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Dear colleague,

**Electricity distribution structure of charges project: Decision on Distribution Network Operators' (DNOs) submission to meet the conditions for approval of the CDCM required by 31 December 2009**

On 20 November 2009 the Authority took a decision on the common distribution charging methodology (CDCM) which had been jointly submitted by DNOs<sup>1</sup> in respect of use of system charges at lower voltages<sup>2</sup>. This decision outlined that, having carefully considered responses to our September 2009 consultation<sup>3</sup>, the Authority was content to approve the CDCM subject to a number of conditions.

These conditions were subject to separate deadlines, the majority of which we required DNOs to meet by 31 December 2009. These are set out in Table 1 below. The DNOs have had 28 days to decide whether to make representations or objections to our approval of the CDCM subject to conditions.

**Table 1 - Summary of conditional approvals under the CDCM**

Conditional approval	Timescale for work
Generation charging in generation dominated areas	1 Sept 2010
Network unavailability rebate payments	31 Dec 2009
IDNO charging - generation tariffs	31 Dec 2009
IDNO input data	31 Dec 2009
IDNO charging - HV split	31 Dec 2009

DNOs submitted a revised CDCM to Ofgem on 11 December along with revised charging models and a statement that individual DNOs would not make further formal representations on the conditional approvals. The 28 day period has now closed and this letter sets out our decision on whether DNOs have met the conditional approvals required by 31 December 2009. Below we provide reasons for our decision on each separate

<sup>1</sup> This document can be found on Ofgem's website at:

[http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/CDCM%20decision%20doc%20201109%20\(2\).pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/CDCM%20decision%20doc%20201109%20(2).pdf)

<sup>2</sup> The CDCM covers charges to customers connected to the high (HV) and low (LV) voltage distribution networks.

<sup>3</sup> This consultation document can be found on Ofgem's website at:

[http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/Ofgem\\_CDCM\\_consultation%20280909\\_1.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Documents1/Ofgem_CDCM_consultation%20280909_1.pdf)

condition. We provide our thoughts on the one representation made on our conditional approvals in respect of the IDNO<sup>4</sup> HV split in that section of our decision below.

### **Network unavailability rebate payments**

The Authority conditionally approved the CDCM to require that DNOs inserted into the methodology statement details of the network unavailability rebates available to generators connected at more than 1,000 volts. In Appendix 3 to our November decision document we outlined that the wording which we would like to appear within the CDCM.

DNOs have now inserted this wording into the main body of the methodology statement as specified by our condition of approval. We consider the inclusion of this wording will provide generators with greater information on the charging products which are available to them and which form the basis of their charges. This increased clarity will provide more certainty in the generation market and thus help to facilitate competition in generation. For these reasons we consider that this amendment helps to better achieve the second Relevant Objective (set out in standard licence condition (SLC) 50.7) that compliance with the CDCM facilitates competition in the generation and supply of electricity and will not restrict, distort or prevent competition in the transmission or distribution of electricity or in participation in the operation of an Interconnector.

On this basis the Authority is satisfied that this condition of our approval has been met.

### **IDNO generation tariffs**

In our September consultation document and our November decision on the CDCM the Authority highlighted that it may be inappropriate for IDNOs to pay the fixed charge element of the embedded generation charge to DNOs. DNOs indicated that they were in agreement with this and in their resubmission they have allocated IDNOs a 100% discount of the fixed charge element of the generation tariff. We consider that this will permit the IDNOs to provide generators with the full unit credit and retain the fixed charge recovered from generators to cover its costs associated with the service cable and customer facing costs which generators impose on IDNO networks. The amendment will permit IDNOs to better compete in the market to adopt new networks which have embedded generation connected. Consequently, we consider that it satisfies us that DNOs have addressed our condition of approval. Specifically, the new approach appears to better achieve the second Relevant Objective (SLC50.7) that compliance with the CDCM facilitates competition in the generation and supply of electricity and will not restrict, distort or prevent competition in the transmission or distribution of electricity or in participation in the operation of an Interconnector.

On this basis the Authority is satisfied that this condition of our approval has been met.

