To distributors, suppliers, customers and other interested parties

Promoting choice and value for all customers

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6 May 2008

Dear colleague,

Consultation on proposals from Scottish Power Distribution and Scottish Power Manweb to modify Use of System charges for Independent Distribution Network Operators (IDNOs)

Distribution Network Operators (DNOs) have licence obligations[1] to have in place as of 1 April 2005 a statement of use of system (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 distribution UoS charges are calculated.

DNOs are required to keep their methodology statements under review and to bring forward proposals to modify the methodology that they consider better achieve the relevant objectives[2].

Before making a modification to a UoS methodology a DNO must submit to the Gas and Electricity Markets Authority (the 'Authority')[3] a proposal to modify its methodology stating how the proposal better achieves the relevant objectives. The DNO then makes the modification unless within 28 days the Authority either directs the DNO not to make the modification or notifies the DNO that it intends to consult and then within three months directs the DNO not to make the modification.

Scottish Power Distribution and Scottish Power Manweb (SP) submitted a proposal on 1 May 2008 to modify their respective UoS charging methodologies in respect of how they

[1] Standard Licence Conditions (SLC) 4-4B.

[2] The relevant objectives for both the connection and use of system charging methodologies, as contained in paragraph 3 of SLC4B and SLC4 of the distribution license respectively are:

- that compliance with the use of system charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Act and by the licence;
- that compliance with the use of system charging methodology facilitates competition in the generation and supply of electricity, and does not restrict, distort, or prevent competition in the transmission or distribution of electricity;
- that compliance with the use of system charging methodology 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; and
- that, as far as is consistent with the sub-paragraphs above, the use of system charging methodology, as far as is reasonably practicable, properly takes account of developments in the licensee's distribution business.

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

charge IDNO customers connected to their networks[4]. The proposals relate to the creation of new, IDNO-specific tariffs for IDNOs connected to the SP Distribution and SP Manweb distribution networks. The Authority has decided to consult on these proposals and formally notified SP Manweb and SP Distribution of this by letter on 1 May.

Background

In order to serve their customers IDNOs connect to a DNO's network. As a result, IDNOs pay the DNO UoS charges which should broadly reflect the costs the IDNOs impose on the DNO's network, measured and collected at the IDNO/DNO boundary. An IDNO's margin is therefore defined by the difference between the boundary charge defined by the DNO and sum of end-customer (all the way) charges defined by the IDNO. In addition to ensuring (as far as reasonably practicable) cost reflectivity in their methodologies, DNOs are also required to ensure their methodologies do not restrict or distort competition.

Historically, IDNOs have been charged based on the size of their contribution to demand on the DNO network and have consequently been charged industrial or commercial (I&C) tariffs, reflective of the magnitude of this demand. IDNOs have raised concerns that this does not represent a cost reflective charge for the following reasons:

- The coincidence to peak demand of IDNO sites with predominantly domestic customers is not in line with the coincidence to peak demand applied in the calculation of I&C tariffs; and
- The calculation of I&C tariffs does not adequately reflect the DNO's avoided costs from which DNOs benefit when IDNOs connect to their networks.

SP's proposed modification

SP's proposed modification attempts to address both of the above points. The specific changes being proposed are summarised in Annex 1. The detailed proposals can be seen as part of the modification proposal report, as published on our website[4].

Annex 2 attempts to identify the main issues with SP's proposal. This consultation process is designed to evaluate whether the Authority has captured the main issues and to support the Authority's analysis by further evaluating the materiality of each of these issues. Annex 3 contains illustrative IDNO margins under the proposed modifications.

The Authority has already consulted on many of the potential issues relating to this proposal due to its similarity with WPD's current IDNO charging methodology[5]. Whilst we do not wish to consult on the same issues repeatedly, each submission must be viewed against its own merits. We feel there are enough differences between WPD's current and SP's proposed methodology regarding charges to IDNOs to justify further consultation in specific areas. In addition, when the same principles are applied in separate cases the results can be different due to variations between the existing methodologies to which modifications are made and the relevance of locational differences amongst others. We believe these are sufficient enough in this case to justify further consultation.

