

Gary Keane  
Distribution Policy Manager  
Office of Gas and Electricity Markets  
9 Millbank  
London  
SW1P 3GE

Our Reference:  
Your Reference:

Head Office  
Inverlmond House  
200 Dunkeld Road  
Perth  
PH1 3AQ

Telephone: 01738 456400  
Facsimile: 01738 456415  
Email:

Date: 20 February 2004

Dear Gary

### **Distribution Rebates to Suppliers**

I write with comments on the contents of Ofgem's decision document on the above subject, which was issued in December.

We noted in our response to the July consultation document that, in our view, a greater regulatory tolerance towards developing an "over-recovery" of allowable revenue during a particular financial year would be a key requirement for protecting the position of DNOs if the ability to offer rebates was to be withdrawn. Allowing DNOs a greater flexibility to manage their revenue recovery positions should, in turn, result in a smoother path of distribution charges from year to year which will benefit suppliers and their customers.

We therefore broadly welcome the changes that Ofgem have proposed, which include a reduction in the required notice period for changes in distribution tariffs from five to three months; a reduction in the penal interest rate on over recovery of allowable revenue from base rate plus four percent to base rate plus three percent; and the introduction of a "deadband" within which penal interest rates will not be levied. However, we note that there are several factors that will increase the unpredictability of allowable distribution revenue going forward. These include:

- the growth of distributed generation (DG) - this will affect the volume of units distributed, which is a driver of allowable revenue;

- the introduction of generator use of system charges for newly connecting DG; and
- an increasing proportion of distribution revenue becoming subject to various complex incentive schemes.

Against this background, therefore, it may be appropriate to consider whether the proposed “deadband” of 2% above and below allowable revenue, may need to be increased to take into account these further uncertainties. We would suggest that a more appropriate deadband would be 4%, based broadly on 2% uncertainty for existing elements of the formula (which Ofgem have recognised) plus 2% for the IIP reward/penalty range.

The same considerations apply to 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 (D in Scotland).

We note that Ofgem intends to take forward any amendments to standard licence condition 4, associated with its decision on distribution rebates, as part of work on the structure of electricity distribution charges. Amendments to the special licence conditions, associated with changes to interest rates and the introduction of a “deadband” around the allowable revenue, are intended to be brought into effect along with the price review modifications early next year. We would support this overall approach.

We also support Ofgem’s consideration of an amendment to the “best endeavours” obligation in paragraph 1 of special condition B (C in Scotland) and to the wording of paragraph 1 of special condition C (D in Scotland) to clarify the Authority’s role if a DNO over-recovers by more than three percent in any one year. Our proposals for revised wording for these conditions are as follows.

#### Paragraph 1 of special condition B (C in Scotland)

We suggest adding the text “, unless the Authority otherwise consents,” after the words “the licensee shall” in this paragraph. This would, for example, allow a DNO, with the agreement of the Authority, to manage an over-recovery position over a period greater than one financial year if this helped to preserve a more stable profile of tariffs over the years.

#### Paragraph 1 of special condition C (D in Scotland)

For the same reasons as set out above, we suggest adding the text “, unless the Authority otherwise consents,” after the words “the licensee shall not” in this paragraph. We would also suggest deleting the remainder of the paragraph after the words “provision of distribution services” as this would become redundant. The Authority would be able to request any relevant information about the projected path of distribution charges (which may include the smoothing of an over-recovery position over a few financial years) in providing its consent to an increase in charges in the following relevant year.

I hope these comments are helpful.

Yours sincerely

Rob McDonald  
**Director of Regulation**