



DCUSA Change Report

DCP 097 and DCP 097A – Changes to the method of cost allocation employed in the Price Control Disaggregation Model for DNO indirect cost categories specifically associated with the volume of customers using the DNO network

1 PURPOSE

- 1.1 This document is issued in accordance with Clause 11.20 of the DCUSA, and details DCP 097 and 097 A – Changes to the method of cost allocation employed in the Price Control Disaggregation Model for DNO indirect cost categories specifically associated with the volume of customers using the DNO network. The voting process for the proposed variation and the timetable of the progression of the Change Proposal (CP) through the DCUSA Change Control Process is set out in this document.
- 1.2 Parties are invited to consider the proposed amendments (Appendix A and B), together with the Consultation documentation (Appendix C), the reconfigured analysis (Appendix D) and submit their votes using the form attached as Appendix E to dcusa@electralink.co.uk by 02 November 2011.

2 SUMMARY

- 2.1 DCP 097 was raised by the Electricity Network Company and seeks to change the CDCM methodology for the calculation of the LDNO discounts, which are used to determine portfolio tariffs applied in respect of LDNO networks connecting to a DNO's distribution system, by using customer Numbers for various costs and Customer Numbers or MEAV for IT & Telecoms and Property Management cost allocation.
- 2.2 The final drafting of DCP 097 that was developed by the Working Group settled on using MEAV for allocating costs to IT & Telecoms and Property Management. DCP 097A was raised by Independent Power Networks and has broadly the same intent as DCP 097, but it differs from the final draft of DCP 097 in that instead of using MEAV as the driver for IT & Telecoms and Property Management, it uses Customer Numbers.
- 2.3 The proposer of DCP 097 felt that the case for allocating a cost driver for these two costs types was less clear, and that a case for using MEAV or Customer Numbers to allocate such costs could be made. Therefore an alternative was raised to give Parties the choice of drivers for these particular two cost types.
- 2.4 The CDCM calculates portfolio tariffs for LDNO networks that connect to a DNO's distribution system by applying LDNO discounts to final tariffs (final tariffs are those calculated in respect of end consumers on the DNO Party's network). Within Step 4 of Schedule 16 in the DCUSA it describes the rules

that the CDCM employs to calculate LDNO discounts. In practice these rules are embedded in an Excel workbook entitled "Method M". In calculating the LDNO discounts the methodology allocates certain DNO indirect opex costs to different network levels using different cost drivers.

- 2.5 It then calculates weighted average percentages for allocating the DNO opex costs. In practice the weighted average percentages are calculated in the Method M 'WPD – Opex Allocation' worksheet and used to allocate opex costs in the Method M 'WPD- Final Allocation' worksheet. In addition, the proportion of direct costs to indirect costs is used in the calculation of LDNO discounts where the LDNO connects to the DNO within a network level where an LDNO connects to the upstream distributor at LV and where the downstream customer is connected at LV.
- 2.6 Currently some of the indirect operating costs are allocated to each network level using an estimate of the percentage of the total Modern Equivalent Asset Value (MEAV) provided at each network level of the DNO's distribution system as a cost driver. Not all indirect costs are allocated to network levels; where they are not allocated they do not play a part in determining the weighted average percentage used to allocate operating costs.
- 2.7 DCP 097 and DCP 097A each propose to change the cost drivers used to allocate some of the indirect costs. The proposed changes to the cost drivers are shown below:

Cost Category	Cost Allocation Driver		
	Current	Proposed DCP 097	Proposed DCP 097 A
Customer Call Centre	MEAV	No Customers	No Customers
IT & Telecoms	Do Not Allocate	MEAV	No Customers
Property Mgt	Do Not Allocate	MEAV	No Customers
HR & Non-operational Training	MEAV	No Customers	No Customers
Finance & Regulation	MEAV	No Customers	No Customers
CEO etc	MEAV	No Customers	No Customers

- 2.8 The change proposal notes that the IT/Telecoms and Property Management costs should be allocated, and by doing so the direct costs do not have an undue bearing on the weighted average percentage of costs used to allocate

opex.

