

Proposed variation:	Distribution Connection and Use of System Agreement (DCUSA): DCP077 (Urgent) – CDCM Change – Rate of Return Percentage		
Decision:	The Authority ¹ decides that DCP077 be made ²		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested Parties		
Date of publication:	17 January 2011	Implementation Date:	As soon as reasonably practicable – specific date to be determined by the DCUSA Panel

Background to the proposal

The price controls that Ofgem sets for the distribution network operators (DNOs) determine the allowed revenue that they can recover through use of system charges. One of the components that determine these allowed revenues is the allowed rate of return ('the allowed RoR') on the regulatory asset value. This allowed RoR represents the cost to a company of raising the funds for its activities and it is calculated as the weighted average of the cost of debt and cost of equity. This allowed RoR is reassessed and changed as appropriate at each price control review. For the current distribution price control (DPCR5), Ofgem concluded that the appropriate allowed RoR to use when determining the allowed revenue was 5.6%.

All DNOs are obliged by the distribution licence to use the Common Distribution Charging Methodology (CDCM) to determine the charges that low voltage customers and certain high voltage customers³ have to pay for using the electricity distribution system (DUoS). In broad terms, the process involves determining the costs associated with a 500MW increment in capacity and allocating them to different customer categories (based on their voltage of connection and consumption pattern). The allocated costs imply a charging rate per unit of capacity for each customer category. These charging rates will then be scaled up (or down) to ensure that DNOs recover their allowed revenue and thereby obtain final charging rates for different customer categories.

The CDCM was approved at the end of 2009 and a component of the methodology was an annuity rate of return ('the annuity RoR') which is used to annuitise asset costs associated with the increments in capacity. The annuity RoR included in the CDCM was 6.9%, in line with the value for the allowed RoR in the applicable price control at that time (DPCR4). The CDCM was incorporated within the DCUSA in April 2010 following our decision on DCP059.⁴

This proposal seeks to modify the annuity RoR in the CDCM from a fixed value of 6.9% (calculated during DPCR4) to the value of the allowed RoR within the most recent price control review (currently 5.6%).

DNOs brought forward this issue for discussion at the Distribution Charging Methodology Forum (DCMF) in April 2010. In the following months they considered that updating the annuity RoR in the CDCM was a housekeeping issue and should be promptly resolved. However the issue was not formally raised as a variation to the DCUSA, on an urgent basis, until mid-November 2010. We also note that the original variation proposal submitted to the DCUSA Panel did not include the required analysis to assist DCUSA Parties in their voting and the Authority in its decision on the variation, leading to delays in the DCUSA voting process.

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 Currently the CDCM does not apply to certain designated properties that are treated on the same charging basis as premises connected at extra high voltage levels.

⁴ The DCP059 decision document can be found at:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=43&refer=Licensing/ElecCodes/DCUSA/Changes>.

The proposed variation

DCP077 was proposed by Electricity North West Limited (ENW) to change the annuity RoR set out in clause 57 (Table 3) of Schedule 16 in the DCUSA. The proposed variation would change the annuity RoR from a fixed value of 6.9% (calculated during DPCR4) to the applicable allowed RoR based on the most recent price control review (currently 5.6%⁵). ENW sought urgent treatment of the variation, with an implementation date for the variation of 6 December 2010 (prior to the publication of indicative DUoS charges for 2011-12). DCP077 was sent to a Working Group for assessment.

The DCP077 Working Group considered that the proposal would better facilitate a number of DCUSA objectives. That is, DCP077 would save the need to amend the annuity RoR value in the CDCM at each distribution price control review, thus assisting DNOs in facilitating the discharge of their licence obligations. Moreover, the Working Group considered the proposed variation would improve cost reflectivity of DUoS charges and reflect DNOs' business developments in line with successive price control reviews. As a result of insufficient analysis of the impact of the variation, the Working Group extended the period of DCUSA Party voting and revised the proposed implementation date from 6 December 2010 to "as soon as reasonably practicable after Authority consent".

