Proposed modification:	**Distribution Connection and Use of System Agreement (DCUSA) DCP118 – Allocation of EHV costs in the CDCM Price Control Disaggregation Model**		
Decision:	The Authority[1] directs that proposal DCP118 be made[2]		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	25 April 2013	Implementation Date:	1 April 2014

This decision changes the way that distribution charges (paid by customers) are split between the incumbent Distribution Network Operators (DNOs) and the Independent Network Operators (IDNOs).

Background to the modification proposal

DNOs levy charges for use of their networks, i.e. connection charges and Distribution Use of System (DUoS) charges. The Common Distribution Charging Methodology (CDCM) is used by the DNOs to calculate charges for customers connected at the Low Voltage (LV) and High Voltage (HV) network levels.[3]

Some customers are connected to parts of the network where IDNOs provide the immediate electricity distribution network. Generally, those customers also use assets which are beyond those provided by the IDNO and which are provided by a DNO. Therefore, it is appropriate for such a customer's DUoS charge to be split between the IDNO and the DNO to reflect the respective costs. The DNO calculates the total DUoS charge that the customer owes for the assets that it uses from its point of connection up to the distribution-transmission boundary. This is called the 'all the way charge', and is the cost the DNO would have faced for the same provision of network. The customer pays the 'all the way' charge to the IDNO, and the IDNO then pays a discounted charge to the DNO; the amount that the IDNO keeps is called the 'IDNO discount'. So, in essence, the DUoS charge is split: the IDNO keeps the IDNO discount, and the DNO receives the discounted all the way charge. The larger the IDNO discount, the greater scope for the IDNO to make profit, so the IDNO discount is an important component of the IDNO business.

For LV- and HV-connected customers, the IDNO discounts are calculated by the DNOs using the CDCM Price Control Disaggregation Methodology (also called "Method M")[4]. Method M forms part of the CDCM, as specified in Schedule 17 of the DCUSA. It is implemented by the DNOs using their Method M Excel workbooks. Because some network costs are not clearly associated with a particular asset, Method M uses cost allocation drivers to determine how much of each type of network cost should be allocated to each network level.

In order to provide accurate IDNO discounts, it is important that Method M associates the assets with the correct customers. For example, some EHV and 132kV assets lead only to EHV-connected customers, whereas some EHV assets lead to lower network voltage levels and then on to HV- or LV-connected customers. These are treated as follows:

[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] Some HV-connected customers are charged under the EHV Distribution Charging Methodology (EDCM). However, for the purposes of this letter, we refer to EHV-connected customers to mean all customers (HV- and EHV- connected) that are charged under the EDCM.
[4] Similarly, customers connected at the extra high voltage (EHV) level are charged under the EDCM and the EDCM Price Control Disaggregation (also called "Extended Method M").

1. The EDCM and Extended Method M use the costs of EHV and 132kV assets that are for EHV-connected customers only. This is appropriate as it allocates costs to those customers that are responsible for them.
2. The CDCM omits the costs of EHV and 132kV assets that are for EHV and 132kV customers only (i.e. item 1, above) from its calculation of 'all the way' charges for HV- and LV-connected customers. This is appropriate, as it avoids double counting these costs.
3. The CDCM uses the costs of EHV and 132kV assets that are used by HV- and LV-connected customers to calculate their 'all the way' charges. This is appropriate, as it allocates costs to those customers that are responsible for them.
4. However, Method M does not omit the costs of EHV and 132kV assets that are for EHV customers (i.e. item 3, above) from its calculation of IDNO discounts. This causes these IDNO discounts to be smaller than they arguably should be, as explained below. This is the issue that DCP118 seeks to address.

A simplified worked example of how the relevant costs are distributed between DNOs and IDNOs in line with the treatment above is as follows:

Worked example

Imagine a network with five network levels, one of which is the EHV and 132kV assets, and only the lowest level of which is provided by an IDNO. Let us say that each of the five network levels has costs of £20 to be allocated between customers, totalling £100. Suppose that an LV-connected customer uses 5% of the assets in each of the five network levels, from its connection to the distribution-transmission boundary. If none of the EHV and 132kV assets were used only by EHV-connected customers, then the LV-connected customer could be expected to pay 5% of each network level, i.e. 5% of £100, which is £5. As the IDNO has provided all of the lowest level of the network (at a cost of £20), the IDNO could keep 5% of £20, i.e. £1. The CDCM and Method M would calculate these values correctly: the CDCM would calculate the 'all the way' charge to be £5 and Method M would calculate the charge split as £4 received by the DNO and £1 received by the IDNO as an IDNO discount.

