

Modification proposal:	Scottish Power EnergyNetworks¹ ("SP") Electricity Distribution Use of System Charging Methodology: Interim² IDNO tariffs		
Decision:	The Authority ³ directs that this proposal be not vetoed ⁴		
Target audience:	DNOs, IDNOs, Suppliers, Generators and other interested parties		
Date of publication:	3 September 2009	Implementation Date:	As soon as practically possible following a not veto decision

Background to the proposal

SP has licence obligations⁵ to have in place three charging statements: the statement of use of system ("UoS") charging methodology, the statement of UoS charges and statement of connection charging methodology and charges. The statement of UoS charging methodology outlines the method by which distribution UoS charges are calculated. SP has a requirement to keep the methodology under review and bring forward proposals to modify the methodology that it considers better achieves the relevant objectives.⁶

The Authority has been encouraging Distribution Network Operators ("DNOs") to modify their charging methodologies to bring forward specific IDNO tariffs which better reflect the costs IDNOs impose on their distribution networks. As yet only Western Power Distribution plc⁷ and Scottish and Southern Power distribution plc⁸ have had IDNO charging proposals not vetoed. In July 2008 a DNO/IDNO working group was established with the aim of developing more appropriate charging arrangements for IDNOs. DNOs, including SP are now bringing forward proposals as a result of the work undertaken in this group. In addition to the decisions outlined above, the Authority is consulting on a proposals from ENW, CE, CN and has vetoed a proposal from EDF.

¹ Scottish Power EnergyNetworks own two electricity distribution licensees – Scottish Power Distribution and Scottish Power Manweb. This letter applies to both licensees.

² In this case the 'Interim' methodology would apply until 1 April 2010 when the common distribution charging methodology (CDCM) is due to be implemented.

³ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

⁴ This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

⁵ Standard licence conditions (SLC) 13 -14.

⁶ The relevant objectives for the UoS charging methodology, as contained in paragraph 3 of SLC 13 of SP's licences are:

- (a) that compliance with the UoS charging methodology facilitates the discharge by the licensee of the obligations imposed on it under the Electricity Act 1989 and its licence;
- (b) that compliance with the UoS charging methodology facilitates competition in generation and supply of electricity, and does not restrict, distort or prevent competition in the transmission or distribution of electricity;
- (c) that compliance with the UoS charging methodology results in changes which reflect, as far as is reasonably practicable (taking into account of implementation costs), the costs incurred by the licensee and its distribution business; and
- (d) that, so far as is consistent with sub-paragraphs (a), (b) and (c), the UoS charging methodology, as far as is practicable, properly takes account of developments in the licensee's distribution business.

⁷ The proposal was not vetoed in December 2007 and can be found at:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/SP%20uos006%20mod.pdf>

WPD had a second IDNO charging methodology not vetoed in June 2009:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/Decision%20letter%20WPD%20Wales%20issued%20050609.pdf>

⁸ <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/Final%20decision%20letter%20SEPD.pdf>

SP's proposal

On 7 August 2009 SP submitted a modification proposal to their use of system charging methodology which sought to introduce interim IDNO tariffs⁹.

This proposal seeks to take the price control settlement in DPCR 4 as a proxy for the total cost of SP's business. SP then use cost drivers to allocate these total costs to network levels to ascertain the percentage of total costs associated with owning and operating each network level. This allows SP to generate a boundary tariff to the IDNO by providing a percentage discount on the 'all the way'¹⁰ charge which represents the network levels which the IDNO provides downstream of the boundary. In the past the Authority has been clear that DNOs should bring forward proposals to introduce specific IDNO charges¹¹.

Decision not to consult

In April, the Authority consulted on WPD's cost allocation methodology, which is very similar to that which SP now proposes¹². Equally, the Authority recently 'not vetoed' an interim proposal from SSE which also uses a very similar cost allocation model. Given these earlier consultations and the precedent set by them, we consider that there would be little merit in consulting upon principles contained in SP's proposal particularly as the views of industry on the proposed cost allocation methodology are well known.

The Authority's decision

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

The Authority's reasons

The reasons for the Authority's decisions are set out below.

