Proposed variation:	**Distribution Connection and Use of System Agreement (DCUSA) DCP228 – Revenue Matching in the CDCM**		
Decision:	The Authority[1] directs this modification[2] be made[3], an alternative implementation date be considered in accordance with clause 14.2 of Part 1C of DCUSA and a revised implementation date be submitted.		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	08 September 2016	Implementation date:	To be confirmed in accordance with clause 14.2 of Part1C of DCUSA

Background

The Common Distribution Charging Methodology (CDCM) determines 'pre-scaled charges' based upon a hypothetical 500MW model that is representative of the Distribution Network Operators' (DNOs) distribution systems. The resulting total revenue from these pre-scaled charges will differ from the allowed revenue we determine through price controls. This difference is reconciled through scaling whereby the pre-scaled charges are adjusted (upwards or downwards) to arrive at a set of charges which generate a revenue stream equal to the allowed revenue.

The current scaling mechanism

The gap between the revenue generated from pre-scaled charges and the allowed revenue is not allocated to specific unit rates, capacity charges or fixed charges in the Common Distribution Charging Methodology (CDCM). The current scaling mechanism reconciles the revenue gap through the transmission exit cost level. This has the effect that a large part of revenue matching falls on the peak time band known as the "red/day unit rate".

The proposer of this modification argues that the current approach to scaling significantly distorts the economic signals provided from the pre-scaled tariff rates, and therefore produces tariffs which are not reflective of the incremental costs of reinforcing the network.

DCP123 Revenue matching methodology change

In August 2014, we decided to reject a proposal (DCP123[4]) to change the scaling method. Three options were debated by the DCUSA Change Proposal (DCP) working group with the proposed solution being an apportionment of scaling across the CDCM tariff elements and then to convert these apportionments to fixed adders to each tariff element. We rejected the proposal on the grounds that we remained unconvinced that the working group had demonstrated that this better facilitated the charging objectives. Although we rejected the proposal we recommended that industry should develop this work further.

[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] 'Change' and 'modification' are used interchangeably in this document.
[3] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[4] Refer our decision letter: https://www.ofgem.gov.uk/sites/default/files/docs/2014/08/dcp123d.pdf

The modification proposal

Following our rejection of DCP123 British Gas raised DCP228 on 13 January 2015. This proposal is similar to one of the options put forward in DCP123, although it was not taken forward as the proposed option at that time. We rejected DCP123 as it failed to demonstrate that scaling would have been spread in a more cost-reflective way. The change report states that the intent of DCP228 is to maintain the incremental cost signals produced by the pre-scaled tariffs and not to be used to allocate any cost not included within the CDCM. DCP228 proposes the application of a *fixed adder*[5] to the pre-scaling unit rates for the different charge types. This largely maintains the pre-scaled differences between charges. The proposal retains two elements of the existing arrangements:

- a floor level of zero ie scaling does not result in negative values for any tariff component; and
- DG (distributed generators) do not contribute to scaling revenues.

The working group which assessed the proposal undertook a detailed impact assessment of DCP228. In most DNO areas, domestic and non-domestic 'single rate'[6] consumers would generally face a reduction in charges whereas 'two rate'[7] consumers would face a small increase in charges. In most DNO areas, for HH customers the red period unit charges will fall but the amber and green charges will rise. The net effect is that charges for HH consumers in aggregate will rise, with the largest increases being faced by those consumers connected at HV level.

The working group issued a consultation document in May 2015. There were ten responses, limited to DNOs and suppliers. These respondents were generally supportive of the principle of DCP228. All except one respondent agreed that DCP228 better facilitated charging objective 3.

DCP228 proposed an implementation date of 1 April 2016. Following our decision to consult (see below), meeting the proposed implementation date was not possible. Furthermore, due to the 15 months' notice of charges required by DCP178[8] an implementation date of 1 April 2017 is also no longer possible. The earliest date this DCP could be implemented is now 1 April 2018.

DCUSA Parties' recommendation

The Change Declaration for DCP228 indicates that DNO, IDNO/OTSO [9], Supplier and DG parties were eligible to vote on DCP228. For the DNO party category, there was majority support for the proposal and for its proposed implementation date. For the supplier party category there was 50% support for the proposal and less than 25% support for its proposed implementation date. IDNO/OTSO and DG parties did not vote. In accordance with the weighted vote procedure, the recommendation to the Authority is that DCP228 is rejected. The outcome of the weighted vote is set out in the table below:

DCP228	WEIGHTED VOTING (%)							
	DNO		IDNO/OTSO		SUPPLIER		DG	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	64%	36%	n/a	n/a	50%	50%	n/a	n/a
IMPLEMENTATION DATE	59%	41%	n/a	n/a	25%	75%	n/a	n/a

[5] Adds fixed amounts in terms of cost per unit.

[6] Single rate consumers are those who are charged the same rate irrespective of time of day.

