

Electricity distribution rebates to suppliers

Consultation document

July 2003

Summary

This document is Ofgem's first consultation paper on distribution use of system rebates. Distribution companies set their use of system tariffs to recover the revenue allowed by their price control. Some over or under recovery of allowed revenue is inevitable; however the price control incentivises distribution companies to minimise this difference through the application of interest charges.

Over the past few years, several distribution companies have persistently over-recovered against their revenue target during the year and then paid a rebate to suppliers towards the end of the financial year to avoid or reduce the over-recovery. Had these companies not made a rebate, their charges in subsequent years would have been lowered (by the amount of the over-recovery including interest charges and penalties). These companies will have benefited from interest savings on the additional revenues retained during the year. Further, Ofgem is concerned that most customers do not appear to benefit from the rebates as their one-off nature means that competition does not encourage suppliers to pass them on to the customers.

The total value of rebates paid to suppliers between April 2000 and March 2003 was over £90 million.

In Ofgem's view, requirements for distribution charges to be cost-reflective are likely to preclude rebates from April 2005. Prior to that date, Ofgem intends to rely on enforcement of existing licence conditions should any companies propose to pay rebates rather than reduce charges in subsequent years. In recognition of the risks of over or under recovery, Ofgem will consider whether other changes to the framework are appropriate, such as allowing minor changes to tariffs to be made with a shorter notice period or reducing the interest charges.

Ofgem welcomes views on the issues raised in this paper by 29 September and, having considered responses, intends to produce a decision document by November 2003.

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1. Rationale

Introduction

- 1.1. Ofgem's principal statutory objective is to protect the interests of consumers (existing and future), wherever appropriate by promoting effective competition. Many areas of the energy industry are subject to, or are in the process of being opened to, competition. Where competition has been introduced, Ofgem will continue to monitor these markets to ensure that they operate effectively and deliver ongoing benefits to consumers.
- 1.2. There are some areas of the energy industry where it may not be possible or appropriate to introduce competition. This applies to the transportation of energy to consumers over national and local networks of wires and pipes. In these areas, companies retain an effective monopoly over the provision of services and Ofgem has put in place price controls and other incentive regimes to protect the interests of consumers.
- 1.3. There are 14 licensed distribution network operators (DNOs) in Great Britain. Each distribution network consists of a range of assets that facilitate the transfer of electricity from the transmission network and directly connected generators to customers' premises. Each distribution business sets charges for use of their network in response to the constraints imposed by the price controls and other licence conditions, and taking account of the incentives that they face. These charges are paid by electricity suppliers who recover their costs from consumers through retail prices.

Issue

- 1.4. A number of DNOs have made substantial rebates to suppliers in respect of distribution use of system (DUoS) charges between April 1999 and March 2003. Rebates are made to avoid sizeable final over-recoveries against the distribution price controls, as any final over-recovery is subject to interest penalties.
- 1.5. By retaining any over-recovery until the year-end, companies may benefit from the supplementary income that they are able to generate throughout the year.

Ofgem is concerned that rebates may not be passed on from suppliers to the customers and are therefore not in the best interests of customers.

- 1.6. Electricity distribution costs account for around £2 billion annually and typically make up 25 to 30 per cent of the retail prices paid by consumers.

Objectives

- 1.7. Ofgem's principal objective is to protect the interests of customers. Undertaking this project to review the process of giving rebates should help protect the interests of customers by providing appropriate incentive arrangements to encourage DNOs to set distribution charges at a level consistent with the price control framework and avoid substantial rebates.
- 1.8. The project will evaluate electricity distribution rebates against several important criteria. These include the principles that electricity distribution charges should:
 - ◆ be cost reflective, to facilitate cost-based retail prices
 - ◆ be both predictable and transparent, and
 - ◆ not restrict, prevent, or distort competition.
- 1.9. It is also important that, where revised arrangements are considered appropriate, these avoid undue risks to distribution companies and minimise the regulatory burden for the industry.

