

Guidance

Draft Guidance: Prohibition on Generating Guidance (POGG)

Publication date: 28 September 2018

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Overview:

This draft guidance provides detail on Electricity Distribution standard licence conditions 31D, relevant for independent distribution network operators (IDNOs) and standard licence condition 43B, relevant for distribution network operators (DNOs) of the electricity distribution licence. It describes in detail the circumstances in which ownership and operation of generation may be permissible for relevant Electricity Distributors (hereafter referred to as 'licensees') and the criteria against which applications for a direction will be assessed. It further describes the process and procedures in place for the assessment and the granting of a direction.

This guidance is for electricity distribution licensees and all parties interested in the provision of electricity storage services.

We are consulting on this draft guidance as part of the statutory consultation on the new licence conditions to which it applies. Should you have any comments on this guidance, please respond by 27 October 2018.

After considering your views on this guidance, we will issue our final guidance document alongside our final decision on the licence changes. We expect this final guidance to take effect the day after issuing directions to modify the relevant licences.

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1. Introduction

Section summary

This chapter sets out our rationale for standard licence conditions 31D (for IDNOs) and 43B (for DNOs) (hereafter 'the new licence conditions') in the Electricity Distribution Licence. We describe the actual, or potential, conflicts of interest that may arise where Electricity Distributors ('licensees') own and operate generation assets. The new license conditions are intended to minimise the risk of such conflicts arising and facilitate the development of flexibility services in the electricity market.

Purpose of document

1.1 This document clarifies the terminology used and the application of the policy referred to across standard licence conditions (SLC) 31D and 43B in relation to prohibiting licensees from operating generation assets.

Rationale for Condition 31D and 43B

The benefits of electricity storage

1.2. Electricity storage can be a valuable source to provide flexibility services for network operators, offering an alternative solution to avoid or defer the need for traditional reinforcement or to support cheaper and faster network connections. Storage facilities can also be used to provide balancing services, and other ancillary services to the system operator.

1.3. By removing barriers to technologies like storage, we can enable more participants to provide flexibility services in managing the system. This will help deliver cost savings and security of supply for the current and future system by creating greater competition in the provision of flexibility services.

Conflicts of interest

1.4. Where competitive activities are carried out by monopoly network operators, there is the potential for competition to be distorted, for new market entrants to be deterred, and for investment in distribution networks to be affected. We believe the market for storage technology-based services is such an area.

1.5. Potential conflicts arise because distribution licensees control the physical infrastructure needed to trade energy and flexibility services. The provision of such competitive services, where provided by a licensee in an area of their network operations, has the potential to distort the market in two ways. Firstly, the licensee operating a generation asset to provide flexibility services may make use of its monopoly position in combination with access to lower cost of capital to compete against market participants, potentially undercutting them on price and thereby distorting competition. Secondly, licensees may have the ability to restrict the activities of market participants by denying (or impeding) their network access and preventing them from offering flexibility services in the first place.

Regardless, any perception by market players who are considering investing in a generation asset that licensees operating a similar asset are in a position to potentially distort competition has the potential to negatively impact the development of a market for these competitive services.

1.6. Licensees' incentives to invest efficiently in the network can also be affected, if decisions are driven by shorter-term market signals, rather than longer-term investment signals. There can also be circumstances where the licensee has information about current and future flexibility service needs across its network not available to the wider market, which might give it an undue advantage in competitive activities. It is important that these risks are managed.

1.7. In the case of network-owned and operated storage, distortions or foreclosure have the potential to affect not just the uptake of storage by third party providers, but also the uptake of other forms of flexibility – such as DSR or flexible generators – that provide the same or similar services in the same markets. GB has a competitive market for aggregation of flexibility services that has the potential to deliver significant benefits to GB consumers by facilitating wider provision of flexibility services.

1.8. Our view is that over time – as the role of licensees continues to evolve and the potential for conflicts of interests increases – there will be a need for the unbundling regime to be strengthened to include separate ownership of assets with generation capability. This view is consistent with the direction of European rules on storage ownership laid out in the Clean Energy for all Europeans package¹.

