

Modification proposal:	<b>Distribution Connection and Use of System Agreement (DCUSA) DCP266 – The calculation and application of LDNO discounts</b>		
Decision:	The Authority <sup>1</sup> has decided to reject <sup>2</sup> this modification <sup>3</sup>		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	30 March 2021	Implementation date:	N/A

## Background

The intent of DCP266 (the “Proposal”) is to amend the way in which Distribution Network Operator (DNO) tariffs are calculated and applied to Licensed Distribution Network Operators (LDNOs) connected to their networks.

LDNOs are charged a discounted tariff by the relevant host DNO for the use of the DNO’s network. This discount is applied to the DNO’s all-the-way tariff to reflect the fact the LDNO is providing the last section of the distribution network that connects the end consumer. The DNO all-the-way tariffs are calculated in accordance with the Common Distribution Charging Methodology (CDCM), which is prescribed for in the Distribution Connection and Use of System Agreement (DCUSA). The LDNO discounts that are applied to these tariffs are calculated with use of the Price Control Disaggregation Model (PCDM), which is also prescribed for in the DCUSA.

Currently, in order to determine the discount percentages, the PCDM allocates allowed revenues on a unit basis to different network tiers using cost allocation drivers from sources specified in Schedule 29 of the DCUSA. Next, the percentage of the total revenue applied to each network level and the proportion of the network levels used by the embedded network are determined. These are then used to calculate the discount percentage for each combination of boundary level (the voltage at which the host and embedded network connect) and end user level (the voltage at which the end user

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<sup>1</sup> 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.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

<sup>3</sup> ‘Change’ and ‘modification’ are used interchangeably in this document.

connects to the network). The discounts calculated in the PCDM are then applied to the relevant tariffs calculated in accordance with the CDCM.

## **The modification proposal**

DGP266 was raised by British Gas (the “Proposer”) on 9 March 2016. The intent of the modification is to address an alleged defect in the current approach used to calculate and apply LDNO discounts. The Proposer believes that currently there is an inaccurate allocation of revenues between the DNO and the LDNO that arises due to the underlying approaches of the CDCM and the PCDM and the way in which the values produced in each are reconciled.

The CDCM is an incremental cost methodology designed to produce tariffs that send forward-looking signals to users of the network. These tariffs are scaled up via residual charging to match allowed revenues.<sup>4</sup> The PCDM is a cost model designed to allocate total revenues between the DNO and the LDNO. The Proposer notes that they would expect the LDNO discount to be equal to the LDNO revenue allocation derived in the PCDM for the provision of the relevant LV network. They consider that a discount percentage calculated using only the total cost and revenue approach in the PCDM subsequently applied to an incremental cost tariff calculated in the CDCM does not produce LDNO discounts that are reflective of a reasonable allocation of total costs of the elements of the DNO’s business that are being undertaken by the LDNO.

The proposed approach to rectify this alleged defect is to determine the LDNO unit revenue for the relevant network tiers using the same approach as is used currently, but to then convert it to a percentage discount by dividing this LDNO unit revenue by an average absolute unit price for each all-the-way tariff in the CDCM. This is produced by dividing the total revenue collected from all components of that tariff by the total volume associated with the tariff. The discount is then applied to the relevant CDCM tariff. The intention of this method is that the percentage discount is calculated with reference to the CDCM all-the-way tariffs rather than only with reference to the revenues calculated in the PCDM.

## **Competition in Electricity Distribution**

Respondents to the first Working Group consultation raised concerns regarding the negative impact that the Proposal could have on competition in the distribution of electricity. Specifically, whether or not the solution would result in the DNOs breaching their competition law obligations (in particular, the prohibition against abuse of a position of dominance) as a result of the Proposal potentially constituting a margin squeeze against LDNOs, meaning that LDNOs may be unable to operate other than at a loss, or with reduced profitability.

