

Guidance on third party access charges for licence exempt gas and electricity distribution networks

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Target audience: Consumers and their representatives, distribution network operators (DNOs), independent distribution network operators (IDNOs), owners and operators of distributed energy schemes, suppliers and any other interested parties.

Overview:

Licence exempt gas and electricity distribution networks will have an obligation to provide third party access once the legislation implementing the Third Energy Package has come into force in Spring 2011. Currently UK law does not require exempt network operators to offer third party access.

All exempt distribution network owners wishing to charge tariffs for connection to and use of the network will need to publish these tariffs and a methodology for calculating them. All methodologies will need to be approved by Ofgem before they come into force.

This document consults on a high level common methodology for the setting of network tariffs by licence exempt network owners and on a process for approving the methodologies of licence exempt network owners for calculating network tariffs.

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Context

The requirement to provide third-party access to gas and electricity distribution systems is set out in Article 32 of the EU Gas and Electricity Directives¹. Tariffs for third party access in Great Britain, or the methodologies underlying them, are required to be approved by Ofgem and must be applied objectively and without discrimination between system users.

To date, the UK Government has implemented the EU Gas and Electricity Directives in respect of Great Britain through a combination of legislation, licences and industry codes. Under current arrangements, an entity which operates under a gas or electricity distribution licence exemption is exempt from the requirement (present in distribution licences) to provide third party access to the system.

However, the May 2008 European Court of Justice's ruling in the Citiworks case (Citiworks AG v Sächsisches Staatsministerium für Wirtschaft und Arbeit als Landesregulierungsbehörde (C-439/06)) clarified that the requirement to provide third party access applied in respect of all distribution systems, and that it is not open to Member States to exempt certain types of distribution systems from the requirement unless a specific derogation had been granted under the Gas and Electricity Directives.

In light of the Citiworks ruling, the Government now needs to make provision for third party access to licence exempt distribution systems. Under the provisions of the Article 32 Ofgem as the National Regulatory Authority must approve methodologies used by exempt network owners for calculating distribution tariffs before they come into force. To minimise the administrative burden on exempt networks Ofgem intends to outline a common methodology that these networks can opt for and issue some guidance on how they might comply with it.

Associated Documents

[DECC Consultation on the provision of third party access to licence exempt electricity and gas networks](#)

[Directive 2009/72/EC of 13 July 2009 concerning common rules for the internal market in gas](#)

[Directive 2009/72/EC of 13 July 2009 concerning common rules for the internal market in electricity](#)

¹ Directive 2009/72/EC of 13 July 2009 concerning common rules for the internal market in gas and Directive 2009/72/EC of 13 July 2009 concerning common rules for the internal market in electricity repealing Directive 2003/54/EC.

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Summary

The Government has proposed to make changes to existing legislation to ensure that licence exempt electricity and gas distribution system operators offer third party access as required under Article 32 of the EU Directives for the internal market in electricity and the internal market in natural gas. Currently, licence exempt distribution network operators are in a position to refuse to offer terms for third party access.

Third party access can be described as:

- customers being able to use a system that they do not own or control in order to transport gas or electricity purchased for their own use or for resale;
- suppliers being able to use a system that they do not own or control in order to transport gas or electricity for sale to customers.

The requirement to allow third party access to licence exempt networks will be set out in legislation, and will be enforceable by Ofgem as the National Regulatory Authority (energy) in Great Britain.

As with licensed distribution networks, all exempt distribution network owners wishing to charge tariffs for connection to and use of their network will need to seek approval from Ofgem for the methodology used to calculate tariffs before it comes into force. Where parties seeking or already making use of third party access to exempt distribution networks dispute the application of methodologies' then they are able to refer the dispute to Ofgem for resolution.

Objectives

This document consults on a common methodology that licence exempt distribution network operators can employ to set charges for third party connection to and use of their distribution system. It also sets out the process which Ofgem proposes to follow to approve exempt distribution network operators charging methodologies, whether they choose to adopt the common methodology or propose an alternative. We also provide guidance on the terms and conditions for connecting to an exempt distribution system.

The objectives of introducing a common methodology with guidance on how to implement it is to minimise the administrative burden for exempt network operators in providing third party access and to provide stakeholders, including those wishing to access exempt networks, with as much clarity as possible about the charging aspects of the third party access regime. Stakeholders should also monitor the Government's response to their consultation on third party access to licence exempt distribution for further guidance on the commercial and technical requirements applying to these systems. This document has been published in parallel to the Department of Energy and Climate Change's (DECC's) consultation process to support the transition to the new arrangements for licence exempt distribution systems.

Methodology for Calculating Tariffs

The standard requirement for distribution use of system tariffs is that they are set to recover the costs incurred by the distribution system operator in its distribution business. Distribution system costs are therefore commonly used as the starting point for calculating distribution tariffs. We are proposing a similar approach for licence exempt gas and electricity distribution systems.

A licence exempt distribution network operator should recover an amount of revenue from its customer base that is consistent with the operating costs and capital expenditure (both depreciation and a reasonable profit) associated with its network. Each "building-block" of the exempt distribution network operator's costs, and how these are reflected in a final use of system tariff, should be justified by reference to a separate set of current and historical accounts prepared specifically to reflect the costs of the operation of the distribution system. To turn these costs into final tariffs they need to be allocated to individual users of the distribution system on an objective and justifiable basis. It is also important that the final tariffs should not favour one user of the distribution system over another. That is to say, the final use of system tariff should be applied on a non-discriminatory basis.

