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Date: 28 June, 2002

Our Ref:

Your Ref:

Andrew Walker
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LEgroup
an EDF company

Dear Andrew,

Regulation of new electricity distribution licence holders – Ofgem open letter May 2002

I am replying to your letter of 31 May relating to the regulation of new electricity distribution licensees.

Form of consultation

In our view, a short "open letter" may not be the right vehicle for adequately explaining the areas of concern or for providing a detailed rationale to support the proposed changes. On the other hand, a standard Ofgem consultation document could have been expected to describe the existing regulatory framework in electricity for potential new Distribution Network Operators (DNOs), including the Authority's statutory duty to have regard to the need to secure that licence holders can finance their activities, for comparison the existing framework in gas for Independent Gas Transporters (IGTs) and its operation to date, and a timetable for the completion of this review.

Connection charges

Standard Licence Conditions, complemented by the Authority's powers under the Electricity Act and Competition Act, are likely to provide adequate protection for customers with regards to connection charges. These provisions also mirror the safeguards afforded to the customers of the ex-PES DNOs.

Use of system charges

Capping new DNOs' charges at the level of the relevant ex-PES DNO may be an appropriate short term solution. However, Ofgem's interim arrangements may prevent proper cost reflection in particular situations.

Quality of service

Quality of service on new networks should be set at a level that is appropriate in all the circumstances. In particular, it would be appropriate for Ofgem to take account of the cost-quality trade-off in setting the standards.

The Information and Incentives Project (IIP) was linked to the entire package of proposals accepted by ex-PES DNOs as part of the last price control settlement and the use of RPI-X regulation. It may be difficult to adapt IIP for application to new DNOs that are not subject to RPI-X price control regulation.

Financial Ring-Fencing

It is not clear from the open letter what problems Ofgem is attempting to resolve. A further explanation of Ofgem's reasoning in this area would be welcome. In our view, Ofgem should consider the appropriate balance between low barriers to entry/exit and the need to protect customers. However, it is not clear how a start-up company could comply with the existing credit rating arrangements for ex-PES DNOs or how any alternative arrangements could be constructed that would offer customers broadly similar protection.

Way forward

We believe that Ofgem should ensure that there is fair competition in the initial tendering to construct the private network and this should ensure efficiency and good standards. In particular, inappropriate payments to developers that may result in higher long term costs to customers should be discouraged. Furthermore, potential cross subsidies between distribution and supply should be deterred.

Once a network has been commissioned, a local monopoly situation may then exist and a degree of further regulatory supervision may be required. An appropriate interim solution might in most circumstances be to ensure that the new DNO's charges do not exceed those of the relevant ex-PES DNO. An additional safeguard might be the use of ex post rate of return regulation, i.e. triggered by complaint about overcharging, perhaps using the Authority's existing Competition Act powers.

Timetable

To remove the great deal of uncertainty for potential new DNOs, it is important that the existing timetable for the interim arrangements does not slip. However, it seems premature for Ofgem to publish a modified draft licence Condition 46 in June, i.e. before it has received or considered responses to this consultation. A clear timetable for the completion of the entire review would be welcome.

A more detailed commentary on your open letter is contained in the attachment to this letter. You will already have seen the joint letter from my colleague Roger Barnard and John Cooper of Wragge & Co to Nicola Northway, Ofgem's General

Counsel, dated 20 June, which addressed the legal issues surrounding your open letter. This is attached for ease of reference and both letters taken together constitute LE Group's response.

I hope you will find our comments helpful. If you have any queries, please do not hesitate to call either Tahir Majid on 020 7487 7274 myself on 020 7331 3563.

Yours sincerely,

Denis Linford
Group Head of Regulation

Attachment

Regulation of new electricity distribution licence holders - Commentary by LE Group on Ofgem open letter May 2002

1. Form of consultation

The "open letter" may have also been an inappropriate mechanism to consult on such an important issue as charging by DNOs. The importance of the issues covered by this consultation is supported by the Authority's own published Rules of Procedure which list:

- the "matters [that] are reserved for a decision of the Authority, and may not be delegated other than to a committee of the Authority: ...
  - Regulatory Issues
    - 9. The policy informing significant proposals to modify any condition in a licence issued under ...the Electricity Act 1989 where the principal purpose of that condition is to control or limit the charges or revenue of the licensee".

Though the conditions of an existing licensee are not to be modified, this consultation deals with equivalent matters.

2. Charging

2.1 Connection charges

The Standard Licence Conditions (SLCs) provide a number of safeguards for customers with regard to connection charges. In particular, "Condition 4: Basis of Charges for Use of System and Connection to System: Requirements for Transparency", para 4 (b) allows the licensee to recover only "a reasonable rate of return". "Condition 4A: Non-discrimination in the provision of Use of System and Connection to System", "Condition 4B: Requirement to Offer Terms for Use of System and Connection" and "Condition 4C: Function of the Authority" provide further safeguards to customers. Condition 4C enables the Authority to determine the terms and costs of a connection on application by either the licensee or the customer. Section 23 of the Electricity Act permits the Authority to carry out such a determination where matters are referred to it up to one year after the making of the connection.

