Interim draft review of Ofgem's DCP 206 decision

by **Franck Latrémolière** on **Thursday 2 July 2015**

1. This review of Ofgem's decision to reject DCP 206 comprises:

   (a) An annotated copy of Ofgem's document, highlighting the main errors affecting particular section of text.

   (b) Copies of episodes 1, 4, 6, 10 and 12 of Pants On Fire, which give details of some of the errors in Ofgem's documents.

2. The annotated copy of Ofgem's document includes cross-references to Pants On Fire episodes through circled numbers.

3. This review is an interim draft. There are some points on competition which are highlighted in the annotated copy of the Ofgem's document but have not yet been the subject of a Pants On Fire episode. I will provide an updated review when I have completed these additional episodes.

Legend:
✔ No problem found
①④⑥... Pants On Fire episodes
💩 Wrong fact or false reasoning
🐍 Misrepresentation of others
🐷 Prejudice or head in sand

Proposed variation:	**Distribution Connection and Use of System Agreement (DCUSA) DCP206 – Removal of Charge 1 from the EDCM**		
Decision:	The Authority[1] has decided to reject[2] this modification[3]		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	22 May 2015	Implementation date:	n/a

Background

The Extra-high voltage Distribution Charging Methodology (EDCM) was introduced to calculate electricity distribution system import use of system charges in 2012-13 and export charges in 2013-14. A component of the EDCM is Charge 1 which represents forward looking expectations of reinforcement costs and feeds into charges. For each distribution network operator (DNO) the value of these costs are determined by using one of two approaches: long run incremental cost (LRIC) or forward cost pricing (FCP). Charge 1 results in location specific charges related to the two main drivers of future reinforcement needs, ie actual consumption in a period of peak demand, known as the super red period[4], and maximum capacity. These charges are intended to provide price signals that encourage economic use of the network by encouraging: (a) lower levels of consumption in the super red period than would otherwise be the case and (b) new consumers to locate in areas where there is spare capacity, rather than areas where reinforcement is likely to be shortly triggered. ✔ 💩

The proposer of DCP206 considers that Charge 1 creates several defects:

- As the charges are based upon potential future reinforcement costs, consumers may be paying charges based on costs that may not actually be incurred by the DNO. 🐍
- Alternatively, consumers may over-contribute to reinforcement costs by paying in advance through Charge 1 and again, once the reinforcement is triggered, through consumer contributions in their connection charges. 🐍
- Consumers may also experience changes in charges that are a result of activities of other consumers, rather than changes within their control. 🐍

① There is an ongoing industry-led review of the EDCM. The review report is expected to be published in June or July 2015.

The modification proposal

Modification proposal DCP206 was raised by E.ON (the proposer) on 13 March 2014. The proposed modification seeks to remove Charge 1 from the calculation of import charges under Schedule 17 "EHV charging methodology (FCP model)" and under Schedule 18 "EHV charging methodology (LRIC model)" of the DCUSA. If implemented, this would remove the unit charges for super red consumption and the forward looking locational element of capacity charges. ✔

The proposed change would have no impact on generation credits paid to generators in respect of avoided or deferred DNO costs. ✔

[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] This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.
[3] 'Change' and 'modification' are used interchangeably in this document.
[4] The super red periods for each DNO are the times of day and year of their peak demand periods. Each DNO determines their individual super red periods in accordance with their own demand profiles.

The Working Group which assessed the proposal was unable to undertake a consolidated impact assessment of DCP206 due to legal confidentiality constraints. We undertook to collate the individual DNO impact analyses to provide a consolidated impact assessment on behalf of the Working Group. This consolidated assessment indicated that approximately one third of consumers' charges would increase and the remaining two thirds would experience decreases in charges, if DCP206 were to be implemented. It further showed that 6.4% and 7.6% of consumers would experience increases or decreases respectively that are greater than both 5% and £2,000 per year.

In June 2014, the Working Group carried out a consultation on the proposal. The responses to this consultation are summarised in the Change Report and provided in full in the Change Report.

The change proposal form states that this proposal better facilitates DCUSA general objective 3.1.2. and charging objectives 3.2.2 and 3.2.3. The majority of the working group considered that DCP206 only better facilitates charging objective 3.2.3.

