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1 September 2008

Dear Colleague,

Changes to the licence fee cost recovery principles following the Consumers, Estate Agents and Redress Act 2007

Following the implementation of provisions contained within the Consumers, Estate Agents and Redress Act 2007 (the "CEAR Act"), changes are proposed to the Standard Licence Conditions. Ofgem is currently consulting on these changes.¹

In addition to amendments to Standard Licence Conditions, the CEAR Act will also require revisions to the licence fee cost recovery principles document. The current version was issued in December 2005.²

Changes to consumer representation

The CEAR Act resulted in changes to consumer representation.

The CEAR Act replaced the functions of energywatch with a new consumer advocacy system covering companies in all industries. energywatch will be abolished on 30 September 2008. The new two tier system will take effect from 1 October 2008.

The first tier is Consumer Direct, who will provide advice to consumers and refer them back to the company as necessary. In the case of energy companies, where the customer is

¹ **126/08** - Consultation on modification of licences and codes to reflect the abolition of energywatch and its replacement with NCC
(<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=175&refer=Markets/RetMkts/Compl/ConsRep>)
² <http://www.ofgem.gov.uk/Licensing/Work/Documents1/12424-Licence%20fee%20cost%20recovery%20principles%20December%202005.pdf>

vulnerable or is facing disconnection, Consumer Direct will escalate enquiries if appropriate to the second tier, the new National Consumer Council (NCC). Ofgem licence fee payers will be responsible for paying an element of each body's costs that relate to the energy industry. The relevant proportion of costs will be decided by the Secretary of State.

The current licence fee cost recovery principles document only permits Ofgem to recover the costs of the Gas and Electricity Consumer Council (energywatch). It is proposed to revise paragraph 2.5 of the principles document to cover the following costs:

- Closure costs of energywatch
- Set-up costs of the new National Consumer Council that relate to the energy industry
- On-going costs of the new National Consumer Council that relate to the energy industry
- On-going costs of Consumer Direct that relate to the energy industry

Responsibility for metrology functions

In addition to changes in licence conditions resulting from the CEAR Act, changes will be required once the Energy Bill that is currently passing through Parliament becomes law.

Since April 2006, most of Ofgem's statutory functions in relation to the technical aspects of gas and electricity meters have been carried out by National Weights and Measures Laboratory (NWML) under an administrative arrangement set out in a Memorandum of Understanding. This was a first stage in creating a single point of reference and expertise for measuring instruments in the UK and ensuring full alignment of UK legal metrology policies, particularly regarding consistency with the European Measuring Instruments Directive (MID). The final stage of the process is to transfer the relevant statutory responsibilities from Ofgem to NWML.

The transfer involves only those functions of Ofgem which relate to legal metrology (essentially, the accuracy of meters and ensuring long term conformance to performance requirements), NWML will not be assuming responsibility for other areas of policy relating to meters (such as the roll-out of smart meters or the rules on prepayment meters). The only change to the cost recovery principles, are that metrology services will be directly funded by licence fee payers rather than through the Ofgem budget. The effect on the licence fee is therefore neutral.

Further consultation on these changes will be undertaken once the Energy Bill receives royal assent.

Proposed changes

A copy of the proposed licence fee cost recovery principles as a result of the CEAR Act is attached at Annex [A].

Comments invited

Ofgem would welcome the views of interested parties on the issues raised in this letter by 29 September 2008. Any comments can be addressed to:

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Annex A
Licence fee cost recovery principles
(Draft)