Enforcement of these licence obligations is complemented by the Authority's ability under Section 27 of the Electricity Act to impose penalties of up to 10% of a company's turnover. Alternatively, the Authority can use its concurrent powers under the Competition Act to investigate anti-competitive behaviour. Under the Competition Act, Ofgem may impose penalties of up to 10% of a company's turnover for up to

three years. As all Distribution Network Operators (DNOs) are effective monopolies, the Competition Act could be relevant to their activities and charges. Existing precedent would suggest that a more formal definition of a reasonable rate of return is unnecessary.

SLCs complemented by the Authority's powers under the Electricity Act and Competition Act provide adequate protection for customers with regard to connection charges. These provisions also mirror the safeguards afforded to the customers of the ex-PES DNOs.

2.2 Use of System charges

SLCs provide safeguards to customers in relation to Use of System charges through Conditions 4, 4A, 4B and 4C, though the licence does not specifically limit the licensee to earning a "reasonable rate of return". However, as licensees would be effective monopolies, the Authority's concurrent powers under the Competition Act, precedents on the appropriate levels of rate of return and the ability to levy significant penalties would be an additional safeguard for consumers.

2.3 Ofgem's proposals for Interim Arrangements

Ofgem has proposed interim arrangements whereby a new DNO's charges for use of its electricity distribution network for domestic consumers should not exceed those charges that would be made in similar circumstances by the ex-PES DNO in that area.

2.3.1 Ofgem's rationale

As part of its rationale for introducing interim arrangements that extend beyond the existing SLCs, Ofgem notes that gas customers on IGT networks are afforded greater protection than the electricity SLCs, and further notes that despite this the gas arrangements have given rise to a number of concerns. Ofgem has not stated what is the nature of the greater protection in gas. It would be helpful if Ofgem could clarify this.

Ofgem further notes examples of the concerns that have arisen with the charging arrangements and activities of certain IGTs. Each of these is addressed below:

- "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 to the exercise of monopoly power, suggesting the need for further investigation. A wide range of rates of return exist in the sector";
  - Ofgem's May 2002 document on regulation of IGT charging reported concerns about rates of return up to 19 %. Ofgem has not explained why it has not used its existing powers under the Electricity and Competition Acts both to investigate this issue and address it if concerns arise. Where the existing arrangements in gas are shown to be inappropriate for the protection of

customers Ofgem should consider greater protection than that offered by the SLCs in electricity.

- "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";
  - Ofgem's document states "It is possible for a GT [elsewhere in the Ofgem document this is referred to as being an IGT issue rather than a GT issue] to establish a methodology that reduces the initial connection charge to a customer, with the costs recovered over time through higher transportation charges. ... This type of charging method can distort the development of competition through reducing the initial connection charge against which ICPs [Independent Connections Providers] have to compete to win contracts." Ofgem presented no evidence as to the extent of this problem or of its effects on competition. However, to the extent that this is an area for concern a safeguard to customers is the Authority's existing powers under the Competition Act to ensure that these distortions are remedied. To prevent this problem arising at all, perhaps Ofgem should have the power to approve all charging methodologies.
- "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";
  - Ofgem's document "Review of domestic gas and electricity competition and supply price regulation – Evidence and Initial Proposals" notes
    - "A number of suppliers said that their incentive to acquire customers served on non-Transco networks is reduced by one or more of the following factors: ....."
      - "The lack of consistency and unpredictability in and between GTs' transportation charges creates pricing difficulties for suppliers"; - Lack of consistency in charging arrangements may need to be looked at. However, the advantages to suppliers of consistency needs to be balanced with the possible advantages of innovation from IGTs and the link between the specific charging/financing needs of individual IGTs and their charging methodologies.
      - "The relative expense or difficulty of providing prepayment meters to customers on these networks" – The interim arrangements may be a solution to this problem. However, this problem appears not to have been fully evaluated by Ofgem. The higher costs may be justified in the circumstances.
- "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." Ofgem has not explained what these concerns are or quantified their effects.

Ofgem has highlighted a number of concerns about the current arrangements in gas and the limited protection afforded to potential electricity customers if only the SLCs were applied to new DNOs. However, little or no evidence has been presented about the exact nature of these concerns or their quantification. Consequently, it is difficult to consider fully the merits of Ofgem's proposals.

