



## **DCUSA Change Report**

### **DCP 230– Rate of Return Enduring Solution**

## 1 PURPOSE

- 1.1 This document is issued in accordance with Clause 11.20 of the DCUSA and details DCP 230 'Rate of Return Enduring Solution'.
- 1.2 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.
- 1.3 Parties are invited to consider the proposed amendments (Attachment 2) and submit their votes using the form attached as Attachment 1 to [dcusa@electralink.co.uk](mailto:dcusa@electralink.co.uk) no later than **23 September 2015**.

## 2 BACKGROUND AND INTENT OF DCP 230 CHANGE PROPOSAL

- 2.1 DCP 230 has been raised by Western Power Distribution and seeks to revise the legal text within DCUSA for the 'Annuity Rate of Return' to equal the pre-tax real weighted average cost of capital set for each DNO. The Change Proposal form is included as Attachment 3.
- 2.2 The Proposer explains that it was identified in 2014 that the words then contained within the DCUSA for the 'Annuity Rate of Return' were aligned to the Distribution Price Control Review 5 (DPCR 5) Distribution Licence and were no longer applicable under the RIIO-ED1 Distribution Licence. DCP 217 'Rate of Return' was raised to address this issue in the short-term, and was subsequently approved on 1 December 2014 by the Authority, and was implemented into the DCUSA on 1 April 2015. However, an enduring solution is felt to still be required.

## 3 DCP 230 – WORKING GROUP CONSIDERATIONS

- 3.1 The DCUSA Panel established a Working Group to assess DCP 230. The Working Group met on four occasions and was comprised of DNO, Supplier and Ofgem representatives; it is noted that all DCUSA Parties were invited to join the Working Group.
- 3.2 Meetings were held in open session and the minutes and papers of each meeting are available on the DCUSA website – [www.dcusa.co.uk](http://www.dcusa.co.uk).

- 3.3 The Working Group noted that DCP 230 follows on from DCP 217, which set the rate of return in DCUSA to 5.6%. The value of 5.6% was used to avoid referring to values defined in the DPCR5 Licence, but the value itself is the same as that used in DPCR5.
- 3.4 The proposed DCP 230 solution uses a commonly accepted formula for the Weighted Average Cost of Capital (WACC) to determine the rate of return. The inputs to the formula are derived from the RIIO ED1 Licence; hence the resulting rate of return used in the charging methodology will be aligned to the WACC used in the determination of allowed revenue. This will ensure that the rate of return and allowed revenue values are aligned, and hence the cost signals created by the charging methodology will not be distorted by using a rate of return and allowed revenue figures derived from different sources.
- 3.5 The Working Group discussed whether a formula or hard-coded value would be more appropriate for use in the DCUSA. As one of the inputs to the formula used is the corporation tax rate which is subject to change year on year, to avoid the need for a DCUSA change every time the corporation tax rate changes, it was felt more appropriate to use a formula over a hard coded value.

#### **4 DCP 230 CONSULTATION**

- 4.1 The Working Group carried out a consultation to give DCUSA Parties and other interested organisations an opportunity to review and comment on DCP 230. There were five responses received to this consultation. The Working Group discussed each response and its comments are summarised alongside the collated Consultation responses in Attachment 4.
- 4.2 A summary of the responses received, and the Working Group's conclusions are set out below:

##### **Question 1: Do you understand the intent of DCP 230?**

- 4.3 The Working Group noted that all respondents understood the intent of DCP 230.

##### **Question 2: Are you supportive of the principles of DCP 230?**

- 4.4 The Working Group noted that all respondents were supportive of the principles of DCP 230.

**Question 3: Do you have any comments on the proposed legal text?**

- 4.5 A DNO Respondent noted that the proposed text does not set out the detailed calculation as described in the accompanying formula, that in their view it should be stated whether or not the figure should be rounded and, if so, to how many decimal places. Finally, it should be clarified whether pre-announced tax rates, for the regulatory year, will be applied or the statutory rate in force, at the time.
- 4.6 The Working Group agreed to revise the legal text according to the comments received.

