

**Regulation of Independent Electricity  
Distribution Network Operators**

**Decision Document**

July 2005 176/05

## Summary

This document sets out Ofgem's decision on the appropriate long term regulatory regime for new independent distribution network operators (IDNOs) and incumbent DNOs operating outside their distribution services area

Three distribution licences were issued to IDNOs during 2004 and at this time Ofgem initiated a review to develop sufficiently robust long term arrangements for the regulation of IDNOs to protect the interests of consumers.

Three main areas have been considered: price control arrangements for IDNOs, the application of financial ring-fencing conditions and any changes to the commercial and contractual industry framework to incorporate IDNOs.

The document proposes the:

- introduction of a relative price control for IDNOs and DNOs operating out of area to take effect from 1 April 2006 which links the price the IDNO or DNO operating out of area can charge to the incumbent DNO to which they are connected; and
- amendment of the existing financial ring fencing conditions that apply to IDNOs to bring them more into line with those currently applied to DNOs.

This document provides Ofgem's views on the range of commercial and contractual arrangements to apply to IDNOs including:

- credit cover arrangements;
- industry contractual structures; and
- boundary equipment including metering;

In addition following an open letter consultation in March 2005 Ofgem proposes to introduce the new licence conditions for IDNOs as follows:

- last resort supply – payment claims;
- powers for compulsory purchase of land; and
- other powers to undertake street works.

Draft licence modifications proposals are contained in this document. Views on these drafts and other issues are invited by 9 September 2005. It is intended that statutory consultations with the relevant distributors will follow during the autumn of 2005.

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# 1. Introduction

## ***Purpose of this document***

- 1.1 This document concludes the consultation on the appropriate long term regulatory regime for IDNOs. The long term review was initiated during 2004 when three licences were issued to IDNOs. Interim regulatory arrangements were established in granting the licences with a view to developing sufficiently robust long term arrangements to protect the interests of consumers.
- 1.2. The purpose of this document is to set out Ofgem's decisions on the following matters:
- price control arrangements for IDNOs and for DNOs operating out of area;
  - appropriate financial ring-fencing conditions; and
  - introduction of additional licence conditions to switch on Schedule 3 and Schedule 4 Electricity Act 1989 powers and a condition regarding payment of claims in the case of last resort supply.
- 1.3 The document also includes Ofgem's views on commercial and contractual issues raised through the consultations including the contractual structure of electricity distribution, boundary and isolation equipment, boundary metering and credit cover requirements.

## ***Background***

- 1.4 As a consequence of changes to the Electricity Act 1989 (the Act) by the Utilities Act 2000 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). This means that apart from the DNOs that evolved on 1 October 2001 from the Public Electricity Suppliers (PES), other persons can be granted a licence to operate existing or newly built distribution networks.
- 1.5 For the ex-PES DNOs the electricity distribution licence contains both standard and special licence conditions. Standard licence conditions (SLCs) are included in all electricity distribution licences with those in sections A and B of the licence applying to

all distribution licensees while those in section C apply to only those licensees with a Distribution Services Direction. IDNOs do not at present have Distribution Services Areas (DSA) and Section C is not currently switched on for IDNOs.

1.6 However in considering whether existing section B SLCs would provide adequate protection for the interests of consumers it was determined that further conditions were required. It was proposed that interim arrangements should be established for IDNOs until such time that a wider ranging review of these matters could be completed. These interim arrangements comprise additional conditions that would provide further protection to consumers. The distribution licence for each IDNO is split into three sections:

- Section A – Interpretation, Application and Payments;
- Section B – General; and
- Section BA – Specific.

1.7 IDNO licences contain SLCs identical to the SLCs in section A and B of the distribution licence for ex-PES DNOs. In addition, section BA for each IDNO consists of the following amended 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.

1.8 Full drafting of conditions BA1 to BA6 can be found in the Appendices to the July 2004<sup>1</sup> consultation paper.

1.9 Ex-PES DNOs may establish licensed networks GB wide and some of the DNOs have now developed networks outside their distribution services area. Ofgem considers that the issues raised in this document in respect of IDNOs generally also apply to ex-PES

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<sup>1</sup> Regulation of Independent Electricity Distribution Network Operators – consultation paper, July 2004, 180/04

DNOs developing and operating out of area networks. Any reference to IDNOs in this document should be read to include DNOs operating out of area except where stated.

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

- 1.10 Ofgem issued three licences to IDNOs during 2004 but committed at this time to reviewing the regulatory regime and as part of this review undertook to consider how these arrangements would apply to ex-PES DNOs operating out of area.
- 1.11 There have been two main documents on the review of the long term regulatory framework: Ofgem consulted in July 2004 on the regulatory regime to apply to IDNOs in particular considering the charge restriction arrangements, financial ring fencing requirements and commercial issues. In January 2005<sup>2</sup> an initial conclusions document was published which set out Ofgem's initial views on these areas.
- 1.12 In addition to the topics covered in these consultations two further issues have been identified in recent months and these are considered within this document. In March 2005 Ofgem undertook an open letter consultation<sup>3</sup> on whether the Schedule 3 and Schedule 4 powers under the Act which enable the distribution licence holders to compulsory purchase land and undertake street works should be switched on for IDNOs. They are currently switched on for DNOs through SLC 34, Compulsory Acquisition of Land etc, and SLC35, Other Powers etc, in section C of the licence. The consultation also considered whether SLC48, Last Resort Supply: Payment Claims, in section C, should also be switched on for IDNOs. Separately Ofgem has published industry credit cover guidelines<sup>4</sup> for network operators in February 2005. However, due to the way IDNOs are regulated, consideration needs to be given to the most appropriate credit cover arrangements for IDNOs.

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<sup>2</sup> Regulation of Independent Electricity Distribution Network Operators – Initial Proposals Document, January 2005, 18/05

<sup>3</sup> Open letter consultation on the application of section C licence conditions for Independent Electricity Distribution Network Operators, March 2005, 88/05

<sup>4</sup> Best Practice guidelines for gas and electricity network operator credit cover – Conclusions document, February, 58/05

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

Chapter 2 – Price control arrangements: this outlines in detail Ofgem’s final proposals for the price control arrangements for IDNOs which takes the form of a relative price control.

Chapter 3 – Financial ring-fencing: this chapter details a number of changes that Ofgem proposes to make to the financial ring-fencing conditions for IDNOs to bring them into line as far as possible with those applied to the ex-PES DNOs.

Chapter 4 – Commercial arrangements: this covers a range of issues and includes Ofgem’s views on credit cover requirements, boundary equipment and boundary metering.

Chapter 5 – Other licence conditions: this follows up the March 2005 consultation on the need to introduce further licence conditions on IDNOs. Ofgem proposes three further licence conditions to be applied to IDNOs.

Chapter 6 – Implementation: This chapter outlines how it is intended to implement the proposed changes outlined within this document.

Appendix 1 – BA1: details drafting of the revised price control licence condition.

Appendix 2 – BA2-BA6: details drafting of the revised financial ring fencing conditions.

Appendix 3 – Other licence conditions: details of drafting of proposed other licence conditions.

## ***Timetable and responses***

- 1.13 This document covers a wide range of issues all relating to the regulation of IDNOs. The table below details estimated timescales and milestones noting in particular the timescales for licence modifications.

