

Modification proposal:	Scottish & Southern Power Distribution¹ ("SSE") Electricity Distribution Use of System Charging Methodology: Interim² IDNO tariffs		
Decision:	The Authority ³ directs that this proposal be not vetoed ⁴		
Target audience:	DNOs, IDNOs, Suppliers, Generators and other interested parties		
Date of publication:	12 August 2009	Implementation Date:	1 April 2009 ⁵

Background to the proposal

SSE has licence obligations⁶ to have in place three charging statements: the statement of use of system ("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. SSE 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.⁷

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 Western Power Distribution plc has had IDNO charging proposals not vetoed⁸. In July 2008 a DNO/IDNO working group was established with the aim of developing more appropriate charging arrangements for IDNOs. DNOs, including SSE are now bringing forward proposals as a result of the work undertaken in this group.

SSE's proposal

On 24 July SSE submitted a modification proposal to their use of system charging methodology which sought to introduce interim IDNO tariffs⁹.

¹ Scottish and Southern Power Distribution own two electricity distribution licensees – Scottish Hydro Electric Power Distribution and Southern Electric Power Distribution. This letter applies to both licensees.

² In this case the 'Interim' methodology would apply from 1 April 2009 until 1 April 2010 when the common distribution charging methodology (CDCM) is due to be implemented.

³ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

⁴ This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

⁵ SSE have chosen to introduce this proposal retrospectively. They have provided evidence to Ofgem that this will have no impact on the UoS charges of other customers.

⁶ Standard licence conditions (SLC) 13 -14.

⁷ The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of SLC 13 of SSE'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.

⁸ The proposal was not vetoed in December 2007 and can be found at:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/SSE%20uos006%20mod.pdf>

WPD had a second IDNO charging methodology not vetoed in June 2009:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/Decision%20letter%20WPD%20Wales%20issued%20050609.pdf>

⁹ SSE's proposal can be found on Ofgem's website at:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/SSEPD%20IDNO%20Modification%20Interim%20240709.pdf>

At present SSE charge IDNOs on the same basis as commercial customers. These charges are calculated using a distribution reinforcement model ("DRM"). The DRM models the costs of adding 500MW of simultaneous demand to SSE's network. This produces an incremental cost per network level. These costs are allocated to customer classes on the basis of their contribution to maximum demand. These costs are then scaled up or down by a fixed percentage to ensure that SSE recovers their allowed revenue.

In the past the Authority has been clear that DNOs should bring forward proposals to introduce specific IDNO charges¹⁰.

Respondent's views

In April, the Authority consulted on WPD's cost allocation methodology, which is very similar to that which SSE now proposes¹¹. The difference between SSE's and WPD's proposal is mainly related to tariff application whereby SSE apply charges by so called "portfolio billing". Nonetheless, the Authority has already consulted on portfolio billing – as part of its joint consultation on IDNO charging¹². Therefore, the Authority can see little merit in asking for further responses on SSE's proposal. Furthermore, it considers that industry's views on both the cost allocation methodology and portfolio billing are well known, since Ofgem also provided verbal feedback on the joint IDNO consultation in the June IDNO/DNO steering group meeting¹³.

The Authority's decision

The Authority has decided to not veto SSE's proposal. In coming to our decision the Authority has considered the proposed modification against the relevant objectives and the Authority's wider statutory duties.

The Authority's reasons

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

Relevant objective (b) – That compliance with the methodology facilitates competition in the generation and supply of electricity and does not restrict, prevent or distort competition in the transmission or distribution of electricity.

SSE state that the proposal provides a guaranteed income for each IDNO plot¹⁴ and therefore better meets the relevant objective (b). The Authority agrees with this assertion and provides specific comments on aspects of SSE's proposal below.

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

SSE's current IDNO charging methodology is based on an incremental cost which is allocated to customer classes on the basis of their contribution towards peak demand. IDNOs are classed as commercial customers and so have the incremental costs allocated to them on the basis of the load profile of a commercial customer. These costs are then scaled to meet allowed revenue.

