Promoting choice and value for all customers

To distributors, suppliers, generators, customers and other interested parties

Our reference: 76/09
Your reference: ENW 2009/004.1
Direct Dial: 020 7901 7194
Email: rachel.fletcher@ofgem.gov.uk

30 June 2009

Dear colleague,

Consultation on 2009/004.1 proposal from Electricity North West Limited to implement an interim IDNO use of system charging methodology and charges

Distribution Network Operators (DNOs) have licence obligations[1] 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.

DNOs are required to keep their statement of UoS charging methodology under review and to bring forward proposals to modify the methodology that they consider better achieve the relevant objectives[2].

Before making a modification to a statement of UoS charging methodology a DNO must submit to the Gas and Electricity Markets Authority (the "Authority")[3] a proposal to modify its methodology stating how the proposal better achieves the relevant objectives. The DNO then makes the modification unless within 28 days the Authority either directs the DNO not to make the modification or notifies the DNO that it intends to consult and then within three months directs the DNO not to make the modification.

Electricity North West Limited ("ENW") submitted a proposal on 16 June 2009 to modify its statement of UoS charging methodology in order to introduce IDNO specific tariffs at EHV,

[1] Standard Licence Conditions (SLC) 13.

[2] The relevant objectives for both the connection and 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.

[3] Ofgem is the office of the Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

HV & LV[4]. On 18 June 2009, the Authority notified ENW in writing of its intention of consult upon its revised IDNO charging proposals[5].

ENW submission

In July 2008 an IDNO/DNO working group was established with the aim of introducing common, specific IDNO UoS charges to take effect from 1 April 2009. This group was unable to agree a common approach for April 2009, but DNOs have continued to work independently to develop their own IDNO interim charging tariffs. The working group has resulted in six out of seven DNOs, including ENW, proposing capacity ramping modifications. These ensure that where a capacity charge is levied on IDNO sites, the IDNO is charged on the basis of the highest capacity currently used, which may for some time, be below the capacity of the site once fully developed. The Authority approved these modifications in February and March 2009 on the basis that they better achieve the relevant objective not to restrict, prevent or distort competition in distribution.

Furthermore, in June and following consultation, the Authority approved a UoS methodology modification from the Western Power Distribution (WPD) group which revised its IDNO tariffs. The submission from ENW reflects the work they have carried out both inside and outside the working group[6]. ENW propose to implement their IDNO tariffs retrospectively from 1 April 2009. ENW's proposal seeks to allocate total LV revenue to network components in order to establish ENW's equivalent costs of operating an IDNO network. These equivalent costs are then subtracted from ENW's 'all the way' tariffs in order to produce a specific IDNO tariff for each LV customer class. A more detailed summary of ENW's proposal can be found in Annex 1 to this letter.

From 1 July 2009 a new licence condition will oblige all DNOs to implement a common HV/LV distribution UoS charging methodology by 1 April 2010. This methodology is to include specific IDNO tariffs. ENW's proposal relates to the methodology for setting IDNO charges in the period up to the implementation of the common methodology on 1 April 2010.

Views sought

In April 2009, Ofgem published a joint consultation on IDNO charging[7]. The second part of this consultation set out a number of alternative methodologies DNOs might choose to adopt for the enduring arrangements from 1 April 2010. ENW's proposal raises very similar issues to those discussed in that consultation and we do not propose to consult on these issues again. This consultation focuses on the specific detail of ENW's proposal. In coming to our decision on ENW's modification, we will judge the proposal in its entirety, according to whether it better achieves the relevant objectives. The Authority will also consider its statutory duties in coming to its decision.

The proposal from ENW represents a substantial change to their current methodology. The Authority has taken the decision to consult on the proposed modifications to further evaluate the whether the proposed methodology better achieves the relevant objectives. In Annex 2 to this letter, we highlight the new issues which ENW's proposal raises.

