

## OPEN LETTER ON THE REGULATION OF NEW ELECTRICITY DISTRIBUTION LICENCE HOLDERS.

Dear Sir/Madam

31 May 2002

### REGULATION OF ELECTRICITY DISTRIBUTION LICENCE HOLDERS

#### Introduction

At present all electricity distribution licences contain both standard and special licence conditions. The special licence conditions contain important conditions relating to price control and quality of service. The Utilities Act 2000 provides Ofgem with the power to grant new licences. In doing so it is appropriate to consider whether a licence should contain special as well as standard licence conditions. There are a number of issues relating to the effectiveness of licences containing only standard electricity distribution licence conditions in protecting the interests of consumers. Several companies have recently expressed an interest in acquiring an electricity distribution licence and so it is appropriate to consider these matters further.

Standard licence conditions (SLCs) are included in all electricity distribution licences. Those in section B of the SLCs are intended to apply to all distribution licensees. Existing licensees are also obliged to comply with section C SLCs following the exercise by the Secretary of State of powers pursuant to Schedule 7 of the Utilities Act 2000. For new licensees section C conditions are suspended and will only operate if, with consent of the licensee, Ofgem issues a Distribution Services Direction. Therefore, as well as considering whether existing section B SLCs would provide adequate protection for the interests of consumers it is also appropriate to consider whether any of the section C SLCs should be brought into effect by a Distribution Services Direction or turned into special licence conditions for new licence holders. This would allow these conditions to have immediate effect following the granting of a new electricity distribution licence.

This letter deals with matters relating to charging, quality of service, financial ring-fencing and regulatory accounts for any new electricity distribution licence holders. It makes proposals for interim arrangements to ensure that the interests of consumers are properly protected. The intention is that these arrangements should remain in place until a wider ranging review of these matters can be completed. As part of this wider review a consultation paper will be published later this year.

#### Charging Arrangements

At present the SLCs do not contain any formal price control obligations. The only SLCs relating to charge restriction are section B conditions 4, 4A, 4B and 4C. Condition 4 provides for the publication of charging statements and that connection charges should be set to reflect an appropriate proportion of direct and indirect costs and a reasonable rate of return on those costs. In addition Section 23 of the Electricity Act allows Ofgem to determine certain disputes with respect to connection charges. Condition 4A relates to non-discrimination. Condition 4B sets out requirements to offer terms. Condition 4C allows Ofgem to determine disputes with respect to either use of system or connection, however in determining disputes in relation to use of system charges Ofgem must take into account the licensee's Condition 4 charging statement.

These conditions suggest that the present SLCs provide only limited protection for consumers with respect to the level or structure of electricity distribution use of system charges. In some respects these arrangements appear weaker than those pertaining in the gas industry where a number of licensed Independent Gas Transporters (IGTs) have operated for some time. IGTs build or adopt network extensions, predominately for new housing developments, and charge gas shippers for transportation over these networks. These companies are subject to Gas Transporter (GT) SLCs but not special price control conditions. Despite the additional protections offered by standard GT licence conditions (such

as the charging methodology objectives set in GT licence condition 4A) the charging arrangements and activities of certain IGTs have given rise to a range of concerns. For instance:

- ◆ information on the rates of return associated with gas transportation charges shows a wide range of prospective returns across the sector. It is not clear whether these differences relate to efficiency or the exercise of monopoly power, suggesting the need for further investigation;
- ◆ in May 2001 Ofgem published a review of competition in the markets for connections that noted that the activities of certain IGTs appeared to be distorting the development of competition;
- ◆ as noted in the review of competition for domestic consumers published in November 2001 suppliers have reported difficulties and concerns in dealing with consumers on IGT networks; and
- ◆ Energywatch has expressed concerns with respect to the operation of IGTs and suggested that they should be regulated in a way broadly consistent with other energy networks.

As a result of Ofgem's concerns about certain IGTs interim arrangements have been introduced for the acceptance of charging arrangements pursuant to GT SLC 4C. The interim arrangements require that the SLC 4 and SLC 4C charges for transporting gas to sites on IGT networks should not exceed the equivalent charge for a similar site connected to Transco's network. They came into effect on 7 December 2001 and apply only to SLC 4C charging arrangements accepted after to this date. In May 2002 Ofgem also published a consultation paper on the regulation of IGT charging. This paper discussed what sort of arrangements would be appropriate for the regulation of IGT charging in the longer term.

It is now proposed to introduce similar interim arrangements for any electricity distribution licensee that does not have a special price control licence condition. These should protect the interests of consumers by limiting the scope for overcharging for distribution use of system services. The interim arrangements would require that the licence holder's charges for use of its electricity distribution network, to enable supply to domestic consumers, should not exceed those charges that would be made in similar circumstances by the licensee in whose service area the network is located. The intention is to publish a draft special licence condition designed to put these arrangements in to effect in June 2002 and include this as a special licence condition in any new electricity distribution licences, until a wider review of the regulation of these companies has been completed.

