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?