

Dear Colleague

Decision on proposed changes to the Ofgem licence fee principles document

On 30 June 2016, we issued an open letter on proposed changes to the Ofgem licence fee principles document (**the 'LFPD'**). That open letter followed Ofgem replacing its RPI-x cost control regime with a five year framework.¹

The consultation period ended on 28 July 2016. We reviewed all responses and updated the Licence fee principles document accordingly. The final version of the document is enclosed as an annex to this letter.

Summary of responses

1. One response identified typographical errors within the draft document

Our response: We have updated the document to correct the errors.

2. One response requested that any variations to the settlement agreed with HM Treasury, such as exceptional costs, be communicated to licensees as soon as possible, with another response requesting that there be an opportunity to comment on the impact of settlement variations on the licence fee payer

Our response: Any changes to the settlement will be explicitly communicated through either the forward work programme which is consulted on in December and finalised in March, or the licence fee letters issued in July and December.

3. One response questioned whether Independent Distribution Network Operators are included within the LFPD

Our response: Independent Distribution Network Operators (IDNOs), like Distribution Network Operations (DNOs), are holders of electricity distribution licences and therefore are included within the LFPD.

¹ https://www.ofgem.gov.uk/system/files/docs/2016/06/lfpd_open_letter_0.pdf

4. One response requested the opportunity to review drafts of any reconciliation of adjustments before they are formally issued

Our response: a reconciliation of adjustments is included in the licence fee letter which is issued in June each year.

5. One response identified that the definition of an electricity customer has been developed from a document which is no longer in use

Our response: We have updated the LFPD document to include the correct link to the definition.

6. One response asked for clarity on whether a proportion of any overspends (excluding unanticipated high cost projects) would be borne by Ofgem out of future budgets

Our response: Ofgem is committed to a real-terms reduction of 15% in expenditure by 2019-20. Any overspends on projects will as far as possible be absorbed within this budget.

7. One response asserted a belief that ad hoc projects should more closely cover reform and renovation within the energy market, rather than treating wider infrastructure concerns.

Our response: We have passed this comment onto the team with responsibility for preparing the forward work programme.

Should you have any further questions on the LFPD document, please contact Gavin Jenkins at gavin.jenkins@ofgem.gov.uk.

Yours faithfully

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Licence fee cost recovery principles

April 20142016

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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 an 'appropriate proportion' of the amounts specified in paragraphs 2(a)–2(l) of the gas transportation SLC, paragraphs 3(a)–3(l) of the electricity transmission SLC, paragraphs 5.1(a)-5.1(l) of the electricity distribution SLC; and an adjustment by reference to the actual costs of the previous year in paragraph 2(m) of the gas transportation, paragraph 3(m) of the electricity transmission SLC, and paragraph 5.1(m) of the electricity distribution SLC.

1.3. The 'appropriate 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 'appropriate 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

1. Purpose

2.1. These principles set out the arrangements for making payments to the Authority.

2. 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 ~~2014-15~~ 2016-17 and subsequent years until changed after consulting licensees.

3. 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;
- any costs of the Secretary of State or the Gas and Electricity Consumer Council (energywatch) which relate to a transfer scheme made in respect of energywatch under the Utilities Act 2000 or the Consumers, Estate Agents and Redress (CEAR) Act 2007;
- the appropriate proportion[±] of the costs 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 costs of the Secretary of State which relate to the abolition of energywatch;
- the appropriate proportion of the costs 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 costs 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 costs 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 appropriate proportion of the costs of ~~the~~ Citizens Advice or Citizens Advice Scotland on, or in connection with, the support of any qualifying public consumer advice service;
- the costs 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~~ cost control framework.

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:

<p>Total gas customers</p> <p>to</p> <p>Total gas customers plus total electricity customers</p>
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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:

<p>Total electricity customers</p> <p>to</p> <p>Total gas customers plus total electricity customers</p>
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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

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~~ their 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 holders².

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

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 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 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.

2.17. Ofgem will also attach to the invoices a reconciliation of adjustments as calculated under Ofgem's ~~RPI-X~~ cost control 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.

4. Appendix 1 Cost control regime guidelines and procedures

1.1. To minimise our costs on consumers whilst maximising the impact we have, it is recognised that we have a responsibility to achieve value for money from all our activities. As part of HM Treasury's Spending Review 2015 exercise, we have agreed with government a five-year framework to take our total expenditure down from £89.5m in 2015-16 to £82.0m in 2019-20, representing a reduction in real terms of 15%.