[7] Two rate consumers are those that are subject to peak and off-peak unit charges.

[8] https://www.ofgem.gov.uk/publications-and-updates/distribution-connection-and-use-system-agreement-dcusa-dcp178-notification-period-change-use-system-charges

[9] Independent Distribution Network Operator/Offshore Transmission System Operator

Ofgem consultation[10]

After reviewing the change report and the supporting evidence we decided to consult because:

a) We recognised the scale of the change and the impact on larger industrial consumers.
b) We considered it appropriate to consider alternative options to scaling, eg Ramsey pricing, a percentage adder or some other mechanism.
c) We also considered it appropriate to explore further some of the technical criticisms of the proposal in relation to specific aspects, eg zero price floor, how the charges affect different consumers, and interactions with other parts of the methodology.

We asked:

- '*Is scaling an issue best considered in relation to the specific choice between approving DCP228 or not, or is scaling an issue where change should only be made after a wider consideration of the range of different approaches?*
- *Is there any extra evidence respondents would like to raise with regards to DCP228 from a technical perspective (eg the scale of the impact)?*
- *If we were to decide to approve this change, what would the impact of a later implementation (eg 1 April 2018) be?*
- *Are you aware of you as a consumer, or others as consumers, having made a decision to manage consumption away from the peak red area in response to the charges? If so, please describe the details.*'

We received 24 non-confidential responses and one confidential response. These came from a wide range of stakeholders, including: DCUSA parties (DNOs and suppliers) and non-DCUSA parties (consumers and consumer representative organisations, water utilities, government departments, aggregators and consultants).

Several respondents considered that the issue of scaling in the CDCM should be subject to a wider consideration and further analysis.

Some non-domestic consumers, their representative bodies and several suppliers raised concerns that this proposal will weaken the incentive to reduce consumption at peak periods.

Some respondents expressed concerns that the zero floor for charges in the event of negative scaling distorts the price signals from the pre-scaled differentials as determined through the incremental cost model and is therefore not cost reflective.

Most respondents recognised that the proposed implementation date of 1 April 2016 is no longer possible. Of the 12 respondents that commented about the implementation date eight suggested that it be postponed to 1 April 2019 or later.

Several respondents cited examples of managing consumption away from the peak red period, some of which referred to investment undertaken. Some respondents suggested that this proposal will weaken the viability of these investments and could lessen the incentive for future similar consumption management initiatives.

[10] Our consultation document and supporting information can be found at https://www.ofgem.gov.uk/publications-and-updates/consultation-proposal-amend-arrangements-scaling-under-common-distribution-charging-methodology-dcp228

Our decision

We have considered the issues raised by the proposal and the Change Declaration and Change Report dated 10 August 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 also considered and taken into account the responses to our consultation. We have concluded that:

- implementation of the modification proposal will better facilitate the achievement of the DCUSA Charging Objectives;[11]
- directing that the modification be made is consistent with our principal objective and statutory duties,[12] and
- the proposed implementation date is not accepted and that an alternative implementation date should be considered in accordance with clause 14.2 of Part 1C of DCUSA. A revised implementation date should be submitted to us as soon as possible, with a request to direct a new later implementation date be substituted for 1 April 2016.

Reasons for our decision

We consider this modification proposal will better facilitate DCUSA Charging Objective 3 and has a neutral impact on the other relevant 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

Our principal reason for rejecting DCP123 was that '*the working group has not succeeded in demonstrating fully the effects of their proposal as being better than the current mechanism, or meeting the stated Charging Objectives better*'. The Change Report for DCP228 provides further clarity and evidence.

The Change Report states that DCP228 better facilitates DCUSA Charging Objective 3. The current application of scaling primarily to the red time band distorts the incremental cost signals produced by the pre-scaled tariffs in the CDCM. Allocating the revenue shortfall or surplus across each of the unit rates on a fixed adder basis as DCP228 proposes would improve cost reflectivity by maintaining the incremental cost differential between unit rates across all tariffs and all time bands. The working group and the results of the working group's consultation generally agreed with this assessment although some expressed their concern that setting a floor price of zero weakens cost reflectivity. The scaling process introduces a distortion to the differences between the unit rates determined from the incremental cost model. This proposal removes much of this distortion. We therefore agree that DCP228 improves cost reflectivity overall but we recognise that the zero floor price for unit rates still distorts the incremental cost signals to some degree. On balance we agree that DCP228 better facilitates this charging objective.

We have also considered the view of the consultation respondents who proposed that the issue of scaling in the CDCM should be subject to a wider consideration and further analysis. Although we agree that further analysis may be beneficial and may result in

[11] 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.
[12] The Authority's statutory duties are wider than matters that the Parties must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.

further improvements, we consider this proposal to be an improvement and should not be rejected on this basis. Further improvements can be raised through future change proposals.

