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Mr Gary Keene
Distribution Policy Analyst
Ofgem
9 Millbank
London
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30th September 2003

Dear Mr Keene,

Re. Electricity distribution rebates to Suppliers – Consultation Document

Please accept this response to the above consultation as reflecting the views of Innogy plc and its subsidiary supply companies.

Innogy supports Ofgem's view that distribution charges should be cost reflective, transparent and predictable. Furthermore the actions of the DNOs should not be allowed to distort competition in supply.

However, we believe that Ofgem's concerns relating to the recent practice of distribution rebates to suppliers have been over stated, if not misconstrued and that some of the proposals outlined in the paper will lead to increased market distortion and rises in supply costs which will ultimately be borne by the customer.

The existing penalties for over recovery are factored into the price control to incentivise accurate forecasting by the DNOs. Ofgem's analysis reveals rebates of £90 million over three years. Based on the total revenue base of £6 billion this equates to an over recovery across the industry of less than 1.5%. Yet present penalties do not apply until over recovery exceeds 3%. This and Ofgem's summary of those DNOs involved in the issue of rebates illustrates that the problem is localised to inaccurate forecasting by a small number of companies. Indeed only two DNOs issued rebates in 2002/3.

Ofgem acknowledges that of the rebates paid those associated with larger Business Customers, approximately half of the payment concerned, should filter through to the customer via pass through DUoS charges. We would argue that the remaining rebates relating to smaller customers will also be passed on to the consumer via the operation of competitive forces.

Suppliers offer prices that include margins sufficient to cover the risk of uncertainty in the cost of supply, in particular that associated with the forward price of energy. In addition Suppliers will forecast movements in transportation charges by reference to the price control. Thus if a DNO sets charges that over recover it is likely that Suppliers will find anticipated margins eroded, until rebates restore the anticipated position. Consequently it would appear that the current mechanism does not disadvantage customers, although it may create cash flow difficulties to Suppliers.

The proposed mechanism of reducing notice periods for change to 60 days removes incentive on DNOs to correctly forecast whilst increasing the administrative burden on suppliers. Frequent changes in DUoS charges would cause significant additional cost to the management of billing systems. Due to the inconsistencies between DNO charging structures any price revisions have to be manually applied to our billing systems. This process takes a minimum of 5 days per system, adding significantly to supply costs, thus increase prices to end consumers. In the case of fixed-term contracts, the facility for DNOs to revisit charges at frequent intervals would create difficulties both in setting prices and recovering additional costs, even if contracts allowed such recovery.

Suppliers will be forced into frequent price revisions to manage fluctuations in charges or alternatively to increase margins to accommodate the additional risks proposed in respect of distribution charges.

In light of this we would propose that Ofgem conduct further analysis, before undertaking corrective action, to determine if their concerns surrounding rebates to suppliers are justified, or whether market forces are sufficient to ensure that the benefit is returned to the customer.

As stated previously we believe that this not a general issue but restricted to a small number of DNOs. Therefore the main policy proposal of scrutinising the reasonableness and justification of future rebates should be sufficient.

However we acknowledge that changes proposed within the forthcoming price control may undermine the ability of DNOs to forecast cost accurately to avoid over or under recovery. If this were the case then a more appropriate approach might be to modify the penalty system by the adoption of scaled interest charges incurred for inaccuracies. Currently penalties are imposed if over recovery exceeds 3%. Ofgem’s own analysis indicates that this is achieved by most DNOs. By introducing an increased scale of penalty at 1%, 3% and 4%, Ofgem could strengthen the existing incentive, whilst recognising the increasing impact of external factors. However for the reason illustrated above, any changes to the interest charges should not be introduced before April 2005.

We trust that you find our comments helpful. We would be willing to discuss them further at a time convenient to you.

Yours sincerely

Zoë Keeton
Economic Regulation