

Proposed variation:	<b>Distribution Connection and Use of System Agreement (DCUSA) DCP106: Visibility to DCUSA Parties Regarding Applications to the Authority by DNOs to Change Allowed Revenue</b>		
Decision:	The Authority <sup>1</sup> has decided to reject DCP106 <sup>2</sup>		
Target audience:	DCUSA Panel, parties to the DCUSA and other interested parties		
Date of publication:	19 September 2012	Implementation Date:	N/A

## Background to the modification proposal

Suppliers need to be able to forecast their costs in order to plan various aspects of their business (pricing strategies, cash management, etc). A key input to these cost forecasts is the level of distribution Use of System (UoS) charges made by Distribution Network Operators (DNOs). The calculation of UoS charges is particularly dependent on DNOs' allowed revenues, among other things. The DNOs are best placed to forecast their own allowed revenue, as they have the best insight into their likely performance against price control incentive schemes and other operational aspects of the distribution price control.

A number of information provision modifications have been approved in recent years to ensure that suppliers have sufficient information to allow them to better forecast UoS charges. DCP030 and DCP050 were approved and implemented in February 2009 and February 2010 respectively.<sup>3</sup> DCP030 sought to provide detailed information that suppliers and IDNOs require on DNOs' allowed revenues and expected changes to UoS charges. DCP030 introduced DCUSA Clause 35A which mandates DNOs to provide quarterly revenue information. DCP050 introduced a requirement on DNOs to host regular teleconferences to explain this information to interested parties. DCP066A was also approved and then implemented in January 2011. The modification required DNOs to provide details of additional significant items in Table 1 of Schedule 15 of the DCUSA.<sup>4</sup> The information provided would allow users to track revenues from DNOs' Price Control settlements through the DNOs' charging methodologies (e.g. the Common Distribution Charging Methodology (CDCM)) and into final UoS charges, with each significant element itemised. The modification also introduced new requirements on DNOs to provide a range of possible values for volatile items contained within the revised Schedule 15 as Table 2. DNOs now have to provide details of Low, Central and High<sup>5</sup> case values for the items reported in Table 2 for the current and next charging years.

Additionally, as a result of the implementation of DCP001<sup>6</sup>, clause 19.1 of the DCUSA provides that Distribution Network Operators (DNOs) and Independent Distribution Network Operators (IDNOs) must use reasonable endeavours not to vary their UoS charges more than two times a year, on 1 April and 1 October. This is consistent with the obligation in the Electricity Distribution licence (the licence), which states that DNOs must give 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 could still change their charges on another date provided that three months' notice is given. All of these

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

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

3 Decision letters for DCP030 and 050 can be found on our website at:

<http://www.ofgem.gov.uk/Licensing/ElecCodes/DCUSA/Changes/Pages/Changespage.aspx>

4 For full details of the reporting requirements proposed by DCP066 and 066A, please visit the DCUSA website:

<http://www.dcusa.co.uk/Extranet/CP.aspx?id=93>

5 The 'central' reported position (i.e. the mean) should be accompanied by an estimate of the 'low' case (i.e. the 10th percentile (P10)) and 'high' case (i.e. the 90th percentile (P90)) for the reported item.

6 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>

modifications share the common aim of guaranteeing the transparent and regular provision of relevant information on revenues which should inform suppliers' forecasts of UoS charges and lead to more cost reflective charges to consumers.

## The change proposal

DCP106 was raised by Npower Limited (the proposer) in August 2011. The change proposal requires DNOs to contact DCUSA Parties in writing at the time that they make an application to Ofgem for extraordinary changes to allowed revenue. The DNOs would be required to provide DCUSA Parties with notice of the reason for their request, the monetary value requested, the proposed timescales over which the revenue change would be recovered and the implementation dates requested for such changes. The proposer recognised that there might be information in the application to us that is confidential to the DNO. To maintain confidentiality, DCP106 only seeks to obtain key details of the applications that would assist DCUSA Parties in their forecasting of charges, i.e. not all of the information set out in the application(s). If approved, all information requested above would be included within the DCP066A report.

The proposer noted the significant amount of work undertaken in recent years to improve the transparency of information to Suppliers through the DCP066A reports. These reports are produced quarterly and may or may not include an allowance for additional funding the DNO may have requested from us. In their view, without understanding the effect of these requested additional funding, suppliers could not be confident about the numbers used in their forecasts to predict future charges. The proposer believes the requirements set out in DCP106 would give suppliers greater visibility of potential changes to allowed revenues.

A Working Group was established to develop and assess the change proposal. An initial consultation was issued to suppliers, DNOs and IDNOs in February 2012 to determine whether parties supported the intent of DCP106 and its impact on them if it were implemented. There were mixed responses to the consultation, with a majority of the DNOs not supporting the change proposal and all suppliers supporting it.

