

Next steps in delivering the electricity distribution structure of charges project



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Overview:

Our October proposal to require the Distribution Network Operators to introduce a common, cost reflective distribution charging methodology and common governance arrangements by 1 April 2010 was opposed by Scottish Power and Scottish and Southern Energy. We therefore failed to reach the legal threshold required to implement our proposals. We still think that our proposals are important and that they would help to tackle climate change by attracting more distributed generation and encouraging more demand side management. We also think they offer real benefits to suppliers and customers and will provide a simpler and more effective set of arrangements that can evolve over time under better governance arrangements.

Before taking a final decision on whether to refer this matter to the Competition Commission we are seeking the views of industry, particularly from suppliers, generators and customer groups, on how best to progress this matter.

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Context

On 1 October 2008 Ofgem held a statutory consultation on a collective licence modification proposal to require the Distribution Network Operators (DNOs) to introduce a common distribution charging methodology and common governance arrangements by 1 April 2010. Four distribution licensees out of 19 objected to the proposal creating a blocking minority. The statutory objections came from Scottish and Southern Energy and Scottish Power Energy Networks who hold two DNO licences each. Both companies cited our decision to require DNOs to apply a Long Run Incremental Cost methodology at Extra High Voltage level on the distribution networks as the reason for their objection.

Delivering the structure of charges project remains a priority for Ofgem. DNOs forecast very significant capital investment in their networks from 2010 to 2015 (£5bn-£6bn) and a good proportion of this is due to load growth. Given the significant increase in energy prices in recent years, increasing fuel poverty and the increasing pressures on business and domestic customers because of the deteriorating economic outlook, it is even more important we do all we can to assess the need for this investment in the networks. It is also important that the charges encourage significant new loads, who have some flexibility over where they locate (for example IT data centres) to locate where spare capacity already exists or away from parts of the network where it will be more expensive to connect them.

We think this issue is sufficiently important and urgent that the most appropriate way forward is for us to refer the matter to the Competition Commission now. We consider that the package of measures we sought to introduce in October would deliver benefits to all network users and ultimately customers.

Associated Documents

- Delivering the electricity structure of charges project: decision document, 135/08, and collective licence modification proposal 137/08, both October 2008
- Decision in relation to SP's proposal to modify its electricity distribution use of system charging model, September 2008
- Decision in relation to EDF's proposal to modify its electricity distribution use of system charging model, September 2008
- Decision on a common methodology for use of system charges, consultation on the methodology to be applied across DNOs, and consultation on governance arrangements, 104/08, July 2008
- Delivering the electricity distribution structure of charges project, 36/08, April 2008

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Summary

Ofgem has been urging the electricity distribution network operators (DNOs) to introduce new, more cost reflective charging methodologies for several years. DNOs have missed several deadlines and made limited progress, and to date only one DNO, Western Power Distribution, has had a revised long term EHV charging methodology implemented.

Following consultation in April and July 2008, we held a statutory consultation in October on a proposal to require the DNOs to introduce a common, cost reflective distribution charging methodology and common governance arrangements by 1 April 2010. Four distribution licensees out of 19 objected to the proposal creating a blocking minority. The statutory objections came from Scottish and Southern Energy and Scottish Power Energy Networks who hold two DNO licences each. Both companies cited our decision to require DNOs to apply a Long Run Incremental Cost (LRIC) methodology at Extra High Voltage (EHV) level on the distribution networks as the reason for their objection.

Where twenty per cent or more licensees (by market share or by number of licences) object to a collective licence modification proposal the modification cannot be made. Twenty one per cent of licensees by number of licences objected to our October proposal. We therefore narrowly missed the threshold and are not able to make our proposed modification.

We are disappointed that we are unable to implement our October proposal at this stage, but we remain committed to continuing with the structure of charges project. We think it is important, given our statutory duties, to do all we can to ensure network charges for generation and demand customers are more cost reflective. This is essential to reduce the need for expensive network investment at a time of high energy bills and a deteriorating economic outlook, and to encourage more local generation and demand response to help tackle climate change. The DNOs are seeking approval for £5-6 billion of load related investment on the distribution networks between 2010 and 2015 under the current distribution price control review. They forecast that £2-2.5 billion of this investment will be at EHV level. Although it is difficult to quantify precisely the potential impact that revised charging arrangements would have, a 5 per cent reduction of investment at EHV level would avoid the need for £100-125 million of investment over the forthcoming price control period.

Equally, we consider it important that we continue to press for common charging arrangements across all 14 DNOs. We think this will benefit suppliers who are increasingly offering fixed price contracts to their domestic and business customers that last for more than one year. To do this, they incur costs in devoting resources to understanding the differing charging methodologies that are in place and the potential for network charges to change from year to year. Suppliers seek to recover these direct network costs from customers but they will also apply a risk premium if they think there is a likelihood that charges may change over the course of any fixed price contract. A single common methodology as opposed to seven different DNO methodologies would allow suppliers to better manage this risk.

New open and inclusive governance arrangements are also very important. Our recent work on Long Term Energy Network Scenarios¹ and on the Distribution Price Control Review² have highlighted that the role of DNOs could change profoundly over the coming years. This could require substantial investment in additional network capacity - for example, to deal with greater use of electric vehicles in response to climate change concerns. Alternatively, they may need to move to more active network management and operation to deal with greater local generation, demand side management and microgeneration. This suggests that the network charging methodologies may need to change and evolve to reflect these developments. Equally, in the shorter term, the debate within the industry and among academics about the best way of making charges more cost reflective would suggest that a common methodology would need to be responsive to further development following its implementation. We therefore think it is very important that in future, companies (suppliers and generators) and potentially customers (or customer groups) who are materially affected by network charges should be able to propose charging methodology modifications.

In this document we seek views on the best way of achieving the above objectives. As well as the views of DNOs themselves, we are particularly keen to hear the views of those industry parties who did not have the opportunity to vote on our October statutory consultation. We think that the most appropriate way forward would be to refer the whole matter for a ruling by the Competition Commission (CC). We recognise that this option could take several months and would require Ofgem and the industry to prepare references and make representations, but we think it would provide a clear landing on the issues that have divided the DNOs for many years.

We are also inviting views on the costs and benefits of any other potential ways forward. Among other options, these could include: consulting on a revised licence condition to implement new cost reflective charging and governance arrangements at lower voltage levels only (and referring the narrower issue of Extra High Voltage level charging to the CC); or alternatively, allowing DNOs the choice to pursue either the LRIC or Forward Cost Pricing approach at EHV level for a fixed period.

We recognise that the issues set out in this document present potentially difficult choices for industry parties. If there is sufficient demand to facilitate a full understanding of the options discussed, we would be willing to hold an industry workshop at our offices in Millbank in January. In addition we are open to meeting bilaterally with any parties who wish to discuss any aspect of this document or our October document in more detail.

