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*Promoting choice and  
value for all customers*

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Date: 17 December 2007

Dear Colleague

**Decision in relation to modification proposal WPD/WALES/UOS006: Changes to the Use of System Charging methodology to incorporate IDNO Networks and consequential changes to the form of Use of System Charging Statement**

On 19 October 2007, Western Power Distribution (South Wales) ("WPD") submitted to the Gas and Electricity Markets Authority ("the Authority")<sup>1</sup> a proposal to modify the Use of System (UoS) charging methodology in relation to new tariffs for Independent Distribution Network Operators ("IDNOs") in WPD.

The proposal addresses similar issues to previous proposals from WPD dated 21 March 2007, which was vetoed following consultation, 10 September 2007, which was withdrawn and 14 September 2007, which was vetoed following informal consultation.

On receiving WPD's last proposal, we issued a four-week consultation on the proposal. We received eight responses (three of which are of a confidential nature). The consultation closed on 20 November 2007.

Having carefully considered the proposals made by WPD and responses to our consultation we have decided **not to veto** WPD's proposal in relation to new IDNO tariffs for 'predominantly domestic' sites. For avoidance of doubt it remains WPD's responsibility to comply with all relevant legislation, including the Competition Act 1998. This decision is not an approval of WPD's conduct for those purposes.

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

***Background to WPD proposal***

WPD has licence obligations<sup>2</sup> 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

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

<sup>2</sup> Standard Licence Conditions (SLC) 4-4B.

and bring forward proposals to modify the methodology that it considers better facilitate achievement of the relevant objectives.<sup>3</sup>

On 12 July 2007, after consulting with the industry, the Authority issued a decision letter to veto WPD's modification proposal WPD/WALES/UOS003 in relation to new IDNO tariffs<sup>4</sup>. 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.

On 12 October 2007 the Authority issued a decision letter to veto WPD's proposal WPD/WALES/UOS005. The Authority acknowledged that WPD addressed the two main concerns raised with reference to the previous proposal. The Authority, however, considered that the approach to scaling and allocation of indirect overheads across voltage levels on a fixed percentage basis may have resulted in inappropriate charges to IDNOs.

### ***WPD's proposal***

WPD propose to introduce new yardsticks for predominantly domestic LV and HV IDNO sites. WPD also propose five new IDNO specific tariffs, one for HV and four tariffs for LV sites banded according to distance of the IDNO site from the local substation. The proposed tariffs are calculated on the basis of new demand profiles and comprise a kWh charge only.

Allocation to the new tariffs will be automatic for those IDNO sites where more than 60% of the site's maximum demand is domestic and will be agreed with the relevant IDNO where the percentage of maximum demand of a domestic nature is between 40% and 60%. IDNO sites where less than 40% of maximum demand is domestic will be subject to the current non-domestic UoS tariffs.

WPD's proposal assumes that 50% of the capital cost of the LV main and all of the capital costs of the service have been covered by contributions. The remaining capital cost is allocated based on the distance between the IDNO connection and the source substation on WPD's network. WPD assume that the IDNO always connects at the beginning of each band and so aims to minimise the risk of understating costs avoided due to the IDNO.

WPD propose an amended approach to scaling for LV IDNO tariffs compared to their previously vetoed proposal. WPD state that since the latest veto decision they have undertaken analysis which implies a lower level of avoided cost than that included in their previous proposal. WPD now assume that the level of indirect overheads and residual elements (in p/kWh) for the HV IDNO tariff should be applied to the LV IDNO tariffs.

### ***Respondents' views***

We invited comments on WPD's revised proposal through a formal consultation which closed on 20 November 2007. We received eight responses (3 from DNOs, 1 from an IDNO, 1 from energywatch and 3 confidential responses). The following section summarises the

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<sup>3</sup> 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 license;
- (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.

<sup>4</sup> 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>

non-confidential responses. All of the responses were considered carefully in reaching our decision.

