

# **Regulation of Independent Electricity Distribution Network Operators**

## **Consultation Paper**

July 2004      180/04

## Summary

This document sets out Ofgem's initial consultation on developing the appropriate long term regulatory regime for new independent distribution network operators (IDNOs).

Changes to the Electricity Act 1989 by the Utilities Act 2000 introduced distribution as a separate activity requiring authorisation. As a consequence, any person can apply for a licence to operate existing or newly built distribution networks. Ofgem is currently considering four applications for a distribution licence. These applications are proceeding on the basis of interim arrangements for the regulation of IDNOs. Ofgem has consulted on licence modifications for each of the IDNO applicants under Section 8A of the Electricity Act 1989 to introduce financial ring fencing provisions and a restriction on use of system charges for domestic consumers.

The objective of this consultation is to develop sufficiently robust long term arrangements for the regulation of IDNOs to protect the interests of consumers. This paper discusses:

- ◆ the contractual arrangements in the electricity sector compared to the gas sector and the consequences of this on the regulation of IDNOs;
- ◆ charging arrangements under condition BA1 and options for long term arrangements; and
- ◆ the financial ring fencing conditions and, in particular, alternative arrangements under condition BA5.

When considering the appropriate regulatory framework for IDNOs, Ofgem needs to consider the existing contractual arrangements in the electricity industry. These arrangements are different to those in the gas industry; this paper compares the two and sets out the implications for IDNO regulation.

This paper also discusses whether the charging arrangements proposed in condition BA1 are suitable as long term arrangements. Condition BA1 requires that IDNOs' charges do not exceed the charges in place at the relevant time that would be made by the incumbent distribution network operator (DNO) in whose distribution services area the IDNO's network is located. This paper sets out options for alternative arrangements. The alternative options identified are:

- ◆ rate of return regulation;
- ◆ RPI-X regulation based on the IDNO's costs;
- ◆ RPI-X regulation based on the incumbent DNO's charges as a starting point and
- ◆ relative price control (RPC) regulation.

Finally, this paper discusses the financial ring fencing conditions which will be applied to all new distribution licences. Condition BA5 on the credit rating of the licensee allows for alternative arrangements to an investment grade credit rating. This paper sets out Ofgem's proposed alternative arrangements which are intended to afford consumers the same protection as the requirement for an investment grade credit rating.

Ofgem is seeking views on the issues discussed in this paper and responses should be received by 13<sup>th</sup> September 2004. Ofgem intends to publish a proposals document later in 2004.

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# 1. Introduction

## *Purpose of this document*

- 1.1. This document opens the consultation on the appropriate long term regulatory regime for new independent distribution network operators (IDNOs)<sup>1</sup>. The main aim of the review is to develop sufficiently robust long term arrangements to protect the interests of consumers.
- 1.2. The purpose of this document is to set out Ofgem's initial thoughts and seek views on the important issues for the development of long term arrangements, including:
  - ◆ the contractual arrangements in the electricity sector;
  - ◆ charging arrangements; and
  - ◆ financial ring fencing conditions.

## *Background*

- 1.3. As a consequence of changes to the Electricity Act 1989 ("the Electricity Act") by the Utilities Act 2000 ("the Utilities Act") which introduced distribution as a separate activity requiring authorisation, the Gas and Electricity Markets Authority ("the Authority") can grant a licence authorising a person to distribute electricity for the purpose of giving a supply to any premises ("a distribution licence")<sup>2</sup>. This means apart from the ex-Public Electricity Suppliers (ex-PES) distribution network operators (DNOs) that came into existence on 1 October 2001, other parties can apply for a licence to operate existing or newly built distribution networks.
- 1.4. Potential IDNOs will operate electricity distribution networks which will predominantly be network extensions connected to existing distribution

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<sup>1</sup> The term 'independent distribution network operator' (IDNO) will be used to define any electricity distributor other than the ex-PES distribution network operators that came into existence on 1 October 2001.

<sup>2</sup> The Electricity Act 1989 (as amended), section 6(1)(c).

networks, eg. to serve new housing developments on both greenfield and brownfield sites. Ofgem is currently considering four applications for a distribution licence.

- 1.5. At present there are private distribution networks connected to incumbent distribution networks. These networks are authorised by exemptions<sup>3</sup> (and are, as such, unlicensed) which limit the amount of electricity that can be supplied to domestic consumers on an exempt distribution network to 2.5MW<sup>4</sup>. Private networks are regulated by the Department of Trade and Industry, which attaches conditions to the exemptions regime, and are not within the scope of this consultation.
- 1.6. There are also currently DNOs operating distribution networks outside their distribution services areas ("out of area networks"). DNOs are not obliged to comply with any of the requirements of Section C of their distribution licences outside their distribution services area; therefore although these networks are licensed, they are not subject to the same degree of regulation as within area networks.

### ***Previous documents and consultations***

- 1.7. There have been two previous consultations on developing the regulatory regime for IDNOs in the form of open letters to the industry<sup>5</sup>. This document opens the wider consultation on the appropriate long term regulatory regime and develops the discussion in these previous open letters. The open letters are available on Ofgem's website<sup>6</sup>.
- 1.8. In response to an application for a licence the Authority may, following consultation, modify the standard licence conditions to such extent as it considers requisite to meet the circumstances of the particular case<sup>7</sup>. Notices

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<sup>3</sup> The Electricity (Class Exemptions from the Requirement for a Licence) Order 2001, Statutory Instrument No. 3270/2001.

<sup>4</sup> As a broad guide, 2.5MW of electricity equates to supplying around 2,500 domestic consumers at maximum demand.

<sup>5</sup> Ofgem's open letters on the regulation of new electricity distribution licence holders, 31 May 2002 and 16 April 2003.

<sup>6</sup> These are available on Ofgem's website under the 'IDNO Regulation' area of work.

<sup>7</sup> Electricity Act 1989 s8A (2) (as amended by the Utilities Act 2000)

under section 8A (3) of the Electricity Act proposing modifications to the standard licence conditions for a new electricity distribution licence were published for each of the four applicants<sup>8</sup>. These modifications are outlined in chapter 3.

## ***Structure of this document***

1.9. The structure of this document is as follows:

- ◆ Chapter 2 sets out a Summary Impact Assessment for the review outlining the issues being addressed, the objectives of the review, the policy options and impacts.
- ◆ Chapter 3 explains the legal framework relevant to the regulation of IDNOs. It also outlines the current position with IDNO applications and incumbent DNOs operating networks outside their distribution services areas.
- ◆ Chapter 4 considers the contractual arrangements in the electricity sector as compared to the gas sector and the consequences of these on the regulation of IDNOs.
- ◆ Chapter 5 sets out the current charging arrangements under new standard condition BA1 and the options for longer term arrangements.
- ◆ Chapter 6 explains the financial ring fencing conditions and the alternative arrangements under condition BA5. It also seeks views on any other suitable arrangements which would afford consumers the same protections as the requirement for an investment grade credit rating.
- ◆ Chapter 7 outlines the next steps.
- ◆ Appendix 1 sets out the full text of condition BA1 Charging Arrangements.

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<sup>8</sup> These are available on Ofgem's website under the 'IDNO Regulation' area of work.



- 1.10. Appendix 2 sets out the full text of conditions BA2-BA6 on financial ring fencing.

### ***Timetable and responses***

- 1.11. Ofgem would welcome responses and comments on the content of this consultation document and these should be received by 13<sup>th</sup> September 2004. Ofgem intends to publish a proposals document later in 2004.

- 1.12. Responses should be sent to the address below:

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- 1.13. All responses will be held electronically in Ofgem's Research and Information Centre. In addition, they will normally be published on the Ofgem website unless they are clearly marked confidential. Where possible, consultees should put confidential material in appendices to their responses. Ofgem prefers to receive responses electronically so they can easily be placed on the website.
- 1.14. Copies of this document and other material relating to this review are available on the Ofgem website under the 'IDNO Regulation' section of work.
- 1.15. Should you have any questions regarding issues raised in this document please contact Donna Rossall on 020 7901 7416.

## 2. Summary Impact Assessment

2.1. This summary impact assessment sets out the issues, objective, scope and policy options of this review and seeks views on the potential impacts.

### *Issue*

2.2. There have been ongoing structural and legislative changes within the energy industry which include the ongoing development of competition in electricity supply, generation, connections and metering. In addition the Energy Act 2004<sup>9</sup> covering UK energy strategy, the civil nuclear industry, renewable energy sources and energy markets and regulation will impact on the industry.

2.3. Further structural changes are anticipated with the entry of new licensed distribution network operators made possible through changes to the Electricity Act introduced by the Utilities Act.