DCUSA Parties' recommendation

The Change Declaration for DCP206 indicates that each DNO Party, IDNO/OTSO[5] Party and Supplier Party was eligible to vote on DCP 206.[6] All DNO parties voted. No votes were cast in the other categories, including the Supplier Party category (the proposer's party category). A majority (>50%) voting in the DNO Party category voted to reject the proposal and its proposed implementation date. In accordance with the weighted vote procedure, the recommendation to the Authority is that DCP206 is rejected. The outcome of the weighted vote is set out in the table below:

DCP206	WEIGHTED VOTING (%)							
	DNO		IDNO/OTSO		SUPPLIER		DG[7]	
	Accept	Reject	Accept	Reject	Accept	Reject	Accept	Reject
CHANGE SOLUTION	34	66	n/a	n/a	n/a	n/a	n/a	n/a
IMPLEMENTATION DATE	33	67	n/a	n/a	n/a	n/a	n/a	n/a

Our decision

We have considered the issues raised by the proposal, responses to the consultation and issues set out in the Change Declaration and Change Report dated 16 April 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 not better facilitate the achievement of the DCUSA Charging Objectives.[8]

In coming to our decision we have also considered our wider statutory duties, including particularly our principal objective under the Electricity Act 1989 to protect the interests of existing and future energy consumers.

Reasons for our decision

We consider this modification proposal will not better facilitate DCUSA Charging Objectives 3.2.2 and 3.2.3 and has a neutral impact on the other relevant objectives. We

[5] Independent Distribution Network Operator/Offshore Transmission System Operator
[6] The terms "DNO Party", "IDNO Party", "OTSO Party" and Supplier Party" have the meaning given to them in the DCUSA
[7] Distributed Generation
[8] 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

also consider that the modification proposal is not consistent with our principal objective to protect the interests of existing and future energy consumers.

DCUSA Charging Objective 3.2.2 – that 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)

Those in support of the modification argued that charging objective 3.2.2 would be better facilitated by:

- eliminating the incentive for consumers to build their own infrastructure;
- eliminating an element of import charges on generators; and
- improving predictability and transparency.

The majority of respondents to the consultation and the majority of the working group, however, felt that this objective is not better facilitated. Their reasons, and counter arguments are provided in the Change Report.

We consider that those consumers who choose to build their own infrastructure are making economic decisions based on the current cost reflective charge. We have not been provided with evidence to demonstrate that removing this charge would improve competition.

We agree that the removal of Charge 1 would eliminate an element of the charging model that consumers find hard to understand and therefore may improve transparency which may improve competition. However, the report has not demonstrated that such benefits outweigh the network efficiency encouraged by the current locational and time of use charges. We consider that, in the round, this proposal does not better facilitate this objective.

DCUSA Charging Objective 3.2.3 – that 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

Some Working Group members believed that the removal of Charge 1 better facilitates charging objective 3.2.3 because they considered it would:

- increase the scaling amount, which the proposer regards as more cost-reflective;
- remove the alleged anomaly that EDCM customers could be paying for reinforcement that may not necessarily happen, if load growth is low; and
- remove the alleged anomaly that EDCM customers may experience changes in charges, as a result of new consumers connected to the system (or a change in demand from other existing consumers).

Some respondents to the consultation considered that this objective is not better facilitated. They stated that forward looking cost signals are an important way of encouraging consumers to adjust behaviour, in particular the unit based charge which incentivises consumers to reduce demand at system peak times. Although the majority of the consultation respondents felt that this objective was not better facilitated by this proposal, the majority of the Working Group concluded that this objective was better facilitated by the proposal.

⑥ We consider that Charge 1 is cost reflective, as it reflects the long-run incremental cost of connecting to distribution networks (for EHV customers). This is, as intended by the developers of the EDCM, to provide signals to customers to help DNOs achieve savings through deferred reinforcement.

We do not agree that DCP206 better facilitates this objective because we do not consider we have been provided with evidence to demonstrate that the removal of Charge 1 would improve cost reflectivity. In our view, Charge 1 is, as intended, a form of long-run incremental cost based charging and reflects the incremental costs *'reasonably expected to be incurred'* in accordance with the charging objective. When the EDCM was being developed, the DNOs were forecasting potentially £1.6bn of reinforcement at the EHV level during the price control at that time (DPCR5).[9] We included Charge 1 in the methodology as we considered that it could encourage a reduction or deferment of this reinforcement. We continue to hold this view and believe that reflecting long-run incremental costs in the EDCM is appropriate.

⑩

We further note that the proposal intends to set Charge 1 to zero thereby retaining the opportunity to introduce an alternative to Charge 1 in the future. This may create a situation where unit charges for super red consumption will fall to zero for one or more years and then rise again once an alternative to Charge 1 is developed. We note that some respondents indicated that even if Charge 1 in its current form was found to be defective consideration should be given to replacing it rather than its removal so as to maintain the locational and time of use price signals.