Date:	Issue:	Milestone:
October 2005	Price control arrangements, Financial ring-fencing conditions	Statutory consultation on licence modifications proposed for each of the IDNOs (currently three), and for price control arrangements only all DNOs for out of area
October 2005	Other licence conditions	Statutory collective licence modification proposed for all IDNOs and DNOs (currently seventeen)
November 2005	Financial ring-fencing, other licence conditions	Licence modifications take effect (subject to considerations of any representations or objections)
1 April 2006	Price Control Arrangements	Amended price control arrangements take effect (subject to consideration of representations or objections)

- 1.14 Comments on the issues raised in this document and the attached draft licence modifications should be received by 9 September 2005 and should be sent to:

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- 1.15 All comments 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, parties should put confidential material in

appendices to their responses. Ofgem prefers to receive responses electronically so that they can be easily placed on the website.

- 1.16 Should you have any questions regarding the issues raised in the document please contact Mark Cox on 020 7901 7458.

## 2. Price Control Arrangements

### *Form and scope of control*

- 2.1 Ofgem is currently applying interim charging arrangements for IDNOs which are provided for in condition BA1. The interim arrangements were designed to protect end consumers by ensuring that an equivalent customer by connecting to an IDNO's network would not be charged any more than if they had connected to the ex-PES DNO's network. The interim arrangements also facilitated competition in supply by maintaining the tariff structure and level between the IDNO and DNO. The disadvantage to this arrangement was that it provided uncertainty to the IDNO as to the future path of the level of charges it could levy. The charges the IDNO can levy are restricted under BA1 and are based not on its costs, but rather on the charges of the DNO. The price cap approach exposed the IDNOs to the resulting DNO price variations.
- 2.2 The review of the charging arrangements has considered approaches that would reduce the risk borne by IDNOs without losing some of the benefits outlined above. In the January document Ofgem proposed to change the charging arrangements and detailed two options for the enduring price control.

### *Starting point of control*

- 2.3 It was proposed for both options that the start point of the control should set the IDNO's initial charge at the time of connection equal to the host DNO's charge to equivalent domestic customers at that time. The rationale for this is that if the IDNO did not extend the network it would be the host or incumbent DNO which did so. This approach was supported by responses to the January consultation.

### *Path over control*

#### Option 1

- 2.4 This proposed a relative price control framework where IDNO charges continually follow the DNO's charges subject to a pre-determined floor and ceiling set at plus and

minus 5%, increasing to 10% after five years. This floor and ceiling would also be subject to a path over the price control period and this was proposed to follow RPI. This provides more predictability to IDNOs, as charges will only vary within the pre-determined limits and also benefits consumers and supply competition by keeping IDNO and DNO charges in line in most circumstances.

### Option 2

- 2.5 The alternative approach proposed was the setting of a specific price control for the IDNO. This would be based on pass through of the upstream use of system charges (similar to NGC exit charges in the DNO price control) for which the IDNO has no control and an RPI-X regulation of the additional element to reflect the IDNO costs. Provisionally it was proposed that X be set at zero. It was recognised that this approach would provide a greater degree of certainty to IDNOs but it was likely that prices on DNO and IDNO networks would diverge more quickly with potential disadvantages.
- 2.6 In general most respondents supported option 1 as it better balanced the need to protect end consumers, promote competition in supply and also provided greater certainty to IDNOs compared with the interim arrangements.
- 2.7 One response did not support this approach and preferred option 2 on the grounds that the disadvantages that the consultation had outlined did not outweigh the benefits. Some responses were also concerned that the floor and ceiling in option 1 were too wide providing little certainty to the IDNO, and that the movement to ten percent after 5 years was not justified. However a number of responses, particularly from suppliers were not in favour of this option due to diverging prices between the DNO and IDNO networks. Different distribution prices on the IDNOs network may lead to differential pricing by suppliers which potentially could increase supplier costs or may lead to higher supplier prices in general due to the need to bear the risk from different prices. Although there is a potential for IDNO prices to be lower than DNO prices in this arrangement which might provide benefits for suppliers this was not considered in the responses.
- 2.8 It was also noted that it would be difficult to determine a level for X within the price control arrangements as although the work and research undertaken for the DNOs'

distribution price control could be used this was not necessarily valid for IDNOs. The January document outlined a 10 year price control for IDNOs which would mean that a longer term view would also be required to ascertain an appropriate value of X made more difficult due to the limited history of IDNO operation.

- 2.9 A further concern raised by the consultation was the level of complexity required to implement, administer and monitor such a solution at this stage. As this approach is nominally a price led control while the upstream distribution use of system (DUoS) charges would be measured in total revenues it makes this a complex and difficult arrangement to manage.
- 2.10 The main benefit of Option 2 is that it eliminates exposure to the upstream DNO's charges which reduces the IDNO's risk. However, with greater transparency in the DNO's costs and charges through published methodology statements there will be more information available on the level and structure of these charges.

### ***Period of control***

- 2.11 In determining over what period of time the price control should be set for IDNOs Ofgem had to consider and balance the need to provide certainty to IDNOs over a sufficient period of time against the fact that there is little track record on which to base a price control for IDNOs and it is not clear that setting a long price control period would be in the interests of end consumers. Ofgem proposed a ten year control in the January document but highlighted that this would be reviewed in year 6 (i.e. 2011) to determine if the arrangements were still appropriate but that any changes coming from this review would not be applied to committed IDNO sites before 2016, i.e. the price control arrangements would be site specific for any overlap. In this way sites committed from 2006 would run the full course to 2016 and to avoid any uncertainty towards the end of the price control period a decision would be made early (2011) so that IDNOs could continue to invest knowing arrangements would be in place from 2016.
- 2.12 There was little consensus on the most appropriate period of control with some respondents arguing that it should be consistent with the DNOs (5 years) while others proposing a minimum of 10 years, with 20 years being more desirable to encourage adequate investment.

- 2.13 Ofgem has considered this issue and although a longer period will provide greater certainty to IDNOs particularly in considering finance for these projects this needs to be balanced against the uncertainty of how IDNOs will develop and Ofgem does not believe that it is in the best interests of consumers to extend the period of control beyond 10 years.

### ***Additional Issues***

#### ***Non-domestic customers***

- 2.14 Currently BA1 deals with charging arrangements for domestic customers and the January document stated that Ofgem is not minded to extend BA1 to non-domestic customers at this point due to the protection afforded by SLC 4C<sup>5</sup>.
- 2.15 Responses to the consultation were varied with a number of DNOs proposing that BA1 should be extended to include non-domestic customers while other DNOs believed that the arrangements were adequate in this regard. One DNO noted that with the non-discrimination provisions and the requirement on IDNOs to publish an approved charging methodology, this should provide sufficient transparency and protection to non-domestic customers. SLC4 requires IDNOs to have in place charging methodologies which are approved by the Authority for use of their system. This charging methodology would describe calculation of distribution charges for all customers.

#### ***Nested Networks***

- 2.16 There is the possibility over time that nested networks may be created as IDNOs connect to other IDNOs. The January document raised this issue as such networks have been developed in the gas sector. There were limited responses to this issue which suggested that this issue would require further consideration once the arrangements for IDNOs had been agreed.

