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cc: Maria Liendo and Jim McOmish (by email
only)

9 April 2009

Dear Colleague,

Decision in relation to SP Distribution Ltd (SPD) connection charging methodology modification proposal SPEN-09-01: Changes to Connection Charging Methodology to reflect "Capacity Ramping" arrangements for Independent Distribution Network Operators (IDNOs)

On 13 March 2009, SPD submitted a proposal to the Gas and Electricity Markets Authority ("the Authority")¹ to modify its connection charging methodology for its distribution network.

SPD has proposed to introduce a new method to deal with capacity requirements for IDNOs, which involves adjustments to its Use of System (UoS) and connection charging methodology statements. This letter refers to the changes made to the connection 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

SPD 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 statement of connection charging methodology and charges. The connection charging methodology outlines the method by which connection charges are calculated. SPD 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 objectives³.

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

² Standard licence conditions 13-14.

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

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

The IDNO/DNO boundary charging working group was established October 2008 to develop common charging arrangements for IDNO customers. The modification reflects the proposal developed as part of this working group.

SPD modification proposal

SPD's proposal can be understood by reading together the connection methodology, the UoS methodology and the statement of UoS charges.

- SPD's proposal outlines arrangements for capacity build-up on IDNO networks within its connection charging methodology statement. SPD will agree arrangements in the connection agreement via a ramping profile (normally over three years but extendable up to five years) and will monitor the ramping up of demand via an annual review of the IDNO's forecast capacity requirements. The annual review will include consideration as to whether this capacity is still required. Where IDNOs want to reserve capacity for the long term and this capacity would otherwise be released for general use SPD's connection methodology proposal says that the IDNO is required to pay UoS charges based on the level of the long term capacity required.
- In its UoS methodology, SPD's proposal states that an IDNO would initially attract UoS charges based on its demand at the time of connection, and this will be allowed to increase over an extended period of time (three years, or five years if mutually agreed between SPD and the IDNO) up to the limit imposed by the requested capacity.
- In its statement of UoS charges SPD sets out that UoS charges during the ramping period will be based on the maximum kVA demand in any given year from 1 April.

Ofgem's decision

We have considered the proposal to modify the connection methodology against the relevant objectives and our wider statutory duties. We consider that this modification results in improved clarity as it encourages an IDNO to come forward with an honest appraisal of its capacity requirements as a site develops over time. A connection charge based on the predicted total capacity requirement of a fully developed network (referred to as the maximum required capacity by SPD) reflects the costs incurred by SPD in its distribution business, and encourages efficient network development. We consider this better achieves 13.3 (d) of the licence by properly taking account of developments in the licensee's distribution business.

The inclusion of a three year capacity ramp up (or five years if agreed between parties) means that there is an incentive on the IDNOs not to overstate long term capacity requirements since SPD could reduce the required connection capacity to the capacity requirements at the time of this review at three (or five) years. In the long term (i.e. beyond the three years, or in some cases five years) the IDNO would then pay UoS charges based on its total capacity requirements represented by the maximum required capacity, which would represent a further incentive to accurately forecast capacity requirements. The inclusion of this review at three (or five) years, along with yearly reviews during the ramp up period, prevents IDNOs from overstating capacity requirements and enables the licensee to properly take account of developments in its business in accordance with 13.3 (d).

We note that SPD's proposal broadly mirrors arrangements discussed between DNOs and IDNOs at the IDNO/DNO boundary working group. SPD's modification proposal sets out that capacity requirements are to be agreed between the DNO and IDNO at 1, 2 and 3 years with SPD monitoring the IDNO site's performance over time against this. It is not clear in the modification proposal how SPD will apply this yearly review process and how this relates to the reservation of 'long term' spare capacity. In line with industry discussions it is our expectation that SPD's reference to a 'joint review' between it and an IDNO regarding 'long term' capacity will essentially allow the IDNO some discretion over the pattern of ramp up during the initial 3 years of connection such that long term capacity requirements do not run counter to the spirit of a ramping period. Should this not happen we would expect IDNOs to bring this matter to our attention and for SPD to then clarify this process further in its connection methodology statement.

It should be noted that the processes and legal tests in relation to modifications and the Competition Act 1998 investigations on IDNO matters 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 Electricity North West Ltd under the Competition Act 1998.

We have decided **not to veto** the modification to the connection 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 black ink, appearing to read 'Rachel Fletcher', is written over a light grey rectangular background.

Rachel Fletcher

Director, Distribution

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