Promoting choice and value for all gas and electricity customers

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| Modification proposal: | **Electricity North West's (ENW)Electricity Distribution Use of System Charging Methodology: Interim[1] IDNO tariffs** | | |
| Decision: | The Authority[2] directs that this proposal is not vetoed[3] | | |
| Target audience: | Distributors, Suppliers, Generators and other interested parties | | |
| Date of publication: | 22 October 2009 | Implementation Date: | 1 April 2009[4] |

***Background to the proposal***

ENW has licence obligations[5] to have in place three charging statements: the statement of use of system ("UoS") charging methodology, the statement of UoS charges and the statement of connection charging methodology and charges. The statement of UoS charging methodology outlines the method by which distribution UoS charges are calculated. ENW 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.[6]

The Authority has been encouraging Distribution Network Operators ("DNOs") to modify their charging methodologies to bring forward specific IDNO tariffs which better reflect the costs IDNOs impose on their distribution networks[7]. As yet only WPD[8], SSE[9] and SP[10] have had IDNO charging proposals not vetoed. In July 2008 a DNO/IDNO working group was established with the aim of developing more appropriate charging arrangements for IDNOs. DNOs, including ENW are now bringing forward proposals as a result of the work undertaken in this group. In addition to the decisions outlined above,

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[1] In this case the 'Interim' methodology would apply until 1 April 2010 when the common distribution charging methodology (CDCM) is due to be implemented.
[2] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[3] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[4] ENW wish to introduce this proposal retrospectively. It has indicated within their modification report that this retrospective has minimal impact on its revenues and thus the charges for other users of the network.
[5] Standard licence conditions (SLC) 13 -14.
[6] The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of SLC 13 of ENW's 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 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 iaccount 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.

[7] See our December 2007 not veto letter on WPD's IDNO proposal: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20006%20IDNO%20charging%20decision%20letter%20wales.pdf
[8] The proposal was not vetoed in December 2007 and can be found at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20006%20IDNO%20charging%20decision%20letter%20wales.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] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/Final%20decision%20letter%20SEPD.pdf
[10] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/SP%20IDNO%20decision%20letter.pdf

the Authority is consulting on proposals from CE[11], CN[12] and has vetoed a proposal from EDF[13]. We also note that all DNOs have now submitted the common distribution charging methodology which contains a specific IDNO cost allocation generating new IDNO tariffs. Ofgem is currently consulting on these proposals and consultation closes on 26 October[14].

***ENW's proposal***

On 25 September 2009 ENW submitted a modification proposal to their use of system charging methodology which sought to introduce interim IDNO tariffs[15].

This proposal takes the price control settlement in DPCR 4 as a proxy for the total cost of ENW's business. ENW then use cost drivers (primarily net capex and modern equivalent asset value -MEAV) to allocate these total costs to network levels to ascertain the percentage of total costs associated with owning and operating each network level. This allows ENW to generate a tariff to the IDNO boundary which represents a reasonable estimate of average total DNO costs. In the past the Authority has been clear that DNOs should bring forward proposals to introduce specific IDNO charges[16].

***Decision not to consult***

In April, the Authority consulted on WPD's cost allocation methodology, which is very similar to that which ENW now proposes[17]. Equally, the Authority recently 'not vetoed' interim proposals from SSE and SP which adopt a very similar cost allocation model. Given the earlier consultation on WPD's proposals and the precedent set by our recent decisions on SSE's and SP's proposals we consider that there would be little merit in consulting upon principles contained in ENW's proposal, particularly as the views of industry on the proposed cost allocation methodology are well known. We would also stress that once the modification proposal comes into effect, ENW will continue to offer their current commercial tariff to IDNOs meaning that IDNOs can continue on the current arrangements if they so wish.

Furthermore, as discussed in more detail below, we consider the methodology behind the new tariffs to be a significant step forward on IDNO charging and the Authority considers that consulting again on this methodology would be an unnecessary delay to the introduction of these new tariffs. As stated above we would ask parties to note that ENW, along with all other DNOs, have submitted a methodology very similar to this proposal to Ofgem as part of the common distribution charging methodology (CDCM). The CDCM is due to be implemented in April 2010 and on 28 September 2009 Ofgem issued a detailed consultation on the DNOs' proposals which includes a section on the IDNO specific part of the CDCM.

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[11] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/CE%20Interim%20IDNO%20Consultation.pdf

[12] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/CN%20IDNO%20Consultation.pdf

[13] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/Final%20EDF%20interim%20IDNO%20decision.pdf

[14] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/Ofgem_CDCM_consultation%20280909_1.pdf

[15] ENW's proposal can be found on Ofgem's website at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/ENWPD%20IDNO%20Modification%20Interim%20240709.pdf

[16] 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

[17] 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

***Reasons for the Authority's decision***

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

ENW states that the proposal provides a fixed income for each IDNO plot[18] and removes any mismatch between the tariff structure they levy at the IDNO boundary and the tariff structure the IDNO is able to recover from its end customers. Therefore, ENW consider that its proposal better meets relevant objective (b). The Authority agrees with this view. We provide specific comments on aspects of ENW's proposal below.

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

At present ENW 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 ENW'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 ENW recovers their allowed revenue.

ENW 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 and considers that it produces a boundary tariff which is a reasonable estimate of average total DNO costs, rather than avoided costs.

Under the terms of the relative price control[19] (RPC) and their charging methodologies[20] an IDNO can only recover the same income from its end customers as the host DNO would have done. The IDNO therefore relies upon the difference between the boundary charge levied by the DNO and the DNOs own published end tariffs as an income on which to operate their network and earn a reasonable return. This difference represents the IDNO gross margin.

