

Electricity Distribution Price Control Review

Appendix – structure and scope of price control licence modifications

June 2004

Summary

This document sets out Ofgem's initial thought regarding the framework of licence conditions that will be required to implement the revised price controls for electricity distribution companies from 1 April 2005. It identifies where improvements can be made to the existing licence structure and seeks views on whether these might be desirable. The document also sets out the process for modifying the licences and lists those areas of the licences that are likely to require revision as a result of Ofgem's price control proposals.

Initial drafting of a special licence condition for the distributed generation incentive mechanism is set out in Appendix 1 of this document.

Table of contents

1. Introduction	1
Purpose and structure of this document	1
Responding to this document.....	3
2. The process for making licence modifications	4
Introduction	4
Informal consultation on licence modifications.....	4
Statutory consultation on licence modifications	4
Other areas to be considered	7
Timetable and process for implementing the price controls	7
3. The general framework of licence obligations.....	9
Introduction	9
Objectives.....	9
Existing framework of obligations	10
4. Amendments for form and scope of the price control.....	16
Introduction	16
Key proposals of the price control review	16
Impact of proposals on the licence conditions	17
5. Quality of service and other outputs	19
Introduction	19
Key proposals of the price control review	19
Impact of proposals on the licence conditions	20
6. Distributed generation, Innovation funding, and registered power zones	22
Introduction	22
Key proposals of the price control review	22
Impact of proposals on the licence conditions	23
7. Other issues.....	24
Introduction	24

Other aspects of the price control review.....	24
Appendix 1 Distributed Generation licence conditions.....	26

1. Introduction

- 1.1. The existing price control framework is embodied in several standard and special licence conditions of the electricity distribution licences. These conditions prescribe how the revenue allowance may be adjusted for a range of factors, including a company's performance under various incentive mechanisms. The licence conditions also set out the obligations on Distribution Network Operators¹ (DNOs) to set distribution charges consistent with their revenue allowances.
- 1.2. Ofgem has also put in place a range of reporting obligations as part of the special and standard licence conditions. Where appropriate, Ofgem has supplemented these obligations with detailed guidance, such as the IIP Regulatory Instructions and Guidance, setting out precise definitions for items to be measured and reported. Together, these obligations determine the timing and detail of information to be provided by DNOs to Ofgem in order to demonstrate ongoing compliance with the price control restrictions.
- 1.3. In order to remove the existing price controls and implement the revised distribution price controls from 1 April 2005, Ofgem will propose amendments to relevant parts of the distribution licences. In some areas of the framework, the obligations on DNOs will remain largely the same as they are at present, whilst in other areas Ofgem will need to propose changes to implement its proposals fully.

Purpose and structure of this document

- 1.4. The purpose of this document is to set out Ofgem's initial thoughts regarding the framework of licence conditions that will implement the revised price controls from 1 April 2005. The intention is to describe where improvements can be made to the existing licence structure and seek views on whether these might be desirable. The documents will also set out the process for modifying the licences and list those areas that are likely to require revision as a result of Ofgem's price control proposals.

¹ The fourteen licensed distributors that were separated from the public electricity suppliers
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

1.5. The document is structured as follows:

- ◆ **the process for making licence modifications (Chapter 2)** – this Chapter sets out the process for modifying the electricity distribution licences. It also sets out the timetable that Ofgem intends to follow to enable the price control to be in place for 1 April 2005;
- ◆ **the general framework of obligations (Chapter 3)** – this Chapter describes the overall framework of licence conditions that encapsulate the current price control framework. It also identifies areas where Ofgem considers improvements might be made;
- ◆ **amendments for the form and scope of the price control (Chapter 4)** – this Chapter outlines aspects of the price control in relation to the form and scope of the price controls that will impact upon the framework of licence conditions;
- ◆ **quality of service and other outputs (Chapter 5)** - this Chapter outlines aspects of the price control in relation to quality of service incentives and other outputs that will impact upon the framework of licence conditions. It also identifies changes to the Guaranteed and Overall Standards of Performance that are set out in Regulations and Determinations under the Act;
- ◆ **distributed generation, Innovation Funding, and Registered Power Zones (Chapter 6)** - this Chapter outlines aspects of the price control proposals in relation to the new incentive arrangements;
- ◆ **other issues (Chapter 7)** – this Chapter summarises some of the issues that may also impact upon the framework of licence obligations and other aspects of work that Ofgem is intending to undertake; and
- ◆ **distributed generation licence conditions (Appendix 1)** - this Appendix provides initial drafting of a special licence condition for the distributed generation incentive mechanism.

Responding to this document

1.6. Ofgem would like to hear the views of all of those with an interest in the development of revised price controls for the DNO, and in particular the framework of licence conditions that will implement Ofgem's price control proposals.