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<sup>5</sup> SLC 4C. Non-Discrimination in the Provision of Use of System and Connection to the System

## ***Ofgem's Final Proposals***

- 2.17 It is proposed that Option 1, a relative price control, should be implemented as this provides a better approach at this time to deliver the long term charging arrangements for IDNOs. Although option 2 has some advantages, in the medium term Option 1 provides a more proportionate response.
- 2.18 In the January document three options were considered as to the timing of implementation of any new arrangements: April 2005, September 2005 or April 2006. There was a range of responses with different parties supporting each of the three options for different reasons. With the need for any new arrangements under BA1 to be agreed through a statutory licence consultation with the relevant licensee, it is unlikely that the licence structure will be in place until November 2005. On this basis it is proposed that the new arrangements start from 1 April 2006. Networks already established by IDNOs before this time will move to the new arrangements at this date.
- 2.19 Option 1 will require the IDNO to charge no more than the host DNO for domestic consumers subject to certain limits. Ofgem considers that the arrangements as described above provide some protection to non-domestic customers and therefore does not intend to extend the arrangements within BA1 to cater for non-domestic customers. However Ofgem intends to keep this under review and if it is found that this does not provide sufficient protection leading to customer or user complaints then Ofgem may consider changing the licence to cater for non-domestic customers explicitly in BA1.
- 2.20 The starting point for the price control will be set such that each element of the IDNO's tariff is no higher than the host DNO. There will be a floor and ceiling of +/- 5% for the period of the control. This floor and ceiling will apply to the host tariff as at 1 April 2006 and not be subject to the timing of the connection of IDNO's networks. Where the DNO's tariff goes outside of these limits then the IDNOs price will be capped at these limits. The floor and ceiling will also be subject to an RPI adjustment annually and this will be based on an average 6 month RPI.
- 2.21 It is proposed that the new arrangements should come into force from 1 April 2006. It is intended that any future changes to the price control arrangements will not come into affect until 2016 at the earliest. Arrangements applying after 2016 will be considered

well in advance (2011). For the avoidance of doubt the price control period for each IDNO will be for 10 years, each individual site developed by the IDNO over the coming years will not be subject to a ten year price control.

### ***Implementation***

- 2.22 The current BA1 charge restriction condition was included in each IDNO licence at the time of grant and it is necessary to undertake a statutory consultation on any modification. Any change will require each licensee's consent.
- 2.23 In advance of a statutory licence modification Ofgem has prepared a draft of a revised BA1 condition which includes the necessary changes to implement the proposals described above. This draft is included in Annex 1 of this document and any comments on this draft are welcomed. Ofgem intends to propose similar modifications to special condition G1 of the DNO licences.

### 3. Financial Ring-Fencing of IDNOs

- 3.1 This chapter does not apply to DNOs operating outside their distribution services area.
- 3.2 Financial ring-fencing conditions currently apply to licensed electricity distribution companies, electricity transmission companies, gas distribution companies (although not currently Independent Gas Transporters<sup>6</sup>) and the gas transmission company. 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.
- 3.3 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. 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.

#### ***Proposed changes***

- 3.4 As part of the Distribution Price Control Review (DPCR4) for the ex-PES DNOs, Ofgem made collective licence modifications of the financial ring-fencing conditions in section C of the distribution licence<sup>7</sup>. The collective licence modifications did not affect the ring-fencing conditions in section BA of the IDNO licence. In light of this Ofgem consulted in the January document whether the same or similar changes should be made to the financial ring-fencing conditions for the IDNOs.

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<sup>6</sup> It is proposed to introduce similar financial ring-fencing arrangements for IGTs, see document Financial ring-fencing for new and existing gas transporters, Initial proposals, November 2004 (250/04)

<sup>7</sup> Electricity Distribution Price Control - Licence modifications, March 2005 (95/05)

3.5 The modifications include some changes to the definitions and the inclusion of an issuer rating by Fitch Ratings Ltd or any of its subsidiaries for the purposes of paragraph 2 of SLC 46 (BA5 of the IDNO licence).

3.6 In addition the modifications proposed to change SLC 47, Indebtedness (condition BA6 of the IDNO licence) to include a “cash lock up” arrangement. This condition currently prohibits the licensee, without the prior written consent of the Authority, from transferring, leasing or lending any sum or sums, right or benefit to any affiliate or related undertaking otherwise than by way of certain types of transaction, and subject to certain conditions. These transactions include payment of dividends and other distributions, certain transfers of money or other valuable assets on deferred payment or repayment terms, payments of principal and interest on certain loans, fair value payments for goods, services and tax losses, and acquisitions of certain investments.

3.7 The changes made to the licence require prior written approval of the Authority for some transactions to be made if a trigger event has occurred and has activated a so called “cash lock up”. The trigger event for ex-PES DNOs is based on a fall in the credit rating of the licensee such that it no longer retains an investment grade credit rating or it is on review for downgrade or has a negative outlook. In the case of IDNOs where they may have agreed alternative arrangements to a credit rating then views were invited as to the most appropriate trigger event. It is proposed that the existing alternative arrangements to a credit rating in BA5, Credit Rating of Licensee remain.

3.8 In summary the proposed changes are as follows:

BA2. Restriction on Activity and Financial Ring Fencing	Minor drafting changes and clarification
BA3. Availability of resources	Change obligation timing, minor changes for consistency and clarification
BA4. Undertaking from Ultimate Controller	No change
BA5. Credit Rating of Licensee	Restructured text, addition of Fitch Ratings Ltd

BA6. Indebtedness Introduction of new cash lock arrangement, clarification and minor drafting changes.

- 3.9 Responses to the January document were generally supportive of the proposed changes to the financial ring-fencing conditions to bring them into line with those changes as part of DPCR4. One IDNO did not support the changes and felt that the existing financial ring-fencing conditions placed too great a burden on IDNOs. Another IDNO wanted to wait to review the proposed modifications in detail before being able to comment.
- 3.10 Most responses felt that the trigger event, in the absence of the licensee having a credit rating and having in place alternative arrangements, should be failure of the parent company under the keepwell agreement (as required as part of the alternative arrangements).

### ***Ofgem's Final Proposals***

- 3.11 It is proposed to implement similar revisions to conditions BA2 to BA6 to those made for ex-PES DNOs as part of the price control review (DPCR4) to their financial ring-fencing conditions SLCs 43 to 47. The changes are generally minor and are intended to provide greater clarity to the conditions. The introduction of a cash lock up arrangement in BA6 provides greater protection to the licensee and its customers in the event of financial difficulty. It is intended to retain the alternative arrangements in BA5 as at present.
- 3.12 Under BA6 it is proposed that the trigger event for the cash lock up should be the failure to comply with the terms of the alternative arrangements agreed by the Authority. This would include failure of the parent to meet the terms of the keepwell agreement.

### ***Implementation***

- 3.13 The current BA2 to BA6 conditions were included in each IDNO licence at the time of grant and for the purposes of any modification it is necessary to undertake a statutory consultation on the proposals and any change will require each licensee's consent.

3.14 In advance of a statutory licence modification Ofgem has included a draft of revised BA2-BA6 conditions which, due to the relative simplicity of the changes, are marked up with the relevant changes. This draft is included in Annex 2 of this document and any comments on this draft are welcomed.