We intend that the common methodology for calculating tariffs should be high level and allow exempt network owners a degree of flexibility in the structure of the charges that they apply to network users. To that end, the common methodology will consist of the high level principles outlined above, namely:

- the resulting tariffs must be justified by reference to the costs of the distribution network as evidenced by accounts specific to the operation of the network;
- costs must be allocated to individual network users on an objective and justifiable basis; and
- the final tariff must not favour one user over another.

Network operators will need to inform us that they intend to calculate their final distribution tariffs by reference to the common methodology. Where they wish to, exempt operators may submit more detailed methodologies to us for our approval. These methodologies will be judged against the high level principles outlined above.

Next steps

We are seeking stakeholder views on our proposal to introduce a common charging methodology that licence exempt networks can opt for, the high level charging principles that underpin it and our proposed process for approving methodologies. To this end, we have posed a number of specific questions to industry stakeholders in this document. The response to these questions will provide some direction on the matters that we are seeking to clarify. Respondents may wish to provide views on other matters they consider relevant to the provisions of third party access in the EU Gas and Electricity Directives. The consultation period will run for six weeks. We will then publish guidance based on consideration of views arising from this consultation.

1. Introduction

Chapter Summary

This chapter outlines the context to this document, including the role of the Office of Gas and Electricity Markets in approving network charges, the licence exemption regime for gas and electricity networks and the Government's proposals to ensure that exempt distribution networks offer third party access if requested.

Context

The Office for Gas and Electricity Markets

1.1. The Office for Gas and Electricity Markets (Ofgem) is the national regulator in Great Britain. The Gas and Electricity Markets Authority (GEMA) is the governing regulatory authority of Ofgem. GEMA determines strategy, sets policy priorities and takes decisions on a range of matters, including price controls, charging methodologies and enforcement, across Great Britain's energy sector.

EU Gas and Electricity Directives

1.2. The EU Directive concerning common rules for the internal market in electricity (the "Electricity Directive"), and the EU Directive concerning common rules for the internal market in natural gas (the "Gas Directive") outline a set of common rules for transmission, distribution, supply and storage in EU's main internal energy markets. The objective of the legislation is to promote consumer choice and fair competition.

1.3. Article 32 of the Gas and Electricity Directives, require Member States to ensure the implementation of a system of third party access to gas and electricity transmission and distribution systems based on published tariffs, applicable to all eligible customers and applied objectively and without discrimination between system users.

Licence exemptions

1.4. Under the Electricity Act 1989, it is illegal to generate, transmit, distribute or supply electricity without a licence or an exemption from the requirement to have a licence. A system of exemptions in Great Britain was formalised by the Electricity (Class Exemptions from the Requirement for a Licence) Order 2001 (the "Class Order 2001"). These exemptions allow transmission and distribution operators to operate without a licence.

1.5. Similarly, under the Gas Act 1986, a licence is required to convey gas through pipes to premises or to a pipe-line system operated by a gas transporter, to supply gas which is conveyed to premises through pipes, or to arrange for gas to be put into, conveyed on or taken out of a pipe-line system. Exemptions from the requirement to hold a licence are contained in various exemptions orders made under s.6 Gas Act 1986 and a number of exceptions from the prohibition on the carrying out of activities without a licence are contained in schedule 2A to that Act.

1.6. Under current arrangements, an entity which operates under an electricity distribution exemption is exempt from the requirement (present in distribution licences) to provide third party access to the system. An entity which distributes gas under an exemption or exception from the requirement to hold a gas transporter's licence is, like an exempt electricity distributor, also exempt from the requirement to provide third party access to the system.

Citiworks AG

1.7. In May 2008, the European Court of Justice's (ECJ) ruling in Citiworks AG clarified that the requirement to provide third party access applied in respect of all distribution systems, and that it was not open to Member States to exempt certain types of distribution systems from the requirement unless a specific derogation had been granted under the Directives.

1.8. The complaint in Citiworks had been brought by an electricity supplier seeking to compete with a monopoly supplier at Leipzig airport. The ECJ ruled that the German law which exempted the owners of certain systems from the requirement to provide third party access contravened the requirement to provide for third party access to distribution systems. The judgment made it clear that, unless a specific derogation had been granted under the Directive, all distribution networks must be open to third party access so that customers connected to those networks have the option to choose their own electricity and gas suppliers.

1.9. In light of the Citiworks ruling, the Government needs to make provision for third party access to licence exempt distribution systems. The Department of Energy and Climate Change (DECC) issued a consultation on 19th October setting out the Government's proposals on this issue².

Government proposals

1.10. The Government has proposed changes to legislation to ensure that licence exempt electricity and gas distribution network operators offer third party access as

² DECC (2010): 'Consultation on the provision of third party access to licence exempt electricity and gas networks'

required under the Electricity and Gas Directives. The requirement to allow third party access to licence exempt networks will be set out in legislation, and will be enforceable by Ofgem as the National (energy) Regulatory Authority in Great Britain.

1.11. As with licensed distribution networks, all exempt distribution network owners wishing to charge tariffs for connection to and use of the network will need to seek approval from Ofgem of the methodology they will use to calculate final tariffs. To minimise the administrative burden on exempt networks, we intend to outline a common methodology that these networks can opt for and issue some guidance on how they might comply with it.

Purpose of this document

1.12. This document consults on a common methodology that licence exempt distribution network operators (ENOs) can employ to set charges for third party use of their networks. It also sets out the process we propose to follow to approve ENO methodologies for calculating network tariffs.

1.13. The rest of this document is structured as follows:

- Chapter 2 provides background information on third party access and technical terms related to distribution system charging methodologies.
- In Chapter 3 our proposed common approach for calculating use of system charges is outlined.
- Chapter 4 considers the basis and terms and conditions for third-party connection to licence exempt distribution networks.
- Chapter 5 outlines our proposed approval process for third-party access charges, including reporting requirements.
- The final chapter sets out next steps and summarises the information provided in this document.

