

25 January 2008

**BY EMAIL ONLY**

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Our ref            LR/MRC

Dear Sirs

## **ELECTRICITY DISTRIBUTION LICENCE REVIEW (“EDLR”)**

### ***Introduction***

We write on behalf of Independent Power Networks Limited (“IPNL”), which is an electricity distributor licensed under Section 6 of the Electricity Act 1989.

Please take this letter as IPNL’s response to the Ofgem consultation document *Electricity Distribution Licence Review: Proposals* (25 October 2007), and accept our thanks for allowing us the opportunity to reply today rather than by the original consultation deadline.

### ***Summary***

IPNL supports the aim of improving “*the clarity and ease of use of the licence without making substantive changes to the obligations placed on licensees*”. The licence is a public document and should be readily accessible both in terms of location (for example, on the internet) and drafting.

The majority of the Authority’s proposals achieve this aim. There are, however, some significant substantive changes in the licence.

IPNL believes that substantive changes should not be introduced during what is ostensibly a review of the licence drafting. This is particularly the case where the change places an extra burden on the licensee or removes one of the licensee’s fundamental rights or protections.

Although it is arguable that distributors have all had the opportunity to engage in the process, we gather that participation has been very limited – most likely because the EDLR was expressed to be a review of the drafting only. We expect that there would have been greater participation if it were known that substantive changes would be pursued.

## **Response**

### Amended Licence Conditions

Ofgem held a public workshop on the EDLR on 29 November 2007. We were unable to attend and sent you an email on the day expressing Independent Power Networks Limited's ("IPNL") concern that Amended Licence Conditions ("ALC"s) applicable to individual distributors should remain eligible for modification only with that distributor's consent. Nicholas Rubin telephoned on 10 December 2007 to explore IPNL's concerns in more detail and confirmed that the requirement for individual consents to ALC modifications would be removed as part of the EDLR.

### *IPNL's concerns*

In summary, IPNL's concerns relate to modification of the "BA" conditions in its distribution licence without its consent. The BA conditions contain IPNL's fundamental rights, comprising IPNL's price control, finance and resource restrictions, ultimate controller arrangements and credit rating requirements.

We do not believe that the applicable law allows the Authority to remove the requirement for individual consent without amendment of the statute.

Additionally, despite the contrary description in the licence, we do not believe that the BA conditions are standard conditions amenable to the collective licence modification procedure under Section 11A of the Electricity Act 1989 (as amended) ("the 1989 Act") but can only be modified with the licensee's consent under Section 11 or following a reference to the Competition Commission under Section 12.

### *What is a Standard Licence Condition ("SLC")?*

Section 33 of the Utilities Act 2000 provides that "*[s]uch conditions as may be determined by the Secretary of State before the commencement of subsection (3)<sup>1</sup>, ... shall be standard conditions for the purposes of licences of that type, subject to any modifications of the standard conditions for the purposes of licences of that type*" (emphasis supplied).

The wording of Section 33 is clear that SLCs are "standard" to licences of a type. The clear implication is that in order to be an SLC, the condition must be a condition applicable to each and every licence of a particular type and must have been designated as such by the Secretary of State under Section 33 of the Utilities Act, or be a modified version of a designated condition. Such modifications are made Part I of the 1989 Act.

The procedure set out in Section 11A of the 1989 Act is commonly referred to as the collective modification procedure.<sup>2</sup> Section 11A enables the standard conditions of all licences of a particular type (for example, distribution licences) to be amended simultaneously, presumably so the conditions remain "standard" to each type of licence.

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<sup>1</sup> 1 October 2001 subject to transitional provisions that have now expired.

<sup>2</sup> Section 11A sits in Part I of the Act.

Section 8A of the 1989 Act also sits within Part I, but has a different function. It allows for modifications specific to a particular licence – as opposed to uniform changes to all licences of a particular type - to be made at the time the licence is granted. In our view, modified versions of SLCs introduced under Section 8A are therefore a distinct species of condition requiring different treatment under the 1989 Act.

#### *Section 8A of the 1989 Act*

Section 8A (1) of the 1989 Act automatically incorporates SLCs into every distribution licence granted under the 1989 Act, subject to Section 8A (2). Section 8A (2) provides that upon granting a distribution licence the Authority may modify the SLCs in their application to the recipient of the individual licence.

