December 1999

Reviews of Public Electricity Suppliers 1998 to 2000

Supply Price Control Review

Final Proposals

REVIEWS OF PUBLIC ELECTRICITY SUPPLIERS
1998-2000

SUPPLY PRICE CONTROL REVIEW
FINAL PROPOSALS

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FOREWORD

The present regulatory controls on the Public Electricity Suppliers' (PESs') supply businesses' prices to designated customers were set in place until 31 March 2000. This document sets out final proposals for arrangements from 1 April 2000. The document explains the reasoning behind the final proposals and the reasons why Ofgem believes they are in the best interests of customers.

If PESs accept these proposals, Ofgem intends to make appropriate licence modifications to take effect from 1 April 2000. If PESs do not accept these proposals, Ofgem will refer the issue of the revision of the relevant supply price restraints to the Competition Commission (formerly the Monopolies and Mergers Commission). PESs have until 20 December 1999 to indicate their acceptance or rejection of the proposals in this document.

Ofgem published an Initial Proposals document in October 1999[1]. It suggested that revised price restraints should be confined to the two major tariffs for domestic customers. It suggested that prices for Standard Domestic and Domestic Economy 7 tariffs should, on average, fall by 9.9 per cent and 6.4 per cent respectively. It also proposed that direct debit discounts and tariffs for non-domestic customers should not be subject to direct price control.

PESs and other interested groups have since responded with views on these Initial Proposals. Ofgem has taken these into account in setting final proposals.

Ofgem's final proposals are that price restraints should continue to apply to Standard Domestic and Domestic Economy 7 tariffs for a period of two years. The restraints will take the form of a cap on final prices in the first year of the control. On the basis of these proposals, the restraint would lead to an average reduction of £15 (about 6 per cent) on an average annual bill for Standard Domestic customers, and £7 (or about 2 per cent) for Economy 7 customers. In the second year of the control, maximum prices would be required to remain at their nominal levels.

If you have any queries concerning issues raised in this document, Shaun Kent on 0121 – 456 – 6254 (or e-mail : kents@offer.gsi.gov.uk) or Colin Green on 0121 – 456 – 6385 (or e-mail : greenc@offer.gsi.gov.uk) will be pleased to help.

Ofgem
December 1999

[1] *Review of Public Electricity Suppliers 1998 to 2000 : Supply Price Control Review Initial Proposals*

1 INTRODUCTION

General approach

1.1 In setting a revised price control, the Director General of Electricity Supply (DGES) must balance his duties to ensure that all reasonable demands for electricity are met; that licence-holders can finance their licensed activities; and to promote competition. Given that these duties are due to be replaced by a general duty to protect customers, following the inclusion of a Utilities Bill within the recent Queen's Speech[1], it also seems appropriate to consider the price control reviews against that background.

1.2 In the context of a market which is in transition to full competition, such as the domestic electricity supply market, it is appropriate to consider the state of the competitive market in order to assess which customers still require the protection of competition; to assess the impact of competition on prices; and to ensure that the benefits of the competitive market are being reasonably reflected to all customers. At the same time, price controls need to be set at a level which does not restrict, prevent or distort the further development of competition.

1.3 It is also appropriate to consider the costs and pricing policies of the PESs. The DGES presently has a subsidiary duty, among others, to promote efficiency. Price control reviews provide a significant opportunity to do this. As with the consideration of the electricity distribution price controls, the DGES considers that a pass-through of, or full allowance for, inefficiently incurred costs is not generally in the interests of customers. Comparative analysis of the PESs' price regulated supply business costs and prices is an important tool in considering efficiency.

The development of competition

1.4 Following the phased opening of the market to full competition, completed in May 1999, over 12 per cent of customers with a maximum demand of less than 100 kW have now chosen to switch supplier. Compared with incumbents' prices, there is now a range of savings available to customers in each PES area, up to a maximum of about 10 per cent of a customer's annual bill for a Standard Domestic tariff.

1.5 The operation of fully effective competition will in the long term offer the best protection of customers' interests. The Initial Proposals noted that in the meantime there might well be customers or groups of

[1] See also '*A Fair Deal For Consumers Modernising The Framework for Utility Regulation The Future of Gas and Electricity Regulation The Government's Proposals for Legislation*' published by the DTI in September 1999

customers who had fared relatively less well than other customers in terms of the range of offers and savings available. In June 1999 Ofgem published *A Review of the Development of Competition in the Designated Electricity Market* which used a range of indicators to assess the development of the competitive market and the extent to which different groups of customers were benefiting from it.

1.6 The review broadly concluded that the newly opened under 100 kW market was developing rapidly, but that experiences and evidence differed across customer groups.

1.7 Recent evidence has broadly confirmed these trends. A survey carried out by MORI on Ofgem's behalf during September and October 1999 found that 95 per cent of electricity customers asked were aware that it was possible to buy electricity from suppliers other than the local electricity company. Of those electricity customers that had changed supplier, 88 per cent found it either very easy or fairly easy to leave their previous supplier. However, of those electricity customers that had not yet switched electricity supplier, only 7 per cent indicated that they were very or fairly likely to switch in the next 12 months.

Price restraints and the development of competition

1.8 The Initial Proposals concluded that most domestic customers would for the time being require additional protection through the operation of revised price restraints. It noted that revised price restraints should complement, rather than seek to replace, the development of the competitive market. The further development of competitive forces will depend significantly on the level at which the restraints are set and the extent to which competitors can offer savings and achieve margins by offering competitive prices against these levels.

1.9 Accordingly, Ofgem has sought to strike a balance between the immediate need to protect customers who are not yet benefiting fully from the introduction of competition and the longer term aim of encouraging competitive activity. The final proposals for price restraints given in Chapter 7 pass further immediate benefits to customers. At the same time, the proposals leave scope for competing suppliers to offer prices at least 5 per cent below the levels implied by the restraints, based on presently available savings. This headroom would tend to encourage the retention and new entry of competing suppliers. It may be increased in dual fuel offers or through further reductions in generation purchase costs that might arise in the future.

Initial Proposals

1.10 Ofgem's Initial Proposals reflected the above by proposing to restrain the prices of two key tariffs, Standard Domestic and Domestic Economy 7, in each PES area. Ofgem would set maximum price levels for each of these tariffs in each PES area. On average, across all PESs, Ofgem's Initial Proposals envisaged Standard Domestic and Domestic Economy 7 tariff prices falling in real terms by 9.9 per cent and 6.4 per cent respectively.

1.11 These proposals would tend to protect customers' interests by setting these 'backstop' prices at levels that reflect present costs. Such levels were intended to enable competitors to achieve efficiency savings and to offer competitive prices in a manner consistent with the operation of a competitive market.

Process leading to final proposals

1.12 Interested parties were invited to respond to the Initial Proposals by 29 October 1999. 29 formal responses were received, 11 from PESs, 13 from Electricity Consumer Councils (ECCs) and 5 from other interested parties. Annex B lists the respondents. In addition, PESs have had opportunities to respond both during formal meetings with the Director General of Electricity Supply and during a series of working level meetings.

1.13 On 16 November 1999, Ofgem wrote to all PESs setting out revised calculations of the level of restraints based on a number of adjustments requested by or discussed with PESs. These adjustments were intended to maintain the original aim of balancing immediate benefits for electricity customers by cutting electricity supply prices with the longer term benefit for customers of promoting competition. The adjustments, which are discussed in chapters 4 to 6, generally served to reduce the impact of the Initial Proposals.

1.14 In formulating final proposals, Ofgem has considered a number of points raised by respondents. PESs have for example, raised a number of factual points regarding the detailed calculations. PESs and others have also raised a number of points of principle. The ECCs argued that non-domestic customers should continue to receive additional protection through price restraints. A large number of respondents, including independent suppliers, agreed that the Initial Proposals should be relaxed to permit more headroom for competition to develop. Careful consideration has been given to these views in framing the final proposals.

Final proposals

1.15 This document reviews the issues raised in the Initial Proposals and sets out Ofgem's revised and final assessment of the form of control and maximum level of prices that should apply to Standard Domestic and Domestic Economy 7 tariffs. It also considers a number of issues associated with the setting of the restraints, such as the use of non-discrimination conditions, reporting requirements for generation purchase costs, and the implementation of the proposals, should they be accepted by PESs.

2 FORM, SCOPE AND DURATION

Introduction

2.1 The Initial Proposals document discussed three broad options for revised arrangements for price restraints. It concluded that an appropriate form for continued regulation would be an RPI-X control on maximum prices to be charged. It also suggested that relative price regulation, while having some advantages in principle, would be impractical to implement and might create some adverse incentives.

