

The Company Secretary
Central Networks East plc
Westwood Way
Westwood Business Park
Coventry
CV4 8LG

Promoting choice and
value for all customers

Your Ref: CN 003
Our Ref: RBA/DPC/SOC
Direct Dial: 020 7901 7255

CC: John Hill (by email only)

24 January 2008

Dear Colleague,

Decision in relation to modification proposal to the connection charging methodology: Clarification of the apportionment rules.

On 27 December 2007, Central Networks East plc ("CNE") submitted to the Gas and Electricity Markets Authority ("the Authority")¹ a proposal to modify its connection charging methodology.

The proposal modifies the connection charging statement by providing clarification of the apportionment rules through the provision of a definition for Required Capacity and additional wording explaining how this is calculated in a number of different circumstances. The Required Capacity represents the numerator of the cost apportionment factor (CAF).

Having carefully considered the issues raised in the proposal, the Authority has decided to veto the proposed modification.

This letter sets out the background to the modification proposal, explains briefly the proposed changes and sets out the reason for the Authority's decision.

Background

CNE has licence obligations² to have in place as of 1 April 2005 three charging statements: the statement of use of system charging ("UoS") methodology, the statement of UoS charges and the statement of connection charging methodology. The statement of connection charging methodology outlines the method by which connection charges are calculated. CNE has a requirement under standard licence condition 4B to keep the methodology under review and bring forward proposals to modify the methodology that it considers better achieves the relevant objectives.³

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

² Standard licence conditions 4-4B

³ The relevant objectives for the connection charging methodology, as contained in paragraph 3 of standard licence condition 4B of CNE's licence are:

- (a) that compliance with the connection 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 connection 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.

The apportionment rules provide a sliding scale approach to contributions from a connecting party to reinforcement costs. In the case of existing customers who request an increase in supply capacity, "Required capacity" can be taken to mean either the total capacity or the incremental capacity requested. The apportionment rules aim to provide sufficient locational signals within the connection charge but equally to recognise the benefit that other users will get from the asset installed.

CNE Modification proposal

CNE proposes to modify the connection charging methodology statement by:

- Including a definition of "Required Capacity".
- Setting out how the Required Capacity numerator of the CAF is calculated for existing customers who are seeking an increase in the supply capacity. CNE considers two circumstances, namely where these customers derive their requested increase in connection capacity from previously reinforced assets or whose request triggers further reinforcement on CNE's Network.

In April 2006 Ofgem presented a paper to the Implementation Steering Group ("ISG") which explained how it would be beneficial for DNOs to provide some extra clarity on how they applied the apportionment rules.⁴ This paper asked for clarity in regard to existing customers whose request for extra capacity triggered an additional reinforcement of the network: in particular, the paper sought clarity over the application of "incremental capacity" or "total capacity" at the numerator of the CAF formula. This modification proposal has been submitted by CNE in an attempt to provide such clarity.

Firstly, CNE defined "Required Capacity" as the capacity required after CNE have taken account of the customer's diversity of demand.

Secondly, CNE's proposal prescribes for four scenarios explaining how they intend to calculate Required Capacity in separate circumstances. In particular, the scenarios differ to account for contributions to existing – as opposed to new – reinforcements, as well as in terms of the timing of the request for an increase in supply capacity.

The Authority's decision

The Authority has considered the proposal against the relevant objectives and wider statutory duties.

The Authority acknowledges that the new definition of "Required Capacity" is helpful to customers and aids clarity.

CNE's proposal also attempts to clarify the approach used in calculating the CAF for existing customers. The Authority considers that the use of incremental capacity is generally in line with the principle that connection charges shall recover an amount for reinforcement based on a proportionate share of the costs of such reinforcement⁵. The

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

⁴ The Implementation Steering Group concluded in March 2007 and was replaced by the Distribution Charging and Methodologies Forum (DCMF). The ISG paper can be found at: <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/13906-Appportionment%20rules%20review.pdf>

⁵ SLC 4B, paragraph 7, letter (c), number (iii).

Authority also concedes that under specific exceptional circumstances it may be reasonable to depart from this general principle, where the request of the existing customer triggers new network reinforcement⁶.

However, the Authority also considers that the proposed wording of key concepts in the proposal is unclear. This ambiguity would prevent existing customers from reasonably estimating whether their connection charge for reinforcements would be based on the "incremental capacity" or "total capacity" requested.

CNE's proposal refers to "the prescribed five year period". The Authority is concerned by the ambiguities of the wording of this concept: As used in some scenarios, it has to be interpreted as the time from the installation of the reinforcement, whilst in other cases it would be appropriate to interpret this as the time elapsed from the customer's original request of connection. The Authority considers that the proposed wording generates confusion and would not increase the clarity of the methodology.

The Authority is also concerned about the lack of clarity over the concept of "previously reinforced assets". It is not clear whether this is limited to reinforcements triggered by a specific first comer (or "initial contributor", in the wording of the Electricity (Connection Charges) Regulations 2002⁷, as amended⁸) or encompasses reinforcement undertaken by CNE to cater for general load growth. The Authority is concerned that this ambiguity may be misleading for customers. It could also result in inappropriate charges for previously installed reinforcements which were undertaken in anticipation of general load growth.

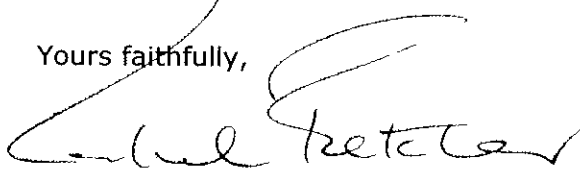
The Authority has decided to veto the modification to the connection charging methodology statement.

Comments

Ofgem set out in April 2006 that further clarifications on the application of the apportionment rules are needed and set out its policy views in the abovementioned ISG discussion note. The Authority notes the slow progress achieved so far and urges DNOs to review their statement to provide clarity.

Please contact Alberto Prandini at alberto.prandini@ofgem.gov.uk or on 020 7901 7281 if you have any queries in relation to the issues raised in this letter.

Yours faithfully,



Rachel Fletcher

Director, Distribution

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

⁶ Please refer to the fourth area for clarification in the ISG paper of April 2006 for further details. We have no visibility of the likelihood or materiality of these exceptional scenarios, but we note that some DNOs have decided to use the "incremental capacity" approach without any qualifications.

⁷ Available at: <http://www.opsi.gov.uk/si/si2002/20020093.htm>

⁸ Available at: <http://www.opsi.gov.uk/si/si2002/20023232.htm>