

Electricity distribution rebates to suppliers

Decision document

December 2003

Summary

This document sets out the changes that Ofgem intends to make to the regulatory framework for rebates of distribution charges to suppliers. This follows the publication of a consultation document in July 2003 on the issues associated with rebates from distribution network operators (DNOs) to suppliers. The document also contains information on all rebates provided by DNOs to suppliers since April 2000.

The purpose of this document is to set out a revised regulatory framework that provides DNOs with appropriate incentives to set distribution use of system (DUoS) charges based on accurate forecasts of actual and allowed revenue.

Since April 2000, seven DNOs have provided a total of 14 rebates to suppliers. A rebate typically takes the form of a credit against future charges for the use of the distribution system. By providing a rebate, a DNO may avoid the penalties that would be associated with recovering more than the revenue allowed by the price control framework. The provision of rebates appears to be inconsistent with the development of charges that meet the principles of predictability, transparency and cost reflectivity. These principles are set out as some of the objectives of Ofgem's review of the structure of electricity distribution charges.

The main decisions on proposed changes to the regulatory framework to apply from April 2005 are that:

- ◆ DNOs should only be allowed to give rebates with the prior consent of the Authority
- ◆ the notice period for DUoS tariff changes will be reduced to three months
- ◆ a 'deadband' will be introduced within which penal interest rates will not be levied for over or under recovery of less than or equal to two percent of allowed revenue. The interest rate in this band will be equivalent to the 'base rate' plus one and a half percent
- ◆ the penal interest rate levied on the whole amount of any over recovery if it is greater than two percent of allowed revenue will be reduced to 'base rate' plus three percent and

- ◆ DNOs will be required to include information on any recent or proposed rebates in an annex to DUoS charging statements.

Ofgem welcomes comments on the implementation of the decisions set out and the issues discussed in this document - in particular it would be helpful to receive proposals on the form of any changes to standard or special conditions of the electricity distribution licence. Comments should be received by 20 February 2004.

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1. Introduction

Purpose of this document

- 1.1. Ofgem's principal objective is to protect the interests of consumers, including future consumers. The July 2003 consultation document¹ outlined Ofgem's concerns about the impact of rebates from distribution network operators (DNOs) to suppliers.
- 1.2. The main purpose of this document is to set out Ofgem's decisions on changes to the regulatory framework for rebates of distribution charges to suppliers. The decisions set out in this document will put in place a revised regulatory framework from April 2005. This framework should provide DNOs with appropriate incentives to set distribution use of system (DUoS) charges based on accurate forecasts of actual and allowed revenue. Therefore, the decisions contained in this document will aim to protect consumers by facilitating the development of charges that meet the principles of predictability and transparency.
- 1.3. This document also identifies those DNOs that have given rebates since April 2000. This will increase the transparency of historic DUoS charges.

Legal context

- 1.4. In areas where companies retain an effective monopoly over the provision of services, Ofgem has put in place price controls and other incentive regimes to protect the interest of customers. Under the distribution price control framework, an interest rate is applied to any year-end over or under recovery. The resulting sum is then carried over to be set against the DNO's allowed revenue in the following regulatory year. Currently, a penal interest rate equivalent to the average specified rate² ('base rate') plus four percent is applied to any over recovery. The 'base rate' is applied to any under recovery.

¹ 'Electricity distribution rebates to suppliers. A consultation document' 74/03

² Defined in special conditions of the distribution licence as 'the average of the daily base rates of Barclays Bank plc current from time to time during the period in respect of which the calculation falls to be made'.

- 1.5. In addition, special condition C³ of the electricity distribution licence provides powers for the Gas and Electricity Markets Authority (the Authority) to affect the charges of any DNO that breaches specified trigger levels for year-end over and under recovery. The current trigger levels for over recovery are three percent in one year and an aggregate of four percent in two successive years.
- 1.6. Standard licence conditions 4-4B (SLCs) of the electricity distribution licence⁴ place obligations on DNOs in providing connection and use of system. These include procedures for developing transparency in charges, a requirement to be non-discriminatory in provision of connection and use of system, and a requirement to offer terms for connection and use of system.

Policy context

- 1.7. The July document outlined suggested changes to the regulatory framework. These included the imposition of greater restrictions on rebates, a shorter notice period for minor tariff changes and a reduction in the interest rate applied to year-end over recovery. The responses to the July document are summarised in appendix 1. All non-confidential responses are available on the Ofgem website (www.ofgem.gov.uk).
- 1.8. The July consultation document set out five objectives of this project. The achievement of these objectives by the decisions set out in this document has largely been considered as part of the summary impact assessment in chapter 2. The objectives are:
- ◆ consumers pay cost-reflective charges
 - ◆ charging stability
 - ◆ facilitate competition
 - ◆ avoid undue risks to distribution companies and

³ 'Restriction of distribution charges: adjustments'. A copy of this condition is included in appendix 4.

⁴ The standard licence conditions of the electricity distribution licence as determined by the Secretary of State on 27 September 2001 are available from the DTI website

(www.dti.gov.uk/gas_and_electricity/regulation_policy/licences/index.shtml). Information on subsequent licence modifications is available from the Ofgem website (www.ofgem.gov.uk)

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- ◆ minimum impact on workload.
- 1.9. The main related policy areas are the corresponding arrangements in gas, the review of the structure of electricity distribution charges and the distribution price control review. The linkages are outlined briefly below.
- 1.10. The relevant arrangements and obligations set out in NGT's gas transporters licence are that:
- ◆ NGT must provide a minimum of 28 days notice of any tariff changes with the use of its best endeavours to provide at least 150 days notice⁵
 - ◆ an interest rate equivalent to the base rate plus three percent is levied on any year-end over recovery. The 'base rate' is applied to any under recovery at the end of the year and
 - ◆ the Authority may take action against NGT if their level of over recovery is greater than four percent in one year or an aggregate of six percent in two successive years.
- 1.11. The decisions in this document should complement the work undertaken as part of the review of the structure of electricity distribution charges. On 26 June 2003, Directive 2003/54/EC⁶ was adopted by the European Commission. Article 23 (2) of the directive states that regulatory authorities shall be responsible for fixing or approving the methodologies used to calculate or establish terms and conditions for connection and access to networks, including distribution tariffs. In the light of the provisions contained within the directive, Ofgem has decided to take forward the proposal for the introduction and approval of charging methodologies for DNOs. This proposal will take the form of proposed licence modifications. These modifications are expected to be set out in the April 2004 document on the structure of charges. Further details about this proposal and about the directive are contained in the November 2003 initial decision document on the structure of charges⁷.