- 2.9 The justification for the change of cost drivers that DCP 097 examined for: *Customer Call Centre, HR and Non-Operational Training, Finance and Regulation, and CEO etc*, was that use of MEAV was an inappropriate cost driver for these indirect costs and that using 'No of customers' as a cost driver better reflects the way these indirect costs are incurred.

3 DCP 097 – WORKING GROUP

- 3.1 The DCUSA Panel established a Working Group to assess and refine DCP 097.
- 3.2 The DCP 097 Working Group met on 6 occasions and consisted of representatives from DNOs, IDNOs and Ofgem.

4 CONSULTATION

- 4.1 The Working Group carried out a Consultation to give Parties an opportunity to review and comment on the CP, and there was seven responses received.
- 4.2 There was general agreement for the following questions which were posed in the Consultation:
- Do you understand the intent of the CP and are you supportive of its principles?
 - Do Supplier Parties consider themselves materially impacted by the CP and eligible to vote?
 - Do you agree with the level of data used in the Impact Analysis undertaken by DNOs on behalf of the Working Group? Provide supporting comments
 - Do you agree with the associated impact assessment completed by the Working Group?
 - Do you agree that the legal drafting and is it appropriate to meet the Intent of DCP 097?
- 4.3 The Consultation asked whether DCP097 better facilitates the DCUSA General and Charging objectives. There were seven responses in total, and four agreed that this CP better meets the objectives, and three respondents felt that this CP does not better facilitate the relevant objectives as it is currently written.
- 4.4 One the respondents noted that although they can agree with some of the

cost drivers that are proposed, they do not feel that all of them offer the best solution. Therefore, they stated that they do not agree that changing the remaining categories as per the proposal is more cost reflective and therefore do not accept that overall the change proposal better meets the DCUSA general and charging obligations.

- 4.5 A second respondent considered the proposed changes to the cost drivers as shown in the table shown in paragraph 2.4, and although they agreed that some of the proposed changes better facilitates the Charging Objectives, they were not convinced that the totality of the proposed change would necessarily better facilitate the Charging Objectives.
- 4.6 The same respondent explained further that this CP proposes to change the cost drivers used to allocate some of the indirect costs. The manner in which Method M manages the assignment of indirect cost is through a cost driver matrix factoring a portion of these costs to each network level, where the declared cost drivers are used as a proxy for indirect costs. The use of a proxy is necessary because the costs must be scaled down from the overall DNO business to a proportion of the individual tariffs. The principle of the cost allocation driver is to determine firstly whether a cost type should be allocated to a network level and if so to identify the most appropriate proxy for the differences in size of DNOs businesses.
- 4.7 They further noted that they considered that it is not possible to assess all six changes collectively, and each should have been assessed individually. However, they considered that the very tightly worded intent of the CP in practice precluded the Working Group from considering any alternatives.
- 4.8 The third respondent does not believe that the change proposal better meets the DCUSA general and charging obligations because they feel it would be more appropriate to individually assess the categories.
- 4.9 There were four respondents who all agreed that this CP would better facilitate the DCUSA General and Charging Objectives, and when considered in their entirety, the change of all the cost drivers within this CP represents an improvement in the cost allocation methodology currently in place.
- 4.10 The Working Group discussed these comments during the meeting. The proposer noted that:
- The choice of costs drivers was subjective and that under the initial

development of the CDCM and in prior submissions by DNOs this had been an area of significant debate with differing views.

- DNOs had had the full scope available to them in the initial development of the CDCM to consider all options on costs drivers and had decided on MEAV.

