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Dear Cemil

### **PRICE CONTROL LICENCE MODIFICATIONS**

I am writing to give you this response (attached) to the appendix published by Ofgem at the end of June on the scope and structure of the distribution licence modifications and associated regulatory controls which Ofgem believes will be needed to give effect to the 2005 price control settlement. The response has been prepared by industry members of the joint legal working group on behalf of all licensed distributors.

We were glad to be able to discuss timetable and working arrangements with you when we met on 27 July. We recognise that the scope of the group's work is limited to the price controls, standards of performance, and company reporting. Nevertheless, the proposed consultation timetable at page 8 of the June appendix is very challenging in terms of the quantity and quality of the legal work to be delivered by the group. It does not allow for any slippage arising from under-resourcing, the emergence of any major differences with the industry, or the need to ensure full quality control of the outputs.

In addition, some legal aspects of the emerging package, for example in relation to the pricing treatment of separated metering activities, have not been widely discussed and could prove technically difficult. We are also concerned about the apparent disconnect between the legal working group and Ofgem's working groups dealing with such topics as distributed generation and quality of service.

We note, however, that the legal group will be meeting on a fortnightly basis from mid-August onwards and with Ofgem's lawyers present, so that all concerned can be fully involved in progressing detailed drafting issues as well as debating high-level issues of form and structure. On that basis, the industry members of the group are confident that the challenges posed by Ofgem's timetable can be met.

We hope that these comments and the attached paper are helpful, and we look forward to seeing you again at the group's second meeting on 17 August.

Yours sincerely

**Roger Barnard**

on behalf of the industry members  
of the joint working group

## Electricity Distribution Price Control Review

### **OFGEM'S PAPER DATED JUNE 2004 ON THE STRUCTURE AND SCOPE OF PRICE CONTROL LICENCE MODIFICATIONS**

#### Comments on behalf of licensed distributors

1. Ofgem's paper invited views on a number of specific issues. We have set out the issues in bold type below and our comments follow each extract. References in this paper to 'the Act' are to the Electricity Act 1989. The 'key principles' that we mention from time to time are those set out at paragraphs 3(a) to (d) below.
  - **Paragraph 3.18: views on whether Ofgem's proposed new structure for the price control licence conditions set out at paragraph 3.17 (revenue allowances in special conditions, information recording and reporting obligations in standard conditions, and detailed definitions and guidance in separate RIGs) is desirable, or whether it might be refined further.**
2. Ofgem describes this as 'a simpler framework' for the price control conditions. It is unclear that this is truly the case. As we understand it, Ofgem proposes to rationalise some elements of the current tripartite structure while also extending and applying this to the increasingly complex price controls of the future, with a view to securing greater clarity and coherence for price regulation as a whole.
3. On that basis, we are broadly content with the proposal, subject to the following key principles, which are of overriding importance to distributors:
  - (a) Some aspects of the price controls are so fundamental to each licensee's business that they must always remain a matter for individual agreement, and for modification only with company consent or following the special process provided for at section 12 of the Act.
  - (b) In particular, all elements of a licensee's price control (including the core definitions) which directly impact the scoping, composition, calculation, or adjustment of allowed revenues must be maintained within special licence conditions. It is inappropriate for any such elements to be capable of being modified on the basis of a collective voting procedure.
  - (c) The corollary is that the standard licence conditions must only be used to provide for the regulation of those elements of the price control framework, such as information recording and reporting obligations and the mechanics of compliance monitoring, that are genuinely common to all licensees.
  - (d) Any further incorporation of detailed non-core definitions and 'guidance' into documents such as RIGs or RAGs below the face of the licence must be accompanied by a review of the change-control mechanisms for these. In particular, there is a strong case for a new standard licence condition setting out a uniform change-control procedure for all subsidiary documents within the price control framework which are binding on the licensee.

