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Dear Gary

Date: 29 September 03

### **Electricity Distribution Rebates to Suppliers**

I am writing with SSE's response to Ofgem's recent consultation on the above.

In summary, we are concerned about any reduction in a DNO's flexibility to deal with revenue over- and under- recovery positions against the allowable revenue set out in the distribution price controls. Rebates to suppliers towards the end of the financial year are currently one mechanism available to DNOs to mitigate the risk of an over-recovery. We therefore welcome Ofgem's objective to avoid undue risks to DNOs and have set out below comments on Ofgem's specific proposals in the consultation paper.

Ofgem notes in the consultation paper a number of factors which contribute to the difference in outturn distribution revenue versus forecast revenue and which can hence lead to over- or under-recovery of allowable income. Looking to the future, we see this picture being further complicated by the potential growth of certain types of distributed generation. Furthermore, the calculation of distribution allowable revenue itself could become more difficult to predict with a greater proportion subject to incentive schemes of various kinds and the possible introduction of new and unpredictable generation use of system charges. We note also, in the context of the distribution charge structure review, that Ofgem has expressed a preference for a greater emphasis on unit based charges rather than fixed charges. This would increase the volatility of actual revenue and thus the risks of an over- or under-recovery position developing during the charging year.

There is thus every reason to expect that DNOs will continue to see “recovery positions” (i.e. differences between allowable and actual distribution business revenue) developing in a particular financial year after charges for that year have been set. As Ofgem is aware, by the time the final recovery position for a particular financial year is known, the next financial year is already underway with charges in operation that have been notified some time earlier. There is therefore a lag of at least a year before the outturn recovery position for a particular year can be addressed, in the absence of rebates or other measures to influence the recovery position within the financial year concerned. Over this period, distribution charges might be reduced followed by an increase or vice versa, giving an unstable path of charges (possibly extending over a number of years) as significant recovery positions are unwound. Indeed, avoiding this disturbance to distribution tariffs is one of the reasons given by DNOs who have given rebates to explain their actions.

We agree that it is appropriate for Ofgem to consider the other constraints on DNOs in setting and adjusting charges, some of which may act to exacerbate the potential disturbance in tariffs described above. Avoiding such disturbance to distribution tariffs would be welcomed by suppliers and their customers and hence would support competition in supply. In this respect, Ofgem’s objective for charging stability, as discussed in section 5 of the document, should take precedence over a high degree of cost reflectivity of distribution charges in any particular year. In our view, the key to greater stability in distribution charging is to allow DNOs to manage a recovery position over a number of financial years with a view to keeping the charges stable within that time frame.

We welcome Ofgem’s proposal to reduce the notice period for making changes to distribution charges and to consider reducing the interest charges on over-recovery positions. We suggest that a regulatory tolerance of existing and projected over-recoveries is the key to achieving stability in distribution charging. Together with the proposals on reduced notice periods, this would result in a climate whereby DNOs could adjust charges in small increments over time to keep in step with forecasts of allowable revenue without triggering tariff disturbances through undue focus on the recovery position in any particular single year.

The licence conditions affected by this would be the following:

1. **Special Condition C, paragraph 1** – the “best endeavours to ensure” that charges are not set to exceed allowable revenue should be relaxed to allow a small margin of over-recovery when charges are set, for example 3%;
2. **Special Condition C, paragraph 1** – the definition of  $I_{dt}$  should be changed to remove the penalty interest rate above the average specified rate if there is an over-recovery, thus leaving DNOs financially neutral to the existence of an over-recovery;
3. **Special Condition D, paragraphs 1 and 2** – the over-recovery percentages at which the restrictions on charge-setting come into play should be changed to reflect the “allowed percentage of over-recovery” specified in Condition C paragraph 1. If this is set to 3%, for example, then the operative percentages in paragraphs 1 and 2 should be 6% and 7% respectively.

The current requirement for 5 month's notice of amendment to use of system charges is contained in paragraphs 13 and 14 of Standard Condition 4. Ofgem's proposal for the notice period for minor changes to charges is 60 days. We note that the contractual requirement under the distribution use of system agreement is for 40 days notice to be given to suppliers and consider that there is no additional value in having two notifications given 20 days apart. It would thus seem sensible to adopt the contractual 40 day notice period for such minor changes to charges. To ease administration for suppliers, there could be a requirement for the effective date for any increase in charges to coincide with the start of a calendar quarter.

Ofgem's suggestion is that the definition of "minor" changes to charges is to be at or less than 5%. We have reservations about a potential increase of 5% on a reduced notice period as such a change, feeding through to a change in retail prices of about 1% is significant compared to supply business margins. We therefore suggest that there is a limit of 3% on any proposed increases that can be effected by the reduced notice period.

Together, these elements would allow a DNO to be more financially neutral to a developing over-recovery and would allow more frequent, small changes to charges. Both of these factors should contribute to a more stable path of distribution charges, which would be in the interests of DNOs, suppliers and customers, and we would be in favour of introducing them as soon as is feasible.

I hope these comments are helpful.

Yours sincerely

Rob McDonald  
**Director of Regulation**