Ensuring operational unbundling of all generation assets

1.9. The licence changes make it clear that licensees must not engage in generation – including storage – of electricity, unless an exception applies. The prohibition extends to assets that are licence exempt.

1.10. SLC 31D for IDNOs and SLC 43B for DNOs in the Electricity Distribution Licence aim to ensure that licensees apply effective operational unbundling to all generation assets which they may own, including licence exempt generation such as storage. The new condition will apply to the operation of any unlicensed generation (including assets with less than 50MW of capacity). This guarantees that protections are in place to minimise the risk of conflicts of interest. These proposals intend to give deeper effect to the unbundling requirements for distribution system operators set out at Article 26 of the Electricity Directive.²

1.11. Chapter 2 of this document contains detail on the allowed exceptions. Chapter 3 contains detail of the criteria for a direction issued by the Authority (Category C exception) that would give effect to an exception and Chapter 4 contains detail on the process for requesting a direction issued by the Authority. We are also clear that location of the assets relative to the licensee's network operation should be considered when applying for a direction. This may be particularly relevant to Independent Distribution Network Operators (IDNOs) that, within their structures, also own small generation facilities (such as CHP) as part of heat networks. In our view, the degree of geographical proximity of assets under

¹ The Commission's proposals can be found in their entirety [here](#).

² The EU Electricity Directive can be found [here](#).

ownership and operational control of the licensee to the licensees' network operation is an important factor to consider:

- Where generation assets are located close to the licensees' network operation, there is a greater risk of a conflict of interest existing. In such circumstances, the Authority may only issue a direction where the applicant can demonstrate how potential conflicts of interests are to be managed.
- In circumstances where a lesser degree of geographical proximity is present, and in circumstances where the generation asset may be located outside of the area of network operation of the licensee, the potential for conflicts of interest is significantly lower and there may be a clearer case for a direction. For the avoidance of doubt, we would not expect licensees (DNOs) to seek ownership and/or operational control over generation assets in other licensee's areas.

A note on innovation

1.12. Our view is that this policy does not stand in the way of future innovation in the distribution sector. When considering future innovation projects, stakeholders should account for the policy direction set out in SLC 31D/43B and this guidance. As clarified in 1.5, we believe any actual or potential conflicts of interest which may arise where licensees own and operate generation assets must be avoided. The same principle applies for innovation projects. We think there is limited insight to be gained from innovation projects where the business models or structures are not reflective of the emerging policy landscape.

1.13. Processes currently exist which allow licensees to apply for project specific derogations where this may be required. Guidance³ is available from our website outlining the application process as well as how we assess any such application for derogation.

Your feedback

1.14. Alongside the publication of this draft guidance, we are undertaking the statutory consultation for the relevant licences to which this guidance relates. We are keen to receive your comments on this guidance. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this guidance?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Any further comments?

Please send any general feedback comments by 27 October 2018 to Chiara Redaelli:
flexibility@ofgem.gov.uk

³ https://www.ofgem.gov.uk/sites/default/files/docs/2009/01/090119derogationsguidance_0.pdf

2. Prohibition on Generating by a Licensee pursuant to SLC 31D.1/43B.1

Section summary

This chapter provides detail on the circumstances when a licensee is prohibited from generating electricity and the exception categories set out in the new licence conditions.

2.1. The prohibition on generating by licensees pursuant to SLC 31D.1 for IDNOs and SLC 43B.1 for DNOs applies to circumstances where generation assets which are owned by a licensee are also operated by the same legal person. Should these licence conditions be implemented, we propose they will take effect as of 1st April 2019.

2.2. Where a licensee has put in place arrangements to eliminate the conflicts of interest described in paragraph 1.5 through business separation measures, they may use one of the exemptions specified in SLC 31D for IDNOs and SLC 43B for DNOs.

2.3. The licensee should satisfy himself that his arrangements meet any obligations under EU and GB legislation to legally separate the operation of generation assets, where required.

