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*Promoting choice and  
value for all customers*

Our Ref: RBA/DPC/SOC  
Date: 16 January 2008  
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Cc: Andrew Neves (by email only)

Dear Colleague,

**Decision in relation to modification proposal of December 2007 for introduction of specific Use of System tariffs for Independent Distribution Network Operators**

On 20 December 2007, Central Networks East plc (CN) submitted a proposal to the Gas and Electricity Markets Authority ("the Authority")<sup>1</sup> to modify its Use of System (UoS) charging methodology for its distribution networks.

This proposal intends to make available to Independent Distribution Network Operators (IDNOs) new schedules of charges based on existing tariffs but expressed as day unit and night unit charges. IDNOs would be able to choose whether to be charged the existing tariffs or the proposed unit-only charges.

Having considered the issues raised in the proposal, we have decided **to veto** the proposed modification.

This letter sets out the background to the modification proposal, summarises the proposed changes and explains our decision.

*Background*

CN has licence obligations<sup>2</sup> to have in place as of 1 April 2005 three charging statements: the statement of use of system charging methodology, the statement of UoS charges and the connection charging methodology. The UoS methodology outlines the method by which UoS charges are calculated. CN has a requirement to keep the methodology under review and bring forward proposals to modify the methodology that it considers better achieves the relevant licence objectives.<sup>3</sup>

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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 4-4B

<sup>3</sup> The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of standard licence condition 4 of the 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.

### *CN's modification proposal*

- CN proposes to make available to IDNOs four additional tariffs ("alternative tariffs") based on the existing non-domestic tariffs<sup>4</sup> which are levied on IDNOs ("base tariffs"). The alternative tariffs are expressed as simple day unit and night unit rates, without any capacity, fixed or reactive power charges.
- IDNOs would be given the option to choose between the base and the alternative tariffs at the time of connection and at subsequent reviews.

### *Ofgem's decision*

We have considered this proposal against the licence objectives and our wider statutory duties. The following paragraphs explain the reasons for our decision.

CN proposes to introduce unit-only tariffs for IDNOs which are derived from the same cost basis as tariffs for non-domestic customers. We note that the existing tariffs were developed with reference to industrial and commercial customers and as such may not reflect the specific nature of embedded networks.

We consider that as part of this proposal CN has not sufficiently demonstrated that they have considered the costs avoided resulting from the IDNO serving those customers that CN would otherwise have served. In particular, there is no explanation or comparison of the network costs and overheads allocated to the fixed and variable elements in the company's boundary and the all-the-way tariffs. It is crucial that UoS tariffs reflect the costs incurred by CN in serving an embedded network and recognise the costs avoided. For this reason, we are not satisfied that the proposed modification would better reflect the cost incurred by the licensee.

CN's proposal results in two sets of tariffs being available for the same class of customer. CN's own analysis (see page 7 of the modification report) shows substantial differences in the UoS charges resulting from the application of the base and the alternative tariffs to the same IDNO customer, for several representative sizes of embedded network. We consider that the base tariffs and the alternative tariffs cannot be cost-reflective at the same time in the majority of situations. Furthermore, CN appears not to be in a position to identify which tariff is more cost-reflective for individual sites and customers may have an incentive, at least in some cases, to choose the less cost reflective tariff, if this results in lower UoS charges. We hence consider that there is the risk that UoS charges to IDNOs may be inappropriate in most cases and this may also distort competition.

CN considers that the proposed modification overcomes issues with capacity charges and reactive power charges and gives embedded network operators greater certainty about margins available to them. We consider that whilst removing fixed elements from the alternative tariffs to embedded networks, CN's proposal falls short of aligning the tariff structures at the boundary and for end-customers<sup>5</sup>. We consider that such differences

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(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> CN proposes to use the tariffs that are most commonly used for embedded networks: Small non-domestic two-rate (LLFC 010), Medium non-domestic LV two-rate (LLFC 021), LV half-hourly (LLFC127) and HV half-hourly (LLFC 365).

<sup>5</sup> CN's tariffs to domestic customers have a standing charge and unit-charge.

give rise to the potential for inappropriate margins in situations where the load or load-shape of end-customers is different from the typical assumptions used in setting tariffs<sup>6</sup>.

The licensee is bound by the licence to ensure that tariffs at the boundary and for end customers are as far as reasonable cost reflective and to make modifications that better achieve this. If UoS tariffs are cost reflective, we do not envisage that substituting properly applied capacity charges with unit-only charges can better meet the obligation to not distort, prevent or restrict competition in distribution. If, on the contrary, UoS tariffs are not cost-reflective, we consider that switching to unit-only charges for the purposes of making higher margins available would not address this issue and would not better meet any relevant licence objective.

We accept CN's view that it may take several years for IDNO developments to reach full capacity; however, we consider that the issues highlighted by CN in this respect are not sufficient to justify the replacement of capacity charges with unit-only tariffs in the manner proposed. It is our view that this is an issue related to the application – rather than the calculation – of capacity charges, and as such could be addressed through appropriate commercial arrangements for the phasing of capacity requirements.

We have decided to veto the modification to the UoS charging methodology statement.

#### Comments

We expect all DNOs to keep their methodologies under review, as experience with independent licensed distributors is acquired. We reiterate that we urge DNOs to review their approach to charging IDNOs without delay, in light of this letter and other recent Ofgem decisions.

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

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<sup>6</sup> Decision letter of 12 July 2007, available at:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/SP%20Distribution%20IDNO%20DNO%20charging%20mod%20FINAL%20120707.pdf>