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| Modification proposal: | <b>Distribution Connection and Use of System Agreement (DCUSA) DCP095 - Treatment of LV costs in the Price Control Disaggregation Model in determining tariffs to LDNOs connecting to upstream LDNOs at LV</b> |                      |              |
| Decision:              | The Authority <sup>1</sup> directs that DCP095 be made <sup>2</sup>  |                      |              |
| 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)<sup>3</sup>. 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 that 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 at<sup>4</sup>.

The LV Split is calculated by:

- a) determining the total length of the DNO's LV mains used by LV-connected LDNOs;
- b) dividing that total length by the number of end users on LV-connected LDNO networks; and
- c) dividing the result by the average length of LV network per LV end users on the DNO's own LV network.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

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

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

<sup>4</sup> 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.

## The modification proposal

DCP095 was proposed by the Electricity Network Company in June 2011. The proposer argued that using the average length of the DNO's entire LV network (LV mains and LV services) to calculate the LV split is not correct, as the downstream LDNO will always provide 100 per cent of the LV services.

The change proposal therefore seeks to change Method M so that the LV network level is split into two network levels: LV mains and LV services. The LV split would become the 'LV mains split' and be calculated based on the average length of LV mains per LV end user connected to the DNO's network. There would be no split in the LV services network level. The total percentage of DNO costs allocated to LV services will be included in the discount percentage for the end user types that the LDNO provides LV services for.

The proposer argues that the change would result in a more cost reflective solution that would reduce distortions in the way discount percentages are currently calculated for such connections.

We note that the impact of the proposal is to increase the discount factors applied to charges levied on LV connected LDNOs. Consequently, the average annual charge an LDNO pays to a DNO for use of the upstream network in supplying an LV domestic customer will reduce by less than £1<sup>5</sup>. 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 electricity distribution customers. Therefore, the extra revenue they need to recover from other customers will be insignificant on a per customer basis<sup>6</sup>.

## DCUSA Parties' recommendation

The Change Declaration for DCP095 indicates that DNO, IDNO/OTSO<sup>7</sup>, Supplier and Distributed Generation (DG) parties were eligible to vote on DCP095. In each party category where votes were cast there was unanimous support for the proposal and its proposed implementation date.

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

| DCP095              | Weighted Voting (%) |        |           |        |          |        |                 |        |
|---------------------|---------------------|--------|-----------|--------|----------|--------|-----------------|--------|
|                     | DNO                 |        | IDNO/OTSO |        | SUPPLIER |        | DG <sup>8</sup> |        |
|                     | Accept              | Reject | Accept    | Reject | Accept   | Reject | Accept          | Reject |
| Change solution     | 100                 | 0      | 100       | 0      | 100%     | 0      | N/A             | N/A    |
| Implementation date | 100                 | 0      | 100       | 0      | 100%     | 0      | N/A             | N/A    |

We note that while UK Power Networks voted in favour of the change proposal they did so by a 'narrow margin'. They stated that 'although we can identify an improvement in terms of the principle of splitting LV Costs into greater detail by examining LV Mains and

<sup>5</sup> This is the average across all 14 DNO areas and is based on the consumption assumptions currently made in the CDCM.

<sup>6</sup> 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.

<sup>7</sup> Means the National Electricity Transmission System Operator in its capacity as the operator of Offshore Transmission Systems.

<sup>8</sup> No votes were cast in this category of Parties.

LV Service separately, we do however have concerns over the assumptions underlying the split values and the allocation of value assigned to LV Service’.

### **The Authority’s decision**

The Authority has considered the issues raised by the proposal, the Change Report and the Change Declaration<sup>9</sup> 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. We note that the overall intent of the proposal has received unanimous support.

The Authority has concluded that:

1. Implementation of change proposal DCP095 will better facilitate the achievement charging objectives 3.2.1, 3.2.2 and 3.2.3 and is neutral to 3.2.4.
2. Directing that the change is approved is consistent with the Authority’s principal objective and statutory duties.<sup>10</sup>

### **Reasons for the Authority’s decision**

The Authority’s assessment of DCP095 against the Charging Objectives is set out below:

***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. We consider that in terms of distribution, the same arguments as outlined under Charging Objective 3.2.2 below apply.

***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 DCP095 would enable the CDCM to better achieve this objective. As discussed below in relation to Charging Objective 3.2.3, the change proposal should result in a more cost reflective distribution of revenue between DNOs and LDNOs. It is our view that by doing so, the proposal reduces the likelihood of the distortion, restriction or prevention of competition in the distribution of electricity.

***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.***

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<sup>9</sup> All documents can be accessed via the DCUSA website: <http://www.dcusa.co.uk/Extranet/CP.aspx?id=93>

<sup>10</sup> The Authority’s statutory duties are wider than matters that the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 as amended as well as obligations arising under EU legislation.

We consider that DCP095 would enable the CDCM to better achieve this objective. The charges levied on LDNOs are set by the CDCM, with reference to the costs incurred by the DNO in running its own business. In calculating these charges, splitting up the LV part of the network between LV services and LV mains helps to provide a more accurate reflection of the costs incurred by DNOs and those that are incurred by LDNOs. This revised calculation should result in discounts to LDNOs that are more reflective of the costs incurred by DNOs and, by extension, a more cost reflective distribution of revenue between DNOs and LDNOs.

**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 consider the proposal is neutral in respect of this Charging Objective.

#### *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.

#### **Decision notice**

In accordance with SLC 22.14 of the Electricity Distribution Licence the Authority hereby directs that change proposal DCP095 'Treatment of LV costs in the Price Control Disaggregation Model in determining tariffs to LDNOs connecting to upstream LDNOs at LV' be made.

Rachel Fletcher

**Acting Senior Partner, Smarter Grids and Governance: Distribution**

Signed on behalf of the Authority and authorised for that purpose