## 4. Commercial Arrangements

### *Aligning gas and electricity structures*

- 4.1 The July 2004 document outlined that the contractual structure in the electricity industry is different to that in the gas sector, and despite the advantages of a distribution “one bill” approach for suppliers, the arrangements do place a burden on IDNOs with the liability for upstream DUoS. The consultation sought views on whether it would be beneficial to apply similar contractual arrangements as those that exist in the gas sector to the electricity sector.
- 4.2 None of the responses supported a change to the market structure, most highlighting significant cost to change and criticising the gas arrangements. Some of the IDNOs noted that it may not be efficient to change to a two bill approach but sought changes to other areas of the arrangements, such as the credit arrangements for upstream DUoS, to create improved arrangements rather than aligning electricity with gas arrangements.
- 4.3 In the January 2005 document Ofgem noted that, although responses had highlighted increasing costs, there was little evidence provided of the costs and benefits and requested that further consideration be given by the industry to the costs and benefits of changing the arrangements and the practical issues involved. Ofgem noted that this issue would become increasingly important as the industry becomes more complex for example through nested networks and distributed generation.
- 4.4 The responses to the January document provided further evidence of increasing costs from changing the arrangements. Some responses noted that the industry structure had already been assessed under the auspices of the Distribution Business Focus Group (DBFG) led by Gemserv which brought about changes to the relevant agreements and processes to allow for new distribution network operators and these costs had been considered in developing these proposals.
- 4.5 Elexon provided a more detailed response which looked at potential costs to the settlement (reporting) systems if the arrangements were changed. Costs of these changes were assessed and Elexon estimated that in excess of £200,000 would need to be spent on the settlement system to revise the data flows to the relevant parties - this was

assuming that the change was constrained to only two network operators. It is expected that further costs may need to be borne by other parties such as suppliers to receive two (or more) sets of data from distributors which may impose further costs as part of this change although there was little quantification of these costs. Some DNOs argued that they would incur costs for changes to their billing systems to include the additional information for billing suppliers for customers on IDNOs' networks. None of the responses supported changing the contractual arrangements.

### ***Ofgem's Views***

- 4.6 In light of the information provided and the costs involved in changing the arrangements, the case has not been made to change the basic structure of the contractual relationships between the upstream DNO, IDNOs and suppliers in electricity distribution at this time.
- 4.7 Further consideration is given below to appropriate credit arrangements for IDNOs regarding upstream DUoS charges following comments in a number of responses.

### ***Boundary equipment***

- 4.8 In the January document Ofgem noted that in order to satisfy regulation 6 of the Electricity Safety, Quality and Continuity Regulations<sup>8</sup> (ESQCRs) distributors have to fit protective devices to their networks. Consequently fuses or a circuit breaker will have to be fitted at each point of connection. This will normally also provide an isolation facility that will have operational benefits for both the DNO and IDNO. As stated in the document it is for each licensee to satisfy itself that it is compliant with the ESQCRs but in most cases Ofgem would expect that this would be achieved by a single protective device. In discussions with the DTI Engineering Inspectorate they supported the view that in most cases two circuit breakers may not be necessary to meet the requirement of the ESQCRs. They noted that there may be exceptions to this and each case should be considered to ensure that parties are satisfied that they meet the regulations. Ofgem supports this view and would expect parties to reach agreement on the operation and

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<sup>8</sup> Statutory Instrument No. 2002/2665. Note the DTI are currently consulting on amending the ESQCRs.

maintenance of this equipment. In these cases Ofgem proposed that the IDNO (connecting party) should bear the cost of any equipment.

- 4.9 Responses supported the need for isolation equipment to ensure that the ESQCRs were met, although the IDNOs recognised that as compared to the DNO extending the network this would be an additional cost which, if borne by the IDNOs, would place them at a competitive disadvantage. There was strong opposition to the need for two pieces of isolation equipment and where these exceptional situations occurred some parties felt that the additional cost should be borne by the DNO.

### ***Ofgem's Views***

- 4.10 There is a requirement on licensees to identify minimum cost connection arrangements. In many circumstances this should mean that only one set of isolation equipment, supported with appropriate shared operating procedures, should be necessary. There may be exceptional circumstances where licensees can justify the requirement for duplicate sets of protection equipment but as stated above it is for licensees to ensure that they are compliant with the ESQCRs.
- 4.11 Where one set of isolation equipment is used then this equipment must be provided in a manner which enables both licensees to have reasonable access. Ofgem expects licensees to co-operate to reach reasonable commercial arrangements that provide access and assign responsibility for operating, repair, maintenance and replacement.
- 4.12 It is proposed that the IDNO requiring the connection should pay for the protection / isolation equipment at the interface. If the IDNO did not pay for this equipment then it would mean that end consumers generally would be required to pay for this equipment and this may increase costs to end customers. However, it is Ofgem's view that, in general, the IDNO should only be expected to pay for one set of equipment.

### ***Boundary metering***

- 4.13 In the January document Ofgem highlighted that there were a number of benefits to be obtained from having boundary metering, such as more accurate information that would

aid in the process of calculating use of system charges and losses. It was also recognised that there were costs associated with the installation of boundary metering, which would not have been incurred if the DNO had extended the network. These were not limited to the cost of the meter but included the costs of the associated equipment, housing equipment and the need for land space to site this equipment. Ofgem asked for quantitative information on the arguments for and against metering and also whether there should be a one size fits all principle or whether different approaches should be taken subject to size or voltage of connection.

4.14 There was a wide range of responses on this issue. Most respondents accepted that the case for metering at higher voltages was stronger, although not all the IDNOs accepted the need for it. At lower voltages and for smaller sites stronger arguments were made against the benefits of boundary metering with some parties noting that any form of metering would be disproportionate. The main views put forward for boundary metering in the responses were to facilitate:

- the control and identification of losses across both networks. DNOs are also incentivised through their price control arrangements to reduce losses;
- the calculation of agreed charges between networks allowing costs to be targeted to parties and enabling accurate billing of IDNOs by DNOs;
- the development of embedded generation;
- IDNOs with the identification of unmetered supplies consumption;
- IDNOs with data identifying the potential abstraction of electricity; and
- certainty of market data to suppliers which may avoid increased supplier costs.

4.15 The main views represented in the responses against the need for metering were:

- If the DNO had extended the network then there would be no metering and charges would be based largely on profiled metering. There should not be an additional cost through further metering just because there is another distributor supplying the end consumer.
- The disadvantages of boundary metering are not only the costs of meters and associated equipment but the fact that this equipment takes up a significant footprint on any development land. These issues make IDNOs less competitive on cost but also less attractive to developers due to the additional equipment on site.

- End consumers' bills are in the large part based on profiled data or estimates which get reconciled over time. The installation of boundary metering may mean that the IDNO is exposed to the errors or incorrect profiling assumptions on actual take. IDNOs proposed that this risk should be shared with the DNO as otherwise the DNO is fully protected.
- 4.16 Some responses noted that it may not be efficient to install metering at the ownership boundary and that pragmatic solutions should be identified which would provide a similar level of information.
- 4.17 The responses outlined that there are material costs involved in the provision of metering. At the small end of the market, where the network provides supply to only a small number of domestic dwellings, it is likely that this additional cost will make the IDNO uncompetitive.
- 4.18 It was unclear from the responses as to the type of metering proposed to be installed at the boundary or approaches that DNOs intended to take to metering and the processing of this data. For instance it was not clear whether it is intended to install half hourly type metering with appropriate telecommunications and recording devices or whether it is intended to use more low technology approaches with kWh meters which would be read manually on a regular basis.

### ***Ofgem's Views***

- 4.19 Ofgem has considered the responses to the January document and recognises that boundary metering is an important issue which may affect the development of IDNOs. Although there may be additional costs it is necessary to establish the impact that an IDNO's network has on the upstream network to allow this to be charged to the IDNO in an efficient manner whatever size or voltage of connection. It is Ofgem's view that it is necessary to identify a suitable mechanism that ensures that electrical flows on the boundary can be measured or estimated accurately and, with the potential for every connection scenario to be different, it is for the industry to consider suitable and proportionate mechanisms to achieve this aim rather than for Ofgem to impose a single approach.