⁵ As set out in standard licence condition 4: 'Charging of Gas Shippers – General'

⁶ concerning common rules for the internal market in electricity and repealing Directive 96/92/EC.

⁷ 'Structure of electricity distribution charges. Initial decision document' 142/03

1.12. As set out in the November document on the structure of charges, the objective of the review is to develop robust long term charging structures for connection to and use of the distribution system. Paragraph 4.5 of the November document described five charging principles that are consistent with the objectives of the review:

- ◆ cost reflectivity
- ◆ simplicity at the point of use
- ◆ ease of implementation
- ◆ transparency and
- ◆ predictability.

1.13. Some of the decisions set out in this document will be implemented in the revised special conditions to be developed as part of the distribution price control review. The new special conditions primarily refer to the operation of the price control and will come into force on 1 April 2005. Changes to the price control may influence the extent to which DNOs can predict the revenues arising from activities regulated under these controls. Further information on the distribution price control review is available from the Ofgem website.

Outline of this document

1.14. Following chapter 1, the outline of this document is as follows:

- ◆ Summary impact assessment (chapter 2); this chapter outlines the issues associated with electricity distribution rebates. It assesses the impacts of both the current framework and the revised arrangements
- ◆ Timetable and responses (chapter 3); this chapter sets out the timetable for this project and the associated review of the structure of charges. Although this is a decision document, the implementation of the decisions will not occur until April 2005. Therefore Ofgem welcomes comments on the document, which may be taken into account in implementation of the proposed licence modifications

- ◆ Decision chapter (chapter 4); this chapter summarises Ofgem's decisions for revisions to the regulatory framework. These decisions are explained in further detail in chapter 5. Chapter 4 also outlines the proposals suggested in the July document and the responses that Ofgem received
- ◆ Changes to the regulatory framework (chapter 5); this chapter discusses in more detail the revisions that Ofgem intends to make to the regulatory framework. This includes a consideration of the process of implementing these revisions and
- ◆ Historic rebates (chapter 6); this chapter contains information on rebates that have been given since April 2001 and identifies the DNOs that have given rebates.

2. Summary impact assessment

Issue

- 2.1. This summary impact assessment refers to the revised regulatory framework to apply from April 2005.
- 2.2. A distribution business should set charges to recover the annual revenue allowed by its price control. However, the final levels of both actual and allowed revenue are uncertain. Unexpected variations in the level of actual revenue will be caused primarily by deviation from forecasts of the number of units distributed, for example owing to unpredictable weather. Incentive arrangements, such as the losses incentive, will drive changes to the revenue allowed by the price control mechanism. A DNO can change its DUoS tariffs during the regulatory year. However, it is obliged by its licence to provide five months notice of any amendment to DUoS tariffs unless it has obtained the prior consent of the Authority.
- 2.3. Consequently, at the end of the year, a DNO may recover more or less than its allowed revenue. An interest rate is then applied to the difference between allowed and actual revenue. The resulting sum is then carried over to be set against the DNO's allowed revenue in the following regulatory year.
- 2.4. Over the three years since the start of the current distribution price control in April 2000, seven DNOs have given a total of 14 DUoS rebates to suppliers. The total value of these rebates is approximately £90m. The cost of distributing electricity annually is about £3bn and DUoS charges comprise about 25-30 per cent of a typical domestic bill.
- 2.5. The current regulatory arrangements with regards to rebates do not adequately protect the interests of consumers. Rebates breach some of the charging principles set out as part of the review of the structure of charges. For example, rebates are not transparent to users because details of a rebate are not contained in the DUoS statements that the DNOs are obliged by licence to provide to any party on request. Responses from users to the July document highlighted the fact that they were unaware of rebates.

- 2.6. In addition, DNOs could potentially use the rebate mechanism to overcharge during the year and avoid paying interest on the over recovery by returning it as a lump sum credit to suppliers. Users have expressed concerns that consequently some rebates may have been neither cost-reflective nor passed on by suppliers to consumers, even those who have pass through contracts with suppliers. This may mean that customers are paying higher DUoS charges throughout the year without benefiting from the rebate.

Impacts

- 2.7. A rebate represents an unpredictable change to DUoS charges. This may adversely affect suppliers and consumers. The provision of a rebate affects a supplier's cashflow position as it is typically given as a credit on the first DUoS bill received by the supplier after the implementation of the final rebate.
- 2.8. It is unclear what impact the provision of rebates has on competition in the supply market. One respondent to the July document stated that the provision of rebates favours new entrants rather than incumbent suppliers when the value of the rebate for each supplier is based on the number of customers registered when the rebate is given, rather than the average over the regulatory year.
- 2.9. Ofgem believes that there is no direct impact on competition in other areas of the electricity industry. For example, generators connected to the distribution network do not currently pay DUoS charges.

Objective

- 2.10. The proposals set out in this document will put in place a revised regulatory framework from April 2005. This framework should provide DNOs with appropriate incentives to set DUoS charges based on accurate forecasts of actual and allowed revenue. Therefore, the decisions contained in this document will aim to protect consumers by facilitating the development of charges that meet the principles of predictability and transparency.