2. Structure, timetable and responses

Purpose and structure of this document

- 2.1. This document represents Ofgem's first consultation in relation to DUoS rebates. In particular, the document sets out initial thoughts in relation to:
- ◆ the increasing number and size of one-off DUoS rebates to suppliers
 - ◆ the reasons for these
 - ◆ the implications for the protection of consumers' interests, and
 - ◆ the desirability of changes to the regulatory framework.
- 2.2. Where Ofgem would appreciate views on specific aspects of this paper, this is indicated at the end of chapter 5. Ofgem welcomes the views of all interested parties on these and other issues raised in this document.
- 2.3. The remainder of this document is structured as follows:
- ◆ Chapter 3 describes the main features of the regulatory framework that influence distribution rebates. The chapter also provides background on past DUoS rebates and their implications
 - ◆ Chapter 4 identifies the main charging principles with respect to electricity distribution charges and discusses the implications for consumers of DUoS rebates
 - ◆ Chapter 5 considers the policy options in respect of rebates and sets out Ofgem's initial thinking in respect of these matters, and
 - ◆ Appendix 1 provides a summary of DNO views on distribution rebates based on responses to an information request issued by Ofgem in February 2003.

Project timetable

- 2.4. This document represents the start of the consultation process in relation to DUoS rebates. The table below sets out the timetable for the project over the coming months:

Table 2.1: Outline project timetable

| Deliverable | Objective | Deadline |
|------------------------------------|---|-------------------|
| Consultation paper (this document) | Provide background on distribution rebates and set out initial thoughts | July 2003 |
| Responses deadline | | 29 September 2003 |
| Decision paper | Set out Ofgem's conclusions | November 2003 |

- 2.5. Ofgem is willing to meet with interested parties to provide them with an opportunity to provide feedback and comments on this document. Once Ofgem has considered the views of interested parties, it expects to publish its proposals in respect of the key aspects of distribution rebates in November 2003.

Related policy areas

Structure of electricity distribution charges project

- 2.6. The rebates project is linked to the structure of charges project. The issues considered under the structure of charges project include:
- ◆ the principles used in setting charges for connection to and use of the distribution network
 - ◆ the boundary between connection and transportation charges
 - ◆ ongoing use of system charges for distributed generation, and
 - ◆ the balance between fixed and variable components of distribution charges.
- 2.7. These issues have implications for the flows of revenue to DNOs and together with any changes to the use of rebates will also have implications for how DNOs set their charges.

Distribution price control review

- 2.8. Work has started on the distribution price control review (DPCR) that will put in place price controls for distribution services for the five year period from 1 April 2005. Changes to price controls may influence the extent to which DNOs can predict the revenue arising from activities regulated under these controls. Together with any changes to the use of rebates, this will have implications for how DNOs set their charges.

Responding to the document

- 2.9. It would be helpful to hear from those persons with an interest in the issues raised in this document, including DNOs, suppliers, customers, and their representatives. Views are invited by 29 September 2003. Where possible, responses should be sent electronically to:

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- 2.10. All responses, except those marked confidential, will normally be published on the Ofgem website and held electronically in the Research & Information Centre. Respondents should try to confine any confidential material to appendices in their responses. Ofgem prefers to receive responses in an electronic form so that they can easily be placed on the Ofgem website.
- 2.11. Should you have any questions regarding the issues raised in this document, please contact Gail Crick on 020 7901 7210 or Gary Keane on 020 7901 7330. A copy of this document and other Ofgem publications are available from the Ofgem website (www.ofgem.gov.uk).

3. Background

Introduction

- 3.1. This chapter describes the main areas of the regulatory framework that have an impact on distribution rebates. The chapter also summarises historical rebates given by companies over the current price control period. This covers the period from 1 April 2000 to 31 March 2005. Rebates made prior to the start of this price control period are not reviewed by this project.