Specifically, we are looking for views on:

[4] Modification report - Use of System Charging Methodologies for IDNO Networks ENW/2009/004 which can be found on our website at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/ENW%20Modification%20Proposal%20ENW2009004.pdf

[5] This letter can be found on our website at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx

[6] In July 2008, ENW submitted a modification proposal to introduce IDNO tariffs which was subsequently vetoed by the Authority.

[7] This document can be found at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/WPD%20CE%20and%20Reckon%20consultation_final.pdf

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- The extent to which the proposals are more cost reflective than the ENW's current methodology[8];
- Whether ENW demonstrate that its proposal facilitates competition in generation and supply and does not restrict, distort or prevent competition in transmission and distribution[9];
- Whether we have correctly captured the main issues raised by ENW's proposal; and
- The specific questions related to ENW's proposal in Annex 2.

Responding to this consultation letter

Views are invited on these points from any interested parties, including IDNOs, DNOs, suppliers, customers (including distributed generators) and their representatives.

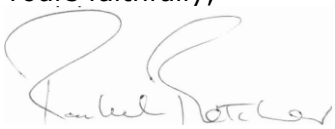
Views are invited by **28 July 2009**. Where possible, responses should be sent electronically to Mark Askew, e-mail distributionpolicy@ofgem.gov.uk.

The process associated with modifications to the charging methodologies is detailed within the electricity distribution licence (SLC 13). As the Authority's decision is time bound, please ensure that your comments are received by the date indicated so that they can be fully considered. It may not be possible to consider responses on the ENW's modification proposal that have been received after this date, however, as the Authority needs to make a decision on this matter on or before 18 September.

All responses will be held electronically by Ofgem. They will normally be published on our website unless they are clearly marked confidential. Consultees should put confidential material in appendices to their responses where possible.

Copies of this document are available on our website under the distribution charging modifications area of work[10]. If you have any questions concerning either consultation document please contact Mark Askew at mark.askew@ofgem.gov.uk or on 0207 901 7022.

Yours faithfully,



Rachel Fletcher
Director, Distribution
Duly authorised on behalf by the Authority

[8] Standard condition 13(3(c)) of the electricity distribution licence.
[9] Standard condition 13(3(b)) of the electricity distribution licence.
[10] http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Pages/DistChrgMods.aspx.

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Annex 1 – Summary of ENW's proposal 2009/004

The starting point for ENW's methodology is to calculate the average revenue in p/kWh for LV connected customers based on the revenue recovered from all LV connected customers divided by the number of units flowing through the LV network.

The next stage of ENW's cost allocation is to establish a cost for each network component[11] for:

- Operating and faults expenditure (excluding network rates);
- Asset replacement capital expenditure; and
- General reinforcement capital expenditure.

These are calculated using regulatory reporting pack (RRP) data to produce a cost which is divided by the number of units flowing through each network component. This produces a p/kWh cost matrix for each of the above costs. Where RRP data does not go into sufficient granularity, ENW allocate costs between network and substations according to their modern equivalent asset value (MEAV) proportion.

ENW subtract the total operating and faults expenditure cost matrix (in p/kWh) from the LV revenue cost matrix. They then subtract the p/kWh cost matrix of asset replacement capital expenditure. ENW state that the remaining p/kWh is an estimate of the revenue they receive to cover return on capital. This remainder is then allocated to network components in the same proportion as net capex additions to the network included in the forecast business plan questionnaire (FBPQ).

ENW assume that an IDNO is entitled to 100% of the costs allocated to LV services as part of a discount from the 'all the way' tariff. However, at the LV network level, ENW state that the IDNO should pay for the proportion of the LV main that they use. ENW calculate this proportion as the average length of LV main per end user compared to the average length of LV main ENW provides to IDNO networks.[12] This proportion calculates that on average the IDNO provides 84% of the LV main per user. Therefore, the IDNO is entitled to keep 84% of the costs allocated to the LV main in the form of a discount from the 'all the way charge'.