SSE proposes to move away from this incremental charging methodology towards a methodology which identifies the total costs associated with the part of its network equivalent to that 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 scaled

¹⁰ Please see the Authority's decision letter on WPD's IDNO charging modification of December 2007: <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20006%20IDNO%20charging%20decision%20letter%20wales.pdf>

¹¹ As part of our Joint Consultation on IDNO charging in April: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20CE%20and%20Reckon%20consultation_final.pdf

¹² See the footnote 11 above.

¹³ These views can be seen in the minutes of the IDNO/DNO steering group meeting from 2 June: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/IDNOs/Documents1/Steering%20group%20minutes%202%20June_Final.pdf

¹⁴ In this context plot refers to a single premise connected to the IDNO network e.g. a house or office.

incremental costs, there is potential to restrict, prevent or distort competition in distribution as the IDNO (under relative price control¹⁵ and the terms of their charging methodologies¹⁶) can only charge the same end tariff as the host DNO and therefore may not recover its fixed costs. A cost allocation to IDNOs which does not include fixed costs runs the risk of leaving the IDNO unable to recover these costs. Consequently, in the long term the IDNO may be forced from the market.

The Authority therefore considers that SSE's proposal to move away from charging IDNOs on a scaled incremental cost approach towards a total cost approach better achieves relevant objective (b)

2. Portfolio billing

IDNO sites may contain a variety of end user customer classes. At present, SSE levy a boundary charge on each IDNO site. This is a single tariff on which the consumption of the entire site is charged. IDNOs have stated that this can result in a mis match in tariff structure between what they pay at the boundary to DNOs and what they can recover (under RPC and the terms of their charging methodologies) from end users connected to their network. For example in some cases, IDNOs are required to pay a capacity element in their boundary charge which they can't recover from their end users. A portfolio billing approach allows SSE to produce a specific IDNO tariff for each end user which is connected to the IDNO network. This tariff structure mirrors that of the 'all the way' charge which IDNOs can recover from their end customers. These tariffs are then aggregated to produce an IDNO bill. The Authority considers that this prevents any mis match of tariff structure and ensures that the cost methodology which SSE propose is used to provide a fixed discount for every IDNO end customer. This provides certainty in the market and allows IDNOs to make longer term planning and investment decisions on the basis of the net DUoS income¹⁷ they will receive from each of their end customers. The Authority therefore considers that this aspect of the proposal better meets relevant objective (b).

3. Cost allocation methodology

The Authority considers that allocating capital costs to network levels according to net forecast capex will reduce the risk that SSE restrict, prevent and distort competition in distribution compared to their current methodology. This approach provides the IDNO with the same return on assets as SSE receives on its network. This creates a more level playing field of competition for both SSE and IDNOs to bid for new networks and thus better achieves relevant objective (b).

Relevant objective (c) – That compliance with the methodology results in charges which reflect as far as is reasonably practical (taking into account implementation costs) the costs incurred by the licensee in its distribution business.

SSE state that their proposal better meets the relevant objective (c) because it introduces specific IDNO tariffs which take account of the fact that IDNO sites predominately serve domestic premises and therefore have load characteristics more in common with domestic customers rather than commercial ones.

1. Creation of new specific IDNO tariffs for IDNO sites

The Authority considers that IDNO sites will place different costs on SSE's network than a standard commercial customer as IDNO sites tend to be predominately domestic and have load profiles more similar to those of a domestic, rather than commercial customer. It is therefore appropriate that SSE 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 based on identifying the total costs of operating SSE's equivalent IDNO network better reflect the costs which IDNOs place on SSE's network. As such the Authority

¹⁵ This is a price cap which states that IDNOs can't charge domestic customers a higher tariff than the host DNO.

¹⁶ RPC is relative price control which caps domestic IDNO charges to the same level as those of the host DNO. However, all IDNOs have a charging methodology in place which states that they will replicate all host DNO tariffs.