- 4.11 It was confirmed by the proposer of DCP 097 that the intent was intentionally written to have a narrow scope. The proposer felt that to allow a broader scope would have a significant risk of derailing the intent, and delaying an April 20102 implementation. This would ensure that the option that is set out in the CP itself is the one which the Working Group evaluates, and that the scope could not be broadened to consider other alternatives. The proposer felt that the preliminary analysis sufficiently demonstrated the best option to take forward.
- 4.12 The Working Group was not able to reach a consensus in agreeing that the DCUSA General or CDCM Objectives were better facilitated by this Change Proposal.
- 4.13 The other area in which there were contrary comments to the agreement of the majority of the group was in regard to whether they believe that the intent of DCP 097 is adequately met, or whether there are alternative ways of meeting the intent of DCP 097.
- 4.14 One respondent noted that an alternative approach to the identified defect would be to examine ways of improving the values underlying the weighing/split values and to model this case within Method M accordingly. However, they felt they were not able to suggest this during the RFI as the very tightly worded intent of the CP does in practice preclude any alternative from being considered by the Working Group.
- 4.15 The Consultation then asked whether it was believed that the intent of DCP 097 is adequately met, or that there are alternative ways of meeting the intent of DCP 097. There were seven responses to the Consultation and three did not believe that the intent was adequately met, while there was a general agreement by the other four that it was.
- 4.16 Of the respondents that agreed that this CP adequately meets the intent, one respondent noted that the intent of DCP 097 was intentionally narrowly drafted and the proposed solution is the optimum way of meeting this

intent. A second respondent felt that as the intent was quite tightly defined, therefore they did not believe there are any alternatives.

- 4.17 There were three respondents which did not feel that the intent of the CP was adequately met. Two of the respondents do not agree with the overall intent of DCP 097 as they believe it is less cost reflective than the existing methodology.
- 4.18 The third respondent noted that an alternative approach to the identified defects from this CP being raised would be to examine ways of improving the underlying values and to model those. When considering these changes they considered that many of costs would be better represented though a value derived from more than one cost allocation driver, i.e. a composite value or factor. They go on to note that they did not suggest this during the RFI or working group as the very tightly worded intent of the CP in practice precluded proposing any alternatives.
- 4.19 As with the other items that were raised on the Consultation responses, the Working Group reviewed the comments during their meeting. All the alternative opinions and viewpoints were discussed and analysed, however, it was confirmed by the proposer of DCP 097 that the intent was intentionally written to have a narrow scope. This would ensure that the option that is set out in the CP itself is the one which the Working Group evaluates, and the scope could not be broadened to consider other alternatives. The proposer felt that the preliminary analysis sufficiently demonstrated the best option to take forward.
- 4.20 The Working Group did not reach a consensus in agreeing that the intent of DCP 097 has been adequately met.
- 4.21 The Consultation also asked if there were any additional comments from respondents, and two provided further details to strengthen their views. The first stated that they would be able to support a CP that proposed to revise the cost allocation driver of Customer Call Centre costs from "MEAV" to "No. of Customers" and IT & Telecoms and Property Management costs from "Do Not Allocate" to "MEAV". The Party noted that they would have recommended to the Working Group an alternative version of the CP which included drivers that were not available as options in the original DCP097. However, the tightly worded intent precluded this from happening, except with the two original options that were originally proposed, MEAV or

Customer Numbers which was later split into DCP 097 and DCP 097A.

- 4.22 There were also various comments that addressed the governance of the Method M spreadsheet, as well as the cumulative effects of implementing the four CPs (DCP 094 – 097) which this working group reviewed. These comments were discussed and deemed to be outside the scope of the Working Group.
- 4.23 One respondent felt that there was a possibility that there could be material impacts on Suppliers in the future, and therefore they should be given the opportunity to vote and comment on the Change Proposal. The proposer did not feel that there was an immediate impact on Suppliers, however to address this point, it was agreed to give Suppliers the opportunity to vote on DCP 094.
- 4.24 A complete and detailed summary of all Party responses are set out in Appendix C.
- 4.25 Whilst reviewing the Consultation responses, it was brought to the Working Group's attention by Ofgem that it would like to see the impacts and materiality of DCP 097 and DCP097A expressed in monetary values. The analysis has been reconfigured to show both the percentage and monetary value changes.
- 4.26 The additional analysis was circulated to the Working Group, and it was concluded that these changes will have a minimal impact upon tariffs. The additional analysis details the changes in tariffs in both percentage and monetary value changes and is attached as Appendix D.

5 PROPOSED LEGAL DRAFTING

- 5.1 The proposed legal drafts of DCP 097 and DCP 097 A have been drafted by the Working Group, and reviewed by Wragge and Co, and are attached as Appendix A and B

6 EVALUATION AGAINST THE DCUSA AND CHARGING OBJECTIVES

- 6.1 The Working Group considered the Consultation responses regarding whether DCP 097 and DCP 097A better facilitated each DCUSA General and CDCM Objectives. There were seven responses to the Consultation and 4

agreed with the CP better facilitating the relevant objectives and 3 did not. The full set of Consultation responses is attached as Appendix C.