Views sought

The proposals represent a number of changes to SP's existing methodology. The Authority has taken the decision to consult on the proposed modifications to further evaluate the extent to which the changes they represent address the current issues and do not raise further issues in relation to the way(s) in which SP's modification proposal better meets the relevant objectives. Specifically,

[4] Modification report - Use of System Charging Methodologies for IDNO Networks PR-08-001a, which can be found on our website at http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx.
[5] Joint Consultation document on SP and WPD's proposed modifications to their IDNO charging methodology http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/UoS%20charges%20WPD%20and%20SP.pdf.

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- The extent to which the proposals are more cost reflective than the current methodology[6];
- Whether SP demonstrates that its proposals facilitate competition in generation and supply and do not restrict, distort or prevent competition in transmission and distribution[7];
- Whether the proposed changes allow licence holders to finance their activities[8]; and
- Whether we have correctly captured the main issues raised by SP's modification proposals in Annex 2.

Responding to this consultation letter

Views are invited on these points from any interested parties, including IDNOs, DNOs suppliers, customers and their representatives.

Views are invited by **17 June 2008**. Where possible, responses should be sent electronically to Colette Schrier, e-mail distributionpolicy@ofgem.gov.uk.

The process associated with modifications to the charging methodologies is detailed within the electricity distribution licence (SLC4 and 4B). As the Authority's decision is time bound, please ensure that your comments are received by the date indicated so that they can be fully considered. It may not be possible to consider responses that have been received after this date, however, as the Authority needs to make a decision on this matter on or before 31 July 2008.

All responses will be held electronically by Ofgem. They will normally be published on our website unless they are clearly marked confidential. Consultees should put confidential material in appendices to their responses where possible. We prefer to receive responses electronically so that they can easily be placed on the website.

Copies of this document are available on our website under the distribution charging modifications area of work[9].

Comment

As we have commented previously, we consider that the growth of IDNOs constitutes an important change to DNOs' distribution businesses and that there is a risk that DNOs' charging methodologies could distort competition. We therefore continue to urge DNOs to review their approach to charging IDNOs without delay and to keep these methodologies under review. We also emphasise that it is the responsibility of each DNO to ensure it complies with the requirements of the Competition Act 1998 as for any other legislation.

Please contact Colette Schrier on 0207 901 7341 if you have any queries in relation to the issues raised in this letter.

Yours faithfully,

Rachel Fletcher
Director, Distribution

[6] Standard condition 4(3(c)) of the electricity distribution licence.
[7] Standard condition 4(3(b)) of the electricity distribution licence.
[8] Section 3A(2) of the Electricity Act 1989.
[9] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx.

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Annex 1

1.1. SP is proposing the creation of a new service model, consisting of four LV tariffs and one HV tariff which will be applicable to IDNO customers connecting to its network at LV and HV respectively. The EHV charging methodology remains unchanged under the proposals.

1.2. SP has identified that the IDNO sites connected to its network have profiles which are similar to those of their own domestic customers. SP has recognised that this is not fairly reflected in the current IDNO tariffs and is therefore proposing to introduce tariffs which reflect domestic coincidences to peak demand. SP has provided as part of the Appendix to its submission analysis which shows the correlation between LV and HV IDNO and SP's domestic demand profiles.

1.3. As a result, SP is proposing to introduce day and night unit tariffs which reflect the IDNO's increased contribution to costs during the day.

1.4. When an IDNO connects to a DNO's network, the DNO will benefit by not incurring costs associated with the network nearest to the end customer. The IDNO charges should reflect this. SP has identified that a proportion of network operations and maintenance (O&M) costs and Customer Service, Administration and Billing costs are those which it avoids when an IDNO connects to its network.