- 4.20 Several solutions are potentially available depending on the circumstances of the case. One solution could be to install metering at the boundary and establish the necessary processing but other solutions may be possible such as using real settlement data which is available for end consumers on the IDNO's network and aggregating this up accurately to the boundary. Another solution may be to install metering that is remote from the boundary, e.g. a more convenient location such as a substation, which would be corrected for the true boundary to minimise costs on site. This has been used in other industry situations. It is important to stress that it is for the industry, working together, to identify solutions to this issue and to work out least cost connection solutions that are proportionate for each connection scenario.
- 4.21 However, as noted above if the IDNO had not developed the network extension then the DNO would have been obliged to do so and no boundary metering would have been provided. If the cost of any mechanism was borne by the DNO then it may increase costs to end consumers. Therefore Ofgem proposes that the cost of any such mechanisms should be borne by the connecting party (the IDNO).

### ***Credit Cover requirements***

- 4.22 Ofgem has recently published the best practice credit cover guidelines document and is looking for the industry now to incorporate these guidelines within their commercial agreements. One of the main elements of this guidance is to calculate the maximum unsecured credit limit for licensees beyond which counter parties would need to provide credit cover. The calculation of this maximum credit limit is based on the licensee's Regulated Asset Value (RAV), and is calculated as 2 per cent of RAV.
- 4.23 This approach is appropriate for network operators in general as they have a defined RAV for the business which is necessary as part of their price control arrangements. As explained earlier in this document, IDNOs are currently price controlled through a price restriction condition that takes no account of the licensee's assets and therefore there is no defined RAV. As described in Chapter 2 it is not intended to change this basic approach in introducing new price control arrangements.

- 4.24 Therefore it is necessary to consider how these arrangements should work for IDNOs and what level of credit cover they should require from counter parties. In addition due to the commercial arrangements described earlier the IDNOs are currently liable for upstream DUoS charges to the host DNO and it is important to consider what credit cover requirements are required at this interface.
- 4.25 As DNOs operating out of area will be operating through the same legal entity as their in area business it will generally be practical to apply a single set of arrangements regarding their credit worthiness and therefore it is not expected that the arrangements set out here would apply to DNOs operating out of area.

### ***IDNO Credit Cover requirements***

- 4.26 Ofgem recognises that there is benefit in IDNOs following the best practice industry guidelines on credit cover, not least to ensure that suppliers are faced with consistent arrangements across networks, and therefore has considered alternatives in the absence of a RAV to allow IDNOs to adopt a similar approach to credit cover.
- 4.27 Two approaches have been considered, one which uses the assets of the business as an equivalent RAV and the other an assessment of annual sales as a proxy for RAV. IDNOs may choose to develop networks in different ways with the adoption of different types of developments and therefore network assets may not be an appropriate measure and a sales based approach may be more preferable. Ofgem has assessed the ratio of sales to RAV for the ex-PES DNOs and this equates to an average factor of 4 times. It is therefore proposed that the IDNO assumes a proxy RAV for the purposes of the credit cover guidelines and that this is set at 4 times the IDNO's annual sales revenue. In this way a consistent arrangement will be achieved across the network operators for suppliers.

### ***Credit Cover for Upstream DUoS***

- 4.28 In light of responses from interested parties and concerns raised regarding the payment of upstream DUoS charges Ofgem has considered appropriate arrangements for credit cover at the distribution interface.

- 4.29 The IDNO is contractually liable for the upstream DUoS and, as found when considering condition BA5, Credit Rating of Licensee, the IDNO may not have an investment grade credit rating or may simply be unrated. In applying the guidelines the DNO may choose to treat the IDNO as if they were like any other counter party for the purposes of credit cover and initially ask for full cover until credit history has been established. However, as the sums that would need to be secured are payments from suppliers which need to be passed through to the upstream DNO there is a risk that if the underlying supplier were contracted to the host DNO directly, no cover would be required. Therefore such an approach may lead to additional costs to the industry and may not provide the most efficient solution.
- 4.30 It is also worth noting that in satisfying the alternative arrangements to an investment grade issue credit rating in condition BA5 the IDNO is required to have a keepwell agreement from its parent company where the parent company has an investment grade credit rating. In such cases the DNO's credit limit for the IDNO should be based on the parent's rating and therefore the issue of credit cover will be simpler and straightforward to apply. In cases where the parent does not have an investment grade credit rating, the alternative arrangements require the IDNO to have a keepwell agreement with its parent company but in addition they are required to have some form of security (cash, bank guarantee etc) to cover 6 months of operating costs and asset replacement expenditure. These operating costs include the cost of upstream DUoS charges. Therefore if IDNOs provide cover to DNOs to cover upstream DUoS charges then Ofgem will offset such deposits against the alternative arrangements that the IDNO has agreed with the Authority under BA5.
- 4.31 However, in seeking to minimise industry costs an alternative approach may be the use of a trust arrangement whereby supplier payments are held by trustees who ensure that the upstream charges are paid prior to the remaining monies being paid to the IDNO. Such arrangements have been considered before in catering for network operator interfaces and Ofgem believes that such arrangements, if effective, should be treated as providing cover under the Ofgem best practice guidelines.

## ***Views invited***

- 4.32 Ofgem has not previously consulted on the credit cover requirements for IDNOs and arrangements for IDNOs were not considered within the work undertaken for the industry guidelines. Therefore any responses from interested parties to these proposals should be provided as outlined in Chapter 1.

## 5. Other Licence Conditions

- 5.1 The licences held by IDNOs differ from those of the ex-PES DNOs in that they do not have section C of the distribution licence switched on. Section C sets out obligations on the ex-PES DNO for operation within its distribution services area (DSA). IDNOs do not have a DSA.
- 5.2 However, some of the provisions in section C could be applied to distributors operating on a GB wide basis. These include those provisions relating to financial ring fencing and meter point administration services. Both of these sets of conditions have already been included within the IDNO licence by the introduction of standard conditions BA2 to BA6, as described earlier in this document, and through the introduction of amended section B licence conditions respectively.
- 5.3 Ofgem undertook an open letter consultation on 18 March 2005 to consider if other section C conditions (specifically SLCs 34, 35, and 48) should be included within the IDNO licence in their current or modified form.
- 5.4 In addition the consultation sought views on:
- whether there are any other section C conditions that may be appropriate to include for IDNOs;
  - whether any of the conditions should also apply to ex-PES DNOs operating outside their DSA; and
  - the appropriate mechanism for modifying the IDNO licence to include any further conditions.

### ***SLC 34 – Compulsory Acquisition of Land etc, SLC35 – Other Powers etc***

- 5.5 Both SLC34 and SLC35 activate statutory powers contained within the Act. SLC34 gives effect to Schedule 3 of the Act which provides powers to a licensed distributor for compulsory acquisition of land while SLC35 gives effect to Schedule 4 of the Act which provides powers to a distributor to execute any works, including breaking up streets to carry on the activities authorised by licence.

