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Cc: Nigel Lloyd, Nigel Turvey (by email only)

Date: 5 June 2009

Dear Colleague,

Decision in relation to modification proposal UoS 012 to modify the statement of use of system charging methodology by introducing revised IDNO charges

On 28 February 2009, Western Power Distribution (South West) plc ("WPD") submitted to the Gas and Electricity Markets Authority (the "Authority")[1] a proposal to modify its use of system ("UoS") charging methodology. This modification sought to introduce revised tariffs for Independent Distribution Network Operators ("IDNOs").

On 27 March 2009 the Authority notified WPD of its intention to consult on its proposal. On 9 April 2008 the Authority published its consultation on WPD's proposal alongside a further consultation on IDNO charging[2].

Having carefully considered the proposals made by WPD and responses to our consultation, we have decided to **not veto** WPD's proposals in relation to revised IDNO tariffs.

This letter sets out WPD's proposal, the views of consultation respondents and the reasons for the Authority's decision.

Background to the proposal

WPD has licence obligations[3] to have in place three charging statements: the statement of UoS charging methodology, the statement of UoS charges and statement of connection charging methodology and charges. The statement of UoS charging methodology outlines the method by which distribution UoS charges are calculated. WPD has a requirement to keep the methodology under review and bring forward proposals to modify the methodology that it considers better achieves the relevant objectives.[4]

The Authority has been encouraging Distribution Network Operators ("DNOs") to modify their charging methodology to bring forward specific IDNO tariffs which better reflect the costs IDNOs impose on their distribution network. As yet only WPD and Western Power Distribution (South

[1] Ofgem is the office of the Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.
[2] The consultation is available on our website at:
http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20CE%20and%20Reckon%20consultation_final.pdf
[3] Standard licence conditions (SLC) 13 -14.
[4] The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of SLC 13 of WPD's licences 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 its 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
(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.

Wales) plc have had IDNO charging proposals not vetoed[5]. In July 2008 a DNO/IDNO working group was established with the aim of developing more appropriate charging arrangements for IDNOs. As a consequence of their involvement in the IDNO/DNO working group, WPD have decided to propose a revised methodology for IDNO charges.

WPD's proposal

WPD currently charge LV domestic IDNOs on the basis of a discount from domestic restricted tariff based on the marginal avoided costs associated with the LV network. WPD then vary the level of avoided cost according to how far the IDNO is connected from the HV/LV substation.

WPD propose to move away from this methodology towards charging LV domestic IDNOs on the basis of a discount from the domestic restricted tariff based on the total costs of operating the LV network. WPD also propose to use the same total cost methodology to calculate specific IDNO tariffs at HV and for non domestic IDNO sites. WPD have retained their method of varying the total cost discount according to how far the IDNO site is connected from the HV/LV substation.

WPD's proposal calculates the total costs associated with operating the LV and HV network in the following way. They take the 5 year allowed income set at the last distribution price control review (DPCR4) and divide between operating costs, depreciation and return. WPD then allocate all three sets of costs to network levels using cost drivers. For operating costs, WPD use regulatory reporting pact (RRP) data detailing the attribution of direct costs across network levels. WPD then allocate the indirect costs to network levels according to the proportion each network level contributes towards the total modern equivalent asset value (MEAV) of its network[6]. The known allocation of direct costs is added to the MEAV allocation of indirects to produce an overall allocation of operating costs for each network level. This allocation is divided by units flowing through each network level in order to make it comparable to tariffs. This final allocation is applied to the £million sum of operating costs from the DPCR4 settlement.

For depreciation and return costs, WPD take the amounts from DPCR4 and allocate it to network levels according to the proportions of forecast net capex spend between network levels. This forecast net capex spend is taken from the forward business plan questionnaire (FBPQ) data which is provided to Ofgem as part of the DPCR5 projections.
This allocation is again divided by the units flowing through each network level to produce an allocation which is comparable to a tariff. The network level allocations for operating costs, depreciation and return are then averaged and applied to in year allowed revenue less in year pension deficit payments and any incentive income (positive or negative) earned in that year. This produces a proportion of allowed revenue associated with operating each network level which forms the basis of a discount on WPD's end user charge[7].

For LV domestic IDNO sites (classified as having 60% or more of demand as domestic) the section of the total cost discount associated with direct costs i.e. the direct proportion of LV operating costs is then reduced according to how far away the IDNO site is connected from the LV substation. WPD retain their existing policy of four bands representing each average quartile of distance from the HV/LV substation. IDNOs in the 1st band (nearest the substation) retain 100% of the total cost discount, IDNOs in the 2nd band have the direct proportion of the discount reduced by 25%, the 3rd band by 50% and the last band (furthest away from the substation) by 75%.