¹ Long Term Electricity Network Scenarios (LENS) - final report, Ofgem, 7 November 2008, 157/08.

² Electricity Distribution Price Control Review policy paper, Ofgem, 5 December 2008, 159/08.

1. Introduction

Chapter Summary

In this chapter we summarise recent developments in the structure of charges project; explain our continuing commitment to delivering the objectives of the project; explain that we are looking for industry backing to refer the project for decision to the Competition Commission; and set out our reasons for consulting with industry on next steps.

October statutory consultation on collective licence modification proposal

1.1. On 1 October³ 2008, we issued a decision document in parallel with a statutory consultation on a collective licence modification (CLM) proposal (the 'October proposal') to require the Distribution Network Operators (DNOs) to introduce a common distribution charging methodology and governance arrangements by 1 April 2010. The most controversial of these proposals included a requirement on DNOs to adopt a Long Run Incremental Charging methodology (LRIC) for Extra High Voltage (EHV) customers, rather than the Forward Cost Pricing model (FCP) developed by Scottish Power (SP), Scottish and Southern Energy (SSE) and Central Networks (CN).

1.2. The statutory consultation on our October proposal closed on 29 October. Of the 14 DNO licensees and 5 Independent Distribution Network Operator (IDNO) licensees with a right to object to the proposal, 4 DNO licensees registered statutory objections. These objections came from SSE and SP who each hold two DNO licences each. Both companies cited our decision⁴ on LRIC as the reason for their objections⁴.

1.3. Under Section 11A of the Electricity Act 1989, where 20 per cent or more licensees object to a CLM proposal the CLM proposal cannot be implemented. Four statutory objections from 19 licensees represents 21.1 per cent of licensees, therefore we cannot implement the proposal as consulted on at 1 October 2008.

³ 'Delivering the electricity structure of charge project: decision document', 135/08, Ofgem, 1 October 2008.

⁴ Responses to our October consultation can be found on Ofgem's website at <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=112&refer=Licensing/Work/Notices/ModNotice>.

Consulting on next steps for the structure of charges project

1.4. The DNOs have been working to deliver robust, cost reflective charging on their networks for several years, but existing licence conditions⁵ have not allowed us to enforce delivery of a step change in charging commitments. With few exceptions current methodologies⁶: do not encourage customers from locating in areas where there is spare capacity; fail to encourage Distributed Generation (DG) to locate in parts of the network that would avoid the need for network investment; do not provide incentives to encourage demand side management; and fail to adequately facilitate competition among IDNOs. This is a significant barrier to tackling climate change and exacerbates the problems of high energy bills for domestic and business customers that have risen substantially over the last five years. In the course of our work on distribution charges it has also become increasingly apparent that the range of different methodologies in use across the country imposes significant costs and acts as a barrier to entry to generators and suppliers.

1.5. For these reasons which are set out in further detail in chapter two, and in spite of the result of our October proposal, we remain of the view that it is essential that we find a way to deliver common charging methodologies which more appropriately reflect the cost different categories of users place on the network. In our April consultation⁷ we said that if a sufficient number of DNO licensees objected to a proposed licence condition we would be prepared to refer the matter to the Competition Commission (CC). Having considered DNO responses to our October proposal, and having thought about alternative courses of action, this remains our preferred method of progressing delivery of the project.

1.6. In chapter three of this document we discuss potential ways forward for the project. There is considerable benefit to resolving the long running debate within the industry as to the appropriate charging methodology at EHV and the only way of achieving this now appears to be a CC reference. Having tried and failed to implement a LRIC methodology via the October proposal, we consider that the CC is now the most qualified authority to provide a timely and decisive view on the issue.

⁵ Standard Licence Condition 13.2 of the Electricity Distribution Licence requires DNOs to make such modifications as are necessary for the purpose of better achieving the relevant objectives as set out in paragraph 13.3. Condition 13.2 and condition 13.3 have facilitated incremental charging methodology improvements but to date they have not allowed us to enforce the step changes envisaged as part of the structure of charges project.

⁶ Western Power Distribution (WPD) is the only DNO to have had a revised methodology at EHV level implemented. However, we recognise that a number of DNOs have progressed development of revised EHV methodologies in 2008, and in some cases may not have brought forward modification proposals as a result of Ofgem's July request for a modification moratorium while our October decision was pending. We also recognise that following the result of our October consultation, the seven DNO groups are currently working together towards achieving commonality on their charging methodologies and tariff structures at HV/LV level, with a view to implementing changes from April 2010.

⁷ 'Delivering the electricity structure of charges project', 36/08, Ofgem, 2 April 2008.

1.7. Delivery of the structure of charges project will have an impact on all users of the distribution networks, yet only distribution licence holders had the opportunity to vote on our October proposal. For this reason, in advance of reaching a final decision on whether we should recommend to the Authority that we refer the matter to the CC, we consider, that as well as DNOs' views, it is important that we seek the views of customers, generators and suppliers.

1.8. In our October document we set out our view that our proposal would deliver benefits for customers, generators, suppliers, and IDNOs, and that our decision to implement a revised common charging methodology would allow the benefit distributed generation (DG) provides to the distribution networks to be properly reflected in the charges they face. We outline the principal drivers for the project again in chapter two of this document, but we would like to take this opportunity to invite industry participants who did not have the opportunity to vote on our October proposal to consider the benefits which the common methodology decision would provide to them; where possible, to quantify the extent of those benefits; and to provide us with their view on the most appropriate way for Ofgem to progress delivery of the project.

1.9. In chapters two and three of this document we set out a number of questions relating to next steps on the structure of charges project. We welcome responses to these questions from all industry participants. If industry parties would find it useful, as a means of facilitating discussion on the issues raised in this document, we would be willing to hold an industry workshop in January prior to the close of this consultation. We also welcome bilateral discussions if parties would prefer to raise or discuss any issues in this manner.

2. Drivers for the structure of charges project

Chapter Summary

In this chapter we explain why delivering the structure of charges project continues to be a priority for Ofgem and we summarise the key drivers behind the project. We also summarise the rationale for the key elements of our October decision and reiterate why we consider that the package of measures presented in our October proposal would deliver benefits to electricity users.

Question 1: In this chapter we highlight the key objectives for the structure of charges project and explain why these objectives are policy priorities for Ofgem. Do you consider that Ofgem is right to prioritise delivery of these objectives?

Question 2: Given the potential benefits of delivering the project for electricity customers, generators, distributors and suppliers, do you agree that it would be appropriate for Ofgem to continue to pursue delivery of the project?

Drivers for the structure of charges project

2.1. The structure of distribution use of system charges is important for a number of reasons. It impacts on the DNOs' role in tackling climate change, it is critical to ensure that competition is facilitated whether in generation, supply, or independent distribution and it will ultimately impact on network investment and the costs that customers are charged. Below we explain these impacts in more detail but together they explain our strongly held view that we should continue to pursue the objectives of this project even though our October licence proposals have not been accepted by the DNOs.

