PES SUPPLY BUSINESS MAXIMUM PRICE RESTRAINTS

Introduction

OFFER published proposals for PES supply business maximum price restraints in October 1997 (*The competitive electricity market from 1998 : Price Restraints Proposals October 1997*). These set out the reductions in electricity prices that were to apply to designated customers from April 1998. Designated customers are those customers consuming less than 12 000 kWh per year, and include all domestic customers.

On average the October 1997 proposals envisaged that prices would fall in real terms by 6 per cent in 1998/99 and a further 3 per cent in 1999/00, but the proposals also allowed for adjustments to these reductions in certain circumstances. These circumstances included differences in the out turn level of over-recovery compared to the assumptions on which the maximum price restraints were based, changes in the fossil fuel levy and the introduction of data management services (DMS) penalties. The adjustments that have arisen from these circumstances are described below.

The October 1997 proposals also contained the results of calculations of a yardstick of electricity generation purchase costs for 1996/97. Annex A to this paper sets out the calculations of this yardstick for 1997/98.

Over - Recoveries

The previous PES supply business price control allowed for a pass through of certain costs. PESs set prices against an estimate of these costs, with any over or under recovery of revenue subtracted from or added to the next year's price control. The October 1997 proposals require that actual over recoveries in 1997/98be refunded to customers in either 1998/99 or 1999/00.

The maximum price restraints do not allow for cost pass through, but in setting the level of these restraints an adjustment was made relating to the estimated level of over- or under-recovery in 1997/98. The October 1997 proposals explained that the maximum price restraints would be adjusted for differences in the out turn level of over-recovery compared to the assumption on which the maximum price restraints were based.

Fossil Fuel Levy

Companies are required to purchase certain quantities of electricity from nonfossil fuel sources. Such purchase costs typically exceed market prices. Companies are allowed to recover the excess costs by means of the Fossil Fuel Levy on final electricity prices. The Levy rate is adjusted annually, and the maximum price restraints allow the prevailing rate to be reflected in charges. In England and Wales the fossil fuel levy rate was reduced from 2.2 per cent to 0.9 per cent on 1 April 1998. It was reduced to 0.7 per cent on 1 January 1999. An equivalent scheme operates in Scotland, called the Scottish Renewables Order. The equivalent levy rate was increased from 0.7 per cent to 0.8 per cent from 1 April 1998. It was reduced to 0 per cent from 1 April 1999. Owing to different generation arrangements in Scotland, the Levy only applies to a portion of electricity supplied. The effective levy on all electricity supplied is therefore reduced.

The effective levy rate increased by 0.3 per cent on 1 April 1998, from 0.4 per cent to 0.7 per cent. From 1 April 1999, the effective levy rate is 0 per cent.

DMS penalties

Customers in the under 100 kW market began to be free to choose a supplier other than their local company from September 1998. All customers are now free to choose another supplier. To encourage companies to open their own areas to competition, companies are subject to financial penalties that increase if the introduction of competition was delayed. The October 1997 proposals provided for the maximum price restraints to be adjusted so that customers would benefit directly from the introduction of these penalties.

Impact on prices for 1999/00

As set out in the introduction, the October 1997 proposals required that PESs adjusted tariffs to designated customers by the RPI minus 3 per cent from April 1999. The RPI value used was determined by comparing inflation from July to December 1998 with inflation from July to December 1997, giving an increase of 3.14 per cent. Other things being equal PESs would have been able to increase prices by 0.14 per cent in nominal terms. However the reduction in the fossil fuel levy rate of 0.2 per cent meant that no company was in a position to increase prices in nominal terms.

Further adjustments have been required to take account of over-recoveries and DMS penalties. Customers will benefit from reductions in prices, as described below.

Eastern plans to return its over recovery by making payments of £4 to all quarterly customers, and a £5 payment to prepayment meter customers. Northern refunded about £11 to each of its customers in two instalments during 1998/99. SWEB refunded each of its customers £1.89 during 1998/99.

Five companies, East Midlands, Manweb, Midlands, SWALEC and Scottish Power also made over recoveries that must be refunded to customers. However, on a per customer basis these amounts are small (less than £1 per customer) and the companies are to make refunds in the form of tariff reductions and / or rebates.

Three companies, Midlands, Northern and SWALEC had overrecoveries that differed from those used in OFFER's calculation of the price reductions to apply from April 1998. Midlands anticipated the position, and made average price reductions for 1998/99 1.1 per cent greater than the reduction stipulated in OFFER's proposals. SWALEC have made price reductions from April 1999 that encompass a further 2 per cent as a consequence of the over-recovery position. Northern made price reductions from 1 January 1999 that encompassed further reductions of 2.5 per cent required by the over-recovery position. These price falls also encompassed price falls that would have been required from April 1999 as well as the reduction in the Fossil Fuel Levy.

The effect of the DMS penalties is, in real terms, to reduce average prices to designated customers by about a further 0.5 per cent.