2.4. Specifically, this relates to licensees meeting requirements set out in their licence under SLC 31B-31C for IDNOs, and SLC 42-43 for DNOs, which covers aspects such as information flows, independent decision-making, independent directors, restrictions on access to premises, systems, equipment or service between the licensee and the asset operator, and requirements for a compliance officer and the publication of a compliance statement. Illustrative examples of such arrangements are provided below:

- 2.4.1. Where a licensee has a contractual relationship with an independent third party for the provision of services from an asset, where that asset is neither owned nor operated by the licensee or any of its affiliates – there are no conflicts of interests that would give rise for the need to apply business separation measures.
- 2.4.2. Where a licensee enters into a contract with an independent third party to operate a generation asset and where this involves installing automation equipment or equipment that receives instruction signals from the licensee, this does not make the licensee an operator within the construct of this licence condition. In this scenario, the operator has the final decision-making power. For the avoidance of doubt, operational control does not only mean the physical operation (eg the sending of a control signal to an asset) but refers to the legal right to decision-making about when and how the asset operates.
- 2.4.3. Where a licensee or an affiliate owns a generation asset, requirements for legal separation (as per SLCs 42 and 43 (for DNOs) and 31B-31D (for IDNOs) need to be met to ensure that the party legally responsible for the operation of the asset is sufficiently separated from the licensee to ensure that its decision-making is independent.

Exception Categories

2.5. In certain circumstances it may be in the interest of consumers for the licensee to operate storage in a manner that would otherwise be prohibited by the licence conditions. The new licence conditions provide for three exceptions to the general prohibition.

2.6. Pursuant to SLC 31D.1 for IDNOs and SLC 43B.1 for DNOs, a licensee may operate generation assets where these are covered by automatic exceptions (Category A: Island-based networks and Category B: Generation for specific authorised activities) or a direction has been issued by the Authority (as per Category C: Generation pursuant to a direction by the Authority).

Category A: Island-based networks

2.7. Pursuant to SLC 31D.1(a)/43B.1(a), a licensee can operate generation assets as part of island-based electricity systems without the requirement to seek a direction under Category C: Generation pursuant to a direction by the Authority). This applies to any generation asset, or facility containing a generation asset, connected to its respective electricity system for the technical specification and application(s) present at the time the licence conditions to which this guidance relates to came into force (the effective date).

2.8. A Category A exception is non-transferable. Where a relevant asset is replaced by another asset of similar technical specification and/or application, the asset loses its Category A exception.

2.9. For the avoidance of doubt, permitted activities include routine maintenance activities, and/or replacement, and/or addition of assets or components, which aim to ensure such assets, or the facility of which they are a part, meet their projected lifetime.

2.10. The replacement and/or addition of assets forming part of a facility is considered appropriate where such action is taken to safeguard the facility's purpose of providing security of supply to its respective island location whilst being mindful of the remaining lifetime of the facility as a whole (as determined at the point of commissioning).

2.11. For purposes of this document and licence conditions 31D and 43B, we define island networks as electrical systems which serve physical islands within the jurisdiction of Ofgem, other than mainland Britain. For the avoidance of doubt, this does not refer to electrically islanded systems, commonly known as micro grids.

Category B: Generation for specific authorised activities

2.12. Pursuant to SLC 31D.1(b)/43B.1(b), we recognise that there are certain small-scale applications of licensee-operated generation that help to ensure the safe and reliable operation of the network, and which we consider to be within the normal business activity of the licensee.

2.13. These are:

- 2.13.1. UPS – Uninterruptible Power Supply
These are devices used at substations and other licensee sites to ensure that critical equipment remains energised in the event of a system outage, thereby allowing the licensee to safely manage its systems. These devices do not export electricity to the grid, nor provide any services to the network and are necessary for the safe, efficient and reliable operation of the licensees' networks.
- 2.13.2. ER – Emergency Response
These are devices with generation capability connected to the licensee's network by the licensee for the sole purpose of ensuring continuity of supply in specific outage situations (such as faults or maintenance outages).
- 2.13.3. Energy management at licensee-owned sites
These are devices with generation capability with the sole purpose to generate or conserve electricity produced at licensee sites for later consumption at that same site. Such generation must be designed to match on-site demand, but shall not, at any point in time, be exported to the grid or be used to provide flexibility services for the grid.