2.2 An appropriate duration for revised price restraints is two years. The short duration reflects the likelihood of changes in generation prices and the continued development of the competitive markets. Ofgem expects competition to continue to develop rapidly and intends to remove price restraints at the end of the next control period, subject to competition having fully emerged.

2.3 The Initial Proposals document suggested that some form of continued price regulation would be required to protect the interests of domestic customers. It suggested that it would be appropriate to remove direct price regulation for all non-domestic customers.

2.4 Ofgem's June consultation paper and the Initial Proposals both noted that an important further form of protection for customers not directly covered by price regulation would be the operation of the Electricity Act 1989, of non-discrimination conditions of the PES licences and, after March 2000, the Competition Act 1998. These are likely to be important for example in protecting the interests of customers taking non-standard domestic tariffs, or small businesses taking tariffs closely related to standard domestic tariffs.

2.5 The rest of this chapter sets out Ofgem's and respondents' further views on the form, scope and duration of revised price restraints.

Form

2.6 The Initial Proposals concluded that an appropriate form for future price restraints would be an RPI-X control on the maximum prices to be charged through Standard Domestic and Domestic Economy 7 tariffs. Maximum prices would be required to increase no faster than RPI-X, where X varies between companies in the first year of the control. The levels of the restraints would be set to reflect a pre-specified allowance for generation costs, so that there would be no automatic pass through of these costs. The restraints would also be set to reflect encountered levels of Distribution and Transmission Use of System charges, as well as the Fossil Fuel Levy.

2.7 The PESs generally favoured this form of control. Some PESs said that such restraints should be seen as 'backstop' tariff prices rather than as potential determinants of actual prices. Several PESs supported Ofgem's decision not to pursue the option of relative price regulation and cited reasons similar to those put forward by Ofgem. Of the ECCs that commented on the issue, all supported the RPI-X form of regulation. Three ECCs agreed with Ofgem's decision not to pursue relative price regulation. Of the other respondents, one explained that it was disappointed with Ofgem's decision not to pursue relative price regulation and argued that the option had some merit. Two of the four other respondents supported Ofgem's proposal for the RPI-X form.

2.8 In view of the arguments put forward in the Initial Proposals and views of respondents, Ofgem proposes to implement the RPI-X form of control. This will apply to Standard Domestic and Domestic Economy 7 tariffs.

Scope

2.9 Chapter 3 of the Initial Proposals noted that, while competitive activity was developing quickly in the under 100 kW market, it had not yet developed sufficiently to protect the interests of all domestic customers. Ofgem concluded therefore that revised price regulation would need to apply to domestic customers.

2.10 Ofgem also concluded that price regulation should no longer apply to non-domestic customers. The Initial Proposals noted that these customers were in general receiving better price offers from the competitive market compared with domestic customers. It further argued that small business customers were likely to have a greater commercial awareness than domestic customers and so were less in need of explicit price regulation.

2.11 The form of the control in these final proposals reflects the appropriate scope of price restraints by applying to Standard Domestic and Domestic Economy 7 tariffs. Ofgem proposes that domestic customers taking other tariffs will receive indirect protection regarding price both through the operation of the non-discrimination conditions and through additional conditions intended to prevent real increases in other tariffs.

2.12 Of the PESs who commented on the scope of the controls, most supported Ofgem's initial proposal to target revised restraints at customers taking the two main tariffs. Two PESs argued that Ofgem should have reduced the scope further, for example by focusing on disadvantaged or fuel poor customers. Most PESs who commented on the issue agreed with Ofgem's proposals to remove non-domestic customers from the scope of the revised restraints.

2.13 Of the ECCs that commented, all supported the continuation of price restraints for domestic customers. Most also opposed or expressed reservations about the removal of small non-domestic customers from the coverage of price restraints. Some ECCs for example noted that small corner shops are not necessarily benefiting from effective competition, and that they have similar demand characteristics to larger domestic customers. Of the other respondents who commented on the issue, one supported the removal of non-domestic customers from the scope of the price control, while another supported the continuation of direct price regulation for these customers.

2.14 It would appear reasonable to continue to protect the interests of domestic customers through the direct regulation of maximum prices. Regarding non-domestic, small business customers, Ofgem takes the view that the opportunity to choose from a variety of competing suppliers together with the greater commercial awareness of business customers should provide these customers with sufficient protection.

2.15 During the present price control period, PESs and competitive suppliers have offered discounts to customers willing to pay their bills by direct debit, reflecting the lower administrative and financing cost associated with that payment method. These discounts have not generally constituted different tariffs but rather a reduction of one of the standard tariff types. Ofgem sees no reason to regulate directly the discount offered to direct debit customers.

Duration

2.16 The competitive market is developing rapidly, and it will be appropriate to review the operation and scope of price restraints after a relatively short time. This points to a duration of two years. This period will also allow Ofgem to monitor the effect on generation purchase costs of the introduction of New Electricity Trading Arrangements.

2.17 Most PESs who commented on the duration agreed that two years would be an appropriate duration. One PES argued that a two year duration together with an allowed margin of 1.5 per cent was too long. Another PES agreed with the proposed duration provided that the level of the control was set to be commensurate with the supply business risks over that period. Most ECCs agreed that two years was appropriate. The one other respondent that commented agreed that two years was appropriate.

2.18 It would seem appropriate to set revised restraints for a further period of two years.

Non-discrimination conditions and legislative protection

2.19 The Electricity Act 1989 provides direct protection of customers' interests. It places duties on PESs 'to develop and maintain an efficient, co-ordinated and economical system of electricity supply.'

2.20 The Initial Proposals noted that in addition to the operation of price restraints, customers would continue to receive protection from legislative and licence conditions prohibiting, for example, PESs from exercising undue discrimination, where the PES is in a 'dominant position'. Both the June consultation paper and the Initial Proposals noted that legislative and licence conditions in this area were relatively untested, and that it was not clear how the Competition Act 1998 or the licence conditions 4 or 4A might be applied in practice.

2.21 The proposed form of price control together with these licence conditions would tend to prohibit PESs from supplying customers in their areas not directly protected by price regulation on significantly worse terms than customers protected by price regulation, if they are both similar in terms of cost to service. Hence the existing licence conditions should continue to give protection to customers not directly covered by price regulation. Nevertheless, the Initial Proposals noted that it was for consideration whether the DGES' powers needed to be strengthened in this area.

2.22 Of the PESs that commented on the issue of undue discrimination, two argued that the existing conditions gave the DGES sufficient powers to protect customers' interests. Two also suggested that it would be helpful for Ofgem to clarify the treatment of non-discrimination conditions, perhaps by issuing guidelines on how Ofgem might approach the policing of the issue. One PES argued that enforcement of the non-discrimination conditions could contradict initiatives to be taken under Ofgem's Social Action Plan.

2.23 Of the ECCs who commented, two noted the importance of enforcing the non-discrimination conditions. Another expressed concern that the existing conditions would provide insufficient protection for non-domestic customers. One ECC said that it would welcome a review by Ofgem of whether strengthened powers for the DGES would be relevant. Of the other respondents, one argued that the enforcement of non-discrimination conditions would be too complex or difficult to ensure that reductions in generation costs (beyond any assumed in setting restraint levels) would be passed on to customers. One other respondent argued for Ofgem to specify guidelines about its approach towards non-discrimination issues.

2.24 Ofgem agrees that strict enforcement of the Electricity Act 1989, the non-discrimination conditions and use of its powers under the Competition Act 1998 has not yet been fully tested. In December 1999 Ofgem will publish draft sector specific guidance which, together with the guidelines published by the Office of Fair Trading, will set out the general principles to be applied when exercising powers under the Competition Act 1998 in the electricity and gas markets.

2.25 Ofgem also agrees that these protections should be sufficient to prevent a PES from disadvantaging customers relative to others in its own area. Comparison of PES offers to similar customers outside its own area is not presently directly relevant to the non-discrimination conditions and Ofgem may wish to consider this issue further. This may be particularly important since one of the tests for the establishment of competition will be the extent to which PESs are pricing below the restraints within their own areas.

3 SETTING THE LEVEL OF RESTRAINTS

3.1 The Initial Proposals set out an approach to calculating the level of the restraints based on an assessment of each of the cost components of the tariffs. Cost components are generation purchase costs, distribution and transmission use of system charges, the Fossil Fuel Levy, and supply business operating costs and margins.