Impacts

- 2.11. The revised arrangements will affect the obligations placed on and the incentives faced by DNOs. From April 2005, they will be required to obtain consent from

the Authority before giving a rebate and will be obliged to publish information on rebates as part of their use of system charging statements.

- 2.12. However, there will be a reduced maximum notice period for amendments to DUoS tariffs. In addition, DNOs will face an incentive to set charges based on accurate forecasts of revenue in order to achieve a level of over or under recovery within the specified limits of the 'deadband'.
- 2.13. The reduced notice period will affect suppliers and users. The requirement for DNOs to publish information on rebates will increase the transparency of DUoS charges to users.

Options

- 2.14. The options considered in this SIA are the:
- ◆ introduction of a revised regulatory framework from April 2005 and
 - ◆ the maintenance of current regulatory arrangements.
- 2.15. The impacts associated with the introduction of a revised regulatory framework are discussed in the following sections. The impacts of the current regulatory arrangements have been discussed earlier in this summary impact assessment.
- 2.16. There are numerous other possible options, particularly if there is a consideration of differentiation between measures such as a two month or four month notice period. However, it is not appropriate to consider all of these options as part of a summary assessment.

Revised regulatory framework to apply to rebates

- 2.17. The main decisions on proposed changes to the regulatory framework to apply from April 2005 are that:
- ◆ DNOs should only be allowed to give rebates with the prior consent of the Authority
 - ◆ the notice period for DUoS tariff changes will be reduced to three months

- ◆ a 'deadband' will be introduced within which penal interest rates will not be levied for over or under recovery of less than or equal to two percent of allowed revenue. The interest rate in this band will be equivalent to the 'base rate' plus one and a half percent
- ◆ the penal interest rate levied on the whole amount of any over recovery if it is greater than two percent of allowed revenue will be reduced to 'base rate' plus three percent and
- ◆ DNOs will be required to include information on any recent or proposed rebates in an annex to DUoS charging statements.

Benefits

- 2.18. Consumers and suppliers will benefit from increased predictability of DUoS charges. There will not normally be any ex post changes to charges. In addition, suppliers and customers will be less likely to be overcharged during a year. If they are overcharged, they will receive at least some interest in the reduction in charges in the following year. Charges should also be more cost reflective, providing efficiency benefits.
- 2.19. The DNOs should benefit from the reduced notice period as it may enable them to consider more information when proposing an amendment to charges. In addition, those DNOs that manage to achieve a level of under or recovery within the 'deadband' will benefit from the associated non-penal interest rate.

Risks

- 2.20. The introduction of a requirement for consent may introduce costs and risks for DNOs in attempting to obtain consent from the Authority for a planned rebate. However, the introduction of the requirement for consent is implied by Directive 2003/54/EC. The introduction of a shorter notice period and a 'deadband' for under and over recovery should mitigate this risk. The directive is discussed in further detail in paragraph 1.11 of this document.

Costs

- 2.21. Suppliers have expressed concern that a shorter notice period will result in an increase in supply costs driven by more volatile DUoS charges. However, the proposed arrangements will not increase the potential frequency of tariff changes and consequently should not impair charging stability. For example, under the current five months notice period, EDF Energy Networks (LPN) and EDF Energy Networks (SPN) are amending their charges in December 2003 and April 2004.
- 2.22. In response to an application from Energy Networks Limited (ENL) for an electricity distribution licence, Ofgem has proposed a modification to the licence that would be granted. This modification would introduce a charge restriction condition. This condition would cap the charges for domestic users to the level of those levied by the DNO within whose distribution service area the ENL network is operating. Therefore, the shorter notice period will reduce the time that ENL has to change its charges, if necessary, in response to a change in the charges to which its charge restriction condition is linked. However, ENL should also benefit from the shorter notice period.

Other impacts

- 2.23. Ofgem has proposed that new distributed generators will pay use of system charges from April 2005⁸. In so far as the decisions set out in this document contribute to the achievement of the objectives of the review of the structure of charges, there should be a positive impact of facilitating competition, particularly in supply and generation. For example, the development of cost-reflective and transparent changes will facilitate competition in both supply and generation.
- 2.24. The decisions set out in this document are not expected to have significant environmental impacts or significantly different impacts on different groups of consumers.

⁸ In the November 2003 initial decision document on the structure of charges.
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Impact on Ofgem

- 2.25. The proposed changes to the regulatory framework are not expected to represent a significant increased compliance and monitoring burden on Ofgem.
- 2.26. Given the introduction of a 'deadband' and a shorter notice period, it is expected that there will be fewer rebates in the future than have historically occurred. No rebates are planned for April 2004 and only two were issued in April 2003. Therefore, the requirement for consent from the Authority is not expected to result in a significant increase in Ofgem's workload.
- 2.27. Ofgem already receives information on the end of year recovery position as part of the annual price control returns. This is expected to continue in the next price control. In addition, Ofgem does not intend to change the trigger levels set out in special condition C. These trigger levels are back-up measures that Ofgem would only expect to be breached in exceptional circumstances. During the current price control period, no DNO has reported an end of year recovery position that has triggered these levels.

Compliance

- 2.28. DNOs already submit annual price control returns that contain information on end of year recovery. Although there will be some cost incurred in setting out information on past rebates as part of the charging statement, this would initially only apply to DNOs that give a rebate in April 2005 as no DNO has indicated that it plans to issue a rebate in April 2004.
- 2.29. In 2007, Ofgem intends to review the number of DNOs that have reported year-end over or under recovery outside the limits of the 'deadband'. This information will be gathered as part of the analysis of the annual price control returns.

Outcome

- 2.30. The decisions set out in this document will be implemented as part of the review of the structure of charges and as part of the distribution price control review. Information on the objectives of these reviews is set out in their respective documents. Therefore, it will not be appropriate to set an explicit performance

indicator for rebates. However, there may be a need for general monitoring of related information, such as the number of DNOs that seek consent to give a rebate.