Regulatory framework

- 3.2. The price controls place an obligation on companies to use their best endeavours to set charges to ensure that revenues do not exceed the allowed level determined by the price control formula. However, some components of the price control formula, eg winter demand, are not known in advance of setting charges and therefore charges are set with reference to projected values. The projected amount of revenue raised by any particular charges will be based on a forecast of volumes distributed and other variables.
- 3.3. Forecasting errors may result in an under or over recovery against the price controls at the year end. Consequently, the price control formula includes a correction mechanism to adjust future allowed revenues to correct for past differences between actual and allowed revenues. Allowed revenues may be adjusted downwards (upwards) in the event of an over (under) recovery during the previous year.
- 3.4. To provide appropriate incentives on DNOs to set charges accurately, the distribution licence includes interest charges to apply on the difference between actual and allowed revenues. The price control formula incorporates additional interest penalties to be applied in the event of an over-recovery of revenue.
- 3.5. A rebate is a refunding of DUoS charges by a DNO to a supplier. The rebate is made when a DNO has received too much revenue in comparison to its allowed revenue under the distribution price controls. By giving a rebate and reducing the amount of over-recovery a DNO can avoid the interest penalties described above.

- 3.6. The electricity distribution licence special condition C states that if the average charge per unit distributed exceeds the maximum average charge per unit distributed by more than three per cent, additional restrictions may be placed on future tariffs.
- 3.7. Price controls are an important feature of the framework that regulates DNOs' DUoS charges and provide protection to the generality of consumers in respect of the overall levy of charges. Nevertheless, the price controls are not sufficient to protect the interests of individual consumers or groups of consumers in respect of the overall timing and structure of charges. In the light of this, electricity distribution licence conditions (standard conditions 4 to 4C) impose supplementary criteria in relation to the way DNOs establish and revise network charges.
- 3.8. Under distribution licence standard condition 4¹, distribution companies may amend their DUoS charges, providing that five months' notice is given to all users and the Gas and Electricity Markets Authority ("the Authority"). Giving rebates is considered to be an amendment to the use of system charges. Standard licence condition 4A precludes discrimination in the provision of use of system and connection to system. Ofgem reviews all proposed changes to charges to ensure that companies are complying with these licence conditions.
- 3.9. In the gas industry, Transco must use best endeavours to provide to the Authority 150 days notice of a change to its charges, comparable to the five months notice period for electricity distribution companies. If Transco intend to implement this change to charges, it must subsequently give no less than one months' notice to the Authority. In order to change the charging methodology, Transco is obliged to consult over a period of 28 days before issuing a report to the Authority who then have a further 28 days to review the proposals. This process is normally undertaken within the 150 day notice period for introducing a change to charges.

¹ Electricity distribution licence: Standard conditions. Condition 4. Basis of Charges for Use of System and Connection to System: Requirements for Transparency, paragraph 13.

Why DNOs over or under recover

- 3.10. In February 2003, Ofgem issued an information request to DNOs asking why they might over or under recover DUoS charges, and hence use rebates as a form of changes to charges².
- 3.11. A number of DNOs said that they found it difficult to set charges five months' in advance, especially considering the unknown demand over the future winter period. However, it is possible to change charges 40 days before they take effect. Under the present arrangements, these charges may differ from indicative charges in so far as they reflect reasonable changes in the assumptions underpinning the indicative values. As such, demand over the previous winter may improve forecasts for the following winter period.
- 3.12. Other reasons that may contribute to companies under or over recovering DUoS charges were suggested as being:
- ◆ unknown final NGC exit charges
 - ◆ growth of units distributed
 - ◆ level of maximum demand
 - ◆ the take-up of Meter Asset Provision (MAP) and Meter Operator Provision (MOP) services, and
 - ◆ specific and one-off unanticipated changes to allowed revenue
- 3.13. Given the factors described above, some DNOs give a rebate to suppliers as a change to use of system charges, before the end of the financial year. In response to the February 2003 information request, three companies stated that avoiding paying the penal interest rate was considered when setting use of system charges. If a rebate is given but companies continue to over-recover the allowed revenue, they will be charged interest on the remaining over recovery. In contrast if it is likely that a DNO will under-recover its allowed revenue, the only method it has available to increase its revenue before the year end is to make a change to its charges, giving five months' notice. This appears to create

² A summary of responses to the information request is given in appendix 1.
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perverse incentives for DNOs to set use of system charges higher than would be expected to result in allowed revenue. If in so doing, the DNO exceeds its allowed revenue, the excess can be passed back to the supplier in the form of a rebate rather than incurring tighter restrictions on future changes to charges³.

- 3.14. In addition, by retaining any over-recovery until the year-end, DNOs may benefit from any interest gained on over-recovery retained until it is rebated to the suppliers. This is in addition to the benefits of avoiding interest penalties in future years.

