

Colette Schrier
Commercial Regulation
Electricity Distribution
The Office of Gas and Electricity Markets
9 Millbank
LONDON
SW1P 3GE

Our Ref: jmf/sa/140508

14 May 2008

Dear Colette

Re: Delivering the electricity distribution structure of charges (SoC) project

I am writing on behalf of CE Electric UK (CE) Funding Company and its wholly owned electricity distribution licensees Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL). This letter provides our response to Ofgem's recent consultation on delivering the structure of charges (SoC) project.

I should say at the outset that we remain committed to working with Ofgem and, wherever possible, with other distribution network operators (DNOs) to progress the SoC project. Irrespective of the outcome of Ofgem's consultation, it is our intention to develop revised charging methodologies that will meet Ofgem's requirements by October 2009. We are also ready and willing to work with Ofgem on any aspect of the proposals (including the drafting of an appropriate licence modification) if that would be helpful.

However, we believe that the approach outlined in the consultation paper is likely to delay the implementation of cost-reflective charges for demand and generation customers because it may make it less likely that we can use the work that we have already done on developing our revised charging structures. NEDL and YEDL, like many DNOs, are now well advanced in the preparation of charging structures that better meet the requirements of the current licence condition, having contractually engaged academics and other external consultants to assist us with the development of this project. In fact we have already extracted fifty per cent of the network data required to populate the new load-flow models and our plan is to have this phase of the project completed by the end of June, which will then allow us to undertake the detailed impact and sensitivity analysis that will support our modification proposal. This is in line with the high-level plan we shared with Ofgem on 28 February 2008.

CE ELECTRIC UK FUNDING COMPANY

Registered Office: Lloyds Court, 78 Grey Street, Newcastle upon Tyne, NE1 6AF

Registered in England and Wales. Registered Number: 3476201

If you would like an audio copy of this letter, a copy in large type, Braille or another language, please call 0800 652 6543

The output of the CE charging proposal is a holistic charging model that is seen to be both rigorous and consistent in its approach. Specifically, it will be based on load-flow models at the highest voltage level; treat demand and generation on a consistent basis; recognise the benefits of generation; incorporate revised charging arrangements for independent distribution network operators (IDNOs); and be flexible enough to support future charging developments (e.g. locational charges at the lower voltage levels; demand and generation reactive power charges and potentially short-haul tariffs for mixed demand and generation developments).

Moreover, both of the draft licence modifications that Ofgem has published are problematic for us. The proposals introduce the likelihood of further delay and yet the consultation document makes it clear that any failure to achieve the deadline specified will be met by enforcement action from Ofgem and the probability of significant financial penalties. We are always particularly cautious about taking on obligations that are unclear and never more so than when the consequences of a failure to achieve what is not clear have been so clearly delineated. The way that the modifications are currently drafted, we would be in breach of the duty (and *prima facie* liable to penalties) simply by failing to get the new charging structure approved by Ofgem by the due date. This combination of a fixed deadline; the threat of penalties (which the consultation paper says are likely to be big); the lack of clarity about precisely what we need to do to avoid these; and Ofgem's previous track record in being rather opaque in its statements on this topic makes us very nervous about accepting either of the proposed licence modifications in their current form.

As Ofgem itself notes in the consultation, the modification would require us to achieve the 'Relevant Objectives and Relevant Principles'. This requires us to balance certain objectives that pull in different directions. It is not clear to us how much weight Ofgem will put on each objective. We are therefore unable to assess with confidence how Ofgem might balance these competing objectives in making its own assessment of our proposals prior to any decision being made. We appreciate that, notwithstanding the tone of the consultation paper, Ofgem would be unlikely to take enforcement action, still less to impose financial penalties, against a licensee that had been diligent in its efforts to discern, and to deliver, what Ofgem required in striking the balance between the competing priorities. However, I am sure you will appreciate that we would be very unwise to put ourselves at such risk deliberately.

There are a number of areas in the consultation where we have concerns or that we feel would benefit from further clarity. We would be happy to work with Ofgem to explore and define areas of uncertainty and risk to this project and, if necessary, to assist in developing a licence condition that would be more likely to meet with the approval of licensees. The areas that would potentially benefit initially from further development and clarification are:

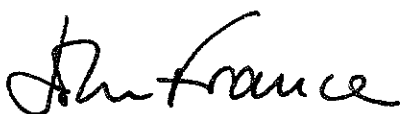
- How would Ofgem treat a DNO that had submitted a methodology change, in good faith, before the deadline only to find that Ofgem then rejected the proposal? What reassurance could Ofgem give to the DNO if there were then insufficient time remaining for the DNO to complete the requisite work in order to secure Ofgem's approval before 1 October 2009?
- How would Ofgem propose to treat funds that have been expended by a DNO, but that now appear to have been wasted due to a requirement to move to a common methodology?

- How does Ofgem plan to treat the mechanism for distributed generation allowances bearing in mind that there is currently no way in which a DNO can give negative cost signals to some generators without recovering that income from other generators (assuming full recovery of the price control allowances)?
- We note from your proposals (Figure A.1: charging methodology boundary) that Ofgem proposes that the cost allocation model should be common but that the tariff structure should remain specific to each DNO. However, much of the tariff structure is derived from the cost allocation model and this may lead to companies being forced into common tariffs. This is likely to lead to a great deal of disturbance to end-user prices. It would also stifle opportunities for innovation. This may not be Ofgem's intention.
- Your consultation envisages *adding* the new licence obligations to those that presently apply by virtue of the current SLC4. However, you do not address the conflict between the 'relevant objectives' as these are expressed in the current licence condition and the 'Relevant Objectives' as you prefer to understand these and as you describe them in paragraph 2.2 of your consultation. Your summary misleads by elision: the third bullet point fails to capture the *historical* nature of the costs that are required to be considered as this obligation is currently expressed, (i.e. 'that compliance... results in charges which reflect, as far as is reasonably practicable (taking account of implementation costs) the costs incurred by the licensee in its distribution business.')
- The fourth bullet point of your summary compounds the error by failing to acknowledge that the obligation to take account of developments in the licensee's distribution business is applicable only to the extent that it is consistent with the first three objectives. This appears to make the objective of reflecting *future* costs subordinate to the objective of reflecting the costs that have already been incurred. We therefore believe that to achieve your objectives from the SoC project you may need to alter the wording of the 'Relevant Objectives' that are presently envisaged.

In summary, we are extremely concerned with Ofgem's proposal to introduce a licence obligation to bring forward new charging methodologies by October 2009 when we are already working to implement innovative solutions before the start of the DPCR5 period. We are also particularly concerned that Option two, Ofgem's preferred approach, is both impractical and unachievable. Option two will stifle innovation and hinder the ability of DNOs to introduce future developments to their methodologies.

I trust the above sets out our concerns sufficiently. I would stress again that we would welcome the opportunity to discuss our concerns with you. We would also be willing to participate in any group that may be established to develop a more acceptable form of licence modification.

Yours sincerely



John France
Regulation Director