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*Promoting choice and
value for all customers*

cc: Nigel Turvey (by email only)

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Date: 12 October 2007

Dear Colleague

**Decision in relation to modification proposal WPD/WALES/WEST/UOS005:
changes to use of system charging methodology to incorporate IDNO networks
and consequential changes to the form of use of system charging statement.**

On 14 September 2007, Western Power Distribution (South West) ("WPD") submitted to the Gas and Electricity Markets Authority ("the Authority")¹ a proposal to modify the Use of System (UoS) charging methodology in relation to new tariffs for Independent Distribution Network Operators ("IDNOs").

This proposal addresses similar issues to previous proposals from WPD dated 21 March 2007², which was vetoed following consultation³, and 10 September 2007, which was withdrawn.

On receiving WPD's current proposal, we invited any further comments on the changes from all electricity distribution licensees (as the parties most directly affected). We consider that this was a proportionate approach for consulting with interested parties on a modification that closely built on a previous proposal and raised very similar issues.

Having carefully considered the proposals made by WPD and responses to our informal consultation we have decided **to veto** WPD's proposals in relation to new IDNO tariffs for 'predominantly domestic' sites.

This letter briefly sets out WPD's proposal, the views of respondents to Ofgem's consultation and the reasons for the Authority's decision.

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

² Modification WPD/WEST/WALES/UOS003, changes to UoS charging methodology to incorporate IDNO networks and consequential changes to the form of the UoS charging statement. The modification report is available at: <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/IDNO%20modification%20request%20Rev%20March%2007%20R3.pdf>

³ <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/UoS%20charges%20WPD%20and%20SP.pdf>

Background to WPD's proposal

WPD has licence obligations⁴ 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. WPD has a requirement to keep the methodology under review and bring forward proposals to modify the methodology that it considers better facilitate achievement of the relevant objectives.⁵

On 12 July 2007, after consulting with the industry, the Authority issued a decision letter to veto WPD's modification proposal in relation to new IDNO tariffs⁶. The Authority raised two main concerns: firstly, WPD failed to provide a justification for the use of a 50% fixed assumption for the attribution of LV main costs to IDNOs; secondly, the restriction of eligibility to IDNO sites with more than 50% of maximum demand having domestic nature could have resulted in inappropriate charges for sites falling either side of the 50% threshold.

WPD's proposal

WPD's proposal introduces five new IDNO-specific tariffs, one for HV and four for LV connections. The grouping of customers for charging purposes will be set out in WPD's methodology statement which will distinguish 'predominantly domestic' IDNO sites as a separate group⁷. IDNO connections that do not qualify as predominantly domestic will be subject to the current non-domestic UoS tariffs.

The proposed tariffs are calculated on the basis of new demand profiles and comprise a kWh charge only. At LV, tariffs are differentiated in four bands according to the distance of IDNO connection from the local substation.

WPD argues that the proposed changes result in UoS charges that more accurately represent the avoided network costs of WPD (paragraph 5.2), when compared to existing charging arrangements. WPD state they do not intend to include in the tariff calculations any additional administration and billing cost they could potentially incur as a result of IDNOs (paragraph 2.18).

We note that part of WPD's justification for its proposal relates to boundary metering. We consider that boundary metering is outside the scope of this decision.

⁴ Standard Licence Conditions (SLC) 4-4b.

⁵ The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of standard licence condition 4 of WPD (South Wales) licence are:

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

⁶ We refer the reader to this decision letter for further details on the background. The letter is available at: <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20S%20Wales%20IDNO%20DNO%20charging%20mod%20FINAL%20120707.pdf>

⁷ Predominantly domestic IDNO sites are defined as sites having more than 50% of a site's maximum demand must be due to domestic customers, albeit the proposal sets out that the connecting IDNO and WPD shall agree on the tariff to be levied for sites with 40% to 60% maximum demand from domestic users.

Respondents' views

We invited comments on WPD's revised proposal on an informal basis in the second half of September 2007. We received seven responses (two IDNOs, three DNOs and two confidential responses).

Responses from IDNOs were generally unsupportive of WPD's proposal, mainly on the grounds of tariff increases in some cases and, more generally, the resulting margins.

One confidential response considered that WPD's charging methodology skews cost allocation towards higher voltage levels, so that the proposed use of the LV yardstick as a starting point for the calculation of IDNO tariffs is inappropriate.

Responses from DNOs raised mainly two types of concerns. First, they criticise some of the details of the methodology for the calculation of avoided costs. Second, they consider that tariffs dedicated to specific customer groups are potentially discriminatory.

The Authority's decision

In coming to our decision we have considered how the proposed modification impacts on WPD's ability to better achieve their relevant objectives and our wider statutory duties.

It is important to note that our decision relates to the methodology rather than the quantification of elements in the methodology.

In the remaining of this section, we will comment in detail on the reasons for the Authority's decision.