History of DUoS rebates

- 3.15. Rebates are a relatively new phenomenon. Prior to the start of the current price control period, few rebates had been made to suppliers, with the first rebates given in 1999. This document focuses on rebates given since the start of the current price control period in April 2000.
- 3.16. Since April 2000, distribution companies have given rebates to supply companies on fourteen occasions, ranging in value from £4 million to £11.1 million (see Table 3.1), with the average rebate being £6.5 million. The total amount rebated over this period is over £90 million.
- 3.17. The February 2003 information request revealed that two DNOs have given a rebate in each of the three years from April 2000 to March 2003. Three DNOs have each given two rebates over this period. This trend appears to support the suggestion that some companies may be setting their tariffs in the knowledge that they can give rebates at the year-end.

Table 3.1: Profile of rebates March 2000-April 2003

| | Total value of rebate (£m)⁴ |
|----------------|---|
| 2000/01 | |
| DNO A | 7.0 |
| DNO B | 8.2 |
| DNO C | 5.1 |
| DNO D | 11.1 |
| DNO E | 6.0 |

³ See special condition C: restriction of distribution charges: adjustments, paragraph 2.

⁴ Value of rebates per MPAN ranged from £2.00 to £8.00.

| | Total value of rebate (£m) ⁴ |
|--|---|
| DNO F | 7.4 |
| Total | 44.8 |
| 2001/02 | |
| DNO B | 5.8 |
| DNO C | 5.0 |
| DNO D | 4.8 |
| DNO E | 6.5 |
| DNO F | 4.1 |
| DNO G | 6.0 |
| Total | 32.1 |
| 2002/03 | |
| DNO B | 8.6 |
| DNO D | 5.6 |
| Total | 14.2 |
| Total rebated April 2000 - April 2003 | £91.1 |

- 3.18. As explained in paragraph 3.6, additional restrictions are placed on future tariffs if the average charge per unit distributed exceeds the maximum average charge per unit distributed by more than three per cent. In some of the above cases, DNOs would have exceeded this threshold. In addition, these DNOs would have incurred substantial interest penalties if they had not provided a rebate. Some DNOs over-recovered despite giving a rebate.

4. Why Ofgem is concerned

Charging principles

- 4.1. In June 2003 Ofgem published its initial conclusions on the structure of electricity distribution charges⁵. Ofgem suggested that, where appropriate, common principles should be recognised and applied across similar networks, and suggested that charges should:
- ◆ facilitate competition
 - ◆ be cost reflective, and
 - ◆ be capable of evolution over time.
- 4.2. The giving of large rebates does not appear to fit well with having transparent, cost-reflective charging structures.
- 4.3. Electricity distribution licence special condition B⁶ stipulates that licensees shall, in setting charges for the provision of distribution services, use best endeavours to ensure that in any relevant year the average charge per unit distributed shall not exceed the maximum average charge per unit distributed. Ofgem is concerned that the history and magnitude of rebates (see table 3.1) suggests that companies are not fully complying with this obligation when they initially set charges.
- 4.4. In particular Ofgem is concerned with the tendency of some DNOs to substantially over-recover through the year and offset this over-recovery by significant rebates to suppliers.

The impact of rebates on retail prices

- 4.5. In all cases, rebates are passed directly from the distribution company to the supplier. Some consumers (eg large businesses) may have arrangements with suppliers that pass through any changes to DUoS charges, so would benefit from rebates. Other customers, including domestic customers, are unlikely to have

⁵ Structure of electricity distribution charges update document. See http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/47_24oct02.pdf

⁶ Electricity distribution licence: Special condition B: Restriction of distribution charges, paragraph 1. Electricity distribution rebates to suppliers

such arrangements. Ofgem is concerned that suppliers do not appear to have passed on rebates to all customers.