1.5. SP has recognised the avoided O&M costs through the creation of four LV tariffs based on the length of the LV connection measured from the source substation, as a proportion of the average LV feeder length in each DNO area. The tariffs assume the customer is connected at the start of each distance band. The distance bands and the associated DNO avoided costs are shown in the table below:

Tariff Name	*Distance (as percentage of average LV feeder length)*	*DNO avoided O&M costs*
LV IDNO Band 1	0-25%	100%
LV IDNO Band 2	25-50%	75%
LV IDNO Band 3	50-75%	50%
LV IDNO Band 4	>75%	25%

1.6. SP has identified the avoided costs associated with a different billing and customer service process for IDNO customers. SP states that a manual process for IDNO billing results in avoided costs associated with existing billing systems but leads to increased costs due to increased manual time commitments. SP proposes to pass on these increased costs as well as recognise the avoided costs.

1.7. SP has recognised that it may not be right to assume the indirect costs being recovered are directly related to the length of the LV circuit. Consequently SP is proposing to modify its approach to scaling for IDNO tariffs by not scaling the LV yardstick as part of the scaling to allowed revenues. This effectively caps the scaling at HV.

1.8. As part of SP's attempt to improve the cost reflectivity of the tariff structure, SP is proposing not to include capacity charges, citing that capacity charges are not appropriate given an IDNO's demand profile. In addition, SP states that it is the IDNO's responsibility to ensure a good power factor in line with relevant objectives set out in previous publications

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from the Authority[10]. As a result, the proposed tariff structures do not include reactive power charges.

1.9. Subject to a 'non-veto' decision by the Authority on these changes, SP proposes to implement the changes, if possible, from 1 October 2008.

[10] 'Structure of electricity distribution charges. Update document and licence modifications' Ref 76/04, April 2004, p.20.

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Annex 2

2.1. Many of the potential issues with this methodology have been addressed by industry during the consultation process for WPD's existing IDNO charging methodology[11]. These are therefore not included here. The Authority has identified specific areas where we feel the methodology is either different or where the application of the methodology produces different results. These focus on:

- The impact of a restricted type IDNO tariff on IDNOs with restricted and/or unrestricted customers;
- The inclusion of one 'domestic only' tariff; and
- The margin changes that result from the proposed tariffs.

2.2. By including day and night unit charges, SP has essentially proposed a restricted type tariff for all IDNOs. The Authority wishes to further understand whether this is appropriate given the potential for IDNOs to levy either restricted or unrestricted tariffs, as the day/night split used to calculate the IDNO tariffs will impact the margin for both restricted and unrestricted IDNO revenues. We have provided analysis on the impacts of a day/night split on IDNO margins in Annex 3. We would welcome views on the extent to which the proposals are cost reflective for both electrically and gas heated IDNO developments and do not limit competition in either case.

2.3. In addition, we are seeking views on the extent to which a domestic only tariff is appropriate considering the makeup of current IDNO developments. This is particularly relevant at HV, where domestic coincidence factors may be less appropriate and the profiles are not as highly correlated according to SP's analysis. Views are welcomed in this area.

2.4. The margin analysis in Annex 3 shows IDNO margins for a notional IDNO development under the proposed tariffs (3.1) along with how margins change with the number of plots on an IDNO site (3.2) and with a different day/night split (3.3). We recognise that larger (> c.25 plots) IDNO developments at LV and some HV developments will have lower margins under the proposed tariffs compared with existing IDNO tariff arrangements whilst smaller LV and other HV developments will benefit from higher margins. We welcome views on whether the proposals represent cost reflective modifications to the methodology and at the same time do not prevent competition in the distribution of electricity[12].