1.7. Responses should be received by 9 August 2004 and should be sent to:

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1.8. Unless marked confidential all responses will be published by placing them in Ofgem's library or on the website. It would be helpful if responses could be submitted both electronically and in writing. Any questions on this document should, in the first instance, be directed to Colin Green, who can be contacted on 020 79017143 or by email at colin.green@ofgem.gov.uk

2. The process for making licence modifications

Introduction

- 2.1. The process for making modifications and amendments to the electricity distribution licences has two main components – informal consultation with interested parties; before a formal statutory consultation process. This section describes these processes in more detail and sets out the timetable Ofgem intends to follow to implement the revised price controls for 1 April 2005.

Informal consultation on licence modifications

- 2.2. Informal consultations are a process whereby Ofgem invites the DNOs and other interested parties to comment on early drafting of the proposed licence modifications. This approach enables Ofgem to refine the drafting of the proposed modifications in light of comments provided and, if possible, obtain broad agreement from the licensees on the form and content of the licence modifications before the statutory consultation is undertaken.

Statutory consultation on licence modifications

- 2.3. Ofgem's² principal objective under the Electricity Act 1989 (as amended by the Utilities Act 2000) is to protect the interests of consumers wherever appropriate by promoting effective competition. The Electricity Act also sets out other important duties for Ofgem³, including:
- ◆ securing that all reasonable demands for electricity are met;
 - ◆ ensuring that licence holders are able to finance their statutory and licensed activities;

² Ofgem is the administrative office for the Gas and Electricity Markets Authority.

³ See sections 3(A) – 3(C) of the Electricity Act 1989 as amended by the Utilities Act 2000
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

- ◆ having regard to the interests of individuals who are disabled or chronically sick, of pensionable age, living on low incomes, or living in rural areas; and
- ◆ having regard to the effect on the environment of activities connected with generation, transmission, distribution or supply of electricity.

2.4. Section 7 of the Electricity Act provides the statutory basis for introducing licence conditions, including those relevant to the price control. This states that a licence may include such conditions that Ofgem considers necessary having regard to its principal objective and statutory duties.

2.5. The statutory process for introducing or modifying the licence conditions depends upon the type of condition that is being introduced or modified. The process for modifying the special licence conditions is set out under section 11 of the Electricity Act. Section 11 is also used to modify the standard conditions of an individual licence. Similarly, the process for collectively modifying the standard licence conditions of distribution licences is set out under section 11A.

Modification of the special and standard conditions of individual distribution licences

2.6. The price control framework is largely embodied within the special conditions and accompanying schedules of the DNO licences. These conditions may not be modified without the consent of the DNO except through legislation or following a reference to, and the decisions of, the Competition Commission. Before making any modifications Ofgem must give notice:

- ◆ that it proposes to make modifications to the standard and special conditions of an individual licensee and set out their effect;
- ◆ stating the reasons for proposing the modification; and
- ◆ Specifying a period (not less than 28 days from the date of publication of the notice) within which representations or objections with respect to the proposed modifications may be made.

2.7. In giving notice, Ofgem must serve a copy of the notice to the DNOs and publish it in such a manner as is considered appropriate to bring it to the

attention of persons (including other DNOs and energywatch) likely to be affected by the modification. A copy of the notice must also be sent to the Secretary of State.

- 2.8. In the event that Ofgem receives objections or material representations to a licence modification proposal made under Section 11 of the Electricity Act, then it is obliged to consider these and determine the appropriate way forward. Where it is considered appropriate, Ofgem may refer the matter to the Competition Commission. Ofgem must consult further in respect of any material revisions made to the proposed modifications in light of any objections or material representations.

Collective modification of standard licence conditions

- 2.9. Some aspects of the price control framework are embodied in some of the standard conditions set out in Section C of the electricity distribution licence. The process for modifying the standard licence conditions is similar to the process for modifying the special licence conditions, with the notable difference that a collective modification may be made with the consent of a majority of licensees, subject to rules about minority blocking.
- 2.10. Before making any modification Ofgem must again give notice of the modifications setting out the proposed modifications, their effect, the reasons for making the modifications, and specify the period of consultation. Similarly, the notice must be served on the licensees and published in such a manner as to bring it to the attention of those likely to be affected by the modification. Copies of the modification notice must also be provided to the Secretary of State and energywatch.
- 2.11. Ofgem may collectively modify a standard licence condition where less than 20 per cent of licensees issue an objection to the proposed modification⁴, either by proportion of licensees or by market share. In the event that there are sufficient objections to the proposed modification then Ofgem may refer the matter to the Competition Commission. Where Ofgem accepts any material representations it has received in relation to a modification proposal, it will be necessary to

⁴ Section 11A(6) & (7) of the Electricity Act 1989 and the Electricity and Gas (Modification of Standard Conditions of Licences) Order 2003 SI No. 1746/2003
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

undertake a further statutory consultation exercise in respect of any revisions made to the proposal.

