Proposed variation:	**Distribution Connection and Use of System Agreement (DCUSA) DCP105:** Fixed Bi-annual Amendment of DUoS charges		
Decision:	The Authority[1] has decided to reject DCP105[2]		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested Parties		
Date of publication:	13 March 2012	Implementation Date:	N/A

Background to the modification proposal

As a result of our decision on DCP001[3], clause 19.1 of the DCUSA provides that Distribution Network Operators (DNOs) and Independent Distribution Network Operators (IDNOs) must use reasonable endeavours not to vary their Distribution Use of System (DUoS) charges more than two times a year, on 1 April and 1 October. This is consistent with the obligation in the Electricity Distribution licence (the licence) which states that DNOs must give three months' notice of changes to charges.

The joint effect of the licence obligation and the DCUSA obligation is that, although DNOs and IDNOs are encouraged to only change their charges on the two specified dates, they could still change their charges on another date provided that three months' notice is given.

The modification proposal

DCP105 was raised by npower Limited (the proposer) in August 2011. The change proposal seeks to amend clause 19.1 so that DNOs and IDNOs are restricted to making changes to DUoS charges on 1 April and 1 October only, thereby removing the "reasonable endeavours".

The proposer considers that the change proposal will improve certainty around suppliers' cashflows. Knowing precisely when changes to DUoS charges will take place helps suppliers to forecast the impact of those changes on their businesses more accurately. Consequently, the proposal would reduce the cost and risk associated with changing suppliers' tariffs by reducing the number of times those tariffs change. The proposer also considers that those consumers on direct contracts[4] will be able to forecast likely changes to their current costs on a more predictable basis.

The proposer considers that this change proposal better facilitates the achievement of DCUSA General Objective (3.1.2)[5].

A Working Group was established to assess the proposal. A consultation was issued to suppliers, DNOs, IDNOs and consumers on 7 October 2011 to determine whether parties were supportive of the intent of DCP 105 and the impact it would have on them if implemented. All respondents to the consultation indicated that they understood the intent of the proposal. However, the proposed solution was not supported by all those who responded, as illustrated in the table below:

[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] DCP001 Alternative was implemented on 1 November 2007. It meant that distributors are restricted to use reasonable endeavours to change tariffs no more than twice a year, with charges to take effect from 1st April and 1st October. The Authority's decision is available on the Ofgem website: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=2&refer=Licensing/ElecCodes/DCUSA/Changes.
[4] Direct contracts are pass through contracts applicable to large industrial and commercial consumers where suppliers immediately pass through any changes in DUoS charges to them.
[5] DCUSA General Objective 3.1.2 is 'the facilitation of effective competition in the generation and supply of electricity and (so far as is consistent therewith) the promotion of such competition in the sale, distribution and purchase of electricity'.

	Supportive	Not supportive	Undecided
Suppliers	8	1	1
DNOs	0	6	0
IDNOs	2	1	0
Consumers	2	0	0

The views of the Working Group were also split on whether the proposal better facilitates one or more of the DCUSA General Objectives. The views of the Working Group and their assessment of the impact of the proposal on different DCUSA and other parties are provided in the DCP105 Change Report (CR)[6].

DCUSA Parties' recommendation

The Change Declaration for DCP105 indicates that DNO, IDNO/OTSO, supplier and DG parties were eligible to vote on DCP105. As shown in the table below, the sum of the weighted votes was not greater than 50% in all categories. In accordance with the weighted vote procedure, the recommendation to the Authority is that DCP105 be rejected. The outcome of the weighted vote is set out in the table below:

DCP105	DNO		IDNO/OTSO		SUPPLIER	
	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	12	88	50	50	100	0
IMPLEMENTATION DATE	12	88	50	50	100	0

The Authority's decision

We have considered the issues raised by the proposal and the Change Declaration dated 7 February 2012. We have taken into account the vote of the DCUSA Parties on the proposal which is set out in the Change Declaration. We have also have considered and taken into account the responses to the Working Group's [7] consultation, which are attached to the CR.

Reasons for the Authority's decision

We have set out our reasons against the DCUSA General Objectives. We also provide our views on relevant wider issues pertinent to this decision.

DCUSA General Objectives

Our reasons are given below against each of the DCUSA General Objectives where, in our view, we consider that the change proposal does or does not better facilitate the relevant objective. For the other objectives, we consider that the impact from the change proposal is neutral.

DCUSA General Objective 3.1.2 'the facilitation of effective competition in the generation and supply of electricity and (so far as is consistent therewith) the promotion of such competition in the sale, distribution and purchase of electricity'

[6] DCUSA change proposals, modification reports and representations can be viewed by registered users on the DCUSA website operated by ElectraLink: http://www.dcusa.co.uk/Public/Default.aspx
[7] In accordance with the role, functions, and responsibilities of the Working Group set out in Section 1B of the DCUSA.

We note that the majority of consultees and the Working Group considered that the proposal would result in more cost reflective charges, thereby improving competition in supply. Respondents also considered that the proposal would allow suppliers to forecast their DUoS costs more accurately and set charges to their customers based on more predictable charging data. The proposal could also provide confidence to IDNOs when they issue quotes and forecasts to their customers about the accuracy of their costs. Furthermore, the proposal could also reduce the risk of unexpected price changes for both suppliers and consumers. In this way, the proposal could promote effective competition by reducing barriers to entry in the market for the supply of electricity. On balance, we agree that the proposal will better facilitate Objective 3.1.2. We explain below our wider views on the issue.