⑫ The grounds for the change proposal relate to the tension that exists between the backward-looking actual cost concept that lies behind DNOs' allowed revenues and the forward-looking cost concept that lies behind economic costs and the structure of tariffs that deliver those allowed revenues. These two concepts are not in conflict because they address separate economic objectives. We consider that the concept of using forward looking incremental costs to allocate allowed revenues to tariffs is cost-reflective and protects consumers by providing signals to minimise network costs.

Decision notice

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, the Authority has decided that modification proposal DCP 206: *Removal of Charge 1 from the EDCM* should not be made.

Ian Rowson
Associate Partner – Regulatory Finance and Governance
Signed on behalf of the Authority and authorised for that purpose

[9] Paragraph 1.6 – https://www.ofgem.gov.uk/ofgem-publications/44219/july-decision-ehv-charging-and-governance.pdf

Pants On Fire, episode 1

by **Franck Latrémolière** on **Friday 19 June 2015**

1. Ofgem's decision on DCP 206 contains the words quoted in exhibit 1.

Exhibit 1 Ofgem's claims

> The proposer of DCP206 considers that Charge 1 creates several defects:
>
> · As the charges are based upon potential future reinforcement costs, consumers may be paying charges based on costs that may not actually be incurred by the DNO.
>
> · Alternatively, consumers may over-contribute to reinforcement costs by paying in advance through Charge 1 and again, once the reinforcement is triggered, through consumer contributions in their connection charges.
>
> · Consumers may also experience changes in charges that are a result of activities of other consumers, rather than changes within their control.

2. Exhibit 2 shows what the change proposal form said about defects of charge 1.

Exhibit 2 Defects of charge 1 according to DCP 206 change proposal form

> This change proposal seeks to address a defect in the EDCM methodologies. The defect is that the charge 1 elements of the EDCM could impose charges that reflect future hypothetical investments needed to meet the growth in demand of other customers. For example, these charge 1 elements could require a current EDCM customer to pay for some of the costs to the DNO of supplying future EDCM or CDCM customers. This application of charge 1 is not cost reflective. It might lead to unfair charges in cases where the costs underpinning charge 1 are not needed or used to distribute electricity, now or in the future, to an EDCM demand customer who would be paying charge 1.

3. Exhibit 3 shows how the DCP 206 change report introduced the objectives.

Exhibit 3 Introductory section in the DCP 206 change report

> 2.2 The CP form states that the defect is that the Charge 1 elements of the EDCM could impose charges that reflect future hypothetical investments needed to meet the growth in demand of other customers. It is further explained that these Charge 1 elements could require a current EDCM customer to pay for some of the costs to the Distribution Network Operator (DNO) of supplying future EDCM or Common Distribution Charging Methodology (CDCM) customers.
>
> 2.3 According to the CP form, the application of Charge 1 is not cost reflective, which may lead to unfair charges in cases where the costs underpinning Charge 1 are not needed or used to distribute electricity, now or in the future, to an EDCM demand customer who would be paying Charge 1.

What's wrong with the first paragraph in exhibit 1?

4. The proposer of DCP 206 was E.ON, who submitted the proposal following discussions at the DCMF Methodologies Issues Group and Ofgem's refusal[1] to designate me as a person that may raise a similar change proposal.

5. It seems a misrepresentation to say that E.ON "considers" anything in relation to DCP 206. By raising the change proposal, E.ON was only trying to make open governance work. I do not recall E.ON staff expressing any views on the merits of the proposal.

What's wrong with the second paragraph in exhibit 1?

6. Ofgem alleges that the proposer saw as a defect of charge 1 that "consumers may be paying charges based on costs that may not actually be incurred by the DNO".

7. Whilst Ofgem's words are true, this feature is not something that a competent economist could consider a defect in a charging methodology. In order to achieve fairness or cost reflectivity, it is frequently necessary to base charges on modern equivalent notional costs, or on notional efficient costs, all of which may differ materially from actual or reasonably foreseeable costs.

8. What the change proposal identifies as a defect of charge 1 is not that it merely relates to hypothetical costs or future hypothetical investments. The defect stated in the change proposal is that charge 1 reflects investments that are *needed for meet the growth in demand of other customers*.

9. The change proposal reiterates the point in the next sentence: *charge 1 elements could require a current EDCM customer to pay for some of the costs to the DNO of supplying future EDCM or CDCM customers*. There is no complaint in here about paying for hypothetical costs: the complaint is about paying for costs which are related to supplying other customers.

10. The change report accurately restates the arguments in the change proposal.

11. In summary:

    (a) The change proposal and change report do not make the allegation that Ofgem invented in the second paragraph in exhibit 1.

    (b) Ofgem falsely accuses the proposer of DCP 206 of making an obviously illogical argument that does not appear in the change proposal or change report.

    (c) Ofgem's decision does not acknowledge the legitimate criticism of charge 1 that is included in both the change proposal and the change report.

