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***
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> Some Working Group members believed that the removal of Charge 1 better facilitates charging objective 3.2.3 because they considered it would:
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> · increase the scaling amount, which the proposer regards as more cost-reflective;
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> · remove the alleged anomaly that EDCM customers could be paying for reinforcement that may not necessarily happen, if load growth is low; and
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> · 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:
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> · 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.
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> · 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.