Table 1

Average real price reductions to Designated Customers in 1998/99 and 1999/00

%	1998/99		1999/00	
	Headline real average reduction	Actual real average reduction	Headline real average reduction	Actual real average reduction
Eastern	8.9	10.1	3.0	3.1
East Midlands	6.3	7.5	3.0	3.9
London	11.8	13.0	3.0	3.7
Manweb	5.8	7.1	3.0	4.3
Midlands	7.1	9.4	3.0	3.1
Northern	4.2	5.5	3.0	10.8
NORWEB	3.4	4.7	3.0	3.7
Seeboard	6.0	7.3	3.0	3.1
Southern	3.2	4.5	3.0	3.9
SWALEC	8.5	9.7	3.0	5.6
SWEB	6.6	7.8	3.0	4.5
Yorkshire	3.7	5.0	3.0	3.1
Scottish Power	2.2	1.9	3.0	4.8
Hydro – Electric	4.0	4.3	3.0	4.2
Average	5.8	7.0	3.0	4.4

Table 1 sets out the estimated effects of all adjustments on real average price changes. These are compared with the required real reductions as set out in the October 1997 proposals document (referred to in table as 'Headline reduction'). Actual real average reductions in 1998/99 were in general higher than the headline reduction because the fossil fuel levy to apply in England and Wales during that year was 0.9 per cent rather than the 2.2 per cent assumed in setting the restraints. In Scotland, the effective Levy rate increased by 0.3 per cent, and so the actual real reduction for Scottish Power is lower than that of the headline reduction. Hydro-Electric expressed their prices before the addition of the Levy, and so this does not affect the comparison.

Actual real average reductions, tabled above, are estimates of the effect of companies' overall price changes. Some companies, for example, introduced or extended payment discount schemes during the period. Such schemes, depending on the take up rate by customers, may have the effect of further reducing average prices paid.

Four companies, Eastern, MEB, Seeboard, and Yorkshire, froze tariffs from 1 April 1999. This has the effect of producing a real price fall of 3.14%. Such a reduction therefore meets the required RPI-3 per cent reduction and goes some way to addressing the reduction in the fossil fuel levy rate. These companies are to make further rebates to customers during 1999/00 that will refund outstanding amounts in respect of the remaining fossil fuel levy, any over recoveries, and DMS penalties.

ANNEX A

THE YARDSTICK OF ELECTRICITY GENERATION PURCHASE COSTS

Introduction

As part of previous supply price control proposals, published in July 1993, OFFER said that it would compile and publish a yardstick of the average cost of electricity generation purchases made by each regional electricity company (REC) for the purpose of supplying franchise customers in England and Wales, who during the period of the price control had no access to competitive supply. OFFER has previously published yardstick results for 1994/95, 1995/96 and 1996/97.[1] This annex sets out the yardstick results for 1997/98.

Background

"Excluded" contracts comprise mainly the five year contracts for coal-fired electricity signed in March 1993, a few contracts entered into at Vesting under Energy Act terms, and a contract signed between NORWEB and an independent power producer (IPP) before Vesting. They accounted for around 60 per cent of REC purchases for the franchise market. "Included" contracts include all other electricity purchase made by the RECs for the franchise market, namely medium and long term contracts signed with Nuclear Electric and IPPs before 1992, short term contracts signed after 1992 and purchases at Pool price. The proportions of different contract type varied from one company to another.

Tables 2 and 3 show the yardstick values for 1997/98 and 1996/97 respectively. They are calculated as the ratio of each REC's actual generation purchase costs to the cost of purchasing identical quantities at identical times from the electricity Pool. This gives a measure of the average premium of contract costs over Pool prices.

The average ratio of all franchise purchases was about the same as in 1996/97 (1.22 in 1996/97 compared to 1.21 in 1997/98). The average ratios for excluded and included contracts have converged since 1996/97 (1.26 and 1.18 in 1996/97 compared to 1.22 and 1.20 in 1997/98).

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[1] OFFER, Yardstick of Electricity Purchase Costs, August 1996;
OFFER, The Competitive Electricity Market from 1998: Price Restraints Fifth Consultation, August 1997.

TABLE 2 : YARDSTICK VALUES OF GENERATION COSTS IN 1997/98

REC	Excluded Contracts	Included Contracts	All Franchise Purchases
Eastern	1.27	1.24	1.25
East Midlands	1.19	1.19	1.19
London	1.22	1.20	1.21
Manweb	1.27	1.08	1.20
Midlands	1.20	1.24	1.22
Northern	1.31	1.18	1.24
NORWEB	1.20	1.29	1.23
SEEBOARD	1.21	1.12	1.17
Southern	1.18	1.18	1.18
SWALEC	1.21	1.30	1.25
South Western	1.20	1.13	1.16
Yorkshire	1.17	1.24	1.20
Average Yardstick	**1.22**	**1.20**	**1.21**

TABLE 3 : YARDSTICK VALUES OF GENERATION COSTS IN 1996/97

	Excluded Contracts	Included Contracts	All Franchise Purchases
Eastern	1.32	1.20	1.26
East Midlands	1.24	1.14	1.21
London	1.24	1.19	1.22
Manweb	1.27	1.11	1.21
Midlands	1.24	1.22	1.23
Northern	1.27	1.18	1.23
NORWEB	1.26	1.14	1.22
SEEBOARD	1.26	1.09	1.19
Southern	1.21	1.24	1.23
SWALEC	1.25	1.19	1.22
South Western	1.25	1.17	1.21
Yorkshire	1.22	1.17	1.20
Average Yardstick	**1.26**	**1.18**	**1.22**