2.5. We would welcome views on any additional issues or considerations which have not been identified in this section.

[11] Joint Consultation document on SP and WPD's proposed modifications to their IDNO charging methodology http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/UoS%20charges%20WPD%20and%20SP.pdf

[12] Standard condition 4(3) of the electricity distribution licence

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Annex 3

3.1. Illustrative margins and assumptions for a notional IDNO development connected to a LV network

Illustrative assumptions		
Number of households	50	
Average household consumption	4109	kWh
Average household capacity	2	kVA
Capacity diversity factor	1	
Day units	75%	
Night units	25%	

	All the way income (IDNO collects)	IDNO income per plot	Site boundary charge by DNO to IDNO	Site IDNO gross margin	IDNO gross margin per plot	% of total all the way charge
SP Distribution (Unrestricted Tariff) with IDNO LV Band 1 tariff	£4,412	£88	£3,088	£1,324	£26	30%
SP Distribution (Unrestricted Tariff) with IDNO LV Band 2 tariff	£4,412	£88	£3,165	£1,247	£25	28%
SP Distribution (Unrestricted Tariff) with IDNO LV Band 3 tariff	£4,412	£88	£3,248	£1,165	£23	26%
SP Distribution (Unrestricted Tariff) with IDNO LV Band 4 tariff	£4,412	£88	£3,325	£1,088	£22	25%
SP Distribution (Restricted Tariff) with IDNO Band 1 tariff	£4,556	£91	£3,088	£1,468	£29	32%
SP Distribution (Restricted Tariff) with IDNO Band 2 tariff	£4,556	£91	£3,165	£1,391	£28	31%
SP Distribution (Restricted Tariff) with IDNO Band 3 tariff	£4,556	£91	£3,248	£1,309	£26	29%
SP Distribution (Restricted Tariff) with IDNO Band 4 tariff	£4,556	£91	£3,325	£1,232	£25	27%
SP Manweb (Unrestricted Tariff) with IDNO Band 1 tariff	£3,724	£74	£2,800	£925	£18	25%
SP Manweb (Unrestricted Tariff) with IDNO Band 2 tariff	£3,724	£74	£2,861	£863	£17	23%
SP Manweb (Unrestricted Tariff) with IDNO Band 3 tariff	£3,724	£74	£2,943	£781	£16	21%
SP Manweb (Unrestricted Tariff) with IDNO Band 4 tariff	£3,724	£74	£3,020	£704	£14	19%
SP Manweb (Restricted Tariff) with IDNO Band 1 tariff	£3,566	£71	£2,800	£766	£15	21%
SP Manweb (Restricted Tariff) with IDNO Band 2 tariff	£3,566	£71	£2,861	£705	£14	20%
SP Manweb (Restricted Tariff) with IDNO Band 3 tariff	£3,566	£71	£2,943	£623	£12	17%
SP Manweb (Restricted Tariff) with IDNO Band 4 tariff	£3,566	£71	£3,020	£546	£11	15%

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3.2. Illustrative graphs showing change in IDNO margin with number of households connected for SP restricted and unrestricted tariffs. This analysis assumes a HV connection is used to serve sites with greater than 400 plots. All other assumptions are the same as in 3.1 above.

Figure 1 - IDNO margins based on proposed IDNO tariffs and SP Distribution domestic unrestricted tariff

