

Your Ref 114/09

Our Ref CE-CDCM response

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Date: 26 October 2009

Dear Ynon

Electricity distribution structure of charges project: distribution network operators' proposals for a common methodology at lower voltages - Ofgem consultation

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

This letter summarises our response to the above consultation, with more detail on the specific questions and areas for further development attached in Appendix 1.

CE is committed to working with the industry, in particular with Ofgem and all other distribution network operators (DNOs), in developing a common distribution charging methodology (CDCM) at lower voltages, to ensure compliance with the licence obligation that came into force on 1 July 2009.

We believe that the proposal that has been submitted to Ofgem for consideration provides a sound platform, which can be improved and enhanced over time and under open governance, and that changes to the methodology can be processed ensuring due diligence and protocol are observed. We therefore believe we have discharged our licence obligations in respect of the eligibility of the submission for approval by the Authority.

The process has been a lengthy one, but, given the legacy position that has previously resulted in several different methodologies currently being in place, the DNOs have achieved a great deal in terms of improved cost reflectivity, transparency and commonality in the following areas:

- A single common model, which will aid suppliers in their understanding and interpretation of use of system charges;

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- More cost-reflective charges ensuring the costs are allocated in a consistent manner;
- A common tariff structure, which will simplify tariffs for suppliers and should reduce the overhead of dealing with different regional tariffs;
- Charging for generators, providing rewards to some distributed generation customer's dependent on location, reflecting that the output from their sites could enable distributors to avoid/defer the need for network reinforcement; and
- Providing discounted tariffs for independent network operators (IDNOs) reflecting the reduction in DNO costs.

We welcome Ofgem's decision to approve the methodology subject to a number of conditions, and feel this is a significant step in ensuring distribution companies are able to work together to respond to any future changes that are proposed under open governance.

In order to ensure we are compliant with our licence CE accepts the three areas that Ofgem detail as areas of conditional approval of the CDCM:

- Commonality in the use of service models - by December 2009;
- Re-insertion of network unavailability payments - by December 2009; and
- Review of generator charging in generation-dominated areas - by September 2010.

However, it should be noted that, whilst we can see the merits of bringing commonality to the service models, we have some concerns about the proposals for generator charges and network unavailability charges.

In principle the network unavailability scheme is a component of the price control and not the distribution use of system (DUoS) methodologies. However, it was included within DNOs' charging methodologies in 2005 as a pragmatic alternative to inclusion within the licence. Its application and continuation are subject to Ofgem's distribution price control review (DPCR5) final proposals and DNOs' acceptance thereof.

It should be noted that the CDCM covers all generators connected at high and low voltage (but not EHV), whereas the network unavailability scheme only applies to incentivised generation under the distributed generation (DG) incentive. Ofgem need to clarify their position on these two points. We propose that this should be removed from the CDCM and put into a standalone statement.

We understand Ofgem's concern with regard to the CDCM's blanket assumption of the positive benefit of generators (particularly in generation dominated areas). A pragmatic solution to this issue at lower system voltages may lie beyond the capability of the DNOs to deliver because of the restrictions of the settlements system (not desegregating by

geographic location). An imperfect solution may therefore be our only option and this would require Ofgem to allow DNOs to recognise these constraints in any solution they offer.

We are aware that the introduction of this new methodology will introduce some significant disturbance in prices for some customer groups. We are seeking to minimise the impact of these changes by communicating the level of disturbance as soon as we can to suppliers and end-users. We are committed to ensuring these customers are kept fully informed of what is happening, not only with the introduction of the new methodology from April 2010 but also the expected impact of the new distribution price control. We have issued communications tailored to each customer group and provided an initial view of recent industry developments and we shall be holding a workshop in November to provide a further update and give them an opportunity to discuss any specific areas in more detail.

If you have any queries or concerns regarding the above, or if you would like to arrange a meeting to discuss, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read "H Jones".

Harvey Jones

Head of Network Trading

Appendix 1

Section 1 – Summary of “minded to” conditional approvals under the CDCM

1. Service models

Ofgem view: We are minded to approve this element of the methodology subject to the condition that the DNOs demonstrate as soon as possible, and by 31 December 2009 at the latest, that the approach submitted in the CDCM methodology is common across DNOs, and if it is not they will need to present proposals to us by that date to make it common. The impact on charges should SP and EDF: change their approach to fall in line with other DNOs would be minimal but they will need to inform customers at the earliest opportunity what the revised charges are if they make these changes.

