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National Grid Electricity Distribution and
other interested parties

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Energy Systems, Management and Security
28 December 2023

Derogation to National Grid Electricity Distribution (NGED) pursuant to Section 2A Clause 19.1B[1] of the Distribution Connections and Use of Systems Agreement (DCUSA)

We have granted a derogation to NGED so that it may publish its final Distribution Use Of System (DUoS) charges for 2025/26 for its East Midlands region after 31 December 2023 (the 15-month notice period required under the DCUSA). NGED will publish draft DUoS charges for all but its c.300 East Midlands Extra High Voltage customers by 31 December, with final charges for all customers to follow as soon as practicable in 2024 but not later than 31 January 2024. We consider it is in the interests of its customers overall, and in particular its EHV customers, to delay publication of final charges to allow it to mitigate what would otherwise have been an exceptional level of volatility of fixed charges for some EHV customers.

Background

Distribution Network Operators (DNOs) recover their allowed revenue from customers through DUoS charges. The methodologies for calculating these charges are the EHV Distribution Charging Methodology (EDCM) for the large, industrial customers connected at the highest voltages, and the Common Distribution Charging Methodology (CDCM) for the remaining customers. The CDCM and EDCM are detailed in the DCUSA document.

[1] "19.1B - The periods of notice described in Clause 19.1A shall apply unless the Authority directs the Company that those periods of notice need not apply. Where the Authority directs the Company that those periods of notice need not apply, the notice period shall be 40 days (without prejudice to any longer notice requirements prescribed by the Distribution Licence)."

There are two versions of the EDCM methodology. Each of the DNO licensees selected one to adopt on an enduring basis when the EDCM was introduced: the Forward Cost Pricing (FCP) or the Long Run Incremental Cost (LRIC) methodologies. This issue so far only appears to have the potential to affect those DNOs using the FCP methodology.

NGED's issue and requested derogation

NGED's issue has some similarities to that for which we issued a derogation to Scottish & Southern Energy Networks (SSEN) Distribution on 1 December.[2] In NGED's case, the issue is driven by a material reduction in allowed revenues between 2024/25 and 2025/26. For East Midlands EDCM customers, this would result in some customers receiving a significant credit fixed "residual" charge despite the intention of these charges to recover residual costs from final demand customers. The NGED issue materialised later than the SSEN issue partly due to delays in NGED receiving EDCM input data from a third party.

Unfortunately, we were only made aware of the issue on 21 December, just four working days before the deadline for publishing charges. Owing to the short timescales, NGED has sought a derogation from the 15-month notice period for publishing final DUoS charges for 2025/26, ie 31 December 2023. It will publish draft CDCM charges by this date.

In the meantime, NGED will investigate an approach to the EDCM methodology for 2025/26 that avoids the perverse outcome of fixed credits for residual network charges. Once it has a proposed solution, it plans to seek a derogation to charge outside of its EDCM methodology for 2025/26. The solution may adapt that used by SSEN, though given the different circumstances, it may propose an alternative approach.

Subject to us granting that derogation, it will publish final CDCM and EDCM charges as soon as practicable in 2024. It does not expect the final CDCM charges to be materially different from the draft charges, but is only publishing draft CDCM tariffs in advance of this because outputs of the EDCM are used in the calculation of CDCM charges and vice versa.

Our assessment

We have considered NGED's proposal to delay publishing final CDCM and EDCM charges for its East Midlands licence area against our principal objective and wider statutory duties. We have considered whether alternative solutions, such as publishing draft EDCM charges now and then republishing final charges under a revised methodology would better facilitate the achievement of these objectives and duties.

[2] Derogation to Scottish and Southern Electricity Networks Distribution pursuant to SLC 13B Part E of the Electricity Distribution Licence | Ofgem

Competition

NGED informed us that the draft EHV tariffs for East Midlands would result in some EHV users facing negative "residual" charges. We think such a dramatic change in the level of charges is potentially harmful for competition. Negative residuals could lead to distortive incentives for customers to hold or increase agreed capacity where it is not needed, which will not lead to efficient system use and could be harmful for competition if it prevents the efficient allocation of capacity to other users.

