

Proposed variation:	<b>Distribution Connection and Use of System Agreement (DCUSA) DCP104: Shared Impact of Manifest Errors in DUoS Charging</b>		
Decision:	The Authority <sup>1</sup> has decided to reject DCP104 <sup>2</sup>		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested Parties		
Date of publication:	12 April 2012	Implementation Date:	N/A

## Background to the modification proposal

“Manifest errors” can occur when data are input incorrectly into a Distribution Network Operator’s (DNO’s) charging methodology model in a way which may result in the misstatement of its Distribution Use of System (DUoS) charges. This misstatement may result in an over or under recovery of allowed revenue which the DNO would seek to reverse by correcting the effect of the error as quickly as possible. Manifest errors are the result of human error in data input and not genuine differences in information input to the charging model, for example, differences between actual and forecast data.<sup>3</sup>

The price control framework<sup>4</sup> is embodied in several charge restriction conditions (CRCs) and standard licence conditions (SLCs) of the Electricity Distribution Licence (the licence). The CRCs prescribe revenue allowances and parameters and how the revenue allowances may be adjusted for a range of factors, including a company’s performance under various incentive mechanisms. The CRCs also set out obligations on DNOs from 1 April 2010, including the setting of distribution charges in a way that is consistent with their revenue allowance.

When a manifest error is identified, charges may be revised by the DNO, with three months’ notice. This can occur at any time of the year and the revised charges are passed on to suppliers and customers. The change in charges to correct a manifest error could be significant. Two recent examples of manifest error changes to charges are provided in the DCP104 Change Report (CR).<sup>5</sup>

In our view, charging volatility can have an adverse effect on retail markets and ultimately on consumers. As a result of our decision on DCUSA change proposal DCP001<sup>6</sup>, clause 19.1 of the DCUSA provides that DNOs and Independent Distribution Network Operators (IDNOs) must use reasonable endeavours not to vary their DUoS charges more than two times a year, on 1 April and 1 October. In addition, the licence, places an obligation on DNOs to provide three months’ notice of changes to charges.

The joint effect of the licence obligation and the DCUSA obligation is that, although DNOs and IDNOs are encouraged to only change their charges on the two specified dates, they can still make changes to their charges on another date provided that three months’ notice is given. One reason for making a change outside of the specified dates may be to correct a manifest error which has been identified and requires early rectification.

<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> The proposed DCP104 legal text definition of manifest error is “an error in the data input into CDCM [charging] model or an error in the calculations within the CDCM model (and not, for the avoidance of doubt, a discrepancy between actual data and the forecast data input into the CDCM model)”.

<sup>4</sup> DPCR5 is the current price control (2010–2015). Details about the price control are available on the Ofgem website.

<sup>5</sup> DCUSA change proposals, modification reports and representations can be viewed by registered users on the DCUSA website operated by ElectraLink: <http://www.dcusa.co.uk/Public/Default.aspx>.

<sup>6</sup> DCP001 Alternative was implemented on 1 November 2007. The Authority’s decision is available on the Ofgem website: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=2&refer=Licensing/ElecCodes/DCUSA/Changes>.

On 13 March 2012, we rejected DCUSA change proposal DCP105<sup>7</sup>, which sought to restrict the DNOs' ability to change their charges to twice a year, on the two specified dates only, by removing the reference to reasonable endeavours. Because of this, DNOs can still make changes to their charges outside of 1 April and 1 October each year.

### **The modification proposal**

DCP104 was raised by npower Limited (the proposer) in August 2011. The change proposal seeks to amend the DCUSA by recognising and defining the term 'manifest error' and setting out how adjustments to charges as a result of manifest errors would be treated. It also seeks to spread the risk associated with changing DUoS charges to correct manifest errors across suppliers, customers and the DNO and to smooth the price impact of correcting manifest errors over a three year period.<sup>8</sup>

The proposer expected that this change proposal would amend Clause 19 of the DCUSA and would better facilitate the achievement of DCUSA General Objective (3.1.2).<sup>9</sup> In the proposer's view, the change proposal would facilitate competition by ensuring that the DNO that has made the manifest error is exposed to some of the risk associated with the correction of the error, rather than the risk only affecting suppliers and customers. The proposer took this view as they considered the change proposal would reduce the potential impact of large price movements on suppliers and customers. As a result, they considered that customers would receive a fairer spread of risk and suppliers would price changes in their charges more transparently and provide customers with more predictable prices. The proposer does not consider that there is an impact on the DNO's recovery of overall allowed revenue, although this is phased over a three year period.

