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Gary Keane
Distribution Policy Analyst
Ofgem
9 Millbank
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Dear Gary

**Electricity Distribution Rebates to Suppliers
- Consultation Document (July 2003)**

Aquila's response to the policy proposals contained in the consultation paper is summarised below.

- We strongly disagree with the proposal to introduce licence modifications to preclude rebates or significant mid-year tariff changes;
- We support :
 - Ofgem scrutinising more closely a DNO's justification for making a rebate or significant mid-year tariff change;
 - the reduction in the notice period for making changes to distribution charges and
 - the reduction in the interest penalty for over-recoveries.

Detailed comments on the consultation paper are attached.

I would however like to express our concern over the number of unsubstantiated and incorrect assertions upon which Ofgem seems to have based its proposal for a licence modification to preclude rebates. In particular:

- paragraph 4.3 suggests that Ofgem believes that DNOs are failing to comply with Special Condition B when initially setting charges. Being one of the DNOs that has made one rebate since 2000, Aquila strongly refutes this suggestion. There are factors that can change revenues and hence over/under recoveries during a year which are not capable of being forecast. Before making such an assertion, therefore, I suggest that Ofgem should have first reviewed the pricing policies of the individual DNOs concerned;
- in paragraph 4.5 Ofgem is concerned that suppliers do not appear to have passed on rebates to all customers. I do not believe that there is any way in

which this could be deduced given the value of rebates which have been made which have typically amounted to less than 1% of retail prices;

- in paragraph 4.2 Ofgem are concerned over the giving of “large” rebates. The total value of the rebates given over the three-year period represents less than 1% of total Use of System prices/revenues which hardly merits the description ‘large’.

Frankly, given the scale of the rebates which have been given by distributors, I am surprised that this issue has warranted such attention from Ofgem and will strongly resist any attempt to impose licence modifications upon the DNOs which preclude the use of such rebates in the future.

I trust that these comments will be useful. Please ring me if you wish to discuss any of the points raised.

Yours sincerely

A K Phelps
Regulation Director

ATTACHMENT

Detailed comments on Ofgem's proposals:

Ofgem has proposed to make licence modifications to preclude rebates or dramatic mid-year tariff changes.

Aquila disagrees with this proposal. We believe that we must retain the flexibility to make adjustments for "one-offs" in order to stabilise both the companies' annual earnings and cash flows as well as the future path of use of system prices for suppliers.

There are times when a DNO is unable to forecast factors that will have a material effect on recovery positions. Such an example is particularly unusual weather. In this case, the change that occurs in consumption and the effect that this has on recoveries can be described as "one-off". To change tariffs for the following year to correct the recovery would mean that pricing would be below its equilibrium (new prices would deliver an under-recovery without the over-recovery being brought forward), and unless there was another significant change in the following year, prices would have to be put back up again. In this situation, Aquila believes it unlikely that a supplier would pass on any short-term benefit, only to have to increase the prices next year. It would therefore appear reasonable to allow a DNO to pay a rebate. Similarly, if Ofgem were to place a fine on a DNO relating to a particular year, it should be able to pay it as a rebate to demonstrate to suppliers that the fine was being paid.

Ofgem intends to scrutinise more closely the reasons behind and the justifications for any DNO planning to give a rebate, prior to April 2005.

Aquila agrees with this proposal, and would suggest that Ofgem extends this beyond April 2005.

Aquila would further suggest that in cases where the rebate or price change was thought to be material, say in excess of 5% of revenue, then the rebate should first be approved by Ofgem. Any agreement to the rebate should only be withheld if Ofgem could demonstrate that either the DNO had failed to comply with Special Condition B in setting initial tariffs, or if the DNO could demonstrate that a tariff change would not be effective.

Ofgem proposes that the notice period for making changes to distribution charges should be reduced to 60 days for minor changes ($\pm 5\%$).

Aquila would welcome a reduction in the notice period for all proposed adjustments to tariffs. Where changes occur to forecast revenues due to economic factors that are expected to continue, rather than one-off events, the ability to make tariff adjustments with a shorter notice period will aid price stability which will benefit both customers and companies alike.

Ofgem proposes that it may be appropriate to reduce interest rate penalties on over-recoveries.

Aquila fully supports this proposal. With the current low level of interest rates, the effect of the penalty on over-recoveries is to effectively double the interest charged on the over-recovery. A lower penalty rate would make it less costly for a DNO to carry forward an over-recovery from one year to the next.

To summarise, Aquila welcomes Ofgem's proposed reductions in both the notice period for tariff changes (to 60 days) and the interest penalty on over-recoveries. However we believe that this should apply for both material (over 5%) and non-material tariff adjustments. Companies should also be permitted to retain the flexibility to use rebates particularly to deal with over-recoveries of a "one-off" nature in order primarily to avoid instability in tariffs and company cash flows. However, we accept that any 'material' changes in charges should require Ofgem's prior agreement.