Following these concerns being raised, the Working Group sought advice from the DCUSA legal advisors. The advice confirmed that there was a risk that the solution could result in

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<sup>4</sup> Reforms to distribution network residual charges are being implemented in April 2022 as a result of our Targeted Charging Review: <https://www.ofgem.gov.uk/publications-and-updates/targeted-charging-review-decision-and-impact-assessment>

a margin squeeze against LDNOs potentially amounting to an abuse of dominance by DNOs. However, in order to reach a conclusion on the potentially anti-competitive impacts of the Proposal, an assessment of costs in each of the specific cases would necessarily be required, such that it was not possible to provide conclusive advice at a principled level. It was therefore suggested that a series of As Efficient Competitor (AEC) tests were carried out. This is a highly fact-specific legal test that can be used to determine whether the downstream arm of a dominant undertaking can operate profitably in any given circumstance. Applying the AEC test could therefore be used to seek to confirm, insofar as possible, if the Proposal would result in an abusive margin squeeze.

Following the advice from the DCUSA legal advisors, and in response to the possibility that a breach of competition law might result if the Proposal were implemented, there was significant concern regarding whether the Working Group could continue and who could or should carry out the AEC test given its fact-specific and commercially sensitive nature. Subsequently, three members of the Working Group chose to withdraw citing competition law concerns. The remaining members of the Working Group concluded they would not be able to carry out the AEC tests and could not compel the DNOs to do so. As such, the Proposal represented a known (but unquantifiable) risk that one or more DNOs could be in breach of their competition law obligations if implemented. Following this conclusion and the legal advice, no further meetings of the Working Group were held. A decision was made that the Secretariat would provide a summary of the legal advice received for voting parties, alongside a suggestion that competition law be considered when voting. In place of the view from the Working Group regarding whether the solution facilitates the Applicable Charging Methodology Objectives, DCUSA Party responses to the second consultation (the "Consultation") published by the Working Group during the development of the Proposal would be used.

### **DCUSA Parties' recommendation**

The outcome of the weighted vote is set out in the table below. In the DNO party category, the majority voted to accept the Proposal and there was unanimous acceptance of its proposed implementation date. In the LDNO/OTSO party category, votes unanimously rejected the Proposal and the majority voted to reject its proposed implementation date. No votes were cast in the Supplier party category and parties in the CVA Registrant and Gas Supplier categories were not eligible to vote.

In accordance with clause 13.5 of the DCUSA, the recommendation from Voting Parties to the Authority is that DCP266 is rejected.

DCP266	WEIGHTED VOTING (%)									
	DNO <sup>5</sup>		LDNO/OTS O <sup>6</sup>		SUPPLIER		CVA Registrant		Gas Supplier	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	80	20	0	100	n/a	n/a	n/a	n/a	n/a	n/a
IMPLEMENTATION DATE	100	0	16.66	83.33	n/a	n/a	n/a	n/a	n/a	n/a

## Our decision

We have considered the issues raised by the Proposal, the associated Impact Assessment, and the Change Declaration and Change Report dated 12 November 2019. Having regard to our principal objective and statutory duties<sup>7</sup> and whether the Proposal better facilitates the Applicable Charging Methodology Objectives, we have considered and taken into account the vote of the DCUSA Parties on the Proposal that is attached to the Change Declaration. We have concluded that:

- Implementation of the modification proposal will not better facilitate the achievement of the Applicable Charging Methodology Objectives.<sup>8</sup>

## Reasons for our decision

***Second Applicable Charging Methodology Objective – that compliance with the Relevant Charging Methodology 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 the participation in the operation of an Interconnector***

Three of the ten respondents to the Consultation consider that the modification better facilitates the second Applicable Charging Methodology Objective. In brief, the reasons given were that the modification would allow for more cost reflective revenue allocation between the DNO and the LDNO, and that the modification would lead to a reduction in the volatility of the absolute level of discount that the LDNOs would receive, therefore resulting in improved competition. The remaining seven respondents were generally of the opinion that the opposite is true: that the modification would not better facilitate the second Applicable Charging Methodology Objective because it would result in less cost reflective allocation of revenues between the DNO and the LDNO.

<sup>5</sup> Distribution Network Operator

<sup>6</sup> Independent Distribution Network Operator/Offshore Transmission System Operator

<sup>7</sup> 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.