#### Locational signals

energywatch expressed concerns that domestic customers are passive recipients of network services, and do not choose the voltage level of connection. LORE objected that the proposals encourage developments to locate in the parts of the DSA that are already the most developed, leading to higher costs for IDNOs.

#### Treatment of different customer types

SSE were unconvinced by WPD's rationale and justification for the 'predominantly domestic' site description, and agreed with EDF that the 40-60% negotiable boundary could lead to increased subjectivity, reduced clarity and additional administrative burden for both parties. LORE added that the proposal does not address mixed use developments.

#### Indirect costs

UU's favoured option was to develop a new approach to indirect cost allocation, on the basis that the proposed cap is not cost reflective. EDF and UU thought that the proposed unit-only tariff would not adequately allocate indirect costs because some costs are fixed in nature.

#### Avoided costs

SSE called for quantification and explanation of the proportion of LV avoided network costs, and suggested that an outline of HV avoided costs is needed in the methodology. LORE considered the approach to avoided customer service and billing costs as anti-competitive.

### **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 part of this section, we will comment on the reasons for the Authority's decision.

#### *Cost reflectivity and facilitating competition*

##### Dedicated IDNO tariffs

WPD indicates that domestic IDNO networks have a different load shape to non-domestic connections. They state that the introduction of an IDNO tariff designed for predominantly domestic loads and the introduction of banded prices reflecting the point of connection of the IDNO network will be more cost reflective.

WPD explains that their proposal to withdraw standing charges for predominantly domestic IDNO networks puts the IDNOs on a similar footing to WPD during the development phase of a connection and does not restrict competition in distribution.

We consider that WPD's approach will provide a higher degree of cost reflectivity in charges for predominantly domestic IDNO sites as these are based on dedicated tariffs derived from domestic profiles, rather than the current commercial tariffs.

## Restriction on eligibility

WPD's approach provides dedicated IDNO tariffs for LV and HV IDNO sites that are predominantly domestic in nature. WPD automatically allocate IDNO sites where the maximum demand is more than 60% domestic and allow the IDNO a degree of flexibility in agreeing the appropriate tariff where between 40% and 60% of the maximum demand is domestic. WPD have provided analysis that only a small proportion of IDNO sites will fall within this 40-60% band.

We consider that this approach is pragmatic and a reasonable compromise between cost reflectivity and simplicity of implementation. We believe that this approach is more appropriate than a fixed percentage threshold as such an approach could have a significant impact on sites falling just outside the threshold. However, we would expect WPD to review their approach as experience with IDNOs develops in their distribution services area.

## Cost allocation

WPD states that the differences between the existing tariffs for IDNOs and the proposed IDNO tariffs take account of the costs that WPD expect to avoid when customers are connected via an IDNO network, as well as allowing IDNOs additional flexibility to develop and expand their business.

For HV IDNO sites WPD propose to introduce one dedicated tariff for predominantly domestic sites. The UoS charges are based on the costs that WPD will incur as a result of the connection. WPD assumes that the IDNO will connect to a feed from the WPD network at HV. The UoS charges for these sites consist of a kWh unit charge, including an element of scaling.

WPD's proposal for LV IDNO predominantly domestic sites is to introduce four tariffs, banded according to the distance between the IDNO network and the source substation on WPD's network. The charges allocated to the tariff exclude connection charges, which are recovered up-front and WPD assume that 50% of the capital costs of the LV main and all of the capital costs of the LV service are recovered for in this way.

WPD's distance-based LV IDNO tariffs allocate a proportion of the 50% of LV mains capital costs that it assumes have not been included in the connection charge, as well as other UoS charges such as those for operation and maintenance. UoS charges for these IDNO sites are therefore based on WPD's costs for the part of the network that the IDNOs are using.

As outlined in our previous decision letter WPD assumes that for LV sites the IDNO will connect at the beginning of each band. This guards against the risk of understating the network costs avoided that could result from the use of average assumptions.

We consider that WPD's tariffs must reflect the costs imposed by IDNOs on WPD's network and that these costs are dependent on the length of the LV network that the DNO provides. We consider that the banded approach at LV reduces the level and impact of average assumptions and so can more closely reflect the costs imposed in specific cases.