Efficient network investment

2.2. With few exceptions the current methodologies do not provide demand and generation users of the networks with cost reflective charging signals regarding siting decisions, or regarding efficient use of the network. In our view this inhibits the efficiency of future investment and the use of the existing network assets.

2.3. Providing a regulatory framework for energy network investment which incentivises economic efficiency is an important part of our duty to protect the existing and future interests of consumers. By reducing, avoiding or deferring the need for network investment, cost reflective charging signals can reduce use of system costs for all customers.

2.4. The DNOs are asking for £5-6 billion of load related investment between 2010 and 2015. Between £2-2.5 billion of this investment is forecast at EHV level, a significant proportion of which is driven by demand and generation decisions at EHV

level. Cost reflective charging methodologies have the potential to reduce the level of investment required by incentivising customers to connect to areas of the network without capacity constraints and away from network 'hotspots'.

2.5. The full extent to which customer behaviour is influenced by charging arrangements is difficult to quantify, but in electricity transmission there is evidence to suggest that the implementation of cost reflective use of system charges has influenced the siting decisions of power generation. Given the costs of investment at EHV level, substantial efficiency savings can arise from influencing a relatively small number of investment decisions. As indicated, a 5% reduction of investment at EHV level would equate to efficiency savings of £100-125 million over the forthcoming price control period.

Climate change

2.6. In recent years, Ofgem's responsibility to contribute towards the effort to tackle climate change has also been a major driver of the structure of charges project. Since 2006, there have been a number of changes in government and EU policy towards reducing carbon emissions from the electricity industry. In reducing the distance over which electricity is distributed, DG at a regional and localised level has the potential to reduce both transportation energy losses, and the level of infrastructure required to meet energy needs. In the main, existing use of system charging methodologies do not recognise the benefits which DG can provide to the network and so can be said to undervalue it. Unless charging methodologies accurately reflect the costs and benefits which demand and generation customers provide to the network, they will continue to inhibit the development of DG, and in the future will inhibit the effectiveness of low-carbon electricity demand-side initiatives such as the take up of smart metering technology.

Competition

2.7. Lastly, in the course of our work on distribution charges it has also become increasingly apparent that the range of different methodologies in use across the country imposes significant costs and acts as a barrier to entry to generators and suppliers. Suppliers in particular put significant time and resources into understanding methodologies and trying to forecast changes in charges. To manage the risk associated with changes in the level of charges, they apply a risk premium. Existing suppliers consider that a single common methodology would make managing this process more efficient and would ultimately reduce the costs of supplying electricity to customers. A potential new entrant supplier would need to invest considerable time and resource in understanding the 14 different methodologies before it was able to determine the risks and costs of introducing a national electricity supply product.

2.8. In addition, existing charging methodologies have not been updated to reflect the entry of new IDNOs to the industry in recent years. This has resulted in discrepancies between DNOs in the way IDNO access charges are calculated, which is seen as having a detrimental impact on the growth of this sector. A single common

methodology would remove this potential barrier to competition and create a consistent and transparent framework for IDNOs to operate in.

2.9. Table 1 summarises the key aspects of the structure of charges project and analyses their impacts in terms of efficiency, competition and sustainable development benefits.

Table 1

What we have now	What we want	Why is this important?		
		Efficiency	Sustainable development	Competition
Methodologies largely untouched for decades	Revised cost reflective charging model	- Efficient investment and use of existing assets will contribute to lower system charges and help fuel poverty	- Facilitate the development of DG - Compliment smart metering roll out - Incentivise Demand Side Management	- Facilitate IDNO competition by creating consistent IDNO charging framework
Variety of methodologies across 14 DNOs	Common charging methodology	- Reduced administrative costs and charging risk premium	- Lower barriers to new generation entrants	- Lower barriers for new supply market entrants
Pace of change dictated by DNOs	Deadline (2010 or as soon as possible thereafter)	- Cost reflective charges could mitigate high DPCR5 capex forecasts	- Measures to tackle climate change required as a matter of urgency	- Development of IDNO market has been slow relative to IGT market
Change depends on DNO modification proposals	Common governance & non-DNO access	- Consumers and suppliers will be able to propose efficient changes to DNO methodologies	- Necessary to ensure methods are responsive to major changes anticipated on distribution networks	- Ensures DNOs are accountable to needs of generation and supply markets

Rationale for October CLM proposal

2.10. In chapter one of our October document we set out in full the reasons for the decisions reached in the October proposal. For reference, an abstract containing the full text of the rationale is published in appendix two of this document. The section below provides a summary of these reasons.

Timeline, commonality and governance

2.11. The principal reason for our decision to require the DNOs to implement the common methodology by 1 April 2010 relates to the significant level of investment forecast for the distribution networks in the next price control period. In our view new charging arrangements could mitigate the need for investment by encouraging new load to locate where there is spare capacity. Given the high investment forecasts highlighted in paragraph 2.4, any modest aggregate reduction in the level of expenditure would represent significant savings to customers, for example, a

saving of 5% would equate to between £100-125 million over the price control period. Our view was and is that the sooner charging methodologies are in place which signal capacity constraint issues, the more likely it is that efficiency of investment benefits will be realised. Our decision to set a time dated licence obligation was also guided by our experience in trying to progress delivery of the project to date. Without a formal licence condition, any requirement on DNOs to deliver would not be binding and we would not be able to take enforcement action if DNOs failed to meet the deadline.

2.12. Following our July consultation, we reached the view that there was a strong case for implementing a common methodology across GB distribution networks. Suppliers and generators support a common methodology and have cited benefits in terms of efficiency, transparency and reduced charging risk premium totalling multiple millions of pounds per year. A common charging methodology would remove one of the sources of complexity in the industry and reduce barriers to entry for suppliers and generators. These benefits would outweigh any (modest) additional costs on DNOs from the commonality decision⁸. DNOs were initially concerned that some of the work they had done in developing their own methodologies may be wasted and this would be a cost of the commonality decision. Given that we expect the common methodology to develop, we indicated that we expected that much of the work would be drawn upon over future years.

2.13. Our decision to specify the model to be adopted as the common methodology was based upon general agreement from the DNOs as well as suppliers and generators in response to our July consultation, that if Ofgem was to introduce a common charging methodology it would be appropriate that we should decide which methodology it should be. DNOs considered the alternative – that DNOs agree among themselves which methodology should be adopted – to be unworkable and that drawn out debate among them would mean they would not be able to meet the deadline set in the licence. Similarly, generators and suppliers indicated a preference that this decision be taken by Ofgem rather than DNOs.