2. Third party access and network charges

Chapter Summary

This chapter provides background on the legal, commercial and technical issues referred to throughout this guidance document.

Overview

2.1. The requirement to provide third party access to distribution systems is set out in Article 32 of the Gas and Electricity Directives. In this section we provide background on the third party access requirements in the Directive and on DECCs proposed implementation of those requirements.

2.2. Also in this section we provide some guidance on what can be reasonably covered by charges made by the owners of energy infrastructure with respect to the users of that infrastructure.

Third party access

2.3. The text box below provides a high-level definition of third party access as it relates to gas and electricity systems:

Third-party access

Third party access can be described as:

- ➔ customers being able to use a system that they do not own or control in order to transport gas or electricity purchased for their own use or for resale;
- ➔ suppliers being able to use a system that they do not own or control in order to transport gas or electricity for sale to customers.

2.4. Article 32 of the Gas and Electricity Directives requires that a system of third party access to the distribution system be based on published tariffs, applicable to all eligible customers and applied objectively and without discrimination between system users.

2.5. The text box below summarises the key requirements for fixing or approving methodologies used to calculate or establish the terms and conditions for connection and access to national networks:

Terms and Conditions of third-party access

Article 32

- ➔ Tariffs, or the methodologies underlying their calculation, should be approved prior to their entry into force in accordance with Article 37 (see below).
- ➔ The tariffs, and the methodologies underlying their calculation, should also be published prior to entry into force.
- ➔ The distribution system operator may refuse access where it lacks the necessary capacity. Duly substantiated reasons must be given for such refusal and based on objective and technically and economically justified criteria.
- ➔ The national regulatory authority (Ofgem) shall ensure that those criteria are consistently applied and that the system user who has been refused access can make use of a dispute settlement procedure.
- ➔ The national regulatory authority (Ofgem) shall also ensure, where appropriate and when refusal of access takes place, that the distribution system operator provides relevant information on measures necessary to reinforce the network.

Article 37

- ➔ Tariffs and methodologies shall allow the necessary investments in the networks to be carried out in a manner allowing those investments to ensure the viability of the networks.

2.6. It is important to note that the third party access requirements will not apply to all owners of energy infrastructure. As DECC's consultation on the application of the third party access requirements makes clear, they will only apply to infrastructure that meets the definition of a distribution system operator under the Directive. DECC will publish guidance on which infrastructure meets the definition prior to the changes in legislation, implementing third party access for ENOs, coming onto force.

Network charges

2.7. All ENOs wishing to make charges for connections to and use of their networks must seek approval for the methodology used to calculate final tariffs before they come into force. Where no charges for use of the network are to be made, no tariff needs to be put in place or approved by Ofgem. That is, the Government is not proposing to impose any third party access obligations on exempt distribution networks unless a customer has expressed an interest in obtaining access to the system or being supplied by an alternative supplier.

2.8. Network operators typically impose network charges to recover the costs of operating their networks. It is reasonable for owners of energy networks to levy network charges on parties who make use of their network that reflect the cost of providing network services.

2.9. The standard approach to network charges is to split the recovery of costs between charges made at the time of connection to the network and charges made for on-going use of system charges for utilisation of the network. Typically, although not exclusively, the initial charges reflect the incremental cost of providing connections to the network and upgrading it to accommodate a new user, whilst the on-going charges are a contribution to the on-going costs of operating and maintaining the network.

2.10. For each aspect of the network charges a number of different things need to be considered when determining final tariffs:

- What costs are included (the “coverage of the charge”)?
- What is the structure of the charges (how are costs recovered from the customer base)?
- Who pays (which customers should contribute to network costs and how much)?

2.11. In the sections which follow we set out some high level principles that will form a common methodology that an ENO can employ when setting final network charges (tariffs) as well as some guidance for how a final charge may be determined using these principles. These principles will also form the basis that we propose to evaluate any more detailed methodologies put to use by ENOs for approval.

3. Calculating Network Charges

Chapter Summary

Network charges are intended to recover the costs of providing access to and maintaining and operating distribution networks. In this section we summarise the high level principles for network charges and provide some guidance on how they might work in practice.

Questions:

Question 1: Do you have any views on the proposed principles that will underpin ENOs' network charges?

Question 2: Is the common methodology we have proposed proportionate? Is further guidance required on particular issues?

3.1. For each stage of the methodology, we provide definitions of terms and the information the ENO will need to calculate its connection and use of system tariffs. At the highest-level, ENOs will need to calculate its distribution tariffs with reference to the costs of its distribution system, as set out in a separate set of accounts for the distribution business.

3.2. The rest of this section is structured as follows:

- We describe the objectives of the networks charges.
- We then outline the broad structure of network charges.
- We provide guidance on identifying network costs.
- We provide guidelines on how costs are allocated to final tariffs.
- Finally, we outline a number of consultation questions on the common use of system charging methodology.

Objectives and principles

3.3. As we have noted above, the main purpose of network charges is to recover the costs of maintaining and operating the network. Therefore the key principle underpinning any charges is that they should reflect these costs. Typically a network will involve more than one user and therefore the network costs will need to be shared between all users. Consequently a network charging methodology will need to allocate costs to different users. Any methodology for determining the final charges to different users needs to be objective and justifiable and to not favour one user

over another. Therefore, the key charging principles that an ENO charging methodology must conform to are that:

- the resulting tariffs must be justified by reference to the costs of the distribution network;
- costs must be allocated to individual network users on an objective and justifiable basis; and
- the final tariffs must not favour one user over another.

3.4. These principles require that network costs are allocated in a reasonable manner across all network users. This will include users who are third party access users and other networks users including any that are affiliated with the network owner.