### Quality of Service

At present there are a number of obligations in place on existing electricity distribution licence holders to ensure Ofgem receives accurate and consistent information on their quality of service and to ensure that distribution companies have incentives to deliver an appropriate level of service to consumers.

Section C SLC 49 requires licensees to provide Ofgem with annual information on their quality of service. Licensees are required to measure this information in accordance with the Regulatory Instructions and Guidance (RIGs) for reporting output measures. They must also allow auditors (appointed by Ofgem) to conduct a review of the measurement systems and the accuracy of their data.

On 1 April 2002 a modification was made to the distribution price controls, to introduce a quality of service incentive scheme. The scheme links revenue to three key areas of quality of service:

- ◆ the number of interruptions to consumers' supplies;
- ◆ the duration of these interruptions; and
- ◆ the quality of telephone response provided to consumers.

Each of the existing distribution companies can be penalised annually, by up to 1.75 per cent of its regulated revenue, if it fails to meet its targets for the number and duration of interruptions. Each company may also earn additional revenue if it outperforms its targets for 2004/05. They may also be

rewarded or penalised depending on their quality of telephone response compared to other companies.

In addition all of the existing distribution companies are subject to guaranteed and overall standards of performance. For example, there are guaranteed standards on restoring consumers' supplies within 18 hours following an interruption and on multiple interruptions. Where the company fails to achieve the standard, it is required to pay a fixed level of compensation to the consumer concerned.

Taken together these requirements provide important safeguards for consumers' quality of service. Ofgem would expect to apply similar standards of performance to new licensees as apply to existing distribution companies, but they may need to be tailored to reflect the size of any new entrants and other specific circumstances. Equally SLC 49 on reporting and the incentive schemes were designed with existing distribution companies in mind, and it will be necessary to give further consideration to the nature of reporting, quality of service targets and incentives that should be put in place for new entrants. These issues will be dealt with in a consultation paper to be published later this year.

In the interim it is important that Ofgem receives accurate and consistent information on the quality of service provided by new licensees and that this information is comparable with that provided by existing distribution companies. Under section B SLC 5, new distribution licensees will be required to produce a statement setting out the criteria they would use to measure their security and availability of supply and quality of service. As a minimum, Ofgem would expect new licensees to record data on the number and duration of interruptions to supply and the number of short interruptions in line with the definitions set out in the RIGs. They will also be required to provide an annual report on performance within 2 months of the end of the financial year.

#### Financial Ring-Fencing

In order to protect certain licensed activities from adverse financial circumstances that might arise elsewhere in the group a number of financial ring fencing conditions have been developed and are now section C SLCs. These are:

- condition 43 – restriction on activity and financial ring fencing;
- condition 44 – availability of resources;
- condition 45 – undertaking from ultimate controller;
- condition 46 – credit rating of licensee; and
- condition 47 – indebtedness.

Taken together these provide important safeguards for the financial stability of the licensed company and so for the protection of the interests of consumers. Nevertheless these conditions were designed bearing in mind the circumstances of those existing licence holders with distribution service area obligations. All the existing licence holders are relatively large companies. New electricity distribution licence holders may be companies that are significantly smaller than the existing licence holders. It might be more difficult for smaller companies to comply with the SLC 46 which requires the licensee to use all reasonable endeavours to ensure that at all times it retains an investment grade issuer credit rating. Therefore it is proposed to create a special licence condition based on the existing SLC 46 but modified to allow Ofgem to give consent to alternative financial arrangements for compliance. It is the intention to publish a draft of modified licence condition 46 in June 2002. In due course it may be necessary to consider whether other changes to the existing financial ring-fencing licence conditions might lead to obligations that better suit the circumstances of smaller companies. This requires further consideration and will be dealt with in a consultation paper to be published later this year. In the interim it is proposed to introduce conditions 43 to 47 above (including modified condition 46) as special licence conditions in any new electricity distribution licence before it is issued. The licensee would then need to comply with these obligations as soon as its licence is granted.

## Regulatory Accounts

In November 2000 Ofgem published final proposals for regulatory accounts for gas and electricity licence holders. These proposals concluded that regulatory accounting provisions should only apply to those companies subject to formal price control. At present formal price controls only apply to the existing licence holders with service area obligations. Therefore, at this stage it is not appropriate to seek to activate the section C SLCs relating to regulatory accounts or change of financial year.

In modifying or granting a licence it is necessary for Ofgem to act in a way that is consistent with European Union's Electricity Directive 96/92/EC. This requires that the companies produce separate accounting information on electricity activities. Nevertheless, this does not require a full regulatory accounts licence condition and the proposals on financial ring-fencing (in particular licence condition 43 – restriction on activity and financial ring fencing) should ensure that the licensees statutory accounts provide adequate information on the turnover, costs and assets associated with electricity distribution activities.

## Conclusion

This letter describes important interim proposals relating to the regulation of electricity distribution licence holders without distribution service area obligations and price controls. It would be helpful to receive any comments on the issues raised in this letter before the end of June 2002. They should be sent to:

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Yours faithfully

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