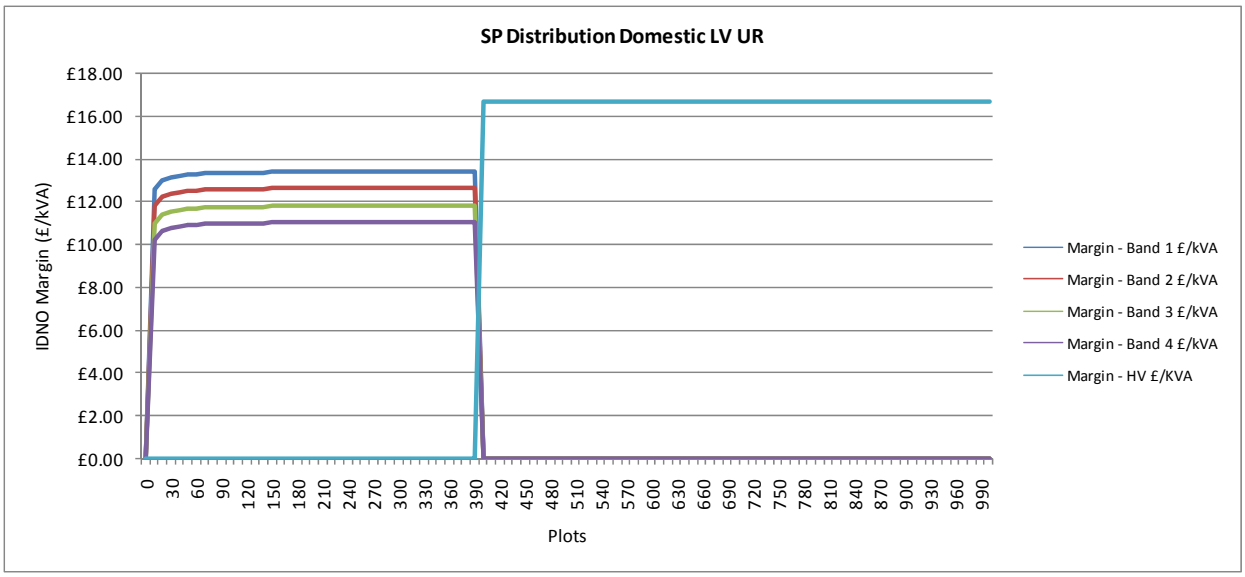

Figure 2 – IDNO Margins based on proposed IDNO tariff and SP Distribution domestic restricted Tariff

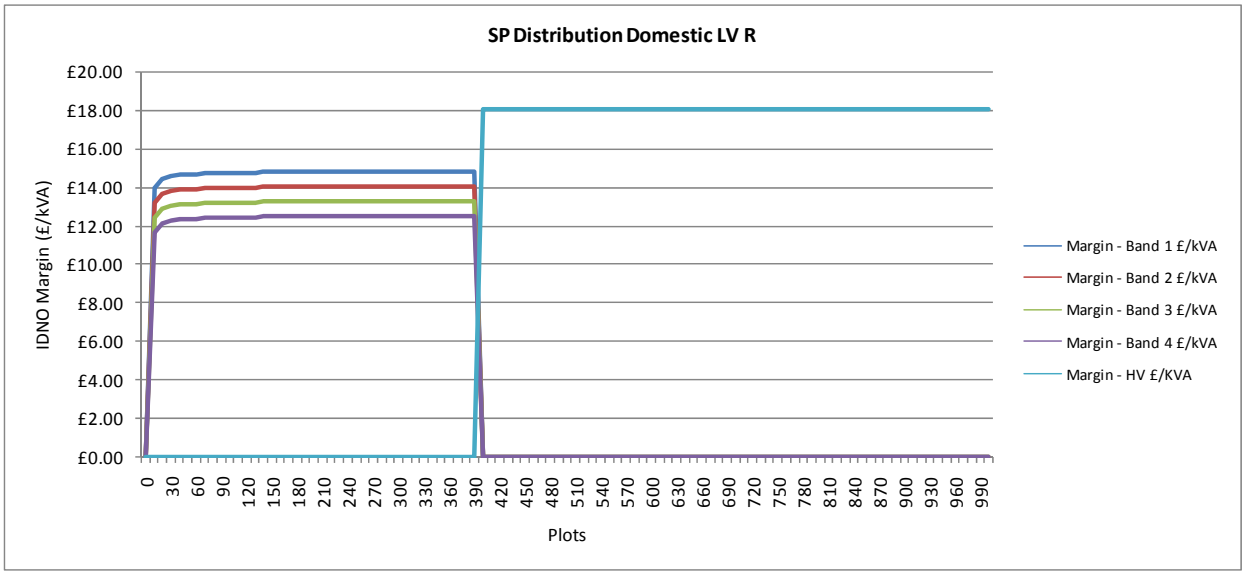

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Figure 3 - IDNO Margins based on proposed IDNO tariff and SP Manweb domestic unrestricted Tariff