- 4.6. To the extent that rebates favour incumbents over new entrants, DNOs that give rebates may be distorting competition in the supply market. This is contrary to standard licence condition 4A⁷.
- 4.7. While Ofgem believes that consumers do not currently benefit from rebates given from DNOs to suppliers, they may, however, be more likely to benefit from longer-term changes to use of system charges which may be reflected in suppliers' charges, according to market forces.
- 4.8. The information request responses suggested that the main reason for DNOs preferring to use rebates as opposed to conventional changes to charges is to maintain price stability between years. Ofgem is concerned that consumers may not be seeing any benefit from millions of pounds in rebated charges.
- 4.9. It is empirically difficult in the absence of direct information from suppliers or customers to test the proposition that rebates have not been passed through to customers. One possible approach is to analyse indirectly whether rebates appear to have been factored into movements in regional domestic electricity prices over the price review period.
- 4.10. There are empirical difficulties using this approach since rebates represent only one element of a supplier's cost to serve. To the extent that other 'bought in costs' vary by region, eg purchase costs, transmission and distribution costs, these may act to offset the effect of the pass through of a distribution rebate. In addition, unless levels of competitiveness in supply are uniform across all distribution regions, competitive pressures on final prices may vary slightly, potentially masking pass through effects. Consequently, caution must be exercised when examining any correlation between distribution rebates and domestic prices.
- 4.11. Notwithstanding these caveats, Ofgem notes that average domestic customer bills by distribution area over this price control period do not demonstrate

⁷ Electricity distribution licence: Standard conditions, Condition 4A. Non-discrimination in the provision of use of system and connection to system, paragraph 4.

‘consistency’ between the reduction in the average bill and the amount rebated by the corresponding DNO. This lack of consistency is particularly pronounced in some regions, even where transmission and distribution charge reductions over the period are taken into account.

5. Ofgem objectives and policy options

Objectives

- 5.1. Ofgem's role is to protect and advance the interests of consumers by promoting competition where possible, and through regulation only where necessary. The following objectives are consistent with this role and are in line with the charging principles outlined in paragraph 4.1.

Objective 1 – Consumers pay cost-reflective charges

- 5.2. In setting retail supply prices, suppliers will reflect the various costs that they incur in providing electricity to consumers. Retail prices will therefore reflect the costs of wholesale energy purchases, transportation, and customer services. Cost reflective transportation charges will help facilitate the development of cost reflective retail supply charges faced by consumers.
- 5.3. At present, there is no requirement for suppliers to pass on any rebate to consumers. This may result in supply companies receiving a rebate from distributors at the year-end and not passing this on to consumers in the form of lower retail prices. In this case customers will not pay retail prices that reflect the true underlying costs that they impose on the distribution system.

Objective 2 – Charging Stability

- 5.4. It has been suggested by suppliers that consumers prefer stable charges. High volatility in distribution charges may not benefit the consumer as higher retail tariffs may result from an increase in the suppliers' margins to accommodate the increased uncertainty and added risk. This objective may conflict with objective 1 as charges which very accurately reflect costs may not be stable.

Objective 3 – Facilitate competition

- 5.5. In line with principles put forward in the June 2003 structure of charges document, DNO charging methodologies should assist the development of the competitive market. Ofgem has proposed that their charging methodology

should facilitate competition in generation, transmission, distribution and supply.

- 5.6. Ofgem considers that it would be undesirable to intervene in supply markets by insisting on pass-through of rebates.

Objective 4 – Avoid undue risks to distribution companies

- 5.7. The five month notice period makes it difficult to respond to unanticipated under-recoveries against the price control within the year. The resulting price disturbances could be large and undesirable to consumers. In general, DNOs are incentivised to overstate charges since they can make one-off rebates to eliminate over-recoveries and avoid the possibility of under-recovery.

Objective 5 - Minimum impact on workload

- 5.8. It is desirable to keep the workload impact on Ofgem and the industry to a minimum with a solution that is straightforward to regulate.

Main policy proposals

- 5.9. Ofgem has initially concluded that distribution charges should be cost-reflective, transparent, predictable, and facilitate competition and has proposed that licence modifications should be introduced to achieve this. Subject to the outcome of the consultation, this is likely to preclude rebates or dramatic mid-year tariff changes which would achieve the same effect.
- 5.10. Prior to April 2005, Ofgem intends to scrutinise more closely the reasons behind and the justifications for any distribution company planning to give a rebate. In particular, Ofgem would consider any evidence of breach of special condition B (use of best endeavours to set charges within the price control cap) and/or standard condition 4A (facilitating competition).

