

**Licence fee cost recovery principles**

April 201314

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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 and SLC A4 in electricity transmission licences) and SLC 5 'Licensee's payments to the Authority' in the 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(g) of the gas transportation and electricity transmission SLCs, paragraphs 5.1(a) -5.1(g) of the electricity distribution SLC; and an adjustment by reference to the actual costs of the previous year in paragraph 2(h) of the gas transportation and electricity transmission SLCs, and paragraph 5.1(h) of the electricity 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. 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.

### ***Legal status***

- 2.2. These principles constitute the principles for the purpose of the 'Payments by Licensee to the Authority' or 'Licensee's payments to the Authority' SLCs and explain how the Authority will calculate the total amount payable under these –SLCs for each licence holder that has this SLC included in its licence. They will apply for the financial year 2013-14 and subsequent years until changed after consulting licensees.

### ***The principles***

- 2.3. All of the costs that will be recovered by Ofgem 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 with a Section C (system operator standard conditions) Direction which is still in effect; and
  - electricity distribution.
- 2.4. The costs that will be recovered by Ofgem through the 'Payments by Licensee to the Authority' or 'Licensee's payments to the

Authority' SLCs on the basis of the formulas in paragraphs 2.7 and 2.8 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' or 'Licensee's payments 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' or 'Licensee's payments to the Authority' SLCs;
- ~~• the appropriate proportion<sup>1</sup> of the expenses of the National Consumer Council (NCC), including expenses relating to its establishment;~~
- ~~• the appropriate proportion<sup>1</sup> 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 the Gas and Electricity Consumer Council (energywatch) which relate to a transfer scheme made in respect of energywatch under

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<sup>1</sup> The appropriate proportion is those costs in respect of the gas and electricity industries as directed by the Secretary of State.

the Utilities Act 2000 or the Consumers, Estate Agents and Redress (CEAR) Act 2007;

- the appropriate proportion of the expenses of Citizens Advice or Citizens Advice Scotland which relate to a transfer scheme made in respect of the National Consumer Council under section 23 of the Public Bodies Act 2011;
- the expenses of the Secretary of State which relate to the abolition of energywatch;
- the appropriate proportion of the expenses of the Secretary of State which relate to the abolition of the National Consumer Council and the transfer of functions to Citizens Advice and Citizens Advice Scotland;
- the appropriate proportion of the expenses of the Secretary of State which relate to the transfer of functions and the conferring of functions on Citizens Advice and Citizens Advice Scotland by the Public Bodies (Abolition of the National Consumer Council and Transfer of the Office of Fair Trading's Functions in relation to Estate Agents etc) Order 2014 (S.I. 2014/...);
- the appropriate proportion of the expenses of the Secretary of State which relate to a transfer scheme made in respect of the National Consumer Council under section 23 of the Public Bodies Act 2011;
- the relevant proportion<sup>1</sup> of the expenses of the Citizens Advice or Citizens Advice Scotland on, or in connection with, the support of any qualifying public consumer advice service;
- the expenses of the Secretary of State and the National Measurement Office (NMO) which relate to statutory metrology services; 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' or 'Licensee's payments to the Authority' SLCs are costs incurred on behalf of other government departments.

- 2.5. 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 paragraphs 2.7 and 2.8 without unreasonably penalising either gas or electricity customers.
- 2.6. 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.
- 2.7. The costs that will be recovered by Ofgem as defined in paragraph 2.4 will be recovered from the gas licence holders holding the type of licence identified in paragraph 2.2 based on the following proportion:

Total gas customers
to



Total gas customers plus total electricity customers

- 2.8. The costs that will be recovered by Ofgem as defined in paragraph 2.4 will be recovered from the electricity licence holders holding the types of licence identified in paragraph 2.2 based on the following proportion:

Total electricity customers  
to  
Total gas customers plus total electricity customers

- 2.9. 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 as such and described in National Grid Gas plc's Ten Year Statement.

- 2.10. 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.

- 2.11. 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:

Number of gas customers that are directly connected  
to any licensed gas transportation network of the  
licence holder that is not the NTS  
to

Total number of gas customers
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2.12. 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 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 holders.<sup>2</sup>

2.13. 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
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2.14. For price control purposes, the licence fee is treated as a pass through cost.

2.15. 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

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<sup>2</sup> 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 transmission portion between these parties.

element of the licence fee. On 22 February 2005 Ofgem issued notices to the three transmission licensees in accordance with section 11 of the Electricity Act 1989 which included these proposals.

- 2.16. 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' or 'Licensee's payments to the Authority' SLCs will accompany invoices for licence fees.
- 2.17. 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' or 'Licensee's payments to the Authority' SLCs and the costs for the preceding relevant year calculated in accordance with paragraph 2.4 of this document.
- 2.18. 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 the summer 2009 by the Chief Executive and Chief Operating Officer, Ofgem announced that it would continue to impose a cost control regime (RPI-X) on itself for a further period of 5 years commencing from April 2010. 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 document is to set out the guidelines under which RPI-X operates for the period 1 April 2010 to 31 March 2015.

### **What costs are included?**

All Ofgem's administration costs will be included in the cost control regime.

Over time, Ofgem's work may increase or decrease due to new legislation or work undertaken on behalf of other government departments. While some costs are recovered from the respective department we are not always able to recover all costs. It is proposed that all such work would be included in the regime with a corresponding change to the cost regime baseline. Such costs include:

#### **Legislation**

Work arising from new legislation or European Directives that is part of Ofgem's core responsibility and will be included in the licence fee.

In 2009-10 (the baseline), relevant costs would include new duties arising from the Energy Act 2008 for future consumers such as RPI-X@20 and Discovery projects (the majority of which is recovered from licence fees).