DNOs provided impact assessments to help DCUSA Parties in their vote on the proposed variation. According to the assessments, as a result of updating the annuity RoR, most of the customer groups would see their DUoS charges for 2011-12 change by less than 1.5%. Off-peak DUoS charges for domestic and small business customers would on average fall by about 4% while generation DUoS charges would fall by about 10%. DCP077 would lead to significant increases in some high voltage (HV) DUoS charges in ENW's area, eg HV medium non-domestic (up by 3%) and HV sub HH metered (up by 10%). The proposed variation has a large impact on some components of customers' DUoS charges, eg Unit Rate 1 of Eastern Power Network's HV Sub HH Metered (+31%). This reflects the fact that, under the CDCM, as asset-related costs decrease, users who use more assets will benefit (eg low voltage (LV) customers), offset by a corresponding increase in charges for other users (eg HV customers).

DCUSA Parties' recommendation

All DCUSA Parties who voted on DCP077 unanimously supported the proposal to change the annuity RoR in question. Except for one DCUSA Party supplier, they also fully supported the revised proposed implementation date of "as soon as reasonably practicable".

In accordance with the weighted vote procedure, the recommendation to the Authority is that DCP077 be accepted. The outcome of the weighted vote is summarised below:

DCP077	WEIGHTED VOTING (%)							
	DNO		IDNO		SUPPLIER		DG	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	100	0	100	0	100	0	n/a	n/a
IMPLEMENTATION DATE	100	0	100	0	75	25	n/a	n/a

The Authority's decision

⁵ <http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntlrs/DPCR5/Pages/DPCR5.aspx>

The Authority has considered the issues raised by DCP077, taking into account the vote of the DCUSA Parties on the proposal which was attached to the Change Declaration dated 15 December 2010.⁶ The Authority has concluded that:

- implementation of DCP077 will better facilitate the achievement of the Applicable Charging Methodology Objectives⁷
- deciding that the change be made is consistent with the Authority's principal objective and statutory duties.⁸

Reasons for the Authority's decision

Standard Licence Condition (SLC) 22A.15 requires that every modification proposal raised under the DCUSA in relation to the CDCM must have as its aim the better achievement of the Applicable Charging Methodology Objectives. DCP077 seeks to ensure the CDCM will promptly reflect the applicable allowed RoR when a price control period starts. We consider that the proposal will ensure consistency between the CDCM and our price control decisions on the applicable allowed RoR, giving clarity to stakeholders. Among other things, we consider that the variation helps to ensure fairness and cost reflectivity of customer charges. We consider it is therefore appropriate to implement DCP077 as soon as reasonably practicable, in line with our duty to protect customers' (including end users') interests.

We set out our views on the extent to which the proposed variation meets each of the Applicable Charging Methodology Objectives below.

(a) 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

DCP077 means that DNOs will apply an improved CDCM, eg more cost reflective. We consider that this objective is better facilitated as DNOs will be in a better position to discharge their general obligations imposed under their distribution licences.

(b) 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 consider that DCP077 would have a neutral impact on competition as this proposal does not change the common requirement that all DNOs should apply the same annuity RoR in determining customer charges.

(c) 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 consider that the proposed change ensures that DNOs will use a more applicable annuity RoR to determine customer charges. The value is more cost reflective and in line with the broad developments in the capital markets. This ensures a fairer allocation of

⁶ The DCP077 Change Declaration can be found online at: <http://www.dcusa.co.uk/Extranet/CP.aspx?id=94>

⁷ The Applicable Charging Methodology Objectives are set out under SLC22A. As stated in the Authority's DCP059 decision letter, from April 2010, charging modifications will be assessed against these objectives.

⁸ 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.

costs that DNOs have incurred or are expected to incur by pursuing more cost reflective differential across unscaled charges for different customer groups.

We note that the DNOs' impact assessments illustrate the level of implied distortion of existing customer charges. For example, the impact assessment shows a consistent 10-12% reduction in generation charges across every DNO for the 2011-12 regulatory year.⁹

(d) So far as is consistent with other Charging Objectives in relation to DNOs discharging their obligations under the Act and the Distribution Licence and cost reflectivity, the Charging Methodologies, so far as is reasonably practicable, properly take account of developments in each DNO Party's Distribution Business

We consider that DCP077 would mean that DNOs will be required to apply a more applicable annuity RoR in line with the market developments to which each DNO is subject. Therefore we think the change helps DNOs ensure the CDCM is consistent with objective d).