3.2 The final proposals have been calculated in a similar manner, using refined calculations of cost components that reflect arguments put forward by the PESs and others. The Initial Proposals noted that it would be appropriate to set the level of the restraints to reflect published distribution and transmission use of system charges, as well as the Fossil Fuel Levy. These final proposals also take this approach.

3.3 The Initial Proposals also set out a number of guiding principles for setting revised restraints. Briefly, these are to set price restraints that :

- Complement, and do not distort, restrict or prevent, the development of competition;
- do not try to capture anticipated but unrealised reductions in generation and other costs;
- protect customers not yet benefiting from the introduction of competition;
- reflect efficient costs across PESs for generation purchase costs and supply business operating costs and margins. This is expected to create greater harmonisation of these costs; and
- represent a smooth path towards a regulatory regime with no further explicit price restraints.

3.4 Chapters 4 to 6 set out Ofgem's revised and final views on generation purchase costs, the treatment of distribution and transmission use of system charges, and supply business costs and margins. In forming revised views, Ofgem has sought to reflect the principles outlined above.

4 UPDATED VIEW ON GENERATION COSTS

Introduction

4.1 Generation purchase costs account for about 50 per cent of a Standard Domestic customer's annual bill, excluding VAT. The Initial Proposals set out Ofgem's approach to assessing an appropriate generation cost allowance for the Standard Domestic and Domestic Economy 7 tariffs. This chapter briefly reviews the approach and sets out, in the light of comments from PESs and others, revised estimates.

The Initial Proposals

4.2 Ofgem's Initial Proposals set out an appropriate generation allowance in calculating the level of maximum price restraints for Standard Domestic and Domestic Economy 7 tariffs from 1 April 2000. Ofgem used national load profiles and 1998/99 Pool prices to determine an underlying Pool purchase cost for each tariff type. The Pool Selling Price component for the domestic unrestricted profile was £28.75/MWh in 1998/99 prices. To this was added a contract premium of just under 11 per cent and an allowance to reflect electrical losses between power stations and customer meters.

4.3 Ofgem's Initial Proposals stated that an appropriate guiding principle in determining the allowed costs of contracts would be to have regard to the net premium paid by a PES over the whole of its generation purchase portfolio. Neither relatively expensive nor relatively inexpensive contracts should be apportioned to one part of the market rather than any other. After examining the net premium paid by all PESs in relation to the costs of their entire generation portfolios, Ofgem proposed an addition to Pool purchase costs of just under 11 per cent for each PES's contract costs.

4.4 Taking these together, Ofgem's Initial Proposals document proposed that the appropriate generation cost allowance in 2000/01 for a domestic unrestricted profile would on average be £34.82 per MWh, and for a domestic restricted profile would be £29.66 per MWh in 1998/99 prices.

Respondents' views

4.5 Respondents to Ofgem's Initial Proposals document broadly supported the principle of setting a prespecified generation purchase cost allowance in calculating maximum price restraints. Many respondents for example noted that such an approach would encourage PESs to achieve efficiencies in generation purchase costs.

4.6 A number of PESs raised two technical points regarding the approach set out by Ofgem. First, PESs noted that Ofgem's Initial Proposals set out an adjustment to reflect the financial cost of electrical losses. This adjustment represented the electrical losses incurred in supply customers with a demand below 100kW. A number of PESs commented that this approach did not fully reflect the losses incurred in transporting electricity to domestic premises. Many PESs argued that published low voltage line loss factors should be used to determine the appropriate adjustment for electrical losses. Some PESs also suggested that published loss factors should be weighted by half-hourly Pool Selling Price to reflect the true financial costs of electrical losses.

4.7 Second, some PESs argued that regional load profiles differ materially from the national average profiles used by Ofgem in calculating the generation cost allowance. These PESs have argued that an allowance should be made for such regional differences.

4.8 Many respondents to the Initial Proposals commented on the level of the contract premium used in setting the generation cost allowances. A number of PESs commented that the demand characteristics of the domestic load profiles imply more unpredictable prices than for other profiles. As a result, domestic load profiles should be allocated a higher contract premium to hedge against such unpredictability. Some PESs argued that on this basis a premium nearer 15 per cent, as reported in Table 5.3 of Ofgem's Initial Proposals, would be more appropriate.

4.9 Some PESs expressed the view that Ofgem's allowance for the contract premium would limit their ability to recover the full cost of relatively expensive contracts signed prior to the opening of the under 100kW market to competition. Of these PESs, some argued that these contracts helped to facilitate new entry in to the generation market, thus reducing the dominance of the two major generators at that time, thus promoting competition.

4.10 Some PESs also argued that these contracts had been subject to and passed an economic purchasing test. The PESs suggested that this implied that the DGES had accepted that it was reasonable to recover these excess costs from the (former) franchise sector and that they should be allowed to continue to do so. One PES argued that failure to allow these costs in setting revised price restraints might jeopardise the financial viability of its supply business.

4.11 Of the other respondents to Ofgem's Initial Proposals, many supported the single portfolio approach. While recognising the benefits of a uniform allowance, one respondent commented that Ofgem should consider the individual circumstances of each company. It was suggested that the price restraints should allow the market to determine the appropriate level of costs. In contrast, another respondent commented that the generation cost allowance used in setting the price restraints should not reflect the excess costs of long term contracts above the present market level. In these circumstances they argued that a contract premium of 7 per cent was appropriate.

Discussion

Losses and regional variations in load profile shape

4.12 Regarding losses, Ofgem agrees that it is more appropriate to use published line loss factors to uprate generation costs. Accordingly, Ofgem has calculated an appropriate loss factor for each PES area using published data evaluated against the relevant customer load profile. Table 4.1 shows the revised loss adjustment factors for the Standard Domestic and Domestic Economy 7 tariff types.

4.13 Regarding regional load profiles, Ofgem believes that in practice the effect of such differences is likely to be small. In support of this view, two PESs commented that they do not consider such regional variations in setting prices outside of their area. Ofgem therefore considers it appropriate to use national average profiles in setting the appropriate generation cost allowances for maximum price restraints.

TABLE 4.1 LOSSES ADJUSTMENT FACTORS

PES	Standard Domestic	Domestic Economy 7
Eastern	1.1074	1.1058
East Midlands	1.1075	1.0992
London	1.1123	1.1057
Manweb	1.1595	1.1519
Midlands	1.1074	1.0982
Northern	1.1135	1.1075
NORWEB	1.1135	1.1093
SEEBOARD	1.1147	1.1109
Southern	1.1047	1.1020
SWALEC	1.1121	1.1072
South Western	1.1041	1.1027
Yorkshire	1.1200	1.1101
ScottishPower	1.1116	1.1108
Hydro-Electric	1.1408	1.1400

Allowed contract premium and legacy contracts

4.14 Ofgem considers that it reasonable to set an allowance for the contract premium based on a PES's entire purchase portfolio, so that one customer group is not disadvantaged to the benefit of another. Ofgem does not however accept that the PESs should be given an additional allowance to reflect differing regional circumstances, nor is it clear that domestic profiles would require a premium above that for the market as a whole.

4.15 Ofgem recognises that a variety of contracts (including those which enabled plant to be built by new entrants) has had some beneficial effect on the competitiveness of the generation market as a whole. When such contracts were reviewed with regard to economic purchasing, it was in the context of an anticipated opening of the market to competition in 1998. Many PESs had an equity share in the relevant generating stations.

4.16 Ofgem believes that it would not be appropriate to make these contracts a special case; nor to expect the price controlled market to bear an undue share of the relevant cost. By adding the overall cost of these contracts to the nationally allowed generation cost, the price restraints would permit PESs who have purchased economically overall to recover their generation costs in full.

4.17 In view of the above, Ofgem propose that an allowance of just under 11 per cent is sufficient for the domestic sector.

Future generation costs

4.18 It is anticipated that new electricity trading arrangements (NETA) will be in place by October 2000. These arrangements, which are designed to facilitate bilateral contract negotiation and trading, should also promote increased competition. Further consents for gas fired stations, which may follow the implementation of new trading arrangements, would further reinforce this.

4.19 Some respondents to Ofgem's Initial Proposals commented that the generation cost allowance used in setting maximum price restraints should reflect future market conditions, for instance by including an allowance for future reductions in generation costs resulting from NETA. Ofgem recognises that there is significant uncertainty surrounding the impact of NETA in the short term. Ofgem therefore does not accept that it is appropriate to pre-empt reduction in generation costs that might result from the operation of the revised trading arrangements. To do so would impose substantial risk on supply businesses.