[1] http://dcmf.co.uk/ofgem-refusal-to-designate-for-dcp-on-mig-issue-63.html
A topic for a future episode of Pants On Fire, maybe.

What's wrong with the third paragraph in exhibit 1?

12. Ofgem alleges that the proposer saw as a defect of charge 1 that "consumers may over-contribute to reinforcement costs by paying in advance through Charge 1 and again, once the reinforcement is triggered, through consumer contributions in their connection charges".

13. The change proposal's identification of the defects of charge 1 says no such thing.

14. The change report does identify a double-charging issue in its section on the relevant objectives. This is reproduced in exhibit 4.

Exhibit 4 Double charging according to DCP 206 change report

> If an EHV customer has been paying DUoS with a high locational element and a new customer connects to the same node, the new customer may drive reinforcement. Where this is the case the new customer will fund a large portion of the reinforcement through a customer contribution and this will be in addition to the contributions made by the existing customer through their DUoS charge. Alternatively, if the existing EHV customer increases their import capacity they will drive the reinforcement and pay a customer contribution. At higher network levels it is likely that the customer contribution will pay for all or most of the reinforcement costs. This will be in addition to the reinforcement costs that the customer has already paid for through their use of system charge and consequently the customer could pay for the same reinforcement twice.

15. It is possible that Ofgem has correctly understood the argument in exhibit 4. However, Ofgem's specific wording suggests that this might not be the case, because Ofgem talks about consumers collectively over-contributing. In fact, two separate issues arise from exhibit 4:

    (a) Customer A might be charged (through charge 1) for a reinforcement to accommodate customer B, and that reinforcement might also be covered by customer B's connection charge.

    (b) In some circumstances, a single customer might be double-charged (through charge 1 and through a connection charge) for the same network reinforcement.

16. By using a collective formulation, Ofgem appears to ignore the second issue. If Ofgem took its duty to protect the interests of customers seriously, it would not use the collective formulation: it would ask itself whether the interests of each customer are properly protected, insofar as in reasonably practical, by its regulatory actions.

What's wrong with the third paragraph in exhibit 1?

17. Ofgem alleges that the proposer saw as a defect of charge 1 that "Consumers may also experience changes in charges that are a result of activities of other consumers".

18. The change proposal's identification of the defects of charge 1 says no such thing. I cannot see the argument anywhere in the change propsosal or change report — it seems to have been invented by Ofgem.

19. Ofgem's words are true, but this feature is not something that a competent economist could consider a defect in a charging methodology. In order to achieve fairness or cost reflectivity, it is frequently necessary to allocate common costs or assets between different customers; this inevitably leads to the charges to one customer being dependent on the consumption of other customers. That such interactions should happen is no indication of a defect in a charging methodology.

20. As in the second paragraph of exhibit 1, in the fourth paragraph of exhibit 1 Ofgem falsely accuses the proposer of DCP 206 of making an obviously illogical argument.

Why?

21. The phrase "straw man" is sometimes used to refer to the logical fallacy which consists in falsely describing one's opponent's position as something different and less robust to what it is (the man of straw), and then attacking the fictional position.

22. It is a cowardly way of putting up a pretence of argument in circumstances where you are either wrong or not equipped with the skills to address the argument actually made. It is also an accurate description of the Ofgem conduct outlined in this episode.

Pants On Fire, episode 4

by **Franck Latrémolière** on **Saturday 20 June 2015**

1. Ofgem's decision on DCP 206 contains the words quoted in exhibit 1. This purports to be a representation of the arguments made in the change report in favour of the majority position of the DCP 206 working group that DCP 206 would better facilitate the achievement of Charging Objective 3 (DCUSA clause 3.2.3).

Exhibit 1 Ofgem's claims about the arguments for cost-reflectivity

> ***DCUSA Charging Objective 3.2.3 – that 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***
>
> Some Working Group members believed that the removal of Charge 1 better facilitates charging objective 3.2.3 because they considered it would:
>
> · increase the scaling amount, which the proposer regards as more cost-reflective;
>
> · remove the alleged anomaly that EDCM customers could be paying for reinforcement that may not necessarily happen, if load growth is low; and
>
> · remove the alleged anomaly that EDCM customers may experience changes in charges, as a result of new consumers connected to the system (or a change in demand from other existing consumers).