Structure of network charges

3.5. The standard approach to network charges is to split the recovery of costs between charges made at the time of connection to the network and charges made for ongoing utilisation of the network.

3.6. Both the upfront customer charges and the on-going use of system charges should be determined according to the principles set out above. Where costs have been recovered through upfront customer contributions they should not be included in the calculation of on-going tariffs.

3.7. We do not specify a particular structure to the various elements of network charges. We recognise that ENOs will currently be recovering costs in a variety of different ways from network users. The differences in form of cost recovery will no doubt reflect the different circumstances of each network owner and the requirements of the network users.

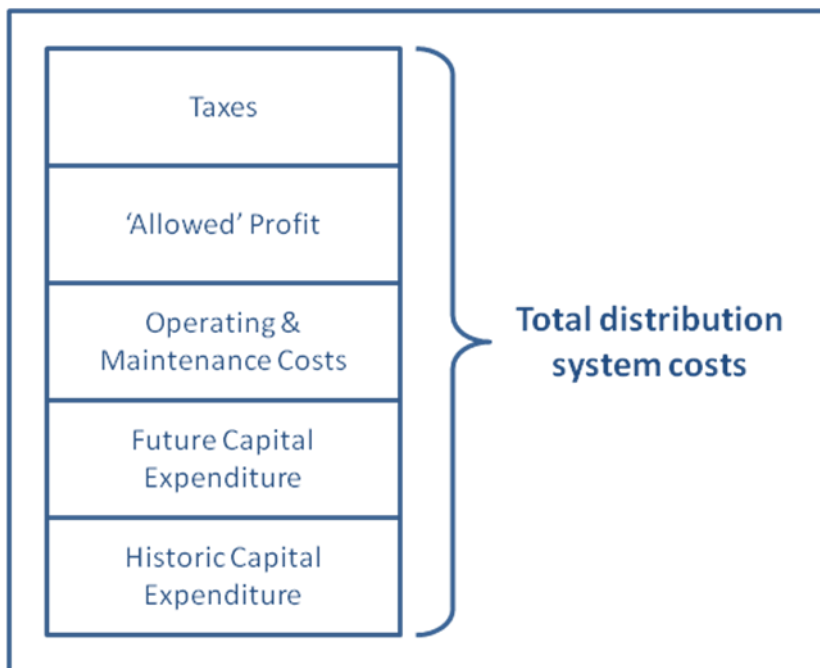
3.8. It is not our intention that ENOs are required to adopt a particular structure for their network charges. It is our intention that ENOs should retain the flexibility to recover network costs in a way that meets their needs and the needs of their networks users. What is important is that the final tariff and how it is derived and applied can be evidenced as being consistent with the principles outlined above.

Identifying network costs

3.9. ENOs should recover an amount of revenue from its customer base that is consistent with the operating and capital expenditure of its business. Tariffs should therefore be set at a level that recovers the annual capital costs of the distribution system, and the annual operating expenditure to operate and maintain the distribution system.

3.10. The main elements ("building-blocks") of revenue to be recovered from a customer base is set out in Figure 3.1.

Figure 3.1: The Elements of ENO allowed revenue



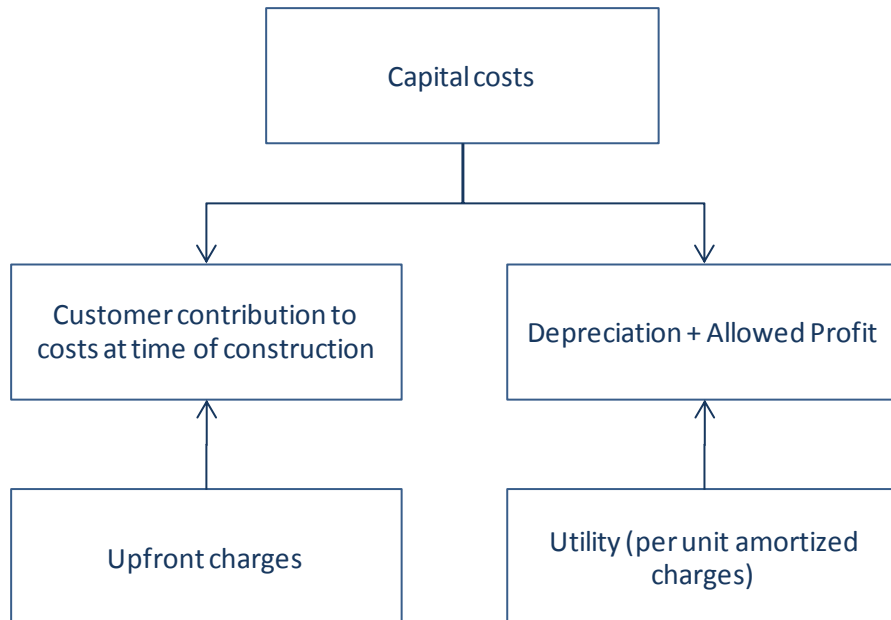
3.11. We consider each component ("building-block") of the use of system charging methodology in the sections which follow.

Capital expenditure

3.12. The ENO will need to demonstrate which capital costs have been contributed to ("expensed") by existing users of the network (capital contributions arise when customers made payments to the distribution system owner, which contributed to the original costs of constructing the distribution system assets).

3.13. Customer contributions should be justified by reference to the historical accounts prepared for the operation of the distribution system.

3.14. Customer contributions may be recorded as revenue, in full, in the year in which they are received. Alternatively, the value of the contribution can be deducted from the value of the asset. This is an accounting issue for the ENO to address in the preparation of its distribution system accounts. Where capital costs are recovered through customer contributions they should not be included in the calculation of the on-going use of system charges.