ENW then convert this allocation into a tariff by looking at the total percentage of total revenue from LV connected customers which is allocated to each network tier. ENW calculate that 27% of costs are allocated to the network components which an LV connected IDNO will typically operate. Therefore the IDNO tariff should be 27% less than the 'all the way' tariff. ENW calculate 27% of an average user's annual bill to establish the value of the discount which needs to be applied. ENW divide the average annual bill into its fixed and unit components. They apply the value of the discount first to the fixed charge. If there is any discount remaining they then apply it to the annual revenue recovered from the unit charge. The remaining revenue is then divided by the average annual consumption to produce the IDNO unit rate. ENW use this method to produce an IDNO tariff for the following LV customer classes:

- Domestic unrestricted (PC 1)
- Domestic restricted (PC 2)
- Non domestic unrestricted (PC 3)
- Non domestic restricted (PC 4)
- PC 5-8
- Non Domestic half hourly (HH)

[11] Network components comprise of the following, 132kV network, 132/33kV transformer, 33kV network, 33/11kV transformer, 11kV network, 11kV/LV transformer, LV network, LV services.
[12] This is best illustrated as a formula; Average length of DNO main per end user/(Average length of DNO main to IDNO per user + Average length of DNO main per end user).

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ENW offer two separate ways in which the resulting tariffs can be structured. The first is under a portfolio based system which provides a single bill for each customer class which IDNOs have connected to their networks across the whole of ENW's distribution service area (DSA). The second method is to categorise an IDNO site as either domestic or non domestic and for domestic sites allow the IDNO to choose either the IDNO domestic unrestricted, or IDNO domestic restricted tariff for the relevant POC of the IDNO site. Non domestic sites will continue to be charged on the basis of the standard commercial tariff. ENW have also stated that they will provide IDNOs with the option to remain on the current commercial tariff if they wish to.

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Annex 2 – Main issues and Questions

ENW's proposal represents a substantial change in the way that IDNO tariffs are calculated and billed and raises a number of questions to which we are keen to receive respondent's views. As stated in the cover letter, ENW's proposal raises similar issues to those on which we have previously consulted. Therefore, this consultation focuses on the issues which we consider to be specific to ENW's proposal. These issues can be split out into three areas – cost allocation methodology, tariff application and impact analysis.

Cost allocation methodology

1. Use of LV revenue

ENW choose LV revenues as their starting point for the allocation of costs to network components. This is part of their move to base IDNO tariffs on the 'all the way' charge discounted for their equivalent total costs of providing the IDNO network. In our decision letter of 5 June 2009 on WPD's revised IDNO charging methodology[13], the Authority stated that it agreed with an approach which identified the equivalent total costs of providing the IDNO network. However, we are interested to receive views on the extent to which LV revenues (recovered from an incremental charging model) are a reasonable proxy for total costs.

We invite views over the extent to which LV revenues are an appropriate starting point for a total cost allocation methodology.

We also invite views on the extent to which a methodology based on allocation of total LV revenues to upstream and downstream better achieves the relevant objectives in terms of cost reflectivity and not restricting, preventing or distorting competition in distribution.

2. Use of MEAV to disaggregate data

ENW propose to construct a cost matrix of all network components to which they allocate LV revenue. Some of the input data ENW use from RRP is not broken down to all of these network components. In particular, this data does not differentiate between network and transformation levels. In order to achieve this level of granularity, ENW apportion the costs between network and transformation levels according to the proportion of the total network MEAV which comprises of the network level and transformer.

We invite views on the extent to which it is cost reflective to use MEAV to apportion RRP data between voltage and transformation levels.

3. Estimating capital

In their proposal, ENW make the assumption that once total LV revenue has had operating and faults expenditure and asset replacement expenditure deducted, then the residual constitutes capital which it then allocates to network components in the same proportion as forecast net capex additions to the network.

We invite views on whether it is reasonable to assume that the residual constitutes a reasonable proxy for capital costs associated with the LV network.

