Proposed variation:	**Distribution Connection and Use of System Agreement (DCUSA) DCP206 – Removal of Charge 1 from the EDCM**		
Decision:	The Authority[1] has decided to reject[2] this modification[3]		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	22 May 2015	Implementation date:	n/a

Background

The Extra-high voltage Distribution Charging Methodology (EDCM) was introduced to calculate electricity distribution system import use of system charges in 2012-13 and export charges in 2013-14. A component of the EDCM is Charge 1 which represents forward looking expectations of reinforcement costs and feeds into charges. For each distribution network operator (DNO) the value of these costs are determined by using one of two approaches: long run incremental cost (LRIC) or forward cost pricing (FCP). Charge 1 results in location specific charges related to the two main drivers of future reinforcement needs, ie actual consumption in a period of peak demand, known as the super red period[4], and maximum capacity. These charges are intended to provide price signals that encourage economic use of the network by encouraging: (a) lower levels of consumption in the super red period than would otherwise be the case and (b) new consumers to locate in areas where there is spare capacity, rather than areas where reinforcement is likely to be shortly triggered.

The proposer of DCP206 considers that Charge 1 creates several defects:

- As the charges are based upon potential future reinforcement costs, consumers may be paying charges based on costs that may not actually be incurred by the DNO.
- Alternatively, consumers may over-contribute to reinforcement costs by paying in advance through Charge 1 and again, once the reinforcement is triggered, through consumer contributions in their connection charges.
- Consumers may also experience changes in charges that are a result of activities of other consumers, rather than changes within their control.

There is an ongoing industry-led review of the EDCM. The review report is expected to be published in June or July 2015.

The modification proposal

Modification proposal DCP206 was raised by E.ON (the proposer) on 13 March 2014. The proposed modification seeks to remove Charge 1 from the calculation of import charges under Schedule 17 "EHV charging methodology (FCP model)" and under Schedule 18 "EHV charging methodology (LRIC model)" of the DCUSA. If implemented, this would remove the unit charges for super red consumption and the forward looking locational element of capacity charges.

The proposed change would have no impact on generation credits paid to generators in respect of avoided or deferred DNO costs.

[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.
[2] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[3] 'Change' and 'modification' are used interchangeably in this document.
[4] The super red periods for each DNO are the times of day and year of their peak demand periods. Each DNO determines their individual super red periods in accordance with their own demand profiles.

The Working Group which assessed the proposal was unable to undertake a consolidated impact assessment of DCP206 due to legal confidentiality constraints. We undertook to collate the individual DNO impact analyses to provide a consolidated impact assessment on behalf of the Working Group. This consolidated assessment indicated that approximately one third of consumers' charges would increase and the remaining two thirds would experience decreases in charges, if DCP206 were to be implemented. It further showed that 6.4% and 7.6% of consumers would experience increases or decreases respectively that are greater than both 5% and £2,000 per year.

In June 2014, the Working Group carried out a consultation on the proposal. The responses to this consultation are summarised in the Change Report and provided in full in the Change Report.

The change proposal form states that this proposal better facilitates DCUSA general objective 3.1.2. and charging objectives 3.2.2 and 3.2.3. The majority of the working group considered that DCP206 only better facilitates charging objective 3.2.3.

DCUSA Parties' recommendation

The Change Declaration for DCP206 indicates that each DNO Party, IDNO/OTSO[5] Party and Supplier Party was eligible to vote on DCP 206.[6] All DNO parties voted. No votes were cast in the other categories, including the Supplier Party category (the proposer's party category). A majority (>50%) voting in the DNO Party category voted to reject the proposal and its proposed implementation date. In accordance with the weighted vote procedure, the recommendation to the Authority is that DCP206 is rejected. The outcome of the weighted vote is set out in the table below:

DCP206	WEIGHTED VOTING (%)							
	DNO		IDNO/OTSO		SUPPLIER		DG[7]	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	34	66	n/a	n/a	n/a	n/a	n/a	n/a
IMPLEMENTATION DATE	33	67	n/a	n/a	n/a	n/a	n/a	n/a

Our decision

We have considered the issues raised by the proposal, responses to the consultation and issues set out in the Change Declaration and Change Report dated 16 April 2015. 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 modification proposal will not better facilitate the achievement of the DCUSA Charging Objectives.[8]

In coming to our decision we have also considered our wider statutory duties, including particularly our principal objective under the Electricity Act 1989 to protect the interests of existing and future energy consumers.