Figure 3.2: Key issues related to capital expenditure

3.15. Alternatively, the ENO may choose to recover the capital costs of the distribution system over an estimated period of benefit, or the useful economic life of the distribution system assets (depreciation of capital costs). This should occur through two separate accounting charges:

- a depreciation charge (capital expenditure spread over a period of years);
- an allowed rate of return ("profit") on the capital employed.

3.16. The ENO will need to justify the depreciation charge included in its tariff by reference to the accounts for its distribution system. The ENO will also need to justify its view of the appropriate cost of capital (profitability) for remunerating the capital invested in the gas or electricity distribution system.

3.17. The text box below provides some high-level guidance on how a distribution system owner could approach the calculation of the depreciation charge and an appropriate cost of capital (allowed profitability) for the distribution system. This is provided simply as guidance and so in Appendix 2 we have also provided a worked example of how a ENO might seek to apply this approach using simplified illustrative assumptions.

3.18. Ultimately it is for the ENO to justify the assumptions used to calculate third party access tariffs. ENOs may also adopt their own methodology to calculate the depreciation, cost of capital or any other element of the network tariff should they wish to do so.

Depreciation and Allowed Profitability

In this text box we set out a method which ENO's could adopt to calculate the depreciation and allowed profitability element of the TPA tariff.

(1) ENOs should obtain the historic cost of constructing the distribution system. The historic asset value of the network should be justified by reference to the accounts prepared for the operation of the distribution system.

(2) The historic asset value of the distribution system should then be uplifted by inflation (Retail Price Index (RPI)) from the year in which the distribution system came into operation to the current year in which TPA is being provided.

(3) Once the asset base of the network has been uplifted for inflation, the Net Book Value of the network can be calculated:

i) The current cost of the network should be divided by an appropriate depreciation asset life for the network (for example, 45 years) to derive an annual depreciation charge for the network.

ii) The Net Book Value of the distribution system can then be calculated by subtracting accumulated depreciation for each year since the network came into operation from the current value of the network.

(4) The rate of return on the capital invested in the distribution system should be consistent with the risks of the business.

One approach to calculate the rate of return (allowed profit) could be:

Allowed profit = Cost of Capital x Net Book Value of distribution assets

The distribution system owner could use the Cost of Capital adopted by Ofgem for licenced network operators in the gas and electricity sectors. This is: 4.7% in electricity distribution; and 4.94% in gas distribution.

The Cost of Capital adopted for licensed network operators is a (post tax) real return on capital employed.

Operating expenditure

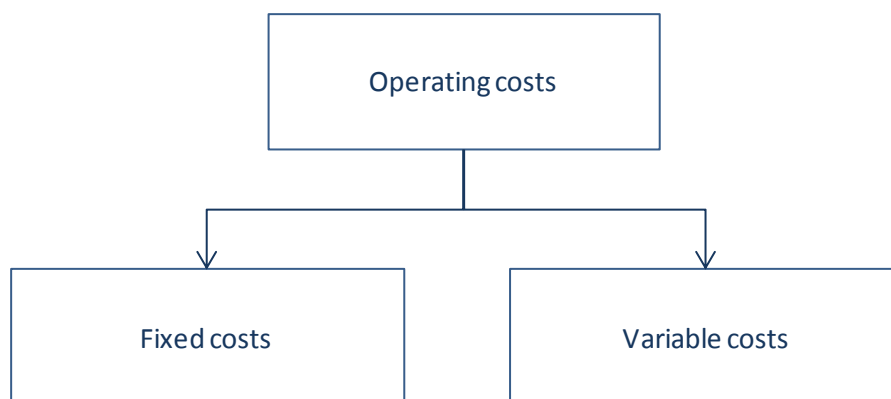
3.19. Operating and maintenance costs should reflect the fixed and variable costs associated with provision of the distribution system. The ENO should identify and quantify (where possible) expenditure that represents a fixed business cost (i.e. expenditure that does not materially vary with the level of activity performed).

3.20. In addition, the ENO should identify and quantify (where possible) expenditure that represents a variable business cost (i.e. expenditure that is directly related to the activity performed).

3.21. Operating and maintenance expenditure should be justified by reference to the separate set of accounts prepared for the operation of the distribution system. Where practicable, the ENO should demonstrate those costs that are shared with other parts of its business (see section on cost allocation below).

3.22. Figure 3.3 below illustrates the different components a ENO's tariff submission will need to address in relation to operating and maintenance expenditure. Each of these building blocks of operating expenditure should be based on the accounts for the distribution system business.

Figure 3.3: Key issues related to operating expenditure



Taxation

3.23. The ENO will need to calculate the value of taxes paid on profit arising from its operation of the distribution system. The ENO should demonstrate how taxation costs have been allowed for in setting the final use of system charge.

3.24. Taxation costs should be justified by reference to the separate set of accounts prepared for the operation of the distribution system.

Cost allocation

3.25. Tariffs should only include expenditure that is directly relevant to the licence exempt distribution system. For the purposes of approving the third party use of system tariff, Ofgem may require the ENO to disclose:

- asset values and the recovery of the costs of providing those assets;
- future capital expenditure (if any);
- operating and maintenance expenditure.

3.26. Each of which must be allocated to:

- activities related to the operation of the distribution system; and
- other activities related to ENO related businesses.

3.27. The ENO should be able to demonstrate how each of the components are then applied to derive the final use of system charge. Tariffs must be calculated based on the separate accounts prepared by the ENO for the operation of its gas or electricity distribution system.

3.28. It is useful to re-state that ENOs should ensure that 'building blocks' of system cost relate specifically to assets and activities involved in the operation of the distribution system. As such, they should not include costs related to any other activities, such as the supply of energy to customers.