- 5.6 All the responses supported the need for application of SLC34 to all distributors, including IDNOs and ex-PES DNOs operating out of area, although due to its infrequent use the case was not strong and no examples were provided. Applying it would provide a level playing field for all distributors in providing new connections and developments.
- 5.7 In general responses supported the application of SLC35 to IDNOs but some of the responses raised concern over the safety implications of installing multiple cables in the same highway or street. Concern was raised that there were not sufficiently robust processes in place to manage this safely and therefore any introduction should be carefully considered or at least delayed until they had been developed effectively. Some of the responses noted that without these powers IDNOs would not be able to compete for development projects on an equal footing with ex-PES DNOs.

### ***SLC48 – Last Resort Supply: Payment Claims***

- 5.8 SLC48 details the circumstance in which a licensee must increase its use of system charges in order to compensate a supplier who has become a supplier of last resort. In the absence of this condition, the IDNO would not be obliged to pay the supplier of last resort for their losses incurred and claimed, however, the IDNO may be exposed to an increase in end consumer charges by the host DNO.
- 5.9 There was general support for this condition to be applied to all parties. One IDNO response noted that they supported its inclusion but thought that more detail as to how it would apply to them was necessary before they could accept such a change. One response from a DNO raised concern about consumers on the IDNO's network paying twice, once from the DNO uplift in price and two for the IDNO uplift in price due to the nature of the IDNO price control.

### ***Other Conditions***

- 5.10 One DNO proposed that SLC 36B should apply to IDNOs, which is an obligation in the absence of anyone else to provide metering equipment and services. This particular issue was consulted on by Ofgem during 2004 and Ofgem concluded that this should

be retained solely by the ex-PES DNO<sup>9</sup>. Ofgem does not intend to review this issue further at this time.

- 5.11 Two DNOs proposed that SLC 49, Incentive Scheme and Associated Information, should apply to IDNOs and DNOs operating out of area. Ofgem does not support the need for this condition to be applied at present and intends that quality of supply monitoring can be achieved through statements provided under SLC 5 in section B of the licence and that these would be in line with the RIGs for the Information and Incentives project. One response also noted that if an IDNO's circumstances changed, for instance if it affiliated with a supply business, then other provisions may need to apply.

### ***Ofgem's Final Proposals***

- 5.12 It is proposed to introduce SLC 34 and 35 into all distribution licences by moving the conditions to section B as it is important where possible to provide consistent arrangements for all distributors. Although SLC34 would only be needed in rare situations it is likely to be more efficient to provide for this power in advance of the need to ensure that all distributors can undertake their business on similar terms. There are also a number of safeguards within the Act in using the compulsory purchase powers.
- 5.13 It is not appropriate to limit IDNOs from undertaking projects which require work to be executed in the street and the application of SLC35 will mean that distributors will need to apply safe practices to deal with potentially multiple circuits of different ownership in pavements and highways to ensure that they satisfy the existing street works legislation.
- 5.14 It is proposed to introduce an amended version of SLC48 into all distribution licences by moving the condition to section B but due to the nature of the IDNO price led control it will be necessary to amend the condition to make it more flexible.

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<sup>9</sup> The provision of metering services by new electricity distribution network operators, Decision document, June 2004 (136/04)

## ***Implementation***

- 5.15 It is proposed to introduce three new conditions in section B of the licence which will replicate SLC34, SLC35 and SLC48. SLC48 will need to be amended as discussed to cater for the different arrangements for the IDNO price control. These conditions can then be made ineffective in section C to avoid duplication.
- 5.16 Annex 3 details the new and amended licence conditions to be applied in section B of the distribution licence.

## **6. Implementation**

- 6.1 This document contains several different work areas relating to IDNOs and this chapter details how it is intended to implement these proposals. As discussed earlier draft licence modifications are contained in the attached appendices which are provided for discussion in advance of statutory licence modifications.
- 6.2 Any comments on the draft licence modifications should be provided as detailed in chapter 1 of this document by 9 September 2005. It is proposed to consult on licence modifications during October 2005.

### ***Price control arrangements – BA1***

- 6.3 A draft of the revised licence condition is contained in Appendix 1 detailing the proposed relative price control. Due to the number of changes required this is not a change marked version of the existing BA1 conditions but is based around the existing form. It is proposed that modifications will be made to each of the extant IDNO licences to amend the existing BA1 condition with the new price control arrangement taking effect from 1 April 2006. It will be necessary to undertake individual licence modification consultations. In addition it will be necessary for DNOs to amend special condition G1 similarly to cover their out of area operation.

### ***Financial ring-fencing conditions – BA2 to BA6***

- 6.4 Drafts of the revised licence conditions are contained in Appendix 2 detailing the proposed changes to the existing conditions. This draft details the existing conditions BA2 to BA6 which have been marked up for ease of reference. To modify the licences it will be necessary to undertake an individual consultation for each licensee. It is proposed to undertake this licence modification with the changes required to BA1 detailed above and these changes will come into effect once they have been consented to by the relevant licensees.

## ***Other licence conditions***

- 6.5 It is proposed to introduce three new conditions in section B of the distribution licence which would apply to all distributors and duplicate the existing SLCs 34, and 35, and amend SLC48. In effect SLC 48 will be extended to include arrangements for IDNOs but will not change the arrangements for DNOs.
- 6.6 Appendix 3 outlines a draft of the new conditions to be introduced to section B and it is proposed that a collective licence modification for all distributors will be undertaken at the end of the summer to introduce the new conditions. The existing SLCs 34, 35 and 48 would then be made ineffective. These changes will come into effect once they have been consented to by the distributors.

# Annex 1- Draft revised standard condition BA1

## *Charging Arrangements*

### **Part A - General**

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 shall, subject to paragraph 3 and 4, set these use of system charges so that the charges shall not exceed the use of system charges set by the incumbent licensee to any equivalent domestic customers.
3. In any year, where the incumbent licensee's equivalent use of system charge for a typical domestic customer is more than 105% of its use of system charges as set on 1 April 2006, and indexed by the Retail Price Index in accordance with paragraph 5 thereafter, the licensee shall reduce the fixed or variable components of its charge relative to the incumbent licensee's charges to ensure that its use of system charges to typical domestic customers do not, except with the prior written consent of the Authority, exceed this limit.
4. In any year, where the incumbent licensee's equivalent use of system charge for a typical domestic customer is less than 95% of its use of system charges as set on 1 April 2006, and indexed by Retail Price Index in accordance with paragraph 5 thereafter, the licensee may increase the fixed or variable components of the charge relative to the incumbent licensee's charges provided that its use of system charges to typical domestic customers do not, except with the prior written consent of the Authority, exceed this limit.

### **Part B – Supplementary restrictions**

5. For the purposes of this condition:

“incumbent licensee” means the licensed distributor that has a Distribution Services Direction specifying the distribution services area within which the domestic premises connected to the licensee's system are located.

“indexed by Retail Price Index” means multiplied by the ratio of the arithmetic average of the Retail Price Index numbers, published by the Office for National Statistics each month, with respect to each of the six months July to December (both inclusive) of the preceding relevant year and the arithmetic average of the Retail Price Index numbers with respect to the same months in the relevant year commencing 1 April 2005.

- “typical domestic customer”
- i) For a domestic unrestricted customer this should be taken as 3500kWh for annual consumption;
  - ii) For a domestic restricted customer this should be taken as 3000kWh for day time or other peak time unit consumption;
  - iii) For a domestic restricted customer this should be taken as 4500kWh for night time or other off-peak annual consumption;
  - iv) For neither restricted nor unrestricted the annual consumption will be the value specified by the Authority.

6. The Authority may specify by direction, which of the use of system charges made by the incumbent licensee are relevant for the purposes of determining use of system charges to equivalent domestic customers.

