



Modification proposal:	DCP 094 – Treatment of ‘Load related new connections & reinforcement (net of contributions)’ in the Price Control Disaggregation Model used to determine LDNO discount factors		
Decision:	The Authority ¹ has decided to reject this proposal ²		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	9 December 2011	Implementation Date:	1 April 2012

Background to the proposed modification

The common distribution charging methodology (CDCM) was implemented in April 2010 and sets out how distribution use of system (DUoS) charges for users connected at low voltage (LV) and high voltage (HV) are calculated. The CDCM introduced specific charges for licensed distribution network operators (LDNOs)³. These charges are derived from discounting the CDCM charge for end users to take account of the proportion of the network which the LDNO provides instead of the DNO. The discounts used to derive LDNO charges are calculated through the Price Control Disaggregation Model, also known as “Method M”. This uses a series of cost drivers to disaggregate the price control settlement into four network levels - LV, LV/HV, HV and extra high voltage (EHV). This is used to generate a proxy for the percentage of cost which lies in each of the four network levels. This proxy forms the basis of the discount provided on the CDCM charge to generate the LDNO specific charges.

At the network level where the LDNO is connected to the DNO (HV or LV), both the DNO and the LDNO will provide network assets used to supply the LDNO’s end customers. Method M allocates the costs at this network level between the DNO and the LDNO. Indirect costs are allocated to the LDNO and direct costs are split between the DNO and the LDNO using the ‘LV split’ or ‘HV Split’, depending upon the voltage level at which the LDNO connects. The ‘split’ estimates the proportion of direct costs at that network level that are borne by the DNO in respect of customers connected to the LDNO network. The final discount is the sum of the percentage of costs for the network levels at which the LDNO provides all the distribution assets, and the percentage of costs that it is deemed to bear in respect of the network level it connects to the DNO at⁴.

Under clause 101 of the CDCM, data from the DNOs’ regulatory reporting packs (RRP) is used to calculate the proportion of direct costs at HV and LV. Clause 101 further clarifies that capital expenditure net of customer contributions should be included in this calculation and, where this results in a negative number⁵, it should be replaced with a zero. Ideally this would result in capital costs being allocated to the network level at which they are incurred and customer contributions being allocated to the network level they were recovered in respect of.

¹ The terms ‘the Authority’, ‘Ofgem’ and ‘we’ are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

² This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

³ This includes Independent Network Operators (IDNOs) and Distribution Network Operators (DNOs) operating out of their distribution services area.

⁴ For clarity, this is the percentage of the total costs across all network levels that the LDNO bears at that specific network level, rather than the percentage of the costs associated with that network level that the LDNO bears.

⁵ ie where customer contributions are greater than the costs.

Due to data disaggregation issues, it is not possible to do this accurately for the 'Load related new connections & reinforcement (net of contributions)' elements of capital cost. In practice, DNOs allocate all load related reinforcement costs to the network level at which the customer is connected, rather than the network level at which the reinforcement was carried out, and all customer contributions are subtracted from the costs that are allocated to the LV network level. The impact of this at LV is an underestimation of direct costs at LV, which results in higher discount percentages for LV connected LDNO networks. The impact of this at HV is an overestimation of the direct costs at HV, which results in a lower discount percentage for HV connected LDNO networks. The underestimation of the proportion of direct costs at LV is limited because negative numbers are replaced by zero.

The modification proposal

DCP094 was proposed by the Electricity Network Company in June 2011. The proposer considers that removing 'Load related new connections & reinforcement (net of contributions)' from the calculation of the proportion of direct costs at HV and LV, would result in more cost reflective discount percentages. The change proposal seeks to change the Method M accordingly.