Other areas to be considered

- 2.12. Ofgem has set out proposals to modify the Guaranteed and Overall Standards of Performance to recognise the development of incentive mechanisms for delivering appropriate standards of service. Guaranteed Standards are not contained in licence conditions but are prescribed by regulations which Ofgem makes with the consent of the Secretary of State.
- 2.13. Current Overall Standards were determined by Ofgem in accordance with its statutory powers after consultation and research. Ofgem now proposes to remove Overall Standards and replace some of them with additional reporting requirements under the quality of service Regulatory Instructions and Guidance (RIGs).
- 2.14. In general, the legislative process for introducing or amending statutory instruments is rigorous and lengthy and may take several months to conclude. In the light of this, Ofgem will discuss the changes with the Department of Trade and Industry (DTI) and undertake an informal consultation with interested parties in September in order to implement its proposals to amend the Guaranteed Standards of Performance and remove the Overall Standards of Performance for 1 April 2005.

Timetable and process for implementing the price controls

- 2.15. Ofgem is looking to begin the statutory consultation on changes to the licence conditions to implement the price controls at the end of January 2005. This should provide sufficient time for any representations and objections to be considered before the price controls take effect on 1 April 2005. In order to consult informally on the licence modifications before undertaking the statutory consultation at the end of January 2005, Ofgem intends to follow the timetable for drafting and consultation that is set out below.

2.16. Ofgem intends to establish an industry working group to assist in the development of the revised price control licence conditions. The group will comprise legal or regulatory representatives from DNOs to provide an appropriate balance of knowledge and expertise to provide effective input into the development of the price control licence conditions. In particular, the main purpose of this group is to debate the high level form and structure of the revised licence conditions and not to agree the changes to the licences. Nothing discussed in this group is intended to replace the informal and statutory consultation process. Ofgem also expects that the working group will provide a forum for discussing common issues and concerns in relation to the licence conditions and identify options for consideration. Ofgem intends to hold the first meeting of the group in late July 2004

Consultation timetable

Date	Milestone	Purpose
28 June 2004	Publish outline document	Set out the process for modifying the licences and identify the key areas for change. Provide initial drafting of the licence conditions to introduce the new DG, IFI, and RPZ incentive schemes
9 August 2004	Responses received to this document.	
September 2004	Publish update document	Provide initial drafting of the core price control conditions
October 2004	Receive comments/responses to the September update	
November 2004	Publish final price control proposals with detailed drafting of the accompanying licence modifications	
December 2004	DNOs respond to the proposals and draft licence conditions	
January 2005	Revised draft licence modifications provided to DNOs for final comments. Statutory consultation begins	
February 2005	Any objections and representations given to Ofgem	
March 2005	Overall Standards are removed Guaranteed Standards are amended Price control licence modifications are made.	To implement the price control for 1 April 2005

3. The general framework of licence obligations

Introduction

- 3.1. The DNO price control licence conditions and reporting framework have evolved as the structure and operation of the electricity industry has developed and the framework of incentive regulation has been refined. It is important to consider whether, in implementing revised price controls from 1 April 2005, further changes or improvements to the structure of the licence conditions might be desirable or required to address any issues with the existing framework.
- 3.2. This Chapter describes the key features of the existing framework of licence conditions and obligations, how they operate, and thoughts on where the framework might be improved.

Objectives

- 3.3. The framework of licence obligations serves two main purposes. Firstly, it provides the boundaries within which the licensee must operate in undertaking its statutory and licence activities. Secondly, it provides a framework for ensuring that the activities of the licensee are effectively monitored to ensure that they fall within the specified boundaries.
- 3.4. The extent of the obligations placed upon the licensee is largely determined by the principal objective and statutory functions of Ofgem and the statutory obligations and authorised activities of the licensee. Nevertheless, it is important that the balance of requirements does not impose an undue burden on Ofgem, licensees and consumers. Therefore, the purpose of this document is to set out Ofgem's initial thoughts in relation to the following questions:
 - ◆ does the existing structure and framework of price control licence conditions best facilitate the achievement of Ofgem's principal objective and statutory functions?
 - ◆ if not, what refinements to the structure and framework might be desirable to better facilitate these requirements? and

- ◆ how does the change impact upon the burden of regulation?

Existing framework of obligations

Introduction

- 3.5. The regulatory framework in relation to the price controls and related quality of service incentives are set out in Special conditions A to G of the distribution licence⁵, with supplementary obligations and provisions set out in Schedule A of the special conditions.
- 3.6. The structure of the price control licence conditions has remained largely unchanged since privatisation. The traditional approach to implementing revised price controls has focused upon making those amendments to the existing licence conditions that are necessary for the price control to take effect. This has been done within the context of the established framework of licence conditions and as a consequence many aspects of the established framework have been retained from price control to price control.

