



Making a positive difference
for energy consumers

Electricity distribution licensees
and other interested parties

Direct Dial: 020 901 7196
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Date: 28 September 2018

Dear Sir/Madam,

Enabling the competitive deployment of storage in a flexible energy system: Changes to the electricity distribution licence

This letter sets out the steps we are taking to clarify that distribution licensees must ensure there is separation of operation of generation assets from the licensee's activities, even where such generation assets are licence exempt. This includes consulting on statutory changes to the electricity distribution licence conditions.

If implemented, these changes will add new licence conditions to the electricity distribution licence that prohibit licensees from generating electricity, which includes the operation of electricity storage assets. For the avoidance of doubt, electricity storage is defined as a form of generation whereby the electricity is converted in a form of energy that can be stored, that energy is stored and subsequently reconverted back into electricity.

A new licence condition will be added as 31D in Chapter 7, relevant for independent distribution network operators (IDNOs) and 43B in Chapter 11, relevant for distribution network operators (DNOs) to ensure that the same principles apply equally to both IDNOs and DNOs. While this will continue to allow licensees to own generation (and therefore storage) assets for now, the new conditions would ensure that licensees cannot operate such assets themselves. The operation of such assets would have to be carried out by a legally separate party.

Background

In our call for evidence, *Towards a smart, flexible energy system* – published jointly with the Government in November 2016 - we committed to ensuring the energy system works for people and businesses. A smarter and more flexible system offers significant benefits for consumers and the economy.

Ofgem has a central role in helping this to happen through effective regulation of monopolies and enabling competitive markets. Following the call for evidence, Ofgem committed in its 2017-18 forward work programme to setting out a plan of action for removing regulatory barriers to storage. We announced the specific actions in the *Smart Systems and Flexibility Plan (SSFP)* in July 2017.

The Office of Gas and Electricity Markets

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In order to ensure that a competitive market for storage and other flexibility services can develop, and to ensure compliance with EU law¹, we committed in the plan to clarifying the regulatory position on ownership and operation of storage by distribution businesses. We consulted on making changes to the electricity distribution licence to implement this in September 2017².

In the September consultation we proposed to:

- Introduce a new licence condition to the electricity distribution licence. The condition prohibits licensees from generating electricity. This ensures that operation of generation is sufficiently unbundled from distribution businesses.
- Issue a guidance document to accompany the new licence condition. The guidance would clarify when we would expect licensees to apply for an exception from the new condition, set out criteria that we would take into account when assessing applications, and describe how licensees should apply for an exception and the potential timescales for our decision.

Summary of responses and our views

We received 38 responses to our consultation from a wide spectrum of stakeholders.

There was overwhelming support for our proposals with 36 out of 38 respondents supporting our general policy direction. There was a lesser degree of support on whether we should go further than the proposals laid out in the September 2017 consultation (22 encouraging us to go further, whereas 16 opposed this).

As part of their responses, stakeholders noted three main points:

- 1) That regulatory certainty would be enhanced if greater detail of the policy's principles were moved from the guidance document into the new licence condition. Our original intent was to only provide high-level policy principles in the licence condition, with further detail in the guidance document which would sit alongside the new licence condition. In response to this stakeholder feedback, and in the context of our evolving thinking regarding this policy, we agree it would provide more clarity on the policy's intent and application if more detail were added in the new licence condition. We have provided further clarification in the guidance document. We now believe that, in combination, the new licence condition and the guidance document provide the right level of regulatory clarity, given the two documents' legal status.
- 2) That distribution businesses should not, under any circumstances, either own or operate any generation assets. A number of stakeholders felt so strongly about the requirement for separation that they reiterated the requirement that options should be explored beyond legal separation to ensure that no influence could be exerted by distribution businesses on storage operations. In response to the point made regarding distribution businesses not owning or operating generation assets, we would reiterate that the primary aim of this policy is to ensure that conflicts of interest, which arise in circumstances where distribution businesses are involved with generation, are avoided. We acknowledge, however, that there are very limited circumstances where distribution businesses may have good reason for operating generation assets, including storage assets. These circumstances are fully explained

¹In particular Article 26 of the Electricity Directive which describes legal separation from the operation of generation under the unbundling regime for DNOs. The EU Electricity Directive can be found [here](#)

²The policy consultation on storage unbundling be found [here](#)

in the next section. With regards to requiring legal separation we are satisfied that the existing legal unbundling regime as specified in European legislation³ (Article 26 of the Electricity Directive) and transposed into the UK licencing framework⁴ (condition 31 for IDNOs and conditions 42/43 for DNOs) is currently sufficient with regard to conflicts of interest arising from where the same legal entity owns and operates a generation asset (including storage assets). Our view is that over time – as the role of the DNOs continues to evolve and the potential for conflicts of interests consequently increases – there will be a need for the unbundling regime to be strengthened to include separate ownership of storage. For the time being, we do not intend to go beyond this existing framework.

- 3) That we should provide additional clarity on the definitions used to describe, in particular, the limited circumstances in which generation and/or storage asset operation may be permissible for a licensee. A number of stakeholders requested that the guidance document should call out very specific technical exceptions. We agree that further detail on the types of applications would provide greater clarity, and so confidence, for both affected licensees and interested market parties. We have included these as part of the Guidance where possible. It is important to note, however, that it is not possible to name every technical application that may be captured under the exceptions. The next section sets out our final view on this matter.