Exhibit 2 What the change report actually says about the arguments for cost-reflectivity

> **Charging Objective 3** – Some Working Group members argued that Objective 3 is better facilitated because:
>
> · The change removes Charge 1, which is an element of the calculation of charges to an EDCM demand customer that does not reflect the costs incurred, or reasonably expected to be incurred, by the DNO in maintaining the supply to that EDCM demand customer. If this Change Proposal is implemented, then the revenue no longer collected through Charge 1 will instead be recovered through scaling within the EDCM model. EDCM scaling is based on capacity, consumption, and assets notionally used to maintain the supply to the customer; compared to Charge 1, EDCM scaling better reflects the costs incurred or reasonably expected to be incurred by the DNO in providing distribution services to EDCM demand customers.
>
> · The justification behind the removal of locational generation charges was that generation is often sized to the capacity of the connection. This meant that any forward looking charging methodology immediately drove reinforcement and led to excessive DUoS charges. The same principle can be applied to the

EDCM import charges. Where a large EHV customer is connected to a network that is close to reinforcement they will incur higher DUoS charges. Where no additional customers connect to the same node for a long period of time, the existing customer will continue to contribute towards the future reinforcement even though the DNO is not incurring any additional costs as a result of this customer. Consequently, the DUoS charge could be considered non-cost reflective as a result and it would be more appropriate to collect future reinforcement charges through a scaling element which socialises the charge across all customers.

· If an EHV customer has been paying DUoS with a high locational element and a new customer connects to the same node, the new customer may drive reinforcement. Where this is the case the new customer will fund a large portion of the reinforcement through a customer contribution and this will be in addition to the contributions made by the existing customer through their DUoS charge. Alternatively, if the existing EHV customer increases their import capacity they will drive the reinforcement and pay a customer contribution. At higher network levels it is likely that the customer contribution will pay for all or most of the reinforcement costs. This will be in addition to the reinforcement costs that the customer has already paid for through their use of system charge and consequently the customer could pay for the same reinforcement twice.

Ofgem's misrepresentation of the first point

2. The first argument given in the change report for the proposition that DCP 206 improves cost-reflectivity (see exhibit 2) is based on the proposition that Charge 1 is an element of the calculation of charges to an EDCM demand customer that does not reflect the costs incurred, or reasonably expected to be incurred, by the DNO in maintaining the supply to that EDCM demand customer. This point is explicit in the change proposal form and in the change report: charge 1 reflects the costs of investments to serve other customers (CDCM and EDCM), not the cost of serving the EDCM customer that is paying it. See also episode 1 of Pants On Fire.

3. The change report then proceeds to examine possible adverse consequences of removing charge 1 without changing the total EDCM revenue target. Specifically, it observes that scaling will increase. This is simply an acknowledgement of fact: it does not say that the benefit of DCP 206 is to increase scaling, as Ofgem misrepresents (see exhibit 1).

4. The change report finally observes that EDCM scaling, based on usage and assets notional used to maintain the supply, will better reflect the costs incurred or reasonably expected to be incurred by the DNO in providing the service.

5. Ofgem's misrepresentation of the argument leads it to omit altogether the main point, which is that charge 1 does not reflect the correct costs. Ofgem ignores the point made in order to avoid addressing it.

Ofgem's misrepresentation of the second point

6. Ofgem claims that a second point put forward by the Working Group majority in favour of finding DCP 206 to be cost-reflective was that DCP 206 would "remove the alleged anomaly that EDCM customers could be paying for reinforcement that may not necessarily happen, if load growth is low".

7. The anomaly invented by Ofgem is not alleged in the change report. Ofgem insults the intelligence of its readers, or reveals its own shortcomings in this area, by suggesting that charging for reinforcement that may not necessarily happen would be an anomaly. It is perfectly commonplace for charges to reflect hypothetical costs that are not likely to be incurred: for example, the LRAIC methods frequently used in parts of the electronic communications sector, or the ICRP method used by National Grid Electricity Transmission, all involve settings prices on the basis of a completely notional cost of a notional project to construct a modern equivalent network — when there is no actual plan to construct such a network.

8. The anomaly invented by Ofgem includes the proviso "if load growth is low". That is not in the change report: the arguments in the change report apply irrespective of whether load growth is low or not.

9. The change report does not even mention the fact that the existing EDCM methodology relies on a fiction of 1 per cent annual load growth even in parts of the network where there is no load growth at all.

10. Ofgem's decision, despite having invented an alleged problem if load growth is low, does not even address that point. Ofgem cannot even deal with its own lies, let alone the arguments that were actually put to it.

Ofgem's misrepresentation of the third point

11. Ofgem alleges that the working group saw a benefit of DCP 206 in that it would "remove the alleged anomaly that EDCM customers may experience changes in charges, as a result of new consumers connected to the system (or a change in demand from other existing consumers)".

12. That is untrue. The change proposal and the change report do not allege that the dependence of one customer's tariff on other customers' demand is an anomaly, and they do not allege that DCP 206 would remove that feature. Ofgem has made this up.