- **Paragraph 4.7: views on the approach proposed at paragraphs 4.5 and 4.6 (a core price control revenue restriction, supplemented by additional conditions for pass-through items and incentives).**
4. We welcome the proposal to make the treatment of new incentive mechanisms and cost pass-through items more explicit and transparent by placing them in separate (special) licence conditions outside the core price control condition. We agree that this approach should provide more flexibility to modify components of the price control without opening up the entire price control restriction.
- **Paragraph 4.9: views on the proposals set out in paragraph 4.9 and, in particular, on what specific elements of Schedule A should remain explicitly set out within the licence.**
5. Schedule A has always been an untidy mixture of measures. It was added to the pricing framework at a late stage in the privatisation process when it became clear that a number of principles not addressed by the main conditions, particularly in relation to cost attribution and the revenue treatment of certain items outside the price cap, needed to be brought together and spelt out in one place.
  6. We note Ofgem's suggestion that parts of Schedule A may have been interpreted inconsistently by distributors. We also note that it would have been open to Ofgem at any time, whether at or between reviews, to rectify this. We are not aware that the schedule has caused major problems either for distributors or Ofgem. It appears to have worked well for 15 years with very little modification. So any proposals for changing Schedule A need to be assessed with caution.
  7. Nevertheless, assuming a price control settlement with broadly the features set out in Ofgem's initial proposals document, and applying distributors' key principles to these, it seems clear that most of the components of Schedule A could usefully be restructured within Ofgem's tripartite framework for the new price controls without harming licensees' interests. We suggest the following approach:
    - (a) Most of Part A (principles for attribution) would be more sensibly located in a recast set of regulatory accounting guidelines (or alternatively in the new set of price control RIGs recommended at paragraph (c) below) – subject to distributors' key principle 3(d).
    - (b) Part B (EHV premises) and most of Part E (calculation of factor in respect of distribution losses) will need to be reshaped anyway, in view of Ofgem's proposals for the future treatment of EHV supplies and distribution losses, and would be better incorporated into the main price control conditions.
    - (c) Those parts of Parts A, C, and E dealing with the provision of information or reports to the Authority could mostly become a new standard licence condition supporting a new set of RIGs which would include, inter alia, the present contents of special licence condition D (information to be provided in connection with the charge restriction conditions). This approach would suitably cover issues of data recording and information reporting for price control purposes – subject again to distributors' key principle 3(d).

8. This would mean that the only strong case for retaining any remaining elements of Schedule A on the face of the licence is in relation to most of Part C (excluded services) and all of Part D (regulated distribution unit categories). Applying their key principles, distributors would wish to see these elements retained in the form of special, not standard, licence conditions.
- **Paragraph 5.10: views on the approach proposed in chapter 5 for dealing with quality of service and, in particular, on how Ofgem might construct an appropriate supply restoration licence condition.**
9. We are broadly content with Ofgem's proposals for the regulatory treatment of quality of service, subject to the following important exception.
10. A major item in Ofgem's package is the proposal to transfer the 18-hour supply restoration standard from the Electricity (Standards of Performance) Regulations 2001 into a new standard licence condition, where it would operate as a 'normal' weather standard alongside a new 'severe' weather standard based on the interim arrangements developed after the October 2002 storm.
11. It is difficult for us at this stage to address the merits of transferring one aspect of the regulations into the standard licence conditions when Ofgem has not explained why it regards this as the optimum approach. We do, on the other hand, foresee a number of obvious, and significant, difficulties:
  - (a) The regulations require the payment of compensation to consumers when prescribed performance standards are not met. This is specifically provided for by section 39A(2) of the Act. However, there is no equivalent statutory authority for the payment of compensation under licence conditions. On accepted principles of statutory interpretation, the absence of such authority creates an immediate problem of lack of *vires*, since secondary law-making powers are treated as including a power to require the payment of money only if express provision to that effect is made by the enabling Act.
  - (b) In the case of electricity licence conditions, such a provision does exist, but only in relation to the payment of licence fees (section 7(2)(b) of the Act). So, licences cannot be used to create an enforceable basis for compensation payments to customers – an important legal principle that needs to inform Ofgem's policy. Even if there were good reasons for Ofgem's proposal, no agreement with distributors could have the effect of giving Ofgem statutory powers that it does not actually possess.
  - (c) A degree of flexibility in the process, enabling storm payment thresholds to be relatively easily changed in the light of experience, would be desirable. This – along with a stronger element of licensee control over changes under the collective modification process for standard licence conditions – might be perceived as an advantage of Ofgem's proposal. In practice, however, it would be open to Ofgem to circumvent any such change mechanism, at any time, by reverting directly to its section 39A powers. As well as depriving the distributors of any certainty of approach to amendments, this would also raise the potential for a double jeopardy of obligations.

