



**Electricity distribution rebates to suppliers – consultation
document – July 2003**

A Response by British Gas Trading

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EXECUTIVE SUMMARY

British Gas Trading (British Gas) welcomes the opportunity to respond to Ofgem's consultation in respect of 'Electricity distribution rebates to suppliers'. British Gas has contacted Distribution Network Operators (DNOs) and Ofgem in the past querying the practice and process of DNO rebates.

If the price control framework permits the DNO to increase its profits beyond those assumed at the setting of the price control, without any associated improvements in efficiency, then the arrangements are not operating as they should and are therefore not acting in the interests of customers.

DNOs appear to use rebates to by-pass the existing financial incentives designed to prevent DNOs from inappropriately benefiting from windfall cash flows and to avoid other reporting and charge restriction obligations.

Rebates have been worth approximately £4m in unwarranted increased profits to DNOs.

Rebates have probably cost suppliers and hence customers between approximately £5.5m and £8m.

We believe that Ofgem should publish the identities of DNOs using rebates as the information is effectively already in the public domain.

There appears to be little justification to the use of rebates. However, if they are to be used then they should be accompanied by the addition of interest charges.

Dramatic mid-year tariff changes are unlikely to occur if accompanied by the addition of interest charges and Ofgem enforces existing obligations.

Reductions in charge adjustment notice periods and interest rate charges are unnecessary. Rather, there is a good case for increasing interest charges from 1 April 2005.

Consideration should be given to amending the price control on a retrospective basis so that it has the financial effects on DNOs as were originally intended. Furthermore, the other reporting and charge restriction obligations applying to end of year over recovery should be extended to any within-year charge adjustments or rebates.

Ofgem should undertake an investigation into possible breach of DNO obligations under their licences.

1. INTRODUCTION AND GENERAL COMMENTS

British Gas Trading (British Gas) welcomes the opportunity to respond to Ofgem's consultation in respect of 'electricity distribution rebates to suppliers'. British Gas has an interest in the outcome of this issue because of our presence in the electricity supply market. British Gas has contacted Distribution Network Operators (DNOs) and Ofgem in the past querying the practice, process and frequency of DNO rebates.

British Gas agrees that this non-confidential response can be placed in the Ofgem library.

2. REGULATORY FRAMEWORK

2.1 Price control

As distributors are natural monopolies, Ofgem protects the interests of customers by setting price controls using the RPI-X framework. This framework is intended to ensure that the prices paid by customers are capped whilst at the same time providing strong incentives towards efficiency by allowing the DNO to keep any supra-normal profits that arise as a consequence of its increased efficiency (for example through reduced costs) during the price control period. Thereafter, the increased efficiency revealed by the DNO is passed onto customers (for example through reduced charges) in setting the next price control.

If the price control framework permits the DNO to increase its profits beyond those assumed at the setting of the price control, without any associated improvements in efficiency, then the arrangements are not operating as they should do and are therefore not acting in the interests of customers. DNOs appear to be abusing their monopoly position.

Electricity distribution price controls are set on the basis of the forecast efficient level of costs/revenues. Once these revenues have been calculated, Ofgem has often adjusted the forecast revenues on a Net Present Value neutral basis so that there is a smoother path of prices (these could be constant, increasing or decreasing prices) to avoid forecast prices increasing and then decreasing from one year to the next. This directional price stability helps customers and further aids supplier planning.

The forecast distribution revenues contain a series of assumptions including the number of units distributed, company cash flows plus other variable items like NGC exit charges. Changes to any of these assumptions can affect the actual level of distribution charges from one year to the next.

2.2 Charging

2.2.1 'Special' licence conditions

Once the forecast smoothed stream of revenues has been set DNOs are incentivised to not set distribution charges such that there is over recovery of charges compared with those determined by the price control formula (via the need to pay interest). This incentive is further reinforced by a best endeavours obligation and additional reporting and charge restriction obligations.

This incentive and obligation should ensure: -

- Ongoing compliance with the principle of price stability; and

- Prevent any inappropriate benefits flowing to DNOs with respect to windfall cash flows.

The best endeavours obligation means that in setting its charges a DNO must take whatever actions are necessary, irrespective of the cost or reasonableness of the actions, using all of the information that it has available to it at that time, to ensure that it does not over recover against its price control formula. The effect of this should be to ensure that over recovery is small and infrequent.

