

Modification proposal:	<b>Amendment of Western Power Distribution's (WPD) South Wales and South West Use of System (UoS) Charging Methodologies to revoke the HV/LV Distribution Reinforcement Model (DRM) Methodology from the Implementation Date of the CDCM (WPD/WALES/WEST/UOS017)</b>		
Decision:	The Authority <sup>1</sup> directs that this proposal is not vetoed <sup>2</sup>		
Target audience:	DNOs, IDNOs, Suppliers, Generators and other interested parties		
Date of publication:	18 February 2010	Implementation Date:	1 April 2010

## Background

Distribution Network Operators (DNOs) have licence obligations<sup>3</sup> to have in place a statement of use of system (UoS) charging methodology, a statement of UoS charges and a statement of connection charging methodology and charges. The statement of UoS charging methodology outlines the method by which distribution UoS charges are calculated.

From 1 April 2010, the Common Distribution Charging Methodology (CDCM) will replace DNO's existing HV/LV UoS charging methodologies. The CDCM is a common UoS charging methodology that was developed by all DNOs and approved, subject to conditions, by Ofgem on 20 November 2009<sup>4</sup>. To facilitate the implementation of the CDCM, all DNOs are obliged by SLC 50 to revoke their existing HV/LV UoS methodologies on 1 April 2010.

Similarly to the CDCM, DNOs are obliged in accordance with SLC 50A to develop common charging arrangements in relation to customers connected to their extra-high-voltage (EHV) networks (an EHV Distribution Charging Methodology (EDCM))<sup>5</sup>. The EDCM will replace DNOs' existing EHV UoS charging methodologies from 1 April 2011.

On 7 December 2009, Ofgem published its DPCR5 Final Proposals<sup>6</sup>. Our Final Proposals set out the price control settlement that will apply to each DNO between 1 April 2010 and 31 March 2015.

As a consequence of the impending implementation of the CDCM and DPCR5 Final Proposals, we asked that each DNO review their EHV methodologies. DNOs are now bringing forward modifications to their existing EHV methodologies to ensure they continue to be clear and effective from 1 April 2010, but which also have a minimal impact on charges ahead of the implementation of the EDCM from 1 April 2011.

WPD submitted a modification (UOS015) report on 11 December 2009 that set out its proposals to modify its statements of UoS charging methodologies in respect of its South

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

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

<sup>3</sup> Standard Licence Condition (SLC) 13.

<sup>4</sup> Our November 2009 decision to approve the CDCM subject to conditions is published on our website at: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=533&refer=Networks/ElecDist/Policy/DistChrgs>. Our December 2009 decision regarding DNOs' work on four of the five conditions is published on our website at: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=543&refer=Networks/ElecDist/Policy/DistChrgs>. The CDCM applies to charges at high and low voltages (HV and LV).

<sup>5</sup> This work is set out on the Energy Network Association's website at: <http://2009.energynetworks.org/edcm/>. For further information see our July 2009 decision letter at

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=487&refer=Networks/ElecDist/Policy/DistChrgs>

<sup>6</sup> See our Final Proposals document on our website at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=346&refer=Networks/ElecDist/PriceCtrls/DPCR5>

Wales and South West distribution services areas (DSAs). On 21 December 2009 the Authority notified WPD in writing<sup>7</sup> of its intention to consult on these proposals.

On 11 January 2010 WPD withdrew modification UOS015 and replaced it with a new proposal (UOS016). The new modification report was submitted because the report for WPD UOS015 contained incorrect details of WPD's indicative charges. WPD UOS016 contained the correct indicative charges and there were no additional differences between the modification reports for UOS015 and UOS016.

In accordance with SLC 13.6, on 14 January 2010, we notified WPD of our intention to consult on their proposals and also published our consultation document<sup>8</sup>. The deadline for responses was 11 February 2010.

Following the conclusion of our consultation of WPD's modification proposal UOS016, WPD withdrew their modification proposal because of concerns raised in consultation responses regarding the capping of LRIC charges, specifically around the lack of justification for the approach being proposed.

On 12 February 2010, they submitted a revised version, UOS017, which excluded changes originally raised in UOS016 in relation to excluding assets from and capping certain asset charges from the calculation of final charges for pre-2005 distributed generators (DG)<sup>9</sup>.

We received 8 responses to this consultation which have been placed on our website. We refer to responses within the section of this decision that sets out the reasons for the Authority's decision where they are directly relevant to this modification proposal UOS017.