September 2008

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1. Introduction

- 1.1 The principles covered in this document set out the arrangements for making payments to the Gas and Electricity Markets Authority ('the Authority').
- 1.2 Under the Standard Licence Condition (SLC) entitled 'Payments by Licensee to the Authority' (SLC 3 in gas transportation licences, SLC A4 in electricity transmission licences and SLC 5 in electricity distribution licences), the amount to be paid annually by the licensee is a 'relevant proportion' of the amounts specified in paragraphs 2(a)–2(h) of the gas transportation and electricity transmission SLCs, paragraphs 5.1(a)–5.1(h) of the gas distribution SLC; and an adjustment by reference to the actual costs of the previous year in paragraph 2(i) of the gas transportation and electricity transmission SLCs, and paragraph 5.1(i) of the gas distribution SLC.
- 1.3 The 'relevant proportion' is defined as 'the proportion of the costs attributable to the licensee in accordance with principles determined by the Authority for the purposes of this condition generally (after consultation with the licensee and others likely to be affected by the application of those principles) and notified to the licensee or, in relation to the costs of the Competition Commission, in accordance with any direction given by the Competition Commission under section 177(3) of the Energy Act 2004 or, in the absence of such direction, in accordance with such principles'. This document sets out the principles determined by the Authority for the purpose of calculating the 'relevant proportion' in relation to the three types of licence referred to in paragraph 1.2 above.
- 1.4 The principles will be kept under review in the light of any material changes in circumstances, including in particular any modifications made to the 'Payments by Licensee to the Authority' SLCs or where there has been a significant change in ownership of a licensed gas or electricity network.

Ofgem would expect to consult licensees before making any changes to the principles.

2. The principles

Purpose

- 2.1 These principles set out the arrangements for making payments to the Authority. They also cover the recovery of the costs that the Competition Commission incurs in relation to licence modification references to it concerning gas or electricity licensees.

Legal status

- 2.2 These principles constitute the principles for the purpose of the 'Payments by Licensee to the Authority' or 'Payments to the Authority' SLCs and explain how the Authority will calculate the total amount payable under the 'Payments by Licensee to the Authority' or 'Payments to the Authority' SLCs for each licence holder that has this SLC included in its licence. They will apply for the year 2008-09 and subsequent years until changed after consulting licensees.

The principles

- 2.3 All of the costs that will be recovered by Ofgem, excluding Competition Commission costs relating to licence modification references where a direction is issued under section 177(3) of the Energy Act 2004 (once the Secretary of State has made the necessary licence changes), will be recovered from the network businesses that hold the following types of licence:
- gas transportation;
 - electricity transmission licences where the licensee has been issued a Section C (system operator standard conditions) Direction which is still in effect; and
 - electricity distribution.

- 2.4 For a licence modification reference, where the Competition Commission issues a direction under section 177(3) of the Energy Act, Ofgem will recover the previous year's costs of that reference from licence holders as directed. All types of licences could potentially be included not just the three listed in paragraph 2.3.
- 2.5 The costs that will be recovered by Ofgem through the 'Payments by Licensee to the Authority' SLCs on the basis of the formulae in paragraphs 2.8 and 2.9 comprise in relation to a relevant year the estimate of:
- Ofgem's costs being the net of:
 - All Ofgem's own costs, calculated in accordance with Ofgem's RPI-X cost control regime (as described in Appendix 1) rather than what Ofgem actually expects to spend and less Ofgem's exceptional costs (see paragraph 2.6) and less Ofgem's own costs that will be recovered by means other than through the use of the 'Payments by Licensee to the Authority' SLCs; and
 - All Ofgem's own income. For the purposes of these principles Ofgem's own income excludes the income recovered through the 'Payments by Licensee to the Authority' SLCs;
 - the appropriate proportion of the expenses of the National Consumer Council (NCC) including expenses relating to its establishment;
 - the appropriate proportion of the expenses of the Secretary of State which relate to the establishment of the NCC;
 - any expenses of the NCC, the Secretary of State or energywatch which relate to a transfer scheme made in respect of energywatch under the Utilities Act 2000 or the CEAR Act;
 - the expenses of the Secretary of State which relate to the abolition of energywatch;

- the expenses of the Office of Fair Trading (OFT) which relate to the expansion of Consumer Direct to enable it to cater for gas and electricity consumers; and
- the appropriate proportion of expenses of the OFT on, or in connection with, the support of Consumer Direct.
- the previous year's Competition Commission costs in connection with references made to it with respect to the licence or any other licence where it does not give directions as to how the costs should be recovered; and
- any adjustment as calculated under Ofgem's RPI-X regime.

An example of Ofgem's own costs that will be recovered by means other than through the use of the 'Payments by Licensee to the Authority' SLCs are costs incurred on behalf of other government departments.

