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16 January 2009

Dear Mark

Re: Code Governance Review: charging methodology governance options

I am writing on behalf of CE Electric UK Funding Company (CE) 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 consultation on the code governance review: charging methodology governance options. Whilst our response is mainly from a distribution perspective we also refer to the current transmission process where appropriate.

We support Ofgem's aims of bringing greater rigour, accountability, transparency and effectiveness to the governance arrangements for the charging methodologies. However, we believe that all of these aims can be achieved without the additional layer of cost, risk and complexity that Ofgem proposes as an alternative to the status quo in the consultation. We believe that the existing transmission charging methodology forum (TCMF) and distribution charging methodology forum (DCMF) provide a conduit for all industry participants to contribute and comment on any charging proposals. We do, however, recognise that the TCMF has been established since 2001 and as such has evolved over time. Some simple modifications and clarification of the terms of reference of the DCMF may be needed to better focus them on achieving the majority of these aims. We note that:

- There is nothing under the current governance arrangements stopping interested parties from approaching network operators, either directly or via the TCMF/DCMF, to discuss any potential changes that could be made to charging methodologies to better meet the licence requirements;
- Ofgem is seeking feedback on the cost effectiveness of these proposals from end users, suppliers and network operators without offering even the most high-level cost benefit analysis. Ofgem has only sought such cost/benefit data as part of this consultation rather than to inform its initial views on the options available. We believe that, if such analysis had been included in this consultation paper, it would show a significantly negative business case for such a change. We assume that no decision will be made until this data is collected, analysed, published and consulted on. Only then can any decision on this subject be said to be in line with the principles of good regulation;
- Interestingly, Ofgem suggests in section 3.20 of the consultation that distribution network operators (DNOs) caused delays to the progress of implementing new charging arrangements. However, it is clear that, if Ofgem had moved to a common

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licence modification and specified a type of charging model several years ago (as we urged), the industry would have been saved a significant amount of wasted time and effort;

- Ofgem believes that, by opening the submission of charging methodology changes to end-users and suppliers, it will make charging methodologies more cost reflective. However, network operators operate under a licence condition that requires them to act without undue discrimination when bringing forward changes to charging methodologies. This is not the case for suppliers and end-users, which are likely to have a vested interest in any prospective modifications and hence may act solely with commercial self-interest in submitting changes to charging methodologies. There is also the potential that they may act together, thus nullifying Ofgem's suggested mitigation for this issue. This has been seen on a number of occasions within the distribution connection use of system agreement (DCUSA) voting structure; and
- Ofgem's own consultants (the Brattle group) do not recommend making the charging methodologies subject to industry codes review. We note that Ofgem does not explain why it has gone against the advice of their own consultants and are still considering alternative mechanisms.

The following paragraphs summarise our views on each of the categories that Ofgem has outlined. Our views on the specific questions raised in the consultation paper are shown in Annex 1 to this response.

- **Promotion of inclusive, accessible and effective consultation** - We concede that the current charging arrangements do not allow access to end-users and suppliers to formally submit charging proposals and amendments. However, interested parties are not precluded from suggesting possible improvements to the existing methodologies; we would urge Ofgem to be cautious on this issue. As discussed above, network operators have an obligation to act without undue discrimination in bringing forward charging modifications, being particularly aware of our obligations not to restrict, prevent or distort competition. Those parties who might seek to submit change proposals do not necessarily (and rightly from their perspective) share these obligations – indeed it could be said that they have a duty (to their shareholders) to maximise their opportunity and returns by acting in a commercially self-interested way. This could ultimately lead to a significant amount of time analysing proposals that will be vetoed by Ofgem; or potentially lead to distortion in competition.

It should also be noted that we do not believe that the mitigation strategy suggested by Ofgem (i.e. to have some form of block-vote threshold from each group) will work in practice as industry groups tend to share positions on specific issues, which means they may easily reach the thresholds suggested by Ofgem.

It is our view that both the TCMF and DCMF are the best forums to consult on changes to charging methodologies. Whilst we would concede that more can be done to improve inclusiveness and effective consultation of these forums, we believe that small changes in the terms of reference of these groups, (particularly the DCMF) so that ratification of proposals by a smaller sub-group is required prior to submission to Ofgem. This could solve much of this perceived problem without the (as yet unquantified) administrative burden that Ofgem is considering imposing on the industry if new governance arrangements were to be introduced.

- **Governance rules are transparent and easily understood** - It is not clear that any one option offers any advantage in this respect. Whilst it may be true to say that there is some dissatisfaction with the current arrangements, they are at least clear to the industry. Option 3 (entering into existing codes governance) could be said to be weak against this category because the existing code governance arrangements are different for different codes and would present different regimes to users. It should

also be noted that not all end-users are signatories to the agreements (e.g. DCUSA) mentioned by Ofgem and therefore may be unrepresented in these forums.

- **Administered in an independent and objective fashion** - We refer Ofgem to the comments made in the paragraph above on this subject – we are the only industry participants with licence requirements that force us to act in a non-discriminatory manner and promote competition in this area.
- **Rigorous and high-quality analysis of the case for and against proposed changes** - We note Ofgem's comments on the rigour of the submissions it has received from network operators. We would submit that Ofgem itself has complained in the recent past about the level of rigour and analysis presented to it by code governance groups.