We note that the change proposal does not have an impact on LDNO charges where that LDNO is connected to the DNO at LV. Where they are connected at HV, the change proposal will reduce the average annual charge an LDNO pays to a DNO for use of the upstream network in supplying an LV unrestricted domestic customer by around 50 pence⁶. We note that this loss in revenue for DNOs will be made up through increasing the charges to all other CDCM customers. However, the number of LDNO customers is less than 200,000 compared to over 28 million CDCM customers. Therefore, the extra revenue they need to recover from other customers will be insignificant on a per customer basis⁷.

DCUSA Parties' recommendation

The Change Declaration for DCP094 indicates that DNO, IDNO/OTSO⁸, Supplier and Distributed Generation (DG) parties were eligible to vote on DCP094. In the IDNO and Supplier categories there was unanimous support for the proposal and the implementation date. In the DNO category a majority of 54% voted to reject the modification and a majority of 83% voted to accept the implementation date. No votes were cast in the DG party category.

The outcome of the weighted vote procedure is set out in the table below:

DCP094	Weighted Voting (%)						DG ⁹	
	DNO		IDNO/OTSO		SUPPLIER		Accept	Reject
	Accept	Reject	Accept	Reject	Accept	Reject		
Change solution	46	54	100	0	100	0	N/A	N/A
Implementation date	83	17	100	0	100	0	N/A	N/A

⁶ This is the average across all 14 DNO areas and is based on the consumption assumptions currently made in the CDCM.

⁷ For example if we assume there are 100,000 IDNO customers who are all LV unrestricted then as a consequence of the proposal DNOs would have around £200,000 extra to recover from the other 28 million customers. This would represent less than 0.8p per customer per year.

⁸ Means the National Electricity Transmission System Operator in its capacity as the operator of Offshore transmission systems

⁹ No votes were cast in this category of Parties

The Authority's decision

The Authority has considered the issues raised by the proposal, the Change Report and the Change Declaration¹⁰ issued on 4 November 2011. We have also considered and taken into account the views of the DCUSA Parties in response to the DCUSA Panel's consultation and Request for Information (RFI), and the DCUSA Parties' recommendation.

The Authority has concluded that:

1. The Workgroup have not provided sufficient evidence for the Authority to assess whether DCP094 will better facilitate the achievement of the Charging Objectives of the DCUSA;
2. The Authority has therefore decided not to direct the implementation of the proposal.

Reasons for the Authority's decision

Our decision in respect of this modification rests on the cost reflectivity of charges under the current arrangements and charges under the proposal. If it had been demonstrated that the proposal resulted in more cost reflective charges, we may have approved the proposal on the grounds that it better achieved Charging Objectives 3.1.1, 3.1.2 and 3.1.3, would have no effect on Charging Objective 3.1.4 and provided it was consistent with our principal objective and wider statutory duties. If it was demonstrated that the current arrangements resulted in more cost reflective charges, we would have rejected the proposal on the grounds that it did not better achieve Charging Objectives 3.1.1, 3.1.2 and 3.1.3 and would have no effect on Charging Objective 3.1.4.

In our view, the analysis and discussion carried out by the Workgroup has not been sufficient for us to reach a decision in respect of the relative cost reflectivity of charges under the current arrangements and under the proposal. The Authority may only approve a proposal to modify the CDCM if it is sure that the proposal will better achieve the Charging Objectives. We are in this case unable to say whether the modification better achieves the Charging Objectives and as such we are unable to direct the implementation of the proposal.

Charging Objective 3.2.1 That compliance by each DNO party with the Charging Methodologies facilitates the discharge by the DNO party of the obligations imposed on it under the Act and by its Distribution Licence.

We note that under standard licence condition (SLC) 4.6, DNOs have an obligation not to restrict, distort or prevent competition in the generation, transmission, distribution, or supply of electricity, or in the operation of an interconnector. In our view, more cost reflective discount percentages would, by providing a more cost reflective allocation of costs between DNOs and LDNOs, reduce the likelihood of the restriction, distortion or prevention of competition in the distribution of electricity.