### **Summary of WPD's proposals**

WPD's proposals seek to make changes to its methodology to take account of the implementation from 1 April 2010 of both the CDCM and DPCR5 – which, amongst other things, removes an exemption that allows the DNOs to not charge pre-2005 DG from paying generation distribution use of system (GDUoS) charges.

WPD proposes to make the following changes<sup>10</sup>:

- Clarify charging arrangements for pre-2005 DG;
- Update references to regulatory cost of capital following the publication of the DPCR5 final proposals<sup>11</sup>;
- Update the section entitled 'Reconciliation of LRIC and DRM<sup>12</sup> output to required revenue' to ensure the calculation of the £/kVA revenue fixed adder remains effective;
- Remove the 10 per cent cap on generator charge changes;

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<sup>7</sup> This letter can be found on our website at:

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

<sup>8</sup> Please see:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=662&refer=NETWORKS/ELECDIST/POLICY/DISTCHRGMODS>

<sup>9</sup> For more details of WPD's proposal UOS016, please refer to the relevant modification proposal which can be found on our website at

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=661&refer=NETWORKS/ELECDIST/POLICY/DISTCHRGMODS>

<sup>10</sup> Full details of WPD's modification proposal can be found in the modification report which can be found on our website at <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx> and in Annex 1 to our January 2010 consultation document.

<sup>11</sup> UOS017 comes after our decision on the CDCM and DPCR5 final proposals and incorporates one key difference in approach from WPD's earlier modification proposal, UOS013, that we vetoed in September 2009.

<sup>12</sup> Long-run incremental cost and distribution reinforcement model.

- Update references to licence conditions; and
- Replace a large section on the requirements to have a UoS agreement and the terms in those agreements with a single reference to the Distribution Connection and Use of System Agreement (DCUSA).

### Reasons for the Authority's decision

In coming to its decision **not to veto** this proposal, the Authority has considered the proposed modification against the Relevant Objectives<sup>13</sup> and the Authority's principal objective and wider statutory duties<sup>14</sup>.

In summary, we have not vetoed WPD's proposal because it will ensure that their EHV UoS charging methodology will facilitate the introduction of the CDCM and DPCR5 proposals. We consider that in general the changes to charges for EHV customers are generally modest (when compared to current and indicative charges<sup>15</sup>) and are appropriate for the remaining lifetime of the SLC13 charging methodology statement before a common charging methodology at EHV (the EDCM) is expected to be introduced on 1 April 2011. In the few circumstances where changes to charges are more significant, when compared to WPD's indicative charges, we expect that WPD should contact these customers to explain what is driving these changes.

Our decision is based on WPD's proposal better achieving relevant objectives c) and d). A detailed summary of our reasons follows below.

*Relevant objective (c) - that compliance with the use of system charging 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;*

WPD propose to remove a  $\pm 10$  per cent cap on changes to charges from one year to the next. The cap was originally introduced to limit volatility in GDUoS charges at a time when they were relatively small and therefore very sensitive to changes in a small allowed revenue for DG.

WPD consider that the cap is no longer necessary following the decision as part of DPCR5 Final Proposals to combine demand and generation allowed revenues. This is because it will no longer be necessary to scale generator charges to a specific generation allowed revenue and that by removing the cap charge calculation will be more cost reflective.

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<sup>13</sup> The relevant objectives for the use of system charging methodologies, as contained in paragraph 3 of SLC 13 of the distribution license respectively are:

- that compliance with the use of system charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Act and by the licence;
- that compliance with the use of system charging 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;
- that compliance with the use of system charging 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
- that, as far as is consistent with the sub-paragraphs above, the use of system charging methodology, as far as is reasonably practicable, properly takes account of developments in the licensee's distribution business.

<sup>14</sup> 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.

<sup>15</sup> WPD are obliged by SLC 14 to publish indicative charges, three months ahead of when they are to take effect. In this case, WPD published such charges on 16 December 2009, with the intention that they would take effect from 1 April 2010. WPD published these charges on the assumption that their proposal, UOS016, would be implemented.

We consider that the removal of the cap will facilitate the calculation of more cost reflective charges. In particular, the removal of the cap will mean that existing customers final charges fully reflect the cost signal calculated through WPD's LRIC model and new customers charges are not unnecessarily inflated/deflated so as to recover revenue that cannot be recovered from existing customers who have their charges capped. Therefore, we consider that WPD's proposal will better achieve relevant objective (c).