3. Timetable and responses

Timetable

3.1. Table 3.1 below sets out the timetable for this project.

Table 3.1

Date	Milestone
July 2003	Consultation document
November 2003	Initial decision document on the structure of electricity distribution charges
December 2003	Decision document (this document)
April 2004	Update document on the structure of electricity distribution charges
November 2004	DNOs announce indicative rebates (if any) for April 2005 Final proposals document on distribution price control review
February 2005	DNOs announce final rebate (if any) Formal consultation on proposed modifications to special licence conditions
April 2005	Implementation of new regulatory regime

3.2. It is expected that the April 2004 update document on the structure of charges will contain proposed modifications to some SLCs. These modifications will implement the decisions set out in this document.

Responses

3.3. It would be helpful to receive comments on the decisions set out and the issues discussed in this document - in particular Ofgem would welcome proposals on

the form of any changes to standard or special conditions of the electricity distribution licence.

Comments should be received by 20 February 2004. Where possible, responses should be sent electronically to gary.keane@ofgem.gov.uk. Responses can also be sent to:

Gary Keane
Distribution Policy Manager
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE
Fax: 020 7901 7478

- 3.4. All responses will be held electronically in Ofgem's Research and Information Centre. In addition, they will normally be published on the Ofgem website unless they are clearly marked confidential. Where possible, consultees should put confidential material in appendices to their responses. Ofgem prefers to receive responses electronically so that they can be easily placed on the website.
- 3.5. If you have any questions regarding the issues raised in this document, please contact Gary Keane on 020 7901 7330.

4. Decision chapter

- 4.1. This chapter outlines Ofgem's decisions for revisions to the regulatory framework for electricity distribution rebates to suppliers. It also sets out the policies that were suggested in the July 2003 consultation document and summarises the key themes that were evident from the responses. The decisions and evolution of Ofgem's thinking are explained in more detail in chapter 5 of this document.

Consultation document

- 4.2. The suggested policies in the consultation document were:
- ◆ the prohibition of rebates after April 2005
 - ◆ closer scrutiny by Ofgem of any rebates proposed for April 2004 and April 2005
 - ◆ a reduction in the notice period to 60 days for minor tariff changes and
 - ◆ lower interest penalties for over recovery against allowed revenue at the end of the regulatory year.
- 4.3. In addition, table 3.1 in the July document included figures on each rebate given since April 2001. However, the table did not identify the DNOs that had given these rebates.

Responses

- 4.4. Ofgem received 16 responses to the document from a range of parties including DNOs, suppliers and demand customers. There is a more detailed summary of responses in appendix 1. All non-confidential responses are available in full on the Ofgem website.
- 4.5. DNOs generally did not favour the prohibition of rebates after April 2005 and highlighted the role of suppliers in passing on rebates to consumers. One respondent noted their concerns about the potentially distortionary impacts of the proposals associated with the elimination of rebates.

- 4.6. However, other respondents strongly criticised the practice of giving rebates because they felt that rebates are not cost-reflective and are not transparent. One respondent said that some rebates distorted competition in supply by favouring new market entrants. Demand customers noted that they had previously been unaware that DNOs have provided rebates to suppliers and stated that they did not believe that rebates had been passed onto users. Some respondents asked Ofgem to identify the DNOs that have given rebates and wanted Ofgem to take action against suppliers and/or DNOs on the issue of rebates.
- 4.7. There was broad support from all groups of respondents for the policy of Ofgem more closely scrutinising rebates in the future.
- 4.8. DNOs typically supported the proposal of a shorter notice period for minor tariff changes. There was some discussion on the appropriate length of the notice period and the development of an appropriate definition of minor tariff changes. However, two DNOs noted that a shorter notice period would not resolve the underlying problems and difficulties associated with setting charges based on revenue forecasts. Other respondents were not supportive of a reduced notice period because they were concerned that it may increase DUoS tariff volatility.
- 4.9. One respondent that supported the introduction of a shorter notice period presumed that a similar change would be made to the licence for gas transporters.
- 4.10. All DNOs supported a reduction in the penal interest rate levied on year-end over recovery. Several DNOs and other respondents favoured the introduction of a 'deadband' in the interest rate arrangements. However, one respondent stated that the penal interest rates for over recovery should actually be increased rather than decreased.

Ofgem's decision

- 4.11. Following consideration of the comments received in responses, information provided by DNOs and views expressed in bilateral discussion, this document sets out Ofgem's decisions.
- 4.12. The main decisions on proposed changes to the regulatory framework to apply from April 2005 are that:

- ◆ DNOs should only be allowed to give rebates with the prior consent of the Authority
- ◆ the notice period for DUoS tariff changes will be reduced to three months
- ◆ a 'deadband' will be introduced within which penal interest rates will not be levied for over or under recovery of less than or equal to two percent of allowed revenue. The interest rate in this band will be equivalent to the 'base rate' plus one and a half percent
- ◆ the penal interest rate levied on the whole amount of any over recovery if it is greater than two percent of allowed revenue will be reduced to 'base rate' plus three percent and
- ◆ DNOs will be required to include information on any recent or proposed rebates in an annex to DUoS charging statements.

4.13. The restriction on paying rebates without consent could be implemented through a requirement to gain consent for a charging methodology, as discussed in the Structure of electricity distribution charges Initial Decision document (142/03) published in November 2003.

4.14. Amendments will be considered to the wording of some of the relevant special conditions in the existing distribution licences. Any amendments will be considered as part of the preparation of special conditions to apply from April 1 2005.

4.15. This will include a review of the 'best endeavours' obligation in paragraph 1 of special condition B⁹ to ensure that the obligation is focused on the setting and reviewing of tariffs rather than the provision of rebates. In addition, amendments may be proposed to the wording of paragraph 1 of special condition C¹⁰ to clarify the Authority's role if a DNO over-recovers by more than three percent in any one year.

⁹ Special condition C for the Scottish distribution businesses.