13. It is true that under the EDCM, one customer's tariff on other customers' demand. There are several mechanisms through which this occurs, for example:

    (a) network use factors depend on modelled flows for other EHV exit points;

    (b) charge 1 depend on modelled flows for other EHV exit points; and

    (c) the amounts charged in EDCM scaling and EDCM contributions to direct costs, network rates and indirect costs depend significantly on the patterns of use of the network (and the assumptions made about that use) by CDCM customers.

14. By removing charge 1, DCP 206 eliminates point (b) above. It does not eliminate points (a) or (c). You would have to be stupid or ill-informed to think that DCP 206 would remove changes in EDCM tariffs as a result of new consumers connected to the system or a change in demand from other existing consumers.

15. In any event, that interaction is not something that a competent economist could consider a defect in a charging methodology. It can be appropriate to allocate common costs or assets between different customers; this leads to the charges to one customer being dependent on the consumption of other customers. That such interactions should happen is no indication of a defect in a charging methodology. The change proposal and change report do not make the error that Ofgem appears to allege of treating such interactions as anomalies.

16. In summary, Ofgem insults the intelligence of its readers, or reveals its own shortcomings in this area, by falsely claiming that DCP 206 does something that it does not do, and by falsely claiming that members of the working group have made the mistake of alleging that a perfectly normal feature of a charging methodology is an anomaly.

A reminder from episode 1

17. The phrase "straw man" is sometimes used to refer to the logical fallacy which consists in falsely describing one's opponent's position as something different and less robust to what it is (the man of straw), and then attacking the fictional position.

18. It is a cowardly way of putting up a pretence of argument in circumstances where you are either wrong or not equipped with the skills to address the argument actually made. It is also an accurate description of the Ofgem conduct outlined in this episode.

Pants On Fire, episode 6

by **Franck Latrémolière** on **Saturday 20 June 2015**

1. Ofgem's DCP 206 decision rests on the cost-reflectivity analysis quoted in exhibit 1.

Exhibit 1 Ofgem's analysis of cost reflectivity for DCP 206

> We consider that Charge 1 is cost reflective, as it reflects the long-run incremental cost of connecting to distribution networks (for EHV customers). This is, as intended by the developers of the EDCM, to provide signals to customers to help DNOs achieve savings through deferred reinforcement.
>
> We do not agree that DCP206 better facilitates this objective because we do not consider we have been provided with evidence to demonstrate that the removal of Charge 1 would improve cost reflectivity. In our view, Charge 1 is, as intended, a form of long-run incremental cost based charging and reflects the incremental costs 'reasonably expected to be incurred' in accordance with the charging objective. When the EDCM was being developed, the DNOs were forecasting potentially £1.6bn of reinforcement at the EHV level during the price control at that time (DPCR5). We included Charge 1 in the methodology as we considered that it could encourage a reduction or deferment of this reinforcement. We continue to hold this view and believe that reflecting long-run incremental costs in the EDCM is appropriate.

Quality of the evidence base for Ofgem's conclusions

2. There is nothing in Ofgem's decision to support the assertions in exhibit 1. There is no logical reasoning that might back up a view on cost-reflectivity. There is no fact-based analysis. There is no analysis of the illustrative case study included with the change report.

3. There is nothing at all. This would be something to marvel about if it was not such a sad statement about the state of UK economic regulation.

Quality of Ofgem's reasoning: first sentence

4. Ofgem starts by the assertion "that Charge 1 is cost reflective, as it reflects the long-run incremental cost of connecting to distribution networks (for EHV customers)".

5. This claim suffers from three problems. It is unsupported by any evidence or reasoning. It is irrelevant. It is likely untrue.

6. The claim is unsupported by any evidence or reasoning as noted above.

7. The claim is irrelevant because charge 1 is being applied as a use of system charge, whereas the alleged cost is the cost of "connecting to distribution networks".

8. The claim is likely untrue because the FCP and LRIC methods of calculation of charge 1 are not targeted on measuring the cost of connecting to the distribution network for EHV customers. They are instead targeted on measuring costs of

reinforcing the distribution network in order to meet a hypothetical steady growth in demand by all customers over time; non-EHV customers usually represent the largest part of the hypothetical demand growth in FCP or LRIC calculations.

Quality of Ofgem's reasoning: second sentence

9. In the second sentence quoted in exhibit 1, Ofgem says that charge 1 is "to provide signals to customers to help DNOs achieve savings through deferred reinforcement".

10. This claim suffers from three problems. It is unsupported by any evidence or reasoning. It implies an erroneous analysis of Ofgem's statutory objectives. It is likely untrue.