### **IDNO charging HV split**

In our September consultation on the CDCM we commented that we do not consider that the current HV split proposed by the DNOs appropriately reflect the usage of a DNOs' network by HV connected IDNOs serving an HV end user. Our November decision required DNOs to bring forward an evidence based proposal for calculating the input HV split percentage.

Through the IDNO/DNO working group<sup>5</sup>, data on the average IDNO use of the HV network has been provided allowing DNOs to generate a national average (55%) illustrating the proportion of HV network which an IDNO owns on average to a HV end user. DNOs have

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<sup>4</sup> IDNOs are independent DNOs. They do not have a designated services area and compete to operate distribution networks across Great Britain.

<sup>5</sup> This was an industry working group established in July 2008 to provide a forum for DNOs and IDNOs to discuss IDNO UoS charging related issues.

clearly detailed the calculations behind this average in the CDCM. Whilst ideally a DNO-specific figure would be used, the Authority appreciates that some DNO areas have very few IDNO HV connections at this point in time and the use of such specific data may provide misleading and inaccurate results in such areas.

We have also noted that the information gathered to inform the split indicates that there are a relatively small proportion of IDNO networks that own a significantly larger proportion of the HV network than the national average. The use of a national average may deter the development of such networks in the future because they are not receiving a broadly appropriate share of HV network costs through the difference between the 'all the way' (ATW) and the boundary charge. We would encourage DNOs to keep the HV split under review through the open governance process. The potential options should not preclude the possibility of using more than one HV split depending on the characteristics of the downstream customers.

The Authority considers that the provision of a more robust, evidence-based calculation for the HV split is, on average, more reflective of the costs IDNOs impose on DNO networks. Consequently, we consider that it appears to better achieve the third Relevant Objective (SLC50.8) that compliance with the CDCM results in charges which, so far as is reasonably practicable after taking account of implementation costs, reflect the costs incurred, or reasonably expected to be incurred, by the licensee in its Distribution Business.

Furthermore, given that the DNOs' original CDCM submission did not allocate any of the revenues associated with the HV network to IDNOs, the Authority considers that the revisions made by DNOs to allocate some of this HV revenue to IDNOs will help to better achieve the second Relevant Objective (SLC50.7) that compliance with the CDCM facilitates competition in the generation and supply of electricity and will not restrict, distort or prevent competition in the transmission or distribution of electricity or in participation in the operation of an Interconnector.

On this basis the Authority is satisfied that this condition of our approval has been met. We note that one DNO made a formal representation against this condition on the basis that an evidence-based approach would require input from IDNOs and that this input was outside the control of DNOs. We note this representation and had data not been forthcoming from IDNOs we would have taken this factor into account as part of this decision. However, the Authority was encouraged by the fact that DNOs and IDNOs were able to co-operate in the provision of this data and develop an evidence-based approach and we therefore consider that this concern is no longer valid.

### **IDNO input data – consistency and appropriateness of input data across DNOs**

In our November decision document on the CDCM we highlighted that different DNO companies used separate underlying assumptions to populate the forward business plan questionnaire (FBPQ) data which is used as an input to the CDCM. In particular, we highlighted that these underlying assumptions may well be affecting the outputs in EDF's three DNO areas. EDF has undertaken a review of its input data and has subsequently made a number of changes to its FBPQ data in order that it better represents their costs, and they have proposed these changes should take effect from 1 April 2009 as part of an interim (pre-CDCM) charging methodology<sup>6</sup>. EDF have also included this revised input data in the revised CDCM submission of 11 December 2009.

Amongst the changes that EDF has made is to more appropriately allocate electricity safety, quality and continuity regulations (ESQCR) costs, include an updated forecast of LV load growth reinforcement capital expenditure and ongoing LV replacement capital

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<sup>6</sup> These changes are illustrated in EDF's interim IDNO UoS charging proposal which is available on Ofgem's website at:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/EDF%20Energy%20Networks%20-%20UoS%20Mod%20Proposal%2029%20-%2027112009.pdf>

expenditure. These changes have brought the capital expenditure (capex) allocations on EDF's EPN and SPN networks more into line with that used by other DNOs, although LPN's network remains a significant outlier compared to other DNOs.