A Working Group was established to assess the proposal and to develop a solution. The revised legal text proposed by the Working Group seeks to modify Schedule 16 of the DCUSA (the CDCM) to introduce 'Part 4 – Adjustments in the case of Manifest Errors'. Unless otherwise determined by the Authority (on the DNO's application), where a manifest error is forecast to result in an over or under recovery of revenue from DUoS of no more than +/- four per cent of the DNO's allowed revenue for the charging year, the proposed modification would require the DNO to smooth adjustments of DUoS charges over the course of a three year period.<sup>10</sup>

The Working Group issued a consultation to suppliers, DNOs, IDNOs and consumers on 24 November 2011 to determine whether parties understood and supported the intent of DCP104 and the impact it would have on them if implemented. All respondents to the consultation indicated that they understood the intent of the proposal. However, the proposed solution was not supported by all those who responded, as illustrated in the table below:

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<sup>7</sup> The Authority's decision on DCP105 is available here:

<http://www.ofgem.gov.uk/Licensing/ElecCodes/DCUSA/Changes/Documents1/DCP105D.pdf>.

<sup>8</sup> Under the current regime, price changes resulting from the correction of manifest errors have an immediate impact on charges and affect only suppliers and customers.

<sup>9</sup> DCUSA General Objective 3.1.2 is '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'.

<sup>10</sup> We note that the suggested changes to DCUSA are to Schedule 16 (the CDCM) rather than Schedule 19 (Charges) as proposed in the original change proposal. Because of this, in our view, DCP104 should be assessed against the DCUSA Charging Objectives (Clause 3.2) and not the DCUSA General Objectives.

	Supportive	Not supportive	Undecided
Suppliers	3	0	0
DNOs	1	5	0
IDNOs	0	2	0
Consumers	0	0	0

The views of the Working Group were split on whether the proposal better facilitates one or more of the DCUSA Charging Objectives. The detailed views of the Working Group (including their evaluation of the proposal against the DCUSA Charging Objectives) and other parties are provided in the CR.

### **DCUSA Parties' recommendation**

The DCP104 Change Declaration (CD) indicates that DNO, IDNO/Offshore Transmission System Operator (OTSO), supplier and Distributed Generation (DG)<sup>11</sup> parties were eligible to vote on DCP104. As shown in the table below, the sum of the weighted votes in favour of the proposal was not greater than 50 per cent in all categories. In accordance with the weighted vote procedure, the recommendation to the Authority is that DCP104 be rejected. The outcome of the weighted vote is set out in the table below:

<b>DCP104</b>	DNO		IDNO/OTSO		SUPPLIER	
	Accept	Reject	Accept	Reject	Accept	Reject
	CHANGE SOLUTION %	0	100	0	100	100
IMPLEMENTATION DATE %	0	100	0	100	100	0

### **The Authority's decision**

We have considered the issues raised by the proposal and the CD of 6 March 2012. We have taken into account the vote of the DCUSA Parties on the proposal, which is set out in the CD. We have also considered and taken into account the responses to the Working Group's<sup>12</sup> consultation, which are attached to the CR. Whilst the proposer justified their proposal against the DCUSA General Objectives, we consider it appropriate to consider the proposal against the DCUSA Charging Objectives and have therefore set out our reasons against those objectives.<sup>13</sup>

**We have concluded that implementation of change proposal DCP104 will not better facilitate the achievement of the DCUSA Charging Objectives.<sup>14</sup>**

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

We have set out our reasons against the DCUSA Charging Objectives which, in our view, are relevant to our decision. For the other objectives, we consider that the impact of the change proposal is neutral. We also provide our views on relevant wider issues pertinent to this decision.

<sup>11</sup> No votes were cast in the DG category.

<sup>12</sup> In accordance with the role, functions, and responsibilities of the Working Group set out in Section 1B of the DCUSA.

<sup>13</sup> The suggested changes to DCUSA are to Schedule 16 (the CDCM) rather than Schedule 19 (Charges) as proposed in the original change proposal. Because of this, in our view, DCP104 should be assessed against the DCUSA Charging Objectives (Clause 3.2) and not the DCUSA General Objectives.

<sup>14</sup> The DCUSA Charging Objectives (Applicable Charging Methodology Objectives) are set out in Part B of Standard Licence Condition 22A of the Electricity Distribution Licence and are also set out in Clause 3.2 of the DCUSA.