¹⁰ Special condition D for the Scottish distribution businesses.

- 4.16. DNOs have recently provided notice of indicative changes to charges from April 2004. No DNO has indicated that it plans to issue a rebate in March 2004.
- 4.17. If any DNO issues notice of an indicative rebate to be given in March 2005, Ofgem intends to consider the avoided interest cost in setting the price control to apply for that DNO from April 2005 in order to protect the interests of consumers. This is a change in policy applying to prospective actions of DNOs. Ofgem does not currently intend to change policy to have a retrospective impact in relation to historic rebates.
- 4.18. Tables 6.1 and 6.2 in chapter 6 list all rebates given since April 2001 and identify the DNOs that gave them. The publication of this information will address concerns expressed by some users that they had not been aware that DNOs have given rebates to suppliers.

5. Changes to the regulatory framework

The role of Ofgem

- 5.1. As part of the review of the structure of charges, Ofgem intends to modify SLC 4 of the electricity distribution licence so that DNOs will be required to have their charging methodology approved by Ofgem. Ofgem does not expect to approve methodologies that include the provision of a rebate to suppliers because this would not normally be consistent with the charging principles set out earlier in this document. Therefore, a DNO will only be able to issue a rebate with the prior written consent of the Authority because the rebate will represent a deviation from the charging methodology.
- 5.2. However, the possibility of obtaining consent retains some flexibility for a DNO to issue a rebate if this is the most appropriate response to events that it has little or no control over but significantly affect its income. The requirement for consent will enable Ofgem and the DNO to consider alternative approaches, such as the return of the over recovery over the following year or several years.
- 5.3. Ofgem does not intend to change the over and under recovery trigger levels for potential action by the Authority that are set out in paragraphs 1 – 3 of special condition C of the distribution licence. During the current price control period, no DNO has breached the trigger levels for over and under recovery contained within special condition C. These trigger levels are designed as back-up measures that Ofgem would expect to be breached only in exceptional circumstances.
- 5.4. However, it may be helpful to amend the wording of paragraph 1 to provide the Authority with greater discretion – for example in allowing the more gradual return of over recovery over several years. Action by the Authority is already discretionary under paragraphs 2 and 3.

Notice period

- 5.5. Paragraphs 13 and 14 of SLC 4 state that a DNO shall not amend its use of system charges without giving notice of no less than five months or obtaining the prior consent of the Authority.

- 5.6. Ofgem intends to reduce the notice period from five to three months. This will allow DNOs to react more quickly to events over which it has little control but that significantly affect its income. This decision reflects the views expressed in responses to the information request that Ofgem sent to DNOs in February 2003.
- 5.7. The shortening of the notice period for DUoS tariffs will occur in conjunction with the retention of a longer notice period for changes to charging methodologies as part of the review of the structure of charges. This should protect suppliers, and therefore consumers, from major disruptions to DUoS charges.
- 5.8. As outlined in paragraph 2.22, Ofgem has proposed a licence modification that would introduce a charge restriction condition in response to an application from Energy Networks Limited (ENL) for an electricity distribution licence. Consequently, a change by a DNO to its charges may require ENL to change its own charges. If both distribution businesses are obliged to give five months notice of changes to charges, there could potentially be up to a ten month delay between the announcement of indicative charges by the DNO and the implementation of revised charges by ENL.
- 5.9. Ofgem does not intend to introduce a shorter notice period for minor tariff changes. As a result of a consideration of the responses and further thinking by Ofgem, it is clear that there are significant problems in robustly defining a minor tariff change. In addition, the enforcement of this proposal could result in an increased workload for Ofgem and the industry.

Interest rate arrangements

- 5.10. Within a 'deadband' of two percent plus and minus of allowed revenue, an interest rate equivalent to the 'base rate' plus one and a half percent will be applied to year-end over or under recovery. This interest rate is closer to the cost of debt assumed in the distribution price control review than either the average specified rate or the average specified rate plus four percent.
- 5.11. An interest rate equivalent to the 'base rate' plus three percent will be applied to the whole amount of over recovery when a DNO records over recovery greater

than two percent of allowed revenue. The 'base rate' will be applied to the whole amount of under recovery when a DNO reports under recovery greater than two percent of allowed revenue.

- 5.12. These symmetrical arrangements will incentivise DNOs to achieve year-end recovery within the 'deadband' by penalising levels of recovery that breach the limits of the band. The introduction of a 'deadband' is also designed to recognise the difficulty of accurately forecasting allowed revenue as the price control becomes increasingly more complex - eg with increased connection of distributed generation.

Obligations on DNOs

- 5.13. Under paragraph 9 of SLC 4, a DNO is obliged to provide a copy of its latest charging statements to any person who requests a copy. Paragraph 2 of SLC 4 lists the items that must be included in the use of system charging statement. This list does not include details of any rebates to suppliers. The details of a rebate, which is a retrospective lump sum adjustment to charges, are contained in the notice detailing any amendments to charges that DNOs are obliged to produce under paragraph 13 of SLC 4. However, the DNO is only required to send this notice to the Authority and to any person who has entered into a use of system agreement – this is typically suppliers rather than network users.
- 5.14. Consequently, demand customers have not been aware that distribution companies have been giving DUoS rebates to suppliers. Ofgem intends to modify SLC 4 to oblige DNOs to include information of any rebates given or announced in the last twelve months in an annex to the charging statements. This measure will increase the transparency of DUoS charges.
- 5.15. Special condition B contains an obligation that a DNO shall in setting its DUoS charges use its best endeavours to ensure that actual revenue does not exceed allowed revenue. There were mixed views on whether rebates provided evidence of compliance with or breach of this obligation.
- 5.16. If necessary, amendments will be made to the wording of the 'best endeavours' obligation in special condition B of the distribution licence to ensure that the obligation is focused on the setting of tariffs rather than the provision of rebates.

