



energyperspective

Distributed generation tail must wag the distribution charging dog

Last Tuesday saw the eighth meeting of the electricity Distribution Charging Methodologies Forum (DCMF), and the agenda was dominated by Ofgem's proposal—now out for statutory consultation until 29 October—to modify distribution licences to effect a common distribution charging methodology and new supporting governance arrangements. The new regime would be applied by the seven distribution network operators (DNOs) in setting their use of system charges from the start of the next price control in April 2010.

While the reform process has been long and drawn out—commencing in earnest over five years ago—even at this late stage there is a fundamental disagreement between the regulator and at least one of the DNOs on the new economic model that should be applied for setting charges. That disagreement threatens a Competition Commission investigation and further delays. This *Energy perspective* considers the position reached and some of the tensions.

Pedigree aspirations

Having first expressed disappointment with progress by DNOs in developing their own new charging methodologies under the so-called Structure of Charges project last November (*Energy Spectrum* 122 p2), Ofgem has this year sought to impose a long-run incremental cost-based (LRIC) approach by 2010. Following further consultations on the pros and cons of the various charging methodologies being pursued by the DNOs, its efforts have culminated in a statutory consultation, which closes on 29 October (*Energy Spectrum* 153 p11).

The consultation sets out both the proposed single charging methodology (which we describe further below) and revised governance arrangements aimed at allowing parties other than DNOs to propose changes. It forms part of a very congested work area that also includes the development of common tariff structures across DNOs and the introduction across the board of charges for independent DNOs.

At DCMF last week, the Energy Networks Association suggested three DNO-led groups to take forward work:

- a charging methodology workgroup, to be supported by consultants and tasked with delivering templates by January 2009 to derive changes from an appropriate economic model. They will subsequently be populated with outputs and sense-checked during the spring and summer, enabling Ofgem to make a final decision on implementation by September next year;
- a governance workgroup, to review potential models for network charging methodologies and changing them; and
- a methodology developments workgroup, to consider areas where Ofgem's consultation has not proscribed an approach, including tariff structures, transparency and predictability—as there is a proposed obligation to provide a five-year forward view of potential charge developments. Longer term products will also be considered as there is a proposal that fixed, long-term distribution tariffs and charges may be appropriate for some users at extra high voltages (EHV).

DCMF chairman Andrew Neves emphasised last week that, assuming the proposals are accepted by sufficient DNOs, then the very aggressive project timescales would demand total commitment from all parties, and a number of critical milestones for deliverables must be met along the way for the target date to be adhered to.

Leader of the pack

But implementation of this programme and timetable will depend on whether enough DNOs accept not just the principle of a common methodology but also the regulator's preference for it and consent to its entrenchment through adoption of a proposed collective licence modification (CLM). Unlike previous consultations where Ofgem has canvassed views on the concept of a common method only, its latest statement makes clear the regulator wants to see a specific methodology implemented—the so-called long-run incremental cost-based (LRIC) network charging model for

EHV distribution networks with the existing distribution reinforcement model (DRM) used for high and low voltage charging.

In Ofgem's opinion such an approach is economically robust and would:

- associate demand users' behaviour with the investment costs of the assets they utilise by linking use of system charges to small changes to projected growth in demand;
- through its use of pricing nodes, produce a strong economic signal when assets are more highly utilised to signal to impending reinforcement for demand or potential attractiveness for generation investment. This approach should lead to more efficient investments in networks over time;
- involve a symmetry between generation and demand, which it considers "crucial" if network operators are to provide cost-reflective economic signals that users can respond to and contribute collectively to system security; meaning that
- "in principle, [it would] value and reward efficient use of the distribution network by customers in local parts of DNOs networks as system configuration changes and new or better managed load and generation affect the utilisation of network assets."



Although it has acknowledged concerns about potential charging volatility, Ofgem's overall conclusion is clear: "We think that of all the charging models that are currently developed and widely understood by the industry, LRIC is the most consistent with the expected changes to distribution networks and with the greater uptake of distributed generation."