Ofgem's proposed generation cost allowance

4.20 After considering all the issues, Ofgem proposes to use national load profiles in calculating an allowance for generation costs. Ofgem also considers that a premium of just under 11 per cent is sufficient to reflect the additional costs of purchase contracts. This allowance gives some recognition for the additional costs of long-term electricity purchase contracts. Ofgem also proposes a revised allowance for electrical losses based on published low voltage line loss factors for each PES area.

4.21 Taking these together, Ofgem proposes that the appropriate generation cost allowance in 2000/01 for a domestic unrestricted profile would on average be £35.49 per MWh, and for a domestic restricted profile would be £30.12 per MWh in 1998/99 prices.

5 UPDATED VIEW ON DISTRIBUTION AND TRANSMISSION USE OF SYSTEM CHARGES

Introduction

5.1 Suppliers pay Distribution and Transmission Use of System (DUoS and TUoS) charges for the transportation of electricity from power stations to customers' premises. In 1998/99 distribution and transmission charges together accounted for around a third of a typical domestic customer's annual bill. Ofgem proposes to ensure that the levels of the restraints for Standard Domestic and Domestic Economy 7 customers reflect the actual published charges faced by supply businesses in respect of the transportation of electricity.

5.2 For the purposes of estimating indicative price reductions for the Standard Domestic and Domestic Economy 7 tariffs in 2000/01, Ofgem has estimated the level of use of system charges to take effect from 1 April 2000 using PES indicative DUoS charges produced in November. These are broadly consistent with the final proposals for distribution price controls published in December 1999, although PESs may make adjustments to their indicative DuoS charges to reflect the final proposals. Estimated DUoS charges are set out in Table 5.1.

Transmission use of system charges – England and Wales

5.3 Suppliers pay the National Grid Company (NGC) the costs of transporting electricity across the transmission network. These costs comprise two distinct components. One part is the Transmission Network Use of System (TNUoS) charge. The other part is the Transmission Services Use of System (TSUoS) charge.

TABLE 5.1 ESTIMATED DUOS CHARGES FOR STANDARD DOMESTIC AND DOMESTIC ECONOMY 7 CUSTOMERS IN 2000/01 (1999/00 PRICES)

	Standard Domestic[1]			Domestic Economy 7[2]		
PES	Average unit rate 1999/00	Average unit rate 2000/01	Change Since 1999/00	Average unit rate 1999/00	Average unit rate 2000/01	Change Since 1999/00
	p/kWh	p/kWh	%	p/kWh	p/kWh	%
Eastern	1.91	1.43	25.0	1.23	0.91	25.5
East Midlands	2.20	1.67	24.0	1.32	1.00	24.0
London	2.30	1.66	27.5	1.47	1.06	27.
Manweb	2.68	2.05	23.4	1.77	1.35	23.4
Midlands	2.14	1.69	21.1	1.34	1.06	21.1
Northern	2.45	1.88	23.2	1.49	1.18	20.9
NORWEB	2.47	1.64	33.8	1.52	0.93	38.6
SEEBOARD	2.04	1.36	33.3	1.27	0.84	33.3
Southern	2.19	1.81	17.5	1.34	1.11	17.5
SWALEC	3.22	2.56	20.7	1.96	1.55	20.7
South Western	2.52	2.02	19.9	1.60	1.27	20.8
Yorkshire	2.26	1.74	23.1	1.43	1.10	23.1
ScottishPower[3]	2.94	2.41	18.0	2.08	1.71	18.0
Hydro-Electric[4]	2.38	2.25	5.4	1.66	1.52	8.4
Unweighted mean	2.41	1.87	22.4	1.53	1.19	22.2

Note:

1,2 A Standard Domestic customer is assumed to consume 3,300kWh per year. A Domestic Economy 7 customer is assumed to consume 3,000kWh during the day and 3,600kWh at night.

3,4 ScottishPower's Economy 7 tariff represents the Domestic White Meter tariff. Hydro-Electric's Domestic Economy 7 tariff represents the Domestic Economy 8 tariff.

Transmission network use of system

5.4 For the England and Wales PESs, Ofgem's Initial Proposals set out an allowance for TNUoS charges applying to Standard Domestic and Domestic Economy 7 tariffs using costs reported in the PES business plans. These estimates were rolled forward to determine the appropriate allowance for 2000/01 using the operation of the price control applying to NGC's transmission business, and included the forecast effect of correction factors.

5.5 NGC publishes TNUoS charges prior to the start of the year to which they will apply. In order to allow the pass through of and to monitor the transmission element of tariffs, Ofgem proposes instead to determine directly the TNUoS component applicable to each standard tariff type using these published charges.

5.6 Ofgem proposes that the appropriate TNUoS component for each of the price restraints be determined by multiplying the demand from the relevant domestic load profile at 17:00 on a winter weekday by the relevant NGC demand charge for each PES region. The resulting transmission cost can then be spread over the average annual consumption for the load profile to determine the appropriate per unit TNUoS allowance.

5.7 NGC typically publishes TNUoS charges around January of each year. In calculating the indicative real reductions in the Standard Domestic and Domestic Economy 7 tariff prices for 2000/01, it is therefore necessary to estimate the level of TNUoS costs to be incurred by the supply businesses from 1 April 2000. This has been done by estimating the appropriate TNUoS charge for each of the standard tariff types in 1999/00 and rolling this forward by the operation of NGC's transmission price control.

5.8 NGC is presently reviewing the basis for calculating TNUoS charges to suppliers for non half-hourly metered customers. Ofgem is aware that, as part of this review, NGC is examining alternative bases on which TNUoS charges may be calculated in 2000/01. In order to preserve the pass through of published TNUoS charges in setting restraints, Ofgem proposes that licence modifications allow for the possibility of revised charging arrangements for this element.

Transmission services use of system charges

5.9 TSUoS charges take the form of an addition to the half hourly Pool Selling Price (PSP) which NGC presently passes on to suppliers in England and Wales. Unlike TNUoS charges, TSUoS charges are determined in each half-hourly period to which they apply. It is not therefore clear that it is possible to devise a practicable and transparent mechanism for the direct pass-through of such charges, nor is it clear how such costs may be treated within the framework of the new electricity trading arrangements. Ofgem believes it is reasonable set a pre-specified allowance for TSUoS on a similar basis to generation costs.

5.10 As indicated in the Initial Proposals, Ofgem proposes a TSUoS allowance for each PES, after allowing for network losses, of 0.11 p/kWh for a Standard Domestic tariff and 0.10 p/kWh for a Domestic Economy 7 tariff in 2000/01.

Transmission use of system charges - Scotland

5.11 ScottishPower and Hydro-Electric publish transmission use of system charges within their authorised areas. As explained in the Initial Proposals, charges for this element are governed by a price control. Ofgem has reviewed these price controls and proposed revised transmission charges to 2000/01 for the Scottish transmission businesses of ScottishPower and Hydro-Electric.

5.12 In order to allow the pass-through of and to monitor the transmission element of tariffs, Ofgem proposes to determine the appropriate TUoS component applicable to each standard tariff type using these published charges.

5.13 In calculating the indicative real price reductions in the Standard Domestic and Domestic Economy 7 tariff prices for 2000/01, it has been necessary to estimate the level of TUoS charges. Ofgem has determined that the indicative level of charges should reflect 1999/00 charges rolled forward by the operation of the revised transmission price controls in Scotland.

Respondents' views

5.14 Most respondents to Ofgem's Initial Proposals supported the approach that the final prices to Standard Domestic and Domestic Economy 7 customers should reflect published use of system charges. Many PESs commented that pass-through of published DUoS and TNUoS charges was necessary to achieve the correct balance of incentives. Two PESs commented that it could be difficult to achieve a transparent pass-through mechanism for TNUoS charges and that Ofgem should consider a pre-specified transmission allowance.

Discussion

5.15 The pass through of published DUoS and TUoS charges will ensure that customers pay no more or less than is appropriate. It preserves equity with other second tier suppliers, and should be transparent to monitor.

Most respondents have agreed with this treatment. Ofgem proposes therefore to set price restraints such that they reflect published charges.

6 UPDATED VIEW ON SUPPLY BUSINESS COSTS AND MARGINS

Introduction

6.1 Supply business costs and margins account for about 13 per cent of a typical domestic customer's annual bill, or about 17 per cent after the transfer of costs from PESs' distribution to supply businesses which was set out in the Initial Proposals. The Initial Proposals also described how an allowance for supply business costs could be derived for the setting of price restraints, and noted that an appropriate margin would be 1.5 per cent.

Supply business costs: Initial Proposals

6.2 The Initial Proposals set out a per domestic customer allowance for supply business costs for each PES. This allowance could be translated to a per unit allowance in order to be built into the calculation of the level of restraints.