<sup>8</sup> The DCUSA Charging Objectives (Relevant Objectives) are set out in Standard Licence Condition 22A Part B of the Electricity Distribution Licence.

We do not consider that the modification better facilitates the second Applicable Charging Methodology Objective. It has not been shown that the modification facilitates competition in any of the market activities as defined in the objective. The arguments put forward in favour of the Proposal in the responses to the Consultation suggest that competition is facilitated based on an improvement in the allocation of revenues between the DNO and LDNO. While we agree that more cost reflective allocation of revenues could result in improved competition, we do not consider that it has been demonstrated that the Proposal results in an improved revenue allocation nor, therefore, improved competition.

It was also argued that the Proposal would result in a reduction in volatility of LDNO margins from one year to the next and that this would result in improved competition. While the conclusion of the Working Group's analysis was that the Proposal would result in a decrease in the volatility of LDNO margins, this was only the case when these margins were expressed in terms of a p/kWh. Volatility will increase when LDNO margins are expressed as a percentage of CDCM tariffs.

Ultimately, we consider that the arguments put forward in support of this modification improving competition rely on an assumption that the defect in current arrangements, as defined by the Proposer, results in non-cost-reflective pricing, or outcomes that otherwise hinder competition. We do not consider that this has been demonstrated.

In addition to the lack of evidence supporting the argument that the Proposal would better facilitate this objective, we note the concerns highlighted in the Working Group that implementation of the Proposal could result in anti-competitive effects for IDNOs, potentially placing one or more of the DNOs in breach of their competition law obligations. We have not seen evidence to discount such risks.

***Third Applicable Charging Methodology Objective – that compliance with the Relevant 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 a Distribution Services Provider in its Distribution Business***

One of the ten respondents to the Consultation considered that the modification better facilitates the third Applicable Charging Methodology Objective. The reason given was that the modification would result in DNO charges to LDNOs that would more accurately reflect the costs incurred by the DNO. Five of the respondents considered that the modification does not better facilitate the Applicable Charging Methodology Objective. The other four respondents did not express a view regarding this charging methodology objective.

We do not consider that the modification better facilitates the third Applicable Charging Methodology Objective. We do not think that it has been demonstrated that the Proposal produces charges that are more cost reflective than those that are produced under the status quo. We discussed our stance in relation to this whilst considering the effects on competition above.

Among respondents that did not consider that the Proposal would better facilitate this charging objective, the main reason cited was the increase in the number of instances of LDNO discounts capped at 100% under the Proposal. It was also argued that selectively updating PCDM data would negatively affect cost reflectivity. These concerns are discussed in the following subsections.

### *Capped Tariffs*

When LDNO discounts are calculated under the proposed methodology, there is an increase in the number of raw discounts that exceed 100% of the DNO tariff compared to the current approach. Under the Proposal, as with current arrangements, the LDNO discount would be capped at 100% to prevent LDNOs from being paid to use a DNO's network. Discounts greater than 100% are not considered to be cost reflective, because the DNOs would incur cost in operating their networks, but they would also be crediting LDNOs for using them. We consider that an increase in the number of capped tariffs is not cost reflective, because the tariffs themselves are not cost reflective.

### *Data Selection*

The Proposal would create an inconsistency in time periods from which input data used to calculate discounts is taken. Currently, the PCDM uses data from the 2007/08 charging year in order to determine LDNO discounts. The CDCM uses data from the charging year in question to determine the DNO tariffs. In order to make the two compatible, PCDM input data needs to be updated. However, the scope of the Proposal is limited to conversion of the LDNO revenue into a percentage discount and does not include a full review of all of the data sources that are used in the PCDM. Therefore, input data used in the LDNO revenue allocation will be adjusted to make it compatible with current charging year data, while other PCDM data will not be updated. While we do not consider that this data selection would necessarily result in charges that are not cost reflective, we do consider that selectively updating data and the inconsistency that this would create is an undesirable outcome of the Proposal.

## **Decision notice**

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, the Authority has decided that modification proposal DCP266: The calculation and application of LDNO discounts should not be made.

### **Andrew Self**

#### **Deputy Director, Electricity Network Charging and Access**

Signed on behalf of the Authority and authorised for that purpose