Non domestic LV IDNO sites are charged on the basis of the LV half hourly tariff which is discounted for the costs of operating the LV network. As with domestic LV IDNO sites, there are

4 distance bands where the discount associated with the direct costs of the LV network is varied according to how far away from the HV/LV substation the IDNO connects to WPD's network.

[5] The proposal was not vetoed in December 2007 and can be found at:
http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20uos006%20mod.pdf
[6] WPD chose to not allocate network rates by MEAV which are consequently allocated pro rata to all other costs. WPD allocate transmission exit charges solely to the EHV network on the basis that it is demand at this level which drives the level of exit charges.
[7] WPD applies the discount to a different end user charge depending upon the classification of the IDNO site as domestic or non domestic.

At HV, non domestic IDNOs receive a discount on the domestic restricted tariff which comprises of the total costs of the LV network and the total costs of the HV/LV substation. Non domestic HV IDNO sites receive a discount on the HV half hourly commercial tariff which comprises of the total costs of operating the HV network.

Respondent's views

We invited responses to WPD's proposal in our consultation document of 9 April.[8] We received 8 consultation responses, 2 from IDNOs[9], 5 from DNOs[10] and 1 confidential response. Both IDNO responses stated that overall WPD's proposal was an improvement on their existing methodology although they stressed that they still had fundamental concerns with the distance banding approach employed by WPD for LV IDNO tariffs.

All DNO responses except for CE also criticised WPD's use of banding at LV and stated their preference for a portfolio style tariff to be implemented for IDNO charging. Both IDNO respondents also agreed with this. A confidential response urged Ofgem to veto WPD's proposals on the basis that banded tariffs were not appropriate for IDNOs. The confidential response did comment that WPD's move towards charging IDNOs based on total costs was an improvement and removed some but not all of the barriers to competition in distribution. SSE and CE also agreed that charging IDNOs based on total costs reduces the possibility of restricting, preventing or distorting competition in distribution. SSE added that there was insufficient evidence that such an approach was more cost reflective.

ENC, Energetics and the confidential response all disagreed with WPDs proposal to remove pension deficit payments and incentive income from the pot of income they allocate to network levels. ENC stated that a total cost methodology should allocate all costs and not remove those costs which it considers an IDNO doesn't incur. Energetics and ENC raised concerns over the use of data from the (FBPQ) on the basis that forecast data was not as accurate as actual data.

SP commented that it is possible that WPD's proposal is more cost reflective than a traditional distribution reinforcement model (DRM) but could not comment on the specifics of the DRM which WPD currently has in place. SP also stated WPD had provided no justification on why the (MEAV) of assets is an appropriate cost driver to allocate indirect operating costs between voltage levels.

The Authority's decision

In coming to our decision the Authority has considered the proposed modification against the relevant objectives and the Authority's wider statutory duties.

It is important to note that our decision letter relates to the methodology rather than the quantification of elements produced by the methodology. It is for WPD to ensure its own compliance with the Competition Act 1998 and EC competition law in its implementation of the proposed methodology. 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, this decision does not limit or prejudice any findings which the Authority may make in relation to investigations under the Competition Act 1998.

The reasons for the Authority's decisions are set out below.

1. Use of total costs to calculate IDNO discount on the 'all the way' charge

WPD's current IDNO charging methodology is based on the premise of calculating the marginal network costs which WPD avoids when an IDNO connects to its system compared to the costs

[8] Consultation responses can be found on Ofgem's website at:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=586&refer=Networks/ElecDist/Policy/DistChrgMods
[9] The Electricity Network Company and Energetics Electricity.
[10] Central Electric, Electricity North West, Scottish Power Energy Networks, Scottish & Southern Energy & EDF Energy Networks.

WPD would have incurred if it had operated the new network themselves. These marginal costs are the output of WPD's DRM.

WPD proposes to move away from a marginal avoided cost methodology towards a methodology which identifies the total costs associated with its equivalent network which the IDNO provides. The Authority agrees with this approach. An IDNO must duplicate some of the fixed costs which a DNO incurs in order to compete in the market. For example call centres, billing systems, staff costs. If charges to IDNOs are based on avoided marginal costs, there is potential to restrict, prevent or distort competition in distribution as the IDNO (under RPC and the terms of their charging methodologies) can only charge the same end tariff as the host DNO and therefore may not recover its fixed costs. If the IDNO is unable to recover its fixed costs then in the long term the IDNO is unlikely to be able to remain in the market.

The Authority therefore considers that WPD's proposal to move away from charging IDNOs on a marginal avoided cost approach towards an average cost approach better achieves relevant objective (b) in terms of not restricting, preventing and distorting competition in distribution.