2.14. For the avoidance of doubt, this shall not prevent licensees from operating assets behind the meter which have the sole purpose of minimising their business' carbon footprint and are not used to derive revenue by providing flexibility services. Such measures may also include investments in electric vehicle fleets or small-scale carbon-neutral generation where the sole purpose of such assets is to supply the licensees' premises and such assets are not used to provide electricity or flexibility services. As laid out in 1.5, there are conflicts of interest where a licensee operates generation assets in network areas under their operational control. Therefore, no such activity by licensees in markets for grid support services is permissible.

Category C: Generation pursuant to a direction by the Authority

2.15. The Authority may issue a direction (known as a Category C exception) under 31D.2 or 43B.2, where it considers the licensee to have satisfied certain criteria. Such a direction may be attached with certain conditions it considers appropriate. More detail on such conditions is provided in paragraph 5.4.

2.16. Pursuant to SLC 31D.1(c)/43B.1(c), the licensee would need to apply for a direction from the Authority where it generates electricity, including through an asset, and neither a Category A nor a Category B exception applies. Applications for a direction would be assessed against criteria set out in licence condition 31D/43B and are described in greater detail in chapter 3.

3. Applications for a direction under Category C

Section summary

This chapter provides additional detail on the three criteria which are applicable to a Category C exception. For each criterion, this chapter outlines the minimum requirements we would expect licensees to demonstrate they have met as part of their application for a direction under 31D.2 or 43B.2.

3.1. For the avoidance of doubt, a licensee must not operate an asset as per paragraph 4.1 unless the Authority issues a direction to this effect. There is no provision for implicit consent.

Criteria for applications for a direction by the Authority

3.2. Applications made for a direction under 31D.2 or 43B.2 will be assessed against each of the three criteria set out below.

Criterion 1: Taken reasonable steps to obtain a market-based solution (SLC 31D.2(a)/43B.2(a))

3.3. The licensee seeking a direction has to demonstrate that it has taken reasonable steps to obtain a competitive market-based solution at an efficient cost.

3.4. The licensee would be expected to first signal its flexibility service needs ahead of running a formal procurement process. This may be done, for example, by publishing network information which communicates the current and future flexibility service needs across the licensee's network in a clear and accessible manner to potential market parties.

3.5. When procuring for flexibility services, at a minimum the licensee must demonstrate it has followed an open, transparent, and reasonable procurement engagement. This includes, but shall not be limited to, making use of appropriate communication channels to advertise any procurement for flexibility services, providing clear timescales and sufficient timeframes for market parties to respond to such procurement.

3.6. As appropriate, we would expect any such procurement to:

3.6.1. Ensure the licensee publishes the technical specifications and other relevant design parameters (security of supply standards, environmental compliance standards, etc.);

3.6.2. Ensure any relevant requirements which are essential for potential providers to propose valid bids are communicated and structured in such a way as to attract as wide as possible a range of potential providers, ensure they have a reasonable opportunity to review and, where necessary, clarify them, and develop a proposal.

3.7. Further, the licensee should ensure their procurement process:

3.7.1. allows participants, or a consortium of participants, to propose multiple solutions in their bid or multiple bids with different scope; and

3.7.2. offers a degree of flexibility which allows potential providers to set out alternative means in which they may meet the requirements specified by the licensee; and

3.7.3. is set-up in a technology-neutral way, allowing bidders to propose new and innovative technologies to meet the flexibility service requirements as laid out in the technical specifications; and

3.7.4. makes use of a clear and transparent evaluation methodology for proposals; and

3.7.5. compares economic efficiency of bids to traditional solutions (such as network reinforcement) for which the licensee must justify their rationale for developing the base case for a particular site, the choice and use of assets, as well as the value associated with their business case.