The proposer considered that the change proposal better facilitated the achievement of DCUSA General Objective 3.1.2.<sup>7</sup> A slight majority of respondents agreed with the Working Group that this DCUSA Objective was better facilitated by the change proposal. The views of the Working Group and their assessment of the impact of the proposal on different DCUSA and other parties are provided in the DCP106 Change Report (CR).<sup>8</sup>

## DCUSA Parties' recommendation

The Change Declaration for DCP106 indicates that DNO, IDNO/OTSO and supplier parties were eligible to vote on DCP106. As shown in the table below, the sum of the weighted votes was not greater than 50% in all voting party categories. In accordance with the weighted vote procedure, the recommendation to the Authority is that DCP106 be rejected. The outcome of the weighted vote is set out in the table below:

DCP106	DNO		IDNO/OTSO		SUPPLIER	
	Accept	Reject	Accept	Reject	Accept	Reject
	CHANGE SOLUTION	0%	100%	0%	100%	100%

<sup>7</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>8</sup> DCUSA change proposals, modification reports and representations can be viewed by registered users on the DCUSA website operated by ElectraLink: <http://www.dcuda.co.uk/Public/Default.aspx>

IMPLEMENTATION DATE	0%	100%	0%	100%	100%	0%
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## The Authority's decision

We have considered the issues raised by the proposal and the Change Declaration dated 14 August 2012. We have considered and taken into account the vote of the DCUSA Parties on the proposal attached to the Change Declaration. Whilst we recognise suppliers' need for sufficient notice of possible changes to charges, we have concluded that:

1. Overall, the implementation of the change proposal DCP106 does not facilitate the achievement of the General DCUSA objectives.

## Reasons for the Authority's decision

We note that this proposal was not supported by any of the DNO and IDNO parties. However, it was unanimously supported by Supplier parties.

We consider that the change proposal is neutral on General DCUSA Objective 3.1.2 (facilitating competition) but does not better facilitate General DCUSA Objective 3.1.4 (efficiency in the implementation and administration of the DCUSA). We also consider that the proposal has a neutral impact in respect of the other DCUSA objectives. We consider that the proposal does not better facilitate the objectives overall.

## General DCUSA Objectives

### ***DCUSA Objective 3.1.2 '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'***

We agree that the proposal marginally better meets this objective. Our view is that the proposal is aligned with option 1 of our April 2012 consultation on "Mitigating network charging volatility arising from the price control settlement".<sup>9</sup> The provision of improved information for suppliers and customers is one of the options we consulted on in acknowledgement of stakeholders' concerns regarding charging volatility and their impact on customer's charges. At the time, our view was that the concerns over charging volatility stem more from the unpredictability of charges than to the stability of charges.

In theory, suppliers are less likely to include risk premia in their charges to consumers when changes to UoS charges are more predictable as suppliers can price contracts more confidently. In addition, unpredictable charges create potential cash flow risks for suppliers which could act as a barrier to entry within the market and hinder competition. Initiatives that encourage network companies to improve the provision of information to suppliers and customers will enhance predictability, lower risk premiums and encourage competition.

However, we disagree with the view that cost reflectivity of charges would increase should DNOs provide information in advance to users about their revenue requests to us. We note that applications for changes in revenue are subject to detailed analysis by us which may lead to a lower amount being approved or a rejection of the request. Suppliers relying on DNOs' initial applications to change allowed revenue to forecast UoS charges might lead to Suppliers setting inappropriate charges which might increase their cash flow risk, hence hindering competition.

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<sup>9</sup> On the Ofgem website: [http://www.ofgem.gov.uk/Networks/Policy/Documents1/Charging\\_Volatility\\_Cons.pdf](http://www.ofgem.gov.uk/Networks/Policy/Documents1/Charging_Volatility_Cons.pdf)

Respondents to the February 2012 DCP106 working group consultation were split on whether Objective 3.1.2 is better facilitated by the proposal. A slight majority (five suppliers and one DNO) agreed with the proposer's view. One DNO also disagreed with the view that earlier sight of potential cost changes would enable better forecasting by suppliers. It was unconvinced that there would be a feed through into actual prices to customers any earlier compared with other current mechanisms that are in place. A member of the Working Group noted that if the additional visibility did not result in changes in prices then competition would not be better facilitated.

The majority of DNOs also expressed concerns regarding this proposal encroaching in the relationship between DNOs/IDNOs and us, especially when the information concerned might be considered both commercially confidential and market sensitive information, and therefore not appropriate to be published. We note the Proposer's legal representative's view that there is no overriding legal reason why all such matters would be confidential and that the probability of this was provided for in the legal text accompanying the proposal. However, we agree with the legal representative that there might be good policy reasons for not automatically publishing details of changes to allowed revenue requests and we will exercise our discretion in publishing this information on a case by case basis and in line with our statutory duties.