CE response: We would suggest that DNOs produce a report for Ofgem detailing the application of service models. It would seem that this particular issue is specific to SP and EDF: however, a report setting out the use of service models by each DNO should reassure Ofgem that a consistent approach is being utilised.

2. Network unavailability rebate payments

Ofgem view: The DNOs have not justified removing unavailability rebates from their methodology in their submission. We expect the CDCM to reinsert the methodology for calculating these rebates and our minded to decision is that the methodology for calculating these should be included in the CDCM along the lines set out in a footnote below. We consider that the omission from the CDCM needs to be rectified without delay to ensure the treatment of rebates is clear and that this rebate scheme continues to operate from 1 April 2010. We are therefore minded to approve the CDCM subject to the condition that the DNOs bring forward this change to the CDCM by 31 December 2009.

CE response: The omission of this clause from the CDCM was as a result of strong views amongst DNOs that this scheme does not form part of a distribution use of system (DUoS) charging methodology and should be treated like a guaranteed standard. The reasoning for this is that we understand this is not a refund against DUoS charges where any rebate payment made under CDCM has the consequence of reducing actual revenues received by the DNO relative to total allowances and would therefore be recovered from all other customers in scaling back to allowed revenue. It is more a payment funded by the DNOs, not by allowed revenue, for non-availability of a service. We propose that this should be removed from the CDCM and put into a standalone statement.

We would be keen to understand how the £2 per MW per hour was actually calculated. Furthermore it is our understanding that this payment is only applicable to generators connecting post 2005 and we would welcome confirmation from Ofgem on this matter. In

order to comply with the licence we shall not object to this condition, although we feel that a change should be raised once open governance is in place to decide where this obligation should be placed in future.

In recent correspondence, Ofgem have referred to the scheme as applying only to generators with 'firm' connections. This is different from the DRPC4 final proposal, which specifies 'standard' connections. Ofgem has not defined 'firm' in this regard and needs to do so.

3. Generator charging in generation-dominated areas

Ofgem view: Whilst we recognise that the CDCM is a non-locational model and therefore makes some averaging assumptions, we consider that it would be entirely inappropriate to pay generators and thereby incentivise them to locate where the network is or has scope to be generator-dominated. This is what underlies our March 2009 decision document.

Data submitted to us in relation to SSE's Hydro distribution area suggests generator capacity is 1.42GW and summer minimum demand (assumed as 30% of maximum demand) is 1.14GW. This data suggests that for some DNOs there is likely to be a relatively high proportion of substations where the network is generator-dominated at times in the year, which could be driving incremental investment to reinforce the network. We are not convinced that the data allows the DNOs to assume in the CDCM that all the networks are demand dominated for the purposes of deriving generator credits.

We note that 10GW of DG is forecast to connect during 2010-15 and that this will increase the likelihood of generation driving incremental system reinforcement. Although it is not clear that this is a significant issue today, given the points made above we are minded to accept this element of the methodology with the condition that the DNOs need to review their approach and make proposals to us by 1 September 2010 in relation to generator charging where the network is or will become generator dominated.

CE response: CE provided detailed analysis to Ofgem which demonstrated that both of our networks are in fact demand-dominated: however, we recognise the fact that in some other DNO areas this may not be the case and agree that more detailed analysis may be necessary in order to ensure that, should this happen in the future, we are able to send the correct signal to generators who connect in generation-dominated areas. We expect DNOs to review this over the coming year in order to demonstrate whether or not the assumptions in the CDCM are appropriate.

A pragmatic solution to this issue at lower system voltages may lie beyond the capability of the DNOs to deliver because of the restrictions of the settlements system (not desegregating by geographic location). An imperfect solution may therefore be our only option and this would require Ofgem to allow DNOs to recognise these constraints in any solution they offer.

Section 2 – DNOs' common methodology submission

Question 1: Do you agree with our minded to positions given the arguments / analysis presented here and in the Impact Assessment in Appendix 3? If not, why not?

Response: We think the minded to positions detailed by Ofgem have captured the main areas of concern and through collective working the DNOs should be in a position to address these in the coming months.

