Pants On Fire, episode 5

by Franck Latrémolière on Saturday 20 June 2015

1. DCP 161 was a proposal to increase the rate charged for exceeded capacity under the CDCM. Exceeded capacity is defined in respect of each billing month as the part, if any, of the maximum kVA flow during the month that exceeds the contracted maximum import capacity (MIC).

2. Ofgem's decision to approve DCP 161 rests on the discussion of cost-reflectivity quoted in exhibit 1.

Exhibit 1 Ofgem's discussion of the cost-reflectivity objective

> We have considered the arguments in relation to this charging objective. We consider that DNOs could at times incur additional costs resulting from the use of excess capacity. However, the costs recovered through the upfront contribution are equivalent to the discount on capacity charges rather than a discount on both capacity and excess capacity charges. Where customers make a capital contribution to reinforcement to meet their agreed import capacities (but not beyond) they are provided with a discount on the capacity charge to reflect this contribution. These customers, however, have not made a contribution to a capacity in excess of this MIC.
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> We have considered the impact on customers who remain within their MIC. These and all other customers are effectively cross subsidising those who exceed their MIC but do not pay the full undiscounted capacity charge. The impact analysis shows that the increase in excess capacity charges resulting from this proposal results in very small reductions in charges for most other customers.
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> We agree with the concerns raised that this proposal could be more cost reflective if the excess capacity charge endured for the whole charging year. Imposing the excess capacity charge only for the month of the breach limits the effectiveness of the price signals it sends. This is because it may be better for a customer to accept excess capacity charges for part of a year than to increase the MIC which would add to charges for the whole year. We recognise that the working group examined an option to impose the excess capacity charge over a year but was dropped on the basis that it could unfairly affect those customers who inadvertently and/or occasionally exceeded their MIC.
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> In the round, we consider that, although the benefits of this proposal are limited, this proposal meets this charging objective better as it results in more cost reflective charges.

Ofgem's analysis of cost causation

3. Ofgem's decision says: "Although the industry has submitted evidence on the degree to which excess capacity is being used, we consider that it does not provide adequate evidence of any consequential additional costs incurred by the DNOs".

4. Ofgem is correct here: the change report does not include evidence that consumption in excess of maximum import capacity causes any cost for DNOs. The matter was discussed in working group meetings (observed by Ofgem), and no one came forward with any evidence. The change report records that some working group members doubted the existence of such costs: exhibit 2 quotes a few relevant passages.

Exhibit 2 Change report comments on the lack of evidence on cost causation

> 8.6 However, there were members of the Working Group that felt that there was no evidence that the breach was causing the costs and therefore in their view, it is a penal cost levied to customers. …
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> 9.5 A number of Working Group members expressed concern that a customer exceeding their MIC will not lead to the DNO incurring any additional costs and therefore the customer should not be charged a higher exceeded capacity rate. This was seen by several Working group members as further justification for why the exceeded capacity charge could be considered penal. In their view, the exceeded capacity charge is levied by the DNO for a breach of the connection agreement, and, being based on typical costs of network reinforcement, it is in excess of the losses or costs that have been shown to be likely to be caused to the DNO by customers exceeding their maximum import capacity. …
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> 13.4 … However, some Working Group members did not feel DNOs had provided sufficient evidence that a DNO running an efficient network would invest in additional network capacity to satisfy demand in excess of MIC rather than enforce connection agreements.

5. The change report does not provide evidence of cost causation to address these concerns of some working group members.

6. Despite this, Ofgem's discussion of cost-reflectivity quoted in exhibit 1, the second sentence (which is the first substantive sentence) says that "We consider that DNOs could at times incur additional costs resulting from the use of excess capacity". That consideration has no visible means of support.

Ofgem's view of the interaction between connection and use of system charges

7. Ofgem claims: "Where customers make a capital contribution to reinforcement to meet their agreed import capacities (but not beyond) they are provided with a discount on the capacity charge to reflect this contribution".

8. That claim is false. Capacity charges for CDCM sites are levied at the same rate irrespective of whether the customer has made a capital contribution to reinforcement.

Ofgem's analysis of cross subsidies

9. Ofgem claims: "other customers are effectively cross subsidising those who exceed their MIC but do not pay the full undiscounted capacity charge".