Process

- 5.17. It is expected that some of the decisions set out in this document will require modification to SLC 4. These include the requirement for consent, the reduction in the notice period and the obligation to provide information on rebates in an annex to the charging statement.
- 5.18. Some of the proposals and decisions set out as part of the ongoing review of the structure of electricity distribution charges will require modifications to some standard conditions of the electricity distribution licence (SLCs), including SLC 4.
- 5.19. Therefore, it will be appropriate to consult on any proposed licence modifications in parallel with modifications proposed as part of the review of the structure of charges. The next document due to be published on the structure of charges in April 2004 is expected to include suggested licence modifications that will incorporate the relevant decisions set out in this document.
- 5.20. The introduction of a 'deadband' and the reduction in the penal interest rate for over recovery will be implemented in the revised special conditions to apply from April 2005. In addition, the revised special conditions will reflect any amendments that are made to the wording of special conditions B and C.
- 5.21. As the special conditions will be revised as part of the price control review, Ofgem does not intend to include draft conditions in this document. The relevant extracts from the current special conditions are included in the appendix to this note.

6. Historic rebates

- 6.1. This chapter contains information on rebates given since April 2000. The DNOs have consented to the publication of this information in this document.
- 6.2. In interpreting the figures, it is important to remember retail prices charged by suppliers will reflect a variety of factors, of which distribution charges comprise 25-30%. Therefore, any impact of changes to DUoS charges or DUoS rebates may be masked by other changes and linkages may not be apparent. In addition, DNOs have given rebates in a variety of forms.
- 6.3. Users on pass-through contracts with suppliers have access to the protection afforded by the associated commercial and legal framework. DNOs are typically not parties to pass-through contracts.
- 6.4. Table 6.1 contains the same information on the size and frequency of rebates as Table 3.1 in the July document but identifies the DNOs that have given rebates. No DNO has announced an indicative rebate for March 2004.

Table 6.1¹¹ – rebates (£m)

DNO Grouping	DNO	2000/01	2001/02	2002/03
CE Electric	NEDL	7.0	0	0
	YEDL	8.2	5.7	8.6
EME	EME	5.1	5.0	0
WPD¹²	South Wales	6.0	6.6	0
	South West	11.1	4.8	5.6
UU	UU	7.4	4.1	0
Aquila	Aquila	0	6	0
EDF	LPN	0	0	0
	EPN	0	0	0

¹¹ The glossary in appendix 3 includes further details on the appropriate name of each DNO.

¹² WPD have had discussions with Ofgem and have informed Ofgem that they have no current intention of making rebates in the future.

	SPN	0	0	0
SSE	Hydro	0	0	0
	Southern	0	0	0
SP T&D	SP Distribution	0	0	0
	Manweb	0	0	0

6.5. The percentages in Table 6.2 reflect the fact that DUoS charges are typically designed to recover the sum of allowed revenue and NGC exit charges.

Table 6.2 – rebates as a percentage of the sum of allowed revenue and NGC exit charges

DNO Grouping	DNO	2000/01	2001/02	2002/03
CE Electric	NEDL	3.9	0	0
	YEDL	3.4	2.3	3.6
EME	EME	1.9	1.8	0
WPD	South Wales	4.2	4.5	0
	South West	5.9	2.5	2.9
UU	UU	3.2	1.6	0
Aquila	Aquila	0	2.0	0
EDF	LPN	0	0	0
	EPN	0	0	0
	SPN	0	0	0
SSE	Hydro	0	0	0
	Southern	0	0	0
SP T&D	SP Distribution	0	0	0
	Manweb	0	0	0

Appendix 1 Summary of responses to July 2003 consultation document

Introduction

- 1.1 Ofgem received 16 responses to the July 2003 'Electricity distribution rebates to suppliers. A consultation document' (74/03). Respondents included distribution businesses, National Grid Transco, suppliers and demand users. All non-confidential responses are available on the Ofgem website (www.ofgem.gov.uk).

The merits and disadvantages of Ofgem's initial thoughts on policy

- 1.2 Ofgem suggested in the July document that the objectives of the review would preclude rebates after April 2005. Prior to April 2005, Ofgem committed to scrutinising more closely the reasons behind and the justifications for any distribution company planning to give a rebate.
- 1.3 DNOs did not favour the removal of rebates because they generally felt that rebates were an appropriate mechanism necessary to respond to potentially significant allowed revenue variations driven by events outside a DNO's control. Several DNOs felt that Ofgem should instead concentrate on using its existing powers to review rebates more closely.
- 1.4 One DNO expressed concern that the elimination of rebates would increase the volatility of DUoS charges, which would result in suppliers levying higher risk premiums. In addition, another DNO noted that they have, with Ofgem's approval, used rebates to smooth structural changes to DUoS charges.
- 1.5 Other measures proposed by DNOs included limiting rebates to two percent of allowed revenue and Ofgem approval being required for rebates or tariff changes that represent more than five per cent of allowed revenue.
- 1.6 One DNO supported a relaxation of the 'best endeavours' obligation to enable DNOs to focus on the recovery position over a period longer than a year. Allied to a shorter notice period, they felt that this shift in focus would encourage

charging stability that would facilitate competition in supply and should take precedence over high cost reflectivity in any one year.

- 1.7 Several non-DNO respondents supported the elimination of rebates, with some of these respondents strongly criticising the practice of rebates. One respondent that favoured the elimination of rebates stated that an acceptable alternative approach would be to impose on rebates and significant mid-year tariff changes the same reporting and charge restrictions as faced by end of year over recovery.
- 1.8 One non-DNO respondent supported the Ofgem proposal of paying closer scrutiny to rebates because rebates had only been given by a small number of DNOs. They were concerned that some of the proposals associated with the elimination of rebates would lead to more frequent retail price revisions or increased risk premiums. They noted that the resulting higher supply costs would ultimately be borne by customers.
- 1.9 One respondent proposed that prior to a rebate, Ofgem should advise suppliers of the extent of DNO over recovery so that suppliers can verify the magnitude of the rebate.