- 2.6 In any year where the Authority needs to recover exceptional costs the method for recovering these costs will either be disclosed in the corporate plan for that year, or if this is not possible, in a separate statement. Exceptional costs comprise significant costs that in the opinion of the Authority cannot be divided between gas and electricity licence holders by reference to the formulas in paragraph 2.8 and 2.9 without unreasonably penalising either gas or electricity customers.
- 2.7 The method for determining the number of gas and electricity customers is defined in Appendix 2. All the types of licence holder identified in paragraph 2.3 will be required to make formal returns, showing the number of customers on 30 September of the preceding year, to the Authority by 1 May in each year. It is this number which is used in the following calculations.

2.8 The costs that will be recovered by Ofgem as defined in paragraph 2.5 will be recovered from the gas licence holders holding the type of licence identified in paragraph 2.3 based on the following proportion:

$$\frac{\text{Total gas customers}}{\text{Total gas customers plus total electricity customers}}$$

2.9 The costs that will be recovered by Ofgem as defined in paragraph 2.5 will be recovered from the electricity licence holders holding the types of licence identified in paragraph 2.3 based on the following proportion:

$$\frac{\text{Total electricity customers}}{\text{Total gas customers plus total electricity customers}}$$

2.10 For gas licence holders, half of the amount recoverable will be allocated to the National Transmission System (NTS) and half of the amount recoverable will be allocated to licensed gas transportation networks that are not the NTS. For the purposes of this document the NTS is that part of the system for the time being designated by National Grid Gas plc.

2.11 The amount payable by National Grid Gas plc in its role as the owner of the NTS will be half of the total charge to gas transportation licence holders.

2.12 The amount payable by a gas transportation licence holder in its role as owner of a licensed gas transportation network that is not the NTS will be determined by the proportion of:

$$\frac{\text{Number of gas customers that are directly connected to any licensed gas transportation network of the licence holder that is not the NTS}}{\text{Total gas customers plus total electricity customers}}$$

to
Total number of gas customers

2.13 For electricity licence holders, one half of the amount recoverable will be allocated between the holders of an electricity transmission licence that has a Section C (system operator standard conditions) Direction in effect in its licence (at present this is only the National Grid Electricity Transmission plc who will therefore pay the whole of the transmission portion) and one half of the amount recoverable will be allocated between electricity distribution licence holders¹.

2.14 The amount payable by each holder of an electricity distribution licence will be determined by the proportion of:

Number of electricity customers that are directly connected to any
licensed electricity distribution network of that electricity
distribution licence holder
to
Total number of electricity customers

2.15 For price control purposes, the licence fee is treated as a pass through cost.

2.16 Under BETTA, Ofgem amended the special conditions of each of the transmission licensees to allow recovery of the licence fee from the system operator rather than all transmission licensees. For transmission owners Ofgem retained the licence fee component in the price control but set it at zero from BETTA go-live. For the GB system operator, the licence fee component of its price control was increased to allow recovery of the total electricity transmission element of the licence fee. On 22 February 2005

¹ Were more than one Transmission licensee to have Section C of the transmission SLCs in effect in their licenses, further changes would be required to the principles to consider the allocation of the Licence fee cost recovery principles
Office of Gas and Electricity Markets

Ofgem issued notices to the three transmission licensees in accordance with section 11 of the Electricity Act 1989 which included these proposals.

- 2.17 The Department for Business Energy and Regulatory Reform (BERR) used the powers set out in the Energy Act 2004 to amend the licence conditions for electricity generation, electricity transmission, electricity distribution, electricity supply, gas shipping, gas transportation and gas supply to allow for the Competition Commission's power to direct Ofgem as to how the costs of the licence modification reference should be recovered.
- 2.18 A reconciliation between the final version of the corporate plan for the relevant year, the funding voted by Parliament for the relevant year and the total sum being recovered for the relevant year through the 'Payments by Licensee to the Authority' SLCs will accompany the invoices.
- 2.19 Ofgem will also attach to the invoices a reconciliation of adjustments as calculated under Ofgem's RPI-X regime between the corporate plan for the preceding relevant year, the licence fees recovered for the preceding relevant year through the 'Payments by Licensee to the Authority' SLCs and the costs for the preceding relevant year calculated in accordance with paragraph 2.5 of this document.
- 2.20 The minimum licence fee payable will be £500 a year. Where the amount due under the formula set out above is less than this it will be rounded up to £500.