2.4. The Utilities Act specifies that distribution is a separate activity, which can only be carried out by a person who is authorised to do so by a licence or under an exemption. As a consequence of this:

- ◆ new licensed distribution companies may operate networks connected within existing distribution systems; and
- ◆ ex-PES DNOs may establish licensed networks outside their distribution services area.

2.5. The current regulatory framework for distribution network operators has been developed with ex-PES DNOs in mind. New IDNOs will not have a distribution services area and the related obligations set out in the standard conditions in Section C of the distribution licence, therefore Ofgem has considered whether the existing regulatory framework is suitable for IDNOs. Where it is not, Ofgem has identified suitable interim arrangements for the regulation of IDNOs and is now consulting on the long term regulatory regime.

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<sup>9</sup> The Energy Act 2004 gained Royal Assent on 22 July 2004.

## ***Objectives***

- 2.6. The main aim of the review is to develop sufficiently robust long term arrangements for the regulation of IDNOs to protect the interests of consumers.
- 2.7. This implies that the regulatory framework should:
- ◆ protect the interests of consumers, present and future, by regulating network monopolies and promoting effective competition where appropriate, eg. in the metering and connections markets; and
  - ◆ ensure that regulated companies are provided appropriate incentives to encourage the efficient use of the network.

## ***Scope***

- 2.8. The scope of the consultation covers:
- ◆ the contractual arrangements in the electricity sector as compared to the gas sector and the consequences of these on the regulation of IDNOs;
  - ◆ charging arrangements under condition BA1 and options for long term arrangements; and
  - ◆ the financial ring fencing conditions and, in particular, alternative arrangements under condition BA5.

## ***Policy options***

- 2.9. The present contractual arrangements in the electricity sector are such that where an IDNO operates a network connected to an incumbent DNO's network, a supplier will have a Distribution Use of System Agreement (DUoSA) with the IDNO instead of the incumbent DNO. The IDNO will be charged use of system charges by those DNOs whose networks are used to convey electricity to the premises of the end consumer. This consultation addresses and seeks views on the issues that these arrangements raise such as liability for use of system charges, metering and quality of service. These are discussed in Chapter 4.

- 2.10. There are presently interim arrangements in place for the regulation of IDNOs. Ofgem has consulted on licence modifications for each of the IDNO applicants under Section 8A of the Electricity Act to introduce financial ring fencing provisions and a restriction on use of system charges for domestic consumers.
- 2.11. The interim charging arrangements proposed require that the IDNO's charges should not exceed those charges that would be made by the DNO in whose distribution services area the IDNO's network is located. This consultation proposes and seeks views on possible options for long term charging arrangements. The options identified are:
- ◆ keep the existing arrangements;
  - ◆ rate of return regulation;
  - ◆ RPI-X regulation based on the IDNO's costs;
  - ◆ RPI-X regulation based on the incumbent DNO's charges as a starting point and
  - ◆ relative price control (RPC) regulation.
- 2.12. Financial ring fencing conditions will be applied to all new distribution licences as they provide important safeguards for the financial stability of licensees. Condition BA5 on the credit rating of the licensee allows for alternative arrangements to an investment grade credit rating. Ofgem has proposed alternative arrangements which are set out in chapter 6. This consultation invites views on any other suitable arrangements which would afford consumers the same protection as the requirement for an investment grade credit rating.

### ***Impacts***

- 2.13. This document seeks views on the impacts of the options for long term arrangements identified.
- 2.14. Ofgem has introduced interim arrangements and intends to develop sufficiently robust arrangements to protect the interests of consumers, thus minimising the impact on consumers connected to an IDNO's distribution network.

2.15. A further potential impact may be a positive impact on competition in connections and metering.

2.16. No environmental or social impacts are envisaged.

## 3. Background

- 3.1. This chapter outlines the historical industry structure in the electricity distribution sector and relevant legal framework. It then goes on to explain the current position in terms of applications for new distribution licences.

### *Electricity distribution*

- 3.2. Electricity distribution is primarily the distribution of electricity across the distribution network from grid supply points or generation sets or other entry points (and bulk supply points in Scotland) to the points of delivery to consumers or authorised electricity operators in Great Britain.
- 3.3. Electricity distribution costs account for around £3 billion annually and make up around 25 per cent of consumers' electricity bills. For a typical domestic electricity consumer, based on consumption of 3300 kWh of electricity a year, the distribution element of their bill would be on average £60.
- 3.4. Each incumbent DNO holds a licence to distribute electricity on its distribution system within Great Britain. Following privatisation and a number of corporate mergers and acquisitions, the licences for the fourteen distribution services areas within Great Britain are presently held by seven different companies.
- 3.5. Changes to the Electricity Act and changes in the industry structure now present the opportunity for new licensed distribution companies to operate networks connected to existing distribution systems.

### *Relevant legislation*

- 3.6. The Electricity Act sets out the duties and functions of the Authority, in particular its principal objective to protect the interests of consumers, including future consumers, wherever appropriate by promoting effective competition and regulating where necessary. The Authority must carry out its functions in the manner that it considers is best calculated to achieve the principal objective, having regard to:

- ◆ the need to secure that all reasonable demands for electricity are met;

- ◆ the need to secure that licence holders are able to finance their activities; and
  - ◆ the promotion of efficiency and economy of distribution systems.
- 3.7. In carrying out these duties and functions, the Authority shall also have regard to:
- ◆ the interests of consumers, including those who are disabled or chronically sick, consumers of pensionable age, consumers with low incomes and consumers residing in rural areas; and
  - ◆ guidance issued by the Secretary of State in respect of social and environmental matters.
- 3.8. The Energy Act 2004 places a new duty on the Authority to carry out its functions in the manner best calculated to contribute to the achievement of sustainable development. It also requires the Authority to have regard to the principles of best regulatory practice in carrying out its Gas Act and Electricity Act functions.
- 3.9. Changes to the Electricity Act specify that distribution is a separate activity, which can only be carried out by a person who is authorised to do so by a licence or under an exemption.
- 3.10. The statutory duties of licensed distribution companies are set out in the Electricity Act. Their duties are to develop and maintain an efficient, co-ordinated and economical system of electricity distribution; and facilitate competition in the supply and generation of electricity.

### ***Relevant licence conditions***

- 3.11. The distribution licence for incumbent DNOs is split into three sections which contain standard conditions (SLCs):
- ◆ Section A – Interpretation, Application and Payments;
  - ◆ Section B – General; and

- ◆ Section C – Distribution Services Obligations.
- 3.12. In addition, existing licensees have special conditions which contain important provisions relating to price control and quality of service. Special conditions apply to individual licence holders.
- 3.13. Section C SLCs which include, amongst others, SLCs on financial ring fencing, only apply to incumbent DNOs within their distribution services area. Ofgem has considered whether existing section B SLCs would provide adequate protection for the interests of consumers and if it is appropriate for any of the section C SLCs to be brought into effect for IDNOs.
- 3.14. This led to Ofgem proposing modifications to the SLCs for a new electricity distribution licence which introduce conditions relating to charging and financial ring fencing.
- 3.15. These modifications are necessary to ensure that if a new licence is granted the conditions will be sufficiently robust to protect the interests of consumers. The distribution licence for IDNOs will be split into three sections:
- ◆ Section A – Interpretation, Application and Payments;
  - ◆ Section B – General; and
  - ◆ Section BA – Specific.
- 3.16. Section BA will consist of the following SLCs:
- ◆ BA1 – Charging Arrangements;
  - ◆ BA2 – Restriction on Activity and Financial Ring Fencing;
  - ◆ BA3 – Availability of Resources;
  - ◆ BA4 – Undertaking from Ultimate Controller;
  - ◆ BA5 – Credit Rating of Licensee; and
  - ◆ BA6 – Indebtedness.



- 3.17. Condition BA1 is designed to introduce price control provisions that would create similar obligations as those applying to incumbent DNOs. Conditions BA2 – BA6 are intended to reduce the risks of financial failure by providing obligations similar to those contained in section C of the incumbent DNOs' licence.
- 3.18. Under the long term regulatory framework section BA will remain in the IDNO licence. This consultation addresses the options for suitable long term charging arrangements under condition BA1 and the alternative arrangements under condition BA5.

## ***Current position***

### ***Independent Distribution Network Operators***

- 3.19. Ofgem is currently considering four applications for a distribution licence and has discussed potential applications with other interested parties. No new distribution licences have been granted as yet.
- 3.20. The current applicants are set out in Table 1.

