

Proposed variation:	Distribution Connection and Use of System Agreement (DCUSA) DCP230 – Rate of Return Enduring Solution		
Decision:	The Authority ¹ directs this modification ² be made ³		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	30 October 2015	Implementation date:	1 April 2016

Background

The annuity rate of return in the DCUSA is used in a number of ways within the charging methodologies, such as:

- for the annuitisation of network model asset values, where capital costs that are not covered by customer contributions are converted to annual costs using a level annuity, which takes account of the annuity period and the rate of return; and
- in the calculation of the Forward Cost Pricing (FCP) Load Incremental Charges, found in the EHV Distribution Charging Methodology (EDCM) model.

Previously, the rate in DCUSA was aligned to a term in the electricity distribution licence reflecting the allowed return from the Distribution Price Control Review 5 (DPCR5). Our most recent price control (RIIO-ED1) removed this reference from the distribution licence.

On 1 December 2014 we approved DCP217 (“Rate of Return”) ⁴, which allowed the continuing use of the DPCR5 value of rate of return (5.6%), for the charging year 2015/16, as an interim measure. However, this rate of return was only felt to be appropriate for the short term and DCP230 proposes an enduring solution.

DCP230 proposes to use a commonly accepted formula for the Weighted Average Cost of Capital (WACC) to determine the rate of return. The inputs to the formula will be derived from the RIIO-ED1 Distribution Licence, which will ensure that the resulting rate of return used in the charging methodology is aligned to the WACC used in the determination of allowed revenues.

The modification proposal

DCP230 was raised by Western Power Distribution to seek to amend the legal text within the DCUSA so that the Annuity Rate of Return equals the pre-tax real WACC set for each Distribution Network Operator (DNO).

The proposer believes that DCUSA Charging Objective 3.2.1 is better facilitated by ensuring that the rate of return in the Common Distribution Charging Methodology (CDCM) and in the EDCM is consistent with the RIIO-ED1 Licence.

DCUSA Parties’ recommendation

The Change Declaration for DCP230 indicates that all party categories were eligible to vote on DCP230 but only DNO parties voted. In the DNO party category where votes were cast, there was unanimous support for the proposal and majority (>50%) support for the proposed implementation date. Consistent with the weighted vote procedure, the

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. This decision is made by or on behalf of GEMA.

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.

⁴ The DCP217 decision letter is here: <https://www.ofgem.gov.uk/publications-and-updates/distribution-connection-and-use-system-agreement-dcusa-dcp217-rate-return>

recommendation to the Authority is that DCP230 is accepted. The outcome of the weighted vote is set out in the table below:

DCP230	WEIGHTED VOTING (%)									
	DNO		IDNO/OTSO ⁵		SUPPLIER		DG ⁶		Gas Supplier	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	100%	0%	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
IMPLEMENTATION DATE	72%	28%	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Our decision

We have considered the issues raised by the proposal, the Change Declaration and the Change Report dated 9 September 2015. 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 modification proposal will better facilitate the achievement of the DCUSA Charging Objectives;⁷ and
- directing the modification to be made is consistent with our principal objective and statutory duties.⁸

Reasons for our decision

We consider this modification proposal will better facilitate DCUSA Charging Objective 3.2.1 and has a neutral impact on the other relevant objectives.

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"

We agree with the proposer, the Working Group and the unanimous view of respondents to the industry consultation who support the change proposed by DCP230. We agree that it is appropriate to amend the legal text within the DCUSA for the Annuity Rate of Return to ensure the words align with the DNO's RIIO-ED1 Distribution Licence.

The Working Group considered that if the WACC set for each DNO in the RIIO-ED1 Distribution Licence is used to determine the rate of return, the resulting rate of return used in the charging methodology will be aligned to the WACC used in the determination of allowed revenue.

We accept that it is appropriate to align the rate of return used in the charging methodology with allowed revenues. We agree that by using the same source for the rate of return and allowed revenue figures, cost signals created by the charging methodology will not be distorted.

We note that the implementation date was rejected by one DNO party. We have reviewed the reasons given for that party's rejection. Values of the WACC from the latest Annual

⁵ Independent Distribution Network Operator/Offshore Transmission System Operator

⁶ Distributed Generation

⁷ The DCUSA Charging Objectives (Relevant 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.

⁸ The Authority's statutory duties are wider than matters that the Parties must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.

Iteration Process (AIP) will be available at the end of November 2015. This will inform the charges set for 2016/17 directly. It is true that following the DCP178 change the 2017/18 charging statement will need to be produced without the DNOs having the result of the AIP due to be published in November 2016. Consistent with the legal text, DNOs will use the most recent Annual Iteration Process applicable when setting distribution Use of System Charges. This is the result of DCP178 and not a reason to delay the implementation date from 1 April 2016.

We accept that Charging Objective 3.2.1 is better facilitated by the change, as it ensures that the rate of return in the CDCM and EDCM is consistent with the RIIO-ED1 Distribution Licence.

Decision notice

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, the Authority hereby directs that modification proposal DCP230 "Rate of Return Enduring Solution" be made.

Ian Rowson

Associate Partner – Regulatory Finance and Compliance

Signed on behalf of the Authority and authorised for that purpose