Making a positive difference
for energy consumers

To distribution network
operators, generators, suppliers,
customers and their
representatives, and other
interested parties

Date: 9 December 2015

Dear Stakeholder,

Consultation on a proposal to amend the arrangements for scaling under the Common Distribution Charging Methodology (DCP228)

This letter seeks your views on an industry proposal (DCP228) to change the Distribution Connection and Use of System Agreement (DCUSA). The proposal revises the way certain distribution network charges are 'scaled' to meet the level of revenue the distribution network operators (DNOs) need to recover. We have been asked to make a decision on this proposed change. In order to help inform our decision on whether to approve or reject the change, we are seeking your views on some specific questions (see below) by 5 February 2016.

Introduction and proposed change

A DNO charges its customers to recover the revenues that it is permitted to recover under the terms of its licence. Charging methodologies set the rules for how to allocate the charges to different customer types using an incremental cost model that considers the impact that different customers have on the DNO's costs. The revenue recovered through the resulting charges will not generally produce the required level of revenue. The shortfall or excess is addressed through scaling revenues, also known as revenue matching. The charges calculated by the cost model are scaled to achieve the required level of revenue.

British Gas has proposed a change to the DCUSA, which would revise the way that scaling is applied.

The current approach scales through transmission exit charges. The majority of the scaling revenue impact falls on the red charge[1] or unit rate 1.

DCP228 proposes an alternative approach that applies a fixed adder[2] to the pre-scaling unit rates for the different charge types. This generally maintains the pre-scaled differences between charges. The DCP228 proposal retains two elements of the existing arrangements:

- a floor level of zero ie scaling does not result in negative values for any tariff component; and
- distributed generators do not contribute to scaling revenues.

[1] DNOs determine timebands across the day. The red timeband or unit 1 includes peak usage of the network.

[2] Adds fixed amounts in terms of cost per unit.

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The Final Modification Report and the summary of the consultation undertaken by the DCP228 working group are available, alongside this letter, on our website.

The other relevant documents, including the change proposal, are available on the DCUSA website (www.dcusa.co.uk).[3]

Who does this change affect?

This change is only an issue for the Common Distribution Charging Methodology (CDCM). The Extra high voltage Distribution Charging Methodology, which applies to customers connected to the electricity distribution network at extra high voltages, has its own separate process. This proposal would have an impact on most household, business and other non-household customers connected at low and high voltages.

Industry Recommendation

DCP228 was submitted to us on 10 August 2015. The panel recommendation was to reject. DCUSA voting rules require **majority** support in each voting party category for the recommendation to accept the proposal to be made. There was an equal split in suppliers' votes. Although most DNOs supported the proposal, there was opposition in this category as well.

Why we are consulting

DCP228 would represent a significant change to the CDCM, which, if approved, would have large impacts on customers. From the working group's impact assessments, some customers would face increases (some more than 600%), in the distribution part of their energy bills whereas others would see decreases (some up to 100%). While this varies across the different DNO areas, the general pattern is that distribution charges for domestic customers will fall but those for non-domestic customers will increase. Some large industrial customers have highlighted concerns with the proposal given the scale of its impact on their charges. Also, because most scaling has focused on the red rate, customers who have invested to move their consumption away from this time will see the reward they have expected through the reduction in their charges lessened or removed through this change.

DCP228 and the existing approach are not the only ways of scaling. We accept DCP228 would generally retain signals from cost allocation in the CDCM (subject to the zero floor). However, given the impacts on some charges and the removal of rewards that some customers might have expected we think it is appropriate to ask whether we should consider scaling as a more general issue or whether we should just look at this proposal in isolation. We raise this question in light of our statutory duties, including our principal objective, in carrying out our functions, to protect the interests of existing and future consumers. This wider consideration becomes important because of the scale of the impact from the change. This is not a consultation on different approaches to scaling. This is the point where we are interested in views on whether this proposal should be judged on its own merits only or is this something sufficiently important that we should consider it in conjunction with consideration of other approaches, such as:

- Ramsey pricing: to maximise overall welfare, economic theory suggests that the residual should be addressed through a 'Ramsey pricing' approach which differentiates by the degree that customers respond to changes in the price level.
- Percentage adder: The use of a percentage adder, as opposed to a fixed adder, which would scale up all unit rates by a specific percentage. Such an approach would have a lower impact on the amber and green (or unit rates 2 and 3).
- Applying mark ups in different ways to different units within the CDCM.

[3] To access documents on the DCUSA website, you will need a password. Please contact Electralink via the website if you do not have access but wish to see these papers.

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We are also interested in understanding perspectives on the responses that identified technical criticisms with the DCP228 proposal in response to the working group's consultation. The majority of these related to the existing zero price floor and its interaction with the new approach. In addition, there has been some concern expressed that the impact would fall differently on different customers whose consumption is within the red or unit 1 tariffs. There is also criticism about the interaction with other parts of the methodology, specifically the application of the 500MW model as the basis of incremental cost.

This consultation on the substance of DCP228 is **not** a minded to consultation. We can see there are benefits and costs to the proposal. As notified through DCUSA, we do think however that the proposed implementation date is too early providing too little notice to those who have set out their arrangements in light of current scaling. We acknowledge that the working group recognised the need to provide greater notice than originally envisioned in moving to 1 April 2017. Given that to meet this, the change would need to be reflected in charges by the end of December 2015 this is no longer possible. We think in any case that in light of some of the impacts of the proposal on some customers, the first tenable start date (if we were to decide to approve the proposed change) would be 1 April 2018. We think that an implementation date of 1 April 2018 or later would help customers manage the change in charges and retain much of the reward that they envisaged when investing to move consumption away from the red time period. We are interested in the impact of a longer notice period either to or beyond 1 April 2018.

Consultation questions

Questions:

- Is scaling an issue best considered in relation to the specific choice between approving DCP228 or not, or is scaling an issue where change should only be made after a wider consideration of the range of different approaches?
- Is there any extra evidence respondents would like to raise with regards to DCP228 from a technical perspective (eg the scale of the impact)?
- If we were to decide to approve this change, what would the impact of a later implementation (eg 1 April 2018) be?
- Are you aware of you as a consumer, or others as consumers, having made a decision to manage consumption away from the peak red area in response to the charges?, if so, please describe the details.

Next steps

Please provide your response by email to iain.morgan@ofgem.gov.uk by the closing date of **5 February 2016.**

All written responses should be sent by e-mail, preferably in PDF form to iain.morgan@ofgem.gov.uk. We will publish all non-confidential responses on our website. If you do not wish all or part of your response to be made public, you should clearly mark your response as confidential. If you are submitting confidential material, it would be helpful if this could be confined to an appendix so that we can publish the main body of the response.

We look forward to hearing your views.

Yours faithfully,

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