Implementation date

We accept the DCUSA Parties' majority recommendation for DCP077 to be implemented as soon as reasonably practicable on a date determined by the DCUSA Panel. We expect that the date chosen would comply with the DCUSA (clause 19.1 in section 2A) which states that DNOs must use reasonable endeavours to vary charges no more than two times a year with effect on either 1 April or 1 October. In accordance with clause 19.1 in section 2A of the DCUSA, we also expect that DNOs would give customers at least 40 days notice of these changes. We consider that the chosen date of implementation should take into consideration customers' interests and the potential impact on tariff volatility.

We note that a supplier DCUSA Party rejected the proposal to implement DCP077 as soon as reasonably practicable given "the magnitude of some of the (possible) impacts (of DCP077) upon end users" and that DCP077's possible impacts had not been reflected in the indicative DUoS charges for 2011-12 that DNOs published in December 2010. This party suggested implementing DCP077 on 3 November 2011 as an alternative date, to ensure that the information would be available in a timely manner for the publication of indicative DUoS charges in December 2011.

We appreciate the desire for a longer notice period to provide customers with more certainty in their business projection and planning. In this case, the possible change to the annuity RoR was brought to customers' attention as early as the DCMF meeting in April 2010. All DNOs have already shared their DCP077 impact assessments openly with their stakeholders, including the illustrative charges that would be applied if DCP077 is implemented. In addition, we believe the more applicable annuity RoR should be applied as soon as reasonably practicable to ensure fairness and cost reflectivity of customer charges in line with our price control review decisions. For these reasons, and as there was broad support for the proposed implementation date, we consider that an implementation date determined by the DCUSA Panel that takes into consideration customers' interests and tariff volatility may be appropriate.

Delays in handling DCP077

We have wider concerns about DNOs' handling of DCP077 and their readiness to deal with the challenge of delivering variations in 2011.

We acknowledge a supplier DCUSA Party's criticism that DNOs failed to deliver more variation proposals earlier in 2010. In relation to DCP077, we consider that DNOs had

⁹ The impact assessment is available online at: <http://www.dcusa.co.uk/Extranet/CP.aspx?id=94>

sufficient notice of the issue and should have taken action to amend the value of the annuity RoR much earlier, ideally before the CDCM was incorporated within the DCUSA in March 2010 in time to have the more applicable annuity RoR reflected in the final charges for 2010-11. We are disappointed that DNOs did not raise DCP077 in a timely manner following the discussion of this proposed variation at the DCMF in April 2010.

DNOs have identified a number of changes to the CDCM (potentially over 20) that need to be processed in 2011 so that they can be implemented in due course, mainly in 2012-13. We expect DNOs to act promptly by prioritising outstanding issues and addressing our concerns in a transparent, timely and efficient manner, in accordance with our direction on governance arrangements.¹⁰

Decision notice

In accordance with SLC 22A and SLC 13A of the Distribution Licence, the Authority hereby decides that proposed variation DCP077: '*CDCM Change - Rate of Return Percentage*' be made.

The Authority considers that DCP077 should be implemented as soon as reasonably practicable, in line with the DCUSA Parties' recommendation, taking into consideration customers' interests, tariff volatility and relevant DCUSA requirements. The Authority expects that DNOs will notify affected parties of the potential impacts of this decision in an open, clear and timely manner.

**Rachel Fletcher,
Partner, Distribution**

Signed on behalf of the Authority and authorised for that purpose

¹⁰ For details, please see our July 2009 decision document which is available at: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=487&refer=Networks/ElecDist/Policy/DistChrgs>
For details on the new governance process effective 1 April 2011, please see our December 2010 decision document, which is available at: <http://www.ofgem.gov.uk/Licensing/Work/Notices/ModNotice/Documents1/Modification%20Direction%20201210.pdf>