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| Modification proposal: | Amendment of Use of System (UoS) Charging Methodology to revoke the HV/LV DRM Methodology from the Implementation Date of the CDCM (WPD/WALES/WEST/UOS013) | | |
| Decision: | The Authority ¹ directs that this proposal is vetoed ² | | |
| Target audience: | DNOs, IDNOs, Suppliers, Generators and other interested parties | | |
| Date of publication: | 24 September 2009 | Implementation Date: | 1 April 2010 |

Background to the modification proposal

WPD is the licensed DNO for the South West and South Wales distribution services areas (DSAs). This decision letter relates to the identical modification proposals raised in relation to the Use of System charging methodologies under each of its licences.

Electricity distribution network operators (DNOs) are required by standard licence condition (SLC) 13 of their licences to have a methodology that sets out how they determine charges for use of their distribution systems (UoS charges). The methodology is approved by the Authority on the basis that it achieves the Relevant Objectives³.

On 1 July 2009, new licence obligations (SLCs 13a and 50) were introduced that required DNOs to implement a common distribution charging methodology (CDCM) for their lower voltage distribution networks, i.e. the high- and low-voltage (HV and LV) networks⁴. The CDCM is intended to take effect from 1 April 2010.

If approved, the CDCM will replace all DNOs' existing methodologies for determining charges for use of the lower voltage networks of their distribution systems. DNOs' existing UoS methodologies for calculating charges for use of the higher voltages of their networks – i.e. the extra-high-voltages (EHV) – will remain in place until the end of 31 March 2011. From 1 April 2011 common EHV distribution charging methodologies⁵ (EDCMs) will replace existing EHV charging methodologies.

¹ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

² This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

³ The 'Relevant Objectives' for the connection charging methodology, as contained in paragraph 3 of Standard Licence Condition 13 of the licence are:

- (a) that compliance with the 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 methodology facilitates competition in the 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 methodology results in charges which reflect, as far as is reasonably practicable (taking account of implementation costs), the costs incurred by the licensee in its Distribution Business; and
- (d) that, so far as is consistent with sub-paragraphs (a), (b) and (c), the methodology, as far as is reasonably practicable, properly takes account of developments in the licensee's Distribution Business.

⁴ While SLC 50 applies on and after 1 July 2009, SLC 13A only applies on and after 1 April 2010.

⁵ In accordance with our decision document entitled 'Delivering the electricity distribution structure of charges project: decision on extra high voltage charging and governance arrangements' (Ref 90/09) (please see <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=487&refer=Networks/ElecDist/Policy/DistChrgs>), DNOs must develop and adopt either a common long run incremental cost (LRIC) or forward cost pricing (FCP) model for determining charges for customers connected to their EHV networks from 1 April 2011.

Ofgem is currently reviewing each DNO's price control (DPCR5). On 3 August 2009, Ofgem published a consultation document setting out its initial proposals⁶. We expect to publish a decision document setting out our final proposals at the end of November 2009. Until this point the legal framework for the DPCR5 price control period (April 2010 – March 2015) has yet to be concluded.

The modification proposal

In order to facilitate the introduction of the HV/LV CDCM, WPD proposes to modify its UoS charging methodology to remove its existing HV/LV charging methodology in accordance with SLC 50. The modification also aims to amend its EHV charging methodology to ensure that it remains operable following the implementation of the CDCM as well as making changes to its EHV charging methodology to take account of the new (DPCR5) price control that it expects will apply from April 2010.

In the modification report submitted to Ofgem on 26 August 2009⁷, WPD explained that its modification proposal is intended to make a number of changes, some of which lie outside the scope of this decision. The changes are listed below and those which lie outside the scope of this decision are marked by way of an asterix ("*")⁸:

- Remove the HV/LV distribution reinforcement model (DRM) methodology, except for the WPD-specific IDNO charging methodology*,
- Remove the HV/LV generation tariff methodology, except for the network unavailability rebate payments*,
- Retain the ability not to impose UoS charges on pre-2005 distributed generation, both for EHV customers and for HV/LV customers*,
- Use the split of revenue between EHV and HV/LV from the CDCM, rather than from WPD's current charging model,
- Remove the 10% cap on generator charge movement due to the proposed merger of allowed revenues for demand and generation,
- Update details relating to the reconciliation to required revenue, which assumes that the use of a single pot of allowed revenue is introduced in accordance with DPCR5 initial proposals,
- Update references to licence conditions, and
- Insert references to the Distribution Connection and Use of System Agreement (DCUSA) to replace a larger section on the need for a UoS agreement and the terms in those agreements.