Question 2: Do you consider any additional areas should be conditionally approved?

Response: We do not believe there is any benefit in applying additional conditions on the CDCM. There is a risk that, if additional conditions are applied, this could significantly impact on delivery for April 2010. In addition to the conditions placed on DNOs, Ofgem have also indicated several areas to be considered under open governance in the coming year. Given that work is already underway on the extra-high voltage distribution charging model (EDCM) in order to achieve an April 2011 implementation date, resourcing to address any additional areas could prove very challenging.

Question 3: Do you consider any element of the methodology would warrant an overall vetoing of the DNOs' common methodology submission?

Response: No – a veto at this stage would be a retrograde step. The immense amount of work and commitment given by DNOs and other industry stakeholders should be taken into consideration before Ofgem consider an overall veto of this proposal. As Ofgem has said, there have been significant benefits delivered in the form of commonality and transparency. Extensive consultation has taken place with the industry on specific issues to ensure every opportunity for discussion and input to the final solution was achieved.

We acknowledge that this is by no means a perfect solution, but, given the benefits already achieved and the potential savings for customers from postponed investment yet to be realised, it is an extremely sound baseline to build on.

Question 4: Are there any additional areas you would like to flag as areas you consider warrant further work by DNOs in the future?

Response: We believe the areas of further development Ofgem have highlighted in their consultation are all areas where the DNOs expected to carry out more work, given the level of debate that took place prior to submission. We do, however, welcome the fact that under open governance changes can be raised in a structured way, ensuring the correct level of attention is paid to each relevant issue.

CE would like to comment on the following areas that Ofgem are minded to accept without conditions.

Generator charging from 2010

The CDCM applies to all HV/LV use of system charges and Ofgem agree that there should be no discrimination between generators connected pre and post 2005. Therefore from April 2010 all HV/LV connected generators will attract the same charge/credit. It is not, however, clear whether or not this same approach should be applied to extra high voltage (EHV) customers, given that the methodology for EHV is not to be implemented until April 2011. There is also the question of how allowances are to be split if these two groups of customers are to be treated differently. CE would welcome clarification on these points.

Excess capacity charges

In the consultation Ofgem note that levying one month's excess capacity charge may not represent a significant amount of money, however where a customer is breaching the capacity set out in their connection agreement we would expect remedial action to be taken under this agreement in any case. The connection charging arrangements effectively enable targeted action against customers where the network is constrained and where specific system reinforcement becomes due as a result of a customer breaching capacity.

This was a last-minute change to the model prior to submission, and DNOs still have concerns with the effectiveness of reverting purely to the connection agreement as a means of managing these breaches. Indeed we believe that the use of connection agreements is a "sledge hammer to crack a nut" approach; we would like to see Ofgem recognise that more could be done to prove the case that the correct economic approach is to create (dis)incentives for customers to behave responsibly, rather than resorting to contractual action or disconnection. Significant work has already been carried out to demonstrate that charging a higher capacity rate for such a breach can be much more effective and this matter will be raised under open governance arrangements.

Section 3 – Areas of further development

There are still many areas where additional development work is needed, and DNOs already have the following in their plans for the coming year:

- Longer-term tariff products;
- De-linking of tariffs from suppliers' systems; and
- Portfolio billing for embedded networks.

In the consultation Ofgem detail several more areas for further development including:

- Commonality of 500MW model;
- Splitting out operating expenditure in the model for greater transparency;

- Voltage of supply vs voltage of connection;
- Reactive proxy data;
- Standing charge factors;
- Justification of the non-scaling of generator charges;
- IDNO charging - HV splits;
- IDNO charging - generator charging;
- IDNO input data;
- IDNO standardisation of assumptions; and
- Input data standardisation and provision of greater information

Most of these can be addressed by open governance. However, the volume of work required needs to be assessed, as it should be noted that the DNOs have already started work on developing the proposals for a common EHV methodology in order to comply with the licence requirement to submit a proposal by September 2010.

Derogations

We have submitted two derogation requests to Ofgem for both YEDL and NEDL with regard to excess capacity and reactive power charging. Whilst we currently have a project to ensure delivery of the changes to our billing system we cannot be certain that the changes required will be completed on time and therefore have sought a derogation for three months