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Dear Gary

Electricity distribution rebates to suppliers – A consultation document 74/03

I am pleased to provide East Midlands Electricity's response to this consultation document.

As indicated in our response to your earlier information request, East Midlands Electricity has used rebates in the past to return relatively small amounts of DUoS income that would otherwise have become over-recovery at year end. Rebates have effectively 'tidied up' allowed income within the relevant years, and avoided impacts on prices in following years. Where we have made rebates these have been less than 2% of DUoS revenue.

We view rebates as a useful tool that allows us to manage our recovery position and maintain relatively steady prices from year to year. Also, as detailed more fully later in this letter, rebates facilitate less volatile prices than would be the case if the proposed shorter notice 'mid year' price changes were used. It would be regrettable if this tool was made completely unavailable to DNOs because of 'excessive' use by some.

Ofgem's concern about the return to customers of value rebated to suppliers is understood. However, in the competitive supply market it is for individual suppliers to decide whether they pass on to customers the value of rebates (or, indeed, DUoS tariff reductions or any other changes to their cost base). Short term DUoS price reductions are unlikely to be any better than rebates in this respect. Indeed, increased volatility of DUoS year-on-year and within year might cause suppliers to view DUoS as a more risky element of their cost base, and therefore to build in higher risk premiums when pricing their tariff offerings.

Ultimately it is market pressures that dictate suppliers' pricing policies. Any supplier that passes on to customers the value of rebates (or other reductions to their cost base) will enjoy an enhanced competitive position relative to any that don't.

In view of the points made above, we believe that steady prices over time are the most effective way of ensuring that customers feel the benefits of the DNOs' price controls. Allowing DNOs to fine tune their end of year recovery positions could play a part in ensuring

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stable prices. Given this, we believe rebates should continue to be allowed, subject to prescribed limits, and we believe an upper limit of 2% of allowed revenue could be appropriate.

The following sections address the various specific questions raised in the consultation document:

Whether there are any circumstances in which rebates could be considered cost-reflective

If DUoS tariffs are cost reflective then any proportionate return of DUoS paid could also be deemed to be cost reflective. In any event, if the amounts being returned represent only a small fraction of the charges collected, it is probable that they will be well within the limits of uncertainty surrounding any 'cost reflective' model of DNO costs.

Whether rebates distort competition in supply

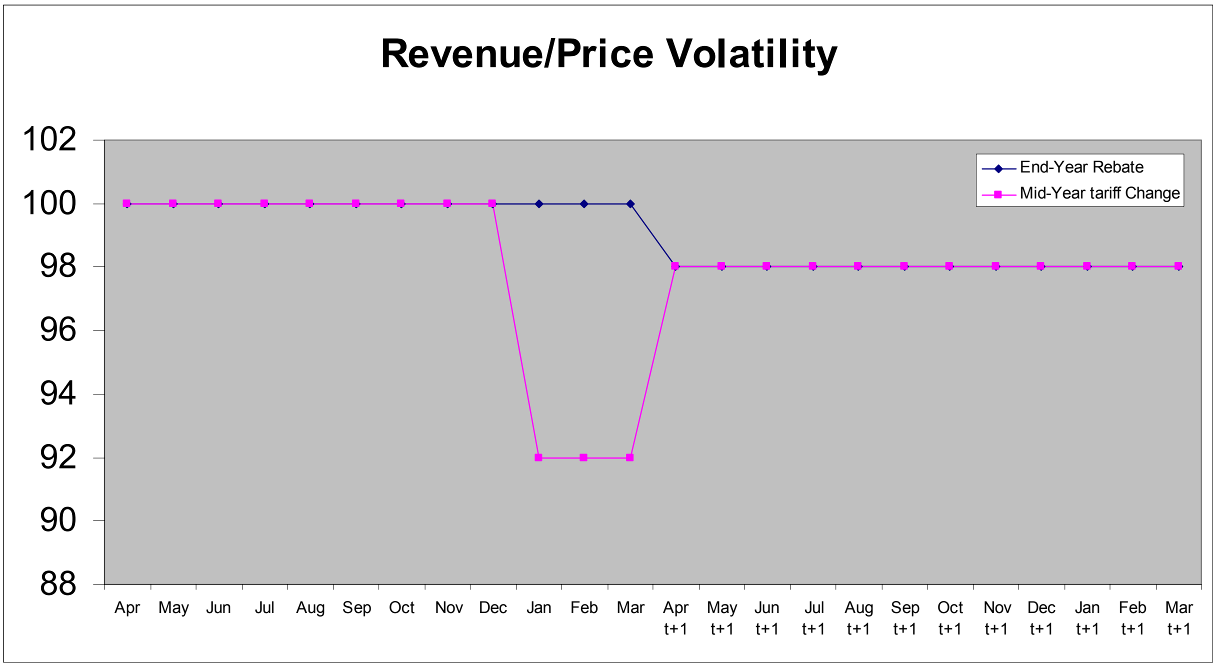
We have no reason to think that rebates distort competition in supply. As outlined above, it is for each supplier to decide its pricing policy in the competitive market in the light of many different cost inputs.

Whether 60 days is an appropriate length of time for DNOs to propose minor tariff adjustments

The suggestion that minor tariff adjustments could be made with short notice is not as attractive as it might first seem.

To illustrate this with an example; if a DNO recognised half way through a regulatory year that over-recovery seemed likely, it would have to analyse the extent of tariff adjustment necessary, work out the details of the changes to each of its many individual tariffs, obtain approval from senior management for the changes, submit appropriate information to Ofgem, and publish details of the tariffs to suppliers 60 days ahead of implementation. In practice this is likely to mean that revised tariffs have only 3 or at best 4 months to take effect. In these circumstances the decrease required to return even a small over-recovery could be large (e.g. 8% to return a 2% over-recovery in 3 months). It would be necessary to allow quite large changes to tariffs to avoid over-recovery, certainly more than the 5% suggested, and, because these are always based on forecasts, the DNO would still run a risk (though an admittedly lower risk) of under- or over-recovering.

In addition to this, tariffs are likely to have to return to somewhere near their former levels the following year, so, with five months notice, these further tariff changes would be announced before the lower tariffs had even come into effect. In comparison to a clean rebate, this seems a recipe for confusion and error, without any compensating improvement in the likelihood of pass-through to customers. The effects described above are illustrated graphically on the following page, and fuller details are contained in the separate spreadsheet sent with this response.



Whether it would be appropriate to reduce interest rate penalties on over-recovery

We believe that equalisation of the interest rates applying to over and under-recovery would be helpful. Equalisation should mean that DNOs were neutral to the timing of recovery, and allow a longer term approach – facilitating a smoother path of prices over the duration of a price control.

I hope these comments are helpful. Please contact me if you would like to discuss them further.

Yours sincerely

Andrew Neves
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