- 6.2 All DCUSA General Objectives were evaluated in respect of this CP, and there was no impact identified by it being implemented on any of them except for General Objective 2.
- 6.3 Following the Consultation responses, the Working Group was not able to reach a consensus in agreeing that the DCUSA General Objectives were better facilitated by each of these Change Proposals. Whilst there was a slight majority of the Working Group which felt that the following DCUSA General Objectives was better facilitated, there were members who did not agree:
- Objective 2¹ – Better Facilitated - The facilitation of effective competition in the generation and supply of electricity and (so far as is consistent with that) the promotion of such competition in the sale, distribution and purchase of electricity.
- 6.4 The Working Group considers that Objective 2 is better facilitated since it considers that the proposed cost drivers offer a better proxy than modern equivalent asset values for allocating the indirect costs and thus better promote competition in distribution. The allocation of operational costs plays a significant component in the determination of tariffs for LDNOs and the margins that LDNOs are entitled to make under the current regulatory regime. The effect of the CP needs to be considered in respect of the overall impact on the weighted average percentages. The effect of the CP is to modify the weighted average percentage that is applied to all costs toward the customer end. This is believed to be reasonable since many of the price control costs are driven by customers, not by the MEAV.
- 6.5 All DCUSA CDCM Objectives were evaluated in respect to this CP, and there was only an impact identified by it being implemented on two of them, CDCM Objectives 2 and 3.
- 6.6 Following the Consultation responses, the Working Group was not able to reach a consensus in agreeing that the DCUSA CDCM Objectives were better facilitated by this Change Proposal. A slight majority of the Working

¹ The facilitation of effective competition in the generation and supply of electricity and (so far as is consistent therewith) the promotion of such competition in the sale, distribution and purchase of electricity

Group felt that following DCUSA CDCM Objectives were better facilitated, while others on the Working Group disagreed:

- Objective 2² – Better Facilitated – Will result in improved cost reflectivity and will aid the facilitation of competition.
- Objective 3³ – Better facilitated - The CP will improve cost reflectivity.

6.7 It is considered that under each of DCP 097 and DCP 097A DCUSA CDCM Objective 2 will be better facilitated as the CP will enhance cost reflectivity.

6.8 The Working Group considers that under each of DCP 097 and DCP 097A DCUSA CDCM Objective 3 will be better facilitated as the CP will improve cost reflectivity, as detailed above.

7 IMPLEMENTATION

7.1 DCP 097 and 097A are classified as a Part 1 matter in accordance with Clause 9.4.2 (B) of the Agreement, and therefore will go to the Authority for determination after the voting process has completed.

7.2 The implementation date, subject to Authority approval, would be 01 April 2012.

7.3 The outcome of DCP097 and DCP 097A will be known by early December 2011, allowing Distributors to take the proposal into account when publishing their indicative charges in December 2011 and final prices in February 2012 for implementation from 01 April 2012.

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)

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

8 ENGAGEMENT WITH THE AUTHORITY

- 8.1 Ofgem has been fully engaged throughout the development of DCP 097 and DCP 097A as a member of the Working Group.

9 PANEL RECOMMENDATION

- 9.1 The Panel approved this Change Report by ex-Committee on the 18 October 2011. The Panel considered that the Working Group had carried out the level of analysis required to enable Parties to understand the impact of the proposed amendment and to vote on DCP 097 and DCP 097A.
- 9.2 The timetable for the progression of the Change Proposals is set out below:

Activity	Date
Change Report issued for voting	19 October 2011
Voting closes	02 November 2011
Change Declaration	04 November 2011
Authority Determination	09 December 2011
CP Implemented	01 April 2012

10 APPENDICES:

- Appendix A - DCP 097 - Legal Drafting
- Appendix B –DCP 097A – Legal Drafting
- Appendix C - DCP 097 – Consultation Documents
- Appendix D – DCP 097 and DCP097A – Reconfigured Analysis
- Appendix E - DCP 097 - Voting Form