2.14. Given our decision to impose a common methodology for implementation by 1 April 2010, we considered that there was a strong case for including governance arrangements as part of the CLM package. Without a central and common change process, the methodology as applied by each DNO could fragment over time or fail to evolve in response to changing market conditions. DNOs have limited incentive to consider and promote changes – whereas suppliers and generators do. We therefore took the opportunity following consultation to require DNOs to develop robust modification arrangements which would provide for the licensee to receive and consult on charging modification proposals with any electricity user whose interests would be materially affected by the common methodology. Our decision on governance was also influenced by our view that providing more inclusive governance arrangements would ensure that the methodology was responsive over

⁸ One-off implementation costs have been estimated in the region of £4m in total for all DNOs.

time to any unintended or unforeseen consequences of our decision to impose a LRIC model at EHV level.

Decision on LRIC at EHV level

2.15. There has been a long running debate in the industry as to the most appropriate distribution charging methodology, particularly at EHV level. The DNOs themselves remain broadly split between two approaches: namely, variations upon LRIC and the FCP methodology. It was principally to resolve this debate, and thereby create a foundation for the common methodology, that we took responsibility for reaching a decision on the model in our October document. In our decision we required DNOs to implement a common Distribution Reinforcement Model (DRM) at HV/LV level, and a LRIC model as the common methodology at EHV level. As noted it was our decision to implement LRIC at EHV level which caused SSE and SP to object to the proposal.

2.16. Those in favour of LRIC note its ability to provide strong cost reflective price signals, reflecting as it does the cost of additional load on the network above the normal load growth rate. We also recognise that those against raise a number of concerns – the model can yield very high or very low prices depending on how close to full capacity the network is, or depending on the rate of underlying load growth, and it can also result in charging volatility if, for example, a new large load changes the capacity loading in a particular part of the network.

2.17. On balance, our view was that while the pros and cons of the FCP methodology, developed by SSE, SP and CN as an alternative to LRIC were finely balanced, the LRIC model would provide the most cost reflective “foundation” for the common methodology. We considered that it was more appropriate to put in place a foundation methodology which was cost reflective rather than apply a foundation that was less cost reflective and hope that it could be modified to be more cost reflective over time.

2.18. Those in favour of FCP argue that although it does not provide such location specific charging signals, relative to LRIC, it is more transparent and produces more stable charges. We recognise that the transparency, predictability and stability of charges are important considerations, particularly for new generators and small suppliers, and we recognise that LRIC if applied blindly can produce more volatile charges.

2.19. To try and address these concerns, in our October proposal, we set out a licence condition associated with delivering the common methodology which required DNOs to approach the Authority in the event that any unforeseen charging implications arose from the common methodology's application. In addition, to mitigate potential charging instability and ensure methodology transparency, we set out obligations on the DNOs to publish their charging models on their websites and to annually publish long term tariff scenarios to help customers understand the potential range of future charges. Finally, we also said that we would expect DNOs to develop proposals to introduce longer term use of system charging arrangements

so that suppliers and customers who wanted to fix their charges in return for making a longer term commitment to pay charges could do so.

3. Next steps in delivering the structure of charges project

Chapter Summary

In this chapter we consider the merits of the options available to us for taking the project forward, and explain why following the result of our October proposal, our view is that the most effective way to pursue delivery of the October package would be to recommend to the Authority that it refers the matter to the CC. We invite industry views on the options considered in this chapter, particularly from customers, generators and suppliers.

Question 1: Do you consider that it would be appropriate for the Authority to refer the package of measures consulted on in our October proposal for a ruling by the CC? On this question we invite generators, suppliers and customer groups to confirm which aspect of our October decision would deliver the greatest benefit to them, and where possible to quantify this benefit.

Question 2: Do you consider that it would be more appropriate for the Authority to modify the October proposal by excluding the requirement for a common charging methodology at EHV level, and opening a CLM statutory consultation on a modified proposal to deliver commonality at HV/LV level only?

Question 3: If you agree that it would be appropriate to consult again on a modified CLM proposal at HV/LV level, do you consider that it would be appropriate for the Authority to refer our October decision to implement a common LRIC methodology at EHV level for a ruling by the CC? If you do not agree that it would be appropriate to refer our LRIC decision to the CC, what option would you recommend to the Authority to deliver revised charging methodologies at EHV level?

Question 4: Are there options we have not considered for ensuring delivery of the structure of charges project, if so what are they?

Options

3.1. The section below sets out our view on the merits of a CC referral. The rest of the chapter sets out our views on the other options available to us.

3.2. At this stage we consider that it would wholly inappropriate for us to consider withdrawing from the project. The substance of our October proposal was supported by a majority of industry, and was defeated by a blocking minority constituting only 21 per cent of electricity distribution licence holders. In our view, unless a licence condition is implemented, timely delivery of commonality and governance arrangements will not be enforceable, and particularly at EHV level, we do not think that revised charging methodologies will be delivered which fully meet the high level objectives of the structure of charges project.

3.3. Since we took the decision to consult on commonality and on a binding delivery date in April, significant momentum has built towards delivery of a common methodology among DNOs, and significant hope and expectation has developed among generators and suppliers that delivery of the structure of charges project may be in sight. We are aware that following the result of our October consultation, the seven DNO groups are currently working together towards achieving commonality on their charging methodologies and tariff structures at HV/LV level⁹, with a view to implementing changes from April 2010. We welcome the steps the DNOs are taking to progress this aspect of our October decision, and where necessary we are prepared to provide guidance to the DNOs on the direction their work is taking. However, the DNOs do not plan to develop governance arrangements in conjunction with this work. Without governance arrangements commonality would not be enforceable and there is a danger that it could be unpicked in the future. Under the auspices of the code governance review¹⁰, Ofgem is currently consulting with industry on the most appropriate form for network charging methodology governance, but as a minimum, we consider that a licence condition is necessary to ensure that the new common charging methodology and an inclusive form of governance arrangements are enforceable on an enduring basis.

Option 1 - Refer the matter to the Competition Commission

3.4. Under Section 12 of the Electricity Act the Authority has the power to make a licence modification reference to the CC concerning any matter which it considers may be expected to operate against the public interest. In our view the statutory objection to the October proposal by a minority of DNO licence holders meets this criterion. In a CC referral, we would be prepared to defend our view that maintaining the current arrangements under which DNOs have individual methodologies which are only changed following modification proposals that they bring forward could be expected to operate in a manner adverse to the public interest, and that our October proposal if implemented could be expected to operate in the public interest.

3.5. In our view the principal benefits of referring our October proposal to the CC would be to preserve the package of measures we sought to introduce in this proposal, and to get a decisive view on the long running debate between LRIC and FCP. Our priority is to ensure the timely delivery of a more cost reflective common charging methodology with governance arrangements which adequately address our objectives for the project. Until the FCP versus LRIC debate is resolved there is a danger that Ofgem will remain in deadlock with some DNOs over the methodology to be applied at EHV level. This could have the effect of seriously delaying the move towards more cost reflective charges. We would welcome the clarity that such a

⁹ See the ENA website for further information: <http://2008.energynetworks.org/structure-of-charges/>.

