analysis: any comments that we make on the SP

¹ The Use of System Charging Methodology has the following objectives set out in Standard Licence Condition 4:

- (a) that compliance with the Use of System Charging Methodology facilitates the discharge by the licensee of the obligations imposed on it under the Act and by the Licence;
- (b) that compliance with the Use of System Charging Methodology facilitates competition in the 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 reasonably practicable, 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 is reasonably practicable, properly takes account of developments in the licensee's distribution business.

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and WPD proposals at this stage are therefore subject to the completion of our own analysis, which may be influenced by the responses to the present consultation.

Both Western Power Distribution (WPD) and ScottishPower (SP) are proposing to introduce specific yardsticks to cover IDNO connections and IDNOs have argued that the two main factors that make their connections unprofitable are half-hourly metering and capacity charges. We would therefore comment on each of the issues raised in your consultation as follows:

Main letter issues

Do the WPD and SP modification proposals better achieve the relevant objectives? Specifically:

- *Are the proposals more cost reflective than the current methodology?*
- *Do WPD and SP demonstrate that their proposals facilitate competition in generation and supply and do not restrict, distort or prevent competition in transmission and distribution?*

We believe that a case can be made that both proposals on the whole would give rise to charges that may be more cost-reflective in the case of IDNOs. There is already a precedent in the industry for average, rather than geographic, tariffs and removing IDNOs from the larger legacy customer groupings will be likely to increase the cost-reflectivity of their charges. However, in principle, it would be possible to say the same about any tariffs that were constructed on a cost-reflective basis for a sub-set of users. De-averaging will result in more cost-reflective tariffs for those users but the case for IDNO-specific tariffs has to be able to answer the challenge of why IDNOs should be singled out, rather than any other group, for such de-averaging. We would welcome Ofgem's clarification of this point. There is also a risk that the creation of specific tariffs will set a precedent and DNOs will have an avalanche of new tariff requests (from different customer groups). This may not facilitate competition as it could potentially introduce more complexity and less transparency for the mass market. We also believe that the WPD proposal to remove capacity charges will weaken the cost signals to customers if it is not accompanied by a refusal to allow IDNOs to reserve capacity in the way that a customer facing capacity charges would do.

Annex 2 issues

Specific Yardsticks for IDNOs

"Views are sought on the extent to which individual customers or groups of customer are singled out as a separate group for charging purposes?"

In the UK-based distribution companies it is accepted custom and practice (that has also, of course, stood the test of regulatory approval) to have a degree of averaging in charging structures; indeed, we believe this very averaging makes it possible for the IDNO business model to exist. At LV and HV system levels the averaging in the tariff models creates opportunities in low-operating cost distribution areas (such as urban areas with a high density of connections) for IDNOs to select sites that increase their margin and therefore develop a portfolio that does not contain the burden of sites in low-density (mainly rural) connection areas.

To make charging methodologies more cost-reflective, DNOs could bring forward developed tariffs that are less averaged and more specific by introducing a range of tariffs for different types of customer with different load profiles e.g. steelworks, supermarkets, petrol stations and places of worship, etc. However, it is worth noting that relevant objective (c) requires that compliance with the Use of System Charging Methodology results in charges which reflect, as far as reasonably practicable, the costs incurred by the licensee in its distribution business, which acknowledges by implication that full cost-reflectivity is not reasonably practicable. It is also important to acknowledge that suppliers tell us they want more simplicity and transparency in tariffs, and the introduction of such tariffs would not facilitate this. Therefore we do not believe that moving away from averaged tariffs would be in the interest of suppliers or end-users in general.

On balance, therefore, we do not foresee a move away from averaged tariffs for all customers, but we hope that one of the consequences of this consultation will be that Ofgem will clarify whether it

considers that there is a valid argument for treating IDNOs as a special case, perhaps in recognition of the fact that they represent a discrete customer group that have certain restrictions placed upon them (the BA1 price cap), which restricts what they can charge to end-users (domestic). We would welcome Ofgem's views on whether it considers the development of cost-reflective IDNO tariffs, against the backdrop of an averaging approach to the design of other tariffs, as permissible discrimination.

Avoided Costs

"Views are sought on the validity of the assumptions utilised in the WPD proposals for estimating the 'last mile saving' derived from IDNO connections."

