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Promoting choice and  
value for all customers

Your Ref: CNE/2008/02  
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CC: Andrew Neves (by email only)

7 April 2008

Dear Colleague,

**Decision in relation to use of system charging methodology modification proposal CNE/2008/02: Capacity build-up on embedded networks**

On 10 March 2008, Central Networks East plc ("CNE") submitted a proposal to the Gas and Electricity Markets Authority ("the Authority")<sup>1</sup> to modify its statement of use of system (UoS) charging methodology for its distribution network.

CNE has proposed to introduce a new method to deal with capacity requirements for embedded networks<sup>2</sup>, which involves adjustments to its statement of UoS charging methodology and connection charging methodology and statement. This letter refers to the changes made to the statement of UoS charging methodology.

Having considered the issues raised in the proposal, we have decided **not to veto** the proposed modification.

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

*Background*

CNE has licence obligations<sup>3</sup> to have in place as of 1 April 2005 a statement of UoS charging methodology, a statement of UoS charges and a connection charging methodology and statement. The statement of UoS charging methodology outlines the method by which UoS charges are calculated. CNE has a requirement to keep the methodology under review and bring forward proposals to modify the methodology that it considers better achieves the relevant objectives.<sup>4</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> Embedded networks include IDNOs, DNOs operating out of area and licence-exempt private networks.

<sup>3</sup> Standard licence conditions 4-4B.

<sup>4</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 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;

### *CNE modification proposal*

- CNE has proposed to outline arrangements for capacity build-up on embedded networks within its statement of UoS charging methodology. The proposed addition would state that an embedded network would initially attract UoS charges based on its demand at the time of connection, and would be allowed to increase its capacity demand up to the limit imposed by the authorised supply capacity (ASC).
- CNE has also proposed to provide a link to the relevant section of the connection charging methodology statement where provisions for capacity review and capacity reservation in the longer term are outlined.

### *Ofgem's decision*

We have considered this proposal against the licence objectives and wider statutory duties. We consider that this modification results in improved clarity to better enable customers to make an estimate of their likely charges.

This modification addresses the particular characteristics of embedded network connections, particularly growth of capacity requirements over time. We consider that for this type of scenario it is appropriate to put in place commercial arrangements for phasing of capacity requirements. By allowing an embedded network operator to pay capacity charges based on capacity uptake over the initial period of connection (three years), we consider that this proposal better meets the relevant objective not to restrict, distort or prevent competition in the distribution of electricity. CNE commented in its proposal document that the IDNO community sees capacity build-up as a significant issue that needs to be overcome.

This proposal may also encourage embedded network operators to communicate their future requirements to host DNOs. This may help to prevent inefficient expenditure by the DNO, which may otherwise undertake a reinforcement based on the initial capacity uptake of an embedded network without knowledge of expansion plans.

We acknowledge that this modification may have the effect of encouraging embedded network operators to request capacity in excess of its requirements if it does not affect its connection charge. This could potentially result in inefficient development of the network and thus higher charges to customers over time. However, the licence obligation on DNOs and IDNOs to develop the network efficiently serves as a counterweight to excessive capacity requests. In addition, the connection charging apportionment rules provide a further signal whereby connection charges could include an element of reinforcement costs.

Developments in the accompanying proposals to modify the connection charging methodology and statement (CNE/2008/03) serve as further mitigating factors to encourage efficient network development. The inclusion of a three year capacity review means that there is an incentive on the embedded network operator not to overstate long term capacity requirements since CNE could reduce the ASC to the capacity requirements at the time of review. To reserve capacity in the long term (i.e. beyond the three years) the embedded network operator would then pay use of system charges based on its total capacity requirements represented by the ASC, which would represent a further incentive to accurately forecast capacity requirements.

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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.

We consider that charges for embedded networks structured in a similar way to the host DNO's all the way charges (that is, not including a capacity charge) would minimise the risk of anticompetitive effects. We consider that by reducing the impact of capacity charges during the initial period of connection this proposal represents a step towards the longer term arrangements we expect DNOs to have in place for embedded networks. We expect CNE to continue its work towards developing boundary tariffs that reflect the costs avoided by the embedded network serving the customer.

We have decided **not to veto** the modification to the use of system charging methodology statement.

*Ofgem's comments*

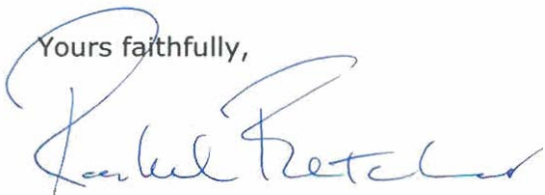
Whilst we welcome efforts to address issues relating to capacity build-up, we note the missed opportunity to discuss the issues with the industry. We consider that this is an industry-wide issue, and would encourage discussion of future proposals at industry fora.

CNE has addressed the issue of capacity requirements on embedded networks which often grow over time. However, other issues remain pertinent, which we raised in our decision to veto a previous charging modification raised by CNW<sup>5</sup>. CNE stated in its modification proposal that it is considering the aspects of our veto letter not covered by this modification, to be addressed in separate proposals, and we would urge CNE to expedite this process.

We also note CNE's claim in the modification proposal that the proposed arrangements for capacity build-up on embedded networks would mirror the way CNE treats its own customers. CNE's current charging statements do not currently reflect such capacity build-up arrangements. We urge CNE to review its charging statements in light of this.

Please contact Tom Handysides at [tom.handysides@ofgem.gov.uk](mailto:tom.handysides@ofgem.gov.uk) or on 020 7901 7289 if you have any queries relating to 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>5</sup> For further information see 'Decision in relation to proposal CNE 003 – introduction of IDNO-specific tariffs' (Ofgem, January 2008)  
<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/CN%20East%20IDNO%20mod%20decision%20letter.pdf>