

## **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.