¹⁰ Code Governance Review: Charging methodology governance options, 132/08, Ofgem, 17 September 2008.

ruling would provide, and would move swiftly to introduce a licence obligation on DNOs to deliver accordingly.

3.6. When the CC accepts a referral their concluding report must answer all of the questions in the reference, but in conducting their analysis we anticipate that the CC can consider any matter relevant in their evaluation of the public interest, including those aspects that are not covered in the reference. On this basis it is entirely possible, for example, that the CC might agree with Ofgem that the existing charging arrangements are adverse to the public interest, while making a different recommendation as to what revised arrangements should be.

3.7. The final decision over how we frame the questions for the CC would be determined by legal Counsel, however some indicative questions we would be likely to ask are as follows:

- is it appropriate for the Authority to place a licence obligation on DNOs to adopt a common charging methodology;
- if it is appropriate for the DNOs to adopt a common methodology is it appropriate for the Authority to specify the models to be adopted as the foundations for the common methodology;
- if it is appropriate for the Authority to specify the models to be adopted as the foundations for the common methodology, is it appropriate for the Authority to place a licence obligation on DNOs to adopt a DRM model at HV/LV level, and a LRIC model at EHV level on the distribution networks; and
- is it appropriate for the Authority to place a licence obligation on DNOs to develop common governance arrangements which provide modification rights to non-DNO licensees?

3.8. In submitting a referral, Ofgem could specify a date of up to six months by which they would like the CC to conclude, but on receipt of the referral, the CC has the power to request a six month extension on that date. If the project was referred to the CC in the first quarter of 2009, we cannot be certain when the CC would be able to conclude¹¹, but in this scenario if the CC supported the recommendations contained in our October proposal it is likely that implementation of the common methodology would slip to 1 April 2011. This would delay the implementation of revised charging methodologies at EHV level by one year, but under this option there would be nothing to prevent DNOs implementing a common methodology at HV/LV level by 1 April 2010 as planned.

¹¹ The last time Ofgem took a case to the CC was in 2000 in the Market Abuse of Licence Conditions case (MALC). This case was referred in May 2000 and the CC took seven months to reach a conclusion.

3.9. In a CC referral we would have to cover the costs of our own external legal assistance, but the CC's costs in connection with the referral would be recovered as part of the relevant licence holders' licence fees under section 7(1)(b) of the Electricity Act, the costs of which would ultimately be borne by electricity consumers. The DNOs would have to fund any direct legal costs incurred in relation to the referral themselves even if they were deemed to have been successful in the matter. In considering the merits of this option we would be keen to hear the views of industry stakeholders over whether this option would represent an appropriate use of our time and of licence fee payers' money.

Option 2 - CLM proposal to deliver commonality and governance at HV/LV

3.10. In their responses to the consultation, SSE and SP set out that the principal reason for their statutory objections related to our decision to advocate LRIC at EHV level. None of the DNOs have indicated that they objected to our decision to implement a common DRM model at HV/LV level and as highlighted in paragraph 3.3, since the result of our October consultation the DNOs have been working together towards achieving commonality on their charging methodologies at HV/LV level. One option to progress the structure of charges project in part would therefore be to hold another statutory consultation, this time on a proposal to introduce a common charging methodology and governance arrangements for HV/LV charging only.

3.11. This approach would 'bank' the benefits of the apparent industry consensus surrounding the application of a common methodology and governance arrangements at HV/LV level. This would establish the working principle of commonality on the distribution networks; would deliver the benefits of more accessible governance arrangements to non-DNO parties; and would allow us to enforce delivery of revised charging methodologies for HV/LV generator charging for implementation for 1 April 2010 and beyond. In the period 2010 to 2015 over 7000MW of installed generation capacity is forecast to connect to the distribution networks, and in the region of 1800MW (comprising some 180,000 projects) of this is expected to connect at the HV/LV levels.

3.12. We consider that there are a number of significant downsides to this approach. A CLM which delivers commonality and governance at HV/LV will not deliver the efficiency benefits to suppliers and generators, that commonality at all voltage levels and a one stop shop governance framework would. However, our principal concern with this approach is that it does not address the important question of which charging methodology should be applied at EHV level. A CLM which addresses HV/LV charging only would provide an incomplete landing for the structure of charges project. The merits of this option can only be fully evaluated in conjunction with how we could progress EHV charging under the scenario. The sub-sections below consider the merits of some of these options.

Option 2A - CLM for HV/LV and 'do nothing' at EHV

3.13. Under this option we would rely on the existing licence conditions to progress delivery of the revised charging methodologies at EHV level. To date this has proven to be an unsatisfactory way of delivering change. Following our July consultation we asked the DNOs not to submit charging modifications while we considered our October decision, but the fact remains that to date only one DNO, WPD, has proposed and had a non-veto decision on a revised methodology at EHV level. We are aware that a number of DNOs are now in a position to submit revised methodologies at EHV level, but to date the existing licence conditions have not allowed us to satisfactorily resolve the FCP versus LRIC debate. We cannot judge modification proposals until they are submitted to us, but as indicated in paragraph 3.5, under this option, until the FCP versus LRIC debate is resolved there is a danger that Ofgem will remain in deadlock with some DNOs over the methodology to be applied at EHV level, which would delay our attempts to deliver revised charging methodologies to this part of the network. A significant downside to this option would also be that it would not deliver the benefits of commonality or common governance at EHV level.

Option 2B - CLM for HV/LV and refer LRIC at EHV to CC

3.14. Under this option we would introduce a licence condition on the DNOs to implement a common methodology and governance arrangements at HV/LV level, and refer our decision to implement a common LRIC methodology and governance arrangements at EHV level to the CC. This would allow the DNOs to progress delivery of commonality and revised charging arrangements at HV/LV level in time for implementation by 1 April 2010, and would potentially reduce the scope of the case to be referred to the CC. However, under this option, if the CC ruled against commonality and governance arrangements being appropriate at EHV level, there could be potential implications for the arrangements applied at HV/LV level. It may therefore be unwise for us to implement a licence requirement to this effect in parallel with a CC reference on EHV charging arrangements.

Option 2C - CLM for HV/LV and allow LRIC and FCP at EHV

3.15. Under this option we would introduce a licence condition on the DNOs to implement a common methodology and governance arrangements at HV/LV level, and, through the same CLM we would allow the DNOs to adopt one of two methodology options at EHV level. Those DNOs who wanted, consistent with our October decision, to progress delivery of a LRIC methodology at EHV level (as described in detail in our October document) could do so, while those DNOs who would prefer to adopt an FCP methodology at EHV level would be permitted to implement this as an alternative. We would still expect DNOs to deliver revised governance arrangements under this option, albeit steps would have to be taken to prevent modifications being raised which sought, against the wishes of the host DNO, to move from LRIC to FCP and vice versa.