*Relevant objective (d) - that, as far as is consistent with the sub-paragraphs above, the use of system charging methodology, as far as is reasonably practicable, properly takes account of developments in the licensee's distribution business.*

As set out above, WPD propose to make a variety of changes to their methodology that take account of recent decisions in relation to the CDCM and DPCR5.

In light of the impending implementation of the CDCM and revocation of their current HV/LV charging methodologies, WPD have proposed changes to their EHV UoS charging methodologies to ensure that it remains operable and clear. Whilst these changes are predominantly incidental changes to references to the methodology for calculating HV/LV charges (via the CDCM) and licence conditions, WPD have also updated their revenue reconciliation process so that it uses the CDCM's 500MW model to split allowed revenue between the EHV method and the CDCM.

As set out in their modification report, the overall impact of WPD's proposal is that EHV demand customers will pay proportionately more. However, 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<sup>16</sup>.

One respondent to our consultation on WPD's modification proposal UOS016 considered that WPD's proposal was inappropriate and that they should continue to use a specific model of their own network, as opposed to the aggregate 500MW model developed in collaboration with all other DNOs for the CDCM. They were concerned that a similar approach used in relation to a different network that had certain network design characteristics (i.e. a high level of underground cabling) would have a more pronounced impact on the split of revenue when compared to other DNOs' networks.

Whilst WPD's proposed methodology could have more clearly explained 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 to effectively split revenue between their EHV methodology and the CDCM. Furthermore, we consider that whilst the 500MW model does not allow for specific network design characteristics to be taken account of in the split of revenue, it is nevertheless an appropriate common and transparent model developed and agreed on by all DNOs.

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, using P2/6 capacity, be zero for wind farms. 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 and that this is appropriate in the period before the EDCM comes in to effect, which is expected from 1 April 2011.

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<sup>16</sup> 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.

Two consultation responses to WPD's earlier modification proposal UOS016 comment on this issue and agree that applying no scaling to EHV DG appears appropriate at this time.

Minimal change in charges for 1 April 2010 is important given that the development of the EDCM in accordance with licence condition 50A will require DNOs to bring forward one of two common approaches for EHV charging by 1 September 2010, for implementation from 1 April 2011. In light of the minimal impact of their proposal, we consider that in the interim, WPD's proposal to not scale DG charges is appropriate and takes account of current and future developments in their distribution business.

Like the CDCM, DPCR5 Final Proposals will take effect from 1 April 2010. Consequently, WPD propose to update their UoS methodology to take account of two particular changes in relation to pre-2005 DG charging and cost of capital.

From 1 April 2010, an exemption enjoyed by all DNOs from charging pre-2005 DG will be lifted. To reflect this, WPD propose to amend their methodology to make it clear that the exemption has been lifted but until appropriate enduring arrangements are developed in collaboration with the industry, no charges will be levied on pre-2005 EHV DG.

In light of responses to our consultation of WPD's modification proposal UOS016, we consider that this proposal is appropriate and helps to manage stakeholders' expectations in relation to pre-2005 DG charging. This is because respondents had raised concerns about the cost reflectivity, predictability and transparency of WPD's proposals and the overall development of enduring arrangements for charging pre-2005 DG by all DNOs. In order to develop appropriate enduring arrangements, we consider that a collaborative effort by the industry is an effective way forward.

WPD also propose to amend the value of cost of capital used in their methodology from 6.9% to 5.6%<sup>17</sup>. This change reflects the change in cost of capital between the current price control (DPCR4) and the proposed price control (DPCR5) to take effect from 1 April 2010. Two consultation responses to WPD's earlier modification proposal UOS016 comment on this issue and consider that updating the cost of capital appears sensible.

We consider that WPD's proposal to amend the value of cost of capital in their UoS charging methodology is appropriate and reflects our Final Proposals.

In our view, WPD's proposals to reflect decisions made in relation to the CDCM and DPCR5 Final Proposals reasonably reflect changes in their distribution business and therefore better achieve relevant objective (d).

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

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**Senior Partner, Local Grids and RPI-x@20**  
**Signed on behalf of the Authority and authorised for that purpose**

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<sup>17</sup> The value of cost of capital that WPD use in their UoS method (currently 6.9%; proposed 5.6%) is the same as the cost of capital we set out in our Final Proposals (currently 5.5%; proposed 4.7%). However, note that WPD use pre-tax cost of debt and equity to calculate cost of capital, whereas for the purposes of DPCR5 Final Proposals, we use the pre-tax cost of debt and post-tax cost of equity to calculate cost of capital (i.e. the 'vanilla WACC').