We consider that the proposal could promote effective competition by reducing barriers to entry in the market for the supply of electricity. However we are not convinced that additional information regarding revenue changes would ensure more accurate forecasting and a reduction of risk premia. We believe that in some cases the early provision of this information by DNOs might mislead suppliers and skew their forecast since they could factor a revenue change that might not materialise. Our normal consultation process should provide notice to all interested parties regarding any potential changes which may be considered more helpful in forecasting charges than a high level figure from the DNOs. On balance, we believe that the proposal is neutral on Objective 3.1.2.

#### ***DCUSA Objective 3.1.4 'the promotion of efficiency in the implementation and administration of this Agreement'***

We consider that the proposal does not better facilitate this objective. During the last two years, significant work has been done to increase transparency and improve the visibility of cost information provided by the DNOs to interested parties, as detailed earlier in this document. In our view, the issue this change proposal is seeking to address is already dealt with through a number of other licence and DCUSA mechanisms highlighted in our April consultation on network charging volatility.

Most DNO respondents to the consultation raised concerns about the proportionality of adding a new reporting arrangement to existing ones. One respondent stated that the information sought by the change proposal is already available in advance since Ofgem consults on changes to allowed revenue and DNOs also provide information in their quarterly DCP066A report.

At the consultation stage, the proposer restated their concerns regarding lack of visibility of these requests which might lead to suppliers' inaccurate forecasting. The proposer cited examples where DNOs have applied for revenue changes without informing other parties in a timely manner and Ofgem have made decisions allowing revenue changes without industry consultation. These unexpected changes have led suppliers to inaccurately forecast UoS charges.

We are sympathetic with the suppliers' concerns and note that we generally consult on material changes to allowed revenues within price controls, e.g. additional project funding or the use of uncertainty mechanisms. Occasionally, there might be some good policy reasons why we might consider it appropriate not to make this information public.

However, we do not consider that these extraordinary incidents which by their very nature are infrequent should merit a change to the DCUSA. Although we agree with the principle of improving information provision, we have to consider whether the change proposal is setting out a new mechanism which is proportionate when set alongside current mechanisms for information provision and whether parties are taking full advantage of current mechanisms to ensure full visibility of changes to revenues which could impact DUoS charges. For example, current mechanisms include:

- **Standard condition 14 of the Distribution Licence, para 11**: the DNO is required to give the Authority three months' notice of charging changes and to send notice of these changes to parties that have entered into a UoS agreement;
- **the DCUSA**: (a) **Clause 19** - 40 days' notice of charging changes to be provided to the user. The DNO shall use reasonable endeavours not to vary charges outside of 1 April and 1 October, and (b) **Clause 35A** – as stated above, DNOs shall send to the Electralink Secretariat and shall publish on their website tables of the actual/forecast revenue position for the current and next charging years as per Table 1. DNOs also have to provide a range of possible values for volatile items contained within the revised Schedule 15 as Table 2. This include details of Low, Central and High values for items such as price control reopeners and significant others which need to be specified by the DNOs at the time of reporting.

We consider that the proposal does not better facilitate the objectives overall.

### **We have therefore decided to reject DCP106.**

We set out below some further thoughts relating to this decision.

We agree that DNOs need appropriate incentives to avoid or decrease the risk of errors and to provide appropriate information to market participants, including Suppliers. As discussed at the Working Group, we consider that a more efficient outcome would be for all parties to make better use of existing arrangements set out in the licence and the DCUSA (Clauses 19 and 35A). An additional reporting requirement would not guarantee more accurate and reliable information for Suppliers. DNOs should make reasonable endeavours to provide accurate cost information and forecasts as set out in Tables 1 and 2 in Schedule 15 and any extraordinary request should be included under the "significant others" item. Additionally, we suggest there should be a specific item in the DCP066A agenda every quarter which covers such issues to ensure visibility to Suppliers.

We recognise there is scope for us to increase the visibility of these extraordinary requests by making them public on a case by case basis if we think it is appropriate and in line with our statutory duties. We are also taking steps to encourage the network companies to improve the way they engage with their stakeholders to ensure they are responsive to their requirements and accountable to them. As part of the current electricity distribution price control and the forthcoming RIIO price controls for electricity and gas distribution, there is provision for network companies to earn a reward if they can demonstrate that their engagement activity has led to exceptionally positive outcomes for their stakeholders. The scope of this mechanism is wide and could potentially include rewarding a DNO that takes actions to improve their information provision, outside of arrangements already in place and for the benefit of suppliers and customers.

**Andy Burgess**

**Associate Partner, Transmission and Distribution Policy**

Signed on behalf of the Authority and authorised for that purpose