**Table 1: IDNO applicants and ownership group**

<b>Applicant</b>	<b>Ownership Group</b>
Energy Networks Limited	Mowlem plc
Global Utility Connections Limited	Cannon Kirk Ltd
Independent Power Networks Limited	Inexus Group (Holdings) Limited
Laing Energy Limited	Laing O'Rourke plc

- 3.21. Ofgem considers that a long term regulatory framework for IDNOs should be implemented as soon as practicable to improve transparency and provide greater regulatory certainty for IDNOs.
- 3.22. The long term framework will develop the interim arrangements to better:
- ◆ protect the interests of consumers;
  - ◆ promote effective competition within electricity distribution; and

- ◆ promote efficiency and economy of electricity distribution systems.

### ***Out of Area Networks***

- 3.23. Ex-PES DNOs may now establish licensed networks throughout the UK and some incumbent DNOs have now developed networks outside their distribution services area. Ofgem's Electricity Distribution Price Control Review Initial Proposals paper<sup>10</sup> proposes to impose similar charging restrictions on DNOs with out of area networks as will apply to IDNOs. This is because although there may be some choice in the provision of out of area networks, once a company has provided the network it will be in a monopoly position and it is important that consumers are provided with protection from the possible abuse of their monopoly position. Subject to such arrangements, any revenue associated with distributing units out of area will be outside the scope of the DNO's price control.
- 3.24. Ofgem considers that the issues raised in this paper in respect of IDNOs generally also apply to incumbent DNOs developing out of area networks. Views are invited on any aspect where this may not be valid. As noted, subject to these views, Ofgem intends to propose similar arrangements for out of area networks as for IDNOs to provide non-discriminatory regulation between the two types of network.

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<sup>10</sup> Electricity Distribution Price Control Review Initial Proposals, June 2004 (145/04)

## 4. Contractual Arrangements

- 4.1. When considering the appropriate regulatory framework for IDNOs Ofgem needs to consider the existing contractual arrangements in the electricity industry. These arrangements are different to those in the gas industry and it is appropriate to compare the two and to identify the implications for IDNO regulation.

### ***Current contractual arrangements***

- 4.2. The contractual arrangements in electricity are underpinned by the provisions of amended SLCs 4, 4A and 4C-4E which require the licence holder to publish its methodology and statement for use of system charges and to offer non-discriminatory terms for use of system.
- 4.3. Electricity suppliers supply industrial and domestic customers nationwide using DNOs' distribution networks and paying DNOs for the use of system. The contractual arrangements between electricity suppliers and DNOs for use of the network are governed by the Distribution Use of System Agreement (DUoSA). Suppliers pay use of system charges for electricity that leaves the distribution system and the charge levied is for use of the distribution network from the entry point to the exit point.
- 4.4. The Utilities Act specifies that distribution is a separate activity, which can only be carried out by a person who is authorised to do so by a licence or by exemption. Therefore IDNOs can operate networks connected to the incumbent DNO's network, ie. an 'embedded network'. In the situation where an IDNO operates an embedded network there will be a DUoSA between the IDNO and the supplier and an additional agreement between the IDNO and the DNO.
- 4.5. The concept of distribution networks connecting to other distribution networks is not restricted to only connecting to the incumbent DNO network. Over time embedded networks could connect to other embedded networks (as has happened in the gas sector). This can be referred to as 'nested networks' ('nested Connected System Exit Points (CSEPs)' in gas).

- 4.6. In the gas sector shippers arrange for the transfer of gas over transportation networks to exit points for the purpose of supply of gas to final consumers by a supplier. Gas transporters (GTs) own and operate these networks with Transco being the largest GT operating the national transmission system and local distribution zones and independent gas transporters (IGTs) operating relatively small local distribution networks. Shippers have direct contractual relationships with both IGTs and Transco and transportation charges are levied on the shipper by Transco and the IGTs for use of each respective part of the transportation network.
- 4.7. In the case of nested CSEPs, shippers have direct contractual relationships with Transco and each IGT over whose transportation network gas is conveyed.
- 4.8. The principal difference between contractual arrangements in electricity and gas is the absence in electricity distribution of one party with direct contractual relationships with each of the other parties (ie. the equivalent of the shipper in the gas sector).

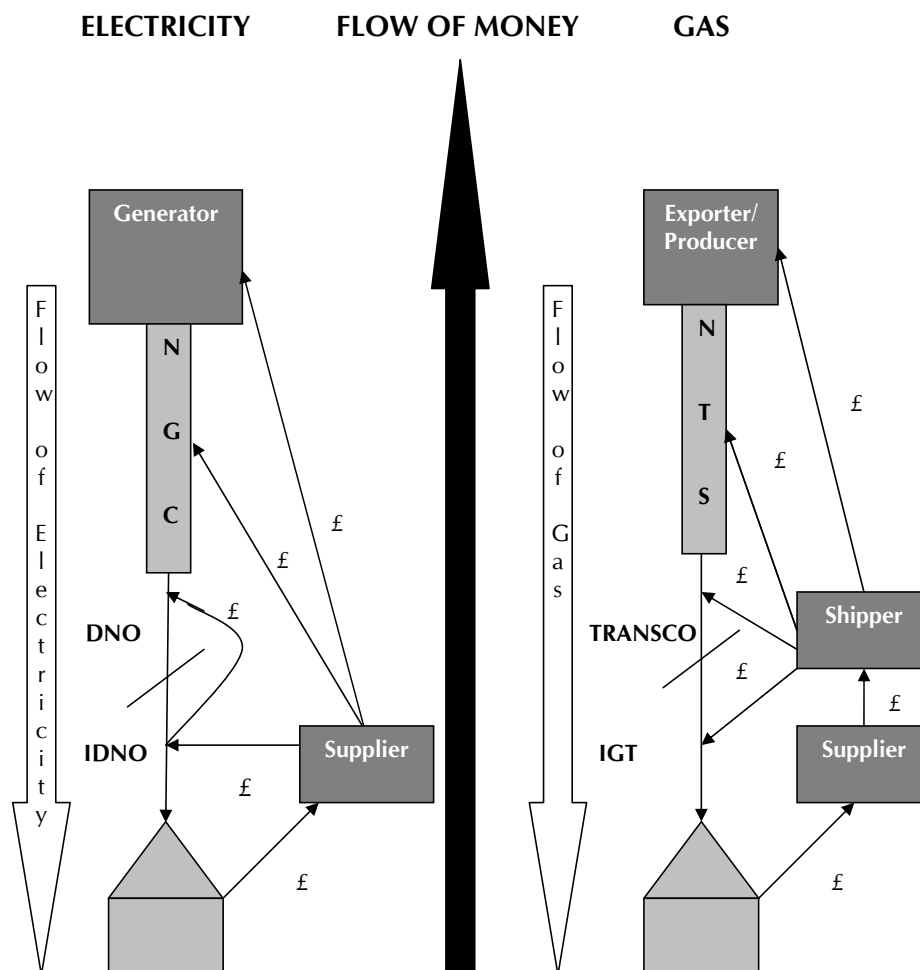
## ***Issues for consideration***

### ***Use of system charges***

- 4.9. Under the present structure, the distribution business that operates the network at the exit point charges suppliers use of system charges for electricity that leaves the distribution system and the charge levied are for use of the distribution network from the entry point to the exit point. In the situation where an IDNO operates the network at the exit point it is expected that the IDNO will collect use of system charges on behalf of all distribution businesses whose networks are used to convey electricity to the end consumer and will then pay use of system charges to the upstream DNO for use of the upstream distribution network. Therefore the IDNO will be liable for upstream use of system charges.
- 4.10. In the gas sector shippers pay transportation charges to Transco for use of the network to the CSEP and pay the IGT for use of the network from the CSEP to the end consumer. Therefore the IGT is not liable for upstream use of system charges.

4.11. The money flows for use of system charges in electricity and gas are illustrated in figure 1.

**Figure 1 Money flows in electricity and gas**



4.12. Possible consequences of the arrangements in the electricity sector are:

- ◆ distribution businesses will need invoicing and payment methods to correctly allocate monies and collect their income; and
- ◆ the IDNO will be liable for the upstream DNO's use of system charges.

4.13. One long term option may be to apply similar contractual arrangements as those that exist in the gas sector to the electricity sector so that one party, eg. the supplier, has direct contractual relationships with each of the other parties.

## ***Metering***

- 4.14. A further issue for consideration is whether or not metering is required for IDNO embedded networks. At present there is no mandatory requirement for settlement or boundary metering between DNOs' networks and embedded networks within the same GSP group<sup>11</sup>.
- 4.15. Possible advantages of installing a boundary meter are increased transparency leading to better quality of data used in the calculation of use of system charges and distribution losses. However any advantages need to be weighed against the cost to the end consumer of requiring a meter and the impact on competition of these costs.
- 4.16. A modification proposal<sup>12</sup> recommending boundary metering between networks within the same GSP group was raised in 2002. The modification proposal was subsequently rejected by Ofgem on the basis that it could not be certain that the proposal would serve to better facilitate achievement of the Applicable BSC Objectives and so no modification was directed. However Ofgem notes that there would appear to be nothing to prevent parties from procuring data collection services of a similar nature but outside the governance of the BSC.