6.3 Ofgem calculated the domestic customer allowance using an average of PES first tier under 100 kW costs. These costs were first adjusted for exceptional items, the transfer of certain costs from PES distribution to supply businesses, the Data Management Services allowance, and an allowance in respect of separation costs. Using customer numbers as an appropriate cost driver suggested that, on average, costs for this portion of a PES's supply business were about £26 per customer, plus a £14 million fixed component.

6.4 Ofgem translated these components into a cost per domestic customer. It spread fixed costs over each PES's customer base at 31 March 1999 less a pre-set customer loss figure of 19 per cent. It adjusted for the ratio of supply business costs per domestic customer to supply business costs per first tier under 100 kW customer. Table 7.8 of the Initial Proposals set out the supply business costs per domestic customer built into the initially proposed price restraints. This table is reproduced as Table 6.1.

Respondents' views

6.5 Most PESs broadly agreed with the method used by Ofgem. Most, however, challenged particular elements of Ofgem's calculations.

6.6 A number of PESs argued that the fixed costs of operating a first tier under 100 kW market should be greater than £14 million. Other PESs argued they were likely to lose more customers than forecast by Ofgem, so that any per customer costs in respect of fixed costs should be higher.

TABLE 6.1 SUPPLY BUSINESS COSTS PER DOMESTIC CUSTOMER IN 2000/01 (1998/99 PRICES)

PES	Supply business Cost £/customer
Eastern	29.86
East Midlands	31.91
London	31.00
Manweb	34.05
Midlands	32.21
Northern	35.80
NORWEB	32.09
SEEBOARD	32.97
Southern	29.32
SWALEC	41.74
South Western	34.05
Yorkshire	32.67
Scottish Power	31.58
Hydro-Electric	45.04

Source: Ofgem's paper *Supply Price Control Review – Initial Proposals*

6.7 Seven PESs argued against Ofgem's assumption that each of the horizontally integrated companies should be awarded only 75 per cent of fixed costs. PESs argued this either on the grounds that any savings from horizontal integration may not have yet occurred, or that the increased reduction in price restraint levels resulting from the assumption would dampen competitive forces in those areas.

6.8 Regarding the transfer of costs from Distribution to Supply businesses, some PESs argued that the portion of this transfer that should be allocated to the first tier under 100 kW market should either be greater, and/or based on customer numbers.

6.9 A number of PESs argued that the allowance in respect of DMS revenues and costs of separation should be given fully to each PES. It followed that such allowance should not be subject to Ofgem's averaging process.

6.10 Some PESs also argued that Ofgem had failed to take into account a number of potential costs. PESs identified for example increased costs as a result of implementing NETA, the Social Action Plan, revised costs of meeting Energy Efficiency Standards of Performance, and business separation. Estimates produced by the companies for example of the anticipated costs with respect to NETA ranged from £2m to £3m for the domestic market. Some PESs also put forward the view that region specific socio-economic conditions would increase their supply business operating costs significantly.

6.11 Of the ECCs that commented on supply business operating costs, some expressed concern over the lack of standardised accounting procedures across PESs for supply business costs. One for example suggested that this was the source of the range of reported margins in the Initial Proposals. Another ECC argued that access to unpublished accounts would be helpful in gauging whether Ofgem's allowances were appropriate. Of the other respondents, two supported the averaging approach adopted by Ofgem.

Energy efficiency standards of performance

6.12 Ofgem's October paper *Energy Efficiency: Standards of Performance 2000-2002* proposed revised standards that would be consistent with expenditure by the PESs of £1.20 per customer. This is an increase of £0.20 on the £1 per customer included within the PES supply business costs in the Initial Proposals.

Supply business costs : final proposals

6.13 Ofgem has produced revised estimates of supply business operating costs taking into account some of the points raised by PESs and other points above. Ofgem remains committed however to the principle of basing an allowance on averages across all PESs, and moving to a set of price restraints that represents harmonisation of these costs. Such an approach would be consistent with, and complement, the development of the competitive market where suppliers with above average costs are likely to be at a disadvantage relative to the market price.

6.14 The following paragraphs describe Ofgem's revised method of estimating supply business operating costs, taking account of relevant points described above.

6.15 Ofgem has taken first tier under 100 kW supply business operating costs for 1998/99 as reported in PES business plans as a starting point for analysis and performed the following adjustments:

- subtraction of exceptional costs, except where a portion of such costs is in respect of expenditure to meet Energy Efficiency Standards of Performance (EESoPs);

- addition of £0.20 per domestic customer to recognise the revised EESoPs; and

- addition of the Distribution to Supply transfer as proposed in Ofgem's December 1999 Distribution Price Control proposals. The transfer has been apportioned to the under 100 kW market on the basis of customer numbers.

6.16 Table 6.2 sets out Ofgem's revised calculation of the transfer of costs from the PES distribution business to the first tier under 100kW supply business. Table 6.3 sets out the adjusted first tier under 100 kW supply business operating costs.

Horizontal integration

6.17 The Initial Proposals were based on the assumption that horizontally integrated companies would be subject to economies of scale. Ofgem assumed that such economies might be captured by assuming that fixed costs for horizontally integrated companies would only be three quarters (on a per company basis) of costs for non horizontally integrated companies.

TABLE 6.2 ANALYSIS OF COSTS TRANSFERRED FROM DISTRIBUTION

PES	Costs Transferred per Distribution price control (1997/98 prices) £m	Costs apportioned to < 100kW market (1998/99 prices) £m
Eastern	30.2	30.4
East Midlands	24.4	25.1
London	41.3	42.5
Manweb	18.9	19.5
Midlands	15.2	15.5
Northern	12.7	12.8
NORWEB	18.3	18.8
SEEBOARD	25.5	26.2
Southern	9.5	9.7
SWALEC	11.3	11.5
South Western	8.9	9.2
Yorkshire	18.4	18.3
Scottish Power	21.6	22.0
Hydro-Electric	7.5	7.7

Source: Ofgem

TABLE 6.3 ADJUSTED FIRST TIER UNDER 100KW SUPPLY BUSINESS OPERATING COSTS (1998/99 PRICES £M)

PES	1998/99 Under 100kW 1st tier supply business costs £m	Exceptional costs £m	Transfer from Distribution To Supply £m	Adjustment for additional EESoP costs £m	Adjusted supply business costs £m
Eastern	63.3	0.0	30.4	0.6	94.3
East Midlands	51.6	6.9	25.1	0.4	70.2
London	53.5	0.0	42.5	0.4	96.4
Manweb	26.1	0.0	19.5	0.2	45.8
Midlands	64.8	13.8	15.5	0.4	66.9
Northern	43.8	0.0	12.8	0.3	56.9
NORWEB	63.2	2.1	18.8	0.4	80.3
SEEBOARD	47.9	0.0	26.2	0.4	74.5
Southern	56.9	0.0	9.7	0.5	67.1
SWALEC	24.9	0.0	11.5	0.2	36.6
South Western	27.1	2.2	9.2	0.2	34.3
Yorkshire	59.1	0.0	18.3	0.4	77.8
Scottish Power	45.9	0.0	22.0	0.3	68.2
Hydro-Electric	50.8	18.8	7.7	0.1	39.8

Source: PES Business Plans and Ofgem

6.18 London and South Western argued against this treatment on the grounds for example that merger benefits could not be achieved immediately nor without substantial investment. Scottish and Southern Energy expressed objections to the adjustment on the grounds for example that it would distort the cost-benefit and timing of otherwise efficient corporate restructuring. Ofgem has accordingly not applied the three-quarters rule to these companies but has sought to reflect the potential efficiencies arising in the proposals.

6.19 When considering an efficient level of costs for the industry as a whole, however it seems reasonable to recognise that horizontal integration is likely to result in economies of scale and lower per unit operating costs. In view of the above, Scottish Power and Manweb, and Scottish and Southern Energy have been aggregated and treated as a single company for the purposes of calculating appropriate cost allowances for both fixed and variable costs.

6.20 The estimate of the fixed cost per PES business derived in this way relates to 12 supply business units. To recognise the fact that Manweb/Scottish Power and Southern/Hydro groups may have higher fixed costs than a non horizontally integrated supply business, each group has been assigned one seventh of the total fixed cost base. The remaining ten companies have been assigned fixed costs equal to one fourteenth of the total fixed cost base.