2. Creation of new specific IDNO tariffs for non domestic IDNO sites and for HV IDNO sites

At present WPD charge a non domestic IDNO LV site on the same basis as a LV commercial customer. The Authority considers that both HV and non domestic IDNO sites will place different costs on WPD's network than a standard commercial customer. This is particularly the case where an IDNO may have a HV point of connection to WPD's system which services predominately domestic LV end users. It is therefore appropriate that WPD develops and implements tariffs to reflect these differences in order to send correct economic signals to users of their network. Consequently, the development of specific IDNO tariffs at HV and for non domestic sites based on identifying the total costs of operating WPD's equivalent IDNO network better reflect the costs which IDNOs place on WPD's network. As such the Authority considers that the proposal better achieves relevant objective (c) in terms of the methodology reflecting the costs incurred by the licensee.

Equally, specific IDNO tariffs at HV and for non domestic LV and HV sites will reduce the risk that WPD may restrict, prevent and distort competition in distribution compared to their current IDNO charging methodology which does not recognise that the IDNO operates some of the network to connect its non domestic and HV sites. IDNOs have argued that many of these sites are foreclosed from competition if the DNOs' boundary charge does not recognise that the IDNO incurs some costs in operating part of the network. By recognising that the IDNO has some costs of operating the network to HV and non domestic sites, it is more likely that such sites will be commercially viable for IDNOs to operate and that they will be able to compete with WPD to for adoption of these new sites. As such we consider the proposal better achieves relevant objective (b) in terms of not to restricting, distorting or preventing competition in distribution.

3. Cost allocation methodology

The Authority appreciates that the allocation of total price control revenue to network levels involves making a number of judgement calls on the drivers used to allocate costs. This exercise is by its nature subjective and consequently open to debate over the cost reflectivity of certain aspects. The Authority considers that WPD has provided reasonable justification and a pragmatic argument for the cost drivers it has used. As such, on balance, we consider that WPD's proposals better achieves relevant objective (c) to reflect the costs incurred by the licensee.

The Authority is inclined to agree with WPD that allocating capital costs to voltage levels in proportion to forecast net capex spend (taken from forward business plan questionnaire – FBPQ – data) appears to be appropriate in this case and consequently believes that this aspect of the methodology is more cost reflective than basing IDNO charges on the avoided marginal capital costs produced by WPD's DRM. The Authority further considers that allocating capital to network levels according to net forecast capex will reduce the risk that WPD restrict, prevent and distort

competition in distribution compared to their current methodology as it provides the IDNO with the same return on assets as WPD would receive if it owned and operated the network. This creates a more level playing field of competition for both WPD and IDNOs to bid for new networks and thus better achieves relevant objective (b) in terms of not to preventing, restricting or distorting competition in distribution.

The Authority is less convinced by WPD's choice of MEAV as cost driver to allocate the indirect costs. As respondents to our consultation have asserted, WPD have demonstrated that total indirect costs increase as the size of the DNO increases but this does not mean that MEAV is the best way to allocate costs between voltage levels.

4. Treatment of pension deficit payments and incentive income

The Authority remains to be convinced that pension deficit payments should be excluded from the allowed revenue which is allocated between network levels. WPD correctly argue that pension deficit is a legacy cost of providing the existing network. IDNOs construct their own network which is not bound by these legacy costs, but equally this new network connects to the existing network which bears the legacy costs. As such it seems appropriate that these costs are allocated across the whole distribution network including downstream of the IDNO boundary. This would seem to generate more level playing field for competition. As such the Authority would urge WPD to consider this point when reviewing their methodology in the future.

The Authority can see a stronger case for omitting the results of incentive schemes (whether they have a positive or negative impact) from the allowed revenue to be split between network levels. This also ensures that the difference between the boundary charge and the 'all the way' end user charge should not be affected by the success or otherwise of WPD in relation to their specific incentive schemes.

5. Retention of distance banded tariffs at LV

At present WPD employs a banded approach for its LV IDNO tariffs. This approach has been retained in WPD's proposal with a slight amendment to have a variable element and fixed element which are calculated by looking at the proportion of direct to indirect operating costs at LV.

The Authority considers that this amendment is more cost reflective than WPD's current banded approach as there is a large element of fixed cost (related to indirect costs) which is required to operate a distribution network. These fixed costs do not vary according to the length of the network which the DNO provides. By making only the costs associated with the direct costs variable, WPD are stating that only direct costs vary with distance. Since direct costs cover activities such as fault repair, tree cutting, replacement of assets and inspection & maintenance there appears to be a clear relationship between these costs and the length of the network. The Authority consequently considers that varying only the direct LV network costs is more cost reflective and thus better achieves relevant objective (c) in terms of reflecting the costs incurred by the licensee.

Our decision

The Authority has decided to **not veto** the modification to the UoS charging methodology statement. This letter constitutes notice pursuant to section 49A of the Electricity Act 1989.

If you have any questions relating to the issues discussed in this letter please contact Mark Askew at mark.askew@ofgem.gov.uk or on 0207 901 7022.

Yours faithfully,

Rachel Fletcher,
Director, Distribution