Is 60 days an appropriate length of time for DNOs to propose minor tariff adjustments?

- 1.10 There was support from some DNOs for a shorter notice period for minor tariff changes to facilitate a smaller percentage adjustment to prices. One DNO stated that minor tariff changes should not be subject to Ofgem approval. Another DNO suggested that in order to reduce the impact on suppliers, tariff changes made with a shorter notice period should be limited to three percent rather than five percent. In addition, increases should be restricted to being implemented at the start of a calendar quarter.
- 1.11 However, two DNOs felt that a shorter notice period would not necessarily resolve other underlying issues, such as other lags in changing tariffs and the potential for under/over recovery driven by tariff changes based on forecast data
- 1.12 One DNO stated that a shorter notice period would be essential if rebates are removed. Another DNO noted that a lengthy notice period had been imposed because of concerns about potential intra-PES communication. A third DNO

proposed a graduated scale that linked the length of the notice period with the magnitude of the percentage tariff change.

- 1.13 Three DNOs proposed moving to a 40 days notice period to co-ordinate with the period set out in the DUoSA. In addition, one of them noted that suppliers often raised objections after the publication of final prices with 40 days notice rather than indicative prices with five months notice.
- 1.14 One respondent supported a shorter notice period to enable DNOs to react to unanticipated revenue variations and presumed that a similar change would be made to the gas transporters licence.
- 1.15 Other respondents were not supportive of a shorter notice period. One of these respondents stated that a shorter notice period would reduce the incentive for DNOs to accurately forecast and would impose a burden on suppliers owing to more frequent tariff changes.

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

- 1.16 This proposal was supported by all DNOs because it would mitigate the cashflow risk from the removal of rebates. Some DNOs and one non-DNO respondent expressed support for the development of a symmetrical interest rate outside a 'deadband' allowance.
- 1.17 In contrast, one respondent suggested that there may be a need to increase the interest rate as it is currently broadly equivalent to the financial gain made from rebates by DNOs and is less than the direct cost to customers and suppliers.

Historic rebates

- 1.18 There was a range of views about the importance of rebates. Two respondents stated that the aggregate value of rebates was only around 1% of DUoS revenue.
- 1.19 Some respondents discussed the role of Ofgem with regards to historic rebates. There was a difference of opinion whether Ofgem should publish the identities of DNOs that have rebated or should provide the information to particular industry groups. In addition, there were various requests for Ofgem to:

- ◆ investigate whether rebates had been given between 1990 and 2000
 - ◆ ensure that all previous rebates are directly returned to customers
 - ◆ ask suppliers whether rebates have been passed on, particularly to customers with pass through contracts and
 - ◆ review whether distribution businesses have been compliant with relevant licence conditions.
- 1.20 One respondent suggested that even if no licence breaches are found, Ofgem should consider retrospectively amending the price control to ensure that it has the intended financial effects.

Current Regulatory Framework

- 1.21 There were mixed views on the operation of the ‘best endeavours’ obligation. One DNO suggested that rebates represent the best method for DNOs to meet this obligation by responding to information on recovery position when it becomes available. Another DNO stated that the provision of a rebate does not necessarily mean that DNOs are not complying with special condition B obligations.
- 1.22 However, one respondent was concerned that rebates were used by DNOs to bypass existing obligations and financial incentives contained within the price control. They noted that the responses to the information request suggested that DNOs were using rebates to avoid under recovery rather than complying with the best endeavours obligation. It was acknowledged by one DNO that rebates can be used to modify the phasing of income across the year
- 1.23 Two respondents noted the current penalties for over recovery incentivised DNOs to forecast revenue accurately. One of these respondents felt that allied to the lengthy notice period, these arrangements encouraged rebates by discouraging the reduction of charges in the following year.
- 1.24 One respondent felt that the existing arrangements are not meeting the Ofgem principles of cost reflectivity and facilitating competition.

Why do DNOs under or over recover?

- 1.25 Four DNOs noted the role of previously unanticipated one-off factors, with one particularly highlighting the role of weather-driven volume changes in the last quarter of the regulatory year.
- 1.26 Two DNOs identified factors that they felt would increasingly hinder revenue forecasting in the future. These included:
- ◆ price control incentive mechanisms
 - ◆ distributed generation
 - ◆ Ofgem preference for unit-based changes
 - ◆ customers with own generation
 - ◆ embedded networks
 - ◆ energy efficiency obligations and
 - ◆ metering competition.

Impact on customers and the supply market

- 1.27 The July document stated that the issuing of rebates may mean that customers will not pay retail prices that reflect the true underlying costs that they impose on the system. In addition, it noted that DNO charging methodologies should facilitate competition.
- 1.28 Two DNOs stated that rebates made in proportion to use of system payments are cost-reflective. In addition, one of these DNOs noted that the impact of rebates is likely to be well within limits of uncertainty of a cost-reflective model. Another DNO highlighted that the cost-reflectivity to customers depends on the actions of suppliers.
- 1.29 There was some debate about the role and actions of suppliers in passing on rebates. Two respondents noted that Ofgem has recently concluded that the domestic market is competitive. Therefore, movements in retail prices should reflect variations in supplier costs and any discrepancy between how customers

benefit from rebates and how they should have benefited is the result of DNO actions. However, one DNO questioned whether suppliers would pass on temporary tariff reductions. Another DNO said that there is no evidence that DUoS tariffs have contributed to the failure of retail prices to follow supplier input prices downwards.