***DCUSA Charging Objective 3.2.1 'that compliance by each DNO Party with the Charging Methodologies facilitates the discharge by the DNO Party of the obligations imposed on it under the Act and by its Distribution Licence'***

The majority of consultation respondents concluded that the proposal would have an adverse impact on DCUSA General Objective 3.1.3, as it could potentially place DNOs and IDNOs in breach of their existing licence obligations. In particular, concerns were raised that the proposal could prevent compliance with CRC3.2. CRC3.2 requires licensees to take all appropriate steps, in setting DUoS charges, to ensure that Regulated Combined Distribution Network Revenue does not exceed Combined Allowed Distribution Network Revenue in a given regulatory year. Some consultees considered that the proposal could increase DNOs' exposure to financial penalties (in the form of penal interest rates) associated with under and over recoveries of allowed revenue set out in CRC14.

Another respondent highlighted that the licence already stipulates that DNOs need to present Ofgem with a charging statement setting out amended charges, and so a mechanism already exists to allow complete visibility of price changes to Ofgem. The same respondent stated that DCP104 would distort competition in the supply market and that a consequential effect might be to adversely affect DNOs' and IDNOs' cash flows, potentially placing them in breach of their licences.

We consider that the change proposal would restrict the ability of the DNOs to efficiently discharge the obligations placed on them by the licence by restricting their ability to control under and over recoveries.

We consider that the provisions in the licence will always take precedence over the DCUSA (or any other code). The proposal will require DNOs to spread the adjustment of DUoS charges following a manifest error over three years. This conflicts with DNOs' CRC3.2 licence obligation to take all appropriate steps to ensure that Regulated Combined Distribution Network Revenue does not exceed Combined Allowed Distribution Network Revenue in a given regulatory year.

CRC14 sets out how charges should be treated in the event of an over or under recovery in any given regulatory year and it imposes restrictions on both the interest rate that may be applied to over and under recoveries of revenue. In requiring DNOs to spread the impact of manifest errors over three years, the proposal would prevent DNOs' correcting any over/under recovery inside a single regulatory year. This would impair DNOs ability to mitigate against incurring penal interest rates under CRC 14.

Further, we note that the proposed amendments to Schedule 16 of the DCUSA give the Authority a role in determining how DNOs should adjust their DUoS charges in the event of an over/under recovery. We do not think such an approach is appropriate and consider that such an obligation should be placed on the Authority by the distribution licence rather than by the DCUSA.

For these reasons we consider that the proposal does not better facilitate DCUSA Charging Objective 3.2.1.

***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'***

We do not consider that the proposal better facilitates DCUSA Charging Objective 3.2.3 as it could reduce the cost reflectivity of charges. Spreading the adjustment of DUoS charges over three years increases the time lag between the identification of a manifest

error and its correction. This could result in a correction, designed to adjust the level of allowed revenue recovered, being applied to the wrong customers, for example, customers not affected by a past under recovery could be subject to higher charges designed to correct the past under recovery and vice versa.

We recognise that there are wider issues concerning how the correction of manifest errors is addressed, and we explain our views on these wider issues below.

### **Ofgem's work on volatility in network charges**

We are aware of suppliers' concerns that volatility in network charges, in both the gas and electricity markets, is affecting their ability to accurately price the cost of supplying energy to their customers. This includes concerns raised around the increasing number of errors made by DNOs when calculating customers' charges. These errors have led to mid-year charge changes. We are also concerned that volatility is adversely affecting customers' energy bills as suppliers are potentially including a risk premium to protect against the volatility in DUoS charges.

Throughout the current RIIO price control review process<sup>15</sup> (for gas distribution companies and transmission owners, stakeholders have discussed with us the impact of network charging volatility. Some useful options on how to mitigate the impact of volatility, from both network companies and suppliers, have been brought forward. We are therefore proposing to consult on this issue more widely in order to allow all stakeholders, including those participating in the electricity market, an opportunity to contribute their views. Within this consultation we will discuss the causes of volatility, including network operator errors in charging calculations, and seek views on whether additional arrangements should be put in place to mitigate their impact and place incentives on DNOs to reduce the risks of volatility. If a modification to the electricity distribution licence is required as a result of our decision, we will consult further on this.

### **Andy Burgess**

#### **Associate Partner, Transmission and Distribution Policy**

Signed on behalf of the Authority and authorised for that purpose

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<sup>15</sup>Page 6: <http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionuncert.pdf>