DCUSA General Objective 3.1.3 'the efficient discharge by each of the DNO Parties and IDNO Parties of the obligations imposed upon them by their Distribution Licences'

The majority of the consultation responses concluded that the proposal might have a negative impact on this Objective, as it could potentially place DNOs and IDNOs in breach of their licence conditions. This is because restricting the DNO and IDNO parties to making price changes only on 1 April or 1 October would affect their ability to produce cost reflective DUoS charges outside of these dates provided they gave the required three months' notice of changes to their charges. Consultees also believed that the consequential effect might be to adversely affect their cash flows and distort the market, potentially placing DNOs and IDNOs in breach of their licences.

The price control framework[8] is embodied in several charge restriction and standard conditions of the distribution licences. These charge restriction conditions prescribe revenue allowances and parameters and how the revenue allowances may be adjusted for a range of factors, including a company's performance under various incentive mechanisms. These licence conditions also set out obligations on DNOs from 1 April 2010, including the setting of distribution charges consistent with their revenue allowance.

Charging Restriction Condition "CRC" 14 imposes certain supplementary restrictions relating to the interest rate that is applied to over and under recoveries of revenue and the level of the increases that may be applied to the licensee's Use of System Charges. If price changes due to exceptional circumstances are not rectified in a timely manner this may result in a significant price disturbance when charges do change as well as potentially applying penal interest rates on DNOs for the under/over recovery.

We consider that the provisions in the licence will always take precedence over DCUSA (or any other code). The proposal will remove the flexibility that DNOs and IDNOs have and would, as stated above, conflict with DNOs' licence obligations in relation to charge restrictions.

Further, during the consultations, two respondents raised their concerns over breaching Standard Licence Condition (SLC) 38 (Supplier of last resort) . We note that the Working Group concluded that there was a potential risk that there could be a valid claim[9], the working group also noted that to date there had been no claims made and therefore the risk was minimal. This condition requires the DNOs to make changes to DUoS charges within a specified period in the event of the failure of a supplier – this change proposal would restrict the DNOs' ability to comply with this licence requirement.

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[8] DPCR5 is the current price control (2010 – 2015)

9 When a supplier goes bankrupt and the DNO receives a valid claim from another supplier via the last resort procedure.

In summary we consider that the change proposal would restrict the ability of the DNOs to efficiently discharge the obligations placed on them as part of the distribution licence agreed at the price control. It would also have an adverse impact on the DNOs' finances as it would restrict their ability to control under and over recoveries which might be seen as a change to the current price control determined agreement. We do not think such an approach would be compatible with the principles of better regulation. The DNOs would only be able to get around this by requesting a derogation under SLC 20.7 from Ofgem against these requirements in the DCUSA. We do not think it should be necessary for the DNOs to seek such a derogation to engage in activities permitted or required by the licence. We think that any changes in the area should first therefore be made by a change to the licence, followed then by any consequential changes to the DCUSA. For these reasons we do not think the proposal better meets DCUSA General Objective 3.1.3.

In our view and in the light of the DCUSA General Objectives, we consider the arguments for rejecting the proposal are stronger that those in favour of approving it.

The Authority has therefore decided to reject DCP105.

We set out below some further thoughts relating to this decision.

We think that the issue this change proposal is trying to address is better picked up as part of this holistic examination by Ofgem that includes consideration of the licence arrangements and does not just consider the issue in the context of the DCUSA alone. In line with this, we are currently looking at the best approach to mitigate manifest errors and volatility issues as part of distribution charges.

We consider that the ability of suppliers to obtain more predictable DUoS charges may potentially reduce unexpected price changes for them and for consumers and enhance competition in the retail energy markets. However, we also disagree with the reasoning that cost reflectivity of charges will increase as a result of a more limited ability for DNOs to adjust their charges. If changes to charges were limited to twice a year as proposed, there would be an increased risk of significant adjustments to charges rather than a timely, less volatile adjustment. This risk could be significant if the DNOs made an error when formulating their charges – this would likely reduce the cost reflectivity of charges and this modification proposal would limit the DNOs' ability to correct it in a timely manner. Limiting DNOs' ability to correct non-cost reflective charges could result in consumer harm.

We consider that issue raised by the change proposal is therefore part of a number of wider issues that affect suppliers and consumers. Additionally, we note that there have been a few instances when DNOs adjusted charges outside of 1 April and 1 October. While we agree that (all else being equal) more predictable charges are desirable, we do not consider that the incidence of changes outside of these two dates is currently significant enough to merit a change to the DCUSA. We agree that DNOs need appropriate incentives to avoid or decrease the risk of errors that lead to changes to charges outside of 1 April and 1 October.

In the section below, we discuss the work we are taking forward on mitigating the volatility of network charges.

Ofgem's work on volatility in network charges

We are aware of suppliers' concerns that volatility in network charges, in both the gas and electricity markets, is affecting their ability to accurately price the cost of supplying energy to their customers. This includes concerns raised around the increasing number of errors made by DNOs when calculating customers' charges. These errors have led to midyear charge changes. We are also concerned that volatility is adversely affecting customers' energy bills as suppliers are potentially including a risk premium to protect against the volatility in DUoS charges.

Throughout the RIIO price control review process[10] (for gas distribution companies and transmission owners), which is currently ongoing, stakeholders have discussed with us the impact of network charging volatility. Some useful options, from both network companies and suppliers have been brought forward on how to mitigate the impact of volatility. We are therefore proposing to consult on this issue more widely in order to allow all stakeholders, including those participating in the electricity market, an opportunity to contribute their views. Within this consultation we will discuss the causes of volatility, including DNO errors in charging calculations, and whether additional arrangements should be put in place to mitigate their impact. If a modification to the electricity distribution licence is required as a result of our decision, we will consult further on this.

Andy Burgess
Associate Partner, Transmission and Distribution Policy
Signed on behalf of the Authority and authorised for that purpose

[10]Page 6: http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionuncert.pdf