## ***Quality of service***

- 4.17. At present there are a number of obligations in place on incumbent DNOs to ensure Ofgem receives accurate and consistent information on their quality of service and to ensure that DNOs have incentives to deliver an appropriate level of service to consumers. Ofgem is considering what quality of service obligations should be in place for the long term regulation of IDNOs.
- 4.18. Section C SLC 49 requires existing 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)

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<sup>11</sup> A GSP Group is a distinct electrical system consisting of the distribution system(s) which are connected to the transmission system and any distribution system which is connected to it but not connected to the transmission system at the grid supply point. The Balancing and Settlement Code, Annex 1 General Glossary. 21 March 2001.

<sup>12</sup> Modification Report – Modification P70: CMRS Metering for inter-DNO Boundaries within a GSP Group, July 2002.

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.

4.19. On 1 April 2002 Ofgem introduced a quality of service incentive scheme (IIP)<sup>13</sup>. The scheme links allowed 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.

4.20. In addition, incumbent DNOs are subject to guaranteed and overall standards of performance<sup>14</sup>. For example, there are guaranteed standards on restoring consumers' supplies within 18 hours following an interruption and on multiple interruptions. Where the DNO fails to achieve the standard, it is required to pay a fixed level of compensation to the consumer concerned.

4.21. Ofgem's proposals for revised quality of service incentive arrangements to apply to DNOs from April 2005 are set out in the distribution price control initial proposals<sup>15</sup>. The proposals include changes to both the standards of performance and the quality of service incentive scheme.

4.22. Ofgem would expect to apply similar standards of performance to IDNOs as apply to existing DNOs operating within their distribution services area, 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.

4.23. 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

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<sup>13</sup> Information and Incentives Project Incentive Schemes: Final Proposals, December 2001.

<sup>14</sup> The Electricity (Standards of Performance) (Amendment No. 2) Regulations 2002, Statutory Instrument No. 742/2002 and The Electricity (Standards of Performance) Regulations 2001, Statutory Instrument No. 3265/2001.

information is comparable with that provided by existing distribution companies within area. 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 of customers, the number and duration of interruptions to supply and the number of short interruptions in line with the definitions set out in the RIGs. The data should separately identify interruptions arising from incidents on their own and the upstream DNO network. They will also be required to provide an annual report on performance within 2 months of the end of the financial year.

### ***Views invited***

4.24. Views are invited on:

- ◆ whether similar contractual arrangements as those that exist in the gas sector should be applied to the electricity sector;
- ◆ the governance of inter-distributor relationships and the appropriate agreements between the two parties;
- ◆ whether boundary metering should be required between a DNO's network and an IDNO embedded network;
- ◆ which parts of the IIP reporting arrangements requirements should apply to IDNOs and how would these need to be modified to reflect their circumstances;
- ◆ which of the standards of performance should apply to IDNOs and how would these need to be modified to reflect differences in size and other circumstances between incumbent DNOs and IDNOs;
- ◆ what arrangements need to be put in place between IDNOs and DNOs to enable IDNOs to report appropriately; and

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<sup>15</sup> Electricity Distribution Price Control Review – initial proposals, June 2004 (145/04)



- ◆ to what extent will the existing reporting arrangements for DNOs need modifying to reflect the existence of IDNOs.

## 5. Charging Arrangements

- 5.1. Ofgem has proposed interim charging arrangements for IDNOs in condition BA1. This requires that IDNOs' charges do not exceed the charges in place at the relevant time that would be made by the DNO in whose distribution services area the IDNO's network is located. Ofgem is considering if the arrangements proposed in condition BA1 are suitable as long term arrangements or if there are other more appropriate charging arrangements.

### ***Existing arrangements***

- 5.2. SLCs in the distribution licence do not contain any price control obligations. The SLCs relating to charging have been recently modified as part of the review of the structure of distribution charges<sup>16</sup> to introduce new conditions relating to preparation of charging methodologies. The amended SLCs, contained in section B of the licence, are:

- ◆ Condition 4 which relates to use of system charging methodology;
- ◆ Condition 4A which provides for the publication of use of system charging statements;
- ◆ Condition 4B which relates to connection charging methodology;
- ◆ Condition 4C which relates to non-discrimination by the licensee between any persons in relation to use of system charges and connection to the licensee's distribution system;
- ◆ Condition 4D which sets out requirements for the licensee to offer terms for use of system and connection; and
- ◆ Condition 4E which allows Ofgem to determine disputes with respect to either use of system or connection, however in determining disputes in

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<sup>16</sup> Section 11A. Modification of standard licence conditions 1, 4, 4A, 4B and 4C of all the electricity distribution licences granted or treated as granted under section 6(1)(c) of the Electricity Act 1989. 6 July 2004 (150/04)

relation to use of system charges Ofgem must take into account the licensee's Condition 4A charging statement.

- 5.3. In addition, existing distribution licences have special price control conditions which set the allowed revenue for each DNO. Special conditions apply to individual licence holders and unlike SLCs, changes are not subject to the statutory process for collective licence modifications.
- 5.4. The present SLCs provide only limited protection for consumers with respect to the level or structure of electricity distribution use of system charges for IDNOs. As a result Ofgem has proposed modifications to the licences of IDNO applicants to introduce condition BA1: Charging Arrangements. This requires that the IDNO's charges for use of its electricity networks (including the standing charge, unit rate and any other component of charges), to enable supply to domestic consumers, should not exceed those charges that would be made in similar circumstances by the licensee whose services area the network is located. The full text of condition BA1 is set out in Appendix 1.
- 5.5. Ofgem recognises that the present condition BA1 was introduced as an interim arrangement and so is now undertaking a review of wider options for long term charging arrangements.

## ***Objectives***

- 5.6. One of the aims of Ofgem's review of the long term regulatory framework for IDNOs is to develop charging arrangements which protect the interests of consumers by:
  - ◆ promoting efficiency of IDNOs;
  - ◆ promoting competition in distribution; and
  - ◆ promoting the efficient use of electricity through cost-reflective charges.
- 5.7. In addition, Ofgem considers that it is important for charging arrangements to strike the appropriate balance between cost reflectivity and simplicity of application and, where appropriate, to be consistent across the industry.

## ***Options***

- 5.8. Ofgem is considering five different options for long term charging arrangements for IDNOs. Each option is set out below with possible strengths and weaknesses.

### ***Option A: Keep existing arrangements***

- 5.9. The existing arrangements are a price-led approach in which IDNO prices are restricted by the incumbent DNO's prices. The logic behind these arrangements is that if the IDNO did not extend the network it would be the incumbent DNO which does so. Therefore in order to not disadvantage the consumer, the use of system price charged by the IDNO should not exceed the price charged by the incumbent DNO.
- 5.10. The strengths of this option include:
- ◆ The consumer is not adversely affected by the fact that the network is owned and operated by an IDNO rather than the incumbent DNO.
  - ◆ It provides a simple pricing regime with minimal regulatory intervention.
- 5.11. The weaknesses of this option include:
- ◆ The IDNO faces some uncertainty in predicting long term revenue streams as it cannot predict the incumbent DNO's charges over the long term.
  - ◆ Charges set relative to the incumbent DNO's charges might not be reflective of the IDNO's underlying costs. In addition, IDNOs could be penalised or rewarded for quality of supply performance on the DNO's network.
  - ◆ Incumbent DNOs may face incentives to rebalance tariffs which will impact on charges.

### ***Option B: RPI-X regulation based on the IDNO's costs***

- 5.12. The most common form of price regulation for utilities in the UK is called RPI-X (Retail Price Index minus X) regulation. In using RPI-X, revenue or prices are allowed to rise by the rate of inflation (RPI) minus an efficiency factor (X). The setting of X takes into account a reasonable rate of return and the potential for efficiency savings.
- 5.13. RPI-X regulation is also often called performance-based regulation in that it seeks to achieve economic efficiency through altering the incentive structure of the industry. Revenue is capped at a particular level that would be sufficient to finance an efficient business encouraging companies to become more efficient to increase profits.
- 5.14. Incumbent DNOs are explicitly price controlled, with a limit on the revenue that may be recovered through use of system charges. Price controls are set every five years based on an estimate of the various allowances which make up companies' cost and comprises operating expenditure, capital expenditure, financing costs and taxation.
- 5.15. This option could be implemented for IDNOs by setting a level of revenue that is sufficient to finance an efficient business based on an estimate of the costs IDNOs will face in running their business. Costs can be estimated using comparative benchmarking between IDNOs. This approach has been used successfully for the regulation of DNOs and the water companies.
- 5.16. The strengths of this option include:
- ◆ RPI-X promotes efficiency by providing an incentive for the company to increase profits by reducing its cost base.
  - ◆ The sharing of efficiency gains with consumers through the operation of the forward looking efficiency X factor. In each year of the price control, the company is required to reduce prices by X. Furthermore, past efficiency gains made by the company are passed on to consumers in the next price review by imposing a tighter price control.