11. Ofgem's claim that charge 1 is "to provide signals to customers to help DNOs achieve savings through deferred reinforcement" is unsupported by any evidence or reasoning as noted in the first part of this episode.

12. Ofgem's claim that charge 1 is "to provide signals to customers to help DNOs achieve savings through deferred reinforcement" implies an erroneous analysis of Ofgem's statutory objectives by claiming deferral of network investment as a benefit. In fact, Ofgem's principal statutory objective "is to protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity". Protecting the interests of consumers includes ensuring that sufficient network investment is undertaken to meet their needs.

13. What Ofgem seems to have done instead of pursuing its statutory objective is to pervert it into an attempt to minimise DNOs' costs and investments. In a context where Ofgem has established a system of price controls under which allowed revenues appear to be set, to some extent, until 2023, minimising DNOs' costs is also known as maximising DNO investors' profits, to the complete disregard of the interests of consumers.

14. Ofgem's claim that charge 1 is "to provide signals to customers to help DNOs achieve savings through deferred reinforcement" is likely untrue because the main drivers of investments in distribution networks are new connections, charges for which do not include charge 1, and changes in patterns of consumption by the majority of customers, whose use of system is paid for under the CDCM (which does not include any charge 1). The application of charge 1 as part of EDCM use of system charges is unlikely to be a driver of investment in distribution networks.

Quality of Ofgem's reasoning: third to seventh sentences

15. If I carry on writing about this today I might end up saying something rude.

16. In the interests of decorum, the analysis of the third to seventh sentences is postponed to a future episode.

Pants On Fire, episode 10

by **Franck Latrémolière** on **Thursday 25 June 2015**

1. Ofgem's DCP 206 decision rests on the cost-reflectivity analysis quoted in exhibit 1.

Exhibit 1 Ofgem's analysis of cost reflectivity for DCP 206

> We consider that Charge 1 is cost reflective, as it reflects the long-run incremental cost of connecting to distribution networks (for EHV customers). This is, as intended by the developers of the EDCM, to provide signals to customers to help DNOs achieve savings through deferred reinforcement.
>
> We do not agree that DCP206 better facilitates this objective because we do not consider we have been provided with evidence to demonstrate that the removal of Charge 1 would improve cost reflectivity. In our view, Charge 1 is, as intended, a form of long-run incremental cost based charging and reflects the incremental costs 'reasonably expected to be incurred' in accordance with the charging objective. When the EDCM was being developed, the DNOs were forecasting potentially £1.6bn of reinforcement at the EHV level during the price control at that time (DPCR5). We included Charge 1 in the methodology as we considered that it could encourage a reduction or deferment of this reinforcement. We continue to hold this view and believe that reflecting long-run incremental costs in the EDCM is appropriate.

2. Episode 6 has commented on the evidence base for Ofgem's conclusions and the quality of the reasoning in the first paragraph of exhibit 1. Episode 8 has commented on the "evidence" point in the first sentence of the second paragraph of exhibit 1.

3. This episode is about the remainder of the second paragraph.

In our view, Charge 1 is, as intended, a form of long-run incremental cost based charging and reflects the incremental costs 'reasonably expected to be incurred' in accordance with the charging objective.

4. This will not generally be true. Charge 1 may well reflect expenditure on particular notional network reinforcement projects, but these projects are not reasonably expected to be delivered because:

   (a) They are planned on the basis of continuous increase of demand. In reasonable expectation, technical progress and Government policy (thermal insulation, appliance efficiency improvements) will lead to reductions in domestic consumption (which is a major proportion of the network demand modelled to calculate charge 1).

   (b) If there is an increase in demand in the future due to so-called low carbon technologies, then the patterns of the new demand are likely to be very different from the assumption in the charge 1 calculation of 1 per cent annual growth in maximum demand across the board. For example, a rise in popularity of plug-in electric cars could mean that suburban residential areas experience increases in

night-time use, whilst photovoltaic panels lead to reductions in daytime net consumption. Such changes (which, contrary to a 1 per cent blanket growth rate, can reasonably be expected to happen) would require a different sort of network reinforcement than the projects whose costs are used in calculating charge 1.

5. Some of the projects underpinning charge 1 will be paid for through connection charges. If this risk of double-charging does not matter to Ofgem, then Ofgem has lost the plot.

6. The criticisms of Ofgem's position raised above are mere detail compared to the essential point that was made in the DCP 206 change proposal: even insofar as charge 1 reflects some costs, and even if they were plausible future costs, they would still be the wrong costs, because they would be the costs of accommodating demand from other customers (including CDCM customers), and not the costs of accommodating demand from the customer who is paying charge 1.

When the EDCM was being developed, the DNOs were forecasting potentially £1.6bn of reinforcement at the EHV level during the price control at that time (DPCR5).