¹⁷ By net DUoS income, we refer to the difference between the income the IDNO recovers from its end customers and that which it has to pay the DNO for use of their upstream network.

considers that the proposal better achieves relevant objective (c) in terms of the methodology reflecting the costs incurred by the licensee.

2. Cost allocation methodology

The Authority appreciates that the allocation of total price control revenue to network levels involves making a number of judgements on the drivers used to allocate costs. The Authority considers that SSE has provided reasonable justification and a pragmatic argument for the cost drivers it has used. As such, on balance, we consider that SSE's proposals better achieves relevant objective (c) to reflect the costs incurred by the licensee.

The Authority is inclined to agree with SSE 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 incremental capital costs produced by SSE's DRM.

The Authority is less convinced by SSE's choice of Modern Equivalent Asset Value ("MEAV") as cost driver to allocate the indirect costs between network levels. Whilst it welcomes SSE's proposal that indirect costs require a different cost driver from direct costs, it considers this is an aspect of SSE's proposal which they may want to consider further when reviewing this methodology in the future.

Our decision

The Authority has decided to **not veto** the modification to the UoS charging methodology statement.

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 SSE 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.

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

Annex 1 – Summary of SSE’s proposal

SSE’s proposal calculates the total costs associated with operating the LV network, LV/HV substation 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 it between operating costs, depreciation and return. SSE then allocate all three sets of costs to network levels using cost drivers. For operating costs, SSE use regulatory reporting pack (RRP) data detailing the attribution of direct costs¹⁸ across network levels. SSE then allocate the indirect costs¹⁹ to network levels according to the proportion each network level contributes towards the total modern equivalent asset value (MEAV) of its network²⁰. 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, SSE 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 SSE’s end user charge²¹.

SSE use this discount to calculate portfolio tariffs. These portfolio tariffs reflect the average use of SSE’s LV main. SSE assumes that the costs associated with the LV main represent those associated with the direct operating costs. Consequently, they calculate the average use of the LV main per IDNO end user compared to the average use of the LV main per end their own end customer

$$\frac{\text{Average length of SSE network per IDNO end user}}{\text{Average Length of SSE network per end user}}$$

This calculation provides a figure of 6.7% for the SEPD area and 8.67% for the SHEDP area. SSE reduces the percentage discount associated with the direct operating costs by these percentages. This produces the following discounts on LV end user tariffs for an LV connected IDNO.

SHEPD – 26.3%
SEDP – 32.1%

SSE uses this calculation to create the following IDNO tariffs:

- Predominately domestic (PC 1 & 2)
- Small predominately non domestic (PC 3 & 4)
- Large predominately non domestic (PC 5-8)

The PC (or profile class) numbers indicate which IDNO boundary tariff will apply for each different type of IDNO end user. The boundary tariff is calculated by applying the discount quoted above to a weighted average of each of the unit and fixed charge from the relevant profile classes. This weighing is dependent upon the customer numbers on each tariff in SSE’s

¹⁸ Direct operating costs are those associated directly with the operation of the network and include such activities as fault repair, tree cutting and maintenance.

¹⁹ Indirect costs are those associated with indirectly with the operation of the network and include activities such as IT , customer call centres and staff costs.

²⁰ SSE chose to not allocate network rates by MEAV which are consequently allocated pro rata to all other costs. SSE 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.

²¹ SSE applies the discount to a different end user charge depending upon the classification of the IDNO site as domestic or non domestic.

area. For example if 90% of SSE's LV domestic end users are on the domestic unrestricted tariff, then the domestic unrestricted fixed and unit charge are given a 90% weighting in the calculation of the predominately domestic 'all the way' tariff. The IDNO LV discount is then applied to this fixed and unit charge to produce the boundary charge.

SSE requires the following information from IDNOs in order to apply their tariffs on a portfolio basis:

- i) The number of energised traded MPANs on each tariff offered by the IDNO.
- ii) The percentage of the total amount of energy attributable to each unit rate on each tariff offered by the IDNO.