We suggest that there would be merit in Ofgem undertaking a review of compliance with the best endeavours obligations of DNOs. This review is likely to be aided by: -

- A comparison of over and under recovery (including rebates and other within year charge adjustments) to understand the differences in performance of each DNO (and group of companies) with respect to their ability to accurately set charges; and
- DNO provision of evidence to Ofgem as to the efforts undertaken and information used to ensure compliance with their obligations, in particular;
 - The factors (if any) that may have increased forecast charge level uncertainty; and
 - The reasons that this could not be mitigated by DNO actions (including the use of better and/or increased information).

The statements of DNOs further support the need for this investigation. Ofgem notes that two DNO 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”.

There is no obligation to avoid under recovery. Consequently, the statement can be interpreted as an admission of deliberate breach of those DNOs’ best endeavours licence obligations.

Ofgem further reports that three DNOs suggested that: -

“they were incentivised to give rebates to avoid the penal interest rate.”

These statements ignore the fact that irrespective of the financial incentives, DNOs should not disregard their other licence obligations. Moreover, as shown elsewhere in this response, the interest charges are not penal. Rather, the charges are broadly equivalent to the potential direct financial gain to DNOs of over recovery whilst being less than the direct costs imposed on customers and suppliers.

2.2.2 Condition 4A. Non-Discrimination in the Provision of Use of System and Connection to System

Paragraph 2 states: -

“In the provision of use of system the licensee shall not discriminate between any persons or class or classes of persons.”

Though the DNO methodologies vary, rebates are often done on the basis of the number of supply points that a supplier has registered at a particular moment in time rather than on

the basis of supply point registrations throughout the period that the rebates apply. This will lead to a discrepancy between the levels of charges paid by customers benefiting from rebates compared to their likely level of charges if no over recovery had occurred. Consequently, the DNO rebate methodology is likely to result in discrimination between individual customers.

3. VALUE TO DNOs OF REBATES

If it is assumed that the annual rebate is given at the end of the year with the excess charges arising evenly throughout the year, there are two possible measures of the potential value to DNOs of the use of rebates: -

- Interest payments avoided;
 - The existing cost to the DNO of charging more than the price control formula is half the amount of overcharging multiplied by (Barclays base rate plus 4%). This gives a cost to DNOs of approximately £4.2m.
- 'Real' value to DNOs;
 - In the absence of interest payments for charges in excess of the price control formula, the real value to DNOs could be estimated as half the amount of overcharging multiplied by (the DNO's regulatory cost of capital plus the rate of inflation over that period). This gives a value of approximately £4m.

4. COST TO SUPPLIERS OF REBATES

As a typical supplier's cost of capital is higher than the DNOs' cost of capital the actual cost to suppliers of the overcharging is likely to be higher. A supplier's cost of capital might be expected to be in the range 10-15%¹. Again, assuming that the annual rebate is given at the end of the year with the excess charges arising evenly throughout the year results in costs to suppliers of approximately £5.6m to £7.9m.

British Gas does not agree with the Ofgem suggestion that rebates could have distorted competition in favour of incumbents over new entrants. As noted earlier, because rebate methodologies only sometimes relate to actual customer registrations throughout the period of the rebate and can instead relate to registrations at a later period, the rebate methodology is likely to be neutral to or favour new entrants.

The use of rebates causes additional supplier cost and inconvenience because of their ad hoc nature.

5. COSTS TO CUSTOMERS (IMPACT ON RETAIL PRICES) OF REBATES

Ofgem recently concluded that the domestic market is competitive. Consequently, it is reasonable to assume that any change in supplier costs is reflected in an equivalent change in customer costs. Consequently, customer costs can be estimated at approximately £5.6m to £7.9m. However, this cost is as a consequence of DNO actions not because suppliers are inappropriately profiting from rebates.

However, because of DNO actions, there is likely to be a discrepancy between the customers benefiting from rebates and the amounts they ought to have received.

¹ BT's regulated cost of capital is 13.5%.

6. REASONS FOR USE OF REBATES

The use of rebates appears to by-pass the existing financial incentives to prevent DNOs from inappropriately benefiting from windfall cash flows. That is, DNOs have increased their profitability beyond that assumed in setting the last distribution price control via the use of rebates rather than increases in efficiency. The reported statements of some DNOs support this conclusion. Additionally, DNOs are avoiding the reporting and other charge restriction obligations.