Decision

We have reviewed the consultation responses and done further work to understand the impacts of the proposed changes through stakeholder engagement. Following this, we have decided to progress work to amend the electricity distribution licence to include new licence conditions that prohibit licensees from generating electricity.

The electricity distribution licence will therefore include the following changes across Chapters 7 and 11:

Adding new definitions for

Relevant Undertaking means either a Relevant Licence Holder, or a Relevant Exemption Holder.

and

Relevant Exemption Holder means a person who:

- (a) carries out the activity specified in Section 4(1)(a) of the Act;
- (b) is authorised to do so by an exemption pursuant to Section 5 of the Act; and
- (c) is an Affiliate or a Related Undertaking of the licensee,

but does not include a person who at the relevant time benefits, and only to the extent that person so benefits, from an exception under condition 31D.1/43B.1.

Amending standard licence conditions 31A to incorporate reference to the new standard licence condition 31D (Prohibition on Generating).

³ The EU Electricity Directive can be found [here](#)

⁴ The Electricity Distribution Licence can be found [here](#)

Replacing any reference to Relevant Licence Holder with *Relevant Undertaking* across SLC 31B and 42.

Amending standard licence conditions 31C and 43 to ensure the publication of the Compliance Report under these conditions is streamlined with wider reporting requirements for licensees as specified in the Regulatory Instructions & Guidance (RIGs) document issued under standard condition 46 (Regulatory Instructions and Guidance).

Adding to the Relevant Requirements (and their equivalent in Chapter 7) to capture requirements as set out by the new standard licence conditions 31D and 43B (Prohibition on Generating by Licensee).

Inserting new standard licence conditions 31D and 43B which prohibits licensees from generating electricity. In general, where distribution businesses are currently involved in the operation of generation, including storage assets, this means they have three options to ensure compliance with the new licence conditions:

- Sell the asset;
- Transfer operation of the asset to an independent third party; or
- Transfer operation of the asset to a separate entity fully compliant with the existing legal unbundling regime.

The new conditions further set out exceptions under which licensees may own and operate generation assets. The conditions note that licensees may operate relevant assets where they have been issued a direction by us, following an asset-specific application which will be assessed against a set of criteria which aim to ensure that licensee-operated generation is a resort of last option. The conditions spell out criteria which form the basis of our assessment for any application we may receive to issue a direction.

Issuing a guidance document (Prohibition on Generating Guidance – POGG) as per Part B of the new standard licence conditions 31D and 43B which allows affected licensees and concerned stakeholders to understand:

- circumstances in which ownership and operation of generation may be permissible for licensees;
- the criteria against which applications for a direction will be assessed;
- the process and procedures in place for the assessment of an application for, and the granting of, a direction.

We note that there are currently a number of licensees who have no affiliated Relevant Licence Holders. We are further aware that a subset of these have therefore been discharged of their obligations in respect of specific licence requirements under standard licence conditions 42 and 43, such as having a compliance officer in post and issuing a compliance report to the Authority. Where this is the case, we will be advising stakeholders that it is our intention to reinstate these requirements to ensure licensees who operate generation assets are captured appropriately under requirements laid out in standard licence condition 43B.

Should these licence changes be implemented, we propose that the new licence conditions take effect on 1st April 2019, while the final guidance will take effect from the day following publication of our decision and the final guidance document. This is to allow licensees who currently own and operate generation assets sufficient time to ensure compliance with the

4 of 5

licence changes. We invite licensees and stakeholders to comment on this proposal in their responses to the statutory consultation. Should they think the proposed timeframe is not sufficient, we ask stakeholders to provide robust evidence to support their view, also taking into consideration that we set out our policy view on storage ownership earlier last year and we have extensively engaged with stakeholders over the past 12 months.

Content of the statutory consultation

The proposed statutory changes to the electricity distribution licence standard conditions will entail modifications to condition 31 and 42-43 and new standard licence conditions 31D and 43B which prohibit licensees from generating electricity.

Next steps

Alongside this letter we have published a statutory consultation notice where we propose to modify the SLCs of the Electricity Distribution Licence. We have also published guidance on the new licence condition.

We welcome comments on the proposed drafting of these modifications and on the guidance. Responses should be received by 27 October 2018. We prefer electronic copies, sent to flexibility@ofgem.gov.uk but alternatively please post them to:

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Unless marked confidential, all responses will be published on our website, www.ofgem.gov.uk. You can ask us to keep your response confidential. We will respect this request, subject to any obligations to disclose information, for example under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

If you would like your response to remain confidential please mark it clearly and restrict all confidential content to an annex. Please include the reasons for confidentiality.

After considering your views, we may issue directions to modify relevant licences. If we proceed with the modifications, we expect these to be published so that the licence changes can take effect in Q2 2019. The guidance document will take effect from the day after issuing directions to modify the relevant licences. Licence holders, trade bodies representing licence holders and Citizen Advice and/or Citizen Advice Scotland will have 20 working days (from the first day after our decision is published) to decide whether to appeal our licence changes to the Competition and Markets Authority (CMA). Subject to appeal, the licence changes will take effect in Q2 2019.