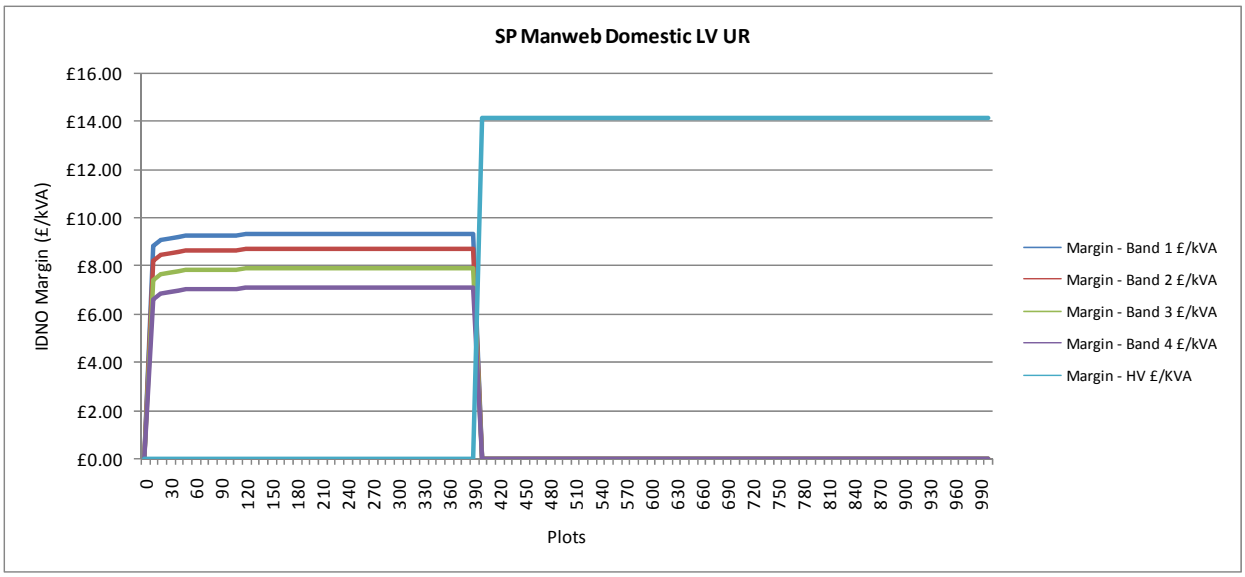
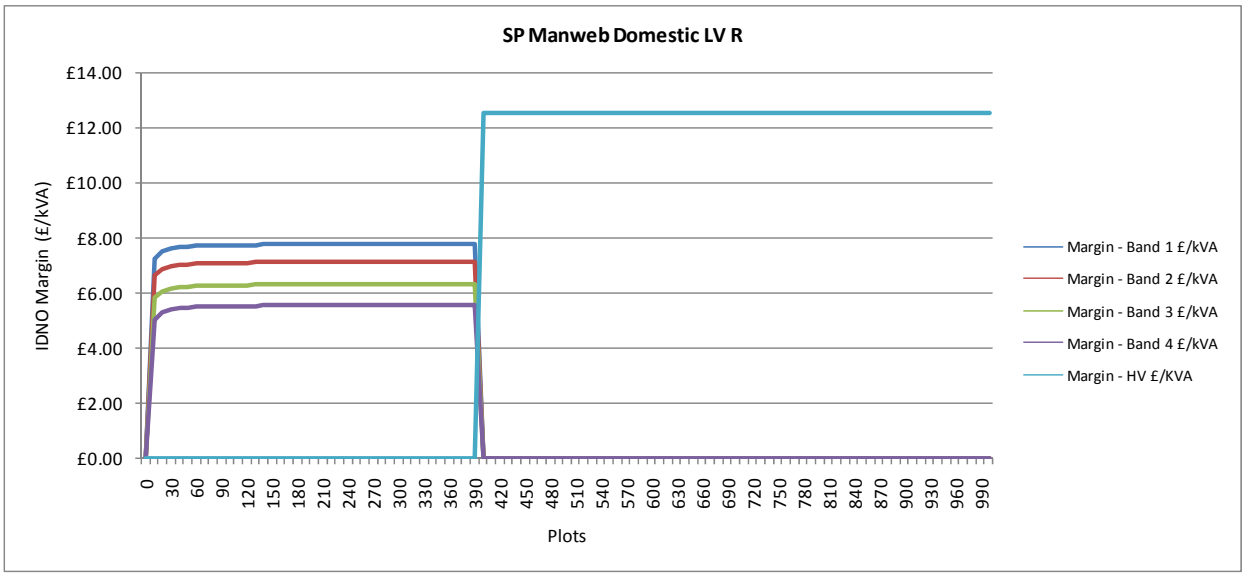