As a matter of common sense, the fact that the Section caters for discrete modifications to individual licences suggests that changes effected under it do not take effect as “Standard” Licence Conditions. This is reflected in Section 8A (7).

Section 8A (7) provides that where part of an SLC is modified under Section 8A (2) the unmodified portion of the Condition shall continue to be treated as an SLC.

By clear implication, therefore, the part of the SLC modified under Section 8A (2) is no longer an SLC, and where an entire condition is introduced under Section 8A that whole condition must be regarded as something other than an SLC.

Our understanding is that the BA conditions of IPNL’s distribution licence were introduced under Section 8A of the 1989 Act. To our knowledge the Authority possesses no other power to deviate from the SLCs upon licence grant.

#### *Amended Licence Conditions (“ALCs”)*

An SLC (or part of an SLC) modified upon licence grant under Section 8A is therefore, for want of a better term, an “Amended” Licence Condition. We note that these conditions are erroneously referred to as “Standard” Licence Conditions in the IPNL distribution licence but believe this cannot be the case in light of the relevant law.

We believe this misunderstanding has arisen because each “IDNO” licence has been granted with an identical scheme of modifications made under Section 8A. This does not, however, mean that the modified conditions are “Standard” conditions. The BA conditions, for example, are not standard across the whole range of licences of the particular type specified in Section 6(1) of the 1989 Act (distribution licences). A quite different approach has been used for the incumbent DNOs.

Because of the way in which ALCs are introduced (ie. by way of individual modification upon grant under Section 8A) we believe the only way that they can be lawfully amended is by individual modification. Post-grant, this takes place under Section 11 of the 1989 Act<sup>3</sup>.

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<sup>3</sup> Or under Section 12, following a reference to the Competition Commission.

### *Section 11 of the 1989 Act*

Section 11 (1) enables the Authority to make amendments to a particular licence subject to certain substantive and procedural conditions. The opening wording of Section 11 (1A) provides that no modification may be made “*unless the licence holder has consented to the modifications*”.

### *Conclusions on Amended Licence Conditions*

We conclude that removal of the requirement for individual consent can only be achieved through amendment of the 1989 Act. Any attempt by the Authority to remove the need for consent in the absence of such amendment would be *ultra vires*.

The ALCs comprising the BA conditions impact directly upon the business of individual distributors. The 1989 Act recognises the significance of this impact and therefore mandates that ALCs applying specifically to individual distributors may only be amended with the licensee’s consent. Even apart from the legal obligation, IPNL strongly believes that this approach should be preserved given the commercial impact of the BA conditions and any amendments to them.

IPNL therefore believes that an appropriate solution would be for certain of the BA conditions – those most central to the distribution business – to become Special Conditions in the new licence and be subject to a need for individual consent under the Act. IPNL believes that this would be appropriate in respect of Conditions BA1, BA5 and BA6.

In terms of implementation, IPNL is content with the proposed re-drafts of these conditions aside from the unjustified introduction of 31 March 2011 discussed immediately below.

### Timescales for disapplication of equivalent to Condition BA1 – Proposed Condition 34.10 (b)

IPNL strongly objects to the unjustified designation of 31 March 2011 as the earliest date by which a disapplication request could take effect under the new licence.

The current date of 31 March 2007 has passed. This means that any successful disapplication request could currently take effect 18 months after the disapplication request. The introduction of 31 March 2011 means that if a request was granted today, it would not take effect for 3 years.

The Authority must explain the basis for this change, which is a significant substantive departure from the current position. Alterations to the fundamental rights of regulated entities must be consulted upon in an appropriate level of detail and not introduced under cover of a “drafting change”.

IPNL therefore believes that the *status quo* should be preserved unless this matter is consulted on separately and in detail.

#### Weakening of the prohibition on discrimination – Proposed Condition 4

The EDLR proposals regarding the consolidation and redrafting of the various prohibitions on discrimination weaken those prohibitions. Ofgem expressly acknowledged this in the consultation document.