Developments to the “traditional” framework

- 3.7. Following the last review of the electricity distribution price controls, Ofgem undertook a review of the regulatory arrangements for quality of service under the Information and Incentives Project (IIP). This included a review of the incentives and reporting requirements for assessing the quality of service performance of each DNO. Ofgem made three key refinements to the regulatory framework following this review, which included:
- ◆ the development of financial incentives applied to performance against explicitly defined outputs to provide stronger incentives for output delivery and ongoing monitoring of performance;
 - ◆ the introduction of detailed definitions under which quality of service performance would be reported. These definitions were applied across all DNOs to ensure consistency of reporting; and

⁵ Special conditions are numbered differently in respect of ScottishPower Distribution and Scottish Hydro-Electric Power Distribution in Scotland.
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

- ◆ the introduction of specified levels of accuracy that DNOs were required to meet in reporting quality of service performance to Ofgem. These measures of accuracy are subject to independent audit.
- 3.8. In implementing these arrangements, Ofgem adopted a different structure and framework of licence conditions from those adopted for earlier price controls. This structure has three elements:
- ◆ Special licence conditions that set out the impacts of the incentive arrangements upon distribution revenues; which is the traditional component;
 - ◆ A standard licence condition that set out what activities should be recorded and measured, in accordance with the Regulatory Instructions and Guidance, by all of the DNOs covered by the scheme; and
 - ◆ Regulatory Instructions and Guidance that support the reporting licence conditions and have simplified amendment procedures to facilitate ongoing development and change to the framework, whilst providing a higher degree of consistency of reporting.
- 3.9. This structure has three identifiable advantages over the framework adopted in establishing other aspects of the price controls. Firstly, specified minimum levels of performance that were not directly subject to financial incentives were supplemented by incentivised outputs. This was a departure from the earlier approach that was intended to provide a degree of certainty as to the principal boundaries of the scheme and the impact on DNOs. The special licence condition obligations fulfilled this function.
- 3.10. Secondly, it was important that the framework of obligations, especially in respect of the detailed components of the reporting definitions allowed sufficient flexibility to make refinements in response to enhanced knowledge arising from operation of the scheme. Consequently, Ofgem established the Regulatory Instructions and Guidance with flexibility in mind.
- 3.11. Finally, Ofgem recognised that some aspects of the obligations were common to all DNOs and therefore these were set out in the standard licence condition.

This enables the obligations to be modified collectively to ensure that consistency is maintained.

The current package of special licence conditions⁶

3.12. As noted earlier, the core elements of the price control framework are presently set out in the special conditions of the distribution licence. Their structure can be summarised in detail as follows:

- ◆ **Special condition A (definitions and interpretation)** – this condition defines those terms relevant to the interpretation of the subsequent special licence conditions;
- ◆ **Special condition B (restriction of distribution charges)** – this condition sets out the price control formula and defines its terms, subject to the provisions of special condition E (allowance in respect of security costs) and special condition G (the quality of service incentive scheme);
- ◆ **Special condition C (restriction of distribution charges and allowed levels of deviation)** – this condition sets out the limits in relation to how far price control income may deviate from the allowance and sets out an adjustment mechanism;
- ◆ **Special condition D (reporting in connection with the charge restriction conditions)** – this condition sets out the reporting requirements and obligations to demonstrate compliance with the price control conditions. Guidance and further restrictions are set out in Schedule A. These reporting obligations are common across all DNOs and therefore DNOs should demonstrate compliance on a consistent basis;
- ◆ **Special condition E (allowances in respect of security costs)** – this condition provides powers of the licensee to suspend the price control condition in the event that the Secretary of State issues a direction under 34(4)(b) of the Electricity Act 1989;

⁶ For the Scottish DNOs the ordering of the licence conditions varies
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

- ◆ **Special condition F (duration of the charge restriction conditions)** – this condition sets out the duration of the distribution price controls and the outlines the formal process for disapplication of the price control conditions;
- ◆ **Special condition G (the quality of service incentive scheme)** – this condition sets out the incentive scheme that enables adjustments to the charge restriction conditions to reflect the licensee’s performance in achieving its targets for quality of service; and
- ◆ **Schedule A (supplementary provisions of the charge restriction condition)** – this schedule specifies conditions and restrictions relating to the treatment, derivation and reporting of specific price control terms. In general, these provisions are common to all DNOs and should be recorded and reported on a consistent basis.

3.13. It is important to consider whether this framework of licence obligations fulfils the objectives set out above. In addition, there are a number of factors that require consideration in developing the structure of the price control licence conditions for April 2005 onwards. These include:

- ◆ the proposed separation of metering activities from other distribution activities with the introduction of specific price control requirements;
- ◆ the proposed introduction of new incentive schemes for Distributed Generation, Registered Power Zones, and the Innovation Funding Initiative; and
- ◆ further amendments to the price control framework where Ofgem is already committed to make changes in relation to earlier policy decisions – e.g. the rebates proposals on the correction factor.

3.14. There may be other developments in the industry, specifically arising in relation to proposed amendments to primary legislation, that will influence Ofgem’s consideration of whether retaining the current framework of licence conditions is appropriate. While it may be possible to introduce new obligations within the established structure, the fact that it will be necessary to make substantial modifications to the conditions provides a good opportunity to consider whether

there are alternative approaches that might be adopted that better facilitate the objectives set out earlier.

