

CONSULTATION ON THE MODIFICATION OF STANDARD LICENCE CONDITIONS FOR NEW ELECTRICITY DISTRIBUTION LICENCE HOLDERS PURSUANT TO SECTION 8A OF THE ELECTRICITY ACT 1989

Dear Sir/Madam

16 April 2003

REGULATION OF NEW ELECTRICITY DISTRIBUTION LICENCE HOLDERS

Introduction

On the 31 May 2002 Ofgem published an open letter requesting views on the regulation of any new electricity distribution licence holders. The letter of 31 May dealt with matters relating to charging, quality of service, financial ring-fencing and regulatory accounts for any new electricity distribution licence holders. It made proposals for interim arrangements to ensure that the interests of consumers are properly protected and said these could remain in place until a wider ranging review of these matters can be completed. It is the present intention to publish a consultation paper on the wider review later in 2003.

This letter summarises the views of respondents to the 31 May letter, sets out Ofgem's present thinking on these matters and initiates a statutory consultation process on the standard licence conditions for a new electricity distribution licence holder pursuant to section 8A of the Electricity Act 1989 (as amended).

Charging Arrangements

The 31 May letter explained that at present the standard licence conditions (SLCs) do not contain any formal price control obligations and provide only limited protection for consumers with respect to the level or structure of electricity distribution use of system charges. It went on to propose interim arrangements for charging based on those already in place for Independent Gas Transporters (IGTs). These would limit the scope for overcharging for distribution use of system services by requiring that the licensee's charges for use of system charges to enable supply to domestic consumers do not exceed those charges that would be made by the licensee in whose service area the network is located.

The majority of those respondents that discussed charging arrangements supported proposals to introduce charge restriction conditions. There was some concern as to whether the proposed arrangements would produce charges that adequately reflected underlying costs. In considering the most appropriate approach to setting charges for use of a network it is necessary to balance advantages of cost reflectivity against factors such as the disadvantages of increased complexity. Having site specific charges for network extensions would appear to be unduly complex and might hinder the development of supply competition for consumers connected to such networks. Given these considerations and the views of respondents it will be appropriate to adopt the proposals for charge restriction conditions set out in the open letter of 31 May 2002.

Several respondents stressed the importance of encouraging the development of competition in the market for final connections and questioned whether the new charge restriction condition would be consistent with this. In so far as the condition provides for the equal treatment of all licence holders it would appear to promote competition between them. To the extent that there are different costs associated with different network developments then these can be taken into account by adjusting the upfront charges levied on the owners of these developments.

One respondent questioned whether it would be appropriate to introduce new charge restriction conditions without the provision of a disapplication procedure similar to that found in other charge

restriction conditions. There is some merit in these arguments and the proposed licence condition has been modified to include a disapplication procedure.

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. Taken together these requirements provide important safeguards and Ofgem would expect to apply similar standards of performance to new licensees as apply to existing distribution companies, although they may need to be tailored to reflect the size of any new entrants and other specific circumstances. These issues will be dealt with in the 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.

Respondents to the 31 May letter generally supported this approach and it is intended to go forward on this basis.

Financial Ring-Fencing

Existing licensed electricity distribution companies are typically part of larger groups of companies. In order to protect the licensed activities from adverse financial circumstances, including those 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.

These conditions were designed, inter alia, to reduce the risk of financial failure and possible consequential disruption to the provision of electricity distribution services. 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 SLC 46 as it 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 standard condition based on the existing SLC 46 but modified to allow Ofgem to give consent to alternative financial arrangements for compliance.

Alternative financial arrangements that Ofgem would consider giving consent to might include 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. The agreement would typically be an undertaking given by a parent company in favour of its subsidiary. The parent would

have to guarantee to make available to the subsidiary whatever financial resources are from time to time necessary for the subsidiary to maintain a minimum surplus of assets over liabilities and or a minimum level of liquidity. The licensee would need to be obliged to follow Ofgem's directions with respect to the enforcement of the undertaking.

There were a range of views expressed about financial ring fencing arrangements and about half of respondents supported the proposals. Other respondents recognised the importance of the financial stability of licensed electricity companies, but suggested that in the event of financial failure another licensed operator should be required to take over the network. It is not clear that Ofgem would have powers to impose such arrangements and given the importance of ensuring that consumers retain access to electricity distribution services it is intended to retain the proposals for financial ring fencing.

Regulatory Accounts

As noted in the 31 May letter the proposals on financial ring-fencing (in particular restrictions 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.

Process

The 31 May 2002 letter envisaged introducing the above proposals by way of new special licence conditions. One respondent questioned whether it would be appropriate to introduce the proposals by way of new special conditions given that many of the obligations would be very similar to existing standard conditions. The respondent suggested that using the process envisaged by section 8 of the Electricity Act and introducing the conditions as new SLCs would provide a more robust process. In the light of these comments Ofgem has decided to adopt this approach and attached to this open letter is a statutory consultation notice pursuant to section 8 of the Electricity Act and draft modifications to the SLCs for any new electricity distribution licence holder.

Responses to the statutory notice and consultation exercise should be received no later than 16 May 2003 and sent to:

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Yours faithfully

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