Figure 4 - IDNO Margins based on proposed IDNO tariff and SP Manweb domestic restricted Tariff



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3.3. Illustrative graphs to show the impact of a change in day/night consumption on IDNO margin. All other assumptions are the same as in 3.1 above.

Figure 5 – Graph showing impact of changing day/night split on IDNO margin calculated using proposed IDNO tariffs and SP Distribution domestic unrestricted tariffs

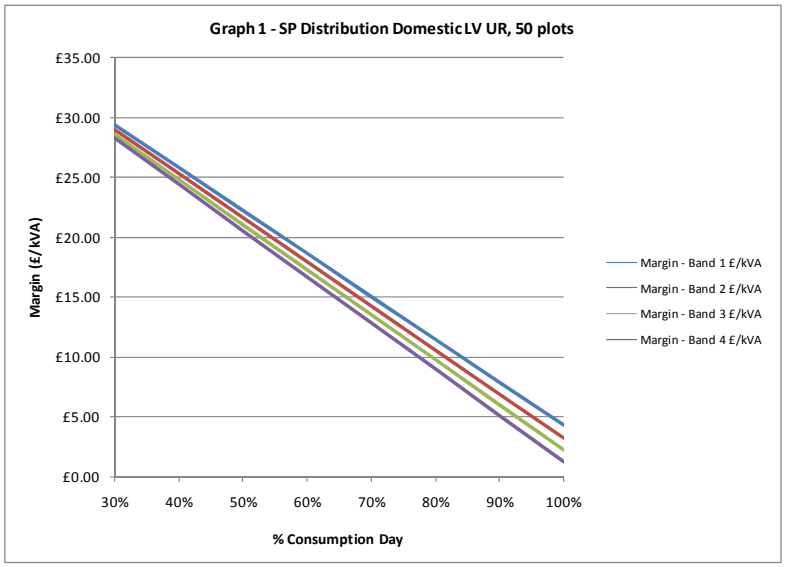

Figure 6 - Graph showing impact of changing day/night split on IDNO margin calculated using proposed IDNO tariffs and SP Manweb domestic unrestricted tariffs

