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| Proposed modification: | **Distribution Connection and Use of System Agreement (DCUSA) DCP217 – Rate of return** | | |
| Decision: | The Authority[1] directs that modification DCP217 be made[2] | | |
| Target audience: | DCUSA Panel, Parties to the DCUSA and other interested parties | | |
| Date of publication: | 1 December 2014 | Implementation Date: | 1 April 2015 |

## Summary

We have decided to direct that this modification to DCUSA is made, for the reasons given in this document. The common distribution charging methodology (CDCM) and the extra high voltage (EHV) distribution charging methodology (EDCM) use a rate to determine the apportionment of the costs of network assets in the charging model. They use a value that is consistent with the rate of return in our most recent electricity distribution price control review 5 (DPCR5). The DPCR5 arrangements are due to be replaced from 1 April 2015 making the current DCUSA reference no longer consistent with the new price control. This proposal suggests continuing to use the current DPCR5 value of rate of return, ie 5.6%, for charging year 2015-2016. We expect an enduring solution, following a more detailed examination of options, to be developed for future charging years.

## Background

The CDCM and the EDCM have, as a primary model input, a value for rate of return or discount rate that is used to determine the annuity values of assets[3]. These annuity values are used to determine the costs associated with the use of assets and their apportionment between network voltage levels and customer types. The current DCUSA references to 'rate of return' and 'discount rate' refer to the *"(pre- tax) cost of capital set by the Authority as part of the then most recent review of the charge restriction conditions applying under the* [Distribution Network Operator] *DNO Party's Distribution Licence".* For the current charging year the applicable rate of return is the value used in DPCR5[4].

From 1 April 2015, these current DCUSA references will no longer be consistent with the approach adopted under the RIIO-ED1[5] price control. An alternative means of determining the rate of return for DCUSA is required for the 2015-16 charges and beyond. There is an urgency to resolve this issue in time for these charging statements to be prepared. The DNO indicative charges for the charging year 2015-2016 will need to include this when published by 6 January 2015[6].

This issue was identified in August 2014, through the open governance process, by the Distribution Charging Methodologies Forum – Methodologies Issues Group (MIG). An enduring change to resolve this issue through the DCUSA governance process would require an evaluation of options to align the DCUSA charging methodologies with RIIO-ED1, consultation with affected parties and our approval. MIG considered that there was insufficient time to go through this process and to prepare the indicative and final charging statements in accordance with their respective deadlines.

[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] The annuity value of an asset is the annual equivalent cost of the asset, including financing costs, over its useful life.
[4] In accordance with Charge Restriction Condition (CRC) 12 of the Distribution Licence.
[5] RIIO-ED1 price control will set the outputs that the 14 electricity Distribution Network Operators need to deliver for their consumers and the associated revenues they are allowed to collect.
[6] In accordance with DCUSA clause 35B.4.

MIG therefore decided that a change proposal should be put forward on an urgent basis as an interim measure, primarily for the 2015-16 charging year, with the intention of a further change proposal being developed for future charging years. The DCUSA panel agreed with the proposer's suggestion that this interim change did not require a working group or consultation and could be moved straight to the report stage of the DCUSA Change Process and shortly therafter voted on by the DCUSA panel.

**The modification proposal**

DCP217 was raised by UK Power Networks Limited on 18 September 2014. It proposes to retain the current value of the rate of return (5.6%) within the charging models. This value has been used since 1 April 2011 for the CDCM and since the introduction of the EDCM in 2012[7]. DCP217 proposes to replace existing DCUSA references to values we set with a fixed rate of 5.6%.

The DCUSA Change Report states that the proposal better facilitates DCUSA general objective 3.1.1[8], and charging objective 3.2.2[9]. It states that utilising an existing modelling input, whilst an enduring solution is considered, will minimise the volatility seen in Distribution Use of System (DUoS) charges. The report also states that this change is important as a failure to address the matter at this time would result in DCUSA not aligning to the Distribution Licence from the start of RIIO-ED1.

**DCUSA Parties' recommendation**

The Change Declaration for DCP217 confirms that all parties were eligible to vote. There was unanimous support for the proposal from each party category where votes were cast (no votes were cast in the Independent Distribution Network Operator (IDNO), Offshore Transmission System Operator (OTSO), distributed generation (DG) and gas supplier categories). In accordance with the weighted vote procedure, the recommendation to us is that the DCP217 change solution and its proposed implementation date are accepted.

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

| **DCP217** | Weighted voting (%) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | DNO | | IDNO/ OTSO | | Supplier | | DG | | Gas supplier | |
| | A | R | A | R | A | R | A | R | A | R |
| Change solution | 100 | 0 | n/a | n/a | 100 | 0 | n/a | n/a | n/a | n/a |
| Implementation date | 100 | 0 | n/a | n/a | 100 | 0 | n/a | n/a | n/a | n/a |

**Our decision**

We have considered the issues raised by the proposal and the Change Declaration dated 28 October 2014. We have considered and taken into account the vote of the DCUSA Parties on the proposal attached to the Change Declaration. We have concluded that:

- implementing the change proposal DCP217 will better facilitate the achievement of the DCUSA Charging Objectives[10]; and

[7] In accordance with Charge Restriction Condition (CRC) 12 of the Distribution Licence.
[8] DCUSA General Objective 3.1.1 – the development, maintenance and operation by each of the DNO Parties and IDNO Parties of an efficient, co-ordinated, and economical Distribution System
[9] 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)
[10] 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.

- directing that the change is approved is consistent with our principal objective and statutory duties[11].

**Reasons for our decision**

We have assessed this proposal against the DCUSA Charging Objectives. We consider this proposal will better facilitate DCUSA Charging Objective 3.2.1 and has a neutral impact on the other charging objectives.

We understand that this interim measure is required to meet immediate needs. We fully expect that full consideration will be given through the DCUSA governance process to develop a longer term solution.

***DCUSA 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***

The current DCUSA references to 'rate of return' and 'discount rate' are not consistent with the RIIO-ED1 licence conditions that take effect from 1 April 2015. This is an interim solution that enables enduring changes to be developed that align with the licence arrangements adopted for RIIO-ED1. We consider that this proposal facilititates this charging 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)***

We have considered the arguments in relation to this charging objective. We agree that this interim proposal may lessen the impact of any changes in DUoS charges from what they would be if an alternative rate of return value was used. The proposal, however, provides no evidence that this will, in turn, lead to an improvement in competiton. We consider, therefore, that this proposal has a neutral impact on this charging objective.

**Decision notice**

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, we hereby direct that modification proposal DCP217: *'Rate of return'* be made.

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

[11] Our statutory duties are wider than matters that the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.