- ◆ When combined with quality of service regulation, it directly addresses the issues that concern consumers, ie. prices and quality of service.

5.17. The weaknesses of this option include:

- ◆ Obtaining and interpreting detailed industry data will be difficult given the present small number of potential IDNOs. IDNOs could also be benchmarked against incumbent DNOs but this assumes that an efficient IDNO's costs are similar to an incumbent DNO's costs. Obtaining and analysing detailed industry data (if possible) will involve significant regulatory and company resource compared to the benefit to consumers.
- ◆ Consumers may be worse off than under option A.
- ◆ IDNO's capital expenditure may be difficult to predict, and there is a risk that the price control assumptions influence competition.

***Option C: RPI-X regulation based on the incumbent DNO's charges as a starting point***

5.18. An alternative form of RPI-X regulation could be implemented by setting the prices charged by the IDNO in year 1 equal to those charged by the incumbent DNO in whose distribution services area the IDNO's network is located. In subsequent years the IDNO's charges will be allowed to rise by RPI-X.

5.19. Under this option the period of review could be extended from five years to ten years or even further with an option to review.

5.20. The strengths of RPI-X regulation based from the incumbent DNO tariff as a starting point include those detailed under option B. In addition:

- ◆ The starting point for the price control is easily determined by reference to the incumbent DNO.
- ◆ De-linking from future movements in the incumbent DNO charges would give IDNOs greater regulatory certainty (particularly if longer review periods are used).

5.21. The weaknesses of this option include:

- ◆ Determining the value of X could involve significant regulatory resource depending on how it is done. Alternatively it could be based on work done under the current DNO price control review.

### ***Option D: Relative Price Control Regulation***

5.22. Relative price control regulation (RPC) involves the setting of prices charged by a regulated utility by linkage to an external reference point. This option could reflect the form of RPC approach adopted in the IGT sector. In summary, IGT transportation charges track estimates of Transco's long term charges, subject to a pre-determined floor and ceiling. The initial IGT charge is equal to Transco's incremental charge from the relevant CSEP to the Single Supply Point (SSP). In subsequent years, the IGT charge is adjusted by the proportional change in Transco's SSP charge. The floor and ceiling is set at five per cent either side of the initial IGT charge and the future path of the floor and ceiling is expressed in terms of a single percentage decrease applied each year derived from long term estimates of Transco's charges.

5.23. One option for introducing RPC for IDNOs would be to develop a similar approach to the one used in the IGT sector. This could involve requiring IDNOs to adopt the incumbent DNO's incremental charge from the exit point on the DNO's network to the metered supply point (MSP). In subsequent years the IDNO charge will be adjusted by the proportional change in the incumbent DNO's MSP charge. A pre-determined floor and ceiling would be set based on a forecast of the DNO charges over the long term.

5.24. The strengths of this option include:

- ◆ RPC promotes efficiency by providing an incentive for the IDNO to increase profits by reducing its cost base.
- ◆ RPC provides some protection for the IDNO against unanticipated changes as charges only fluctuate within the pre-determined floor and ceiling.
- ◆ It is consistent with the pricing regime in the IGT sector.

5.25. The weaknesses of this option include:

- ◆ Using the incumbent DNO's charges as the external reference point may not reflect the cost or operations of the IDNO.
- ◆ It may be perceived as arbitrary or unfair by IDNOs if the costs or efficiency associated with the reference point are difficult for the companies to match.
- ◆ It would be more complex to implement and enforce than option A.
- ◆ It would require forecasts of long term DNO charges which are not readily available.

### ***Option E: Rate of return regulation***

5.26. Rate of return regulation is the most commonly used form of utility regulation in the United States and has been in use for decades. The regulator establishes an appropriate rate of return for the regulated utility based in part on the cost of capital to the utility. This rate of return is then applied to the asset base of the utility to provide a guaranteed return.

5.27. This option could be implemented through the extension of the reasonable rate of return constraint currently applied only to connection charges under Condition 4B<sup>17</sup> of the distribution licence. The introduction of formal specification and verification of the allowed costs and rate of return could further support this option.

5.28. The strengths of rate of return regulation include:

- ◆ Rate of return regulation creates a low risk environment for the regulated company and prevents it from earning excessive profits.

5.29. Weaknesses of rate of return regulation include:

- ◆ There is little incentive for the company to minimise costs. Any reduction of costs would produce a downward adjustment in prices charged in order to earn the same rate of return. In fact, there may be an

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<sup>17</sup> Condition 4B. Connection Charging Methodology.



incentive to increase capital costs – over-engineering or gold-plating of assets – which could increase prices.

- ◆ Monitoring and adjusting prices requires significant regulatory and company resource.

### ***Two-tiered approach***

5.30. A combination of the above options could be applied based on a similar two-tiered approach as has been applied to the alternative arrangements under condition BA5 (see chapter 6). For example, a relatively simple approach such as options A or C may be suitable up to a threshold level of connected supply points (eg. 500,000) and thereafter options B or D may be most appropriate.

### ***Views invited***

5.31. Views are invited on:

- ◆ the existing IDNO charging arrangements;
- ◆ whether the options discussed for long term charging arrangements have other strengths and weakness, what the relative (and where possible quantified) value of the strengths and weaknesses are and how Ofgem should evaluate the options;
- ◆ any other suitable options for the long term charging arrangements;
- ◆ whether a tiered approach to charging arrangements is appropriate and if so, how the threshold should be determined; and
- ◆ the desirability and appropriateness of consistency between charging arrangements in the IDNO and IGT sectors.

## 6. Financial Ring-Fencing of IDNOs

6.1. Financial ring-fencing provisions apply to licensed electricity distribution companies, electricity transmission companies and Transco. They provide important safeguards for the financial stability of these licensed companies and protect the licensee against financial pressures that might arise elsewhere in its group. There are two advantages for consumers in these arrangements:

- ◆ they provide protection against certain events that might otherwise lead to the insolvency of the licensee and so protect consumers from the associated uncertainty and possible disruption; and
- ◆ they should allow the licensee to retain access to financial markets on reasonable terms and so facilitate the funding of future investment programmes.

### ***Existing arrangements***

6.2. The existing financial ring-fencing conditions restrict the activities of the licence holder and the uses for which it may raise and put financial resources. The conditions impose duties on the licensee relating to:

- ◆ the conduct of its business;
- ◆ the maintenance of adequate resources and of ready access to additional finance at reasonable cost (i.e. the maintenance of a investment grade credit rating);
- ◆ the payment of dividends;
- ◆ the basis of transactions with affiliates;
- ◆ the avoidance of cross-default obligations; and
- ◆ the obtaining of certain undertakings from its ultimate holding company or companies.

- 6.3. Companies licensed to operate gas and electricity networks have significant monopoly power and provide an essential service to consumers. In these circumstances regulation is needed to protect the interests of consumers. While it is likely that IDNOs will have fewer consumers connected to their networks than other licensed network operators, Ofgem's view is that all consumers should be afforded the same level of protection whether the network is operated by an incumbent DNO or an IDNO.
- 6.4. At present, section C SLCs which include, amongst others, SLCs on financial ring fencing, only apply to incumbent DNOs within their distribution services area. Ofgem has proposed modifications under section 8A (3) of the Electricity Act to the licences of IDNO applicants to add a new section BA. Standard conditions BA2 to BA6 relate to financial ring fencing.
- 6.5. Taken together conditions BA2-BA6 provide important safeguards for the financial stability of the licensed company and so for the protection of the interests of consumers. The full text of these SLCs is set out in Appendix 2. A brief summary of the conditions is set out below.

### ***BA2 – Restriction on activity and financial ring fencing***

- 6.6. BA2 prohibits the licensee, subject to certain exceptions, from conducting any business or carrying on any activity other than electricity distribution. It also prevents the licensee, without the written consent of the Authority, from holding or acquiring shares or other investments except for:
- a. shares or other investments in a body corporate the sole activity of which is to carry on business for a permitted purpose;
  - b. shares or other investments in a body corporate which is a subsidiary of the licensee and incorporated by it solely for the purpose of raising finance for the distribution business; or
  - c. investments acquired in the usual and ordinary course of the licensee's treasury management operations, subject to the licensee maintaining in force, in relation to those operations, a system of internal controls which complies with best corporate governance practice as required (or in the

absence of any such requirement recommended) from time to time for listed companies in the United Kingdom.

