



Modification proposal:	<b>Distribution Connection and Use of System Agreement (DCUSA) DCP096 - Treatment of Transmission Exit Charges in CDCM Price Control Disaggregation Model (Method M)</b>		
Decision:	The Authority <sup>1</sup> directs that DCP096 be made <sup>2</sup>		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	9 December 2011	Implementation Date:	1 April 2012

## Background to the proposed modification

The common distribution charging methodology (CDCM) was implemented in April 2010 and sets out how distribution use of system (DUoS) charges for users connected at low voltage (LV) and high voltage (HV) are calculated. The CDCM introduced specific charges for licensed distribution network operators (LDNOs)<sup>3</sup>. These charges are derived from discounting the CDCM charge for end users to take account of the proportion of the network which the LDNO provides instead of the DNO. The discounts used to derive LDNO tariffs are calculated through the Price Control Disaggregation Model, also known as "Method M". This uses a series of cost drivers to disaggregate the price control settlement into four network levels - LV, LV/HV, HV and extra high voltage (EHV). This is used to generate a proxy for the percentage of cost which lies in each of the four network levels. This proxy forms the basis of the discount provided on the CDCM charge to generate the LDNO specific charges.

Method M works by allocating capital and operating costs to each of the network levels identified above. Capital costs identified in the price control settlement are allocated using data within DNOs' regulatory reporting packs (RRPs), which directly identify the network level the cost relates to. Separate operating costs are allocated to network levels using cost drivers. One of those costs is transmission exit charges, which are paid by the DNO to the relevant transmission company in respect of providing a connection to the transmission network. Presently, this cost is allocated solely to the EHV level, which is typically the level which connects to the transmission network and thus incurs the charges.

## The modification proposal

DCP096 was received by the Authority on 4 November 2011. The change report states that allocating transmission exit charges to EHV has a disproportionate impact on the overall allocation of operating costs. It states that many operating costs do not have a cost driver allocated to them and that consequently these are allocated according to the average of those which do have a cost driver. The change proposal states that using EHV as a cost driver for transmission exit charges has the effect of placing more of these unallocated costs into the higher network levels.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<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> This includes Independent Network Operators (IDNOs) and Distribution Network Operators (DNOs) operating out of their distribution services area.

The change proposal therefore seeks to change the Method M so that transmission exit charges are not allocated to any specific network level. Further, in recognition that these are costs which are borne solely by the DNO, the change proposal seeks to classify transmission exit charges as 'not to be split'. This is a category of cost within Method M which is removed from the disaggregation model to ensure that DNOs retain 100 per cent of recovery of such charges. This principle is also applied to price control incentive payments. The change proposal therefore enables the DNO to recover transmission exit charges from LDNOs in full whilst ensuring that these charges do not play a part in allocating operating costs.

The working group argues that the change would result in a more cost reflective solution that would reduce distortions in the way discount factors are currently calculated for such connections. The majority of the working group also considered that as a result, the proposal would better facilitate competition in distribution.

We note that the impact of the proposal is to allocate more operating costs into the lower network levels. This has the effect of increasing the discount factors used to calculate LDNO tariffs. Consequently, the average annual charge an LDNO pays to a DNO for use of the upstream network in supplying an LV unrestricted domestic customer will reduce by less than £1<sup>4</sup>. We note that this loss in revenue for DNOs will be made up through increasing the charges to all other CDCM customers. However, the number of LDNO customers is less than 200,000 compared to over 28 million CDCM customers. Therefore, the extra revenue they need to recover from other customers will be insignificant on a per customer basis<sup>5</sup>.

### DCUSA Parties' recommendation

The Change Declaration for DCP096 indicates that DNO, IDNO/OTSO, Supplier and Distributed Generation (DG) parties were eligible to vote on DCP096. In the IDNO/OTSO and Supplier category, there was 100% support for the proposal and its proposed implementation date. In the DNO category, there was majority (>50%) support for the proposal and implementation date.

The outcome of the weighted vote procedure is set out in the table below:

DCP096	Weighted Voting (%)							
	DNO		IDNO/OTSO		SUPPLIER		DG <sup>6</sup>	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
Change solution	74%	26%	100%	0%	100%	0%	N/A	N/A
Implementation date	74%	26%	100%	0%	100%	0%	N/A	N/A

No supporting explanation from the DNO parties<sup>7</sup> that voted against the proposal was included in the Change Report or associated documentation.

### The Authority's decision

<sup>4</sup> This is the average across all 14 DNO areas and is based on the consumption assumptions currently made in the CDCM.

<sup>5</sup> For example if we assume there are 100,000 LDNO customers who are all LV unrestricted then as a consequence of the proposal DNOs would have around £200,000 extra to recover from the other 28 million CDCM customers. This would represent less than 0.8p per customer per year.

<sup>6</sup> No votes were cast in this category of Parties.

<sup>7</sup> SP Distribution and SP Manweb

The Authority has considered the issues raised by the proposal, the Change Report and the Change Declaration<sup>8</sup> issued on 4 November 2011. We have also considered and taken into account the views of the DCUSA Parties in response to the DCUSA Panel's consultation and Request for Information (RFI), and the DCUSA Parties' recommendation.