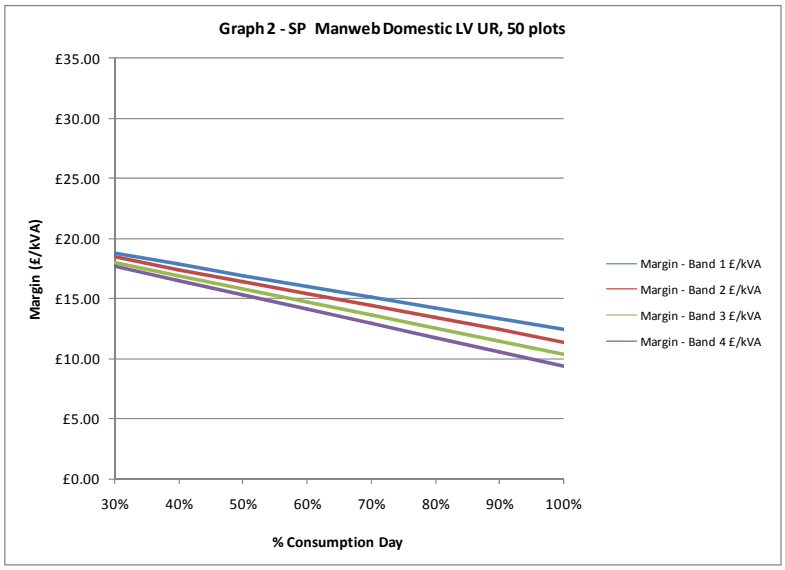

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Figure 7 - Graph showing impact of changing day/night split on IDNO margin calculated using proposed IDNO tariffs and SP Distribution domestic restricted tariffs

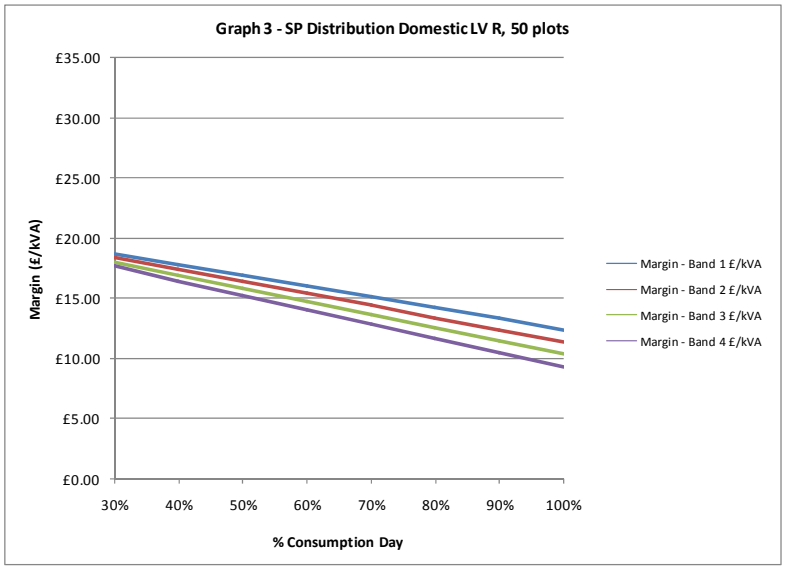
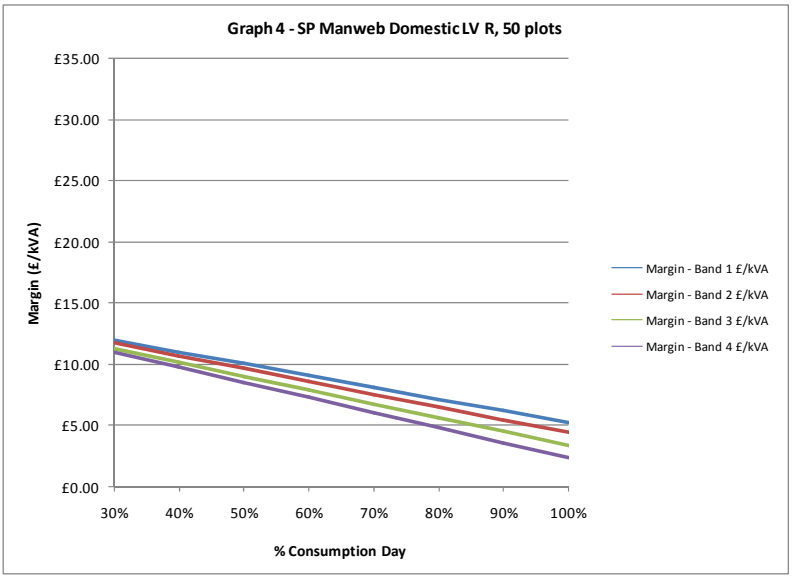


Figure 8 - Graph showing impact of changing day/night split on IDNO margin calculated using proposed IDNO tariffs and SP Manweb domestic restricted tariffs



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