**Question 4: The Working Group feel that DCUSA General Objective 3<sup>1</sup> would be better facilitated by the implementation of DCP 230; please provide your comments on this and any other DCUSA General Objective you feel will be impacted by DCP 230.**

- 4.7 The Working Group noted that the majority of respondents agreed that DCUSA General Objective 3 would be better facilitated.
- 4.8 A DNO respondent explained that they agree with the Working Group that DCUSA General Objectives three is better facilitated by the implementation of DCP 230 than the baseline as the rate of return in the CDCM will be aligned with the RIIO-ED1 allowance for cost of capital, rather than the baseline (interim) position of using 5.6%.
- 4.9 They also feel that General Objective four is better facilitated as this change will be an enduring solution for future Licence changes, compared to the baseline position (pre-DCP 217) which requires a DCUSA change every time there is change to the Licence.
- 4.10 Another DNO respondent felt that due to the concerns raised in relation to the legal text, they do not feel at the current time that General Objective 3 would be better facilitated as a result of this change.
- 4.11 The Working Group noted that the legal text will be amended to address concerns raised within the responses.

**Question 5: The Working Group feel that DCUSA Charging Objective 1<sup>2</sup> would be better facilitated by the implementation of DCP 230; please provide your comments on this and any other DCUSA Charging Objective you feel will be impacted by DCP 230.**

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<sup>1</sup> The efficient discharge by the DNO Parties and IDNO Parties of obligations imposed upon them in their Distribution Licences

- 4.12 The Working Group notes that the majority of respondents believe that DCUSA Charging Objective 1 will be better facilitated by DCP 230.
- 4.13 A Supplier respondent noted that DCP 230 means that the legal text gets changed to ensure that the words align with the DNO's ED1 licence rather than the licence from the previous price control and therefore facilitates the obligation with the appropriate licence.
- 4.14 A DNO respondent explained that due to the concerns raised in relation to the legal text, they do not feel at the current time that Charging Objective 1 would be better facilitated as a result of this change.
- 4.15 The Working Group noted that the legal text will be amended to address concerns raised within the responses.

**Question 6: Do you agree with the approach taken by the Working Group in the Impact Assessment, including the formula used to calculate the results?**

- 4.16 The Working Group notes that all respondents agreed with the approach taken by the working group.
- 4.17 One DNO respondent noted that they agree with the work undertaken by the working group, in relation to the formula used in the impact assessment. However they believe that further work is required to fully understand how the annual iteration process would work whilst the DNO is required to set charges fifteen months in advance.
- 4.18 They further commented that this change has an impact on the underlying costs and a subsequent balancing impact upon the charges due to scaling to match allowed revenue. It needs to be considered that changing the Rate of Return on an annual basis will significantly increase volatility which will be predominately seen in the red / unit 1 rates. It can be seen that some unit rates increase by over 50% under this proposal as a result of revenue matching. It is questionable whether this results in charges that are more cost reflective than the current approach.

**Question 7: Do you agree that the approach taken by the Working Group will align with the RIIO-ED1 Licence?**

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<sup>2</sup> 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

4.19 The Working Group notes that the majority of respondents agree that the approach will align with the RIIO-ED1 Licence.

4.20 One DNO respondent explained that in their view they believe that the timing difference between charge setting and the annual iteration process will cause some disturbance to alignment with the Licence.

**Question 8: Do you agree with the Working Group's conclusion that this CP will have a minimal effect on the EDCM?**

4.21 The Working Group noted that all respondents agreed that there would be a minimal impact on the EDCM.

**Question 9: Are you aware of any wider industry developments that may impact upon or be impacted by this CP?**

4.22 A DNO respondent noted that the implementation of DCP 178<sup>3</sup> will impact this CP. If implementation of DCP 230 is not achieved this year (i.e. implementation date 01/04/2016), then DNOs will be forced to use 5.6% as per the current legal text for both 2016/17 and 2017/18 Charges, taking them almost halfway through the RIIO-ED1 period using values for the cost of capital which are not aligned with the Licence. Hence it is important that implementation is achieved in time for Charge Setting this year.

4.23 Another DNO respondent noted that the potential outcome of BGT's appeal to the CMA may result in further changes as regards debt indexation.