Appendix 1 Cost control regime (RPI-X) guidelines and procedures

Introduction

Following the resource review conducted in early 2004 by the Chief Executive and Chief Operating Officer, Ofgem announced that it would impose a cost control regime (RPI-X) on itself for a period of 5 years commencing from April 2005. It was further announced that the Audit Committee of the Authority had considered and determined "X" to be set at 3 per cent.

The purpose of this appendix is to set out the guidelines under which RPI-X operates.

Allowable Costs

There are some costs that Ofgem incurs over which it has little control. These include work undertaken on behalf of other government departments. While some costs are recovered from other departments we are not always able to recover all costs. It is proposed that all such work would be excluded from the regime and should be awarded cost pass through. Such costs include:

Legislation

Work relating to existing and new legislation or European Directives that is not part of Ofgem's core responsibility.

In 2008-09 the relevant costs would include work for BERR, DEFRA and HMRC on Renewables, CHP and FFL totalling £2,100k (£700k of which is recovered from HM Treasury).

Depreciation

While Ofgem's capital programme itself is funded directly by HM Treasury and not licence fee payers it is nevertheless felt that capital should form part of the cost control regime. However, it is proposed that the depreciation charge,

which is recovered from licence fee payers should not form part of the cost control regime since the cost of depreciation results directly from the capital programme. (ie management control can be imposed on capital expenditure but not depreciation).

In 2008-09 the capital programme is estimated at £1,000k and the depreciation charge is expected to be £850k.

Redundancy

The focus of RPI-X is intended to be on cost rather than headcount. However, if, as a result of the cost control regime, Ofgem is obliged to undertake a major redundancy programme in order to reduce staff numbers, the resultant costs could, particularly in year 1 of such a programme, be excessive before savings were made. Resultant costs are, of course, dependent on the numbers of staff to be made redundant and, under the terms of our redundancy arrangements, the length of service and salary of the individual concerned.

It is not anticipated that large scale redundancies will be required. However, should Ofgem wish to engage in a major redundancy programme, it will estimate the relevant costs and the initial year 1 cost will be excluded from the regime.

Chiene & Tait, providers of Ofgem's internal audit service, audit the estimate of costs and report to the Audit Committee who make a decision on cost pass through.

Year End Flexibility (also known as Teem & Lade)

Ofgem estimates its annual costs to be recovered through licence fees, based on the RPI-X cost control calculation rather than what we actually expect to spend.

Any underspends (anticipated or unplanned) are used to offset an overspend in subsequent years without affecting the reducing profile of the licence fee.

Any outstanding underspend would be returned to licence fee payers. The principles to apply for year 6 of the RPI-X regime and thereafter will be consulted upon in year 5.

This process allows some flexibility in dealing with unplanned expenditure while providing a transparent downward projected licence fee and will be subject to a ceiling of £3m, ie. the total underspend carryover will not be more than £3m at any one time during the five year period. Any "licence fee underspend" in excess of £3m is returned to licence fee payers immediately in the following year in the normal way. Any "licence fee underspend" carryover up to and including £3m will be subject to Audit Committee review and approval each year.

In the event that Ofgem is required to utilise the carryover in-year to deal with unplanned expenditure, Ofgem has to present a case for an increase in resources to HM Treasury.

Major Unexpected Projects

The nature of some of the projects undertaken by Ofgem in relation to the size of the budget can be quite significant. For example, in 2007-08, the cost of a judicial review amounted to 3.7% of the non-payroll administration costs for the year. A delay to a high cost project or an unexpected major new project could therefore have major implications to the budget and the cost control regime.

It is anticipated that unexpected, high cost projects will crop up over the 5 year cost regime period. With "teem and lade" Ofgem should be able to accommodate some unexpected costs. However, this may not always necessarily be the case.

If, exceptionally, Ofgem has to seek additional funding from HM Treasury to undertake a major unplanned piece of work then a similar funding allowance needs to be considered under the cost control regime.