Ofgem's initial thoughts

3.15. It is important that the structure of DNO price control obligations strikes a balance between providing a clear framework within which the DNO should undertake its activities, providing a framework that can be effectively monitored and enforced, and establishing arrangements that minimise the burden of regulation. In reviewing the existing obligations there are 3 main elements:

- ◆ an established framework of restrictions that provide the boundaries, for each individual DNO, on what behaviour is permitted and the level of revenue associated for an efficient company;
- ◆ a package of obligations that are common across all DNOs, including the requirement to report information to demonstrate compliance with the price controls; and
- ◆ detailed guidelines and definitions that establish the information to be recorded on a consistent basis for the purpose of fulfilling the common obligations.

3.16. As discussed above, the previous approach had been to develop the existing special licence conditions. This was considered largely appropriate because the industry structure and framework was largely stable over time and expected to remain largely stable. Experience during the present price control period have demonstrated how difficult it is to accommodate relatively minor developments in the structure in the licence framework.

3.17. In minimising the burden of regulation, Ofgem recognises the benefits of consistency of approach and therefore Ofgem is presently minded to adopt a simpler framework for all price control licence conditions – which will be structured as follows:

- ◆ the revenue allowances for each DNO will be set out in a series of special licence conditions;

- ◆ obligations to record and report information, which will be common across all DNOs, will be set out in a series of standard licence conditions; and
- ◆ detailed definitions and guidance on the treatment of costs, outputs and revenues, will be set out in separate Regulatory Instructions and Guidance.

3.18. **Ofgem would welcome views on whether this structure is desirable, or whether it might be refined further.** The remainder of this document will identify the areas of the existing price control conditions that will require modification and highlight the impact of adopting the framework set out above for how these modifications might be made.

4. Amendments for form and scope of the price control

Introduction

- 4.1. The basic form of the price control is set out in Special condition B⁷ of the electricity distribution licence, along with its component parts. Some elements of the price control formula are set out in supplementary special conditions. Rules in relation to those items which may fall outside the scope of the price control restriction are set out in Schedule A. Many aspects of the initial price control proposals for 1 April 2005 have an impact on both the form and scope of the existing licence conditions. This Chapter describes the impact of these proposals and identifies where changes to the existing framework are required.

Key proposals of the price control review

- 4.2. The price control proposals follow a similar RPI-X format to previous price controls, however there are some differences to how this is expressed. In particular, Ofgem has set out proposals for a revised treatment of several key elements of revenues and costs and these need to be reflected in the revised structure of the licence obligations. The main proposals are as follows:
- ◆ the inclusion of EHV charges for customers connected at 31 March 2005 within the main price control. Previously these charges were excluded items;
 - ◆ changes to the treatment of wheeling charges, to allow pass through of charges payable through DUoS charges and now include the revenue received from wheeling within the price control. Previously, DNOs receiving the energy paid wheeling charges from their revenue allowance and the DNOs distributing the electricity and therefore receiving revenues were allowed to treat this outside the scope of the price control;

⁷ Special Condition C in Scotland.
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

- ◆ the treatment of network rates(subject to final review). Previously rates have been incorporated within the cost allowances;
 - ◆ the development of rolling retention mechanisms for operating and capital expenditure efficiency savings and a sliding scale mechanism to establish the level of capital expenditure savings that a company can retain;
 - ◆ the implementation of revised losses and quality of service incentives; and
 - ◆ the introduction of incentives for distributed generation, innovation funding, registered power zones, and restoration of supply following severe weather.
- 4.3. The remainder of Ofgem’s proposals maintain the form and scope of the price controls largely as it is at present, although the revenue allowances associated with the activities will nevertheless change from those at present.

Impact of proposals on the licence conditions

- 4.4. Fundamentally, the existing price control is being replaced by a revised price control and therefore much of the existing special condition B is expected to be replaced by a new condition or conditions. The price control has four elements:
- ◆ a baseline revenue value reflecting the cost allowances of a DNO meeting their core functions and obligations;
 - ◆ a pass-through element for costs items that are incurred but remain outside significant control of the DNO;
 - ◆ incentive payments and penalties resulting from a DNO’s performance against its incentive targets; and
 - ◆ an annual correction factor for difference between revenue received and allowed under the price controls.
- 4.5. At present, these elements are largely set out in a single price control condition, however, experience has shown that continual development in the price

controls has made the condition disjointed. To address this issue, Ofgem is minded to establish a core price control condition that will set out the price control restriction in terms of the components set out above. This will be supplemented by additional conditions for pass through items and incentives which will set out how the total adjustment has been derived. This provides some degree of flexibility to modify components of the price control without opening up the entire price control restriction.