Cost reflectivity and facilitating competition

WPD indicates that the proposal is more cost reflective than their existing arrangements in terms of better recognising the demand profile of IDNO sites and network costs saved when an IDNO connects. WPD also believes that by removing capacity charges for predominantly domestic sites and providing consistent margins across all sizes of site it is not restricting competition.

We agree with these points. In particular, we welcome the developments in WPD's approach and consider that these are an improvement on WPD's previous proposal.

In our past veto decision, we expressed concerns about the lack of justification for the average assumptions which were used. In the context of IDNO/DNO charging, there is a risk that average assumptions may result in inappropriate charges in a number of situations. WPD's current proposal provides for four tariff bands at LV, which reflect the distance of the IDNO point of connection from the local substation. The tariff for each band includes a specific proportion of the capital cost and the operating and maintenance costs associated with elements of the LV main that are included in the domestic yardstick tariff, in accordance with the proportion of LV network that is required to connect the IDNO.

We consider that this banded approach at LV reduces the level and impact of average assumptions and hence can more closely reflect the costs imposed in specific cases. Further, as WPD's proposal assumes that at LV the IDNO will connect at the beginning of each band, it guards against the risk of understating the network costs avoided that would be involved in average assumptions.

We note that WPD's proposal looks specifically at the avoided costs on the LV network and that IDNO tariffs include an element of scaling that caters for those costs that are not captured by the charging model. This will include both indirect overhead costs and any other adjustments necessary to reconcile revenue projected under proposed tariffs with WPD's target revenue within the price control. For example, WPD South West's current

methodology includes a 26% scaling uplift on costs within the DRM model. The scaling of charges is proportionate to the costs covered by the relevant yardstick – so that greater scaling in p/kWh terms applies to LV charges than HV.

In the case of the proposed IDNO charges, this will result in greater allocation of costs covered by the scaling to all the LV charges than to the HV charges and greater scaling to the bands within LV based on location further from the substation. Our analysis does not suggest that the appropriate allocation of costs to IDNOs would necessarily vary in this way, at least to the extent implied by these calculations. We do consider that some allocation to IDNOs may well be appropriate. We note that one IDNO told us that they considered WPD's HV charge to be broadly appropriate.

We note WPD's comments in its proposal (paragraph 2.18) that it has considered the implications for customer service and billing costs of IDNOs and cannot currently identify any cost reductions. We acknowledge that any such assessment would be difficult given the structure of costs. However, we do consider that allocations could be made.

Restriction on eligibility

WPD propose to restrict the application of the new tariffs to predominantly domestic IDNO sites only, as defined in the proposal. The revised approach now provides a 40% to 60% interval where the classification as predominantly domestic (or not) IDNO site would be discussed and agreed with the IDNO. WPD also provided some analysis to show that the materiality of this simplifying assumption is negligible. They consider that only about 3% of (most recently) installed transformers have a mix of domestic and non-domestic loads that fall within the 40% and 60% band.

WPD's analysis is retrospective and general in nature, and hence may not fully capture the likelihood of future mixed IDNO connections; however, it shows that only in a limited number of cases mixed loads are connected to the same transformer.

We consider that WPD's approach is a practical compromise between cost reflectivity and simplicity of implementation, and will better meet the objectives of the licence condition than the current approach. We would expect WPD to review the analysis and the assumptions they use, as experience with IDNO sites develops in their distribution services area.

Our decision

For the reasons set out above, we consider that most aspects of the proposed changes in the principles and methods of WPD's charging methodology are an improvement on the current methodology. However, we are concerned that the effect of the mechanics of the scaling adjustment may be to allocate more indirect overhead cost to the LV IDNO charges than is justified, particularly for the bands further from the substation.

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

Comments

Notwithstanding this decision, we welcome the constructive approach taken by WPD in developing these proposals to address the comments on their previous proposal. We consider that they have adequately addressed those comments and that the reason for the Authority's decision is a new issue. We consider that there are alternative ways of addressing this issue such as limiting the scaling in the LV IDNO charges to the amounts implied in the HV IDNO charge (in p/kWh terms rather than a fixed percentage as now) or

developing a new approach to allocate indirect overhead costs between categories prior to any residual scaling.⁸ It is for WPD to decide how it wishes to address these concerns.

We expect all DNOs to keep their methodology under review, as further experience with independent licensed distributors is acquired and we urge all of the other DNOs to review their approach to charging IDNOs without delay, in light of this decision letter. In undertaking this assessment, DNOs may find it useful to refer to the Office of Fair Trading's draft *Assessment of conduct* guidelines⁹.

Please contact Alberto Prandini on 020 7901 7281 if you have any queries relating to 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

⁸ We cannot rule out the possibility that the latter approach would provide justification for similar values to those in WPD's current proposal.

⁹ http://www.oft.gov.uk/shared_oft/business_leaflets/competition_law/oft414a.pdf