Criterion 2: Justified that a licensee-operated asset provides the most economic and efficient solution (SLC 31D.2(b)/43B.2(b))

3.8. The licensee seeking a direction has to demonstrate to the Authority that a range of possible solutions have been considered with costs and benefits of each clearly identified and assessed.

3.9. The licensee's assessment must demonstrate that licensee-operated generation provides clear net benefits over other alternatives (including traditional and innovative licensee-led options). Such assessment should analyse both short and long term system impacts. Licensees would further need to demonstrate why net benefits could only be achieved through a licensee-operated asset as opposed to through third party operation.

3.10. For the avoidance of doubt, licensees should note that a market failure would not automatically warrant their operation of a generation asset. To satisfy this criterion, a licensee should be able to demonstrate that they have reviewed a range of options.

Criterion 3: Put in place arrangements that minimise the risk of discrimination or distortion of current and future markets (SLC 31D.2(c)/43B.2(c))

3.11. The Licensee seeking a direction from the Authority is expected to put in place enduring arrangements, in the absence of legal unbundling, which ensure the risks of discrimination or distortion are managed effectively by the licensee. Such measures should be proportional to the degree of potential market distortion and must be demonstrated as part of the licensee's application for a direction.

4. Process for requesting a direction under SLC 31D.2 or 43B.2

Section summary

This chapter provides licensees with information on the time it may take for an application for a direction under 31D.2 or 43B.2 to be reviewed by Ofgem. This chapter also contains further detail on the information applicants are expected to provide and what impact there may be on processing timelines where an application does not meet these expectations.

4.1. In accordance with SLC 31D.2 for IDNOs and SLC 43B.2 for DNOs, the Authority may issue a direction under which a licensee may directly operate a generation asset without putting in place the business separation rules set out in SLC 31B-31C for IDNOs and SLC 42-43 for DNOs.

4.2. The relevant licensee shall submit their request for a direction to the Authority. This request shall contain at a minimum the information identified in paragraph 4.8 and must be in writing.

Timelines

4.3. Where the request for a direction is submitted by the relevant licensee, within two weeks of receiving a request for assessment direction, we will endeavour to confirm with the licensee whether the information provided with the request is complete by assessing the request in accordance with the criteria outlined in chapter 3 and provide an indicative timetable for processing the request. We expect applications to be complete at the time of initial submission. If we consider that the request is incomplete, then the licensee shall submit the required additional information to us within one month of receiving the request for additional information. If no additional information is received within that timeframe, the request for a direction shall be deemed to have been withdrawn.

4.4. We will normally make a decision within six months of receiving a request for a direction. Where we have requested additional information to be submitted by the applying party because we deemed the initial submission to be incomplete, the six-month period commences from the day after the licensee has submitted the additional information. At the point of us determining a request is complete (as per 4.3), we shall provide the applying licensee with a provisional timetable to process their request for a direction.

4.5. Our six-month time frame for making a decision may be extended by up to three months where we request further information from the applying party seeking a direction or from any other interested and/or affected party in relation to the application for a direction. The three-month extension period runs from when we receive the requested information. The party seeking a direction shall provide any additional information that we request within two months of receiving the request. If the party seeking a direction fails to do so within that time limit, the request shall be deemed to have been withdrawn.

4.6. When considering the request, we may choose to consult with stakeholders to understand the potential implications of issuing a direction. Any such consultation period does not count towards the six-month frame limit for making a decision as specified in paragraph 4.5.

4.7. For the avoidance of doubt, the reference to decisions made within the six-month time frame at paragraph 4.4 is indicative only. Failure by the Authority to make a decision on the application for a direction within this timeframe of receipt has no effect on the status of the application.

Minimum requirements of the request

4.8. The request should include as a minimum all of the following:

4.8.1. Details of the applicant, including the full name, address and contact information for the licensee seeking a direction;

4.8.2. A clear description of the asset for which a direction is requested, including the location of the asset, the technical specifications of the asset, the technical (or relevant commercial) applications the asset will be used for;

4.8.3. A clear description of activities undertaken and conclusions as per Criterion 1: Taken reasonable steps to obtain a market-based solution;

4.8.4. A comprehensive quantitative assessment, to satisfy Criterion 2: Justified that a licensee-operated asset provides the most economic and efficient solution ;

4.8.5. A clear description of actions planned and already undertaken by the applicant to Criterion 3: Put in place arrangements that minimise the risk of discrimination or distortion of current and future markets (SLC 31D.2(c)/43B.2(c)).