4.24 The Working Group noted both of these responses.

**Question 10: Are there any alternative solutions or unintended consequences that should be considered by the Working Group?**

4.25 A DNO respondent explained that they believe that the impact of setting final charges fifteen months in advance will require the consideration of how the annual iteration process is best managed.

4.26 Another DNO respondent noted that annual changes to the discount rate will potentially increase the volatility of charges, although this effect may be very small.

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<sup>3</sup> Notification period for change to use of system charges

## 5 EDCM Impact Assessment

- 5.1 The Working Group had originally concluded that there would be little or no impact on EDCM all the way tariffs, and a small impact on EDCM LDNO tariffs. However, following the conclusion of the first consultation, it was determined that there would be a larger effect on the EDCM than previously considered.
- 5.2 The Working Group completed an impact assessment on the EDCM tariffs, based on 2015/16 final tariffs. The rate of return is used in the load flow modelling aspect of the EDCM, and hence impacts on the Network Use Factors and LRIC/FCP dependent on which model the DNO uses.
- 5.3 The EDCM tariff impact is significant for some individual customers, with super-red rates seeing the biggest changes. However the overall change to EDCM revenue for each Licence area is small. The impact assessment is included with the consultation two documents as Attachment 5.

## 6 CONSULTATION TWO

- 6.1 The Working Group sought industry views on the EDCM impact assessment in a second consultation. There were seven responses received to this consultation.
- 6.2 A summary of the responses received, and the Working Group's conclusions are set out below:

### **Question 1: Do you have any comments on the legal text?**

- 6.3 A DNO respondent noted that, for consistency, it would be useful if the formula terms within the legal text exactly match those used in the Licence (where applicable) i.e. Cost of Debt should be 'Cost of Corporate Debt'.
- 6.4 The Working Group agreed with this comment and agreed to update the legal text accordingly.

**Question 2: Do you have any comments on the EDCM impact analysis completed by the Working Group? Please provide supporting comments on this, and the results of the impact analysis.**

- 6.5 A Supplier respondent noted that they struggled to assess the impacts of the change. The impact spreadsheet simply showed the changes to the various elements of the tariffs by “ID”. There are many different “ID”s for each DNO, and some rates are increasing while others are decreasing. The example of WPD showed a modest reduction (from 5.6% to 4.5%) for WPD. This led to modest changes in the Midlands tariffs but some large % swings in the other 2 areas.
- 6.6 They further noted that what would be useful is a summary; what is the total impact in £ when applying the new tariffs to all customers of that DNO, split by “ID” (Based on last year’s data).
- 6.7 The Working Group felt that presenting total revenue information by customer would breach customer confidentiality, whereas presenting the total revenue change by Licence area would not. The Working Group agreed to request from DNOs the total EDCM revenue from 2015/16 final tariffs, and the same from 2015/16 tariffs with DCP 230 applied , to be added into the impact analysis and included within the Change Report. This updated EDCM impact analysis is included as Attachment 6.

**Question 3: Are there any alternative solutions or unintended consequences that should be considered by the Working Group?**

- 6.8 The majority of respondents had no further comments.
- 6.9 One DNO respondent did note that they continue to have concerns over the interaction this part of DCUSA would have with the ‘Annual Iteration Process’ as defined in the Distribution Licence.
- 6.10 The impact of DCP 178 requiring the notification of final Distribution Use of System (DUoS) charges with fifteen months’ notice, would require DNOs to estimate for the cost of corporate debt (CDE) for the upcoming charging year as it would follow the ‘Annual Iteration process’ which is communicated no later than the 30 November prior to the next charging year.

- 6.11 It was explained that DNOs would already be setting final charges at that point for the following charging year. A solution to this would be if the requirement to use the data derived from the Licence through the 'Annual Iteration Process' was lagged by twelve months.
- 6.12 The Working Group noted this issue, but felt that it was out of scope of DCP 230. It was agreed to highlight this to the Ofgem observer on the Working Group for further consideration.

