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Your Ref: SPEN-09-02  
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9 April 2009

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

Dear Colleague,

**Decision in relation to SP Distribution Ltd (SPD) for use of system charging methodology modification proposal SPEN-09-02: Changes to Use of System 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")<sup>1</sup> to modify its use of system (UoS) charging methodology for its distribution network.

SPD has proposed to introduce a new method to deal with capacity requirements for IDNOs (and DNOs operating out of area) wishing to connect an embedded network<sup>2</sup>, 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*

SPD has licence obligations<sup>3</sup> 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 UoS charging methodology outlines the method by which UoS 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 objectives<sup>4</sup>.

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

<sup>2</sup> This modification refers to licensed DNOs' embedded networks, hereafter referred to as IDNOs.

<sup>3</sup> Standard licence conditions 13-14.

<sup>4</sup> 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;
- (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

The IDNO/DNO boundary charging working group was established on October 2008 to develop common charging arrangements for IDNO customers. The modification reflects proposals 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 states that an IDNO would initially attract UoS charges based on its demand (chargeable import capacity) 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 set out in the connection terms.
- In its statement of UoS charges SPD's proposal sets out that UoS charges during the ramping period will be based on the maximum kVA demand in any given year from 1 April. This figure represents the chargeable import capacity during the ramping period.
- In its connection charging methodology statement SPD's proposal states that IDNOs will agree arrangements in the connection agreement via a ramping profile (normally over three years but extendable up to five years). SPD 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.

#### *Ofgem's decision*

We have considered the proposal to modify the UoS methodology against the relevant licence objectives and our 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 IDNO 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 IDNO to pay capacity charges based on capacity uptake over the initial development period of the connection (three years is specified in the accompanying change to the connection charging methodology, with a five year ramp up where this is agreed between the IDNO and SPD) rather than the maximum requested capacity, this proposal appears to reduce the risk of distorting competition and therefore better achieves SLC 13.3 (b). This is because UoS 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 requested capacity.

This proposal may also encourage IDNOs 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 elements 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

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(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.

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 IDNOs to request capacity in excess of its requirements if it does not affect its connection charge (i.e. where it does not trigger reinforcement). This could mean that another potential connecting customer would notionally trigger reinforcement because of the excess capacity that must remain available to the IDNO. 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.

Charges for IDNOs 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. This has the potential to better ensure competition is not restricted, prevented or distorted under SLC 13.3 (b). 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 IDNOs.

It should be noted that the processes and legal tests in relation to charging modifications and any 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 Electricity North West Ltd 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](mailto: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