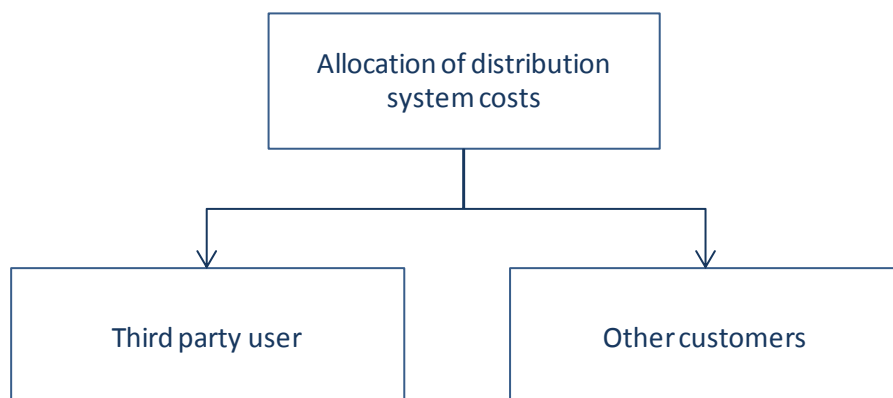
Allocating Costs to Final tariffs

3.29. Having calculated total distribution system costs, the ENO will need to demonstrate how it proposes to recover those costs from its customer base. The allocation of distribution system costs to the third party user should be reasonable and fair, given their use of the distribution system.

3.30. For example, total system costs could be allocated according to capacity required by the customer. The terms of access, and the tariffs applied, should not favour one user of the distribution system over another. That is to say, the final use of system tariff should be applied on a non-discriminatory basis.

3.31. The ENO should also demonstrate whether it intends to revise the tariff at a later date. This also applies to the unit of demand adopted by the ENO for setting the final tariff (for example, the period over which the customer's capacity (used to allocated distribution costs) remains fixed).

Figure 3.4: Allocation of costs to use of system charges



Setting tariffs in future periods

3.32. The sections above provide high-level guidance on the approach a ENO can adopt to calculate final TPA charges. The ENO will need to apply the common methodology (or an approved methodology of its own) on an enduring basis for future charging periods.

3.33. Where the depreciation charge and rate of return on capital have been calculated following the guidance in the text box above, the ENO will need to uplift future charges by inflation (RPI) so as to avoid recalculating the building blocks of the tariff calculation while also providing a reasonable rate of return for the network owner based on its assumption of the Cost of Capital of the gas or electricity distribution business.

Summary of elements of setting tariffs

3.34. Table 3.1 below provides a check-list for each building-block of the common use of system charging methodology.

Table 3.1: Summary of elements of setting tariffs

Component	Summary of requirements
Capital expenditure	<ul style="list-style-type: none"> Establish customer contributions and depreciation charges to recover capital expenditure
Operating expenditure	<ul style="list-style-type: none"> Operating and maintenance costs should reflect fixed and variable costs associated with distribution system provision
Rate of return	<ul style="list-style-type: none"> Justify view on appropriate rate of return (profitability) for distribution business
Taxation	<ul style="list-style-type: none"> Demonstrate how taxation costs have been allowed for in setting use of system tariff
Cost allocation	<ul style="list-style-type: none"> Prepare separate set of accounts for distribution system
Setting final tariff	<ul style="list-style-type: none"> Demonstrate how distribution system costs are recovered from customer base

4. Connection arrangements

Chapter Summary

This chapter considers the basis and terms and conditions for third party connection to licence exempt distribution networks.

Conditions of connections

4.1. Under Article 32 of the Gas and Electricity Directives, licence exempt distribution network operators may only refuse third party access if the system lacks the necessary capacity to cope with any requested additional use.

4.2. Where such a refusal is made, the ENO will need to provide duly substantiated reasons for such a refusal, based on objective and technically and economically justified criteria.

4.3. However, when a refusal of access has taken place, the ENO must also provide relevant information to the third party on the measures that would be necessary to reinforce the network and facilitate access to the system (this is a requirement under Article 32 of both the Gas and Electricity Directives). The ENO may also levy a charge reflecting the cost of providing such information to the third party user.

Terms of connection

4.4. When an ENO is required to offer terms for access to the distribution system, use of system charges should be calculated with reference to the common methodology outlined in the previous section. Alternatively an ENO may also choose to establish their own methodology for calculating tariffs.

4.5. Charges for connecting to the system should reflect the costs of providing the connection to the distribution system. The costs of connection to the system should not be shared with the existing users of the network (i.e. there should be no offsetting or subsidising of such charges). The ENO is required to facilitate necessary connection work and provide all relevant information and physical access to support efficient access to and use of the system.

4.6. As outlined in DECC's consultation on the provision of third party access to licence exempt electricity and gas networks, if there is no existing capacity the ENO is not required to carry out the work to reinforce the network.

5. Process for approval

Chapter Summary

This chapter outlines the process Ofgem intends to follow to approve charging methodologies for third party use of system.

Question Box:

Question 3: Is our proposed approach appropriate? Are there other arrangements which could be put in place and would help the sector comply with the obligations?

Process

5.1. We have summarised each stage of the proposed approval process for use of system charges in Figure 5.1. The ENO should:

- submit a report to Ofgem outlining its proposed use of system charges and its proposed pricing principles for each item charged;
- verify that the proposed charges derive from the application of the proposed pricing principles; and
- verify that the proposed charges can be justified in relation to the accounts for the operation of the distribution system.