- 4.6. It is also anticipated that each incentive arrangement will be supported by individual standard and special licence conditions, similar to the arrangements presently in place for IIP.
- 4.7. **Ofgem welcomes views on this approach.**
- 4.8. Supplementary provisions relating to the price control, including those in relation to excluded services, have been set out in Schedule A to the charge restriction conditions. These provisions set out guidance and instructions in relation to the treatment of revenues and reporting definitions. The proposal to modify the treatment of some revenue and cost items will impact upon the existing guidance and instructions.
- 4.9. Ofgem is minded to replace Schedule A, in part, with a Regulatory Instructions and Guidance document that will establish the reporting definitions for the price control, but will also set out the revenue treatment for items falling outside the scope of the revenue restriction. This will largely be based on Parts A, C and D of Schedule A modified to ensure greater consistency of interpretation across DNOs. Nevertheless, there may be elements of the Schedule that should be retained as part of the special conditions or incorporated within a new standard licence condition. Ofgem would also set out a change process for revising the new Regulatory Instructions and Guidance within the reporting licence condition. **Ofgem would welcome views from DNOs on these matters, and in particular what elements of Schedule A should remain explicitly set out within the licence.**

5. Quality of service and other outputs

Introduction

- 5.1. There are a number of important incentive mechanisms already in place in relation to Quality of service and management of network losses. Ofgem has set out proposals to strengthen the incentives for the period from 1 April 2005 and therefore it is appropriate to consider the impact upon the framework of licence conditions.
- 5.2. As noted above, the approach that has been adopted for the quality of service incentives departs for traditional methods of implementation. For example, the losses incentive arrangements are explicitly set out in special condition B with guidance on reporting set out in part E of Schedule A. In comparison, the IIP incentives have three elements; revenue adjustment calculations set out in the special conditions, reporting obligations set out in standard licence condition 49, and regulatory instructions and guidance for reporting that have been set out in a separate document, supporting standard licence condition 49. Ofgem considers that there are benefits from adopting a common framework for incentive arrangements.
- 5.3. The mechanism for adjustment to revenue under the 'interim arrangements' for storm compensation are contained within special condition B. An accompanying document explains the details of the arrangements.
- 5.4. Some elements of the quality of service obligations, i.e. the Guaranteed Standards of Performance, are set out in a Statutory Instrument. Ofgem's proposals will require some amendments to this.
- 5.5. Further, Ofgem proposes to remove the Overall Standards of Performance and incorporate some of the reporting requirements in the current IIP reporting framework.

Key proposals of the price control review

- 5.6. Ofgem has made three important proposals that will impact upon the framework of licence and statutory obligations. These are:

- ◆ the proposal to amend the Guaranteed Standards of Performance by removing the 18 hour supply restoration standard and introducing a standard licence condition that establishes standards for restoration under both normal and severe weather conditions;
- ◆ the removal of the Overall Standards of Performance from the statutory determinations, and incorporating some of the requirements within the IIP reporting framework;
- ◆ the introduction of strengthened IIP quality of service incentives, based largely upon the existing arrangements; and
- ◆ the introduction of revised distribution losses incentive arrangements.

Impact of proposals on the licence conditions

5.7. In relation to quality of service obligations and outputs, Ofgem is minded to retain the existing structure and amend the relevant provisions of the existing conditions where appropriate. In general, many of the proposed changes require minor revisions to the existing conditions. However, the proposed changes to the standards of performance will require new licence conditions to replace those elements removed from the statutory instrument. This will involve two aspects:

- ◆ the development of a new standard licence condition that sets out the common obligations across DNOs in relation to revised supply restoration obligations; and
- ◆ amendments to the IIP Regulatory Instructions and Guidance to capture some elements of the overall standards of performance that Ofgem propose should be removed.

5.8. Further detail regarding the drafting of these conditions will be set out with the September 2004 price control update document. A revised draft of version 5 of the RIGs for quality of service will be published in July 2004.

5.9. The revised losses incentive framework to apply from 1 April 2005 represents a significant simplification on the existing scheme. Ofgem intends to incorporate

these revised incentive arrangements within the regulatory framework. As a consequence, the reporting definitions and requirements will be set out in a standard reporting licence condition supported by a separate guidance document.

- 5.10. **Ofgem would welcome views on the proposed approach set out above. In particular, we would welcome comments on how we might construct an appropriate supply restoration licence condition.**

6. Distributed generation, Innovation funding, and registered power zones

Introduction

- 6.1. As discussed earlier, Ofgem has identified several new areas where it intends to provide focused incentives in response to industry challenges and change. In light of this, these aspects are additions to the current regulatory framework. This Chapter discusses briefly the approach that Ofgem intends to adopt to implement these revised arrangements.