#### **Work undertaken on behalf of other government departments**

Work relating to existing and new legislation or European Directives that is not part of Ofgem's core responsibility and may be included in the licence fee.

In 2009-10 (the baseline), relevant costs would include work on smart meter rollout administration, CESP, feed in tariff and Heat (the majority of which is recovered from sources other than licence fees).

### **Redundancy**

The focus of RPI-X is intended to be on cost rather than headcount. However, if, as a result of a significant organisational review, 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 individuals 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.

Deloitte, 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 Reserves (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 it actually expects to spend.

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

Any outstanding savings at the end of the five-year regime 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 £5m, ie. the total reserve carryover will not be more than £5m at any one time during the five-year period. Any "licence fee saving" in excess of £5m will be returned to licence fee payers, immediately in the following year

in the normal way. Any "licence fee saving" carryover up to and including £5m 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 for 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, Ofgem will then inform licensees that this amount will be recovered. Any reserves available from previous years will be applied first to offset any additional licence fees. Whilst Ofgem 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 administration 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, paragraphs 2.8 and 2.9.

### **Setting "X"**

## Appendix 9

The process was independently overseen by the Audit Committee, supported by Internal Audit. The Audit Committee has determined that the cost control regime should be set at RPI-3 per cent.

**Costs falling within RPI-X cost control regime**

For 2010-11 (as at September 2009) the net cost to licence fee payers for Ofgem will be £37.682 million. Using the RPI-X cost control guidelines, the calculation is as follows:

<b>Ofgem Budget 2010-11</b>	<b>49,002</b>
2010-11 New activities	18,913
RPI (1.0% as at December 2009 assumed)	679
<b>Baseline + RPI</b>	<b>68,594</b>
Less "X" (3%)	(2,058)

<b>2010-11 RPI-X Budget Ceiling</b>	<b>66,536</b>
<b><i>Less 2010-11 planned income:</i></b>	
Offshore Tender team	(5,242)
Environmental schemes	(1,954)
New environmental schemes	(17,213)
Accommodation recharge	(3,660)
Renewable Obligation/CHP	(700)
FFL/NIRO	(85)

<b>OFGEM NET COST TO LICENCE FEE PAYERS 2010-11</b>	<b>37,682</b>
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**2009-10 YEAR END CARRY FORWARD**

Refundable saving from 2009-10	xxx
Carry forward	x,xxx

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:

A customer means any person to whose premises or pipe-line system gas has been conveyed by a Gas Distribution Network. Customers should be identified from their unique Supply Meter Point Reference Number (MPRN) or connected system exit point (CSEP) location. The method adopted by GDNs to identify customers from their MPRNs or CSEPs shall be agreed in advance with the Gas and Electricity Markets Authority (the "Authority").

### Source:

The above definition of gas customers has been extracted from version 5 of the QoS RIGs.

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 (e.g. import/export meters) but are associated with a single connection point (i.e. MPANs in respect of additional concurrent meters should not be counted).

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 'Electricity Distribution Price Control Network Asset Data and Performance Reporting RIGs: Version 3'. This document provides the instructions and guidance for electricity distribution Standard Licence Condition 45 'Incentive scheme for quality of service'.

## 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 (%)
<b>Electricity distribution</b>		
Electricity Distributor 1	1,000,000	1.5625
Electricity Distributor 2	1,000,000	1.5625
Electricity Distributor 3	1,000,000	1.5625
Electricity Distributor 4	1,000,000	1.5625
Electricity Distributor 5	1,000,000	1.5625
Electricity Distributor 6	1,000,000	1.5625
Electricity Distributor 7	1,000,000	1.5625
Electricity Distributor 8	1,000,000	1.5625
Electricity Distributor 9	1,000,000	1.5625
Electricity Distributor 10	1,000,000	1.5625
Electricity Distributor 11	1,000,000	1.5625
Electricity Distributor 12	1,000,000	1.5625
Electricity Distributor 13	1,000,000	1.5625
Electricity Distributor 14	1,000,000	1.5625
Electricity Distributor 15	1,000,000	1.5625
Electricity Distributor 16	1,000,000	1.5625
Electricity Distributor 17	1,000,000	1.5625
<b>Total</b>	<b>17,000,000</b>	<b>26.5625</b>
<b>Electricity Transmission</b>		
National Grid Electricity Transmission plc (50%)	17,000,000	26.5625
<b>Total Electricity</b>	<b>34,000,000</b>	
<b>Licence holders</b>	<b>Illustrative Customer numbers</b>	<b>Allocation of licence fees (%)</b>
<b>Gas transportation networks (excluding the NTS)</b>		
Gas Transporter 1	1,000,000	1.5625
Gas Transporter 2	1,000,000	1.5625
Gas Transporter 3	1,000,000	1.5625
Gas Transporter 4	1,000,000	1.5625
Gas Transporter 5	1,000,000	1.5625
Gas Transporter 6	1,000,000	1.5625
Gas Transporter 7	1,000,000	1.5625

## Appendix 9

Gas Transporter 8	1,000,000	1.5625
Gas Transporter 9	1,000,000	1.5625
Gas Transporter 10	1,000,000	1.5625
Gas Transporter 11	1,000,000	1.5625
Gas Transporter 12	1,000,000	1.5625
Gas Transporter 13	1,000,000	1.5625
Gas Transporter 14	1,000,000	1.5625
Gas Transporter 15	1,000,000	1.5625
<b>Total</b>	<b>15,000,000</b>	<b>23.4375</b>
<b>Gas Transmission</b>		
National Grid Gas plc (NTS) (50%)	15,000,000	23.4375
<b>Total Gas</b>	<b>30,000,000</b>	
<b>Total Gas and Electricity</b>	<b>64,000,000</b>	<b>100.000</b>

