| | | | |
|---|---|---|---|
| Modification proposal: | **Distribution Connection and Use of System Agreement (DCUSA) DCP097 - Treatment of LV costs in the Price Control Disaggregation Model in determining tariffs to LDNOs connecting to upstream LDNOs at LV** | | |
| Decision: | The Authority[1] has decided to reject this proposal | | |
| 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)[2]. These charges are derived from discounting each 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 tariffs.

Method M works by allocating capital and operating costs to each of the network level identified above. Capital costs identified in the price contol settlement are allocated using data within DNOs' regulatory reporting packs (RRPs), which directly identify the network level the cost relates to. Seperate operating costs are allocated to network levels using cost drivers. Where the network level the cost relates to cannot be identified, such as with some indirect costs, the modern equivalent asset value (MEAV) of the replacement costs of each network level are used to allocate those costs (with the exeption of transmission exit charges which are all allocated to EHV). The remaining indirect costs which do not have an identified cost driver are subsequently allocated on the basis of the outcome of the allocation of all other cost drivers.

We have previously indicated that MEAV may not necessarily be the best cost driver to allocate indirect costs.[3] This is the because the relative value of assets at each network level may not bear a close relationship to the cost.

**The modification proposal**

DCP097 was received by the Authority on 4 November 2011. The proposer argued that certain indirect costs in Method M should not be allocated to network levels according to

[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 includes Independent Network Operators (IDNOs) and Distribution Network Operators (DNOs) operating out of their distribution services area.
[3] See page 4 of the Authority's decision on CE Electric's proposal for the interim IDNO methodology in November 2009: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/CE%20IDNO%20interim%20mod%20decision%20letter.pdf

the value of assets (ie using MEAV as the cost driver) but the nature of the activity undertaken. The working group could not agree on the most appropriate cost drivers for two indirect costs[4] and so an alternative proposal (DCP097A) was raised.

The change proposal and its alternative therefore seek to change Method M so that the following cost drivers are used:

| Cost Category | Current Cost Allocation Driver | Proposed Cost Allocation Driver |
|---|---|---|
| Customer Call Centre | MEAV | Customer Numbers |
| HR & Non-operational Training | MEAV | Customer Numbers |
| Finance & Regulation | MEAV | Customer Numbers |
| CEO etc | MEAV | Customer Numbers |
| Property Management | Do Not Allocate | MEAV (DCP097)/ Customer Numbers (DCP097A) |
| IT & Telecoms | Do Not Allocate | MEAV (DCP097/ Customer Numbers (DCP097A) |

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

The average impact of the proposed modification is summarised below:

| | Average percentage discount on all the way tariffs | | | |
|---|---|---|---|---|
| **Averaged across all DNO areas** | **LV:LV user** | **HV:LV user** | **HV:LV sub user** | **HV:HV user** |
| **Current** | 29.3% | 40.89% | 12.36% | 25.81% |
| **DCP097** | 33.46% | 44.66% | 13.01% | 27.38% |
| **DCP097A** | 35.66% | 46.42% | 12.95%% | 26.33% |

We note that the proposal and its alternative have a significant impact on the discount percentages used to generate IDNO charges, particularly where the end customer is connected to the LDNO network at LV (as illustrated in the LV:LV user and HV:LV user columns). This will reduce the charges which LDNOs pay for upstream DUoS. 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 basis[5].

**DCUSA Parties' recommendation**

The Change Declaration for DCP097 indicates that DNO, IDNO/OTSO[6], Supplier and Distributed Generation (DG) parties were eligible to vote on DCP097 and DCP097A. There was not a majority view amongst the working group. All DNO parties who voted

[4] Property management and IT and Telcoms

[5] For example if we assume there are 200,000 IDNO customers who are all LV unrestricted then as a consequence of the proposal DNOs would have around £600,000 (based on average impact of the proposal) extra to recover from the other 28 million customers. This would represent less than 2.2 p per customer per year.

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

rejected both DCP097 and DCP097A. The one supplier party who voted supported DCP097 but not DCP097A. All IDNO/OTSO parties who voted[7] supported DCP097A and the majority but not all supported DCP097.

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

| **DCP097/097A** | Weighted Voting (%) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | DNO | | IDNO/OTSO | | SUPPLIER | | DG[8] | |
| | Accept | Reject | Accept | Reject | Accept | Reject | Accept | Reject |
| DCP 97 Change solution | 0 | 100 | 0 | 100 | 100 | 0 | N/A | N/A |
| DCP 97 Implementation date | 37 | 63 | 100 | 0 | 100 | 0 | N/A | N/A |
| DCP 97A Change solution | 0 | 100 | 100 | 0 | 0 | 100 | N/A | N/A |
| DCP 97A Implementation date | 37 | 63 | 100 | 0 | 100 | 0 | N/A | N/A |

**The Authority's decision**

The Authority has considered the issues raised by the proposal and its alternative, the Change Report and the Change Declaration[9] 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 DCP097 or DCP097A will better facilitate the achievement of the Charging Objectives of the DCUSA; and
2. The Authority has therefore decided not to direct the implementation of the proposal

**Reasons for the Authority's decision**

The Authority's assessment of DCP097 and DCP097A against the Charging Objectives under the DCUSA 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.

