

Proposed variation:	Distribution Connection and Use of System Agreement (DCUSA) DCP123 – Revenue Matching Methodology Change		
Decision:	The Authority ¹ does not direct this modification ² be made ³		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	12 August 2014	Implementation Date:	n/a

Background to the modification proposal

The Common Distribution Charging Methodology (CDCM) determines 'pre-scaled charges' based upon a hypothetical 500MW model that is representative of the Distribution Network Operators' (DNOs) distribution systems. The resulting total revenue from these pre-scaled charges will differ from the allowed revenue we determine through price controls. This difference is reconciled through scaling whereby the pre-scaled charges are adjusted (upwards or downwards) to arrive at a set of charges which generate a revenue stream equal to the allowed revenue.

The current scaling mechanism

Scaling is a revenue matching process to manage the shortfall between allowed revenue under the regulatory price control and the revenue recovered from the charging model. It is applied on top of pre-scaled charges and, to a large extent, this revenue shortfall is unidentified and is not allocated to specific unit rates in the Common Distribution Charging Methodology (CDCM). The current scaling mechanism recoups the revenue shortfall through the transmission exit cost level. This has the effect that a large part of revenue matching falls on the peak time band known as the red/day unit rate.

The concept of a scaling mechanism was established at the start of the CDCM. At that time, we said it was important that any revenue matching mechanism should preserve economic signals from pre-scaled charges, demonstrate cost-reflectivity and should not increase or introduce volatility.

The modification proposal

This modification was raised by Western Power Distribution (WPD). The modification proposes a new methodology for revenue matching. As described above, the current scaling methodology raises the most revenue shortfall from the red unit rate. The working group considers that this distorts economic signals and produces excessive charges on this unit rate. The aim of the working group was to develop a more cost-reflective scaling approach which preserves or improves cost-reflectivity and the pre-scaled economic signals but reduces distortion. The working group conducted two consultations: the first to outline proposed options, and the second to change the modification's proposed scope, consult on its new proposed hybrid solution and recommend to expand scaling to generation fixed tariffs.

The working group proposed three solutions it considered could provide a more cost-reflective solution for revenue matching. The main aim of all of the three options was to apply scaling across tariff elements rather than applying it at the transmission exit level only as at present. The working group considered this had a less volatile scaling effect. The three potential solutions are described below, with Option 3 being the working group's recommended solution.

¹ 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.

² 'Change' and 'modification' are used interchangeably in this document.

³ This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

Option 1- percentage

- Using pre-scaled charges, raise or reduce each individual charge by the same percentage.

This option aimed to preserve relative differential and guard against volatility. However, the working group considered that it does not maintain the cost differential between tariffs and voltage levels. The working group also noted that the level of distortion of cost differentials between tariffs and voltage levels increased as the level of revenue reconciliation increased.

Option 2- fixed adder⁴

- Apply a fixed p/kWh to all pre-scaled unit rates (ie take pre-scaled charges and either add or subtract a fixed amount to all unit rates (red, amber, green, unrestricted, day, night)).

This approach aimed to preserve cost-reflectivity and the absolute differential between unit rates better. It considered this would reflect the pre-scaled economic signals on these rates. However, it would not apply scaling to all tariff elements. The working group also identified a small distortion in the differential in certain instances where negative scaling occurred.

Option 3- hybrid (working group proposed solution)

- Apportion revenue to be recovered by scaling across the CDCM tariff elements, in proportion to each tariff element's share of pre-scaled revenue.
- Then calculate and apply a fixed adder (ie as in option 2), for each tariff element such that it can recover its apportioned scaled revenue. This approach would apply scaling to all tariff elements.

This is the working group's recommended solution. The working group considers that this solution maintains the pre-scaled price signal for all tariffs elements, including fixed and capacity charges, and makes tariffs less volatile. This option also maintains the economic cost differential between tariffs and voltage levels. The hybrid solution would be applied to all tariff elements given that scaling to a large extent is not pre-allocated or identified for particular unit rates. This means that scaling would be applied to generation tariffs for the first time.

The scaling mechanism proposed under option 3 would be set with a floor at zero (0p/kWh) to avoid negative prices. Negative prices were considered to be counter-intuitive, ie the working group observed that if prices were permitted to be negative then it might imply that putting energy onto the network at that point in time is beneficial to the DNO. As negative prices would be the result of a particular mechanism, rather than being produced by the model itself, this was seen as a potentially inappropriate signal.

The working group consider that option 3 meets DCUSA Charging Objective 3.2.2 better as applying scaling to all tariff elements rather than just to the peak demand unit rate introduces a small improvement in competition. This should result in more predictable revenue forecasting than with the current approach.

The working group also considers option 3 facilitates DCUSA Charging Objective 3.2.3 better. It considers that allocating the unallocated allowed revenue across each of the

⁴ Fixed adder being the concept of a fixed amount added to the pre-scaled tariffs to recoup the shortfall in revenue

different charging elements of the tariff, rather than primarily into one time band, ensures that unit costs reflect the underlying cost signal and are less likely to be unduly excessive. The working group states that the hybrid approach apportions the costs on a more equitable basis and at the same time maintains the pre-scaled costs differentials, thereby preserving the signals.