We have in the past worked well with Ofgem in understanding its concerns regarding proposed changes prior to submission of any change request – this detailed working (which benefited both parties) may be lost under the grouped change options.

- **Cost effectiveness** - We strongly believe that, if the modification process is opened up to all parties, there will be a significant increase in the number of change proposals that the industry needs to work on and submit to Ofgem. This will increase costs for all concerned, not just in working directly on the proposals but also in managing the implications of change within budgets and contractual positions.

We believe that the change options may have a significant impact on network operators' cash-flow position, which could actually damage businesses. There are no other industries where organisations may put forward changes that impact upon and affect the cash-flow of their competitors – this is what Ofgem is seeking to do to network operators.

We also urge Ofgem to publish a full cost-benefit analysis of such a change in order that all industry participants have an opportunity to consider whether this will be a worthwhile step.

- **Flexible rules and processes leading to efficient change management** - We are pleased to note that Ofgem recognises the risk of an increase in the volume of change proposals but believe that the mitigation that Ofgem has offered (as explained above) is entirely inadequate to prevent block-voting based on shared commercial self-interest.
- **Proportionate regulatory burden** - We believe that Ofgem's comments in the paper do not address the proportionality of the regulatory burden, except to say that there is a risk that there will be more change requests – we agree with this assessment based on our experience of DCUSA changes. What we would have expected from Ofgem is a review of the forecast increase in change proposals and a cost assessment of this burden. We would have expected Ofgem to demonstrate what it believes the current regulatory burden is, and how that burden moves and increases (or reduces) with each option. This is entirely absent from the consultation and we assume Ofgem could not viably make such an important decision without it. We await this further detail on this subject.
- **Other risks and issues** - We agree with the Ofgem assertion that the change options raise revenue risks for network operators.

Appendix 1 of the consultation paper contains a cost questionnaire. Having undertaken some high-level analysis we consider that we could potentially face internal cost, to review and evaluate each modification proposal, of circa £10k. This would have a significant financial and resource impact on our organisation, especially if the number of proposals submitted were to increase substantially. In addition to the above costs we also expect to face annual administrative costs for managing any new distribution forum (i.e. workshops/groups, panel

meeting and secretariat support) in the region of £15k per DNO. (We would face additional for transmission meetings).

In summary, we welcome the stance that Ofgem is taking in looking to bring greater rigour, accountability, transparency and effectiveness to the governance arrangements for the charging methodologies. However, we believe that the vast majority of these aims can be achieved without the additional layer of cost, risk and complexity that Ofgem appears to be considering. It should be noted that, (in the context of option 3) in order to address charging methodologies under the DCUSA, Ofgem would have to modify condition 22 of the distribution licence so as to provide a lawful basis for the additional DCUSA content. The consultation paper does not appear to mention that a licence modification is required, given that this is the case Ofgem's third option is objectionable both as a matter of policy and of law.

I hope this response sets out our views sufficiently and would stress that we would welcome the opportunity to discuss these views with Ofgem. We would also be willing to participate in any groups that are established to take forward developments in this area.

Yours sincerely

A handwritten signature in black ink, appearing to read 'H Jones', written in a cursive style.

Harvey Jones

Head of Network Trading

Annex 1: Response to specific questions

Chapter 2

Question 1: Are there any other key issues that should be considered? If so what impact would these issues have on NWOs and network users?

The key issue that has not been considered by this consultation is the cost-benefit trade-off. Whilst this is alluded to throughout the document we have some specific concerns that there simply is not the business case to justify such a move, which would see the resource requirement transfer from Ofgem to the industry.

Question 2: Are there any aspects of the key issues that we have not addressed?

One key issue that is not mentioned but seems to be always mentioned by supply companies is that of predictability and stability in charges. We note that Ofgem concedes that this proposal may bring greater instability to charges for end-users, suppliers and network operators at a time in the economic cycle when companies are looking to reduce risk.

Question 3: Should Ofgem consider governance arrangements for all charging methodologies on a common timetable, or seek to prioritise? If the latter, which methodologies do you consider should take priority and what would the benefits of this approach be?

As we have stated in our response, we believe that Ofgem should consider the option to enhance the DCMF process to minimise disturbance to the industry.

Chapter 3

Question 1: Are there alternative governance arrangements that could be considered appropriate for charging methodologies?

We believe that one option that is not in the Ofgem consultation is an enhanced role for the DCMF similar to the process followed by the TCMF forum. This group could be the conduit by which charging methodologies are submitted to Ofgem and have in its terms of reference representatives from end-users, suppliers, licensed distribution network operators and generator groups.

Question 2: Do you agree with assessment of the options against the principles of the review. Are there others impacts that we have not mentioned?

We have some significant concerns regarding Ofgem's assessment against the principles and they are set out in the main body of our response.

Question 3: What are your views on the cost and risk mitigation measures set out in this chapter? Are there other mitigation measures that could be introduced?

The mitigation strategy suggested by Ofgem (i.e. to have some form of block-vote threshold from each group) we do not believe will work in practice, as industry groups tend to share positions on specific issues, which means they may easily reach the thresholds suggested by Ofgem.