However, if £4 worth of the EHV and 132kV assets is used only by EHV-connected customers, then only £16 of EHV and 132kV assets should be used in the calculation in the CDCM and in Method M. In that case, the LV-connected customer would pay 5% of £96, which is £4.80; the CDCM calculates this correctly. However, the IDNO still provides the LV assets for the customer, and the IDNO discount should still be £1. At present, Method M would include the full cost of EHV and 132kV assets, i.e. it would calculate that the DNO should receive £4, and the IDNO would keep only £0.80. This is lower than the £1 that would be appropriate.

The modification proposal

DCP118 was raised by the Gas Transportation Company (GTC) for and behalf of the Electricity Network Company Limited (the 'Proposer'), in December 2011[5]. The purpose of the modification proposal is to correct the defect in Method M, that has been described above and that has the effect of reducing the IDNO's discount. The proposer stated that the proposal would result in tariffs that are more cost-reflective, and will thereby reduce any potential distortions in competition between DNOs and INDOs. The proposer stated that the way to correct this defect in Method M was to address two issues:

[5] The Draft Change Proposal (DCP) stated that it was raised on 14/12/12. This was a typo. Electralink has confirmed that the DCP was registered in December 2011.

- reduce the EHV and 132kV costs allocated to CDCM customers (by £16 in the above example); and

- reduce the total revenue to be recovered through Method M (to £96 in the above example).

A DCUSA Workgroup was established with IDNO, DNO and Ofgem representatives to assess the proposal.

It considered approaches for addressing the two issues, and decided upon which option (for addressing both issues) was preferable. It issued two Requests for Information. The first sought views on whether the proposed option was appropriate and whether the DNOs had the necessary data to implement that option. The second request sought data from the DNOs to enable the Workgroup to conduct an impact assessment of the proposed option.

The Workgroup's proposed option uses the Modern Equivalent Asset Value (MEAV) which is the measure of the cost of an asset as used in the CDCM and Method M.

Issue 1: To remove EHV and 132kV costs allocated to EHV-connected customers.

The Workgroup proposed using data that is available in the CDCM and EDCM models:

- The CDCM for each DNO contains the MEAV of all of its EHV and 132kV assets.
- The EDCM for each DNO contains a notional MEAV of the EHV and 132kV assets that are used by only EHV-connected customers calculated using Network Use Factors (NUFs)[6].

The difference between the MEAV from the CDCM and the notional MEAV from the EDCM gives a representation of the MEAV of EHV and 132kV assets that are used by CDCM customers. Dividing this by the MEAV of all EHV and 132kV assets (in the CDCM) gives a ratio that determines the split of EHV and 132kV assets between EHV-connected customers and other customers. Applying this in Method M allocates to CDCM customers only the appropriate value of EHV and 132kV assets.

Issue 2: To reduce the total revenue to be recovered through Method M.

The Workgroup proposed using data that is available in the DNOs' Regulatory Reporting Packs (RRPs) for 2007/08. This shows the revenues that a DNO recovered from EHV-connected customers in that year. Subtracting this from a DNO's total allowed revenue, gives the allowed revenue that is recovered from CDCM customers.

The Workgroup issued a consultation to DCUSA parties in November 2012, and seven parties responded. The Workgroup submitted a change report to the DCUSA Panel in February 2013. Parties were invited to vote by 8 March 2013. We received the Change Declaration (dated 12 March 2013) on 19 March 2013.

DCUSA Parties' recommendation

The Change Declaration for DCP118 indicates that DNO, IDNO/OTSO[7], Supplier and Distributed Generation (DG) parties were eligible to vote on DCP118. In the DNO party category there was unanimous support for the proposal and majority support for the proposed implementation date. In the IDNO/OTSO party category, there was unanimous support for both the proposal and the proposed implementation date. In the Supplier

[6] Network Use Factors (NUFs) are a measure of how much of an asset's capacity is used by a particular customer.
[7] OTSO parties are Offshore Transmission System Operators.

party category the vote was split 50% in support of the proposal and the proposed implementation date, and 50% against[8]. No votes were cast in the DG party category. In accordance with the weighted vote procedure, the recommendation to us is that DCP118 is rejected. The outcome of the weighted vote is set out in the table below:

DCP118	WEIGHTED VOTING (%)							
	DNO		IDNO/OTSO		SUPPLIER		DG	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	100	0	100	0	50	50	n/a	n/a
IMPLEMENTATION DATE	72	28	100	0	50	50	n/a	n/a

Our decision

We have considered the issues raised by the proposal and the Change Declaration dated 12 March 2013. We have considered and taken into account the vote of the DCUSA Parties on the proposal which is attached to the Change Declaration. We have concluded that:

- implementation of the change proposal DCP118 will better facilitate the achievement of the DCUSA Charging Objectives;[9] and
- directing that the change is approved as consistent with our principal objective and statutory duties.[10]

Reasons for our decision

We have assessed DCP118 against the DCUSA Charging Objectives. In our view, DCP118 would better facilitate the DCUSA Charging Objectives that are listed below. We consider that DCP118 is neutral with respect to the other Objectives.