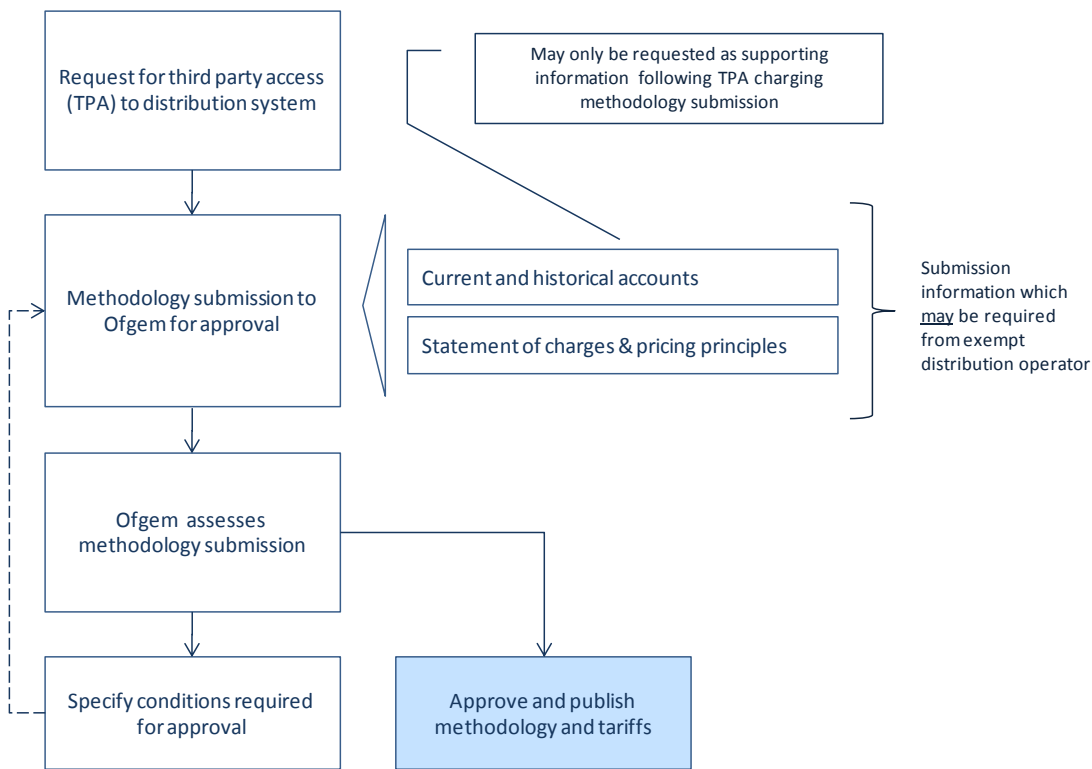
5.2. Where the ENO has applied the common charging methodology, the ENO will need to make reference to each stage of the methodology when seeking approval from Ofgem of its use of system charges.

5.3. In cases where the ENO chooses to apply its own charging methodology, the ENO should provide a more detailed report which outlines the proposed methodology, its principles and objectives.

5.4. Finally, the ENO methodology submission to Ofgem should also set out a timetable from when the ENO expects to charge for access to its distribution system.

5.5. An ENO may not delay third party access pending approval of a proposed methodology; although suppliers using the exempt distribution system may not wish to agree a supply contract until charges are established under an approved methodology.

Figure 5.1: Methodology approval process



5.6. Once a methodology has been submitted for approval to Ofgem, we will endeavour to provide a determination on the ENO's proposal in as timely a manner as possible.

5.7. Ofgem will provide the reasons for making its determination; whether the methodology is approved or whether further conditions would be required in order for the methodology to be approved.

6. Next steps

6.1. In this document, we have set out our preliminary views for guidance on the third party access arrangements for licence exempt gas and electricity distribution system in GB. We have set out a common charging methodology that licence exempt distribution network operators can employ to set charges for third party use of system.

6.2. The objectives of our guidance are to provide stakeholders with greater clarity around the operation of the third party access regime in relation to network charging arrangements. Stakeholders should also monitor the Government's response to the consultation on third party access to licence exempt distribution for further guidance on the commercial and technical requirements applying to these systems.

6.3. Consistent with DECC's proposals for the third party access regime, we propose a simple, transparent and common methodology for setting use of system charges. This is to enable exempt distribution system operators to quickly calculate fair and workable use of system charges when requested by a customer/potential third party supplier.

6.4. Throughout the document we have kept guidance as simple as possible so as to make our proposals accessible to a wide range of industry stakeholders. We welcome stakeholders views on where further guidance would be helpful.

Next steps

6.5. Ofgem is seeking stakeholder views on its proposed common charging methodology for licence exempt distribution networks. To this end, we have posed a number of specific questions to industry stakeholders. This provides some direction of the matters that Ofgem is seeking to clarify. However, respondents may wish to provide views on other matters they consider relevant to the provisions of third party access in the EU Gas and Electricity Directives.

6.6. The consultation period will run for six weeks. Ofgem will then develop and publish guidance based on consideration of views arising from this consultation.

6.7. All licence exempt distribution system operators wishing to charge tariffs for use of the network must seek approval for the methodology used to calculate it. We therefore encourage ENOs who already provide third party access, or expect to receive a request for third party access, to prepare tariff methodology submissions for submission to Ofgem once this consultation period has closed.

Appendices

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Appendix 1 - Consultation Response

Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. Responses should be received by 20th January 2011 and should be sent to:

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1.1. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.2. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

Next steps: Having considered the responses to this consultation, Ofgem intends to publish a final guidance document based on consideration of views arising from this consultation. All licence exempt distribution system operators wishing to charge tariffs for use of the network from 3 March 2011 must seek approval for their tariff methodology by that date. We therefore encourage ENOs who already provide third party access, or expect to receive a request for third party access, to prepare methodology submissions for submission to Ofgem once this consultation period has closed.

