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6 January 2021

Dear Anna,

**Consultation on changes to ‘Annex 3 – Methodology for determining Network Cost Allowance’ of SLC 28AD**

Thank you for the opportunity to comment on proposed changes to the ‘Annex 3’ methodology for determining Network Cost Allowance’ of SLC 28AD. We wish to comment on two issues:

- a) the case for including electricity DUoS charges in the calculation of the headroom allowance, in light of Ofgem’s proposals;
- b) the need to include additional network costs arising from derogations requested by DNOs when allowances are set for the sixth cap period onwards.

We have no comments at this stage on other aspects of Ofgem’s proposed changes to Annex 3.

Including DUOS in the calculation of headroom allowances

We note that the electricity DUoS tariff structure is changing from 1 April 2021 to one where all domestic customers are charged a fixed daily charge and a three-rate, time of use Red/Amber/Green (RAG) unit charge.

For each metering arrangement and region, Ofgem proposes to calculate a weighted average unit charge as the sum of the products of the RAG unit rates and the share of demand in the RAG time bands. A DUoS allowance will then be determined as the weighted average unit charge multiplied by Benchmark Annual Consumption Levels and combined with the annual fixed charge.

Ofgem’s approach reduces the level of precision in how DUoS is estimated relative to the current approach<sup>1</sup>. At the moment, the allowance for each period is calculated using network charges published by all DNOs. This enables suppliers to pass through to customers in each distribution region the actual DUoS charges incurred.

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<sup>1</sup> Unrestricted and two-rate domestic customers are charged either a single or two-rate unit charge

Ofgem's proposal to calculate a weighted unit charge (as opposed to the use of actual unit rates stated in network charging statements) will result in a forward estimate of DUoS that is likely to less accurately reflect actual DUoS costs. The allowance could be higher or lower than actual DUoS costs incurred, and suppliers will be exposed to uncertainty in DUoS cost recovery without a true-up mechanism.

We believe Ofgem should acknowledge this uncertainty by including the DUoS allowance in the list of cost components used to scale the headroom allowance. Currently, Ofgem excludes all network costs when calculating the headroom allowance on the basis that network costs are known with a reasonable degree of precision and are unlikely to vary over a six-month period.<sup>2</sup>

The proposed RAG methodology, whilst practical in terms of implementing DCP268, can no longer be regarded as a reasonably precise estimate of actual DUoS charges. Estimates of DUoS costs will now be subject to similar levels of uncertainty as other policy costs which do count to towards the headroom and should therefore be included in the headroom calculation.

### Derogations

Based on feedback from DNOs at the DCUSO Schedule 15 update on 26 November, we believe that most DNOs are likely to apply for derogations from their charging methodologies and the requirement to provide 15 months' notice of changes to distribution network charges. This could be for a number of reasons including the recovery of bad debt and last resort supplier payments.

Should Ofgem approve these requests, it is likely to result in an increase in DUoS charges with effect from April 2021. It is therefore important that Ofgem includes in the allowance for Period 6 (April to September 2021) any additional network costs resulting from such derogation requests that it is aware of by 5 February 2021 and that it has approved (or considers it likely that it will approve).

Ofgem took this approach for the second price cap period commencing in April 2019 whereby all derogations Ofgem had approved (for both DUoS and Gas Transportation charges) at the end of January 2019 were included in network cost allowances,<sup>3</sup> despite publication by DNOs of these updated charges taking place after 7 February 2019. We would expect Ofgem to adopt a consistent approach to derogations in 2021 but would request confirmation from Ofgem on this point.

Please do not hesitate to contact me or James Soundraraju (tel: 07548707639; email: [jsoundraraju@scottishpower.com](mailto:jsoundraraju@scottishpower.com)) if you have any questions arising from this response.

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<sup>2</sup> 'Default Tariff Cap: Decision Appendix 2 – Cap level analysis and headroom', paragraph 2.21

<sup>3</sup> Default tariff cap level: 1 April 2019 to 30 September 2019 <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-level-1-april-2019-30-september-2019>

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive style with a large initial 'R'.

**Richard Sweet**  
Head of Regulatory Policy