3.16. In September 2008 Ofgem vetoed a proposal to implement an FCP approach at EHV level by SP¹². Consistent with our September decision, further changes would have to be made to this methodology so that it provides appropriate rewards to distributed generation, before FCP could be implemented. Under this option each DNO's choice over which methodology to implement would be subject to individual modification proposals being non-vetoed by the Authority. Any revised methodologies that we did not veto could be implemented with effect from 1 April 2010 and could run for the duration of the next distribution price control. At the end of this period we would assess the performance of each methodology before deciding which, if any, of the methodologies should be adopted as the common methodology in the enduring period.

3.17. In our view the benefits of this approach are limited. The option would allow us to introduce commonality and governance at HV/LV level, and it would prevent us having to refer our decision at EHV level to the CC in the short term. We would also expect that revised methodologies at all voltage levels would be implemented for April 2010, but we think there are significant downsides to this option which are important to consider. These include:

- Allowing differing methodologies at EHV level will not deliver the benefits of commonality and a single set of governance arrangements across all GB networks. In connection with this point, we would be interested to know from suppliers and generators how important commonality is to them at EHV level.
- Significant investment is scheduled to take place on the distribution networks from 2010. FCP does not provide nodal charging signals, and in our view is less cost reflective than LRIC. If LRIC is not implemented consistently across all GB networks until 2015 this will undermine the efficiency of investment benefits from the implementation of revised charging methodologies.
- Allowing FCP and LRIC to coexist on GB distribution networks for a period of five years may result in uneconomic locational signals being sent solely as a consequence of methodology differences. For example, generation siting decisions may be more influenced by the charging methodology rather than the underlying locational costs.
- At the end of five years it may not be possible for us to reach conclusions over which methodology is best. To analyse this fully we would need to run the corollary approach on each network in order to have an accurate counterfactual. For example, the experience of applying LRIC on WPD's network does not give us information on the charges it would have produced, or the consumer behaviour it would have affected, if implemented on SSE's Scottish Hydro network. In any

¹² Decision in relation to SP's proposal to modify its electricity distribution use of system charging model, September 2008
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=501&refer=Networks/ElecDist/Policy/DistChrgMods>.

case there is a strong chance that we would still need to refer the matter to the CC for a ruling at EHV level.

Other options

3.18. We would welcome any views on the above options for taking the project forward. We would also be very interested in any other options that generators, suppliers, customers groups or other industry parties propose that we should consider in delivering revised distribution charging arrangements.

Appendices

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Appendix 1 – Consultation response and questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from customers, generators, suppliers and any industry party who did not have the opportunity to respond to our October proposal.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 22 January 2009 and should be sent to:

Distribution Policy response
Networks - Distribution

Ofgem
2nd floor
9 Millbank
London
SW1P 3GE

E-mail: distributionpolicy@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Any questions on this document should, in the first instance, be directed to:

Lewis Hodgart, lewis.hodgart@ofgem.gov.uk

Tel: 0207 901 7021 (in December)

Tel: 0141 331 2678 (in January).

Chapter 2: Drivers for the structure of charges project

Question 1: In this chapter we highlight the key objectives for the structure of charges project and explain why these objectives are policy priorities for Ofgem. Do you consider that Ofgem is right to prioritise delivery of these objectives?

Question 2: Given the potential benefits of delivering the project for electricity customers, generators, distributors and suppliers, do you agree that it would be appropriate for Ofgem to continue to pursue delivery of the project?

Chapter 3: Next steps in delivering the structure of charges project

Question 1: Do you consider that it would be appropriate for the Authority to refer the package of measures consulted on in our October proposal for a ruling by the CC? On this question we invite generators, suppliers and customer groups to confirm which aspect of our October decision would deliver the greatest benefit to them, and where possible to quantify this benefit.

Question 2: Do you consider that it would be more appropriate for the Authority to modify the October proposal by excluding the requirement for a common charging methodology at EHV level, and opening a CLM statutory consultation on a modified proposal to deliver commonality at HV/LV level only?

Question 3: If you agree that it would be appropriate to consult again on a modified CLM proposal at HV/LV level, do you consider that it would be appropriate for Ofgem to refer our October decision to implement a common LRIC methodology at EHV level for a ruling by the CC? If you do not agree that it would be appropriate to refer our LRIC decision to the CC, what option would you recommend to Ofgem to deliver revised charging methodologies at EHV level?

Question 4: Are there options we have not considered for ensuring delivery of the structure of charges project, if so what are they?

Appendix 2 – Rationale for the licence modification proposal: abstract from 1 October 2008 decision

1.1. We have published below the rationale set out in chapter one of our October document, concerning the decisions taken in our October proposal. The text covers the decision to impose an April 2010 deadline; the decision to impose commonality; the decision to introduce common governance arrangements; and the rationale for the decision on the common methodology. For reference we have also included the sections on 'implementing the methodology' and 'dealing with volatility' which we drafted as necessary counterpoints to the decision to impose LRIC at EHV level¹³.

The April 2010 deadline

1.2. We are particularly concerned to get new charging arrangements in place ahead of April 2010 when the new price control period starts. DNOs tell us they will need to make significant investment in deep reinforcement required to accommodate load growth in particular parts of the network. As set out above new charging arrangements could mitigate the need for investment by encouraging new load to locate where there is spare capacity. Given the high investment costs and volumes involved, any small percentage reductions in the level of load related expenditure represent significant savings to customers.

1.3. In addition to the investment drivers, as part of the price control we are considering a range of measures relating to the DNOs' role in facilitating a low carbon economy. As part of the current price control, DNOs are restricted to charging DG based on the revenue provided for through the DG incentive. This approach may restrict the ability of DNOs to pass on the full benefit that DG may provide to their network. We have consulted on whether it is appropriate to remove this restriction as part of DPCR5 and are minded to do so but on the proviso that there are cost reflective DG charging arrangements in place by April 2010. Also as part of DPCR5 we are considering the need for DG connected prior to April 2005 to be charged use of system charges. These generators were exposed to "deep" connection charging arrangements and are currently not exposed to use of system charges. We are concerned that continuing these arrangements, when significant growth in DG is expected, may not promote economic efficiency. In both cases the charging arrangements described in this document are critical items to enable these policy changes to be facilitated.

¹³ Note that in this appendix, references to Appendix 2, Chapter 3 and Chapter 5 are to those sections of the October decision document, not to this document.

Rationale for a common methodology

1.4. In our July letter we set out that we believed it was appropriate for Ofgem to pick a common methodology and we asked for views on this. There are two main reasons for our decision, set out in July, that DNOs should be required to apply a common charging methodology.