- (d) The effect of including performance standards in the regulations is specified at section 39B of the Act, which includes legal protections relating to the process for determining disputes and a mechanism for enforcing those determinations. It would be impossible for a licence condition to replicate these provisions, leading to an unhelpful (and apparently arbitrary) variance between the standards in relation to matters of process and effect.
  - (e) It is questionable whether it could be beneficial to either consumers or the distributors to separate the provisions relating to standards of performance as between different legal instruments. There is considerable merit, for the sake of clarity, consistency, and ease of reference, in maintaining them collectively in one place with a common legal origin and status.
12. For all of these reasons, this particular proposal within Ofgem's quality of service approach seems to us to be subject to real practical and legal difficulties. While we support the objective of a flexible process, we consider that these difficulties may well be insuperable. But even if it were possible to overcome them, it is not clear that the desired flexibility would necessarily be the outcome. Ofgem has proposed a reallocation of existing obligations without justifying the need for this. We believe that the onus remains on Ofgem, in the first place, to make out a case for any benefit that might be delivered by the change.
- **Paragraph 6.4: views on the initial draft new special licence condition to implement the new scheme to incentivise distributed generation connection, innovation funding, and registered power zones.**
13. We note that although Ofgem's consultation timetable said that the initial drafting of this new special condition would be provided by the end of June, the published draft does not contain the schemes for the innovation funding incentive (IFI) or the registered power zone (RPZ) incentive. Nevertheless, it is helpful to see this early draft of the distributed generation (DG) incentive, as this is a new and quite complex scheme that requires detailed analysis to ensure that it works.
14. The introduction of this new condition via a 'purpose clause' at paragraph 1 is a welcome innovation. Only two other distribution licence conditions contain such a clause – standard conditions 25 (long-term development statement) and 49 (the incentive scheme and associated information) – and both benefit from it. In the interests of clarity and consistency, there is a strong case for introducing all of the new or revised special and standard licence conditions to be associated with the next price control settlement with a brief statement of purpose.
15. Turning to the legal text in detail, we acknowledge that the task of drafting for this new area of price regulation is fraught with difficulty. Our substantive comments are set out below. Attachment 1 contains technical issues and drafting points.
- (a) It is not clear that all the algebraic formulae will in all circumstances always give full and correct effect to Ofgem's policy intentions. For example, the effect of the GAt term, as drafted, is that individual DG projects costing around £120/kW or more to connect will generate returns below the cost of debt, with an adverse effect on a distributor's incentive to invest.

- (b) At paragraph 5, Ofgem's power to ascribe the value of GAt for certain years should be constrained by some element of due process. At the very least, we would expect the words 'following consultation with the licensee' to be inserted immediately after 'Authority' in the first line at the top of page 29.
- (c) The drafting of paragraph 7 is loose and this will attract inconsistencies of interpretation between licensees. We recommend that the paragraph should set out the criteria that a distributor will need to meet to demonstrate that the DG investment was 'utilised mainly' for demand.
- (d) Applying the distributors' key principles, we believe that all the underlined terms in the draft text for the DG scheme – there appear to be seven altogether – should be defined within the condition itself. The same would apply to any such key terms for the IFI and RPZ schemes. Given the novel and untested nature of these developments in network price regulation and their susceptibility to political pressure, it is inappropriate (at least initially) for definitions of operative terms to be located in a RIG-type document.
- (e) The condition should include a specific 're-opener' mechanism enabling the licensee to require Ofgem, in the event of a material unforeseen change in government renewables policy, to undertake a joint review with the licensee of the need (if any) to modify or revoke the scheme.