Treatment of working capital

6.21 Ofgem's broad approach to setting an allowance for supply business operating costs equal to an adjusted average of all PESs' relevant supply business costs would tend to give an allowance based on a mix of customers using different payment types. In particular, direct debit costs were reflected in the previous control. Following their removal from the scope of the new controls, PESs have argued that if the final price restraints are to apply to standard quarterly credit customers, this allowance needs to be uprated to reflect the above average costs of serving these customers in terms of additional working capital. One PES for example estimated the additional cost at £2.80 per customer per year. Ofgem accepts the spirit of this argument and proposes to include a one-off allowance of £1.50 (in 1999/00 prices) to the supply business cost allowance per customer. The majority of working capital will continue to be financed out of the margin.

Calculation of the cost per customer allowance

6.22 Taking a weighted average of the 12 observations gives an estimate for fixed costs of £8.30 million, and a variable cost of £31.30 per customer. Given the treatment of fixed costs and since the domestic sector accounts for on average 85.5 per cent of first tier under 100 kW costs, Ofgem has translated these into a pound per domestic customer allowance as follows:

- the fixed cost per company is given as the overall fixed cost multiplied by twelve fourteenths and 85.5 per cent. A fixed cost per customer is calculated by taking this adjusted fixed cost and dividing by the number of domestic customers less 19 per cent; and

- a variable cost per domestic customer is calculated as the variable cost multiplied by the ratio of average costs per domestic customer to average costs per first tier under 100 kW customer. Added to this are company specific per domestic customer allowances in respect of DMS revenue, separation costs, and working capital. DMS revenue for the supply business is given as one third of the total DMS allowance. Separation costs are set at the level of £0.2 million per PES. The working capital allowance is £1.50 per domestic customer (1999/00 prices).

6.23 Table 6.4 gives the per domestic customer allowances for each PES.

TABLE 6.4 SUPPLY BUSINESS COSTS PER DOMESTIC CUSTOMER IN 2000/01 (1998/99 PRICES)

PES	Cost per domestic customer £	PES	Cost per domestic customer £
Eastern	34.41	SEEBOARD	36.47
East Midlands	35.77	Southern	37.68
London	36.58	SWALEC	42.20
Manweb	38.00	South Western	39.28
Midlands	35.99	Yorkshire	36.26
Northern	38.32	Scottish Power	38.00
NORWEB	35.90	Hydro-Electric	37.68

New Electricity Trading Arrangement costs

6.24 A number of PESs have expressed concern over the costs of implementing NETA. Some PESs for example estimated that implementation may cost a PES an additional £2 - 3 million per year in supply business costs attributable to the domestic sector. These PESs argued for the restraints to be set on the basis of these additional costs.

6.25 It remains unclear at this stage:-

- what the precise level of costs associated with NETA will be and when they might occur;
- if and how any such costs should be attributed to the domestic sector;
- whether such costs would be offset by generation cost savings in the relevant period; and
- whether such costs could be passed through in the competitive market.

6.26 A reasonable approach to this issue would therefore be to defer consideration of building into the restraints an allowance for such additional costs until the costs are better known and until there has been experience of the operation of the revised price restraints.

Margin

6.27 The Initial Proposals suggested that an appropriate allowance for a margin would be 1.5 per cent. Ofgem argued that this level would be the appropriate margin to earn in an area of the market where competition is not fully developed.

6.28 The majority of PESs argued that Ofgem's 1.5 per cent allowance for the margin was too low. Some PESs for example argued that the introduction of the competitive market would increase risks and hence pointed to a higher margin, or that other, similar retailers were earning margins considerably above 1.5 per cent. Some PESs also argued that a reduction in the allowed margin would tend to discourage new entrants to the market, and hence would tend to hinder the development of effective competition.

6.29 Of the six ECCs who commented on the level of the margin, three supported 1.5 per cent. Three others argued that the appropriate level of the margin should be seen in the context of encouraging competitive entry.

6.30 Ofgem takes the view that the prescribed margin of 1.5 per cent is the appropriate level to apply to prices which reflect areas of the market in which PESs face relatively few competitive pressures. The absence of competitive pressures would tend to allow PESs to price to the level allowed by the price restraint, and so building in a margin of 1.5 per cent provides internal consistency in this event.

6.31 A further and more important argument is that Ofgem is not seeking to cap margins in the competitive areas of the market at 1.5 per cent. It is not Ofgem's policy to regulate margins in the competitive market or to penalise genuine efficiencies. Naturally, however, there would be concern if there were to be a major change in margins accompanying a significant fall in generation prices and little or no change in retail prices.

7 FINAL PROPOSALS FOR REVISED MAXIMUM PRICE RESTRAINTS

Introduction

7.1 Ofgem's final proposals are for maximum price restraints on two basic tariffs, Standard Domestic and Domestic Economy 7. Ofgem has calculated indicative levels for the restraints for each PES for the year 2000/01. On average, prices for Standard Domestic tariffs should fall by about 5.8 per cent in real terms, and for Domestic Economy 7 tariffs by about 2.1 per cent in real terms.

Summary of final proposals

7.2 A summary of the final proposals for revised price restraints for Standard Domestic and Domestic Economy 7 customers in 2000/01 is set out in tables 7.1 and 7.2. The impact on a typical Standard Domestic and Domestic Economy 7 bill in each area is set out in tables 7.3 and 7.4 respectively. The tables in Annex A give a more detailed analysis for each company.

TABLE 7.1 INDICATIVE PRICE PER UNIT SUPPLIED TO STANDARD DOMESTIC CUSTOMERS

PES	Existing tariff p/kWh	Proposed 2000/01 tariff (1999/00 prices) p/kWh	Real reduction %
Eastern	7.20	6.58	8.6
East Midlands	7.33	6.83	6.9
London	7.42	7.03	5.2
Manweb	7.96	7.42	6.7
Midlands	7.30	6.90	5.5
Northern	7.81	6.96	10.8
NORWEB	7.40	6.76	8.6
SEEBOARD	7.26	6.64	8.6
Southern	7.36	7.16	2.7
SWALEC	8.37	8.13	2.9
South Western	7.92	7.51	5.2
Yorkshire	7.14	6.89	3.6
Scottish Power	7.86	7.60	3.3
Hydro-Electric	8.01	7.77	3.0
Unweighted mean	7.60	7.15	5.8

TABLE 7.2 INDICATIVE PRICE PER UNIT SUPPLIED TO DOMESTIC ECONOMY 7 CUSTOMERS

PES	Existing tariff p/kWh	Proposed 2000/01 tariff (1999/00 prices) p/kWh	Real reduction %
Eastern	5.11	4.85	5.0
East Midlands	5.06	4.92	2.8
London	5.21	5.11	1.8
Manweb	5.46	5.44	0.3
Midlands	5.29	5.00	5.3
Northern	5.11	5.06	1.0
NORWEB	5.19	4.85	6.6
SEEBOARD	4.97	4.85	2.5
Southern	5.16	5.15	0.2
SWALEC	5.72	5.71	0.2
South Western	5.59	5.39	3.5
Yorkshire	4.98	4.98	0.0
Scottish Power	5.70	5.65	0.8
Hydro-Electric	5.67	5.67	0.1
Unweighted mean	5.30	5.19	2.1

TABLE 7.3 INDICATIVE IMPACT OF FINAL PROPOSALS ON A TYPICAL STANDARD DOMESTIC CUSTOMER'S ANNUAL BILL

PES	Existing £	Proposed 2000/01 £	Reduction £
Eastern	238	217	20
East Midlands	242	225	17
London	245	232	13
Manweb	263	245	18
Midlands	241	228	13
Northern	258	230	28
NORWEB	244	223	21
SEEBOARD	240	219	21
Southern	243	236	7
SWALEC	276	268	8
South Western	261	248	14
Yorkshire	236	227	9
Scottish Power	259	251	9
Hydro – Electric	264	256	8
Unweighted mean	251	236	15

TABLE 7.4 INDICATIVE IMPACT OF FINAL PROPOSALS ON A TYPICAL DOMESTIC ECONOMY 7 CUSTOMER'S ANNUAL BILL

PES	Existing £	Proposed 2000/01 £	Reduction £
Eastern	337	320	17
East Midlands	334	325	9
London	344	337	6
Manweb	360	359	1
Midlands	349	330	19
Northern	337	334	3
NORWEB	343	320	23
SEEBOARD	328	320	8
Southern	341	340	1
SWALEC	378	377	1
South Western	369	356	13
Yorkshire	328	328	0
Scottish Power	376	373	3
Hydro – Electric	375	374	0
Unweighted mean	350	343	7

Calculation of the restraints

7.3 As explained in the Initial Proposals document, each price restraint has been calculated as the sum of :

- the appropriate generation cost (as set out in Chapter 4);
- an estimate of DUoS and TUoS charges applicable to each category (as set out in Chapter 5);
- an appropriate allowance for supply business costs (as set out in Chapter 6);
- a margin of 1.5 per cent on all costs; and
- a fossil fuel levy of 0.3 per cent in England and Wales and 0 per cent in Scotland.