Relevant objective (b) – That compliance with the methodology facilitates competition in the generation and supply of electricity and does not restrict, prevent or distort competition in the transmission or distribution of electricity.

SP states that the proposal provides a fixed income for each IDNO plot¹³ and therefore better meets relevant objective (b). The Authority agrees with this assertion and provides specific comments on aspects of SP's proposal below.

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

At present SP charge IDNOs on the same basis as commercial customers. These charges are calculated using a distribution reinforcement model ("DRM"). The DRM models the costs of adding 500MW of simultaneous demand to SP's network. This produces an incremental cost per network level. These costs are allocated to customer classes on the basis of their contribution to maximum demand. These costs are then scaled up or down by a fixed percentage to ensure that SP recovers their allowed revenue.

⁹ SP's proposal can be found on Ofgem's website at:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/SPPD%20IDNO%20Modification%20Interim%20240709.pdf>

¹⁰ This is the charge which SP would levy on its own end users

¹¹ Please see the Authority's decision letter on WPD's IDNO charging modification of December 2007:

<http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20006%20IDNO%20charging%20decision%20letter%20wales.pdf>

¹² As part of our Joint Consultation on IDNO charging in April:

http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20CE%20and%20Reckon%20consultation_final.pdf

¹³ In this context plot refers to a single premise connected to the IDNO network e.g. a house or office.

SP proposes to move away from this incremental charging methodology towards a methodology which identifies the total costs associated with the part of its network equivalent to that which the IDNO provides. The Authority agrees with this approach.

Under the terms of the relative price control¹⁴ and their charging methodologies¹⁵ an IDNO can only recover the same income from its end customers as the host DNO would have done. The IDNO therefore relies upon the difference between the boundary charge levied by the DNO and the DNOs own published end tariffs as an income on which to operate their network and earn a reasonable return. This difference represents the IDNO gross margin.

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

The Authority therefore considers that SP's proposal to move away from charging IDNOs on a scaled incremental cost approach towards a total cost approach better achieves relevant objective (b)

2. Cost allocation methodology

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

3. Tariff application

The Authority notes that as with its current methodology, SP propose to charge IDNOs under a two rate tariff. The Authority has previously commented that this results in a potential mismatch between the charging structure at the boundary and the 'all the way' charge through which IDNOs recover income from domestic customers. The Authority appreciates that this is an interim methodology, but would urge SP to consider this point when revising this methodology in the future.

However, on balance due to the other benefits of this proposal, overall we consider that it better achieves relevant objective (b).

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

SP states that their proposal better meets relevant objective (c) because it introduces specific IDNO tariffs which take account of the fact that IDNO sites predominately serve domestic premises and therefore have load characteristics more in common with domestic customers rather than commercial ones.

1. Creation of new specific IDNO tariffs for IDNO sites

The Authority considers that IDNO sites will place different costs on SP's network than a standard commercial customer, as IDNO sites tend to be predominately domestic and have load profiles more similar to those of a domestic, rather than commercial customer. It is therefore appropriate that SP develops and implements tariffs to reflect these differences in order to send correct economic signals to users of their network.

¹⁴ This is a price cap which states that IDNOs can't charge domestic customers a higher tariff than the host DNO.

¹⁵ IDNOs have a charging methodology in place which states that they will replicate all host DNO tariffs.

Consequently, the development of specific IDNO tariffs based on identifying the total costs of operating SP's equivalent IDNO network better reflect the costs which IDNOs place on SP's network. As such the Authority considers that the proposal better achieves relevant objective (c) in terms of the methodology reflecting the costs incurred by the licensee.

2. Cost allocation methodology

The Authority appreciates that the allocation of total price control revenue to network levels involves making a number of judgements on the drivers used to allocate costs. The Authority considers that SP has provided reasonable justification and a pragmatic argument for the cost drivers it has used. As such, on balance, we consider that SP's proposals better achieves relevant objective (c) to reflect the costs incurred by the licensee.

The Authority is inclined to agree with SP that allocating capital costs to voltage levels in proportion to forecast net capex spend (taken from forward business plan questionnaire – FB PQ – data) appears to be appropriate in this case and consequently believes that this aspect of the methodology is more cost reflective than basing IDNO charges on the incremental capital costs produced by SP's DRM.