- 6.7. Nevertheless, the licensee is able to undertake de-minimis business provided that limitations on the turnover (2½ per cent of transportation business turnover) and investment (2½ per cent of the sum of the licensee's share capital, share premium and consolidated reserves) of these activities are not exceeded.

### ***BA3 – Availability of resources***

- 6.8. BA3 requires each licensee to at all times act in a manner calculated to secure that it has sufficient management resources, financial resources and financial facilities to enable it
- a. to properly and efficiently carry on the distribution business; and
  - b. to comply with its obligations under the distribution licence and such of its obligations under the Electricity Act as apply to the distribution business.
- 6.9. Each licensee must submit an approved certificate to the Authority each year, which confirms that the directors have a reasonable expectation that the licensee will have available to it sufficient financial resources and financial facilities to carry on the distribution business for the next year.
- 6.10. BA3 also prevents the licensee from paying dividends or making other forms of distribution without first issuing a certificate to the Authority that confirms that the licensee is in compliance with SLCs 24, BA2, BA3, BA4, BA5 and BA6 and the making of the distribution will not cause it to breach any of these obligations in the future.

### ***BA4 – Undertaking from ultimate controller***

- 6.11. This SLC requires the licensee to procure a legally enforceable undertaking from the ultimate controller of the licensee that it will refrain from any action, and will procure that any person which is a subsidiary of or controlled by the ultimate controller will refrain from any action, which would be likely to cause

the licensee to breach any of its obligations under the Electricity Act or the distribution licence.

### ***BA5 – Credit rating of licensee***

- 6.12. BA5 requires the licensee to use all reasonable endeavours to ensure that it maintains at all times an investment grade issuer credit rating.
- 6.13. This condition was designed bearing in mind the circumstances of the existing electricity distribution licensees. These are all relatively large companies. Most IDNOs are likely to be significantly smaller than these companies and Ofgem has acknowledged that it might be more difficult for smaller companies to comply with the requirement to maintain an investment grade issuer credit rating.
- 6.14. BA5 therefore allows Ofgem to give consent to alternative financial arrangements for compliance. The alternative arrangements proposed by Ofgem are discussed further below.

### ***BA6 – Indebtedness***

- 6.15. BA6 restricts the ability of licensees from creating mortgages or other forms of security or encumbrance guaranteeing obligations of other persons, or undertaking any indebtedness to any other person, other than on certain specified terms and for a permitted purpose.

### ***Previous consultation responses***

- 6.16. Ofgem has previously consulted on the appropriateness of financial ring fencing conditions for the regulation of IDNOs<sup>18</sup>. There were a range of views expressed about ring fencing arrangements and about half of the respondents supported the proposals. Other respondents recognised the importance of the financial stability of the licensed electricity distribution companies, but suggested that in the event of financial failure another licensed operator should be required to

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<sup>18</sup> Ofgem open letters on the regulation of new electricity distribution licence holders, 31May 2002 and 16 April 2003.

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 financial ring fencing conditions in section BA.

### ***Alternative arrangements***

- 6.17. Ofgem recognises that the ring fencing conditions were designed bearing in mind the circumstances of incumbent DNOs which are relatively large companies. The April 2003 open letter<sup>19</sup> on the regulation of new IDNOs indicated that Ofgem would develop financial ring fencing arrangements that would allow a financially stable smaller company to comply with these obligations. Ofgem has therefore proposed alternative arrangements to the requirement for an investment grade credit rating under BA5.
- 6.18. The April 2003 letter proposed that Ofgem would consider giving consent to such alternative arrangements as an appropriate 'keep well' agreement. This would be a formal and legally binding agreement from an entity that has and agrees to maintain an investment grade issuer credit rating.
- 6.19. However further discussions with potential licensees and credit rating agencies indicated that such a requirement would still be a significant barrier to many smaller companies operating as licensed electricity distributors. In the light of this and representations from potential licensees Ofgem has considered whether there might be alternative arrangements that would better suit the circumstances of smaller companies and would also protect the interests of consumers.
- 6.20. Ofgem's proposed alternative arrangements are set out in an open letter to the industry<sup>20</sup>. These arrangements take a two-tiered approach with one set of arrangements for IDNOs with less than 500,000 connected supply points and another when this threshold is reached. This limit is below the lowest number of connected supply points for an incumbent DNO.
- 6.21. The alternative arrangements are summarised below:

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<sup>19</sup> Open letter on the regulation of new electricity distribution licence holders, 16 April 2003.

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

- i. A keep well agreement with the parent company of the licensee with an investment grade credit rating, OR
- ii. A keep well agreement with the parent company of the licensee and, if the parent company does not have an investment grade credit rating, cash in escrow or an on-demand bond issued from a third party with an investment grade credit rating of a value of no less than six months operating costs and six months asset replacement expenditure.

◆ **For licensees with more than 500,000 connected supply points**

- i. An investment grade credit rating, OR
- ii. A keep well agreement with an entity with an investment grade credit rating.

6.22. The IDNO will be able to draw down on money held in the escrow account or secured by the bond in the event that its parent company does not fulfil its obligations under the keep well agreement. If the account or bond is drawn upon then the keep well agreement requires the parent company to reinstate the monies. If the parent company does not do so then it is required to put the IDNO (or its networks) up for sale.

6.23. In order for a distribution licence to be granted an applicant would need the Authority's written approval of the required agreements in draft form. The licence will be granted on condition of these arrangements being in place before energisation of the first customer.

6.24. Ofgem considers that the proposed alternative arrangements under condition BA5 go a significant way to fulfilling the same protection afforded by an investment grade credit rating. Although a credit rating does not in itself afford protection in the event of a default by a rated company, it does provide an

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<sup>20</sup> Open letter on financial ring fencing alternative arrangements for new independent distribution network operators (IDNOs), 29 July 2004.

estimate of the probability of a default. Any deterioration in the credit rating is a reasonable indication of a weaker financial position and could serve as a trigger for action to put measures in place to protect consumers in the event of financial failure of a company.

- 6.25. A combination of a keep well agreement from the parent company and cash cover in the form of an escrow account or bond provides financial security for the IDNO and also provides an indication of financial difficulty if the IDNO requires to draw down on the funds in the escrow or bond. However there may be alternative arrangements that would achieve the same level of protection and as such Ofgem would welcome respondents' views.

### ***Operating costs***

- 6.26. Operating costs will include all such costs necessary to run the IDNO's business for a period of six months. Due to the current contractual arrangements in the electricity sector resulting in the IDNO being liable for upstream use of system charges, Ofgem expects that operating costs secured under the alternative arrangements will include upstream use of system charges.

### ***Financial ring fencing in the IGT sector***

- 6.27. Ofgem's final proposals document on the regulation of IGTs<sup>21</sup> proposed that financial ring fencing conditions should only be introduced for existing licensees if a licensee serves more than 30,000 consumers and the requirement for an investment grade credit rating will only be triggered when a licensee serves more than 300,000 consumers. This was due to the potentially significant costs that some of the ring fencing conditions could impose on existing licensees.
- 6.28. Ofgem also recognised that there could be merit in allowing transitional arrangements to facilitate the implementation of the financial ring-fencing arrangements. These could include granting specific derogations in respect of particular conditions for a defined period of time.

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<sup>21</sup> The Regulation of Independent Gas Transporter Charges. Final Proposals. July 2003.



- 6.29. However Ofgem did not want to delay the implementation of the new IGT charging arrangements and therefore decided to address ring fencing at a later date, separately.
- 6.30. Ofgem considers that the constraints that existed in the IGT sector due to timing and costs that some of the ring fencing conditions would impose on existing licensees are not present in the IDNO sector as there are no existing licensees.
- 6.31. Ofgem will be publishing a further consultation on ring fencing in the IGT sector proposing the introduction of financial ring fencing provision. Ofgem recognises the importance of consistency between the electricity and gas sectors and intends to bring the financial ring fencing in the IDNO and IGT sectors in line.

### ***Regulatory accounts***

- 6.32. As noted in the 31<sup>st</sup> May 2002 open letter<sup>22</sup>, the proposals for financial ring fencing (in particular restrictions on activity and financial ring fencing) should ensure that the IDNO's statutory accounts provide adequate information on the turnover, costs and assets associated with electricity distribution activities. Therefore, at this stage Ofgem considers that it is not appropriate to introduce licence conditions relating to regulatory accounts or change of financial year.

### ***Views invited***

- 6.33. Views are invited on:
- ◆ the alternative arrangements to condition BA5 set out in paragraph 6.21; and
  - ◆ any other suitable arrangements which would afford consumers the same protection as the requirement for an investment grade credit rating.