7.4 The proposals allow for the pass through of published DUoS and TUoS charges. To the extent that these turn out differently from Ofgem's present assumptions therefore, the level of the restraints will vary accordingly.

The continued development of competition

7.5 The proposals need to strike a balance between :

- the shorter term protection of customers' interests, by restricting prices where the full benefits of competition are not yet being felt; and
- the longer term protection of customers' interests, by allowing sufficient headroom to permit the free and undistorted development of competition in all areas of the market.

7.6 The proposals to reduce the average annual bills for Standard Domestic customers by £15 and Domestic Economy 7 by £7 meet both these requirements. These reductions in themselves afford a significant degree of protection and allow all customers a share in the present benefits of the competitive market. It should be noted that these reductions apply to existing tariffs, which in some cases are already below the levels set by the present price restraints.

7.7 At the same time, comparison of the proposed tariffs with competing offers suggests that the final proposals will leave a headroom of at least 5 per cent (or a further £13 for each tariff type) over the better competing offers in each PES area (after making an appropriate adjustment to take into account lower distribution prices).

7.8 The competitive headroom for dual fuel offers would be considerably higher (of the order of a further 5 per cent or £13 per tariff after allowing for acquisition costs), reflecting the considerable supply cost savings achievable in the market.

7.9 All of these figures are struck before any impact which might arise from pressure on generation prices arising from more effective competition in that market; NETA; and any relaxation of the current restrictions on consents for gas-fired generating stations.

8 IMPLEMENTATION ISSUES

Introduction

8.1 Subject to acceptance of final proposals by PESs, Ofgem intends to write supply licence modifications before the end of January 2000 which will give effect to the proposals from 1 April 2000. Given the proposed form of control, there are a number of options for expressing the final proposals in the licence modifications. Supply price controls have, in the past, for example, been formally expressed as an RPI-X control where X has been the required real reduction in revenues or prices. Given the form and duration of the presently proposed price restraints, it may be appropriate to adopt a suitably revised treatment.

8.2 In addition, there are a number of other issues that require clarification. The Initial Proposals for example noted that it would be important to monitor the PESs' generation purchase costs during the course of the operation of the revised restraints. It will be important to agree a form and process for this monitoring. Another important issue is the treatment of domestic tariffs that are not Standard Domestic or Domestic Economy 7.

8.3 This chapter sets out Ofgem's views on these issues.

Licence modifications

Treatment of payment types

8.4 The final proposals are intended to set a restraint on prices charged to Standard Domestic and Domestic Economy 7 customers. Prices charged to customers vary by payment method. For example, customers paying 'promptly' receive, from some PESs, a discount on payment. Ofgem has set the level of restraints on the basis of an average mix of prompt and standard payment types across all PESs. Ofgem intends therefore, to write licence modifications in a way that permits PESs to continue to offer prompt payment discounts, provided both that :

- the weighted average of such prices does not exceed the ceiling defined in the licence; and

- PESs do not unduly discriminate between classes of customers in setting prompt payment discounts.

8.5 It is important to note that the calculations and proposed price controls do not apply to the direct debit discount or to the prepayment meter surcharge. Customers paying by direct debit will receive protection through the operation of the non-discrimination conditions. The position of prepayment meter customers is discussed below.

Expression of restraints

8.6 Ofgem's proposed price restraints set a ceiling on prices to be charged to Standard Domestic and Domestic Economy 7 tariffs. This ceiling has been based on a view of appropriate generation purchase costs, supply business operating costs and margin, distribution and transmission use of system charges, and the Fossil Fuel Levy. Ofgem intends that the level of restraints reflect published values for the last three items, effectively treating each as a pass through item.

8.7 It may be appropriate to define in the licence modifications an allowance for each PES in respect of generation purchase and supply business costs, for both Standard Domestic and Domestic Economy 7 tariffs. The licence condition would define the maximum price per unit to be charged during the year as this allowance plus prevailing relevant charges for Distribution and Transmission Use of System charges, plus the Fossil Fuel Levy, plus a 1.5 per cent margin on this total. Ofgem intends that average price increases would be capped where relevant to ensure that maximum prices of the restrained tariffs do not increase in real terms.

Standing charges and unit rates

8.8 The overall restraint will apply to the average unit price, assuming a consumption level of 3300 kWh per year for Standard Domestic, and 6600 kWh per year for Domestic Economy 7. PESs could meet the required restraint therefore by a combination of reductions in standing charges and unit rates. Ofgem is content for PESs to rebalance tariffs in this way provided that standing charges for these tariffs do not increase in real terms.

Retail Price Index

8.9 The allowances for generation purchase and supply business costs will be expressed in 1999/00 prices. It will be appropriate to inflate these figures to 2000/01 prices by using the existing licence definition of RPI. This is based on the annual change of RPI from the previous July to December.

Fossil Fuel Levy

8.10 Revisions to the fossil fuel levy rate in England and Wales take effect from 1 October each year, and in Scotland from 1 April each year. Ofgem intends that the calculated level of price restraints should reflect the prevailing levy rate. The Initial Proposals suggested that, in order to avoid revising the level of the restraints from October each year, the level of restraints be revised only if the levy rate changes by more than one half of a percentage point. Of the respondents who commented on this issue, most agreed that this would be an appropriate treatment. Ofgem therefore intends to frame licence modifications to reflect this approach.

Prepayment meter customers

8.11 In October 1999, Ofgem published *Prepayment Meters A Consultation Document*. This proposed that the allowed maximum prepayment meter surcharge would be £15 per year for most PESs. The maximum for Eastern and Hydro-Electric would be set at £11.22 and £0 respectively. These proposals are presently subject to discussions with the companies. The document noted that prices for prepayment meter customers would need to be decreased in line with the proposals for price restraints, subject to the addition of the maximum allowed surcharge.

Direct debit discounts

8.12 The restraints for the two standard tariffs have been set on the assumption that customers will pay by quarterly credit, perhaps differentiated by 'prompt' payment. The restraints do not therefore constrain the level of any discount that PESs may offer for payment by direct debit. Ofgem would expect any direct debit discount or tariff type not to discriminate unduly between customer classes. Hence customers paying by direct debit will receive additional protection in terms of price through the operation of the non-discrimination conditions.

Treatment of other domestic tariffs

8.13 A small but significant number of domestic customers are supplied under tariffs that are not Standard Domestic or Domestic Economy 7 tariffs. Some customers for example continue to be supplied under tariffs that are no longer offered to new customers. Such customers will not be protected by direct price regulation from 1 April 2000. It is Ofgem's intention that the licence will prohibit any real increase in any component of such tariffs, except where the PES has the prior written consent of the DGES. Such an approach will continue to protect these customers' interests while allowing PESs scope to rebalance such tariffs.

Availability of tariffs

8.14 The proposals are intended to set backstop tariffs that protect the interests of domestic customers. In order to ensure that all domestic customers have the potential to receive such protection, Ofgem intends that PESs make available to all domestic customers the two standard tariffs that will be subject to restraint. Ofgem intends to write licence modifications that reflect this.

Reporting of generation purchase costs

8.15 Chapter 4 set out Ofgem's approach to assessing appropriate generation purchase costs for the purposes of setting restraints. The Initial Proposals noted that it would be important to continue to monitor generation purchase costs over the period that the restraints are in operation.

8.16 PESs gave mixed views on the suggested monitoring of generation purchase costs. Some for example expressed concern about overly detailed or onerous reporting requirements, while others expressed concern over the publication of such monitoring, because it might jeopardise commercial confidentiality. Some other PESs recognised or supported the need for monitoring, subject to these points. One PES suggested that Ofgem consult on the issue before formulating reporting requirements. Of the ECCs that commented, most supported Ofgem's intention to monitor and / or publish information on generation purchase costs. Two other respondents supported the monitoring of generation costs, with one favouring publication of such data, preferably differentiated by fuel type.

8.17 Ofgem intends to pursue the monitoring and possible publication of such data. It will be important to discuss with the PESs and others the appropriate form of such reporting and publication, with due consideration to any administrative burden and concerns over commercial confidentiality. Subject to these discussions, Ofgem intends to publish a further statement regarding the reporting of generation purchase costs early in the new year.