- 1.30 Two DNOs and two other respondents highlighted the role of the pass-on requirement, which it was noted is attractive to suppliers as a risk management tool for larger customers. The effectiveness of this mechanism was questioned on the basis that it was believed that most users are unaware of rebates.
- 1.31 However, one respondent suggested that rebates have not been passed on and consequently DNOs have effectively been supporting suppliers by overcharging and then transferring money to suppliers.
- 1.32 Two respondents suggested that rebates should be based on the charges paid by users – this could be determined by kVA, kWh or the size of contract. One of these respondents was sceptical that the typical method of issuing rebates on an MPAN basis was a valid cost-reflective method.
- 1.33 DNOs generally did not agree that rebates may distort competition in supply and noted that it is difficult to obtain evidence on this issue because rebates represent a small percentage of retail prices. Three DNOs noted that, within the constraints of administration and transactional costs, rebates should be treated as any other change to input costs. One DNO suggested that the perceived failure to pass on rebates had implications for the state of the competitive market beyond the treatment of rebates. Consequently one DNO suggested that, even though the document rules out regulating suppliers, it would be helpful if Ofgem obtained information directly from them.
- 1.34 There was a discussion of the negative impact on suppliers – these included cashflow and costs from the ad hoc nature of rebates. One respondent suggested that rebates have cost suppliers between £5.5m and £8m and have been worth approximately £4m in unwarranted profits to DNOs – the latter figure calculated with reference to the over recovery interest rate penalty.
- 1.35 One respondent suggested that rebates favour entrants to the supply markets when they are based on the number of supply points registered at the end of the

period rather than the number of supply points registered over the period during which over recovery occurred.

Timetable

- 1.36 There was a range of responses on when changes should be introduced and whether or not they should be phased. Some respondents supported the introduction of new arrangements as soon as possible. However, others favoured introducing changes at the start of the next price control period in April 2005.

Appendix 2 List of respondents to July 2003 consultation document

Aquila Networks

CE Electric UK Funding Company

East Midlands Electricity

United Utilities

Western Power Distribution

EDF Energy

Scottish and Southern Energy

SP Transmission & Distribution

National Grid Transco

British Gas Trading

Innogy

BOC Gases

Corus UK

Local Authorities South East Region

Major Energy Users' Council

Appendix 3 Glossary

Terms

‘Base rate’ – an interest rate equivalent to the average specified rate. This is defined in the special licence conditions of the electricity distribution licence as ‘the average of the daily base rates of Barclays Bank plc current from time to time during the period in respect of which the calculation falls to be made’.

‘Best endeavours’ obligation – this refers to the obligation set out in paragraph 1 of special condition B of the electricity distribution licence. A copy of this paragraph is contained in appendix 4.

‘deadband’ – the range within which a non-penal interest rate (equivalent to the ‘base rate’ plus one and a half percent) will be applied to year-end over or under recovery. The limits of the ‘deadband’ are under recovery or over recovery of two percent or less. The non-penal interest rate is closer to the cost of debt assumed in the distribution price control review than either the average specified rate or the average specified rate plus four percent.

DNO – distribution network operator.

DUoS charges – ongoing charges for the use of the distribution system. These are normally paid by suppliers on behalf of consumers.

MPAN – meter point administration number.

Over or under recovery – the difference between the DNO’s allowed and actual revenue. Through the operation of a correction mechanism, the over and under recovery is carried over to be set against a DNO’s allowed revenue in the subsequent regulatory year.

SLC – standard conditions of the electricity distribution licence

Trigger levels – the levels of reported under or over recovery beyond which the Authority may take action against a DNO. Information on these trigger levels are contained in special condition C of the electricity distribution licence. A copy of this special condition is included in appendix 4.

DNO abbreviations

CE Electric – CE Electric UK Funding Company:

YEDL – Yorkshire Electricity Distribution plc

NEDL – Northern Electric Distribution Ltd

EME – East Midlands Electricity

South Wales - Western Power Distribution (South Wales) plc

South West – Western Power Distribution (South West) plc

UU – United Utilities Electricity PLC

Aquila - Aquila Networks plc

LPN - EDF Energy Networks (LPN)

EPN – EDF Energy Networks (EPN)

SPN – EDF Energy Networks (SPN)

SSE – Scottish and Southern Energy

Hydro – Scottish Hydro-Electric Power Distribution Limited

Southern – Southern Electric Power Distribution

SP T&D – SP Transmission & Distribution (part of the Scottish Power group)

SP Distribution – SP Distribution Ltd

Manweb – SP Manweb

Appendix 4 Relevant special licence conditions

Special Condition B: Restriction of distribution charges

1. Without prejudice to Special Condition E (Allowance in respect of security costs), the licensee shall in setting its charges for the provision of distribution services use its best endeavours to ensure that in any relevant year the average charge per unit distributed shall not exceed the maximum average charge per unit distributed calculated in accordance with the following formula:

Special Condition C: Restriction of distribution charges: adjustments

1. If, in respect of any relevant year, the average charge per unit distributed exceeds the maximum average charge per unit distributed by more than 3 per cent, the licensee shall furnish an explanation to the Authority and in the next following relevant year the licensee shall not effect any increase in charges unless it has demonstrated to the reasonable satisfaction of the Authority that the average charge per unit distributed would not be likely to exceed the maximum charge per unit distributed in that next following relevant year.
2. If, in respect of any two successive relevant years, the sum of the amounts by which the average charge per unit distributed has exceeded the maximum average charge per unit distributed is more than 4 per cent, then in the next following relevant year the licensee shall, if required by the Authority, adjust its charges such that the average charge per unit distributed would not be likely, in the judgement of the Authority, to exceed the maximum average charge per unit in that next following relevant year.
3. If, in respect of two successive relevant years, the average charge per unit distributed is less than 90 per cent of the maximum average charge per unit distributed, the Authority, after consultation with the licensee, may direct that in calculating K_{dt} for the purposes of paragraph 6 of Special Condition B (Restriction of distribution charges) in respect of the next following relevant year, there shall be substituted for R_{dt-1} in the formula at paragraph 6 of Special

Condition B (Restriction of distribution charges) such figure as the Authority may specify being not less than R_{dt-1} and not more than $0.90 (D_{t-1}.M_{dt-1})$.