Reasons for the Authority's decision

In coming to its decision **to veto** this proposal, the Authority has considered the proposed modification against the Relevant Objectives and the Authority's wider statutory duties⁹.

In summary, we have vetoed WPD's proposal because it is inconsistent with WPD's current licence conditions and it assumes a method for calculating allowed revenue that

⁶ Ofgem's initial proposals were published in a consultation document entitled 'Electricity Distribution Price Control Review Initial Proposals' (Ref 92/09), which can be found on its website at <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=254&refer=Networks/ElecDist/PriceCtrls/DPCR5>

⁷ A copy of WPD's modification report can be found on the Ofgem website at

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx>

⁸ Appendix 1 sets out the reasons why we consider these matters to fall outside the scope of this decision.

⁹ The Authority's statutory duties are detailed mainly in the Electricity Act 1989, Gas Act 1986, Utilities Act 2000, Competition Act 1998, Enterprise Act 2002 and the Energy Act 2004 as well as arising from directly effective E.C. legislation.

is contrary to those conditions. Specifically, the use of a single pot is currently not allowed in accordance with Special Conditions B1 and D1 of WPD's licences.

Whilst we have decided to veto WPD's proposal on the basis that it is inconsistent with its current licence obligations, we consider that the proposal presented by WPD had merits and that the proposal appeared to mitigate the anticipated effects of the introduction of the CDCM and the next price control on their EHV UoS charging methodology and to set out the consequential effects on their UoS charges. WPD have clearly signalled the impacts of their proposed changes, which in some cases are significant.

We anticipate that WPD will be able to bring forward this modification again once the legal framework allows it. As any such modification is likely to have impacts on customer charges it appeared to us appropriate to comment on the proposed modification at this time. With this in mind we have provided some comments on the detail of their modification proposal in Appendix 2 below. These comments are provided as an indication of our current views and do not in any way fetter our ability to decide on any future modification brought forward by WPD.

Relevant Objective (a) - that compliance with the methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and by its licence

WPD proposes to take account of our DPCR5 initial proposals where we state that our preference is to allow DNOs, where possible, to combine allowed demand and generation revenues into a single pot for the purpose of calculating UoS charges. This is different to the current (DPCR4) price control framework which requires that demand revenue is specifically recovered through demand use of system charges (Special Licence Condition B1, paragraph 1) and generation revenue is specifically recovered through generation use of system charges (Special Licence Condition D1, paragraph 1).

Although calculating and recovering allowed revenue using a single pot is a proposal set out in our initial proposals for DPCR5, we have not yet concluded the DPCR5 review. Consequently, WPD's proposal is invalid because it is contrary to the existing legal framework. We therefore consider that implementing their proposal would not discharge their licence obligations and would be contrary to objective (a). For this reason, we are have decided to veto this modification proposal.

If you have any questions relating to the issues discussed in this letter please contact Nicholas Rubin, either at nicholas.rubin@ofgem.gov.uk or on 020 7901 7176.



Rachel Fletcher
Partner, Distribution
Signed on behalf of the Authority and authorised for that purpose

Appendix 1 - Matters outside the scope of this decision

WPD's proposed modification requests the removal of most aspects of its HV/LV UoS charging methodology as at 31 March 2010. This request appears to be made in contemplation of SLC 50.22(a) which requires WPD to revoke such parts of its UoS charging methodology used for calculating UoS charges in respect of Designated Properties¹⁰ as at that date.

Such a modification request is unnecessary, however. WPD is obliged to make this revocation pursuant to SLC 50.22(a) (note: this obligation is subject only to a non-veto decision on the CDCM by the Authority). No further step is required by WPD to facilitate this revocation.

We also note that WPD proposes to retain certain aspects of its HV/LV methodology when the CDCM is implemented that do not currently form part of the CDCM¹¹. However, the implementation of the CDCM will require the revocation of WPD's HV/LV methodology at that time. That will include those certain aspects it currently proposes to retain. To retain certain aspects of its current HV/LV methodology from the CDCM implementation date, WPD may consider the two potential routes provided for in SLC 50 – seeking a derogation from the CDCM or proposing conditions to which the Authority's approval of the CDCM may be subject. Both routes are at the Authority's discretion.