We believe that DNOs' tariffs already largely avoid including any of the costs of the service cable and part of the mains cable as these assets are paid for via connection charges and tend to be replaced when a new connection is required. Within the CE distribution reinforcement model (DRM) we do not incorporate these costs as we believe this would introduce an element of double charging. With this in mind the exclusion of 50% of the LV network costs seems high, and we would welcome clarification of how WPD have established this figure. Without this level of information we cannot make any further comment. It is difficult to understand how the new tariffs proposed by WPD can be robust or how they can have a high degree of confidence in the assumptions they have made, bearing in mind that they have only one site connected.

As well as the avoided costs due to the connection of IDNO sites, there are also additional costs due to the requirement for bespoke billing arrangements and auditing, as the data received by the DNO will not be received via the normal settlement process. We agree with SP that such additional costs may be imposed on DNOs as a result of IDNO activity. These additional costs may or may not be factored into the WPD proposals, but no specific reference to them has been made in the consultation.

"Views are sought on the WPD and SP proposals with respect to metering"

We believe that metering in general continues to serve a very important function, but we have an open mind as to whether that function might be achieved at lower cost and without a significant loss of data quality.

Although we have some concerns about the validity of the settlement solution (proposed in the IPNL consultation²), we are not discounting this method as a possible longer-term solution. However, any solution will have to:

- utilise industry standard data flows;
- facilitate accurate measurement of energy flows; and
- be robust and auditable.

Prior to formal implementation we recommend that testing is undertaken to ensure that the settlement solution reconciles to physical meter readings (i.e. initially the two solutions should run in parallel until the industry is confident about the validity of the data provided).

Tariff design and capacity charging

"IDNOs have generally argued that the requirement for half-hourly (HH) metering and capacity charges represents two main factors that make IDNO connections unprofitable for small domestic developments".

In principle we believe that capacity charges increase cost reflectivity as most of the costs of serving customers are fixed and/or directly related to their capacity requirements. We therefore regard the inclusion of a capacity element in certain tariffs as appropriate as a matter of principle. Furthermore, the imposition of capacity charges drives behaviour that reduces costs to all customers by placing an appropriate value on capacity, thereby requiring customers to consider carefully their capacity needs. We believe that capacity charges reduce the need for reinforcement in comparison with a situation where capacity can be reserved at no cost to the reserving party. We can see, from an IDNO

² The Settlements Alternative to Boundary metering, IPNL, March 2007

perspective, that the imposition of a capacity charge may in some situations reduce their margin, particularly on sites close to the boundary at which capacity charges are imposed (greater than 100kVA). WPD's proposal to remove capacity charges may address the IDNO concerns on this matter but they may lead to a less cost-reflective tariff if it is not accompanied by a refusal to allow IDNOs to reserve capacity in the way that a customer facing capacity charges is able to do.

In the main, DNOs only levy capacity charges on customers connected in the half-hourly (HH) market above 100 kVA. The distribution reinforcement model (DRM) works on the basis of the coincidence of a customer group peak demand with the system peak demand: however, we do not necessarily have to bill sites based on their maximum (agreed) capacities, it may be more appropriate in certain circumstances to apply capacity charges that are more closely aligned with the user's specific demand at the time of system peak (i.e. it may be appropriate to ignore excessive load at off-peak times). We therefore recognise and agree with the treatment that SP are putting forward in their proposal.

It is worth noting that, for a small "infill" development, DNOs do not necessarily have to charge based on a HH tariff. It may be more appropriate to apply existing NHH tariffs.

Reactive Power Charging

"Views are sought on whether the proposed treatment is appropriate"

CE does not currently impose reactive power charges on any of its customers and we believe that, for most IDNO sites, which are largely domestic, reactive power charges would be inappropriate.

Summary

In summary we believe that both proposals seek to address the main issues raised by IDNOs. CE is currently undertaking analysis in this area and is reviewing the charging methodology and tariff structure. When this work is completed, if we feel that improvements can be made to better achieve the relevant objectives, we shall bring forward charging modification proposals to address any issues that are raised. We hope that in the meantime this consultation exercise will enable Ofgem to make its position on some of these matters clear.

Should you have any queries relating to this response, please do not hesitate to contact me on the above number.

Yours sincerely

Harvey Jones

Harvey Jones
Network Sales Manager