

Dear Sir/Madam

29 July 2004

**FINANCIAL RING FENCING ALTERNATIVE ARRANGEMENTS FOR NEW INDEPENDENT DISTRIBUTION NETWORK OPERATORS (IDNOs)**

Standard Condition BA5: Credit Rating of the Licensee requires a licensee to maintain at all times an investment grade issuer credit rating (as defined in the distribution licence) or, with the prior written permission of the Authority, any such arrangements as the Authority considers appropriate.

The April 2003 open letter on the regulation of new IDNOs indicated that Ofgem would develop financial ring fencing arrangements that would allow a financially stable smaller company to comply with these obligations. It proposed that Ofgem would consider giving consent to such alternative arrangements as an appropriate 'keep well' agreement. This would be a formal and legally binding agreement from an entity that has and agrees to maintain an investment grade issuer credit rating. However further discussions with potential licensees and credit rating agencies have indicated that such a requirement would still be a significant barrier to many smaller companies operating as licensed electricity distributors.

In light of this and representations from potential licensees Ofgem has considered whether there might be alternative arrangements that would better suit the circumstances of smaller companies and would also protect the interests of consumers. Alternative arrangements are set out below.

**For licensees with less than 500,000 connected supply points**

One of the following:

**Option 1**

- 1.1 A keep well agreement with the parent company of the licensee with an "investment grade issuer credit rating", as defined in condition BA5 of the distribution licence.

**Option 2**

- 2.1 A keep well agreement with the parent company of the licensee.

AND (if the parent company does not have an investment grade credit rating)

- 2.2 Cash in escrow or an on demand bond issued from a third party with an investment grade credit rating of a value of no less than six months cash operating costs and six months asset replacement expenditure.
- 2.3 The trigger event for drawing down the escrow account or calling the bond will be a failure by the parent company to meet a call under the keep well agreement. The licensee is required to notify Ofgem as soon as a call is made on monies held in the escrow account/on demand bond. As soon as the escrow account/on demand bond is partially or wholly drawn the parent company will be obliged to either (i) arrange for full re-instatement of the escrow account/bond or (ii) put the licensee (or its networks) up for sale and shall within three months of the date of the invitation accept the best offer made.

**For licensees (including any affiliated companies) with more than 500,000 connected supply points**

One of the following:

Option 1

1.1 An investment grade issuer credit rating.

Option 2

2.1 A keep well agreement with an entity with an investment grade issuer credit rating.

In order for a distribution licence to be granted an applicant would need the Authority's written approval of any draft agreements (keep well and escrow/bond agreements). The licence will be granted on condition of these arrangements being in place before energisation of the first customer.

Cash operating costs are projected operating costs for six months as agreed with Ofgem on a six monthly basis. As the IDNO will be liable for upstream Distribution Use of System ("DUOS") charges, Ofgem expects that operating costs will include upstream DUoS charges.

These arrangements are currently subject to wider consultation and so should only be considered as interim arrangements. If a company were to proceed with its licence application and licensed activities, it would do so on the basis that if the consultation exercise were to indicate that different arrangements would be appropriate for the licensee then it would have to comply with these new arrangements or face the risks and costs of enforcement action.

Should you have any comments or queries please do not hesitate to contact Donna Rossall, Distribution Policy Manager at:

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Yours faithfully



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