[13] This can be seen at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/Decision%20letter%20WPD%20Wales%20issued%20050609.pdf

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Tariff application

1. Applying discount to fixed charge

Once ENW has established the percentage of costs which are allocated to network components, they use this as a basis to establish the value of this in terms of an average end user bill. The difference between the end user bill and the discount is then applied to the revenue recovered from the fixed charge. This can be illustrated in the example below[14].

Average end user bill for a domestic unrestricted customer = £70
Fixed charge= £30
Unit charge =£40
The costs in the LV were identified as 30%.

In this example, for an LV connected IDNO, ENW would calculate that the IDNO tariff should be 30% lower than the 'all the way' tariff which corresponds to a reduction of the bill of £21. ENW apply this reduction to fixed charge first. This would mean that the fixed charge to be recovered from the IDNO would fall to £9. This would be divided by 365 (days in the year) to produce the new fixed charge. In this example, the unit charge would stay the same. Where the discount exceeded the income recovered from the fixed charge, the unit charge would then also be reduced.

At present in ENW's DRM the fixed charge tends to recover the type of network costs which do not vary with consumption, whilst the unit rate recovers these more variable costs. The costs which ENW discount are associated with both fixed and variable costs.

We therefore invite views as to the cost reflectivity of applying the IDNO discount to the fixed charge first. In particular, we ask respondents if they consider whether it is more cost reflective than ENW's current approach.

We would also ask respondents whether they consider that ENW's decision to apply the discount to the fixed charge first better achieves the relevant objective to not restrict, prevent of distort competition in distribution.

2. Providing a choice of IDNO tariffs

ENW propose to allow IDNOs to choose whether to be charged under their new methodology (on a portfolio or site specific basis) or remain to be charged under the current commercial tariffs.

We invite views on whether it is more cost reflective for ENW to offer a choice of different tariffs for IDNOs.

We also invite views on whether having a choice of tariffs better achieves the relevant objective not to restrict, prevent or distort competition in distribution.

3. Information required for portfolio tariffs

ENW specify that for an IDNO to be charged on a portfolio basis they will need to be able to populate a template detailing information on the number of customers on each tariff they have connected to their networks; the total day and night consumption of these customers and for half hourly (HH) customers, the total maximum demand.[15]

[14] The figures used in this example are illustrative but are a reasonable approximation of the actual costs
[15] The full template which IDNOs would be asked to complete is detailed on p12 of ENW's modification proposal which can be found on Ofgem's website at: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/ENW%20Modification%20Proposal%20ENW2009004.pdf

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We would welcome views on whether IDNOs are able to provide this data and what, if any, extra costs will be incurred in providing this information.

Impact analysis

ENW propose to introduce specific IDNO tariffs at EHV, HV and LV to cater for a number of end customers connected to IDNO sites.[16] These tariffs will be based on the cost allocation and application summarised above and outlined in ENW's modification report.

Annex 3 to this letter provides some tariff analysis which compares ENW's proposed tariffs to those under which IDNOs are currently charged.

We note that ENW propose to levy an administration cost on IDNOs to cover the cost of billing IDNOs. For IDNOs on a portfolio tariff, ENW levy a charge of £100 per month per IDNO. For IDNOs who are unable to provide the necessary information to be placed on the portfolio tariff, ENW levy a charge of £67.91 per IDNO site per year. Our impact analysis demonstrates that this administrative charge can make a difference to IDNO margins.

We welcome respondent's views on whether ENW's proposal to produce specific IDNO tariffs are more cost reflective than the current approach of charging IDNOs under the commercial tariffs.

We also welcome respondent's views on whether ENW's proposals to produce specific IDNO tariffs better achieve the relevant objective not to restrict, prevent or distort competition in distribution.

We welcome respondents' views on whether IDNOs impose additional billing costs on DNOs and if so whether it is appropriate to levy the specific billing costs via a separate administration charge. Please answer the question in terms of whether it is more cost reflective or better achieves the relevant objective not to restrict, prevent or distort competition in distribution.

[16] IDNO tariffs will be available to take account of the following end users on IDNO sites; domestic unrestricted, domestic restricted, profile class (PC) 3, PC 4, PC 5-8, HH LV and unmetered.