1.5. The first is that the alternative approach - requiring each DNO to introduce a new methodology that meets a set of "relevant principles" - places regulatory risk on the DNOs. Our April document set out for consultation a set of relevant principles against which DNOs should develop their new methodologies. However, it became clear from discussions that various interpretations could be applied to these principles. DNOs had a legitimate concern that they would expend significant effort working up methodologies only for Ofgem to rule that they had not met the principles, they were in breach of a licence condition and could face a financial penalty.

1.6. We have sought to reduce this regulatory risk by setting out in Appendix 2 a detailed methodology that DNOs should apply by April 2010. If the licence modification proposals associated with this document are voted in by DNOs, we will further reduce the regulatory risk on DNOs by working with them to develop a generic template that will represent the charging methodology decisions in this document. Further, we will ensure this template is an appropriate reflection of the common charging methodology before DNOs begin to apply it to their individual networks to develop charges for implementation by April 2010.

1.7. The second reason for requiring a common methodology is the significant net benefits that commonality will bring to suppliers, generators and customers across the country. Responses to our April and July consultations have highlighted the complexity these parties face and the risk premium they pay because of the difficulty associated with understanding how the quantum of their distribution use of system charges are calculated. Suppliers estimate the cost of managing the risk associated with distribution charging arrangements at several millions of pounds a year. This compares with the estimated one-off DNO costs for implementing a common methodology of £0.5 million per DNO group - or a larger sum if changes to billing systems are required. We consider that the costs of implementing a common methodology will quickly be outweighed by the benefits. DNOs would have to bear some of these costs in any case given the further development work required of DNOs to improve their methodologies. The scale of capital expenditure that could be avoided by implementing more cost reflective charges is expected to quickly offset these costs.

1.8. The move to a common methodology will inevitably mean that some DNOs will need to put to one side the work they have conducted to date. However, we do not consider that this work will be entirely wasted and that it could provide important material as DNOs work to improve and develop the common charging methodology. To the extent that DNOs consider the costs they have expended in developing charging methodologies to be material and efficiently incurred, they have the

opportunity to make a case for these costs to be recovered through the next price control settlement.

Rationale for new governance arrangements

1.9. We have consulted on the proposal to require DNOs to introduce new governance arrangements for the common methodology that would allow users such as IDNOs, suppliers, distributed generators or customers to raise modifications to the methodology and allow for its ongoing development. Respondents to our July consultation widely supported these proposals.

1.10. We see the new governance arrangements as an essential part of the new arrangements for three reasons. There is no agreement over the most appropriate charging methodology and there is no methodology currently available that clearly provides the best trade off between cost reflectivity on the one hand and stability and transparency, for example, on the other. Governance arrangements will allow the common methodology to evolve and improve over time. It will also allow parties other than the DNOs to drive the pace and direction of changes to the methodology in response to wider changes in the energy market.

1.11. We note the ongoing separate Ofgem review of industry governance arrangements¹⁴. As set out in more detail in Chapter 5, we consider it appropriate to 'fast-track' DNO governance arrangements as part of this project so that these arrangements apply from 2010. Governance arrangements will therefore need to be developed and submitted to the Authority for approval not later than 1 September 2009. But our decision on governance for the new common methodology does not prejudice the outcome of this wider governance review. If the ICL review concludes that a different governance model is appropriate then we will seek to change the governance of the common charging methodology through the ICL review at the same time as changes are implemented to other codes.

Rationale for an Ofgem decision on the common methodology

1.12. We are committed to doing all we can to ensure that DNOs can achieve the implementation of the new common charging methodologies ahead of the next price control review. We recognise that there is an exacting timetable for implementation that will only be achieved if we are clear about what DNOs are required to implement and if we take a pragmatic approach to dealing with significant implementation issues or unforeseen results when the methodology is applied to specific networks.

¹⁴ Code Governance Review: Charging methodology governance options', Ofgem, 132/08, 17 September 2008. See our website: <http://www.ofgem.gov.uk/Licensing/IndCodes/CGR/Pages/GCR.aspx>.

1.13. There has been a long running and substantial debate on the most appropriate methodology for distribution use of system charges with no agreement across companies, consultants or academics on either EHV or HV/LV charging arrangements. Responses to our July consultation overwhelmingly agreed that we should make a decision on the common methodology and that it would be very difficult to meet the April 2010 timeline if DNOs had to work together to agree the methodology.

1.14. The detailed decision on the charging methodology set out in this document is the first step in providing DNOs with the clear direction they need in order to implement new charging arrangements. However, it should be noted that the decision represents only the starting point for the methodology and we expect it to improve and evolve post April 2010 through the governance arrangements.

1.15. The decision in this document covers EHV charging and HV/LV charging for both demand and generation customers. Some of the detailed parameters will be worked through as we formulate charging templates in autumn/winter 2008. The decision is not able to cover off fully areas where there is interaction with the ongoing price control review process. In particular, elements of generator charging, including scaling and revenue pots are linked directly to that review. In addition, the treatment of generators who connected prior to April 2005 (and who are currently exempted from paying for use of the distribution system) will be taken forward under the price control review.

1.16. In some areas of the methodology further DNO work is required and this is set out further in Chapter 3 and Appendix 2. We also recognised in July that there are some issues (specifically IDNO charging and HV/LV generator charging) where we have been urging DNOs to take action for some time¹⁵. We do not wish to halt progress in these areas. We expect DNOs to deliver their final solutions in these important areas as soon as possible to deliver against the relevant charging objectives and therefore envisage a two-tier process.

1.17. In particular, in respect of IDNO charges, DNOs need to take steps to bring forward appropriate common charging arrangements and ensure that they are compliant with the requirements of the Competition Act 1998. Given our concurrent powers under competition law we do not think it would be appropriate for us to determine the methodology for DNOs. We also note that IDNOs have raised issues with all of the methodologies currently in use by DNOs and there is clearly a need for

¹⁵ See, for example, page 3 to our July 2007 letter on WPD's IDNO charging proposals: <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20S%20Wales%20IDNO%20DNO%20charging%20mod%20FINAL%20120707.pdf> and page 10 of our decision on EDF's LRIC modification proposal: [http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/EDF%20\(SPN\)%20021%20decision%20letter.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/EDF%20(SPN)%20021%20decision%20letter.pdf).

further industry debate and discussion before we can make a decision on a common IDNO charging methodology.

1.18. We are, however, committed to assisting the industry reach a solution on IDNO charging as soon as possible. We require DNOs to continue to work with IDNOs to discuss the most appropriate approach to IDNO charging and to bring forward proposals ahead of the implementation of the common methodology. We are willing to continue to facilitate and mediate in the process of defining a common IDNO approach. In order to assist this group, we would consider providing 'minded to' decisions on material issues arising should DNOs wish to understand how they are progressing towards a common solution on this matter.