In reaching our decision we have taken into consideration the detailed impact assessment that was included in the change report. This assessment detailed for each DNO the impacts of this change on all consumer types within each DNO area. As noted above, in most DNO areas, domestic and non-domestic 'single rate' consumers would generally face a reduction in charges whereas 'two rate' consumers would face a small increase in charges. In most DNO areas, for HH customers red period unit charges will fall but the amber and green charges will rise. The net effect is that charges for HH consumers in aggregate will rise, with the largest increases being faced by those consumers connected at HV level.

In reaching our decision we have considered our wider duties. We recognise that some larger industrial consumers have responded to price signals generated from the current CDCM methodology and that DCP228 is likely to dilute the case for this type of response. We recognise the concerns raised by this group of consumers but we also see this change as an improvement to the CDCM. Network charges give price signals to users which will inform their decisions on use of the network. We consider that such decisions should be made based on cost reflective charges, and consider that DCP228 results in improved cost reflectivity compared to the current arrangements. Although DCP228 will reduce the benefits of avoiding the peak, the red charges will still be significantly higher than those for the amber and green periods. Activities undertaken to manage consumption away from the peak red periods are still likely to be financially beneficial to those consumers.

We also considered the impact on security of supply of this proposal. As the difference between the charge for the peak red periods and other times is reduced this may reduce the incentive to invest or operate in ways that reduces demand at peak periods. The peak period will however still be the most expensive time to operate. Incentives to manage consumption at peak periods will still remain.

Implementation date

The earliest possible date for implementation for this change is April 2018 as charges for 2016/17 and 2017/18 are already set given the requirement for a 15 months' notice period (as required by DCP178). We are aware of the concerns raised by some consultation respondents, in particular larger HH non-domestic consumers who may be adversely affected by DCP228. Some of these consumers have responded to the current charging arrangements by changing their processes to avoid red charges given the scale of the differential with amber/green charges. The reduction in this difference resulting from the change to the scaling approach under DCP228 reduces the benefits of these responses to the current price signals. Furthermore, some suppliers have expressed concerns that their contracts with consumers extend for longer periods and that they need to provide advance notice to their consumers of any changes to charges. Several consultation responses indicated that a later implementation date, beyond April 2018, would be preferable.

We have carefully considered the arguments made by a number of respondents for a later implementation date than April 2018. At this point we have not seen evidence to justify delaying beyond April 2018 and in particular we note that:

- an April 2018 implementation date already provides over 18 months advance notice of this change, which is a significant period of time
- this modification proposal was raised on 13 January 2015 and hence this change has been known as a possibility for some time

- DCP178 introduced a requirement for a 15 months' notice period of changes to distribution charges to provide more predictability for suppliers and we expect that suppliers will have taken this notice period into account in agreeing contracts with customers
- a number of respondents referred to the increase in costs that will arise from this change and the fact that they had made efforts to reduce consumption during the red time periods. However, we consider that the red charges will still be significantly higher than those for the amber and green periods, and activities and investments made to manage consumption away from the red periods are still likely to be financially beneficial to those consumers.

We recognise the challenges expressed by some respondents about a 1 April 2018 implementation date. Nonetheless, as stipulated under DCUSA[13], we expect implementation of the modification to occur as soon as possible. Any postponement in the implementation date beyond 1 April 2018 would need to be supported by strong evidence and reasoning as to why any such delay would be warranted in this case. We therefore request the panel to carefully consider and submit an alternative to the 1 April 2016 implementation date, in accordance with clause 14.2 of Part 1C of DCUSA as soon as possible.

Targeted charging review

In our open letter on embedded benefits[14], we announced that we would further consider the allocation of sunk and fixed costs including for storage and 'behind the meter' generation, as well as other elements of embedded benefits, and set out how we propose to take this work forward later in the autumn.

Although we are approving this DCP we recognise that the recovery of the sunk and fixed costs of the networks is an area where further changes may occur in the future. Despite the possibility that this change may be superseded by another approach in the future, we believe that approving this change now is better than waiting until the outcome of any future work in this area.

Decision notice

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, the Authority hereby directs that modification proposal DCP228: Revenue Matching in the CDCM, be made.

In accordance with standard licence condition 22.11 of the Electricity Distribution Licence, the Authority hereby directs that the proposed implementation date is rejected and that an alternative implementation date is considered by the panel in accordance with clause 14.2 of Part 1C of DCUSA. A revised implementation date should be submitted to us as soon as possible, with a request to direct a new later implementation date be substituted for 1 April 2016.

Frances Warburton
Partner, Energy Systems
Signed on behalf of the Authority and authorised for that purpose

[13] DCUSA 1C (11.14.4 B): "the implementation date should be the date that enables the proposed variation to take effect as soon as practicable after the decision to implement has been reached"
[14] https://www.ofgem.gov.uk/publications-and-updates/open-letter-charging-arrangements-embedded-generation