2.3.2 Critique of interim arrangements

It would be helpful if Ofgem explained why one group of customers requires more protection than others. To the extent that Ofgem's proposals do not allow the new DNO to fully recover its costs from domestic customers then the DNO may be perversely incentivised to recover a greater proportion of costs from other classes of customers.

The interim proposals may nevertheless be an appropriate way forward in most circumstances. However, charges on this basis may not always reflect the actual costs of the new network. The costs of electricity networks are by their nature project specific. Many factors can materially affect the costs of new build.

Comparison of charges is further complicated by the differences in:

- New DNO depreciation periods versus regulatory depreciation periods pre and post vesting, including accelerated depreciation for some DNOs;
- The effect of depreciation on RAV over time; and
- The link between cost and quality.

2.3.3 Way forward

It would be appropriate for Ofgem to ensure that there is fair competition in the initial tendering to construct the private network and this should ensure efficiency and good standards. In particular, inappropriate payments to developers that may result in higher long-term costs to customers should be discouraged. Furthermore, potential cross subsidies between distribution and supply should be deterred.

Once a local monopoly situation has been created, a degree of further regulatory supervision may be required. As we have said, an appropriate interim solution might be to ensure that the new DNO's charges do not exceed those of the relevant ex-PES DNO. An additional safeguard might be the use of ex post rate of return regulation, i.e. triggered by complaint about overcharging, perhaps using the Authority's existing Competition Act powers.

3. Quality of service

There is no reason why customers on the networks of new DNOs should experience inferior standards of service compared with the customers of ex-PES DNOs. However, the standards should be set at a level that is appropriate to all the circumstances of that network. In general, new networks can be expected to deliver

superior quality of supply performance. In any event, standards of service have to be set within the context of the cost-quality linkage.

The Information and Incentives Project (IIP) was introduced at the last price control review to become a bolt-on package within the context of an RPI-X regime. In isolation, it has a significant number of deficiencies, which have been well documented. It may therefore be difficult to adapt IIP for application to new DNOs that are not subject to RPI-X price control regulation.

With the exception of IIP, there appear to be sufficient reporting obligations contained either within the SLCs or within the GS/OS statutory instrument. Additional reporting appears unnecessary.

4. Financial Ring-fencing

It is not clear from the open letter what problems Ofgem is attempting to resolve. A further explanation of Ofgem's reasoning in this area would be welcome. Ofgem should consider the appropriate balance between low barriers to entry/exit and the need to protect customers. However, it is not clear how a start-up company could comply with the existing credit rating arrangements for ex-PES DNOs or how any alternative arrangements could be constructed that would offer customers broadly similar protection.

5. Timetable

To remove the great deal of uncertainty for potential new DNOs, it is important that the existing timetable for the interim arrangements does not slip. However, it seems inappropriate for Ofgem to publish a modified draft licence Condition 46 in June, i.e. before it has received or considered responses to this consultation. A clear timetable for the completion of the entire review would be welcome.

LEG/28.6.02

20 June 2002

Nicola Northway
General Counsel, Ofgem
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Dear Nicola

Licence Conditions for New Distribution Licensees

As you will know, Ofgem recently published an 'open letter', under Andrew Walker's name, about matters relating to the regulation of new electricity distribution licence holders.

Certain aspects of this open letter worried me from a legal point of view, and I have discussed these with John Cooper of Wragge & Co. The comments set out below are now submitted by us jointly on behalf of London Electricity Group plc, which, as you know, has extensive interests in both licensed and unlicensed distribution network activities.

The Expectations of Licence Applicants

Our first concern is on the borderline between law and policy. It arises from the relationship between the DTI's licence exemptions order and Ofgem's present licensing proposals.

The exemptions order was drawn up on the understanding that those whom it did not benefit would, unless they were ex-PESs, be subject to a certain limited regulatory regime under the standard distribution conditions determined by the Secretary of State. There was a clear expectation that this regime would not include the Section C licence obligations borne by ex-PES distributors. This is reflected in the structure of standard condition 2, which, following a lengthy consultation process, was specifically designed so that Ofgem could not give effect to Section C, in whole or in part, without a licensee's consent.

The proposals outlined in Ofgem's letter reverse the legitimate expectation of a regime for new distribution entrants which is limited to the Section A and Section B distribution licence obligations. We accept that, at the time when the exemptions order was being framed, a potential new distribution licensee

would have been aware that the Authority is empowered under the Electricity Act to modify the standard licence conditions determined by the Secretary of State when granting a licence. Nevertheless, there was no expectation that this power would be used routinely, in a highly artificial manner, to bring into the distribution licence key elements of Section C that Ofgem could not otherwise impose on a licensee except pursuant to a Competition Commission report following a detailed investigation of the merits of the case.