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

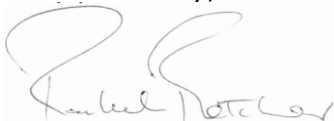
Our decision

The Authority has decided to **not veto** the modification to the UoS charging methodology statement.

It is important to note that our decision letter relates to the methodology rather than the quantification of elements produced by the methodology. It is for SP to ensure its own compliance with the Competition Act 1998 and EC competition law in its implementation of the proposed methodology. It should be noted that the processes and legal tests in relation to modifications and the Competition Act 1998 investigation are separate and distinct. Therefore, this decision does not limit or prejudice any findings which the Authority may make in relation to investigations under the Competition Act 1998.

If you have any questions relating to the issues discussed in this letter please contact Mark Askew at mark.askew@ofgem.gov.uk or on 0207 901 7022.

Yours faithfully,



Rachel Fletcher,
Director, Distribution

Annex 1 – Summary of SP’s proposal

SP’s proposal calculates the total costs associated with operating the LV network, LV/HV substation and HV network in the following way. They take the 5 year allowed income set at the last distribution price control review (DPCR4) and divide it between operating costs, depreciation and return. SP then allocate all three sets of costs to network levels using cost drivers. For operating costs, SP use regulatory reporting pack (RRP) data detailing the attribution of direct costs¹⁶ across network levels. SP then allocate the indirect costs¹⁷ to network levels according to the proportion each network level contributes towards the total modern equivalent asset value (MEAV) of its network¹⁸. The known allocation of direct costs is added to the MEAV allocation of indirects to produce an overall allocation of operating costs for each network level. This allocation is divided by units flowing through each network level in order to make it comparable to tariffs. This final allocation is applied to the £million sum of operating costs from the DPCR4 settlement.

For depreciation and return costs, SP take the amounts from DPCR4 and allocate it to network levels according to the proportions of forecast net capex spend between network levels. This forecast net capex spend is taken from the forward business plan questionnaire (FBPQ) data which is provided to Ofgem as part of the DPCR5 projections.

This allocation is again divided by the units flowing through each network level to produce an allocation which is comparable to a tariff. The network level allocations for operating costs, depreciation and return are then averaged and applied to in-year allowed revenue less in year pension deficit payments and any incentive income (positive or negative) earned in that year. This produces a proportion of allowed revenue associated with operating each network level which forms the basis of a discount on SP’s end user charge¹⁹.

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

$$\frac{\text{Average length of SP network per IDNO end user}}{\text{Average Length of SP network per end user}}$$

This calculation provides a figure of 23.5% for the both the SP Manweb area SP Distribution area. SP reduces the percentage discount associated with the direct operating costs by these percentages. This produces the following discounts on LV and HV end user tariffs for an LV connected IDNO.

SP Distribution – 30.38% at LV, 42.1% at HV
SP Manweb – 31.89% at LV, 44.1% at HV

SP uses this calculation to create the following IDNO tariffs:

- Predominately domestic LV based on a discounted domestic restricted (PC2) tariff
- Predominately domestic HV based on a discounted domestic restricted (PC2) tariff
- Predominately non domestic LV based on a discounted HH LV commercial tariff

These tariffs are applied on a site basis. A site is categorised as domestic if 60% or more of the maximum demand is from domestic connections. If a site has less than 40% of maximum demand from domestic connections, then it is classified as non domestic and where between

¹⁶ Direct operating costs are those associated directly with the operation of the network and include such activities as fault repair, tree cutting and maintenance.

¹⁷ Indirect costs are those associated with indirectly with the operation of the network and include activities such as IT , customer call centres and staff costs.

¹⁸ SP chose to not allocate network rates by MEAV which are consequently allocated pro rata to all other costs. SP allocate transmission exit charges solely to the EHV network on the basis that it is demand at this level which drives the level of exit charges.

¹⁹ SP applies the discount to a different end user charge depending upon the classification of the IDNO site as domestic or non domestic.

40%-60% of maximum demand is from domestic customers then the classification of the site will be made with the agreement of the IDNO.