Chapter One

There are no questions in this chapter

Chapter Two

There are no questions in this chapter

Chapter Three

Question 1: Do you have any views on the proposed principles that will underpin ENOs' network charges?

Question 2: Is the common methodology we have proposed proportionate? Is further guidance required on particular issues?

Chapter Four

There are no questions in this chapter

Chapter Five

Question 3: Is our proposed approach appropriate? Are there other arrangements which could be put in place and would help the sector comply with the obligations?

Chapter Six

There are no questions in this chapter

Appendix 2 - Capital expenditure worked example

The purpose of this appendix is to provide additional guidance to exempt distribution system owners on a methodology which they can apply to calculate the depreciation and rate of return (profitability) elements of TPA use of system charges.

The text box in Chapter 3 provided some high-level guidance on how a distribution system owner could approach the calculation of the depreciation charge and an appropriate cost of capital (allowed profitability) for the distribution system. The table below provides a worked example of this approach based on strictly illustrative assumptions.

Calculations						
Component	Calculation	1	2	3	4	5
Historic cost of network assets (£s)	n/a	100				
Opening current value of network assets	[= Historic cost of network * Cumulative Inflation]					106.12
Annual depreciation	[= Current value of network / Asset Life]	10.61	10.61	10.61	10.61	10.61
Closing Current Net-Book Value	[= Current cost of network - Accumulated Depreciation]	95.51	84.90	74.28	63.67	53.06
Rate of return on capital (allowed profit)	[= Closing Net Book Value (Year 5) * Real Cost of Capital]					2.62
Building blocks for inclusion in Year 5 TPA tariff						
Depreciation	10.61					
Rate of return (allowed profit)	2.62					
Assumptions						
Element	Unit	Assumption				
Current year	Year	Year 5				
Year of TPA request	Year	Year 5				
Asset life	Years	10				
Inflation (Year 2 to 4)	%	2%				
Cumulative Inflation (Year 2 to Year 4)	%	6.12%				
Real (post-tax) Cost of Capital	%	4.94%				

To apply this methodology in practice a ENO will require:

- The historic value (cost) of the distribution network.
- An estimate of **cumulative** inflation since the network started operations.
- An assumption of the distribution system asset life.
- An assumption of the real Cost of Capital of the distribution business.

The Office for National Statistics regularly publishes data on the RPI. The RPI is the most familiar general purpose domestic measure of inflation in the UK. It is available continuously from June 1947.

Appendix 3 - The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

1.3. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.³ Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This appendix must be read accordingly.⁴

1.4. The Authority's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

1.5. The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with,

- the shipping, transportation or supply of gas conveyed through pipes;
- the generation, transmission, distribution or supply of electricity;
- the provision or use of electricity interconnectors.

1.6. Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote

³ Entitled "Gas Supply" and "Electricity Supply" respectively.

⁴ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

competition) in which the Authority could carry out those functions which would better protect those interests.

1.7. In performing these duties, the Authority must have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them⁵; and
- the need to contribute to the achievement of sustainable development.

1.8. In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁶

1.9. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licenced⁷ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems; protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and secure a diverse and viable long-term energy supply, and shall, in carrying out those functions, have regard to the effect on the environment.

1.10. In carrying out these functions the Authority must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.11. The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to

⁵ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Acts in the case of Electricity Act functions.

⁶ The Authority may have regard to other descriptions of consumers.

⁷ Or persons authorised by exemptions to carry on any activity.

communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

1.12. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation⁸ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

⁸ Council Regulation (EC) 1/2003.

Appendix 4 - Glossary

A

Asset life

The life of distribution assets can be defined with regard to the technical life of the asset or the economic life ("usefulness") of the asset.

C

Capital expenditure (capex)

Expenditure on investment in long-lived distribution assets, such as underground cables and pipes.

Connection charges

Charges paid by generators and demand customers for connection to the distribution network.

D

Department of Energy and Climate Change

DECC is the Government department responsible for energy policy and climate change policy in Great Britain.

Depreciation

Expense associated with spreading (allocating) the cost of an asset over its useful life.

E

European Court of Justice

The Court of Justice of the European Communities (often referred to simply as 'the Court') was set up under the ECSC Treaty in 1952. Its principal role is to make sure that EU legislation is interpreted and applied in the same way in all EU countries.

ENOs

Exempt distribution network operators.

Expense

Cost from operations. The opposite of revenues.

G

Gas and Electricity Markets Authority (GEMA)

GEMA is the governing authority of Ofgem. The Authority's powers are provided for under the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998 and the Enterprise Act 2002.

L

Licensable activities

The Gas Act 1986 (as amended) and The Electricity Act 1989 (as amended) (the Acts) prohibit certain activities unless the person carrying on that activity is licensed, exempt from the requirement for a licence, or eligible (under the Gas Act only) for an exception to the prohibition on unlicensed activities.

N

Net Book Value

The asset's cost minus accumulated depreciation.

National regulatory authority

Ofgem is the national regulatory authority for the energy sector in Great Britain.

O

Operating expenditure (opex)

Fixed and variable costs associated with the provision of the service (such as access to the distribution network).

R

Retail Prices Index (RPI)

The Retail Prices Index (RPI) is the most familiar general purpose domestic measure of inflation in the United Kingdom. It is available continuously from June 1947.

T

Third party access

Third party access policies require owners of monopoly infrastructure facilities to grant access to those facilities to parties other than their own customers, including other suppliers.

U

Use of System Charges

Charges paid by generators and demand customers, usually via suppliers, for the use of the distribution network.

W**Weighted Average Cost of Capital (WACC)**

This is the weighted average of the expected cost of equity and the expected cost of debt.

Appendix 5 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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