The effect of Ofgem's present proposals is to circumvent that safeguard so as to ensure that the burden of the regulatory regime is substantially increased for new distributors in all (or most) cases without effective challenge. Against that background, any potential distributor will be entitled to ask the DTI to consider, in these changed circumstances, whether its exemptions order has been drawn widely enough. After all, the Department, in making that order, was subject to exactly the same statutory duties and considerations as Ofgem is in its role as a licensing authority.

The Proposals in Outline

Ofgem's letter proposes that the licences granted to new distributors should contain, in addition to the standard conditions which must be incorporated under section 8A of the Electricity Act, three new types of special licence condition. These are: (i) a condition restricting the use of system charges which can be levied in respect of domestic customers; (ii) a condition on distribution system quality reporting; and (iii) a number of conditions on financial ring fencing.

The first of these new types of condition is directly related to the (special) price control conditions that apply to all ex-PES distributors. The second and third types are based on standard licence conditions that are presently disapplied (ie, that cannot, by virtue of standard licence condition 2, take effect without the licensee's consent) in the case of all licensees other than ex-PESs.

Below, therefore, we analyse new type of special condition (i) on its own, and new types of special condition (ii) and (iii) together.

New Type of Special Condition: (i)

A charging restriction is clearly within the scope of Ofgem's powers. But, in its proposed form – Ofgem intends to limit use of system charges to a ceiling set by reference to the charges of the incumbent distributor – it must be of questionable legality. This is because:

1. It is arguably irrational to cap charges for a new distributor by reference to the charges of a much larger distributor which:

(a) has been subject to the continuing application of RPI–X regulation for over a decade, and

(b) is able to smear its aggregate costs over a large distribution area.

2. It may be anti-competitive (and inconsistent with the Authority's general duty) to cap charges at the proposed level if the restriction acts to prevent the new distributor from establishing a foothold in the market.

3. It is likely to be unfair – in terms both of substance and of process – to automatically limit the allowed revenue for any one company solely by reference to that of another company whose limit has been determined following a lengthy consultation process.

4. A charging restriction that does not contain a disapplication mechanism that can be triggered by the licensee is likely to be seen as discriminatory against the applicant, having regard to the disapplication provisions available in the licence of the ex-PES distributor.

5. In any event, it will be an unlawful fettering of discretion if this Ofgem policy means that the actual circumstances and costs of the would-be new distributor cannot be taken into account.

New Types of Special Condition: (ii) and (iii)

Ofgem's proposed new reporting and financial ring-fencing requirements are effectively modified forms of existing standard conditions. There is therefore a strong case that to apply these provisions to a new distributor is effectively to modify the standard conditions in his licence. If this is correct, the provisions of section 8A of the Electricity Act will apply.

Section 8A contains provisions which apply whenever Ofgem modifies standard conditions on the grant of a licence. It must be interpreted with regard to the intentions of the Act. It would be perverse if Ofgem were able to frustrate the operation of section 8A merely by declaring that it was adding a discrete group of 'special' conditions when the reality (as the open letter demonstrates) is that Ofgem wants to bring into effect modified versions of the standard conditions.

In our view, a court would require section 8A to be applied by reference to the substance, rather than the presentation, of Ofgem's proposals. In this case, the second and third sets of conditions proposed by Ofgem's letter are in practice modified forms of a number of the existing standard conditions, and, as such, section 8A should apply to them prior to the grant of the licence.

On that basis, Ofgem will be dutybound to:

1. Consult on the modifications before granting each licence (see sections 8A(3)–(5)),

2. Ensure that the modifications proposed are those (and only those) that are 'requisite to meet the circumstances of the particular case' (see section 8A(2)), and

3. Reasonably form the opinion that the new licensee would not be 'unduly disadvantaged' in competing with other holders of distribution licences (which would include the ex-PES licence holders as well as other new or prospective licence holders) (see section 8A(6)).

It therefore cannot be clear that any general policy of Ofgem would hold good in the case of each individual licence applicant. The consultation process, and the proper application of the tests referred to at (2) and (3), might necessarily produce quite different results in different cases.

A range of outcomes would, of course, be consistent with good administrative practice anyway, as well as being directly contemplated by section 8A.

Conclusions

It follows from our analyses above that Ofgem's proposals, at least as presented in Andrew Walker's letter, are of questionable legality. This is because:

1. They appear to be irrational and unfair (in the case of Ofgem's proposed new charging restriction), and

2. They imply a lack of due process (in the case of Ofgem's clear policy intention not to grant new distribution licences unless they contain certain modified standard conditions).

We consider that the licensing policy outlined in the letter is therefore likely to be challengeable in law.

We are happy to discuss these points with you if that would be helpful. We have copied this letter to Andrew Walker, and also to the DTI.

Yours sincerely

R B

Roger Barnard
Regulatory Law Manager
LE Group plc

J C

John Cooper
Associate Partner
Wragge & Co