### **Part C – Disapplication provisions**

7. These charging arrangements shall have effect within this licence until such time and in such circumstances as are described in paragraphs 8 to 14.
8. 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 9 or notice is given to the Authority by the licensee in accordance with either paragraph 12 or paragraph 13.
9. A disapplication request shall:
- a) be in writing addressed to the Authority;
  - b) specify the paragraph or paragraphs of this condition to which the request relates; and
  - c) state the date (being not earlier than the date specified in paragraph 11) from which the licensee wishes the Authority to agree that the conditions shall cease to have effect (the disapplication date).
10. The licensee may withdraw a disapplication request at any time.
11. Save where the Authority otherwise consents in writing, no disapplication following delivery of a disapplication request pursuant to paragraph 9 shall have effect until a date being the later of:
- a) not less than 6 months after delivery of the disapplication request; and
  - b) 31 March 2016.

12. Where the Authority has not:

- a) given notice to the licensee that it intends to make a reference to the Competition Commission under section 12 of the Act relating to the modification of this condition (or any part or parts thereof) within the later of:
  - i) three months of receiving a disapplication request, and
  - ii) before the beginning of the six-month period that ends with the disapplication date; and
- b) made such a reference within six months of giving such notice,

the licensee may give notice to the Authority terminating the application of such of the charge restriction conditions (or any part or parts thereof) as are specified in the disapplication request with effect from the disapplication date or a later date.

13. If the Competition Commission makes a report on a reference made by the Authority relating to the modification of this 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 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 condition or the part or parts thereof specified in the disapplication request with effect from the disapplication date.
14. A disapplication request or notice served under this condition may be served in respect of a specified geographic area.

## Annex 2 – Draft Standard Conditions BA2-BA6

### Standard Conditions 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) by the UK listing authority (or a successor body) 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 the equity share of the aggregate turnover of all the de minimis business carried on by ~~and~~ all its relevant associates does not in any period of twelve months commencing on 1 April of any year exceed 2.5 percent 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, carried on by the licensee and all relevant associates ~~or de-minimis businesses~~, does not at any time after the date this condition takes effect in this licence exceed 2.5 percent of the sum of share capital in issue, the share premium and the consolidated reserves (including retained earnings) of the licensee as shown by its most recently audited ~~historical cost financial statements~~ accounting statements of the licensee 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 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 as at its latest accounting reference date to have occurred prior to the ~~date this condition takes effect in this licence~~ date of 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.

less the sum of the aggregate gross amount of all income (whether of a capital or a revenue nature) howsoever received by the licensee in respect of such investment in all completed accounting reference periods since the accounting reference date referred to in paragraph 4(d)(i).

5. For the purpose of paragraph 4, "equity share", in relation to any share holding, means the nominal value of the equity shares held by the licensee in a relevant associate, as a percentage of the nominal value of the entire issued equity share capital of that relevant associate,

6. In this condition :

<p>"permitted purpose"</p>	<p>means the purpose of all or any of the following:</p> <p>the licensee's distribution business or any other business or activity within the limits of paragraph 4;</p> <p>any business or activity to which the Authority</p>
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	<p>has given its consent in writing in accordance with paragraph 3 (d); and</p> <p>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 ~~itself~~ 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 by 31 July of each year submit ~~a certificate~~ to the Authority a certificate, 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, and having taken into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the licensee, 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 available to itself 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, and having taken into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the licensee the directors of the licensee have a reasonable expectation, subject to what is ~~explained said~~ below, that the licensee will have ~~available~~ to itself, 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 available to itself 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 ~~the that~~ certificate, together with a confirmation of the availability of financial facilities.
4. The statement submitted to the authority in accordance with paragraph 3 shall be approved by a resolution of the board of directors of the licensee and must be signed by a director of the licensee pursuant to that resolution.
5. 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.
6. The licensee shall require that each certificate provided for in paragraph 2 is accompanied by a report prepared by its auditors and addressed to the Authority stating whether or not the auditors are aware of any inconsistencies between ~~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 on the most recent accounting statements of the licensee.
7. The directors of the licensee shall not declare or recommend a dividend, and ~~nor shall~~ the licensee shall not make any other form of distribution within the meaning of section 263 of the Companies Act 1985, or redeem or repurchase any share capital of the

licensee unless prior to the declaration, recommendation or making of the distribution (as the case may be) the licensee has ~~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 ~~take all appropriate steps~~ ~~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 Investor 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 issuer rating by Moody’s Investors Service Inc. or any of its subsidiaries; or
- (c) an issuer senior unsecured debt rating by Fitch Ratings Ltd or any other of its subsidiaries ;or
- (d) 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.

In relation to any issuer credit rating, “investment grade” means:

- (a) unless sub-paragraph (b) below applies:
  - (i) an issuer rating of not less than BBB- by Standard & Poor’s Ratings Group or any of its subsidiaries;
  - (ii) an issuer rating of not less than Baa3 by Moody’s Investors Service Inc. or any of its subsidiaries;
  - an issuer senior unsecured debt rating of not less than BBB- by Fitch Ratings Ltd or any of its subsidiaries; or
  - (iv) 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 both the United Kingdom and the United States of America;

(b) such higher rating as may be specified by those agencies from time to time as the lowest investment grade credit rating.

## 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 [referred to in paragraph 2](#);
    - (v) repayment of or payment of interest on a loan not prohibited by sub-paragraph (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,

provided, however, that the provisions of paragraph 5 below shall prevail in any circumstances described or referred to therein;

(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 comes into effect in this licence~~ date of 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, provided, however, that the provisions of sub-paragraphs (c) and (d) shall not prevent the licensee from giving any guarantee permitted by and compliant with the requirements of sub-paragraph (a);

2. ~~(f)~~ The payment condition referred to in paragraph 1(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:

the counter-party to the transaction has and maintains until payment is made in full an investment grade issuer credit rating, or

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.

3. Where the Authority has not permitted to alternative arrangements in accordance with paragraph 1 of BA5 (Credit Rating of the Licensee), then except with the prior consent of the Authority, the licensee shall not enter into or complete any transaction of a type referred to or described in paragraph 1(b) save in accordance with paragraph 5, if:

(a) the licensee does not hold an investment grade issuer credit rating;

- (b) where the licensee holds more than one issuer credit rating, one or more of the ratings so held is not investment grade; or
- (c) any issuer credit rating held by the licensee is BBB- by Standard & Poor's Ratings Group or Fitch Ratings Ltd or Baa3 by Moody's Investors Service, Inc. (or such higher issuer credit rating as may be specified by any of these credit rating agencies from time to time as the lowest investment grade credit rating), or is an equivalent rating from another agency that has been notified to the licensee by the Authority as of comparable standing for the purposes of standard condition BA5 (Credit Rating of the Licensee) and:
  - (i) is on review for possible downgrade; or
  - (ii) is on Credit Watch or Rating Watch with a negative designation;

or, where neither (i) nor (ii) applies:

  - (iii) the rating outlook of the licensee as specified by any credit rating agency referred to in sub-paragraph (c) which at the relevant time has assigned the lower or lowest investment grade issuer credit rating held by the licensee has been changed from stable or positive to negative.