DCUSA Charging Objective 3.2.3 – that compliance by each DNO Party with the Charging Methodologies 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

DCP118 seeks to remove from Method M the costs of EHV and 132kV assets that only EHV-connected customers use. The result would be to increase IDNO discounts to a level that is more reflective of the assets that an IDNO provides. Respondents to the consultation were supportive of the intent of DCP118, and supported the proposed approach.

There were differing views on the use of the data from the 2007/08 RRPs. Some argued that this data does not necessarily reflect the present situation. Others argued that Method M uses data from 2007/08, and so the proposed approach would provide consistency in the data. We agree that consistency of data is appropriate.

There was a general view that the proposed approach would lead to more cost-reflective IDNO discounts. We consider that the Workgroup's proposed approach to the use of data in the relevant charging models will provide a reasonable estimate of the relevant values. It would allow Method M to calculate more accurate IDNO discounts reflecting the split of costs incurred by a DNO and an IDNO in many cases. This is an improvement on the

[8] Only two suppliers voted, so the result was due to the opposition of one supplier.
[9] The Applicable Charging Methodology Objectives (Charging Objectives) are set out in Standard Licence Condition 22A Part B of the Electricity Distribution Licence and are also set out in Clause 3.2 of the DCUSA.
[10] 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.

current situation. For this reason, we consider that DCP118 better facilitates this objective.

DCUSA Charging Objective 3.2.2 – that compliance by each DNO Party with the Charging Methodologies 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 participation in the operation of an Interconnector (as defined in the Distribution Licences)

As discussed above, we consider that DCP118 will make the IDNO discounts more cost-reflective. The current arrangements could mean that IDNO discounts are insufficient to allow an IDNO to undertake certain projects profitably (other things being equal). This could inhibit competition between IDNOs and DNOs. If this change is made, IDNOs may use the additional revenue to expand their activities, and might be encouraged to compete with DNOs for more projects, thereby increasing the potential for competition. For this reason, we consider that DCP118 better facilitates this objective.

Further considerations

We note the proposer's intention was that DCP118 should be implemented on 1 April 2013, but the Workgroup was unable to complete the modification in time for implementation by that date. The majority of Workgroup members supported an implementation date of 1 April 2014. The IDNO members of the Workgroup consider that this would deprive IDNOs of margins to which they consider they are entitled, and so they proposed an implementation date of 1 October 2013. This would result in a mid-year change in charges. It is generally preferable for DNOs to avoid mid-year changes; having only one change per year gives greater stability for customers and suppliers.

The intent of DCP118 is to change the allocation of charges between a DNO and an IDNO. The impact assessment conducted by the Workgroup shows IDNO discounts will increase by up to 4.6%. DCP118 is not directly intended to change the charges paid by customers. The Workgroup explained that changing the model could have a very minor impact upon charges for customers, perhaps in the third decimal place. However, because the DNOs would recover less revenue from the INDOs, the DNOs would have to recover more from suppliers. So, depending upon how (and when) DUoS charges are passed to customers by different parties, it is possible that DCP118 could cause changes in the charges for some customers. Furthermore, an implementation date of 1 October 2013 would require the recalculation of charges and the reissuing of charging statements.

So, overall, we consider that it is preferable in this case to avoid a mid-year change in charges, and to instead Implement DCP118 for 1 April 2014.

We note concerns from IDNO members of the Workgroup that the work did not progress quickly enough to allow an implementation date of 1 April 2013. The DNOs have access to information and expertise that makes them essential to the work of many DCUSA Workgroups. We recognise that this places demands upon their resources, and we encourage Workgroups to ensure that their assessment work, including requests for information, are progressed efficiently and effectively and provide parties with sufficient time to respond. We also encourage the DNOs to contribute as fully as possible to the assessment process by providing views early on any drafts of change proposals, by participating on Workgroups, and by responding promptly to requests for information and consultations. This can be particularly important for modifications that are proposed by smaller parties, including IDNOs and independent suppliers.

Finally, we note that the supplier party that voted to reject DCP118 said that the Change Report gave no reasoning as to why any of the DCUSA objectives are better facilitated. We note that section 9 of the Change Report ("Evaluation Against the DCUSA

Objectives") simply referred to certain objectives, and did not explain how they were relevant to the proposal. However, we note that the Change Report did discuss how the proposal would improve the methodology in ways that would better facilitate the objectives. In this case, we consider that it is clear that the proposal can be justified against the charging objectives. We remind Workgroups to ensure that Change Reports explicitly state the reasoning under each objective that they list in the section "Evaluation Against the DCUSA Objectives".

Decision notice

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, the Authority hereby directs that modification proposal DCP118: *'Allocation of EHV costs in the CDCM Price Control Disaggregation Model'* be made.

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