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Our ref: ENERG/E/CHARGES/DNO/02

**Ms Rachel Fletcher**  
**Director Electricity Distribution**  
**The Office of Gas and Electricity Markets**  
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**19<sup>th</sup> August 2008**

Dear Rachel,

**Delivering the Electricity Distribution Structure of Charges Project**

Thank you for your update of 22<sup>nd</sup> July 2008 and the subsequent invitation to comment on the ongoing proposals.

Turning to the specific questions raised in the consultation document:

**Ofgem to specify common methodology to be applied across DNO's**

Ofgem has already identified the problems associated with asking the DNO's to agree a common methodology between themselves. Without trying to appear critical, it has to be accepted that there is a potential for conflicting views on the best way forward which will make this process extremely difficult and prolonged. In light of these observations, Energetics Electricity takes the view that Ofgem will be required to specify a particular methodology. Energetics Electricity offer the view that the selection should be based on the collective views of all interested parties and not based on the preference of the majority of the DNO's and nor should the selection be based on the quickest and/or most cost effective implementation. This project is arguably the most important piece of regulatory work over the last ten years that, if managed properly, can have a positive impact across the electricity market for many years to come.

**Pros, cons and impact of each model**

▪ *EHV Level Models*

Starting with the EHV level models, the options at the moment are limited to the existing Long Run Incremental Cost (LRIC), the Forward Cost Pricing (FCP) put forward by G3 or the Investment Cost Related Pricing (ICRP)/LRIC hybrid put forward by ENW.

Rather than regurgitate the analysis already conducted by Ofgem or the work of the Distribution Charging Methodologies Forum (DCMF), at Energetics Electricity we have sought to offer our view in the context of the increasingly changing requirements of the UK distribution system.

Our initial assessment of the current options favoured the FCP model on the basis of its cost reflectivity, use of publicly available information and extensive cost drivers

(particularly the use of fault levels). However, whilst the inputs to this model are fairly robust, the assertion from the Frontier Economics report and the analysis conducted by CE and the University of Bath that the resultant cost allocation has no economic rationale raises some doubt over the application of this model at EHV. Add to this the potentially significant distortion in future reinforcement costs, owing to the 87% utilisation threshold and the 10 year reinforcement planning window; the resultant charge rates per KVA (determined by the calculation comparison by W.R.Hodgkins presented at the 7<sup>th</sup> DCMF meeting on 19<sup>th</sup> June'08) show significant step changes depending on the annual growth rate.

In comparison, the LRIC methodology is also cost reflective, gives good locational messages and is effective for positive, negative and zero growth rates. One of the limitations of this methodology is the exclusion of fault level costs, however, further work on this methodology suggests that this will be included in future models. Based on the LRIC methodologies submitted to date, the inherent weakness of this model is the apparent 'sharp' incremental cost signals on low growth/highly utilised networks. However, if the calculation comparison put forward by W.R.Hodgkins were assumed to be correct then the LRIC Corrected (using an annuity factor based on the cost recovery period and not the asset lifetime) would suggest a more robust and transparent set of charges.

- *HV/LV Models*

The models put forward by the respective DNO's fall into two main areas; the Distribution Reinforcement Model (DRM) and the FCP G3 model that utilises historical information from the Regulatory Reporting Packs (RRP).

The obvious advantage of the DRM is the wide application of this model across the industry, albeit there are a number of variants. The downside is the fact that this model has been in place for over 20 years and is arguably not reflective of the changing nature of the distribution network i.e. distributed generation and the introduction of IDNO's. That said, these limitations can be addressed going forward with strong guidance from Ofgem on the appropriate DRM methodology and the corresponding governance arrangements in place to ensure there is no divergence from the 'new' methodology.

The use of RRP in the G3 model has merits to the extent that it uses widely available data as the basis for cost allocation. The downside is that by using historical data and scaling up using RPI, the resultant charges could be spiky in nature since the historical trends can change significantly from year to year. Another advantage of this model is the fact that by using publicly available data the resultant charges are very transparent. If the potential volatility of the historical information can be 'smoothed' by using some form of factoring then the RRP cost allocation model could be considered seriously as a model for the industry.

### **Governance Arrangements**

Ofgem has identified the potential for any future 'common methodology' to be eroded over time through subsequent individual DNO modifications and it's absolutely critical to the success of this project that appropriate governance arrangements remain in place.

Of the options proposed by Ofgem, it is the view of Energetics Electricity that option 2, modifying the current DNO licence, would better serve the wider industry on the understanding that this option encourages collective modification proposals from the DNO's. The suggestion of also setting formal obligations on the licensees to consider change proposals from non-DNO parties has support from Energetics

Electricity on the basis that the modification proposals are not one sided and there is a route for other interested parties to raise proposals that will have to be considered formally.

Of the other two options put forward, Energetics Electricity would have serious concerns about placing this responsibility within the DCUSA, purely on the basis that the drivers for DNO's, IDNO's, Suppliers and Generators can be very different in a competitive and changing marketplace and in theory the work of DCUSA could be affected in dealing with frequent modification proposals.

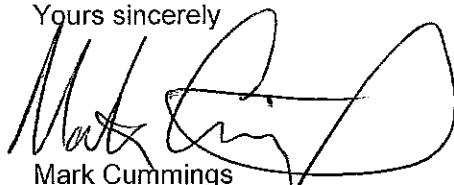
The third option of developing a new charging methodology code clearly has merits whereby there is an opportunity to shape the governance arrangements around the common methodology. On balance however, this option can provide the correct level of governance, wider industry contributions and at a more reasonable cost to all parties.

### **Proposed Processes**

The timescale put forward under annex 4 is certainly very ambitious, albeit necessary to achieve the desired output by April 2010. The main concern from Energetics Electricity is the September timescale for Ofgem to decide on the form of common charging methodology. Depending of the output from this particular consultation there may well be a significant amount of work required to assimilate the views of all interested parties and we would encourage Ofgem not to be driven by this particular milestone and risk compromising the whole project by choosing the preferred common methodology using flawed criteria such as; most cost effective implementation, favoured by the majority or most likely to meet the April 2010 deadline. As outlined in our opening statement, this is a very important piece of work and it's worth taking the time to consider the options thoroughly before deciding on the best methodology. Once this path has been chosen, the resultant work programme can be accelerated where required to meet the desired end date.

Finally, may I take this opportunity to thank you for the opportunity to comment on these proposals and we look forward to receiving your views on the best way forward.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark Cummings', written over a horizontal line.

Mark Cummings  
Director, Energetics Electricity