Should any derogation requests be granted, any retained aspects of HV/LV methodology would replace or complement the related requirement in the CDCM for as long as the derogation lasts. For transparency, the description of any CDCM derogation request that is granted will not sit in a DNO-specific methodology, but instead in an appendix to the CDCM. Such appendix would not be subject to existing DCUSA change control procedures.

¹⁰ See SLC 50.10 for the definition of Designated Properties.

¹¹ WPD intends to retain certain aspects of its HV/LV methodology in relation to: IDNO charging and billing; not charging DG connected pre-2005; and payment of unavailability rebates. Therefore WPD has purposely not removed them from its methodology, making this clear in its modification proposal.

Appendix 2 – Comments on WPD’s modification proposal

Please note that the comments provided in this Appendix 2 are for information only in view of the likely impacts on customers of such a modification proposal. These comments do not form part of the Authority’s decision on WPD’s modification proposal.

Recovery of allowed revenue

The most significant change proposed by WPD is to clarify the method by which WPD will split allowed revenue between recovery through its EHV charging methodology and the CDCM. WPD’s current EHV methodology uses a split of revenue based on the modern equivalent asset values (MEAV) of its lower and higher voltage networks. WPD proposes that the split of revenue will be determined using the 500MW model used in the CDCM.

This proposal impacts on charges because the current split of revenues between EHV and HV/LV is 36:64 in its South West area, which moves to 40:60 under the CDCM split. In its South Wales area the split moves from 38:62 currently to 42:58. Whilst the overall impact is that EHV demand customers will pay approximately 10% more, the impact of this on specific customers varies because of the combination of the locational incremental charge coupled with a £/kVA adder to reconcile to allowed revenue. For example, customers connected to parts of the network which have low or negative locational incremental charges but high demand requirements are much more susceptible to variations in the size of the £/kVA adder because the adder constitutes a much larger proportion of their overall charge. For these reasons, demand customers in WPD’s DSAs would experience changes to their charges of between -0.2% and 44%.

Whilst WPD’s proposed methodology could more clearly explain how its revenue is split, when read in conjunction with its modification report, we consider that WPD’s proposal are likely to ensure that it is able effectively to split revenue should the CDCM be implemented.

WPD also proposes to remove the scaling of EHV generator charges. WPD states that it considered applying the same adder to both demand and generation but discounted this because the network is currently demand dominated and the fixed adder is applied at winter peak which would, they envisage, use P2/6 capacity which for wind farms would be zero. We do not necessarily agree that if there were an adder for generation that it would be applied in this manner but note, having reviewed WPD’s analysis, that this approach appears to deliver minimal change in terms of pricing impacts on customers. Whilst not in their modification report to us, we have established that WPD’s proposed removal of scaling generation charges to those customers charged currently would result in an overall increase to charges of £143,000 in their South West region and a decrease in charges of £22,000 in their South Wales region. Continuing to include a £/kVA adder along existing lines to generation charges would result in an overall increase to charges of £323,000 in their South West region and an increase in charges of £202,000 in their South Wales region.

Minimal change in charges for 1 April 2010 is important given that the EHV methodology may develop further under licence condition 50A¹² which will be effective from 1 October 2009 and will require DNOs to bring forward one of two common approaches for EHV charging by 1 September 2010, for implementation from 1 April 2011.

¹² <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=146&refer=Licensing/Work/Notices/ModNotice>

Removal of 10% cap on DG charges

WPD proposes to remove a 10% cap on generator charge changes. WPD explained that the cap exists currently to prevent excessive volatility in DG charge changes, which is a problem when scaling to a small allowed revenue. However, because from 1 April 2010, they propose that demand and generation allowed revenues will be combined, WPD considers that the cap will no longer be necessary.

We consider that the removal of the 10% cap would be a positive improvement to WPD's charging methodology in that it improves the cost reflectivity of charges.

We note that WPD has implemented a long run incremental cost (LRIC) model at EHV which we anticipate will allow EHV demand and generation pots to be combined for charging purposes in the next price control period.

Housekeeping

In addition to changes to its method for recovering revenue, WPD proposes to make a number of consequential changes that are intended to ensure that its existing EHV UoS charging methodology continues to work following the introduction of the HV/LV CDCM and that references to licence conditions and the CDCM in its methodology are accurate.

WPD's updated references to licence conditions take account of the renumbering of licence conditions from 1 June 2008 under the distribution licence review project and as such this would represent an improvement to WPD's existing charging methodology.