2. What is our settlement?

2.1. Our settlement was agreed with government in December 2015 and is as follows:

SR15 Settlement		2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Expenditure (RDEL) spend							
OfGEM (exc Eserve, exc move costs)		£63.1	£61.1	£60.2	£59.2	£57.7	£57.7
Legal contingency		£2.0	£2.0	£2.0	£2.0	£2.0	£2.0
ESERVE (exc Accomodation)		£24.4	£23.6	£23.2	£22.7	£22.3	£22.3
OfGEM Move costs		£0.0	£2.0	£2.4	£0.0	£0.0	£0.0
Total Expenditure (RDEL) spend		£89.5	£88.7	£87.8	£83.9	£82.0	£82.0
Capital (CDEL) spend							
Core business as usual		£0.4	£1.1	£0.7	£0.9	£1.0	£1.0
London accommodation move		£0.6	£3.1	£11.1	£0.1	£0.0	£0.0
E-Serve accommodation move		£0.0	£1.8	£0.0	£0.0	£0.0	£0.0
Total Capital (CDEL) spend		£1.0	£6.0	£11.8	£1.0	£1.0	£1.0

3. What costs are included

3.1. All Ofgem's administration and capital costs will be included in the cost control framework.

3.2. Expenditure relating to our E-Serve division is effectively ring-fenced within our settlement in line with government plans for E-Serve to be split off. Further details are provided below.

3.3. During the period covered by the framework, we will be reviewing our accommodation requirements. Costs arising from accommodation moves will be incorporated into the settlement.

4. E-Serve arrangements

4.1. Expenditure relating to our E-Serve division is effectively ring-fenced within our settlement. The Budget 2016 included plans to streamline regulators and for E-Serve to be split off from Ofgem.

4.2. E-Serve undertakes work on behalf of other government departments (such as scheme administration for Renewable Obligation, Feed-in Tariff, Domestic and Non-Domestic Renewable Heat Incentive) and costs are recovered directly, either from the respective government departments (such as Department of Energy and Climate Change), or from the scheme itself.

4.3. E-Serve agrees with individual departments the budgetary provision for the work they undertake. Under the ring-fencing arrangements, where it is agreed that E-Serve

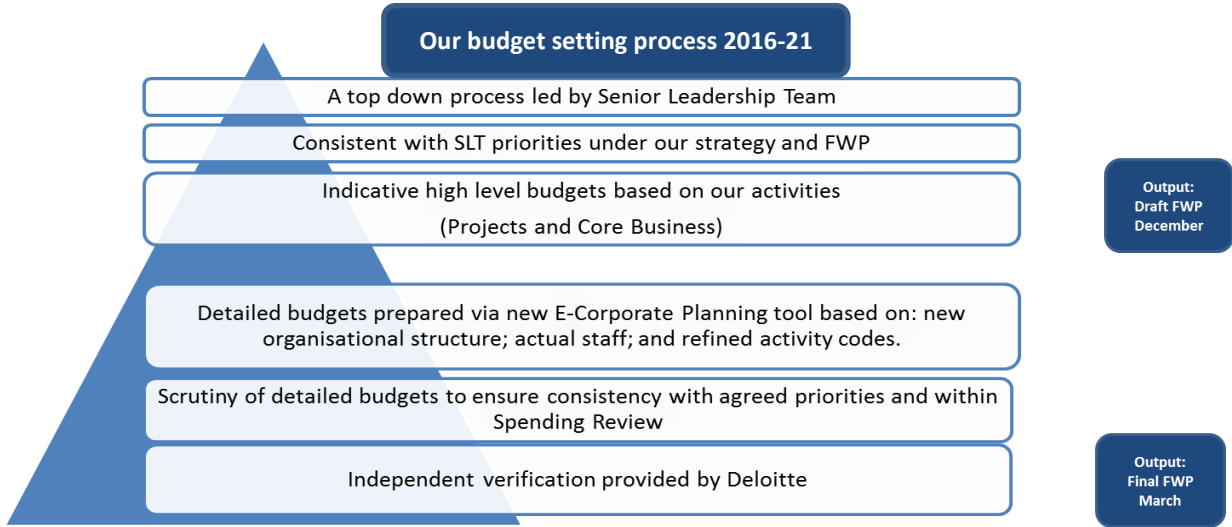
will perform significant new work, in line with government accounting rules³, a budgetary transfer will need to be arranged to fund the activity. Conversely, where E-Serve activity significantly reduces, any saving will not be allocated to other Ofgem regulatory activities.

5. Setting our budget

5.1. Our budget setting process is led by our senior leadership team. We prioritise those activities that we expect to deliver the greatest value for consumers.

5.2. Our activities are split into projects and core business. Where project expenditure is lower than planned, savings are reassessed to ensure that the correct work is commissioned in order to achieve our strategic objectives.

5.3. The process is independently overseen by our Audit and Risk Assurance Committee (ARAC), supported by Deloitte. A high-level diagram of the process is shown below:



5.4. The format to calculate our licence fee is set out in Annex 1.

³ See Managing Public Money - https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/454191/Managing_Public_Money_AA_v2_-jan15.pdf

6. Flexibility for future activities

6.1. The nature of some projects and legal cases undertaken by Ofgem can be quite significant in relation to the size of our overall budget. An unexpected major new project or a lengthy regulatory appeal could therefore have significant implications for the budget and the cost control framework.