## **7 RIIO-ED1 Annual Iteration Process**

- 7.1 One of the responses to the second consultation raised a concern over the Annual Iteration Process (AIP). The Working Group discussed this and has since made amendments to the legal text.
- 7.2 The AIP is defined in the RIIO ED1 Licence as the formal process of annually updating the variable values in the Price Control Financial Model (PCFM) and for the calculation of the incremental change (MOD), positive or negative, on base revenues.
- 7.3 The AIP Process is formally carried out each year before 30<sup>th</sup> November, with values within the PCFM being updated for the following regulatory year (i.e. the AIP which concludes by 30<sup>th</sup> November 2015 will impact on allowed revenues for the 2016/17 regulatory year).
- 7.4 The AIP will impact on DCP 230, as the values used in the formula for calculating the rate of return are subject to change in the AIP. Hence the values to be used in the formula for the rate of return in 2017/18 will not be finalised until 30<sup>th</sup> November 2016. Under DCP 178, DNOs must publish final 2017/18 charges in December 2015, so the final values from the AIP will not be known.
- 7.5 The legal text has been amended to allow for this, with the rate of return being 'calculated in accordance with the most recent AIP available when setting distribution Use of System Charges'. This allows DNOs to use values from the AIP finalised by 30<sup>th</sup> November 2015 for 2017/18 charges.

## **8 EVALUATION AGAINST THE DCUSA OBJECTIVES**

- 8.1 The Working Group reviewed the CP against the DCUSA Objectives and agrees that DCP 230 better facilitates DCUSA General Objective 3<sup>4</sup> and DCUSA Charging Objective 1<sup>5</sup>.
- 8.2 Charging Objective 1 and General Objective 3 are both better facilitated as a result of this change proposal by ensuring that the rate of return in the CDCM and EDCM is consistent with the RIIO-ED1 Licence.

## **9 IMPLEMENTATION**

- 9.1 DCP 230 is 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.
- 9.2 The implementation date, subject to Authority approval, is 1 April 2016.

## **10 PROPOSED LEGAL TEXT**

- 10.1 The draft legal text has been reviewed by the DCUSA Legal Advisor and is included as Attachment 2.
- 10.2 The legal drafting will amend the definition of the rate of return each time it appears within the DCUSA document – once in schedule 16, three times in schedule 17 and twice in schedule 18. At present the value itself (5.6%) is quoted in the DCUSA. The proposed legal text for DCP 230 will amend this so that the formula for calculating the rate of return is defined in the legal text, with each term within the formula defined with reference to the ED1 Price Control Financial Handbook.

## **11 FINAL CONCLUSIONS ON DCP 230**

- 11.1 The Working Group's conclusion, reflecting Party opinion as presented in the Consultation responses, is that the proposed legal drafting meets the intent of DCP 230.

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<sup>4</sup> The efficient discharge by the DNO Parties and IDNO Parties of obligations imposed upon them in their Distribution Licences

<sup>5</sup> 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

## 12 ENGAGEMENT WITH THE AUTHORITY

12.1 Ofgem has been engaged throughout the progression of DCP 230 as an Observer of the Working Group.

## 13 IMPACT ON GREENHOUSE GAS OMISSIONS

13.1 In accordance with DCUSA Clause 11.14.6, the Working Group assessed whether there would be a material impact on greenhouse gas emissions if DCP 230 were implemented. The Working Group did not identify any material impact on greenhouse gas emissions from the implementation of this CP.

## 14 PANEL RECOMMENDATION

14.1 The DCUSA Panel approved the DCP 230 Change Report on 9 September 2015. The timetable for the progression of the CPs is set out below:

<b>Activity</b>	<b>Date</b>
Change Report approved by DCUSA Panel	9 September 2015
Change Report Issued for Voting	9 September 2015
Party Voting Closes	23 September 2015
Change Declaration Issued	25 September 2015
Authority Decision	30 October 2015
Implementation	1 April 2016

**15 ATTACHMENTS:**

- Attachment 1 – DCP 230 Voting Form
- Attachment 2 – DCP 230 Proposed Legal Text
- Attachment 3 - DCP 230 Change Proposal
- Attachment 4 – DCP 230 Consultation Documents
- Attachment 5 – Consultation Two Documents and EDCM Impact Analysis
- Attachment 6 – Updated EDCM Impact Analysis