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<sup>22</sup> Open letter on the regulation of new electricity distribution licence holders, 31May 2002.

## 7. Next Steps

7.1. This paper has addressed the broad issues Ofgem is considering in its review of the regulatory framework for IDNOs. These are:

- ◆ the contractual arrangements in the electricity industry, including boundary metering and upstream use of system charges;
- ◆ charging arrangements for IDNOs; and
- ◆ ring fencing arrangements, specifically the alternative arrangements under condition BA5.

7.2. Supplementary issues also of importance in this review are:

- ◆ incumbent DNOs developing new networks outside their incumbent geographical area; and
- ◆ the nature of reporting, quality of service targets and incentives that should be put in place for IDNOs.

7.3. Ofgem welcomes views on the above and any other issues of relevance to the review of the regulatory framework for IDNOs. Responses to this consultation should be received by 13<sup>th</sup> September 2004.

7.4. Ofgem will consider responses to this consultation and intends to publish initial proposals later in 2004.

# Appendix 1 : Standard Condition BA 1

## *Charging Arrangements*

1. The licensee shall make available and continue to make available charges for the provision of use of system to any authorised supplier using the licensee's network to supply domestic customers.
2. The licensee's distribution use of system charges to domestic customers may vary according to the distribution services area of the licensed distributor within which domestic premises are connected to the licensee's distribution system.
3. The licensee shall set these charges so that, except with the prior written consent of the Authority, the standing charge, unit rate and any other component of charges shall not exceed the distribution use of system charges to equivalent domestic customers.
4. For the purposes of this condition, distribution use of system charges to equivalent domestic customers are the distribution use of system charges made by the licensed distributor that has a Distribution Services Direction specifying the distribution services area where the domestic premises connected to the licensee's system are located.
5. The Authority may specify by direction, which of the distribution use of system charges made by the licensed distributor with Distribution Services Obligations for the distribution services area are relevant for the purposes of determining distribution use of system charges to equivalent domestic customers.
6. These charging arrangements shall have effect within this licence until such time and in such circumstances as are described in paragraphs 7 to 12 of this standard condition.
7. This condition shall cease to have effect (in whole or in part as the case may be) if the licensee delivers to the Authority a disapplication request made in accordance with paragraph 8 of this standard condition or notice is given to the Authority by the licensee in accordance with either paragraph 11 or paragraph 12 of this standard condition.

8. A disapplication request shall:
  - (a) be in writing addressed to the Authority;
  - (b) specify the paragraph or paragraphs of this standard condition to which the request relates; and
  - (c) state the date (being not earlier than the date specified in paragraph 10 of this standard condition) from which the licensee wishes the Authority to agree that the conditions shall cease to have effect (the disapplication date).
9. The licensee may withdraw a disapplication request at any time.
10. Save where the Authority otherwise consents in writing, no disapplication following delivery of a disapplication request pursuant to paragraph 8 of this standard condition shall have effect until a date being the later of:
  - (a) not less than 18 months after delivery of the disapplication request; and
  - (b) 31 March 2007.
11. If the Authority has not made a reference to the Competition Commission under section 12 of the Act relating to the modification of this standard condition or the part or parts thereof specified in the disapplication request before the beginning of the period of 12 months which will end with the disapplication date and the licensee has not withdrawn this disapplication request, the licensee may deliver a written notice to the Authority terminating the application of this standard condition or the part or parts thereof specified in the disapplication request with effect from the disapplication date or such earlier date to which the Authority has given its consent under paragraph 10.
12. If the Competition Commission makes a report on a reference made by the Authority relating to the modification of this standard condition or the part or parts thereof specified in the disapplication request and such report does not include a conclusion that the cessation of such revenue restrictions in this standard condition, in whole or in part, operates or may be expected to operate against the public interest, the licensee may within 30 days after the publication of the report by the Authority in accordance with section 13 of the Act deliver to the Authority written notice terminating the application of this standard condition or the part or

parts thereof specified in the disapplication request with effect from the disapplication date. :

## **Appendix 2 Standard Conditions BA 2 – BA 6**

### ***Standard Condition BA2: Restriction on Activity and Financial Ring Fencing***

1. Save as provided by paragraphs 3 and 4, the licensee shall not conduct any business or carry on any activity other than the distribution business.
2. The licensee shall not without the prior written consent of the Authority hold or acquire shares or other investments of any kind except:
  - (a) shares or other investments in a body corporate the sole activity of which is to carry on business for a permitted purpose; or
  - (b) shares or other investments in a body corporate which is a subsidiary of the licensee and incorporated by it solely for the purpose of raising finance for the distribution business; or
  - (c) investments acquired in the usual and ordinary course of the licensee's treasury management operations, subject to the licensee maintaining in force, in relation to those operations, a system of internal controls which complies with best corporate governance practice as required (or in the absence of any such requirement recommended) from time to time for listed companies in the United Kingdom.
3. Subject to the provisions of paragraph 2 nothing in this condition shall prevent:
  - (a) any affiliate in which the licensee does not hold shares or other investments from conducting any business or carrying on any activity;
  - (b) the licensee from holding shares as, or performing the supervisory or management functions of, an investor in respect of any body corporate in which it holds an interest consistent with the provisions of this licence;
  - (c) the licensee from performing the supervisory or management functions of a holding company in respect of any subsidiary; or

- (d) the licensee from carrying on any business or conducting any activity to which the Authority has given its consent in writing.
4. Nothing in this condition shall prevent the licensee or an affiliate or related undertaking of the licensee in which the licensee holds shares or other investments (a 'relevant associate') conducting de-minimis business as defined in this paragraph so long as the limitations specified in this paragraph are complied with.
- (a) For the purpose of this paragraph " de-minimis business" means any business or activity carried on by the licensee or a relevant associate or relevant associates other than:
    - (i) the distribution business; and
    - (ii) any other business activity to which the Authority has given its consent in writing in accordance with paragraph 3(d).
  - (b) The licensee or a relevant associate may carry on de-minimis business provided that the relevant associate carries on no other business except activities of the distribution business and business activities authorised by the Authority under paragraph 3(d), and neither of the following limitations is exceeded, namely:
    - (i) the aggregate turnover of all the de-minimis business carried on by the licensee and all its relevant associates does not in any period of twelve months commencing on 1 April of any year exceed 2½% of the aggregate turnover of the distribution business as shown by the most recent audited accounting statements of the licensee; and
    - (ii) the aggregate amount (determined in accordance with sub-paragraph (d) below) of all investments made by the licensee and all its relevant associates in their de-minimis business or de-minimis businesses does not at any time after the date this condition takes effect in this licence exceed 2½% of the sum of share capital in issue, share premium and consolidated reserves

of the licensee as shown by its most recent audited historical cost financial statements then available.

- (c) For the purpose of sub-paragraph (b) of this paragraph, “investment” means any form of financial support or assistance given by or on behalf of the licensee or a relevant associate for the de-minimis business whether on a temporary or permanent basis including (without limiting the generality of the foregoing) any commitment to provide any such support or assistance in the future.
- (d) At any relevant time, the amount of an investment shall be the sum of:
  - (i) the value at which such investment was included in the audited historical cost balance sheet of the licensee or a relevant associate as at its latest accounting reference date to have occurred prior to the date this condition takes effect in this licence (or, where the investment was not so included, zero);
  - (ii) the aggregate gross amount of all expenditure (whether of a capital or revenue nature) howsoever incurred by the licensee or a relevant associate in respect of such investment in all completed accounting reference periods since such accounting reference date; and
  - (iii) all commitments and liabilities (whether actual or contingent) of the licensee or a relevant associate relating to such investment outstanding at the end of the most recently completed accounting reference period.

5. In this condition :

“permitted purpose”	means the purpose of all or any of the following:
	(a) the licensee’s distribution



	<p>business or any other business or activity within the limits of paragraph 4;</p> <p>(b) any business or activity to which the Authority has given its consent in writing in accordance with paragraph 3 (d); and</p> <p>(c) without prejudice to the generality of sub-paragraph (a), any payment or transaction lawfully made or undertaken by the licensee for a purpose within sub-paragraphs 1(b)(i) to (vii) of standard condition BA6.</p>
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## ***Standard Condition BA3: Availability of Resources***

1. The licensee shall at all times act in a manner calculated to secure that it has available to it all such resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licences, consents and facilities on such terms and with all such rights as shall ensure that it is at all times able:
  - (a) to properly and efficiently carry on the distribution business; and
  - (b) to comply in all respects with its obligations under this licence and such obligations under the Act as apply to the distribution business including, without limitation, its duty to develop and maintain an efficient, co-ordinated and economical system of electricity distribution.
  