Possible additional options

- 5.11. Eliminating rebates may increase cash flow risk to DNOs unless combined with either reductions to the notice period for making changes to use of system charges or reducing the interest rate penalty on over-recovery.

- 5.12. The standard condition 4 requires a distribution company to provide five months notice for minor mid-year adjustments to charges. Recent experiences suggest that this may be onerous. Reducing the notice period for making changes to the distribution charges would allow companies to react more quickly to unanticipated changes, and the risk of unintended under/over recovery could be reduced.
- 5.13. The main benefit of this would be to avoid undue risks to distribution companies, although consumers may also benefit from reduced charges. These changes to charges may be frequent but are likely to be small, thus retaining a degree of retail price stability, although it is unlikely that these small changes would feed through to customers in the short term.
- 5.14. It is suggested that the notice period be reduced to 60 days for minor adjustments to charges. The level for minor adjustments could be set at +/- five per cent. As DUoS charges account for 25-30 per cent of retail prices, a 5 per cent changes in DUoS charges would represent a 1 per cent movement in retail prices.
- 5.15. To the extent that elimination of rebates and other changes to the price control framework make it more difficult to avoid over and under recovery, it may be appropriate to reduce interest charges from April 2005 (or possibly even during the current price control).

Views invited

- 5.16. Ofgem invites views on:
- ◆ the merits and disadvantages of the initial thoughts set out above on policy; suggestions for other possible measures are welcome
 - ◆ whether there are any circumstances in which rebates could be considered cost-reflective
 - ◆ whether rebates distort competition in supply
 - ◆ whether 60 days is an appropriate length time for DNOs to propose minor tariff adjustments, and
 - ◆ whether it would be appropriate to reduce interest rate penalties on over-recovery.

Appendix 1 - Summary of information request

Why do companies use rebates?

- 1.1 In February 2003, Ofgem issued an information request to companies regarding why they might over or under recover DUoS charges, and hence use rebates as a form of changes to charges. We received eight responses covering all 14 DNOs.
- 1.2 The main factor given as an incentive to give a rebate is the requirement to give five months' notice to make a tariff change. Seven respondents responded saying that the length of the notice period was a problem when setting tariffs.
- 1.3 Several respondents gave financial and price control-related reasons for giving rebates. Two respondents said that rebates reduced charges in the current regulatory year. Two respondents suggested that setting charges higher than necessary and giving a rebate at the year-end was used as a method to avoid under-recovery, whilst three respondents said that they were incentivised to give rebates to avoid the penal interest rate. One respondent gave a reason for giving a rebate as being due to a change in assumptions.
- 1.4 One respondent said that rebates have an immediate effect on revenues, whilst four said that rebates are the quickest way to return over-recovery to suppliers.
- 1.5 According to the responses, the most important factor behind using rebates as opposed to conventional tariff changes was maintaining price stability, with seven respondents listing this as a reason for using rebates. Two respondents also stated that it was a simple way to adjust prices.
- 1.6 There were many reasons given to explain the variance from the assumptions made at the time of tariff setting. These were mainly claimed to be outside the control of the DNO. Two respondents said that weather conditions constitute one reason why their assumptions may be affected, and two said that the unknown final NGC exit charges were a factor.
- 1.7 Consumer-related reasons were given as changes in the growth of units distributed (three respondents), the take-up of Meter Asset Provision (MAP) and Meter Operator (MOP) services (one respondent) and the level of maximum

demand (one respondent). Two respondents stated that the level of economic activity may broadly affect the accuracy of forecasts.

- 1.8 Two respondents stated that specific and one-off subsequent changes to allowed revenue (including fines, merger payments, adjustments to licence fee allocation and consequences of supplier payment default) may also result in a DNO giving a rebate, as these events were not anticipated at the time of setting charges.

Accuracy of forecasts

- 1.9 One respondent gave suggestions as to what would help improve the accuracy of revenue forecasts. The accuracy of the forecast data would be improved if suppliers had reliable Meter Point Administration Number (MPAN) registration procedures; and accurate volume information from the settlements system.