The Authority has concluded that:

1. Implementation of change proposal DCP096 will better facilitate the achievement of the charging objectives 3.2.1, 3.2.2 and 3.2.3 and is neutral to 3.2.4.
2. Directing that the change is approved is consistent with the Authority's principal objective and statutory duties.<sup>9</sup>

### **Reasons for the Authority's decision**

The Authority's assessment of DCP096 against the Charging Objectives is set out below:

#### **Charging Objective 3.2.1 That compliance by each DNO party with the Charging Methodologies facilitates the discharge of the obligations imposed on it under the Act and by its Distribution Licence.**

We note that under standard licence condition (SLC) 4.6, DNOs and IDNOs have an obligation not to restrict, distort or prevent competition in the generation, transmission, distribution, or supply of electricity, or in the operation of an interconnector. We consider that in terms of distribution, the same arguments as outlined under Charging Objective 3.2.2 below apply.

#### ***Charging Objective 3.2.2 That compliance by each DNO party with the 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 (as defined in the Distribution Licence).***

We consider that DCP096 would enable the CDCM to better meet these objectives. As discussed above in relation to Charging Objective 3.2.3, the change proposal removes a potential distortion in the way that operating costs are allocated between the DNO and the LDNO. This is due to the fact that allocating transmission exit charges to EHV has an impact on the average weighting of all other operating costs. Through including transmission exit charges in the 'do not allocate' category but ensuring that they are always retained by the DNO (by including them in the 'do not split' set of costs) the method more accurately reflects the costs borne by DNOs and LDNOs. This improved allocation of costs between the upstream DNO and downstream LDNO should help to ensure a more appropriate LDNO charging methodology which creates a more level playing field in distribution between LDNOs and DNOs. Consequently, we consider that the proposal better facilitates this Charging Objective.

#### ***Charging Objective 3.2.3 – That compliance by each DNO party with the Charging Methodology results in charges which, so far as is reasonably practicable after taking account of implementation costs, reflects the costs incurred, or reasonably expected to be incurred, by the DNO party in its Distribution Business***

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<sup>8</sup> All documents can be accessed via the DCUSA website: <http://www.dcusa.co.uk/Extranet/CP.aspx?id=93>

<sup>9</sup> The Authority's statutory duties are wider than matters that the Panel must take into consideration and are detailed mainly in the Electricity Act 1989 as amended as well as obligations arising under EU legislation.

We consider that DCP096 would enable the CDCM to better meet this objective. By placing transmission exit charges into the 'not to be split' category of costs, it ensures that these costs are always recovered by the DNO regardless of the network level which the LDNO connects at. We consider that this is appropriate since transmission exit charges are not a cost directly borne by LDNOs.

Method M relies on using cost drivers to allocate costs, including operating costs to different voltage tiers. Where no cost driver can be used, the costs are allocated according to the average of those for which cost drivers are used. Allocating transmission exit charges to EHV therefore has an impact on the overall allocation of operating costs to voltage tiers. Whilst, in theory, all operating costs would have a cost driver to allocate them to network levels we recognise that in practice it may be difficult for indirect costs such as network rates, pension deficit costs etc. Consequently, we consider that by not allocating transmission exit charges to any network levels, the proposal will result in a more accurate average allocation of all operating costs. This will enable a more accurate reflection of the costs incurred by DNO and LDNO parties.

Notwithstanding this, we would not want to endorse a principle of not having appropriate cost drivers to allocate operating costs to network levels in the Method M model. We consider that transmission exit charges could be a unique case and that it is only the combination of placing these costs in the 'not to be split' category as well as not allocating a specific cost driver, that greater cost reflectivity is achieved. This is unlikely to be the case for the majority of other operating costs in the Method M model.

**Charging Objective 3.2.4 That, so far as is consistent with Clauses 3.2.1 to 3.2.3, the Charging Methodologies, so far as is reasonably practicable, properly take account of the developments in each DNO parties Distribution Business.**

We note that the change proposal was not raised in response to developments in a DNOs distribution business. Consequently, we consider the change proposal is neutral against this Charging Objective.

#### **Decision notice**

In accordance with SLC 22.14 of the Electricity Distribution Licence the Authority hereby directs that change proposal DCP096 'Treatment of Transmission Exit Charges in CDCM Price Control Disaggregation Model (Method M)' be made.

#### *Competition Act 1998*

It is important to note that our decision letter relates to the methodology rather than the quantification of elements produced by the methodology. It is for DNOs to ensure their own compliance with the Competition Act 1998 and/or Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU) in implementing the proposed methodology. It does not amount to or imply any particular view as to the application or interpretation of the Competition Act 1998 and/or Articles 101 and 102 of the TFEU, or any other law, either prior to this regulatory decision or once this regulatory decision is in place.

Rachel Fletcher

**Acting Senior Partner, Smarter Distribution and Governance**

Signed on behalf of the Authority and authorised for that purpose