Key proposals of the price control review

- 6.2. There are several important elements to Ofgem's proposals, these include:
- ◆ the introduction of an incentive mechanism for distributed generation that enables 80 per cent pass through of costs and a £1.50⁸ incentive payment per kW of capacity connected;
 - ◆ a cap and collar setting out the minimum and maximum rate of return that DNOs are allowed for individual connections under the incentive scheme;
 - ◆ a research and development intensity cap of 0.5% of turnover as part of the innovation funding incentive scheme, with supplementary restrictions on the amount that a company may use to fund internal expenditure; and
 - ◆ an incentive allowance for registered power zone projects meeting the criteria set out by Ofgem, up to a maximum of £0.5 million per year.
- 6.3. The high level structure of the incentive arrangements has been established, however further work will be necessary to develop the detailed criteria and

⁸ £2/kW for Scottish & Southern Energy – Hydro.
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

reporting obligations in relation to the incentive schemes. Ofgem intends to publish further details in September 2004.

Impact of proposals on the licence conditions

- 6.4. Initial drafting of the special licence condition necessary to implement the new scheme is set out in Appendix 1 of this document. Ofgem has also published draft regulatory instructions and guidance in relation to these schemes in addition to this document⁹. **Ofgem would like to hear from DNOs and other interested parties in relation to these initial drafts and how these might be refined.**
- 6.5. It is important to note that the initial drafting has been produced within the context of the current framework of licence conditions. Therefore, further work may be anticipated to incorporate these conditions within the revised structure that has been set out in this document. It is expected that further drafting will be published in September 2004.

⁹ Distributed Generation Incentive, Innovation Funding Incentive, and Registered Power Zones: Regulatory Instructions and Guidance (Version 1), June 2004
Electricity Distribution Price Control Review, Initial Proposals, Appendix
Office of Gas and Electricity Markets

7. Other issues

Introduction

- 7.1. There are a number of other aspects to the regulatory framework that are affected by the initial price control proposals. This Chapter identifies those aspects and describes how Ofgem intends to address them. It is important to recognise that the reporting framework to support these price control obligations will require revision. For example, the reporting obligations for the current framework are set out in Special Condition D of the distribution licences. Nevertheless, Ofgem would welcome views on whether it is appropriate to introduce general regulatory instructions and guidance for price control reporting.

Other aspects of the price control review

- 7.2. The March 2004 policy document and the June 2004 initial proposals have set out several aspects of the price control review that may impact upon the structure and framework of the licence conditions.
- 7.3. Ofgem has identified several issues regarding the consistent treatment of costs across DNOs which has led to extensive normalisation adjustment before cost benchmarks have been established. At present, cost reporting is governed by the draft Regulatory Accounting Guidelines for electricity DNOs and Ofgem request cost information from each of the DNOs on this basis. In light of the experience of this price control review, Ofgem considers that further refinement to the cost reporting guidelines will be required once the price control review has concluded. An important step will be to implement amendments to the regulatory accounts licence condition to ensure that the Regulatory Accounting Guidelines are formally introduced. Ofgem expects to do this as part of the price control licence modifications. **Ofgem invites views on this issue.**
- 7.4. An objective of this process is to establish a co-ordinated and coherent reporting framework to support the price control licence obligations. In general, Ofgem envisages that there will be three elements to the regulatory reporting framework – cost reporting, revenue reporting, and output reporting – supported by

separate guidance documents and standard licence conditions. **It would be helpful to receive views and comments on whether this approach is desirable.**

7.5. There are a number of other areas where Ofgem, in considering amendments either in relation to the price control proposals or commitments already given, anticipate further amendments to the framework of licence conditions. These include:

- ◆ restrictions on dividend payments as a result of a materially weakened and weakening licensee credit rating. The 'cash-lockup' provisions are described in previous price control consultation documents;
- ◆ amendments to allow credit ratings issued by Fitch to be approved in relation to the ring fencing provisions of the licence;
- ◆ amendments to the allowed thresholds for over and under recoveries to provide a deadband of two per cent before interest penalties are applied; and
- ◆ forthcoming proposals in relation to the treatment of bad debts that might arise over the price control period.

7.6. Ofgem is also reviewing the overall burden of obligations on electricity distribution licensees. Part of this process will be to refine, and remove where appropriate, licence conditions to enable a more effective overall framework. Ofgem is keen to remove those conditions that are redundant when making the price control modifications. If possible, Ofgem is also keen to explore other areas that might be removed or refined. **Views are invited on whether there are elements of the licence conditions that could be reviewed or simplified when implementing the price controls.**

7.7. Ofgem would also comments and views on whether there are other areas where amendments might be required other than those discussed in this document.

Appendix 1 Distributed Generation licence conditions

Modification to Special Licence Condition B¹⁰

In special condition B (Restriction of distribution charges) the formula in paragraph 1 shall be amended to read as follows:

$$M_{dt} = P_{dt} + PN_{dt} + LF_{dt} + Q_{dt} + Z_{dt} + CA_{dt} + SW_{dt} + G_{dt} - PM_{dt} - MC_{dt} - K_{dt}^{11}.$$

and the following should be inserted after paragraph 2:

2B for the purposes of paragraph 1:

C_{dt} in the relevant year is as defined in paragraph 2 of special licence condition X (Incentive scheme: calculation of charges restriction adjustment for distributed generation, innovation, and registered power zones incentives).