BREAKDOWN OF FINAL PROPOSALS

Eastern

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	6.3	(0.6)	3.4
Distribution	%	6.6	6.1	6.4
Transmission	%	0.0	0.1	0.1
Supply	%	(7.8)	(3.9)	(6.2)
Margin 1.5%	%	3.0	2.8	2.9
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	8.6	5.0	7.1
1999/00 Typical annual bill	£	238	337	-
2000/01 Typical annual bill (1999/00 prices)	£	217	320	-
Real reduction	£	20	17	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

East Midlands

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	(4.6)	(8.4)	(7.0)
Distribution	%	7.2	6.3	6.6
Transmission	%	0.3	0.5	0.4
Supply	%	(11.3)	(8.0)	(9.2)
Margin 1.5%	%	14.9	12.0	13.1
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	6.9	2.8	4.2
1999/00 Typical annual bill	£	242	334	-
2000/01 Typical annual bill (1999/00 prices)	£	225	325	-
Real reduction	£	17	9	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

London

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	(1.9)	1.7	(1.3)
Distribution	%	8.5	7.7	8.4
Transmission	%	(1.0)	(1.5)	(1.1)
Supply	%	(5.4)	(4.8)	(5.3)
Margin 1.5%	%	4.7	(1.7)	3.6
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	5.2	1.8	4.7
1999/00 Typical annual bill	£	245	344	-
2000/01 Typical annual bill (1999/00 prices)	£	232	337	-
Real reduction	£	13	6	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Manweb

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	(1.6)	(3.4)	(1.9)
Distribution	%	7.9	7.6	7.8
Transmission	%	(1.2)	(1.7)	(1.3)
Supply	%	(9.2)	(6.3)	(8.7)
Margin 1.5%	%	10.4	3.7	9.3
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	6.7	0.3	5.7
1999/00 Typical annual bill	£	263	360	-
2000/01 Typical annual bill (1999/00 prices)	£	245	359	-
Real reduction	£	18	1	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Midlands

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	1.9	(3.4)	0.3
Distribution	%	6.2	5.3	5.9
Transmission	%	0.2	0.2	0.2
Supply	%	(4.9)	(3.3)	(4.4)
Margin 1.5%	%	1.6	6.1	3.0
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	5.5	5.3	5.4
1999/00 Typical annual bill	£	241	349	-
2000/01 Typical annual bill (1999/00 prices)	£	228	330	-
Real reduction	£	13	19	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Northern

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	6.7	1.5	5.6
Distribution	%	7.3	6.1	7.0
Transmission	%	0.0	0.4	0.0
Supply	%	(4.6)	(2.5)	(4.2)
Margin 1.5%	%	1.1	(4.9)	(0.2)
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	10.8	1.0	8.7
1999/00 Typical annual bill	£	258	337	-
2000/01 Typical annual bill (1999/00 prices)	£	230	334	-
Real reduction	£	28	3	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

NORWEB

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	6.1	4.6	5.8
Distribution	%	11.3	11.3	11.3
Transmission	%	0.7	(0.3)	0.5
Supply	%	(11.0)	(7.4)	(10.1)
Margin 1.5%	%	1.0	(1.9)	0.3
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	8.6	6.6	8.1
1999/00 Typical annual bill	£	244	343	-
2000/01 Typical annual bill (1999/00 prices)	£	223	320	-
Real reduction	£	21	23	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

SEEBOARD

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	(0.7)	(7.8)	(3.6)
Distribution	%	9.4	8.5	9.2
Transmission	%	0.2	0.0	0.1
Supply	%	(10.0)	(6.6)	(8.6)
Margin 1.5%	%	9.3	8.1	8.8
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	8.6	2.5	6.2
1999/00 Typical annual bill	£	240	328	-
2000/01 Typical annual bill (1999/00 prices)	£	219	320	-
Real reduction	£	21	8	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Southern

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	3.0	(3.4)	1.6
Distribution	%	5.2	4.6	5.1
Transmission	%	0.3	0.2	0.3
Supply	%	(5.9)	(2.6)	(5.2)
Margin 1.5%	%	(0.3)	1.1	0.0
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	2.7	0.2	2.2
1999/00 Typical annual bill	£	243	341	-
2000/01 Typical annual bill (1999/00 prices)	£	236	340	-
Real reduction	£	7	1	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

SWALEC

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	1.8	(3.0)	0.9
Distribution	%	8.0	7.1	7.8
Transmission	%	0.3	0.4	0.3
Supply	%	(10.2)	(7.4)	(9.7)
Margin 1.5%	%	2.7	2.7	2.7
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	2.9	0.2	2.4
1999/00 Typical annual bill	£	276	378	-
2000/01 Typical annual bill (1999/00 prices)	£	268	377	-
Real reduction	£	8	1	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

South Western

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	2.4	1.1	1.9
Distribution	%	6.3	6.0	6.2
Transmission	%	0.3	0.2	0.3
Supply	%	(8.8)	(4.8)	(7.2)
Margin 1.5%	%	4.5	0.6	3.0
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	5.2	3.5	4.5
1999/00 Typical annual bill	£	261	369	-
2000/01 Typical annual bill (1999/00 prices)	£	248	356	-
Real reduction	£	14	13	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Yorkshire

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	0.6	(3.4)	(0.2)
Distribution	%	7.3	6.7	7.2
Transmission	%	0.2	0.0	0.2
Supply	%	(0.5)	1.2	(0.2)
Margin 1.5%	%	(4.3)	(5.7)	(4.7)
Fossil fuel levy 0.3%	%	0.4	0.4	0.4
TOTAL REAL REDUCTION	%	3.6	(0.9)	2.8
1999/00 Typical annual bill	£	236	328	-
2000/01 Typical annual bill (1999/00 prices)	£	227	331	-
Real reduction	£	9	-3[2]	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

[2]To be capped at no real increase

ScottishPower

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	3.8	2.6	3.3
Distribution	%	6.7	6.6	6.7
Transmission	%	0.1	0.0	0.1
Supply	%	(8.6)	(5.2)	(7.3)
Margin 1.5%	%	1.2	(3.2)	(0.5)
Fossil fuel levy 0.0%	%	0.0	0.0	0.0
TOTAL REAL REDUCTION	%	3.3	0.8	2.3
1999/00 Typical annual bill	£	259	376	-
2000/01 Typical annual bill (1999/00 prices)	£	251	373	-
Real reduction	£	9	3	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Hydro-Electric

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	1.1	1.8	1.3
Distribution	%	1.6	2.5	1.8
Transmission	%	0.3	0.2	0.3
Supply	%	(5.5)	2.0	(3.3)
Margin 1.5%	%	5.6	(6.4)	2.1
Fossil fuel levy 0.0%	%	0.0	0.0	0.0
TOTAL REAL REDUCTION	%	3.0	0.1	2.2
1999/00 Typical annual bill	£	264	375	-
2000/01 Typical annual bill (1999/00 prices)	£	256	374	-
Real reduction	£	8	0	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Great Britain average

	Units	Standard Domestic	Domestic Economy 7	Weighted Average
Real reduction[1]				
Generation	%	1.8	(1.4)	0.7
Distribution	%	7.1	6.6	7.0
Transmission	%	0.0	0.1	0.0
Supply	%	(7.4)	(4.3)	(6.4)
Margin 1.5%	%	3.9	0.9	3.1
Fossil fuel levy	%	0.4	0.3	0.4
TOTAL REAL REDUCTION	%	5.8	2.1	4.7
1999/00 Typical annual bill	£	251	350	-
2000/01 Typical annual bill (1999/00 prices)	£	236	343	-
Real reduction	£	15	7	-
2000/01 GB average typical annual bill (1999/00 prices)	£	236	343	-

Note:

1. Annual bill for Standard Domestic and Domestic Economy 7 has been rounded to the nearest pound.

ANNEX B

LIST OF RESPONDENTS TO THE OCTOBER 1999 INITIAL PROPOSALS DOCUMENT

1. Supply Licence Holders

Eastern Energy
PowerGen
London Electricity
National Power
Northern Electric
Norweb
SEEBOARD
Scottish and Southern Energy
SWALEC
Yorkshire Electricity
Scottish Power

2. Electricity Consumers' Committees

East Midlands ECC
London ECC
Merseyside and North Wales ECC
Midlands ECC
North East ECC
North West ECC
South East ECC
Southern ECC
South Wales ECC
South West ECC
Yorkshire ECC
North of Scotland ECC
National ECC

3. Other respondents

Aquila Energy
British Energy
British Gas Trading
Independent Energy
RJB Mining