2. The licensee shall submit a certificate to the Authority, approved by a resolution of the board of directors of the licensee and signed by a director of the licensee pursuant to that resolution. Such certificate shall be submitted in June of each year. Each certificate shall be in one of the following forms:
  - (a) "After making enquiries, the directors of the licensee have a reasonable expectation that the licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient financial resources and financial facilities to enable the licensee to carry on the distribution business for a period of 12 months from the date of this certificate."
  - (b) "After making enquiries, the directors of the licensee have a reasonable expectation, subject to what is said below, that the licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient financial resources and financial facilities to enable the licensee to carry on the distribution business for a period of 12 months from the date of this certificate. However, they would like to draw attention to the following factors which

may cast doubt on the ability of the licensee to carry on the distribution business.”

(c) “In the opinion of the directors of the licensee, the licensee will not have available to it sufficient financial resources and financial facilities to enable the licensee to carry on the distribution business for a period of 12 months from the date of this certificate.”

3. The licensee shall submit to the Authority with that certificate a statement of the main factors which the directors of the licensee have taken into account in giving that certificate.

4. The licensee shall inform the Authority in writing immediately if the directors of the licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the then most recent certificate given under paragraph 2.

5. The licensee shall use its best endeavours to obtain and submit to the Authority with each certificate provided for in paragraph 2 a report prepared by its auditors and addressed to the Authority stating whether or not the auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit work.

6. The directors of the licensee shall not declare or recommend a dividend, nor shall the licensee make any other form of distribution within the meaning of section 263 of the Companies Act 1985, unless prior to the declaration, recommendation or making of the distribution (as the case may be) the licensee shall have issued to the Authority a certificate complying with the following requirements of this paragraph.

(a) The certificate shall be in the following form:

“After making enquiries, the directors of the licensee are satisfied:

(i) that the licensee is in compliance in all material respects with all obligations imposed on it by standard condition 24 (Provision of Information to the Authority), standard condition BA2 (Restriction

on Activity and Financial Ring-fencing), standard condition BA3 (Availability of Resources), standard condition BA4 (Undertaking from Ultimate Controller), standard condition BA5 (Credit Rating) and paragraph 1 of standard condition BA6 (Indebtedness) of the licence; and

- (ii) that the making of a distribution of [ ] on [ ] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the licensee to be in breach to a material extent of any of these obligations in the future.
- (b) The certificate shall be signed by a director of the licensee and approved by a resolution of the board of directors of the licensee passed not more than 14 days before the date on which the declaration, recommendation or payment will be made.
  - (c) Where the certificate has been issued in respect of the declaration or recommendation of a dividend, the licensee shall be under no obligation to issue a further certificate prior to payment of that dividend provided such payment is made within six months of that certificate.

## ***Standard Condition BA4: Undertaking from Ultimate Controller***

1. The licensee shall procure from each company or other person which the licensee knows or reasonably should know is at any time an ultimate controller of the licensee a legally enforceable undertaking in favour of the licensee in the form specified by the Authority that that ultimate controller (“the covenantor”) will refrain from any action, and will procure that any person (including, without limitation, a corporate body) which is a subsidiary of, or is controlled by, the covenantor (other than the licensee and its subsidiaries) will refrain from any action, which would then be likely to cause the licensee to breach any of its obligations under the Act or this licence. Such undertaking shall be obtained within 7 days of the company or other person in question becoming an ultimate controller and shall remain in force for as long as the licensee remains the holder of this licence and the covenantor remains an ultimate controller of the licensee.
  
2. The licensee shall:
  - (a) deliver to the Authority evidence (including a copy of each such undertaking) that the licensee has complied with its obligation to procure undertakings pursuant to paragraph 1;
  - (b) inform the Authority immediately in writing if the directors of the licensee become aware that any such undertaking has ceased to be legally enforceable or that its terms have been breached; and
  - (c) comply with any direction from the Authority to enforce any such undertaking;

and shall not, save with the consent in writing of the Authority, enter (directly or indirectly) into any agreement or arrangement with any ultimate controller of the licensee or of any of the subsidiaries of any such corporate ultimate controller (other than the subsidiaries of the licensee) at a time when:

- (i) an undertaking complying with paragraph 1 is not in place in relation to that ultimate controller; or

- (ii) there is an unremedied breach of such undertaking; or
- (iii) the licensee is in breach of the terms of any direction issued by the Authority under paragraph 2 of this condition.

## ***Standard Condition BA5: Credit Rating of Licensee***

1. The licensee shall use all reasonable endeavours to ensure that the licensee maintains at all times an investment grade issuer credit rating, or with the prior written permission of the Authority, any such arrangements as the Authority considers appropriate.

2. In this condition:

“investment grade issuer credit rating” means:

- (a) an issuer rating of not less than BBB- by Standard & Poor’s Ratings Group or any of its subsidiaries or a corporate rating of not less than Baa3 by Moody’s Investors Service, Inc. or any of its subsidiaries or such higher rating as shall be specified by either of them from time to time as the lowest investment grade credit rating; or
- (b) an equivalent rating from any other reputable credit rating agency which, in the opinion of the Authority, notified in writing to the licensee, has comparable standing in the United Kingdom and the United States of America.

## ***Standard Condition BA6: Indebtedness***

1. In addition to the requirements of standard condition 29 (Disposal of Relevant Assets), the licensee shall not without the prior written consent of the Authority (following the disclosure by the licensee of all material facts):
  - (a) create or continue or permit to remain in effect any mortgage, charge, pledge, lien or other form of security or encumbrance whatsoever, undertake any indebtedness to any other person or enter into any guarantee or any obligation otherwise than:
    - (i) on an arm's length basis;
    - (ii) on normal commercial terms;
    - (iii) for a permitted purpose; and
    - (iv) (if the transaction is within the ambit of standard condition 29 (Disposal of Relevant Assets)) in accordance with that condition;
  - (b) transfer, lease, license or lend any sum or sums, asset, right or benefit to any affiliate or related undertaking of the licensee otherwise than by way of:
    - (i) a dividend or other distribution out of distributable reserves;
    - (ii) repayment of capital;
    - (iii) payment properly due for any goods, services or assets provided on an arm's length basis and on normal commercial terms;
    - (iv) a transfer, lease, licence or loan of any sum or sums, asset, right or benefit on an arm's length basis, on normal commercial terms and made in compliance with the payment condition;
    - (v) repayment of or payment of interest on a loan not prohibited by subparagraph (a);
    - (vi) payments for group corporation tax relief or for the surrender of Advance Corporation Tax calculated on a basis not exceeding the value of the benefit received ; or



- (vii) an acquisition of shares or other investments in conformity with paragraph 2 of standard condition BA2 (Restriction on Activity and Financial Ring Fencing) made on an arm's length basis and on normal commercial terms;
- (c) enter into an agreement or incur a commitment incorporating a cross-default obligation; or
- (d) continue or permit to remain in effect any agreement or commitment incorporating a cross-default obligation subsisting at the date this condition takes effect in this licence, save that the licensee may permit any cross-default obligation in existence at that date to remain in effect for a period not exceeding twelve months from that date, provided that the cross-default obligation is solely referable to an instrument relating to the provision of a loan or other financial facilities granted prior to that date and the terms on which those facilities have been made available as subsisting on that date are not varied or otherwise made more onerous;
- (e) the provisions of sub-paragraphs (c) and (d) of this paragraph shall not prevent the licensee from giving any guarantee permitted by and compliant with the requirements of sub-paragraph (a);
- (f) the payment condition referred to in sub-paragraph (b)(iv) is that the consideration due in respect of the transaction in question is paid in full when the transaction is entered into unless either:
  - (i) the counter-party to the transaction has and maintains until payment is made in full an investment grade issuer credit rating, or
  - (ii) the obligations of the counter-party to the transaction are fully and unconditionally guaranteed throughout the period during which any part of the consideration remains outstanding by a guarantor which has and maintains an investment grade issuer credit rating.

2. In this condition:

“cross-default obligation” means a term of any agreement or arrangement whereby the licensee’s liability to pay or repay

any debt or other sum arises or is increased or accelerated or is capable of arising, increasing or of acceleration by reason of a default (howsoever such default may be described or defined) by any person other than the licensee, unless:

- (i) that liability can arise only as the result of a default by a subsidiary of the licensee,
- (ii) the licensee holds a majority of the voting rights in that subsidiary and has the right to appoint or remove a majority of its board of directors, and

that subsidiary carries on business only for a purpose within paragraph (a) of the definition of permitted purpose.

“indebtedness”

means all liabilities now or hereafter due, owing or incurred, whether actual or contingent, whether solely or jointly with any other person and whether as principal or surety, together with any interest accruing thereon and all costs, charges, penalties and expenses incurred in connection therewith.