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1 October 2008

Dear Rachel

Consultation on proposal from Electricity North West Limited to modify use of system charges for independent distribution network operators (IDNOs), HV/LV generators and the DRM

I am pleased to provide some responses to the questions raised in your consultation on ENW's DRM Modification Proposal. We believe that our proposals are a significant step forward in the development of a longer term charging methodology that facilitates the introduction of new tariffs for Licensed Distribution Network Operators and HV and LV connected distribution generation.

ENW raised the modification proposal, ENW/2009/001.1, to improve the transparency and consistency of the current DRM methodology. The proposed changes to the DRM methodology facilitate the introduction of the proposed new tariffs for LDNOs and HV or LV connected distributed generation as the steps in the charging methodology are more clearly defined. In the review of the methodology we adopted the three principles steps used in the ENA COG work of:

1. **Identify and attribute/allocate costs**- The approach to cost identification and attribution has been amended so that all costs are identified either in costs per kW terms or costs per customer terms and the cost attribution is undertaken in order to deliver costs in £ million terms per tariff group;

2. **Revenue Reconciliation** - The proposed revenue reconciliation approach is to apply a fixed adder (in £/kW) as opposed to a multiplier so not to distort the costs message in the marginal cost element; and

3. **Tariff Development** - Tariffs are formulated by allocating the costs per tariff group into the tariffs elements appropriate for each tariff group using consistent rules.

The clear separation between the steps increases the transparency of the outputs between each step, which is not present in the current methodology. For example the current revenue

reconciliation approach is undertaken after the tariff structures have been created using a multiplicative scaler to unit costs only which does not give the same clarity in costs signals. We have added further clarification to your description on the existing methodology which we believe has been slightly misinterpreted by Ofgem. We believe that the review of the existing methodology has enabled ENW to restructure the DRM charging process propose to reduce its complexity. The segregation of the steps is an important feature and is the type of feature we would look for in a common charging methodology.

Our responses to the questions raised in your consultation document are in the attached Appendix 1. If you have any questions or queries on our response please do not hesitate to contact Tony McEntee on 01925 534499 or Simon Brooke on 01925 534416.

Yours sincerely,

Digitally signed by Paul Bircham
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Date: 2008.10.02 15:52:34 +01'00'

Paul Bircham
Regulation Director
Electricity North West Limited

cc Karron Baker, Ofgem

Appendix 1 – Responses to the questions raised in the consultation document

IDNOs

1. Respondents' views on the use of a day/night restricted tariff for IDNOs.

The aim of the proposed IDNO tariffs are to reflect the costs that an IDNO's embedded network servicing domestic properties imposes on ENW's distribution network. The use of multi-rate will better reflect the costs than a single rate tariff can. This approach aligns ENW with the other approved approach implemented by another DNO business.

2. Whether respondents consider the lack of an IDNO commercial tariff would influence the development of IDNO commercial connections.

ENW has not yet seen the growth of embedded distribution networks servicing commercial customers. Of the fifty five embedded network only three of these embedded networks service commercial customers. Of these three embedded sites, one is connected at EHV and two at HV. All the feedback that ENW has received in discussions with IDNOs over charging methodologies has been related to domestic developments only. ENW believes, that at this point in time, the lack of an IDNO commercial tariff is not hampering the development of commercial connections. If Ofgem had not decided to move forward with a common charging methodology the next step for ENW after the non-veto decision on ENW-2009-001.1 would have been to consider an IDNO commercial tariff(s).

3. Whether respondents agree with the approach to avoided costs attributed to IDNOs?

In its Modification Proposal ENW has reviewed all the costs identified within the costs modelling and considered whether the costs are appropriate to be included with an IDNO specific tariff. ENW believes that it has identified all the costs that should be included and more importantly excluded from IDNO tariffs.

HV/LV Generation Charging

4. Whether respondents consider generation should be treated as the reverse of demand?

ENW's proposal does not treat generation as the reverse of demand. When demand and generation share the use of a network an appropriate allocation mechanism is required to define the costs applicable to each class of customer. The DRM methodology allocates the relative costs for the use of the network to the network users through the use of load and coincidence factors. At present ENW's distribution network is predominantly demand dominated, so when HV and/or LV generation connects to the distribution network the generation defers the need for reinforcement, thereby reducing the costs of the network. The use of a negative coincidence factor gives a credit to the generation connected to a demand dominated network, with the size of the determining the value of the credit. This is not the same as saying that DRM methodology treats generation as the reverse of demand.

5. Whether respondents consider average generation load factor is an appropriate proxy for the coincidence factor?

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6. Whether respondents agree with the allocation of benefits to generators with a load factor either side of 50%?