In Ofgem's words, the prohibition is "*slightly reduced*". IPNL considers even a slight weakening of this obligation to be of serious concern but in any event does not consider this reduction to be "*slight*". In IPNL's view, Ofgem's "*slightly reduced*" drafting introduces a safe haven for businesses seeking to restrict, distort or prevent competition or strengthen their dominant positions.

Under Ofgem's proposals a distributor may freely engage in anti-competitive behaviour so long as it can demonstrate that out of a range of possible courses of action it took the route least likely to have an anti-competitive effect. The proposals ignore the fact that where an anti-competitive consequence has actually arisen, that consequence will impact not only upon competitors but consumers.

Sections 2 and 18 of the Competition Act 1998, Articles 81 and 82 of the EC Treaty and the case law flowing from each are clear that when considering the effect of a particular behaviour in order to determine whether it is anti-competitive, the intentions of the relevant undertakings are irrelevant. What is key is the effect of the behaviour on the market.

The Authority is obliged to interpret and apply the Competition Act in this way when acting in its capacity as a competition authority. We would therefore appreciate Ofgem's explanation as to how its proposed approach to licence enforcement squares with its concurrent competition jurisdiction.

Whatever the Authority's explanation, the proposed approach appears to greatly reduce the credibility of the Authority's enforcement function. It would appear to condone what the general law regards as anti-competitive behaviour in its licence-enforcement capacity while condemning the same as a concurrent competition law enforcement authority. IPNL believes that the two positions cannot co-exist.

Moreover, the Authority is obliged under Section 3A of the Electricity Act 1989 to "*protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition*". In IPNL's view, the effect of Section 3A is that the Authority should adopt the most competitive solution wherever possible. We do not believe that the Authority's proposals are consistent with this duty and are therefore likely to be *ultra vires*.

#### Offers of terms of connection – Proposed Condition 12.3

The current drafting requires the licensee to make "*detailed provision*" about modifications required to any existing connection in any offer of connection terms under the Electricity Act 1989. This requirement has been omitted in the proposed drafting.

A lot of the recent work of the DCUSA Section 2B Working Group (currently subject to voting) has been about provisions relating to modifications of downstream networks caused by changes to upstream networks.

Currently, two proposals have been put forward: 1) that the upstream network operator should pay for such modifications except where they have been compelled by a change in the law; and 2) that the downstream network operator should pay.

If the second version is accepted and the downstream network operator obliged to pay, its ability to assess whether or not it wants the connection will be seriously prejudiced if the upstream operator chooses to take advantage of this omission and withhold information relating to upstream modifications.

This approach also has the potential to impact negatively upon competition. Without detailed provisions relating to required modifications the connecting distributor will be unable to cost its bid to a developer.

The requirement for detailed provisions about modifications required to any existing connection in any offer of connection terms under the Electricity Act 1989 should therefore be included in the re-draft.

We also note that the proposed licence obligations remove the obligation on licensees to terminate their existing CUOSAs upon designation of Section 2B of the DCUSA. We assume this is because it is contemplated Section 2B will be "live" by the time the new licence comes into force.

This raises an important issue in light of the recent consultation on the DCUSA Section 2B change proposal. The consultation asked when licensees would be able to move from CUOSAs to DCUSA and the Working Group's recommendation was that this should be dealt with bilaterally between distributors.

The current licence condition therefore needs to be amended to take this recommendation into account, assuming it is adopted by the Authority.

#### "Better" facilitation of the Relevant Objectives – Proposed Condition 13.11 and Proposed Condition 14.6

The proposed drafting seems to imply that conditional approvals of Charging Methodologies and requirements to make changes to Charging Methodologies before they will be approved need not actually facilitate the Relevant Objectives (ie. meet the standard), but only go so far as to come closer to such facilitation (ie. approach the standard more closely).

This is because both of these Proposed Conditions refer to "better" facilitation of the Relevant Objectives, rather than simply "facilitation". IPNL is concerned that this will allow inadequate Charging Methodologies – ie. those that fall below the standard - to be approved to the detriment of the market and to consumers, and that the Proposed Conditions should refer only to "facilitation" of the Relevant Objectives.