We made it a condition of our November approval that DNOs had to remove the references to FBPQ data in the CDCM to allow EDF to fully review their input data and use alternative capital expenditure data which they considered appropriate. DNOs have successfully removed references to FBPQ data within the CDCM and replaced them with a reference to "forecast capex data which each individual DNO considers appropriate". This has allowed EDF to utilise their more cost reflective input data within the CDCM. Consequently we consider that this appears to meet the third Relevant Objective (SLC50.8) that compliance with the CDCM results in charges which, so far as is reasonably practicable after taking account of implementation costs, reflect the costs incurred, or reasonably expected to be incurred, by the licensee in its Distribution Business.

On this basis the Authority is content that this condition of our approval has been met.

Although we are satisfied that the condition has been met, the Authority would highlight that even after the changes EDF has made it initially had remaining concerns with the input capex data EDF uses. This capex data is a key cost driver in the CDCM and consequently has a large impact on the outputs of the methodology. These concerns particularly related to its LPN region. Given these concerns we asked EDF to thoroughly review its revised input data to ensure it was appropriate and to explain why the input data for LPN allocates a low percentage of cost to the LV network compared to other DNOs and results in an output which provides IDNOs with a much lower percentage discount on the 'all the way' tariff than other DNOs. Whilst the Authority did not expect the CDCM to produce the same or very similar IDNO discounts in each DNO, it believes it is important for DNOs to be able to explain why their IDNO tariffs are appropriate given their network characteristics.

EDF has explained that most of its LPN network is underground and that to underground the network is 10 times more expensive at the highest voltage levels (extra high voltage, EHV) compared to the LV network. This has the impact of pushing more cost into the EHV level and less into the LV level compared with DNOs who do not underground the vast majority of their network. Furthermore, EDF has highlighted that it does not have to undertake the consac<sup>7</sup> replacement programme in any of their DNO areas and that consequently there is less value in their LV network compared to other DNOs who undertake this programme. EDF has also outlined that in LPN it undertakes a significant number of high value EHV-related projects. These trigger higher levels of capital expenditure at EHV compared to LV and therefore result in a lower percentage of LV costs than other DNOs experience. EDF has provided a short summary document to explain these points, which is published alongside this decision document.

It is for EDF to satisfy itself that its input data to the methodology is robust and appropriate and does not lead to outputs which restrict, prevent or distort competition in distribution. We consider that EDF has provided evidence of some legitimate reasons as to why the proportion of costs contained in its LPN LV network would be lower than other DNOs'. However, it is for EDF on an ongoing basis to assure itself that the tariffs it offers are consistent with its licence obligations and competition law. We would anticipate that DNOs and IDNOs would continue to review the methodology and develop it over time under open governance arrangements. However, overall, given the information which EDF has now provided we consider that in regards to IDNO charging, the CDCM provides a vastly improved baseline compared to previous charging arrangements and one which can now be taken forward and adapted by industry under open governance.

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<sup>7</sup> Consac is a certain type of electrical cable which contains an aluminium sheath and paper insulation. It is more expensive than other types of LV cable available and therefore costs more to replace.

## Next steps

DNOs are required under SLC14.20 to provide their indicative charges for 2010/11 to their customers and the Authority by 31 December 2009. These charges will reflect the approved CDCM including the changes made to charges in meeting the conditions to approval of the methodology by 31 December. DNOs are expected to consider the remaining condition relating to generation charging through the early part of 2010 along with areas for further development set out in our November 2009 CDCM decision document.

The indicative charges at 31 December 2009 will also reflect in charges a small number of DNO-specific derogations against the CDCM where DNOs are not able to implement a common approach from April 2010, primarily due to billing system constraints. Our decisions on derogations have been published on our website<sup>8</sup>.

If you have any queries or comments in relation to this letter please contact [mathieu.pearson@ofgem.gov.uk](mailto:mathieu.pearson@ofgem.gov.uk) or on 0207 901 7294

This decision constitutes notice pursuant to section 49A of the Electricity Act.

Yours faithfully



**Rachel Fletcher**

**Partner, Distribution**

Duly authorised on behalf of the Authority

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<sup>8</sup> <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx>. We have not provided a decision on IDNO billing related derogation requests from Western Power Distribution and EDF Energy Networks due to ongoing development work on IDNO billing at this time.