The use of average load factors is a pragmatic solution to having limited generation data. When ENW analysed the characteristics of the existing generators connected to its distribution network it found that there were two distinct clusters of the load factors exhibited by generators. The further analysis of the generators within the clusters showed there was a strong correlation between the load factor and the coincidence factor displayed by the generators and so ENW adopted the pragmatic approach of making the load factor as a proxy for the coincidence factor. This approach will be kept under review and it is expected that it would change as ENW gather more information on the characteristics of generation connected to its distribution network.

DRM Modifications

7. Whether ENW's approach to scaling is appropriate? Do respondents consider any distortions will arise when moving from a fixed percentage to a fixed adder?

Irrespective of the type of scaling ENW's current approved revenue reconciliation methodology is flawed as it is only the costs that appear in unit charges that are scaled. Since ENW's charging methodology was approved in 2005 the industry has understood better the costs to be included within the charging model(s) and the forms of revenue reconciliation. The proposed change to a fixed adder and including all the costs within the charging model within the revenue reconciliation approach is a clear improvement on the existing approach.

8. Do respondents have any thoughts or comments on the fact that ENW currently scale down, i.e. they propose to apply a negative fixed adder?

ENW's charging model currently identifies more costs that can be recovered from allowed revenue. This has been the case since the use of the DRM charging model within the present regulatory environment. This means that we have to determine a sensible approach to reducing the costs to match the allowed revenue that maintains the marginal cost signals. The use of a fixed adder (expressed in £/kVA), determined by a tariff's contribution to maximum demand is a very effective way of maintaining the marginal costs signals whilst reducing the costs to be recovered to match allowed revenue.

9. Do respondents consider the use of the RRP data is sensible for the O&M percentage?

ENW proposed this change in approach as we were concerned that the current approach was neither transparent nor easily auditable. The use of RRP data for the calculation of the O&M percentage is both transparent and auditable which provides a clearer foundation for the inclusion of forecast costs for O&M for the year ahead. We consider this approach is better than the current approved approach as its is more cost reflective.

10. Do respondents consider the changes to the network yardsticks for connection costs and subsequent changes to the availability charges are sensible?

ENW is proposing an approach which aligns with the generally accepted approach adopted by the industry. ENW had intended to submit a standalone Asset Adoption Payment Modification Proposal after this DRM Modification Proposal had been accepted. The proposed change to the costs recovered in use of system has the effect of reducing the scale of the local assets recovered within the availability charge for Maximum Demand tariffs. To ensure that the cost signal of the availability charge is maintained ENW is proposing to apportionment factors for the availability charge. This is a pragmatic approach to maintaining the cost message of availability charges.

11. Do respondents consider ENW's approach to model the minimum costs of connection for the future asset replacement cost is sensible with regard to their service models?

When a customer connects to our distribution network it will contribute either partly or fully towards the connection charges. Those connection assets will need to be maintained throughout its life and at the end of its life will need to be replaced to ensure the continued connection of that customer to our network. There is a future cost for the replacement of the sole use assets of each connection and as ENW does not seek another connection charge from the customer to remain connected it is proposing to recover the costs for the replacement of the connection asset throughout the life of the current assets. So that by the end of the life of the current assets ENW will have recovered an amount equal to the replacement value of the time expired connection assets. This approach aligns ENW to the approach for the asset replacement of sole use connection assets adopted by other distribution companies.

12. Are licence fees something that can be attributed per customer that reflects costs incurred by the licensee?

In ENW current approved charging methodology licence fees costs are not identified and so the costs are smeared across the all the customers in the revenue reconciliation approach, which may inappropriately misallocation the costs. It is appropriate to identify the licence fees costs for inclusion and allocation within the charging model. This ensures that these costs are allocated accordingly rather than allowing the revenue reconciliation approach to define the costs recovery.

Further Issues

13. Are these changes sufficiently transparent?

ENW has made significant effort to ensure that the DRM Modification Proposal explains in great detail the proposed amendments to the current methodology and in particular the effects of changes on tariffs for each proposed change. We believe that this appropriate and necessary for a reader of the modification proposal to understand the changes proposed and to consider whether the proposals better met the licence relevant objectives.

Comments on description of existing revenue reconciliation approach

The description of the existing revenue reconciliation approach in paragraph 1.39 is slightly misleading. ENW's modelled costs result in draft tariffs that, if applied, would recover more than the targeted allowed revenue. ENW currently apply a multiplier revenue reconciliation approach but this approach is only applied to the costs identified in the unit rate tariff component. This is shown diagrammatically in Figure 1. Figure 1, which ENW helped to construct to describe the existing revenue reconciliation process is correct and is consistent with the description in the ENW's Use of System Charging Methodology Statement. The potential misunderstanding may have arisen over how NGET Rates form part of the revenue reconciliation process. The green boxes representing the NGT Rates before and after reconciliation are the same size and the red dotted lines indicating the reconciliation should be displayed as being parallel, as NGET Rates is not part of the revenue reconciliation process.