Indeed the one new methodology that has been implemented under Ofgem's direction since April 2005 when new licence arrangements for charging were introduced was by Western Power Distribution last April, and this is LRIC-based. Since then, but before the proposed common approach was set out by Ofgem, EDF Energy Networks and CE Electric had been developing their own methodologies on a similar base. Strikingly, two of these DNOs have no distributed generation interests and the third, EDF Energy, is building them up from a low base.

Of the other DNOs, Electricity North West and the so-called G3 of Scottish Power, Scottish and Southern Energy (SSE) and Central Networks had opted for alternatives to LRIC. In recent impact assessment consultations Ofgem has made plain its view that these approaches are inferior documenting a number of defects along the way.

Dog in a manger?

But last week SSE rejected the regulator's proposals because it considered LRIC an inappropriate basis of an enduring longer term distribution charging arrangement. The company's position is driven by arguments it evidently strongly holds about for LRIC's cost reflectivity, transparency, predictability and simplicity. It says that, through its inherent volatility, an LRIC-based distribution methodology could hinder rather than stimulate renewables generation and therefore inhibit progress against wider policy targets. The experience of LRIC-based transmission charging has seen significant year-on-year swings in network charges for larger new renewables generators, in its opinion. It is not a coincidence that the company is also aligned with arguments emanating from the Scottish Government about the continuing appropriateness of National Grid's similar, established investment-cost related pricing (ICRP) model for transmission.

In last week's formal rejection letter it said connection charges should instead be used to send locational signals. The letter also summarised a series of correspondence that make the point that its objections to LRIC-based distribution charging are themselves long-term and not transitional in nature.

It also drew particular attention to the treatment of new and existing renewables generation by commenting: "We remain firmly of the view that it would be inappropriate and impractical to charge use of system for those generators connected prior to April 2005. Indeed so severe are these practical issues that we believe they are a show stopper." The company's argument here is that it, because of the number of connections and complexity of network configuration, its distribution business could end up under LRIC caught in a number of complex, difficult disputes with

small generators, bringing political difficulties in their wake as well as potentially providing unexpected charge shocks to individual operators that would be disruptive to progress against targets that are about to ratchet up.

Dog fight

In the statutory consultation Ofgem said it would recommend an immediate Competition Commission referral in the event that “all, or not enough” DNOs consented to the CLM. And one more rejection by a DNO would probably be enough for that referral and raises the prospect of even more delay and significant upheaval.

SSE's concerns on the common methodology proposals clearly centre on the economic model rather than the governance arrangements—where some other DNOs are rumoured to have concerns. It is at pains to emphasize that its perspective arises from its experience as a distributor, not as an operator of significant embedded generation. Given the volume of new decentralised generation seeking connection to its system, these arguments must be properly assessed. While the distribution charging debate can be broken down to several important matters, the overriding consideration from the current process is to make sure that after largely ducking the issue in 2005 generation charges are properly assimilated into the revised charging structure on a stable basis. Furthermore it is essential that the framework gets the economic model right for both new and existing distribution network users, and if there are to be discrimination issues they are bottomed now.

Yet with its rejection of the proposed G3 methodology and the history set out by SSE in its letter, Ofgem has clearly not been convinced to change its mind on LRIC. But, subject to decisions of the other DNOs, it may yet have to demonstrate the strength of its case to the Competition Commission.

But perhaps progress on the principle of a common methodology and revised governance can still be banked even if another DNO were to formally reject the LRIC approach. This would be a positive step even if a Competition Commission investigation were to eat at least six months into an already very challenging timetable for the common charging model. It would also show a willingness by the DNO community to work towards some form of agreed outcome.

Above all, it would signal a recognition that distribution charges should not be set on a local basis. It would constitute an acceptance that wider competitive goals—in this instance not just renewables policy but also national supply market considerations—should be regarded as more important than narrower concerns about degrees of efficiency, which are anyway controversial. The industry needs debate, not dogma.



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