## Right to Carry out Ancillary Business – Proposed Condition 29.8

The proposed condition states that:

*“The licensee or a relevant associate may carry on Ancillary Business so long as neither of the following limitations is exceeded.”* (Emphasis supplied).

The underlined text purports to regulate the behaviour of an entity other than the licensee, although we assume from the context that this was inadvertent.

If it was deliberate, we suggest it is likely *ultra vires* as being in excess of the Authority’s jurisdiction.

We assume the Authority’s intention is to regulate the behaviour of the licensee by reference, in part, to the activities of the relevant associate. We suggest alternative drafting more likely to meet this aim below:

*“The licensee may carry on Ancillary Business so long as neither of the following limitations is exceeded with respect to the licensee or the relevant associate (as applicable)”*

For the avoidance of doubt, IPL is opposed to the current proposals on the basis that they are inappropriate and in excess of the Authority’s jurisdiction.

## Complaints procedure – Proposed Condition 10

Proposed Condition 10.9 extends the matters in relation to which complaints may be made to a distributor.

The current drafting permits complaints in respect of *“the manner in which [the licensee] conducts its Distribution Business”*. The scope of possible complaints is therefore clearly delineated by the use of *“Distribution Business”* which is a precisely defined term.

The proposed condition also permits complaints that *“relate to the distribution of electricity”*.

Because *“Distribution Business”* is a defined term, the phrase *“distribution of electricity”* must, as a matter of general legal interpretation, mean something else. Neither the consultation nor the licence is clear as to what this is, but general principles dictate that it must be wider than the current drafting. Unfortunately, the proposed drafting increases the burden still further, as it brings matters that *“relate”* to the distribution of electricity within the ambit of the Condition. Again, it is not clear from the proposals what would be regarded as *“relating to”* the *“distribution of electricity”*, which is itself an ambiguous term.

The result of these proposals is that an additional substantive burden is placed on IPNL in relation to which it has not been consulted other than during what is ostensibly a drafting-only review.

#### Information to PSR Customers – Proposed Condition 10.4

This provision places new substantive obligations on licensees by requiring them to provide specified advice and information at particular times, whereas the current obligation is one of “appropriate” information and advice to be supplied “as soon as reasonably practicable”.

The current drafting allows a distributor to take a view as to what will be appropriate to protect the interests and, indeed, wellbeing of PSR Customers, taking into account its own costs and expenses and the steps it, as an individual distributor, is able to take. Prescription of information and timing by Ofgem is likely to impose additional costs on licensees, which will be proportionately larger for smaller distributors: typically IDNOs.

IPNL does not, therefore, support this approach, and recommends that the current drafting should be left in place. It should be borne in mind that no distributor is going to seek to “short change” PSR Customers. They should, however, have a reasonable amount of control over their costs.

#### **Conclusions**

First, we would like to record our disappointment that despite the Authority’s assurances that the EDLR would not result in substantive changes to the licence, it has sought to introduce fundamental changes to the licence governance and change control mechanisms, and the protections afforded to downstream distributors. We believe this confounds the legitimate expectations of licence holders and reserve our right to pursue appropriate substantive and procedural remedies in respect of both this and any other deviations from the Authority’s intentions as stated in *Electricity Distribution Licence Review: Proposals* and other documents issued in the course of the EDLR.

Secondly, and for the reasons set out above, we do not believe that the law permits the Authority to implement the proposed new licence conditions by way of collective modification under Section 11A of the 1989 Act. These Conditions may only be amended under Section 11 of the 1989 Act. This requires the consent of the distributors concerned.

For the avoidance of doubt, IPNL will withhold its consent in respect of any attempt to treat the BA Conditions in its licence other than in accordance with this letter. IPNL will also resist – in the strongest terms - any other modification to the licence that purports to reduce substantive protections or introduce substantive burdens, contrary to the stated aims of the EDLR.

### **Next Steps**

IPNL supports the aims of the EDLR and is keen to support the process. We would be pleased to meet with you to provide whatever assistance we can in finding the best way forward for all concerned.

In the meantime, we would appreciate Ofgem's urgent response in respect of the matters raised in this letter and ask that the EDLR proposals not be implemented until the issues identified in this letter have been resolved.

Yours sincerely



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