4.9. Licensees seeking a direction are advised to give as much notice as possible when making requests since a direction will not be granted unless we are satisfied that the request meets all of the criteria set out in SLC 31D.2 for IDNOs or 43B.2 for DNOs.

4.10. All technical terms should be fully explained, and the request should be presented in as clear a manner as possible to avoid unnecessary delays in our assessment of the request.

5. Our Role under Category C: Generation pursuant to a direction by the Authority

Section summary

This chapter clarifies the Authority's role and the associated decision-making process related to any applications made for a direction under SLC 31D.2 for IDNOs or 43B.2 for DNOs.

Our Assessment

5.1. Each request for a direction is assessed by us individually, on its merits, and against the criteria outlined in chapter 3.

Procedure

5.2. We may consult with the party making the request initially to clarify points relating to the request for a direction in order to satisfy ourselves that there is a need for a direction under SLC 31D.2 for IDNOs or 43B.2 for DNOs.

5.3. As part of our consideration of the request, we may consult with other parties we consider necessary to ensure that the issuing of a direction does not have any unintended consequences.

5.4. When issuing a direction, the Authority may attach conditions to the direction that it considers appropriate. Such conditions may include (noting that this list is not exhaustive and illustrative only):

5.4.1. Time limits after which the licensee would have to reapply for a direction (max five years);

5.4.2. Requirements to put in place additional, yet proportionate, monitoring or reporting procedures; and

5.4.3. Requirements to put in place additional, yet proportionate, measures to manage potential conflicts of interest.

Direction Assessment Criteria

5.5. The criteria we use to assess applications for a direction are described in chapter 3.

Our decision

- 5.6. If we consider that the request for a direction meets the criteria set out at SLC 31D.2 for IDNOs or 43B.2 for DNOs, then we will issue a direction to the applicant allowing operation of a generation asset on their network.
- 5.7. If we consider that the request for a direction has not been sufficiently justified, then we will refuse the request.
- 5.8. Where we refuse a request for a direction, we will provide an explanation to the applying party as to why we have refused the application.
- 5.9. We may revoke a direction if any of the circumstances underpinning the original application no longer apply.
- 5.10. Our decision is final and there is no appeal process set up under this licence. Applicants should note that our refusal of an application does not prevent them from reapplying at a later date, nor does it prevent them from seeking a judicial review.

6. Transparency for market participants on licensee-operated generation

Section summary

This chapter describes our expectation that licensees should be proactive and provide information on assets held under this licence condition to facilitate visibility for markets. In addition, this chapter lays out what information will be published by ourselves on any asset granted a direction under SLC 31D.2 for IDNOs or 43B.2 for DNOs.

Ensuring transparency and visibility of assets

6.1. We believe it is in the interest of market parties and licensees alike that information is available in the public domain about generation assets operated by licensees under SLC 31D for IDNOs, and 43B for DNOs.

6.2. To support market transparency, licensees should recognise the importance of proactively publishing information on generation assets operated by them under the provisions outlined above. In addition to any voluntary reporting undertaken by licensees, we will maintain a register of all directions that we have issued and refused under SLC 31D.2 for IDNOs or 43B.2 for DNOs. This register will contain:

- a) The location of the asset (where the asset is of a mobile nature this should be stated and no further locational information shall be made available);
- b) The basic technical specifications of the asset (installed capacity in MW, energy generation in MWh, voltage, etc.);
- c) The technical applications the asset is used for (as per the application for a direction);
- d) Relevant operational information (at a minimum: energy consumed and energy generated in MWh, and time periods for different operational status of the asset);
- e) The date of commissioning of the asset, and indicative date for decommissioning.