7. This is 2015. Ofgem relies on DNO forecasts from 2008 or 2009 relating to expenditure that was being planned for between 2010 and 2015. Since these DNO forecasts were produced:

   (a) Ofgem make a price control determination for the period 2010–2015, which would probably have included Ofgem's validated allowances for reinforcement (replacing the DNO figures that are said to amount to £1.6 billion).

   (b) Ofgem has just completed a major price control review for the DNOs, with immense quantities of materials and data about costs and investment plans for the period 2015–2023.

8. Why? Is it laziness? Is it that up-to-date data would not support Ofgem's view? Or is it simply that Ofgem's recent price control paperwork is so long and confusing that nobody, not even Ofgem staff, can extract any information from it?

We included Charge 1 in the methodology as we considered that it could encourage a reduction or deferment of this reinforcement. We continue to hold this view …

9. So, looking back, did charge 1 "encourage a reduction or deferment of this reinforcement"?

10. Would this be a good thing if it did? Ofgem's duty is to protect the interests of customers. What Ofgem says it wants to encourage, reducing or deferring investment in network reinforcement, could be counter-productive for this duty if customers have a requirement for network reinforcement to meet their reasonable needs.

11. Do electricity customers have a requirement for network reinforcement to meet their reasonable needs? Well, hopefully yes, otherwise whatever allowances are made for

reinforcement in Ofgem's latest price control (£2 billion according to the table in licence condition CRC 3G) would lead to undue financial burden on customers.

12. Ofgem gives no reasoning to back up its "we continue to hold this view" statement. There is no reasoned re-examination of whether the view was correct at the time, or whether it continues to be correct. In a context of the previous sentence and the DCP 206 change presenting a specific argument about the inappropriateness of EDCM charge 1, saying "we continue to hold this view" sounds like pig-headed prejudice.

We … believe that reflecting long-run incremental costs in the EDCM is appropriate.

13. I agree that "reflecting long-run incremental costs in the EDCM is appropriate".

14. The problem is that LRIC charge 1 and FCP charge 1 do not reflect long-run incremental costs of providing a distribution service to an EDCM customer. As explained in the DCP 206 change report documentation, charge 1 for an EDCM node or network group reflects the costs of reinforcing the network to supply hypothetical future demand of other customers, rather than any costs of supplying the EDCM customer who is paying for charge 1.

15. Is Ofgem displaying pig-headed prejudice again by missing this simple point? Or is it just that Ofgem has not been paying attention to what the argument was? In terms of metaphorical animal heads, might the ostrich be more relevant than the pig?

Pants On Fire, episode 12

by **Franck Latrémolière** on **Thursday 25 June 2015**

1. Ofgem's decision on DCP 206 includes the two sentences quoted in exhibit 1.

Exhibit 1 Ofgem claims about the grounds of the DCP 206 change proposal

> The grounds for the change proposal relate to the tension that exists between the backward-looking actual cost concept that lies behind DNOs' allowed revenues and the forward-looking cost concept that lies behind economic costs and the structure of tariffs that deliver those allowed revenues. These two concepts are not in conflict because they address separate economic objectives.

2. Ofgem's claim in the first sentence quoted in exhibit 1 does not reflect the change proposal or in the change report. This looks like pure invention by Ofgem.

3. Ofgem's claim also does not make sense:

   (a) It is untrue to say that there is a "backward-looking actual cost concept that lies behind DNOs' allowed revenues". Under Ofgem's system of price control, a significant driver of allowed revenues seems to be forward-looking business plans extending to 2023. (If that were not the case, then Ofgem has caused a lot of industry time, effort and money to be wasted on these business plans.)

   (b) Talking about "the forward-looking cost concept that lies behind economic costs" is a sign of economic illiteracy. Economic costs cannot be just forward looking, otherwise there would be no economic value in assets requiring no significant future costs — such as land or radio spectrum rights. Also, a measure of economic cost has to take account of the cost of bringing a service or asset into existence in the first place as well as the costs of maintaining or expanding it, otherwise the business of investing in the service or assets would be unviable, and the service or asset would not exist.

4. Ofgem misrepresents the proposal that was put to it, and purports to replace it with patent nonsense for the purpose of its decision.

A reminder from episodes 1 and 4

5. The phrase "straw man" is sometimes used to refer to the logical fallacy which consists in falsely describing one's opponent's position as something different and less robust to what it is (the man of straw), and then attacking the fictional position.

6. It is a cowardly way of putting up a pretence of argument in circumstances where you are either wrong or not equipped with the skills to address the argument actually made. It is also an accurate description of the Ofgem conduct outlined in this episode.