Reasons for our decision

We consider this modification proposal will not better facilitate DCUSA Charging Objectives 3.2.2 and 3.2.3 and has a neutral impact on the other relevant objectives. We

[5] Independent Distribution Network Operator/Offshore Transmission System Operator
[6] The terms "DNO Party", "IDNO Party", "OTSO Party" and Supplier Party" have the meaning given to them in the DCUSA
[7] Distributed Generation
[8] The DCUSA Charging Objectives (Relevant 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

also consider that the modification proposal is not consistent with our principal objective to protect the interests of existing and future energy consumers.

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)

Those in support of the modification argued that charging objective 3.2.2 would be better facilitated by:

- eliminating the incentive for consumers to build their own infrastructure;
- eliminating an element of import charges on generators; and
- improving predictability and transparency.

The majority of respondents to the consultation and the majority of the working group, however, felt that this objective is not better facilitated. Their reasons, and counter arguments are provided in the Change Report.

We consider that those consumers who choose to build their own infrastructure are making economic decisions based on the current cost reflective charge. We have not been provided with evidence to demonstrate that removing this charge would improve competition.

We agree that the removal of Charge 1 would eliminate an element of the charging model that consumers find hard to understand and therefore may improve transparency which may improve competition. However, the report has not demonstrated that such benefits outweigh the network efficiency encouraged by the current locational and time of use charges. We consider that, in the round, this proposal does not better facilitate this objective.

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

Some Working Group members believed that the removal of Charge 1 better facilitates charging objective 3.2.3 because they considered it would:

- increase the scaling amount, which the proposer regards as more cost-reflective;
- remove the alleged anomaly that EDCM customers could be paying for reinforcement that may not necessarily happen, if load growth is low; and
- remove the alleged anomaly that EDCM customers may experience changes in charges, as a result of new consumers connected to the system (or a change in demand from other existing consumers).

Some respondents to the consultation considered that this objective is not better facilitated. They stated that forward looking cost signals are an important way of encouraging consumers to adjust behaviour, in particular the unit based charge which incentivises consumers to reduce demand at system peak times. Although the majority of the consultation respondents felt that this objective was not better facilitated by this proposal, the majority of the Working Group concluded that this objective was better facilitated by the proposal.

We consider that Charge 1 is cost reflective, as it reflects the long-run incremental cost of connecting to distribution networks (for EHV customers). This is, as intended by the developers of the EDCM, to provide signals to customers to help DNOs achieve savings through deferred reinforcement.

We do not agree that DCP206 better facilitates this objective because we do not consider we have been provided with evidence to demonstrate that the removal of Charge 1 would improve cost reflectivity. In our view, Charge 1 is, as intended, a form of long-run incremental cost based charging and reflects the incremental costs *'reasonably expected to be incurred'* in accordance with the charging objective. When the EDCM was being developed, the DNOs were forecasting potentially £1.6bn of reinforcement at the EHV level during the price control at that time (DPCR5).[9] We included Charge 1 in the methodology as we considered that it could encourage a reduction or deferment of this reinforcement. We continue to hold this view and believe that reflecting long-run incremental costs in the EDCM is appropriate.

We further note that the proposal intends to set Charge 1 to zero thereby retaining the opportunity to introduce an alternative to Charge 1 in the future. This may create a situation where unit charges for super red consumption will fall to zero for one or more years and then rise again once an alternative to Charge 1 is developed. We note that some respondents indicated that even if Charge 1 in its current form was found to be defective consideration should be given to replacing it rather than its removal so as to maintain the locational and time of use price signals.

The grounds for the change proposal relate to the tension that exists between the backward-looking actual cost concept that lies behind DNOs' allowed revenues and the forward-looking cost concept that lies behind economic costs and the structure of tariffs that deliver those allowed revenues. These two concepts are not in conflict because they address separate economic objectives. We consider that the concept of using forward looking incremental costs to allocate allowed revenues to tariffs is cost-reflective and protects consumers by providing signals to minimise network costs.

Decision notice

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, the Authority has decided that modification proposal DCP 206: *Removal of Charge 1 from the EDCM* should not be made.

Ian Rowson
Associate Partner – Regulatory Finance and Governance
Signed on behalf of the Authority and authorised for that purpose

[9] Paragraph 1.6 – https://www.ofgem.gov.uk/ofgem-publications/44219/july-decision-ehv-charging-and-governance.pdf