New Special Licence Condition

Condition X: Incentive scheme: calculation of charges restriction adjustment for distributed generation, innovation and registered power zones incentives

1. The purpose of this condition is to establish the incentive schemes referred to in the principal condition so as to provide for adjustments to the charge restriction conditions to reflect the performance of the licensee in relation to connection of distributed generation (DG), innovation and registered power zones.
2. For the purpose of the charge restriction conditions in the relevant year t , C_{dt} is the amount derived from the following formula:

$$C_{dt} = \frac{GI_t + GP_t - GC_t + GA_t + CO_t + IFI_t + RPZ_t}{D_t}.$$

¹⁰ This should be special condition C for Scottish Hydro-Electric Power Distribution Ltd and SP Distribution Ltd.

¹¹ The term MC_{dt} does not apply to all licensees, but shown here for completeness.

3. For the purpose of paragraph 2, D_t means the regulated quantity distributed in relevant year t .
4. For the purpose of paragraph 2, Gl_t , GP_t , GC_t , and GO_t for relevant year t are derived from the formulae:

$$Gl_t = PIA_t \cdot gir \cdot \sum_{i=1}^{ng_t} gci_{it},$$

$$GP_t = PIA_t \cdot \sum_{j=y}^t \left[\left(\frac{R}{1 - \frac{1}{(1+R)^p}} \right) \cdot gp_j \right],$$

$$GC_t = PIA_t \cdot \sum_{i=1}^{ng_t} idr_i \cdot gci_{it} \cdot (ID_{it} - IDB_i),$$

$$GO_t = PIA_t \cdot gor \cdot \sum_{i=1}^{ng_t} gci_{it},$$

where:

PIA_t (being the price index adjuster) in relevant year t is derived from the following formula:

$$PIA_t = \left(1 + \frac{RPI_t}{100} \right) \cdot PIA_{t-1},$$

where, for the relevant year commencing 1 April 2005, $PIA_t = 1$, and

RPI_t is defined as in paragraph xx of special condition B (Restriction of distribution charges);

gir is the incentive rate for connecting DG, and has a value of £1500/MW [£2000/MW for Scottish Hydro-Electric Power Distribution Ltd];

ng_t is the total number of relevant DG in year t ;

gci_{it} is the incentivised DG capacity for relevant DG i in year t , expressed in MW;

idr_i is the rebate rate for network unavailability applicable to relevant DG i . It has a default value of £2/MWh unless it is agreed otherwise between the licensee and the relevant agents for relevant DG i ;

R is the allowed pre-tax cost of capital for the purpose of this incentive mechanism. It has a value of [x.x%] for the time period between 1 April 2005 and 31 March 2010;

y is the relevant year commencing the later of 1 April 2005 or P years earlier than the relevant year t ;

P is the number of years in the allowed depreciation period for DG related system assets. It has a value of 15;

gp_j is the amount of capital cost entering the pass-through arrangement in year j and is derived from the following formula:

$$gp_j = ptr \cdot (gps_j + gpc_j) - gpc_j - gtd_j,$$

where ptr is the pass-through rate and has a value of 0.8, gps_j is the use of system capex for DG for relevant year j , gpc_j is the shared connection capex for DG for relevant year j , and gtd_j is the assets transferred from DG capex to demand capex for relevant year j as set out in paragraph 7;

ID_{it} is the network interruption duration for relevant DG i in year t , expressed in hours;

IDB_i is the baseline network interruption duration for relevant DG i , expressed in hours. It has a default value of 0 unless agreed otherwise between the licensee and the relevant agents for relevant DG i ;

gor is the operational and maintenance rate for all relevant DG, and has a value of £1000/MW.

5. For the purpose of paragraph 2, GA_t has a value of 0 for all years except for the years commencing 1 April 2010, 1 April 2015, 1 April 2020 and 1 April 2025.

For these four years, GA_t will take a value as ascribed by the Authority at relevant price control reviews which will be aimed to provide a cap at [x%] and a floor at [y%] on the expected or actual return for the licensee's relevant investment consisting of use of system capex for DG and shared connection capex for DG.

6. For the purpose of paragraph 4, the value of the incentive rate for connecting DG, gir , when applied to incentivised DG capacity relevant for the period starting from 1 April 2005 and ending on 31 March 2010, will not be changed before 1 April 2025.
7. For assets originally categorised as use of system capex for DG but subsequently utilised mainly by demand, an appropriate portion of the relevant remaining asset value may be reallocated to the main price control RAV.
8. For the purpose of paragraph 2, IFI_t is derived from in relevant year t from the formula:

$$IFI_t = \dots$$

where:

[definition of terms]

9. For the purpose of paragraph 2, RPZ_t is derived from in relevant year t from the formula:

$$RPZ_t = \dots$$

where:

[definition of terms]

10. All the underlined terms in this special condition are defined in the Regulatory Instructions and Guidance for distributed generation incentive, innovation funding incentive and registered power zones.