- **Paragraph 7.3: views on the implementation of the regulatory accounts licence condition to ensure that the RAGs are formally introduced.**

- 16. The RAGs are currently in their sixteenth [sic] draft, still incomplete and unfit for purpose, and of no legal effect. We endorse the view more recently expressed by Ofgem that the framework of regulatory accounts supported by the RAGs should be replaced by more specific cost reporting tailored to the price control. But it is essential that any such alternative arrangements – including an appropriate new regulatory accounting licence condition – are in place by 1 April 2005.

- **Paragraph 7.4: views on the proposals for a regulatory reporting framework comprising three main elements (costs, revenues, and outputs) supported by separate guidance documents and standard licence conditions.**

- 17. We endorse the three proposed elements of cost reporting, revenue reporting, and output reporting within a more comprehensive regulatory reporting framework, to be supported by standard licence conditions and separate guidance documents, subject in particular to distributors' key principle 3(d).

- **Paragraph 7.6: views on whether there are elements of the licence conditions that could be reviewed or simplified when implementing the price controls.**

- 18. Assuming that this refers to the licence generally, an initial review of the standard conditions suggests that the whole of condition 10 (dealing with BSC and NETA implementation) could be removed (except for paragraph 1), and conditions 11 and 13 (respectively, change co-ordination for NETA, and change co-ordination for the Utilities Act 2000) could be removed in their entirety.

19. In addition, conditions 17, 18, 19, and 21 (requiring codes of practice on services for vulnerable consumers, on site access procedures, and on complaint handling procedures) could possibly be replaced with a unified licence condition dealing more broadly with all these requirements.
- **Paragraph 7.7: views and comments on any other areas where amendments might be required.**
20. **Security costs:** The DTI is reviewing the provisions of the Fuel Security Code, following wide public consultation, but has been silent for nearly a year about the progress of its deliberations. It would be helpful if Ofgem could press the DTI to complete and publish this review so that any necessary changes to special licence condition E (allowance in respect of security costs) can be implemented from next April as part of Ofgem's price control licence modifications.
21. **Disapplication:** Ofgem's June appendix mentions special licence condition F (duration of charge restriction conditions), but only for completeness. This is a last-resort provision under which a licensee can effectively trigger a price control review at five-yearly intervals and so restrict Ofgem's otherwise unlimited power to allow a price control to stay in force for the remaining duration of the licence.
22. There are certain problems associated with this condition, the main one being that, while a licensee is free, in principle, to force a disapplication of a price control, it cannot do so without giving 18 months' notice of termination and, significantly, that notice may not have effect (except where Ofgem agrees otherwise) before the fifth anniversary of the effective date of the implementation of the control.
23. Distributors have recently made submissions to Ofgem about how the next price control settlement should deal with issues of cost uncertainty and the treatment of new obligations between reviews. Those submissions have included illustrative legal drafting for the mechanisms favoured by distributors. If their discussions with Ofgem do not produce satisfactory progress on these issues, distributors will want to review special condition F with a view to considering if it can be adapted to operate more simply and flexibly for disapplication purposes.
24. **Other issues:** A number of consequential amendments to the main price control conditions will be required because of the transition to BETTA, the introduction of the recent licence modifications for the structure of charges project, and the implementation (and potential re-making) of the ESQC regulations.
25. **Payments:** We assume that standard licence condition 20 (payments in relation to standards of performance) may need to be amended if distributors are to be allowed to pay compensation directly to consumers.

**Licensed distributors  
of Great Britain**

**August 2004**

## **Attachment 1:**

### **Distributed generation**

#### **licence conditions**

1. This commentary brings together some technical issues and drafting points raised by distributors in relation to Ofgem's proposed modification of Special Licence Condition B and Ofgem's proposed new special licence condition.