4. Where the Authority has permitted to alternative arrangements in accordance with paragraph 1 of BA5 (Credit Rating of the Licensee), then except with the prior consent of the Authority, the licensee shall not enter into or complete any transaction of a type referred to or described in paragraph 1(b) save in accordance with paragraph 5, if the alternative arrangements permitted to by the Authority are not maintained in accordance with the conditions imposed by the Authority when giving written permission pursuant to paragraph 1 of standard condition BA5 (Credit Rating of the Licensee).

5. Where paragraph 3 or 4 applies, the licensee may not without the prior written consent of the Authority (following disclosure of all material facts) transfer, lease, license or lend any sum or sums, asset, right or benefit to any affiliate or related undertaking of the licensee as described or referred to in paragraph 1(b), otherwise than by way of:

- (a) payment properly due for any goods, services or assets in relation to commitments entered into prior to the date on which the circumstances described in paragraph 3

or 4 arise, and which are provided on an arm's length basis and on normal commercial terms;

(b) 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 where the value of the consideration due in respect of the transaction in question is payable wholly in cash and is paid in full when the transaction is entered into;

(c) repayment of, or payment of interest on, a loan not prohibited by paragraph 1(a) and which was contracted prior to the date on which the circumstances in paragraph 3 or 4 arise, provided that such payment is not made earlier than the original due date for payment in accordance with its terms; and

(d) 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, provided that the payments are not made before the date on which the amounts of tax thereby relieved would otherwise have been due.

6. 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:

that liability can arise only as the result of a default by a subsidiary of the licensee, 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 set out in standard condition BA2 (Restriction on Activity and Financial Ring Fencing).

“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.

“investment grade”

has the meaning given in paragraph 2 of standard condition BA5 (Credit Rating of the Licensee)

“issuer credit rating”

has the meaning given in paragraph 2 of standard condition BA5 ( Credit Rating of the Licensee).

## Annex 3 – New Section B licence conditions

### ***Standard Condition XX. Compulsory Acquisition of Land etc.***

1. The powers and rights conferred by or under the provisions of Schedule 3 to the Act (Compulsory Acquisition of Land etc. by Licence Holders) shall have effect in relation to the licensee to enable the licensee to carry on the activities authorised by this licence and which:
  - (a) are comprised within its distribution business; and
  - (b) are carried on within the distribution services area or necessitate the use of the licensee's distribution system, including any extension of or addition to the licensee's distribution system, whether or not connected to such system.

***Standard Condition XX. Other Powers etc.***

1. The powers and rights conferred by or under the provisions of Schedule 4 to the Act (Other Powers etc. of Licence Holders) shall have effect in relation to the licensee to enable the licensee to carry on the activities authorised by this licence and which:
  - (a) are comprised within its distribution business; and
  - (b) are carried on within the distribution services area or necessitate the use of the licensee's distribution system, including any extension of or addition to the licensee's distribution system, whether or not connected to such system.

## ***Standard Condition XX - Last Resort Supply: Payment Claims***

### **Part A – General**

1. This condition sets out the circumstances in which the licensee shall increase its use of system charges in order to compensate any authorised electricity supplier (a “claimant”) which makes a valid claim for losses that it has incurred in complying with a last resort supply direction.
2. Where the licensee receives a valid claim it shall:
  - (a) within 28 days of receiving a valid claim, increase demand use of system charges by an amount which it reasonably estimates to be appropriate to secure that the consequential increase in revenue equals the specified amount; and
  - (b) take all appropriate steps to pay to the claimant, by quarterly or monthly instalments (as specified in the claim), the specified amount during, or as soon as practicable after the end of, the relevant year.
3. If the amount paid to the claimant under sub-paragraph 2(b) is less than the specified amount, the licensee shall in the following year:
  - (a) pay to the claimant (in accordance with any directions given by the Authority) the shortfall together with 12 months’ interest thereon;
  - (b) set charges which relate to the distribution of electricity to premises during the year following the relevant year to such extent as it reasonably estimates to be appropriate to secure that the consequential increase in its revenue equals the amount of that shortfall together with 12 months’ interest thereon.
4. Where the licensee receives more than one claim for a last resort payment, this condition (other than sub-paragraph 7(a) and 7(b) shall apply separately as respects each separate claim but in so far as it results in changes to the licensee’s use of system charges it shall have the cumulative effect of such separate applications.
5. If the amount of the consequential increase mentioned in paragraph 3 exceeds the specified amount, the licensee shall, during the year following the relevant year,

decrease the charges which relate to the distribution of electricity to premises to the extent that it reasonably estimates to be necessary in order to reduce its use of system revenue for that year by an amount equal to the excess together with 12 months' interest thereon.

6. For the purposes of assessing compliance with any charge restriction condition:
  - a) any modification of the licensee's charges attributable to the licensee's compliance with this condition and any valid claim made; or
  - b) where the charge restriction condition has effect by reference to the charges levied by another licensee, any modification of that licensee's charges attributable to that licensee's compliance with this condition, shall be treated as if it had not occurred.

#### **Part B – Reporting requirements**

7. The licensee shall prepare, in respect of each year in which it increases charges in pursuance of paragraph 2 statements showing:
  - (a) the aggregate amount of its revenue derived from increases in charges in pursuance of paragraph 2;
  - (b) the aggregate amount of the decrease in its revenue resulting from decreases in charges in pursuance to paragraph 5; and
  - (c) in the case of each last resort supply payment, the aggregate payments to the claimant made in respect of the year in question (whenever those payments were made).
8. The licensee shall, within 4 months of the end of the year to which they relate, give the statements referred to in paragraph 5 to the Authority.
9. On giving the statement mentioned in paragraph 5(b) to the Authority, the licensee shall publish it in such manner as, in the reasonable opinion of the licensee, will secure adequate publicity for it.

## Part C – Supplementary provisions

10. Any question whether any estimate for the purposes of paragraph 2(a), 3(b) and 5 is a reasonable one shall be determined by the Authority.

11. The licensee shall not enter into any use of system agreement with an electricity supplier which does not permit variation of its use of system charges in pursuance of this condition.

12. The provisions of this condition shall have effect notwithstanding that the licensee has not provided the notice required by paragraph 5 of standard condition 4A (Charges for Use of System).

13. For the purposes of this condition:

“charge restriction condition”

Means any condition (including without limitation, any revenue restriction condition) of the licence which places a monetary limitation on the charges imposed for the provision of services as part of its distribution business which may be recovered by the licensee during a given period.

“last resort supply direction”

has the meaning given to them in standard conditions 29 (Supplier of Last Resort) and 29A (Supplier of Last Resort Supply Payments) of the standard conditions of the electricity supply licence.

“last resort supply payment”

has the meaning given to them in standard conditions 29 (Supplier of Last Resort) and 29A (Supplier of Last Resort Supply Payments) of the standard conditions of the electricity supply licence.

“relevant year”	means, in relation to any valid claim -
	(a) the current year where the claim was received by the licensee at least 60 days before the end of the current year; or
	(b) the next year where the claim was received by the licensee less than 60 days before the end of the current year.
“specified amount”	means the amount specified on a valid claim together with interest calculated in accordance with paragraph 14;
“valid claim”	means a claim for which a claimant has been give a consent by the Authority pursuant to standard condition 29A (Supplier of Last Resort Supply Payments) of the standard conditions of the electricity supply licence; and
“year”	means a period of 12 months beginning with 1 <sup>st</sup> April.

14. The interest referred to in paragraph 10 is simple interest for the period commencing with the date on which the valid claim was received by the licensee and ending with the date which is 61 days before the start of the relevant year, except where that period is of 30 days or less, in which case no interest shall be payable.