10. That claim seems to rest on three assumptions:

    (a) Consumption in excess of maximum import capacity leads to additional costs or investments borne by the DNO.

    (b) The additional costs or investments in point (a) above lead to higher maximum allowed revenue for the DNO.

    (c) Ofgem's regulatory regime, because of its focus on DNOs' income rather than prices paid by users, does not protect customers against cross-subsidy.

11. The first assumption is the same as Ofgem's claim that "DNOs could at times incur additional costs resulting from the use of excess capacity". It has no visible means of support, and Ofgem's analysis of cross-subsidies therefore follows it into logical oblivion, irrespective of whether the second and third assumptions hold.

12. The second assumption implies that the regulatory regime is based on pass-through of actual costs rather than the imposition of price caps that reflect notional efficient costs. Ofgem's "RIIO" thing is too convoluted for me to figure it out whether that is true. A good regulator would have explained.

13. The last assumption is correct. It is also a significant source of regulatory failure in relation to distribution charges, but that does not seem to trouble Ofgem.

Ofgem's invented reasons for a charge applied on a month basis

14. Ofgem says: "We recognise that the working group examined an option to impose the excess capacity charge over a year but was dropped on the basis that it could unfairly affect those customers who inadvertently and/or occasionally exceeded their MIC".

15. That argument is claptrap:

    (a) If the charge for 12 months is unfair to customers who inadvertently or occasionally exceed for half an hour, then why is a charge for one month for a single half hour's transgression not unfair? What is magical about one month?

    (b) It relies on an approach to charging that depends on the customer's subjective intention ("inadvertently") rather than their objective network use.

    (c) It relies on the false assumption that an "occasional" breach (which could happen at any time, including during a network outage) is less harmful than a regular predictable one (around which network outages could be planned).

16. But was Ofgem right to say that this "inadvertently and/or occasionally" reason was the basis on which the working group dropped the idea of 12-month charging?

17. Exhibit 3 quotes the change report's analysis of the reasons for not pursuing "option 4", which would have extended to 12 months the period for which exceeded capacity charges apply after a breach.

Exhibit 3 Change report reasons for not charging for 12 months of exceeded capacity

> 6.3 Following the responses to the consultation, the Working Group decided that the four options [including option 4] for amending the application of the exceeded capacity charge should not be progressed. This was to avoid complexity for end customers and additional billing costs for Suppliers and DNOs. In addition, under option 4, the Working Group felt that fixing the capacity at the highest level from the previous 12 month period reduced the incentive on customers to stay within their MIC. …
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> 6.64 In regard to Option 4, it was queried by Working Group members why it would be considered fair to charge the higher capacity for a year, if the customer only breaches their capacity once. The question was around if it were a one-off occurrence, as compared to a pattern of behaviour, the consequences could be construed as unfair.
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> 6.65 It was noted that the 12 months was historically used, and the principle that they are paying for a capacity charge needs to be the same as the excess capacity charge. It was explained that there is the situation where it is cheaper for a customer to breach capacity, rather than agree a higher level.
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> 6.66 It was highlighted by the Ofgem representative, that the charge needs to be demonstrated to be cost reflective and this may not be the case under option 4 where the customer will incur a higher exceeded capacity charge for 12 months following a breach.

18. The billing convenience reason given in paragraph 6.3 is valid, but not powerful.

19. The reason given somewhat cryptically in the last sentence of paragraph 6.3 is better. The concern there was that a customer who had exceeded capacity would treat a 12-month exceeded capacity charge as amounting to a temporary increase in authorised capacity, and therefore put no effort in seeking a larger connection or improving controls over its consumption.

20. The point at 6.64 is ill-developed and reflects badly on the members of the working group (which, I am ashamed to say, included me). I do not think that it amounts to any logical argument that could have influenced a competent regulator.

21. The cherry on the cake is at paragraph 6.66: Ofgem told the working group that option 4 would not be cost-reflective, then Ofgem flip-flopped and decided that "We agree with the concerns raised that this proposal could be more cost reflective if the excess capacity charge endured for the whole charging year", and then Ofgem blames the working group for not pursuing option 4 on the basis of a manifestly false "inadvertently and/or occasionally" reason that Ofgem apparently invented. Wow.