

Electricity Distribution Price Control Review - Methodology and Initial Results

IPM Energy Retail Limited Response – 5th June 2009

Introduction

IPM Energy Retail Ltd (IPM) is a newly established electricity supplier targeting half hourly metered medium sized Industrial and Commercial customers. The majority owner of IPM is International Power (IPR), who are a UK-based FTSE-100 independent power generation company with interests in over 45 power stations and some closely linked businesses around the world. With its partner Mitsui & Co., Ltd of Japan, IPR owns and operates 7% of GB's generating capacity, which represented 6% of the market by output in 2007.

Our overall impression of this process is that the level of revenue increases proposed and the uncertainty that exists around these increases represents a significant risk to our business and a barrier to growth for us as a new entrant. Distribution charges can represent up to around 25% of the total costs of supply to a customer and hence tariff increases have a material impact on costs and delivered margins. Due to resource constraints we have not been able to review the detailed methodologies used and so do not have any comments on this but would like to take this opportunity to provide feedback on some of the wider issues that this process raises for us and the implications for competition in the supply sector.

Level of proposed revenue increases

While we agree that charges should be cost reflective, we feel that the complexity of the methodology used puts smaller suppliers at a disadvantage to the larger companies that can afford to dedicate significant resources to forecasting the likely outcome of the process. We have not carried out detailed analysis of the methodology but would like to make the following more general points with regards to the level of increases that are being proposed.

- The UK is experiencing a decrease in electricity demand due to economic conditions and energy efficiency measures. We would expect this to reduce stress on the distribution networks and reduce the requirement for significant investment.



International Power



MITSUI & CO., LTD.

- We are seeing a shift to more embedded generation within the distribution networks. This should reduce total flows from GSP to end user, which may reduce stress on the distribution networks and reduce the requirement for significant investment.
- A large part of the revenue increases is associated with "Real Price Effects". Given that the UK is experiencing a period of deflation we are surprised at the level of increases in revenues that is assigned to this factor.

Given these points, it appears to us that the revenue increases requested by the DNOs are excessive.

Timing of process

The timing of the price control process also causes us issues. The allowable revenue increases for DNOs will not be published until December 2009 and the actual impact on tariffs at site level will not be known until mid February 2010. These changes impact our costs of supply from 1st April 2010 and we would have contracted for supplies covered by the changes as early as April 2009. Given that our primary product is a fixed price, fixed term annual product, the costs of delivering all of the contracts that we are offering to customers will be impacted by the outcome of the review. This leaves us in an uncomfortable position of having to make assumptions regarding the impact the outcome of the Price Control will have on DUoS tariffs when setting tariffs.

The options to manage this risk are to include potentially excessive premiums in our tariffs or to pass through charge increased to end users once they are confirmed. These options do not meet the requirements of our target customer segment (typically medium sized businesses) who need to manage budgets and achieve a low cost electricity supply. We therefore feel it would be a significant improvement if DUoS tariffs were fixed earlier and/or for further into the future. A slightly different approach that we feel could also improve the process would be for there to be a cap on the level of charge increases that can occur for any individual customer in any year. While there would still be uncertainty in costs there would be an upper limit which would reduce the level of risk premium required in tariffs and provide a lower end price to customers. In both of these scenarios any over or under recovery could be rolled into later years.

Interaction with structure of charges project

The further level of complexity is added by the Structure of Charges project that is seeking to harmonise the methodologies to calculate DUoS tariffs by each DNO. This is another very complex process where again small suppliers are at a disadvantage as they do not have the resources available to get into the detail. We understand that these changes will lead to significant disturbance in the allocation of costs to different customer groups and, combined with the overall revenue increases from the price control, results in extreme levels of uncertainty in our costs for any individual customer. Smaller suppliers who focus on particular sectors of the market are disadvantaged here again since larger suppliers who cover all customer groups can take some comfort from the fact that any reallocation will lead to reduced costs for some of their customers with increases on others. This potentially provides a barrier to entry to any niche supplier and favours a large scale, mass market business model.

Reaction to tariff increases

We have a number of customers on supply and the figures quoted in the consultation document coupled with the uncertainty outlined above leads to concerns that our distribution costs could out turn significantly higher than those we assumed when setting customer tariffs. As a new entrant the resulting erosion of margins and potential losses makes market participation look less attractive. Utilising contract clauses that enable pass through of charge increases has significant operational and potential reputational impacts. Given that larger suppliers are more likely to be able to internalise these losses it could be only the smaller suppliers who are forced to increase costs to customers and be exposed to the negative connotations associated with this.

Summary

We feel that there are a number of key issues with this process that are damaging for small suppliers and customers.

- The level of revenue increases appears excessive in the current climate
- Late publication of price control outcomes and the resulting tariff increases leads to significant uncertainty in supplier costs that are passed onto customers in the form of higher tariffs
- The uncapped nature of potential increases leads to higher risk premiums and therefore higher costs to customers and increases likelihood that smaller suppliers may have to pass through increases in costs to avoid significant losses
- The complexity of the methodology and process leads to larger suppliers with greater resources having an advantage over smaller players in understanding and predicting charge increases
- Niche players are exposed to changes in the allocation of allowable revenues to different customer types while larger suppliers covering all customer types are not

We request Ofgem consider these points and seek to limit the potential step change in charge levels that could be experienced for any customer in April 2010.

Stephen Harris

Commercial Manager

DDI: 020 7320 8734

Mob: 07989 492720

Email: stephen.harris@ipmenergyretail.com

Senator House|85 Queen Victoria Street|London|EC4V 4DP