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Annex 3 – Impact Analysis

Table 1.1 below highlights the IDNO gross margin available for a number of LV connected IDNO sites under different scenarios under:

- The current (LV HH) commercial tariff[17]
- The proposed tariff excluding administrative (billing) costs
- The proposed portfolio tariff including administrative (billing) costs
- The proposed site Dom E7 tariff including administrative (billing) costs

Table 1.1: IDNO gross margin per plot under different tariff scenarios

	Current tariff	Proposed portfolio tariff excl. admin	Proposed Portfolio tariff incl. interface costs	Proposed Site tariff incl. interface costs
100% Domestic UR				
10 plots	-£21.50	£18.57	£12.57	£11.78
20 plots	£1.47	£18.57	£15.57	£15.18
30 plots	£9.13	£18.57	£16.57	£16.31
50 plots	£15.25	£18.58	£17.38	£17.22
60 plots	£16.78	£18.58	£17.58	£17.44
80 plots	£18.70	£18.58	£17.83	£17.73
100 plots	£19.85	£18.58	£17.98	£17.90
150 plots	£21.38	£18.58	£18.18	£18.13
200 plots	£22.14	£18.58	£18.28	£18.24
100% Domestic E7				
10 plots	-£19.54	£19.43	£13.43	£12.64
20 plots	-£2.88	£19.43	£16.43	£16.04
30 plots	£2.67	£19.43	£17.43	£17.17
50 plots	£7.12	£19.43	£18.23	£18.07
60 plots	£8.23	£19.43	£18.43	£18.30
80 plots	£9.62	£19.43	£18.68	£18.58
100 plots	£10.45	£19.43	£18.83	£18.75
150 plots	£11.56	£19.43	£19.03	£18.98
200 plots	£12.12	£19.43	£19.13	£19.09
Mixed domestic site				
30 plots	£11.05	£19.11	£17.11	£17.72
50 plots	£17.18	£19.11	£17.91	£18.62
80 plots	£20.62	£19.11	£18.36	£19.13
Mixed non domestic site				
50 domestic UR, 3 LV NNH, 1 LV HH	£85.86	£67.20	£66.09	£38.51

The analysis makes a number of assumptions

Average Dom UR consumption was taken as 3703kWh p.a. split 85% day and 15% night
Average Dom E7 consumption was taken as 7477kWh p.a. split 47% day and 53% night

[17] This has been used for all sites but we appreciate that ENW may offer the NHH commercial tariff to some IDNO smaller IDNO sites. The margins which we have shown are for certain scenarios and we accept that these margins will change under different scenarios and different assumptions. The purpose of this analysis is to provide an indication of margins available and in no way prejudices the findings of the ongoing Competition Act (1998) investigation into ENW.

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The capacity of an IDNO site was calculated differently depending on whether the site was domestic UR or Domestic E7. For domestic UR, we assumed that the site had a minimum capacity of 8kVa and an extra 1.4kVA for each plot on the site. For domestic E7, we assumed that the site requires a minimum of 4kVa and that each house thereafter requires 5.3kVA. 40% of this total is then taken to be the capacity of the site.

For the non domestics, capacity was assumed to be 50.28kVa for a NHH PC5-8 end user and 152.24kVa for an LV HH end user. All these assumptions on capacity and consumption have been taken from illustrative tariff analysis which ENW have provided Ofgem with as part of tariff analysis they submitted alongside their modification proposal.

For administrative costs, ENW state that for portfolio billing IDNOs will be charged £100 per IDNO per month. We have assumed that an IDNO will have 20 sites in ENW's area, meaning that each site has an administration charge of £5 a month or £60 a year. For site based tariffs, ENW levy a charge of £67.91.

For the domestic mixed site, the site tariff levied was the LV E7 IDNO charge. For the non domestic mixed site, the site tariff used was the LV Dom UR IDNO charge.

The 'all the way' tariffs used are those which came into effect on 1 April 2009.

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