Implementing the methodology

1.19. The detailed description of the charging methodology set out in this document still leaves room for interpretation. If the CLM is successful we will work with the industry to achieve generic charging templates over the autumn/winter of 2008/09. This will take the methodology down to a greater level of detail providing DNOs with the clarity they require before they begin to implement the methodology in their own areas in early 2009. We will ensure that the template is an appropriate reflection of the common methodology, further reducing the risk to DNOs of failing to meet their licence obligations.

1.20. DNOs will populate the templates to enable them to calculate charges for submission to the Authority, along with the common methodology by 1 September 2009. The Authority will then decide whether to approve the common methodology by 31 December 2009.

1.21. As stated in our July document, the methodologies have been untested on some networks and for this reason we do not expect the DNOs to apply the methodology "blind". It is for DNOs, consistent with their legal obligations, to determine whether it is appropriate to apply the output of the methodology where the implementation of the approach set out in Appendix 2 appears to give counterintuitive or inappropriate results.

1.22. Where this is the case, we expect firstly that DNOs will discuss the matter with us so that we can assess whether there is a generic issue which can be addressed by alterations to the methodology and the template ahead of April 2010. In the limited circumstances where changes to the methodology and template do not provide a solution to a specific situation and where the methodology is still producing anomalous and non-cost reflective charges we expect DNOs to propose suitable alternative arrangements. These arrangements should be based on their best assessment of the long run incremental cost of providing capacity at that point on their network. We also expect DNOs to publish a clear explanation of the reasons for any adjustments and why they deliver more cost reflective charges at that location than the use of the LRIC model.

1.23. We will be considering whether it is appropriate to formalise the steps that a DNO must take before putting in place alternative arrangements to those set out in Appendix 2. Consistent with our better regulation duty and to reduce the burden and regulatory risk associated with dealing with these anomalous situations, our preference would be to issue guidance on this matter to set out in advance what a DNO is required to do in these circumstances which DNOs may then wish to incorporate as specific steps in their methodology. We will seek the views of DNOs and users on this matter. If it proves difficult to predict and address the full range of anomalies through upfront guidance or steps in the methodology, we will consider issuing derogations to DNOs from the common charging methodology on a case by case basis.

Dealing with volatility

1.24. We also recognise that the new methodology may cause both a one-off step change in charges for initial implementation and year on year charge volatility. We note the concerns that generators and smaller suppliers in particular have raised in this regard and recognise, for example, that year on year charging volatility can be a deterrent to investment in distributed generation and a barrier to entry to the retail market.

1.25. For these reasons, and as a minimum ahead of April 2010, we will require DNOs to publish their charging models on their websites and publish annually long term tariff scenarios to help customers understand the range of future charges. By April 2011 DNOs will have to develop and bring forward proposals for longer term products that would offer generators and customers the choice of fixing their network charges in return for making a long term commitment to pay them, to help customers manage the risk of charging volatility. We would also expect DNOs to consider developing more sophisticated web based tools to help customers to understand and model their future charges. We will consider in due course whether to formalise this in conditions as part of the approval of the common methodology.

1.26. DNOs should continue to work together post April 2010 to consider how the new common methodology may be modified to reduce the degree of year on year volatility and to improve the transparency and predictability of charges for customers.

1.27. In the same way that we require DNOs to deal proactively with any non-cost reflective charges resulting from the methodology (see above) we would expect DNOs to "sense check" the one-off step changes in tariffs that the methodology may produce. Again, we require DNOs to bring these issues to us and consider what, if any, actions should be taken to manage the transition. If not, we would expect the DNO to come forward with proposed alternative arrangements for that specific part of their network or customer category.

Appendix 3 – The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority’s powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts¹⁶.

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly¹⁷.

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them¹⁸; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas¹⁹.

¹⁶ entitled “Gas Supply” and “Electricity Supply” respectively.

¹⁷ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

¹⁸ under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

¹⁹ The Authority may have regard to other descriptions of consumers.

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- Promote efficiency and economy on the part of those licensed²⁰ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation²¹ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

²⁰ or persons authorised by exemptions to carry on any activity.

²¹ Council Regulation (EC) 1/2003.

Appendix 4 - Glossary

A

Authority

The Authority is the governing body for Ofgem, consisting of non-executive and executive members.

C

Competition Act 1998

The Competition Act 1998 (CA98) gives the Office of Fair Trading and the sector regulators, powers to apply and enforce Articles 81 and 82 of the EC Treaty as well as the Chapter I and II prohibitions of CA98 using their concurrent powers. Article 81 and the Chapter I prohibition prohibit agreements which have the object or effect of preventing, restricting or distorting competition. Article 82 and the Chapter II prohibition prohibit conduct by one or more undertakings which amounts to the abuse of a dominant position in the market.

D

Distributed Energy / Distributed Generation

Any generation which is connected directly into the local distribution network, as opposed to the transmission network, as well as combined heat and power schemes of any scale. The electricity generated by such schemes is typically used in the local system rather than being transmitted for use across the UK.

DNOs - Distribution Network Operators

A licensed distributor which operates electricity distribution networks in its designated distribution service areas.

Distribution Price Control Review 5 (DPCR5)

DNOs operate under a price control regime, which are intended to ensure DNOs can, through efficient operation, earn a fair return after capital and operating costs while limiting costs passed onto customers. Each price control typically lasts five years at a time. The existing price control will expire 31 March 2010. DPCR5 is the fifth review of the price control and commenced in early 2008. The resulting price control is planned to commence 1 April 2010.

DSA – Distribution services area

As defined in SLC 1 of the electricity distribution licence.

E

Electricity Act 1989

Electricity Act 1989 c.29 as amended. Also referred to as 'The Act'.

Extra High Voltage (EHV)

Term used to describe the parts of distribution networks that are extra high voltage.

H

[High Voltage \(HV\)](#)

Term used to describe the parts of distribution networks that are high voltage.

I

[Independent Distribution Network Operators \(IDNOs\)](#)

A licensed distributor which does not have a distribution services area and competes to operate electricity distribution networks anywhere within the UK.

L

[Lower Voltage \(LV\)](#)

Term used to describe the parts of distribution networks that are lower voltage.

P

[Engineering Recommendation P2/6](#)

A guide for electricity distribution network system planning and security of supply. It is a revision of Engineering Recommendation P2/5 issued in 1978, which it supersedes.

S

[SLC - Standard Licence Condition](#)

These are conditions that licensees must comply with as part of their licences. SLCs can only be modified in accordance with Section 11A of the Electricity Act. Failure to comply with SLCs can result in financial penalties and/or enforcement orders to ensure compliance.

U

[UoS Charges](#)

Use of System Charges: Charges paid by generators and suppliers for the use of the distribution network.

Appendix 5 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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