As discussed below in relation to Charging Objective 3.2.3, we consider that the discussion and analysis carried out by the Workgroup was not sufficient to reach a conclusion in respect of the relative cost reflectivity of charges under the current arrangements and charges under the proposal. Therefore, we cannot say the proposal better meets Charging Objective 3.2.1.

¹⁰ All documents can be accessed via the DCUSA website: <http://www.dcusa.co.uk/Extranet/CP.aspx?id=93>

Charging Objective 3.2.2 That compliance by each DNO party with the charging methodology 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 the participation in the operation of an interconnector (as defined in the Distribution Licence).

We consider that in terms of distribution, the same arguments as outlined under Charging Objective 3.2.1 above apply. Therefore, we cannot say the proposal better achieves Charging Objective 3.2.2.

Charging Objective 3.2.3 That compliance by each DNO party with the Charging Methodology results in charges which, so far as is reasonably practicable after taking account of implementation costs, reflects the costs incurred, or reasonably expected to be incurred, by the DNO party in its Distribution Business.

As discussed above, based on the analysis and discussion provided, we were unable to reach a conclusion in respect of whether the proposal results in more cost reflective charges. We note that it is clear that the LV figure for 'Load related new connections & reinforcement' will be zero under the current arrangements and the proposal. Therefore, the proposal and the current arrangements will be equally cost reflective in respect of LV connected LDNOs. However, it is not clear to us whether the HV figure for 'Load related new connections & reinforcement (net of contributions)' would be more or less cost reflective under the proposal for a number of reasons:

- Data on the customer contributions that should be allocated to HV is not available and no attempt has been made to estimate what this might be.
- Data on the correct allocation of reinforcement costs is not available and no attempt has been made to estimate what this might be.
- The DNOs allocation of 'Load related new connections & reinforcement (net of contributions)' varies significantly and no discussion or analysis of what the proposal might mean for different DNOs has been carried out.

In light of the above, we are unable to reach a conclusion in respect of whether the proposal results in more cost reflective charges and, therefore, cannot reach a decision that the proposal better achieves Charging Objective 3.2.3.

Charging Objective 3.2.4 That, so far as is consistent with Clauses 3.2.1. to 3.2.3, the Charging Methodologies, so far as reasonably practicable, properly take account of developments in each DNO parties Distribution Business.

We note that the change proposal was not raised in response to developments in a DNO's distribution business. Consequently, we do not consider this Charging Objective is relevant to the proposal.

Advice

The above notes that we are not approving either of the change proposals because it has not been clearly demonstrated that they better meet the relevant objectives.

As stated above, decisions in respect of modifications of this type rest largely on whether the proposal or the status quo is more cost reflective and the evidence provided by the Workgroup has not been sufficient for us to come to a conclusion in that respect. We therefore suggest that the modification be resubmitted and the Workgroup carry out

further analysis in respect of the cost reflectivity of each approach. We would be happy to input into a discussion regarding the type and extent of analysis required.

We also note some members of the Workgroups believe that other options may result in charges that are more cost reflective than those under either the current arrangements or the proposal, and that the Workgroup was precluded from considering these due to the narrow intent of the proposal. While we do not have a view as to whether more cost reflective options exist, given the limitations of the RRP data, we suggest that the proposer leaves room for the consideration of other options within the intent of any new proposal.

Competition Act 1998

It is important to note that our decision letter relates to the methodology rather than the quantification of elements produced by the methodology. This is a regulatory decision. It is for DNOs to ensure their own compliance with the Competition Act 1998 and/or Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU) in implementing the proposed methodology. It does not amount to or imply any particular view as to the application or interpretation of the Competition Act 1998 and/or Articles 101 and 102 of the TFEU, or any other law, either prior to this regulatory decision or once this regulatory decision is in place.

Rachel Fletcher

Acting Senior Partner, Smarter Grids and Governance: Distribution

Signed on behalf of the Authority and authorised for that purpose