



Our ref.

Your ref. SI/JH/Rebate

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Dear Gary

### **ELECTRICITY DISTRIBUTION REBATES TO SUPPLIERS – CONSULTATION DOCUMENT, JULY 2003**

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

This letter represents the response of CE, NEDL and YEDL to Ofgem's "Electricity distribution rebates to suppliers" consultation document.

In summary we believe that:

- under the current framework, rebates provide the only practical means of returning money to suppliers;
- a reduction in the notification period to 40 days could be adopted immediately to enable within year tariff changes to be made in a timely manner;
- consideration should be given to the introduction of a regime that has some form of incentive (in a symmetrical treatment this also means penalty) built in to reward the accuracy of recovery of income; and
- any change in the mechanism needs to be able to accommodate the potentially significant shifts in allowed income that can occur which are not due to the actions of the DNO (e.g. within-year changes in NGC exit charges).

Each of these points is detailed further within the body of the response. We have also sought to respond to each of the specific points on which you requested views.

### ***Merits and disadvantages of the initial thoughts***

We concur with Ofgem's view that distribution charges should be cost-reflective, transparent and predictable, and should facilitate competition in supply. As such we are participating actively in the structure of charges consultation process and believe that, over time, this will provide a long-term solution to the issues identified.

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Whilst development of such long-term solutions takes place we believe that the current arrangements also require some interim attention. It is our view that the onerous five-month notification period means that the only pragmatic method of managing over-recovery, particularly when it arises as a result of a matter outside of the control of a DNO, is to issue a rebate.

The five-month period has two effects that were probably not envisaged when it was first introduced. Firstly, due to the nature of the settlements and billing processes, the first view of actual income for a year does not become available until the end of May. Given this, the earliest that a five-month change could be implemented is actually early November – and even then such a change would only have been based on one month's data. The second is that such a long delay, as we have discussed in our previous response on this issue, means that income would be likely to take on a sawtooth profile, to bring it back on track and subsequently to reset for the following year's income. This is clearly the kind of instability that is recognised as being undesirable within Ofgem's Objective 2.

We believe that implementing a revised time period for notification of changes to charges is therefore an appropriate interim step to alleviate this issue. Whilst within the document 60 days has been discussed as an appropriate alternative time period, we believe that there may be scope to reduce the period to 40 days, bringing it into alignment with the terms of the DUoS agreement.

In making any change to the period of notice cognisance must be taken of the original intention of the notice period – namely to deal with risks associated with intra-PES communication that was perceived might cause issues prior to business separation. At the very least, therefore, it would be reasonable to review the five months' notice requirement for those DNOs in whose licences standard conditions 39 and 40 are not active. However, given that in other forums (such as BSC, MRA and CUSC) changes can be achieved satisfactorily within periods even shorter than either 40 or 60 days, it is clear that time is not the major driving factor. Indeed, we have frequently found that suppliers pay little attention to the publication of our indicative charges, in the main only raising questions when the final charges are published – at 40 days' notice.

In the light of this, we would strongly advocate that Ofgem issue an amendment to SC4 of the distribution licence to introduce a revised notice / consultation period within the current price control period, and ideally within the current regulatory year.

A further consideration that we believe could usefully be factored into the discussion would be the establishment of some levels of tolerability in terms of both over- and under-recovery. This could be used to address the issue that penalty interest rates are applied in the event of any form of over-recovery.

In our view the lack of symmetry in the approach to over- and under-recovery is inappropriate. We believe that under-recovery, which ultimately leads to higher charges in the subsequent year, is also undesirable because it contributes to the instability of prices from year to year.

Consideration should therefore be given to establishing a regime that has "dead bands" of, say,  $\pm 2\%$  variance from actual to allowed income where no interest charges would be levied. The actual size of the "dead band" should be dependent upon an assessment of the sensitivity of actual income to factors not within the control of the DNO. Such a proposal would have no impact on the requirement for DNOs to reduce / increase allowed income in the subsequent year following any under- or over-recovery.

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Outside the “dead band”, further banding of interest charges could be introduced to reflect the tolerability of the performance. These bands could operate in conjunction with the red and amber lights that currently supplement the obligation to use best endeavours to set charges that will not result in the maximum charge per unit distributed being exceeded. Such an approach could be introduced without significant impact on DNOs.

### ***Other issues***

- Two other issues require consideration as part of the discussion on the use of rebates: The current licence requirement on a licensee to use 'best endeavours' to set charges that avoid breaching the maximum amount per unit distributed under the formula; and
- How to manage within year adjustments that arise from changes in underlying charge setting assumptions – particularly those outside of the control of DNOs.

### **Current licence obligation**

One issue that receives no mention within the consultation, and yet is fundamental to the issue of rebates, is that of the licence condition requiring DNOs to use “best endeavours” to set charges that avoid breaching the maximum amount per unit distributed under the formula. On the basis that this requirement does not merely apply at the moment that charges are published, but endures throughout the year, then DNOs must react accordingly if they become aware of any over-recovery issue.

Clearly, the choice must then be made between tariff reductions or a rebate. As identified above, the difficulties of the current mechanism mean that rebates are currently the best means to comply with this.

It is therefore essential to recognise that if any changes are made to the current mechanism then this underlying obligation will also need to be re-considered.

### **Underlying charging assumptions**

We believe that the discussion presented in the document does not deal sufficiently with the potential significant issue of within-year adjustments to underlying charge-setting assumptions. By these we specifically mean the factors over which DNOs do not have control, e.g. NGC exit charges.

It is clear that, if NGC change their exit charge projections, this creates a significant risk to DNOs of over- or under-recovery: indeed, there is a very real possibility that this could occur early in 2004/05 if the implementation of PLUGS is delayed for any reason. If it is the intention to cease rebates post-2005, then an alternative mechanism needs to be found to ensure that DNOs can manage such changes appropriately.

Yours sincerely

**Joseph Hart**  
**Head of Network Pricing**

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