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Direct Dial: 020 7901 7194
Email: rachel.fletcher@ofgem.gov.uk

Date: 20 December 2011

Dear Colleagues

Decision to approve changes to the EHV Distribution Charging Methodology (EDCM) to comply with conditions set pursuant to standard licence condition (SLC) 51A.21 of the electricity distribution licence

Direction to approve further changes to amend inconsistencies within the EDCM pursuant to SLC 51A.20

On 6 September 2011, we published a decision¹ on the EDCM (the "Decision") submitted by the distribution network operators (DNOs)² on 1 April 2011³. The Decision approved the EDCM for the calculation of import (demand) charges only, subject to three conditions set pursuant to SLC 51A.21. We deferred our decision on the EDCM for the calculation of export (generator) charges.

On 30 November 2011, the DNOs, through the Energy Networks Association (ENA), wrote to us stating that they had fulfilled two of the conditions set out in the Decision⁴. They also advised they had modified their EDCM as a consequence of our decision to approve only the EDCM for import charges and to amended errors, omissions and ambiguities in the EDCM following a review of the methodology statements and Excel models.

Decision to Approve of conditions set pursuant to SLC 51A.21

Conditions 1 and 2⁵

The following two conditions contained in the Decision were required to be completed by the DNOs by 30 November 2011:

Condition 1 required a change in the way discounts on charges for licensed distribution network operators⁶ (LDNOs) are calculated. We are of the view that the DNOs' proposed

¹ Electricity distribution charging: decision on the methodology for higher voltage import charges - (Reference number: 116/11) <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=760&refer=Networks/ElecDist/Policy/DistChrgs>

² DNO are Distribution Services Providers as defined in SLC 1.

³ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=679&refer=Networks/ElecDist/Policy/DistChrgs>

⁴ Available at <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx>

⁵ Condition 3 requires the DNOs to further investigate and consult on the issue of how spare capacity on assets used by customers should be treated when allocating costs. The DNOs must submit a report to Ofgem with a recommendation on the issue by 1 June 2012 (i.e. after the introduction of EDCM import charges).

approach gives LDNOs an excessive margin in some cases which could give them an unfair advantage over the DNOs when competing for some new connections.

Condition 2 required that the method of sense-checking the long run incremental costs (LRIC) for each branch be carried out separately for credits and charges. This is intended to improve the cost reflectivity of the locational component of the charge that estimates the future costs associated with reinforcing the network in that area.

Consultation

The DNOs had 28 days in which to make representations on the conditions. None did so. We also invited other parties to comment on the conditions. Two of the LDNOs raised some issues with how the DNOs proposed to calculate the revised customer categories under Condition 1. However, these LDNOs did not bring forward evidence that the proposed method did not fulfil the intent of the condition.

Approval

Based on the report submitted by the DNOs (Appendix 1 to the submission) and the amendments to the EDCM, we consider that both Condition 1 and 2 have been fulfilled. We therefore approve these conditions as having been fulfilled.

In relation to Condition 1, we stated in our decision that the number of customer categories for LDNO discounts should be reduced from 15 to five (three in Scotland) so that discounts do not vary with the network levels the DNO provides above the point of connection. The five customer categories outlined by the DNOs (0000, 132kV (England and Wales only), 132kV/EHV (England and Wales only), EHV and HVplus) meet this requirement.

For Condition 2, the DNOs have made a change to the methodology so that the cap is applied for each branch separately. First for the total of LRIC charges for the branch and then for total LRIC credits for that branch. We consider that the change to the methodology fulfils this requirement.

Changes to the EDCM as a consequence of our decision to only approve the methodology for import charges.

The second category of changes included in the DNOs' letter of 30 November 2011 concerned consequential changes made to the EDCM for import charges. This has involved removing sections of the EDCM that relate to the calculation of charges for generation, as well as a modification to the calculation of demand charges that interacted with the generation calculation.

We agree to these consequential changes on the basis that the methodology statements should only refer to aspects which have been approved. This also ensures that when the EDCM is incorporated into the Distribution Connection and Use of System Agreement, it will be clear that all aspects only relate to that which have been approved, and are those that are subject to open governance.

Direction to approve further changes to amend inconsistencies within the EDCM

Following the submission of the DNOs' proposal on 1 April 2011, they undertook an extensive sense checking process of both the methodology statements and the Excel model that produces the charges.

⁶ A licensed electricity distributor which does not have a distribution services area and competes to operate electricity distribution networks anywhere within Great Britain, as well as a DNO that operates out its distribution service area(s).

Normally we would expect such a process to be undertaken before the submission of the methodology. We accept that in this case, there was continual refinement of the options, particularly around scaling of charges right up until submission. This reduced the amount of time available for the sense checking prior to submission.

As a result of this process, the DNOs have identified a number of changes to the methodology and Excel models. A list and the detail of these changes can be found in Appendix 2 – Report on other changes to the EDCM since 1 April 2011⁷.

We approve the changes given that they remove ambiguity in, and improve clarity of, the methodology. We consider that this will aid the open governance process that parties may use to propose changes to the methodology.

The DNOs stated that the changes to correct errors, omissions and ambiguities do not impact the charges produced by the model. While other changes do result in some variation to charges, we do not consider these to be material. On this basis, we do not consider it necessary to provide an Impact Assessment of the changes.

Our approval is on the basis that, having regard to our principal objective and duties under the Electricity Act 1989, the EDCM achieves in the round the Relevant Objectives set out under the licence. We outline more specifically some of our reasons against the Relevant Objectives below:

50A.7 The first Relevant Objective is that compliance with the EDCM facilitates the discharge by the licensee of the obligations imposed on it under the Act and by this licence.

- We consider that the EDCM for import charges facilitates the licensees' obligations under the Act and the licence, in particular SLC 50A of the licence which concerns the development and implementation of an EDCM.

50A.8 The second Relevant Objective is that compliance with the EDCM 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.

- We consider that the changes to the LDNO charging methodology (extended Method M) help to ensure a robust methodology for the calculation of discounts for LDNOs. Greater certainty and clarity helps facilitate competition in the distribution of electricity.

50A.9 The third Relevant Objective is that compliance with the EDCM 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.

- The changes proposed by the DNOs do not impact the cost reflectivity of charges. However, removal of ambiguity is beneficial in helping to ensure that charges which reflect costs are calculated in the way intended.

50A.10 The fourth Relevant Objective is that, so far as is consistent with the first three Relevant Objectives, the EDCM, so far as is reasonably practicable, properly takes account of developments in the licensee's Distribution Business.

- The changes are neutral against this relevant objective.

⁷ See pages 5-18 of this appendix, available at <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx>

For the reasons set out above the Authority directs pursuant to SLC 50A.20 that the further changes to amend inconsistencies in the EDCM submitted by the DNOs on 30 November 2011 be approved.

This letter constitutes notice pursuant to section 49A of the Electricity Act 1989.

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is written over a light grey rectangular background.

Rachel Fletcher
Acting Senior Partner, Smarter Grids & Governance: Distribution

For and on behalf of the Authority