In such circumstances Ofgem will present a case for additional funding to the Audit Committee who will, after consulting Chiene & Tait, make a decision on whether to allow an upward adjustment to the cost control regime. If HM Treasury approve an upward adjustment to the cost control regime, we will then inform licensees that this amount will be recovered. Any underspend available from previous years will be applied first to offset any additional licence fees. Whilst we would aim to give licensees advance notification of such an event, this may not always be possible.

Major unexpected costs may fall into the category of either normal running costs, such as payroll or contractor costs, or exceptional costs, where in the opinion of the Authority the cost cannot be divided between gas and electricity licence holders by reference to the formulas as detailed in the principles section, paragraph 2.8 and 2.9.

Setting "X"

The process was independently overseen by the Audit Committee chaired by Sir Keith Stuart, supported by Chiene and Tait. The Audit Committee have determined that the cost control regime should be set at RPI-3 per cent.

Costs falling within RPI-X cost control regime

For 2007-08 the net cost to licence fee payers for Ofgem, as set out in the proposed Corporate Strategy and Plan published in January 2007, was £35.624m. Using the guidelines detailed above, the calculation was as follows:

	<u>£'000</u>
Prior Year Ofgem Budget 2006/07	33,938
RPI (4.4% as at December 2006)	1,494
Less "X" (3%)	(1,063)
RPI-X Budget Ceiling	
34,369	
<i>Costs to be met by Licence fee payers that are excluded from the cost control regime:</i>	
Other Government Departments recovery	(750)
Capital	(700)
<i>Costs included in the cost control regime that are funded elsewhere:</i>	
Work for Other Government Departments	1,855
Depreciation	850
2007/08 OFGEM NET COST TO LICENCE FEE PAYERS	35,624

Relevant details concerning licence fee calculations for future years will be set out in that year's Corporate Strategy.

Monitoring

At the end of each financial year, Ofgem produces a report for the Audit Committee setting out progress in relation to "X" and detailing any proposed carryover as part of the year end flexibility arrangements. Chiene & Tait will undertake an audit of the analysis and report to the Audit Committee. The Audit Committee reviews the report, decides on an appropriate year end carryover (if any) and reports on progress to the Authority.

Transparency

During the five year period, Ofgem will ensure that progress in achieving RPI-3 per cent and details of any under or overspend is fully transparent to licence fee payers.

Information will be provided in the following ways:

- **Corporate Strategy and Plan**
As one of Ofgem's main themes, reporting progress on improving efficiency and effectiveness will be essential. A full breakdown of costs together with any under or overspend will be provided;
- **Annual accounts**
Ofgem's resource accounts will detail within the Operating and Financial Review section the under or overspend outstanding at the financial year end; and
- **Licence fee request**
As part of the supporting information provided to licence fee payers, full details of any under or overspend which is agreed by the Audit Committee to be carried over will be provided. Reconciliations between the corporate plan, funding provided by Parliament, and the licence fee will also be provided.

Appendix 2 Definition of gas and electricity customers

The same basis for defining gas customers applies to all gas transportation licence holders for the purposes of this document.

A gas customer is:

Any premises supplied directly from a licensed gas transportation network, where metering equipment is used for the purpose of calculating charges for gas consumption. Customers should be identified from Meter Point Reference Numbers (MPRNs), such that individual customers are identified at each connection point.

The total number of gas customers is defined as the total number of customers directly connected to the licence holder's licensed gas transportation network as at 30 September each year.

Only one (individual) customer should be identified at each connection point. This means aggregating multiple MPRNs which arise due to the type of "tariff" (or equivalent) and/or metering arrangements but are associated with a single connection point (i.e. MPRNs in respect of additional concurrent meters should be ignored).

In some cases (e.g. flats) the connection point may be from the licensed gas transportation system to pipes owned by a landlord or a facilities manager. In such cases, individual customers supplied by such pipes are classed as customers of the licensed gas transportation system where they are identifiable from MPRNs.

Source:

The above definition of gas customers has been developed from the document 'Gas Distribution Quality of Service Regulatory Instructions and Guidance Version 4, Ofgem, August 2008'.