***Charging Objective 3.2.2 That compliance by each DNO party with the charging methodology facilitates competition in the generation and supply of electricity***

[7] These were exclusively IDNOs.
[8] No votes were cast in this category of Parties.
[9] All documents can be accessed via the DCUSA website: http://www.dcusa.co.uk/Extranet/CP.aspx?id=93

***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 competition in distribution will not be restricted, distorted or prevented if DNOs and LDNOs are able to compete on a level playing field. This can be aided in part by ensuring that DUoS charges levied by DNOs on LDNOs most accurately reflect the costs DNOs incur in transporting electricity to them and in addition that LDNOs are able to earn a 'margin'[10] to cover the costs which an equivalent, efficient, DNO would incur for providing the same service. Consequently, ensuring that the 'margin' the LDNO can earn is equivalent to an efficient DNO is one of the key objectives of the Method M model. It attempts to do so using cost drivers to allocate price control revenue in the most cost reflective manner.

The Authority has set out below why it is unable to assess how DCP097 or DCP097A, when taken as two complete packages, are more cost reflective than under the current Method M model. We consider that subsequently, we are also unable to assess how the proposal restricts, distorts or prevents competition any less than under the current Method M model.

***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, reflect the costs incurred, or reasonably expected to be incurred, by the DNO party in its Distribution Business.***

We do not consider that DCP097 or DCP097A would enable the CDCM or by extension the DCUSA to better meets this objective. We recognise that some aspects of the proposal represent an improvement on the current Method M model. For instance we acknowledge that allocating the costs associated with customer call centres may be better allocated to network levels using customer numbers as opposed to MEAV. As highlighted in the proposal, we have previously stated that MEAV may not be the best cost driver for all indirect costs[11].

However, as the working group have commented, the choice of cost drivers is subjective and has been an area of debate since the development of the CDCM and the Method M model. For indirect costs such as 'finance and regulation' and 'HR and non operational training', it is more difficult to construct a clear logic of how they should be allocated to network levels. This is evidenced by the failure of working group parties to agree on the proposed cost drivers and the raising of the alternative proposal DCP097A. Given the subjective nature of this work, we consider that the provision of evidence is crucial in providing a rationale for the change proposal.

We note that there is no evidence within the change report, change declaration or a confidential report provided to Ofgem by a member of the working group as to why, when taken as a whole package, either DCP097 or DCP097A is more cost reflective. The justification presented centres on why MEAV is inappropriate as a cost driver. Whilst we agree that MEAV may be inappropriate for some indirect cost drivers, no evidence has

[10] This refers to the difference between the DUoS charges they are able to recover from their end customers (the 'all the way' charge) and the DUoS charge which the LDNO has to pay to the DNO for use of its upstream network.

[11] See page 4 of the Authority's decision on CE Electric's proposal for the interim IDNO methodology in November 2009: http://www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgMods/Documents1/CE%20IDNO%20interim%20mod%20decision%20letter.pdf

been presented to outline why the alternative cost drivers are more cost reflective. In the absence of this evidence we are unable to understand how DCP097 or DCP097A better facilitates this objective.

***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 DNOs distribution business. Consequently, we consider that the impact of the change proposal is neutral against this Charging Objective.

*Further comments*

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 Charging Objectives.

We recognise that we have previously identified issues with the use of MEAV as a cost driver, as noted by some of the LDNOs. However, we would expect to see a more thorough evidence base and a more expansive investigation of the appropriate cost drivers in a change proposal. We note that this will require information, data and co-operation from DNOs as well as LDNOs. We would expect this to be readily provided, particularly as this is an area of the CDCM which we have indicated requires further work. We note that one DNO party commented in the change declaration that they would be willing to take part in a wider more open discussion on the issues covered in this proposal. We would encourage all parties to undertake this work under a wider remit and look at the issue of indirect cost drivers within Method M more holistically with a view to providing specific rationale and evidence for each proposed new cost driver. We consider that this process, whilst more lengthy, is likely to produce a change proposal with a greater liklihood of gathering wider support amongst DCUSA parties and also obtaining the evidence to enable the Authority to assess it against the Charging Objectives.

*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 At 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