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value for all customers

The Company Secretary
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CC: Ian Bruce (by email only)

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11 March 2009

Dear Colleague,

Decision in relation to Scottish Hydro Electric Power Distribution plc ("SHEPD") for use of system charging methodology modification proposal 08004: Capacity management for Licensed Distribution Network Operators (LDNOs)

On 12 February 2009, SHEPD submitted a proposal to the Gas and Electricity Markets Authority ("the Authority")¹ to modify its use of system (UoS) charging methodology for its distribution network.

SHEPD has proposed to introduce a new method to deal with capacity requirements for LDNOs wishing to connect an embedded network, which involves adjustments to its UoS and connection charging methodology statements. This letter refers to the changes made to the UoS charging methodology statement.

Having considered the issues raised in the proposal, we have decided **not to veto** the proposed modification.

This letter sets out the background to the modification proposal, summarises the proposed changes and explains our decision.

Background

SHEPD has licence obligations² to have in place as of 1 April 2005 three charging statements: the statement of UoS charging methodology, the statement of UoS charges and the connection charging methodology. The UoS charging methodology outlines the method by which UoS charges are calculated. SHEPD has a requirement to keep the methodology under review and bring forward the proposals to modify the methodology that it considers better achieves the relevant licence objectives.³

¹ Ofgem is the office of the Authority. The terms 'Ofgem' and 'the Authority' are used interchangeably in this letter.

² Standard licence conditions 12-13.

³ The relevant objectives for the UoS charging methodology, as contained in paragraph 13.3 of standard licence condition 13 of the licence are:

(a) that compliance with the UoS charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and by this licence;

The IDNO working group was established October 2008 to develop common charging arrangements for IDNO customers. The modification reflects proposals developed as part of this working group.

SHEPD modification proposal

- SHEPD has proposed to outline arrangements for capacity build-up on LDNO networks within its UoS charging methodology statement. The proposed addition would state that an embedded network would initially attract UoS charges based on its demand at the time of connection, and would be allowed to increase its capacity demand up to the limit imposed by the authorised supply capacity (ASC).
- SHEPD has also proposed to reference the connection charging methodology statement where provisions for capacity review and capacity reservation in the longer term are outlined.

Ofgem's decision

We have considered this proposal against the licence objectives and wider statutory duties. We consider that this modification results in improved clarity to better enable customers to make an estimate of their likely charges.

This modification addresses the particular characteristics of LDNO connections, particularly growth of capacity requirements over time. We consider that for this type of scenario it is appropriate to put in place commercial arrangements for phasing of capacity requirements. By allowing an LDNO to pay capacity charges based on capacity uptake over the initial development period of connection (three years) rather than the ASC, this proposal appears to reduce the risk of distorting competition and therefore better achieves SLC 13.3 (b) of facilitating competition. This is because capacity charges will now more closely reflect actual usage during the period the site is developing rather than charging for capacity the site requires once it has reached maturity using ASC.

This proposal may also encourage LDNOs to communicate their future requirements to host DNOs which may help to prevent inefficient expenditure by the DNO, who may otherwise undertake reinforcement based on the initial capacity uptake of an embedded network without the knowledge of expansion plans. We acknowledge that the proposed modification may have an impact on cost reflectivity, insofar as some element of actual costs are driven by capacity requirements, irrespective of actual usage. However, this would only hold for the initial period of connection. The DNO would serve its own customers in this way by assessing the requirements of all customers and reinforcing where it predicts demand growth.

We note that this modification, and proposed amendments to the connection charging methodology statement, may have the effect of encouraging LDNOs to request capacity in excess of its requirements if it does not affect its connection charge. This could mean that another potential connecting customer would notionally trigger reinforcement because of the excess capacity that must remain available to the LDNO. However, the licence obligation on DNOs and other operators of licensed networks to develop the network efficiently serves as a counterweight to excessive capacity requests. In addition, the parallel adjustment to the connection charging methodology provides a further signal where connection charges could include an element of reinforcement costs.

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- (b) that compliance with the UoS charging methodology facilitates competition in generation and supply of electricity, and does not restrict, distort or prevent competition in the transmission or distribution of electricity.
 - (c) that compliance with the UoS charging methodology results in changes which reflect, as far as is reasonably practicable (taking into account of implementation costs), the costs incurred by the licensee and its distribution business; and
 - (d) that, so far as is consistent with sub-paragraphs (a), (b) and (c), the UoS charging methodology, as far as is practicable, properly takes account of developments in the licensee's distribution business.

Charges for LDNOs should be structured in a similar way to the host DNO's all the way charges which do not include capacity charges for domestic sites in order to minimise the risk of anticompetitive effects. Which we consider better achieves SLC 13.3 (b) of facilitating competition. We consider that by reducing the impact of capacity charges during the initial period of connection this proposal represents a step towards the longer term arrangements we expect DNOs to have in place for LDNOs.

It should be noted that the processes and legal tests in relation to modifications and the Competition Act 1998 investigation are separate and distinct. Therefore, in taking this decision, Ofgem does not limit or prejudice any findings which the Authority may make in relation to the current investigation of ENW under the Competition Act 1998.

We have decided **not to veto** the modification to the use of system charging methodology statement.

Please contact Karron Baker by email Karron.Baker@ofgem.gov.uk or on 0207 901 7350 if you have any queries relating to issues raised in this letter.

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Rachel Fletcher', is positioned above the printed name and title.

Rachel Fletcher

Director, Distribution

Signed on behalf of the Authority and authorised for that purpose by the Authority