The same basis for defining electricity customers applies to all electricity transmission and electricity distribution licence holders for the purposes of this document.

An electricity customer is:

Any energised or de-energised entry or exit point to the licensed electricity distribution system, where metering equipment is used for the purpose of calculating charges for electricity consumption. Customers should be identified from Metering Point Administration Numbers (MPANs), such that individual customers are identified at each connection point.

The total number of electricity customers is defined as the total number of customers directly connected to the licence holder's licensed electricity distribution network as at 30 September each year.

Only one (individual) customer should be identified at each connection point. This means aggregating multiple MPANs which arise due to the type of "tariff" (or equivalent) and/or metering arrangements but are associated with a single connection point (i.e. MPANs in respect of additional concurrent meters should be ignored).

In some cases (e.g. flats) the connection point may be from the licensed electricity distribution system to wiring owned by a landlord or a facilities manager. In such cases, individual customers supplied by such wiring are classed as customers of the licensed distribution system where they are identifiable from MPANs.

Source:

The above definition of electricity customers has been developed from the document 'Information and Incentives Project Regulatory Instructions and Guidance version 5, Ofgem, March 2005'. This document provides the instructions and guidance for electricity distribution SLC 49 'Incentive Scheme and Associated Information'.

Appendix 3 Allocation of licence fees to licence holders

Appendix 3 shows an illustrative allocation to each licence holder of the licence fee percentage payable.

Allocation of licence fees to licence holders

Licence holders	Illustrative Customer numbers	Allocation of licence fees (%)
Electricity distribution		
EDF Energy Networks (EPN)Plc	1,000,000	1.5625
Central Networks East plc	1,000,000	1.5625
EDF Energy Networks (LPN) Plc	1,000,000	1.5625
SP Manweb plc	1,000,000	1.5625
Central Networks West Plc	1,000,000	1.5625
Northern Electric Distribution Limited	1,000,000	1.5625
United Utilities Electricity Plc	1,000,000	1.5625
EDF Energy Networks (SPN) Plc	1,000,000	1.5625
Scottish Hydro Electric Power Distribution Ltd	1,000,000	1.5625
Southern Electric Power Distribution plc	1,000,000	1.5625
SP Distribution Limited	1,000,000	1.5625
Western Power Distribution (South Wales) plc	1,000,000	1.5625
Western Power Distribution (South West) plc	1,000,000	1.5625
Yorkshire Electricity Distribution plc	1,000,000	1.5625
Energetics Electricity Ltd	1,000,000	1.5625
Independent Power Networks Ltd	1,000,000	1.5625
Laing O'Rourke Energy Ltd	1,000,000	1.5625
Total	17,000,000	
Electricity Transmission		
National Grid Electricity Transmission plc (50%)	17,000,000	26.5625
Total Electricity	34,000,000	

Licence holders	Illustrative Customer numbers	Allocation of licence fees (%)
Gas transportation networks (excluding the NTS)		
ESP Connections Ltd	1,000,000	1.5625
Quadrant Pipelines Limited	1,000,000	1.5625
ES Pipelines Limited	1,000,000	1.5625
GTC Pipelines Limited	1,000,000	1.5625
Independent Pipelines Limited	1,000,000	1.5625
SSE Pipelines Limited	1,000,000	1.5625
The Gas Transportation Company Limited	1,000,000	1.5625
ESP Networks Limited	1,000,000	1.5625
ESP Pipelines Limited	1,000,000	1.5625
National Grid Gas plc	1,000,000	1.5625
- North West Dist Network (250,000 customers)		
- West Midlands Dist Network (250,000 customers)		
- London Dist Network (250,000 customers)		
- East of England Dist Network (250,000 customers)		
Southern Gas Networks Limited	1,000,000	1.5625
Northern Gas Dist Network Limited	1,000,000	1.5625
Wales & West Utilities Limited	1,000,000	1.5625
Scotland Gas Networks plc	1,000,000	1.5625
Energetics Gas Ltd	1,000,000	1.5625
Total	15,000,000	
Gas Transmission		
National Grid Gas plc (NTS) (50%)	15,000,000	23.4375
Total Gas	30,000,000	
Total Gas and Electricity	64,000,000	100.000