We have signalled our intention to look into the presence and impacts of volatility of EHV DUoS charges as part of our DUoS Reform Significant Code Review (SCR) work. We have not formed an opinion on whether broader intervention is needed, but think that a swing from significant positive fixed charges to significant negative fixed charges was unlikely to be predictable to users and so does not aid business planning or investment certainty.

Cost reflectivity

Absent this derogation, NGED's EDCM unit and capacity charges would over-recover revenue and then pay fixed credits that do not send a signal for reducing the long run costs of the distribution network. This suggests the over-recovery is inefficient and unnecessary when compared to alternatives such as recovering less in the first place. At a time when both domestic and non-domestic users are facing higher costs of energy, it does not seem reasonable to see consumer money paid out to users in standing charges without clear justification.

Process

We recognise that NGED's proposed solution is not the only possible solution, so we have also considered the potential for NGED to publish EDCM charges unamended and then to update them with revised charges once a resolution has been found. While this may have some benefits in terms of transparency, we have concluded the NGED proposal is likely to be the most proportionate route to take.

In particular, the NGED proposal would not lead to unnecessary uncertainty for EDCM customers, by publishing draft charges that may be materially different for some customers by the time charges are finalised under an adapted methodology. By seeking to address this issue as soon as practicable, and no later than 31 January 2024, the delay to publication of charges should only be a matter of weeks and still provide more than a year's notice of charges (compared with two months for transmission use of system charges).

Furthermore, by publishing draft CDCM charges, which we do not expect to be materially affected by amendments to the EDCM methodology, it should maintain certainty for the vast majority of its East Midlands' customers.

Under SLC13B.5, licensees must review the EDCM methodology at least once a year and make such modifications to the methodology as are necessary for the purposes of better achieving the Relevant Objectives.[3] Typically, such a modification would be enabled via a proposal to DCUSA to proceed to industry working group development and ultimately for Ofgem decision. In this instance, with the issue only being confirmed close to the date by which charges are due to be published, the usual modification timetable would add significant uncertainty to the tariffs for affected parties. That is, were any such modification ultimately approved, it would significantly reduce the notice period for charges (to a matter of months) and introduce further uncertainty as a result of relatively short-notice changes to published charges.

In addition, we are currently conducting a SCR into DUoS, which limits the ability of DNOs to propose modifications to the charging methodology which overlap with the scope of that SCR. We have recently sought views on our proposal to examine EDCM volatility in the next phase of that SCR.[4] We will seek to ensure that work considers the causes of the volatility that gave rise to this and SSEN's issue.

We encourage DNOs to examine likely future charges in as far as advance as practicable to ensure any such issues are identified as early as possible.

We understand that there may be some consequential impacts on the ability for IDNOs and DNOs operating out of area to set tariffs for the East Midlands region within their required timescales. We will further engage these parties and consider whether any additional interventions are required.

Decision

We have considered the request in accordance with our principal objective and statutory duties. We have decided to grant the requested derogation in accordance with the Direction below. This letter sets out the reasons for our decision under section 49A of the Electricity Act 1989.

Direction

The Authority hereby directs:

[3] The Relevant Objectives are listed in SLC 22A Part B.
[4] https://www.chargingfutures.com/media/1602/cff-slide-pack-31-october-2023-final.pdf – see slides 38-41.

Pursuant to Section 2A Clause 19.1B of the DCUSA, that the periods of notice described in Clause 19.1A shall not apply to NGED (East Midlands) plc for 2025/26 Use of System Charges.

The direction shall have effect from the date stated below.

Dated 28 December 2023

Yours faithfully,

Andrew Malley
Head of Distribution and Residual Charging

Signed on behalf of the Authority and authorised for that purpose