As outlined above, different network elements are included within the HV and LV yardsticks. We consider that a difference in the HV and LV tariffs is to be expected at least in part due to the additional relevant capital costs within the LV tariffs.

Our role in assessing modification proposals is to form a view on the methodology. It is not our role to approve tariff figures, per se. However, we have undertaken some analysis of the yardstick details provided by WPD in their UoS charging methodology statement. We have considered allocation of WPD's overhead costs, based on data in their Regulatory Reporting Pack, in accordance with cost drivers we have used in the previous price control

review. Our results suggest that the proposed boundary tariffs would enable a licensed distributor at least as efficient as WPD to recover its costs and operate with a margin.

### Scaling

WPD suggests that the proposal to cap the level of scaling for LV IDNO tariffs at the level for HV IDNO tariffs is intended to further accommodate a number of wider licence objectives and to offer a pragmatic solution to the difficulties of allocating costs to particular customer groups and voltage levels. WPD suggest that this would reduce the amount of scaling applied to the charge to the IDNO and so allow greater flexibility for the IDNOs whilst they develop and expand their operations and to determine whether, in the longer term, potential cost savings can be made.

We raised concerns with WPD's approach to scaling in our previous decision letter. WPD's previous approach would have resulted in a greater level of scaling being applied to LV IDNO tariffs compared to HV IDNO tariffs and that this would have increased through the LV bands based on distance from the substation. We were concerned that our analysis did not suggest that the allocation of costs would vary in this way, and to this extent. We consider that WPD's revised approach, to cap scaling for each of the LV IDNO tariffs to the HV IDNO tariff level, will reduce the level of scaling applied to the LV IDNO tariffs and is less likely to over-allocate such costs to LV IDNO tariffs. We consider that the revised approach addresses our previous concerns.

### Losses

There is no explicit provision in the proposed methodology modification that aims to reflect the potential benefits that the host DNO may receive for the losses it does not incur because of IDNO operation. We consider that several customer groups may potentially provide a benefit to the DNO, in terms of reduced losses or increased customer diversity, without receiving explicit compensation for this. We also consider that increased customer diversity would be included over time (on an average basis) in the calculation of yardsticks. If this is a material factor in practice, we consider that there would be a number of ways to address this issue, including changes to loss adjustment factors. We do not consider that this issue justifies veto of the proposed modification.

### *Boundary metering*

We note that WPD's proposal mentions boundary metering and some of the consultation responses expressed concerns about this. We consider that boundary metering is outside the scope of this decision. However, we have considered whether this proposal would adversely affect the possibility of alternatives to boundary metering. We do not consider that it would be likely to have this effect. In the event that it did become a critical constraint, we would expect WPD to review its methodology.

### *Obligations under the licence and/or competition law*

It is for WPD to ensure its own compliance with the Competition Act 1998 and EC competition law in its implementation of the proposed methodology. We have assessed this proposal on whether it better meets the relevant licence objectives. In doing so, we have considered whether under certain scenarios the proposal would allow an equally efficient licensee to WPD to operate profitably, and we are satisfied that it can.

### *Our decision*

For the reasons set out above, we consider that the proposed changes in the principles and methods of WPD's charging methodology are an improvement on the current methodology. We believe that the proposal better meets the relevant licence objectives and that it directly addresses the concerns we raised in our previous veto decision letter.

The Authority has decided not to veto the modification to the UoS charging methodology statement.

*Comments*

We expect all DNOs to keep their methodology under review, as further experience with independent licensed distributors is acquired and we reiterate that we would urge all of the other DNOs to review their approach to charging IDNOs without delay, in light of this decision letter.

Please contact Alberto Prandini on 020 7901 7281 or Nicola Cocks on 020 7901 7036 if you have any queries relating to issues raised in this letter.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'M. Crouch', is positioned above the printed name and title.

Martin Crouch  
Director, Distribution

Signed on behalf of the Authority and authorised for that purpose by the Authority