7. PUBLICATION OF DNO IDENTITIES

Suppliers are aware of the identities of the DNOs providing rebates and of their own share of the rebates. To all intents and purposes, the information in Ofgem's analysis of DNO rebates contained in "Table 3.1: Profile of rebates March 200-April 2003" of its July consultation document is in the public domain. Consequently, we believe that there is merit in Ofgem re-publishing the table revealing the identities of DNOs A to G.

Because of the number of DNOs that are part of merged corporate entities, we suggest that the table could be further expanded to indicate not just the identities of individual licensees but also those licensees that are part of the same corporate group, with the name of that corporate group.

Such "naming and shaming" is likely to act as a deterrent to further inappropriate behaviour in this area.

8. OFGEM'S SUGGESTED CHANGES TO THE REGIME

8.1 Removal of rebates or dramatic mid-year tariff changes

The DNO responses suggesting that the main reason for the use of rebates is to maintain price stability (Ofgem Para 4.8) is likely to be disingenuous. As noted earlier, it is more likely that rebates are being used by those DNOs as a technique to by-pass the existing interest charges, reporting obligations and other charge restrictions. There appears little justification for the use of rebates. However, so long as rebates are accompanied by interest payments and the other protections afforded to end of year over recovery, British Gas would not have a significant problem with them.

Dramatic mid-year tariff changes are undesirable. However, we do not believe that they will occur if DNOs follow their best endeavours obligations and Ofgem reinforces these by undertaking investigation and enforcement for past licence breach in respect of rebates. However, any mid-year adjustments should attract interest payments and other protections like end of year over-recovery.

8.2 Reductions in charge adjustment notice periods and interest payments

As Ofgem notes (Ofgem Para 3.11), though DNOs have to give five months notice of changes to charges they can make changes with up to 40 days notice by updating the indicative charges using up to date assumptions. Moreover, DNOs currently appear to use the five-month notice period to provide rebates and update their charging statements. Consequently there does not appear to be any reason to shorten the notice period for changes to charges. However, if this were felt necessary it would not cause British Gas significant problems so long as the changes did not happen on a frequent basis and were modest in size.

Because some DNOs operate under the existing framework without the need to resort to rebates it does not appear necessary to provide DNO relief by reducing the level of interest charges. As noted earlier, the current level of interest charges are broadly equivalent to the real gain to the DNO of the over recovery. However, these interest charges are significantly lower than the final cost to customers. Consequently, there are good arguments to increase and NOT decrease the level of DNO interest charges.

9. WAY FORWARD

9.1 Investigation and possible enforcement

Ofgem states that: -

“Prior to.. [April 2005].. Ofgem intends to rely on enforcement of existing licence conditions should any companies propose to pay rebates rather than reduce charges in subsequent years.”

The reference to use of enforcement appears to confirm that Ofgem has concluded that the use of rebates by DNOs has been in contravention of their existing licence conditions.

There is further evidence that this could be an abuse as: -

- Only some and not all DNOs have used rebates; and
- This is a recent phenomenon.

There appears to be a strong case for Ofgem carrying out an investigation with respect to possible breaches of DNO licence conditions in light of: -

- Ofgem's views of licence breach;
- DNOs apparent confirmation of licence abuse;
- The materiality of the cost to customers; and
- The importance of ensuring correct behaviour in those elements of the supply chain where competition does not exist.

Where a breach is found there appears to be a strong case for enforcement action.

This investigation and possible enforcement action would not only provide possible recompense for effected parties but would also act as a deterrent to future breaches.

9.2 Changes to the regulatory framework

If Ofgem concludes that there has not been any breach of DNO licence obligations then consideration should be given to amending the existing price control formula as soon as possible (before the end of this price control period of 31 March 2005, on a retrospective basis) so that it has the financial effects that were originally intended. Namely, that any over recovery of charges face the same financial incentives (interest payments) irrespective of whether they are: -

- Year-end over recoveries;
- Measured when DNOs adjust their charges within-year; or
- Measured when DNOs give rebates.

Additionally, consideration should be given to adding the other reporting and charge restriction obligations applying to year-end over recoveries to rebates and within-year adjustments to charges.

For the start of the next price control period (1 April 2005) in addition to the immediate changes noted above, consideration should be given to increasing the level of interest charges to bring them more in line with the effect on customers.

Tahir Majid/Regulatory Affairs/British Gas/ 29.09.2003