DCUSA Parties'⁵ recommendation

The Change Declaration for DCP123 indicates that all parties were eligible to vote. No votes were cast in the DG category. In DNO and IDNO party categories there was unanimous support for the proposal and for its proposed implementation date. A majority of suppliers voted to accept the change solution, but to reject the implementation date. In accordance with the weighted vote procedure, the recommendation to us is that the DCP123 change is accepted and the proposed implementation date is rejected. The outcome of the weighted vote is set out in the table below:

DCP123	WEIGHTED VOTING (%)							
	DNO ⁶		IDNO/OTSO ⁷		SUPPLIER		DG ⁸	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	100	0	100	0	60	40	n/a	n/a
IMPLEMENTATION DATE	100	0	100	0	40	60	n/a	n/a

Our decision

We have considered the issues raised by the proposal and the Change Declaration dated 8 July 2014. We have considered and taken into account the vote of the DCUSA Parties on the proposal, which is attached to the Change Declaration. We have concluded that implementation of the change proposal DCP123 as it stands has not been demonstrated to facilitate better the achievement of the DCUSA Charging Objectives.⁹

We have set out below our assessment against the DCUSA Charging Objectives relevant to the modification. We consider the modification is neutral or has no impact in relation to the other DCUSA Charging Objectives.

DCUSA Charging Objective 3.2.2 – 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)

We agree that a method which would apply scaling more evenly across different tariff elements may result in more predictable revenue forecasting. However, we consider that the current mechanism is also reasonably predictable where scaling primarily falls on the red unit rate through the transmission exit level. We are not satisfied that this new approach, in comparison with the current method, will facilitate this particular charging objective better. We do not rule out a possible small improvement to this objective, as suggested by the working group. However, it is not possible to confirm this based on the

⁵ The DCUSA Parties are established and constituted pursuant to and in accordance with the section 1A of the DCUSA Agreement.

⁶ Distribution Network Operator

⁷ Independent Distribution Network Operator/Offshore Transmission System Operator

⁸ Distributed Generation

⁹ The Applicable Charging Methodology Objectives (Charging Objectives) are set out in Standard Licence Condition 22A Part B of the Electricity Distribution Licence and are also set out in Clause 3.2 of the DCUSA.

evidence provided by the working group and it may be that the change is as predictable or slightly less predictable as now.

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 agree that seeking to apply scaling across each of the different charging elements, and reflecting their pre-scaled revenues, may preserve pre-scaled economic signals through the scaling process. However, we do not consider that removing scaling from primarily the red unit rate, arguably reducing any distorting effect of the current mechanism, is the same as addressing the fundamental effects of scaling to tariff disturbance, cost-reflectivity and volatility. The hybrid solution, in applying scaling to all tariff elements, would cause some tariff disturbance. We do not have sufficient evidence of the extent of this. Furthermore, we are unsure of the relationship between this proposal and other changes to the underlying tariffs, such as the proposed DCP169 (Seasonal time of day (SToD) half hourly (HH) metered tariffs in the CDCM).

We note the concerns of those respondents to the consultation who indicated this would be a significant change and that it did not demonstrate adequately how it would necessarily be more cost-reflective than the current approach. We also note the concerns some respondents raised about addressing the inherent issues in the model which may be driving the difference between allowed revenue and revenue through pre-scaled charges. We do not believe the hybrid solution considers how it might address this difference and the additional distortion created by the current scaling mechanism. We believe that any scaling solution needs to be accompanied by evidence of the effect on differentials in pre-scaled charges as well as how much it may remove current scaling distortion.

We recognise the working group's concern that the shortfall in revenue is largely unallocated and should not fall disproportionately on one unit rate over others. We acknowledge that the proposed approach is seen as preserving cost differentials and minimising distortion and volatility in the model. While the working group's approach to applying scaling to all tariff elements and through unit rates could spread scaling in a more cost-reflective way, we have not received sufficient evidence to demonstrate this.

Without undertaking an extensive and detailed comparison of costs determined through the 500MW model (ie revenue recouped from pre-scaled tariffs) and those allowed for in the price control, it is not possible to identify the principal drivers behind this difference such as operating costs, reinforcement costs etc. The drivers may also be different for each DNO. Without any detailed explanation of these differences, we cannot be sufficiently satisfied that this charging objective is better met by the new hybrid option as opposed to the current mechanism.

We consider the working group has not succeeded in demonstrating fully the effects of their proposal as being better than the current mechanism, or meeting the stated Charging Objectives better. We consider that it would be better to test and provide evidence of the effects of this proposal in conjunction with the forthcoming DCP169 on seasonal time of day tariffs. DCP169 would, if approved, have the effect of reducing the number of units to which a red unit rate would apply and therefore have an impact on the approach taken to revenue matching. We also consider that in reviewing the issues

considered under DCP123 in conjunction with DCP169, a wider set of stakeholders¹⁰ can be engaged and the issue of a suitable implementation date for potential scaling changes can also be addressed. However, we acknowledge the extensive and prolonged work of the group and the overarching principle of its hybrid solution to apply scaling to all tariff elements.

We have decided to reject DCP123, but recommend the industry develops it further alongside or as part of DCP169.

Andrew Burgess

Associate Partner-Transmission and Distribution Policy

Signed on behalf of the Authority and authorised for that purpose

¹⁰ We received some late representations from several telecoms stakeholders requesting that this modification be reconsidered, given the large-scale change it was introducing within a very short timeframe without sufficient consultation with relevant affected parties.