#### **Modification of Special Licence Condition B**

2. Ofgem's proposal to insert a new paragraph 2B 'after paragraph 2' presumably means to refer to an insertion after paragraph 2A. Given the content of current paragraph 2A, it seems odd to propose a new paragraph 2B to follow it. It would seem more sensible to make the content of Ofgem's proposed new paragraph 2B simply an extension of paragraph 2A.
3. There is a point here about the meaning and definition of terms which applies more broadly across the price control conditions. It is not possible to read Special Licence Condition B, as modified, and see what the new term Gdt represents: the most that can be discovered is that it is an amount derived from a formula set out in another licence condition.
4. We therefore believe that it would be useful, as a matter of principle, if individual terms throughout the price control conditions could be given general titles. Such a practice would make these conditions more user friendly.
5. An illustration of this approach, using the proposed new special condition as an example, is given below:
  - '4. For the purpose of paragraph 2, GI<sub>t</sub> (being the incentive element), GP<sub>t</sub> (being the pass-through element), GC<sub>t</sub> (being the rebate for unavailability element), and GO<sub>t</sub> (being the operational and maintenance element) for relevant year t are derived from the formulae:'

#### **Proposed new special licence condition**

6. Our comments in the main paper about the location of the defined terms for this scheme are reinforced by the fact that some thirteen terms (including the seven underlined in the condition) which require interpretation to make the scheme work are given some degree of definition outside the condition (ie, within the RIGs).
7. In looking at the defined terms, there appears to be some confusion as to what are aggregate quantities and what are 'per DG installation' quantities. We suggest that this point should be clarified in relation to each definition.
8. The defined term 'incentivised DG capacity' does not clearly define capacity. It could be nameplate capacity, site export capacity, or the authorised capacity. We recommend nameplate capacity.



9. In paragraph 2, within the formula for  $G_{dt}$ , the terms  $G_{At}$  and  $G_{Ot}$  should be transposed so that they appear within the main formula in the same order in which they are later defined.
10. In paragraph 4:
  - (a) The definition of  $ngt$  reads strangely, because 'relevant DG' is defined in terms of an 'installation'. It would therefore be more appropriate to refer to the number of 'relevant DGs'.
  - (b) It is unclear that the formula for  $G_{Pt}$  is correct. This may be because  $gp_j$  can become negative for an individual installation  $j$ , or because the formula should give a 15-year annuity but does not appear to do so.
  - (c) The derivation of  $G_{Ct}$  makes no allowance for partial restoration of export capacity that may be achievable before restoration of full capacity, which currently defines the completion of a network interruption.
  - (d) The summation over  $i$ , from 1 to  $ngt$ , which is included in the formulae for  $G_{It}$ ,  $G_{Ct}$ , and  $G_{Ot}$ , implies that separate records are available for each installation  $i$ . This potentially imposes onerous recording and collation requirements for microgeneration.
11. Paragraphs 5/6:  $G_{At}$  could be a substantial amount, as it potentially accumulates over the price control period. This could result in volatility in price changes in years when  $G_{At}$  is non-zero. It may be worth considering whether the drafting (whether here or elsewhere) should provide for  $G_{At}$  amounts above a certain level of materiality to be spread across the price control period.
12. In paragraph 7, it is unclear how the 'appropriate proportion of relevant remaining asset value' is to be established. This will not be straightforward because of the differences (i) between the assumed lives for 'use of system capex for DG' and those for other network assets, and (ii) between the profile of revenue resulting from the annuity approach for DG and that resulting from depreciation plus return for other network assets.
13. One aspect of the scheme as designed by Ofgem which is not reflected in either the draft licence condition or the draft RIGs, as far as we can see, is the proposed arrangement for the treatment of high cost projects (specified by Ofgem as those costing more than £200/kW). There will have to be further discussion of this.

## **Conclusion**

14. The interpretation and elucidation of the special new licence condition requires effective mastery of a number of inter-related policy and guidance documents, both current and historic. Going forward, intensive collaboration between Ofgem and distributors is needed in this area of work to avoid the risks of inconsistency and uncertainty in the final legal drafting.

**Licensed distributors of Great Britain**

**August 2004**