6.2. As part of our framework we have agreed with government flexibility of up to 10% in any one year for new income not incorporated into the original Spending Review 2015 settlement as detailed in section 2.1. Flexibility arrangements are laid out in the Treasury's Consolidated Budgeting Guidance.

6.3. It is anticipated that unexpected, high-cost projects may crop up over the 5-year cost regime period. Usually we will prioritise our activities to ensure that we maximise the benefit for consumers with the available funding. If, exceptionally, Ofgem has to seek additional funding agreement from HM Treasury to undertake a major unplanned piece of work then a similar funding allowance needs to be considered under the cost control framework.

6.4. Provided HM Treasury approve an upward adjustment to the settlement detailed in section 2.1 and the activity is funded through licence fees, then we will inform licensees that this amount will be recovered. Whilst Ofgem would aim to give licensees advance notification of such an event, this may not always be possible.

6.5. 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 licence fee principles document, paragraphs 2.8 and 2.9.

7. Year-end savings or overspend

7.1. Ofgem estimates its annual costs to be recovered through licence fees, based on the cost control framework calculation rather than what it actually expects to spend.

7.2. Any licence fee saving or overspend (anticipated or unplanned) identified at year-end will be incorporated into the licence fee calculation in the following financial year. This differs from our previous RPI-X cost control regime where any saving or overspend up to £5 million could be retained as part of a reserve carryover within the overall five-year regime period.

7.3. 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.

7.4. In the case of E-Serve funding, income matches expenditure and so no year-end saving or overspend is anticipated.

7.5. The principles to apply for year 6 after the current framework finishes will be consulted upon in year 5.

8. Monitoring

8.1. At the end of each financial year, Ofgem produces a report for the ARAC Committee setting out progress in relation to our spending settlement and detailing any proposed savings or overspend as part of the year-end arrangements. Deloitte will undertake an audit of the analysis and report to the ARAC Committee. The ARAC Committee reviews progress and reports to the Authority.

9. Transparency

9.1. During the five-year period, Ofgem will ensure that progress and details of any savings or overspend **is are** fully transparent to licence fee payers. Information will be provided in the following ways:

- **Forward Work Programme**
Improving our efficiency and effectiveness for consumers is an essential element of our Forward Work Programme. A breakdown of costs together with any savings or overspend will be provided,
- **Annual Report and Accounts**
Ofgem's Annual Report and Accounts will detail the savings 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 savings or overspend which is agreed by the ARAC 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.

Annex 1 Cost control framework – Licence fee calculation template

5. The net cost to licence fee payers for Ofgem will be £xx,xxx million. Using the cost control framework, the calculation is as follows:

	£000	£000
Ofgem gross expenditure 20xx-xx ¹	xx,xxx	
Less E-Serve related income:		
• Administration of environmental schemes excluding Climate Change Levy	(xx,xxx)	
• Climate Change Levy administration ²	<u>(xxx)</u>	(xx,xxx)
Less other income:		
• Income from tenants ³	(x,xxx)	
• Offshore tenders and competition income	(x,xxx)	
• Refundable savings/overspend from prior year	<u>(x,xxx)</u>	(xx,xxx)
Ofgem net cost to licence fee payers	xx,xxx	
Add other relevant organisation costs:		
• BIS costs ⁴		xx,xxx
• NMRO costs ⁵		xx,xxx
Total cost to licence fee payers		xx,xxx

Ofgem gross costs will be shown in the Forward Work Programme.

² Administration of the CCL is publicly funded.

³ Recovery from the Department for Environment, Food and Rural Affairs in respect of 9 Millbank accommodation costs.

⁴ The Department for Business Innovation and Skills costs represent the energy-sector related costs of Citizens Advice. This is an estimate based on the prior-year budget, which will be amended in the second-tranche licence fee request.

⁵ Payments to the National Measurement and Regulation Office in respect of their statutory responsibility to undertake metrology services.

Relevant details concerning actual licence fee calculations for future years will be set out in that year's Forward Work Programme and licence fee request.

6. Appendix 2 Definition of gas and electricity customers

7. The same basis for defining gas customers applies to all gas transportation licence holders for the purposes of this document.
8. A gas customer is:
 9. *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:

10. *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.*
11. *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.*
12. *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).*
13. *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 Annex A – Glossary of the Regulatory Instructions and Guidance 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'.

14. Appendix 3 Allocation of licence fees to licence holders

15. 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		
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
Total	17,000,000	26.5625
Electricity Transmission		
National Grid Electricity Transmission plc (50%)	17,000,000	26.5625
Total Electricity	34,000,000	
Gas transportation networks (excluding the NTS)		
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
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
Total	15,000,000	23.4375
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