The current boundary charging arrangements which use a scaled incremental approach may not allow the IDNO to fully recover all of the fixed costs associated with owning a network business. ENW's proposal to move towards an approach which seeks to identify the total costs of the network which the IDNO is providing and deduct this from the 'all the way' charge the IDNO recovers, is more likely to allow the IDNO to recover its efficiently incurred fixed costs.

The Authority therefore considers that ENW'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. Cost allocation methodology

[18] In this context plot refers to a single premise connected to the IDNO network e.g. a house or office.
[19] This is a price cap which states that IDNOs can't charge domestic customers a higher tariff than the host DNO.
[20] IDNOs have a charging methodology in place which states that they will replicate all host DNO tariffs.

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

3. Portfolio tariff

IDNO sites may contain a variety of end user customer classes. At present, ENW 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 ENW 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 allocation methodology which ENW propose is used to provide a fixed income for every IDNO end customer. This fixed income provides greater certainty in the market and allows IDNOs to make longer term planning and investment decisions on the basis of the net DUoS income[21] they will receive from each of their end customers. The Authority therefore considers that this aspect of the proposal better meets relevant objective (b).

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

ENW states that their proposal better meets 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 ENW'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 ENW 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 ENW's equivalent IDNO network better reflect the costs which IDNOs place on ENW'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.

2. Cost allocation methodology

[21] 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.

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 ENW has provided reasonable justification and a pragmatic argument for the cost drivers it has used. As such, on balance, we consider that ENW's proposals better achieves relevant objective (c) to reflect the costs incurred by the licensee.

The Authority is inclined to agree with ENW 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 ENW's DRM.

The Authority is less convinced by ENW's choice of MEAV as the cost driver to allocate the indirect costs between network levels. Whilst it welcomes ENW's proposal that indirect costs require a different cost driver from direct costs, it considers this is an aspect of ENW's proposal which they may want to consider further when reviewing this methodology in the future. However, we do not consider that this aspect of the proposal sufficiently detracts from its overall benefit to warrant it being vetoed.

The Authority further notes that ENW employ a formula to calculate the allocation of LV network costs between themselves and the IDNO[22]. The formula which ENW adopts[23] calculates the proportion of their LV network per end IDNO user (2.61m) compared to the combined length of their own LV network per end user (13.09m) added to the length of their network per IDNO end user (2.60m). We do not consider that it is appropriate to add the length of network ENW provide to the IDNO to the average length of their own network. We consider that this is double counting and does not therefore accurately represent an average allocation of LV network costs between ENW and IDNOs. This is not sufficient in itself to outweigh the positive aspects of ENW's proposal. However, we would expect ENW to address this issue in the near future.

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 ENW 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,
**Partner, Distribution**
**Signed on behalf of the Authority and authorised for that purpose**

[22] This is due to the fact that the IDNO will often connected to the DNO at some point down the LV network and the costs in the LV network therefore need to be allocated between DNO and IDNO.
[23] ENW state that their LV network per end user is 13.09m whilst the average length of LV network ENW provide to IDNOs is 2.61m. However when calculating the proportion of the network which IDNOs use on average ENW have stated that it is 2.61m/(13.09m+2.61m). We are unsure as to why ENW add the 2.61m to the 13.09m on their own network.

## Annex 1 – Summary of ENW's proposal

ENW'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. ENW then allocate all three sets of costs to network levels using cost drivers. For operating costs, ENW use regulatory reporting pack (RRP) data detailing the attribution of direct costs[24] across network levels. ENW then allocate the indirect costs[25] to network levels according to the proportion each network level contributes towards the total modern equivalent asset value (MEAV) of its network[26]. 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, ENW 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 ENW's end user charge[27].

ENW state that an IDNO will not use the entire network level at the voltage of connection. The DNO will provide some of this network and the IDNO will provide the rest. In order to reflect this in their cost allocation. ENW use the calculation below to establsish the average proportion of the network level they own when serving an IDNO site.

$$\frac{\text{Average length of ENW network per IDNO end user}}{(\text{Average Length of ENW network per end user} + \text{Average length of ENW network per IDNO end user})}$$

This calculation provides a figure of 16%. ENW reduces the percentage discount associated with the direct operating costs by this 16%. This produces the following discounts on LV and HV end user tariffs for an LV connected IDNO.

ENW – 30.2% at LV, 42.5% at HV

ENW uses this calculation to create a number of IDNO tariffs. First they apply the appropriate discount to the following end user charges to create a range of portfolio IDNO tariffs:

Profile class (PC) 1 – Domestic unrestricted

[24] Direct operating costs are those associated directly with the operation of the network and include such activities as fault repair, tree cutting and maintenance.
[25] 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.
[26] ENW chose to not allocate network rates by MEAV which are consequently allocated pro rata to all other costs. ENW 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.
[27] ENW applies the discount to a different end user charge depending upon the classification of the IDNO site as domestic or non domestic.

PC 2 – Domestic restricted
PC 3 – non domestic unrestricted
PC 4 – non domestic restricted
PC 5-8
LV half hourly
Unmetered

In addition to these portfolio tariffs, ENW also offer the following boundary tariffs in the event that IDNOs are unable to provide the data necessary for portfolio tariffs.

- LV connected with predominantly domestic unrestricted customers;
- LV connected with predominantly domestic restricted customers;
- HV connected with predominantly domestic unrestricted customers; and
- HV connected with predominantly domestic restricted customers.

ENW state that it is for the IDNO to determine the most appropriate tariff to request. As stated above ENW will continue to offer their existing IDNO tariffs alongside these new tariffs.