

November 2000

Separation of PES Businesses

Progress Report

Executive summary

In April 2000 amendments were made to the licences of Public Electricity Suppliers (PESs) requiring the effective separation of their distribution and supply businesses.

This document reports on the progress achieved after six months, setting out the regulatory and policy background to the requirement and describing Ofgem's compliance monitoring programme. Following the agreement of separation plans it was important to ensure that the PESs followed the schedule of work agreed. In addition to holding regular meetings with PESs and their compliance officers, visiting the PESs gave Ofgem the opportunity to review the operation of the distribution businesses and to see how plans were being implemented. The visits were carried out between May and October 2000.

As expected PESs had achieved different levels of separation. Some had finished work on many areas of separation, whilst others had carried out very little of their separation plan. The visits gave Ofgem the opportunity to discuss areas of concern in detail, to look for acceptable ways forward and to ask for remedial action where appropriate. This report puts forward Ofgem's assessment of, and comment on, the good practices and procedural difficulties encountered.

The report also puts forward a programme for future work, including proposals to review Condition 12 of the licence in the light of recent industry developments. Ofgem plans to consult on these proposals in the Spring of 2001. In the meantime, comments are not sought on this report.

Table of contents

1. Introduction.....	1
Background.....	1
References	2
Rationale.....	3
Structure of the document	3
Ofgem Contact	3
2. PES Obligations	4
Condition 12.....	4
Other relevant conditions	4
Derogations	5
Compliance officers.....	6
Utilities Act.....	6
3. Monitoring Activity.....	7
Separation Plans	7
Compliance Officers.....	7
PES Visits	8
4. Findings	11
Managerial Separation.....	11
Physical Separation	13
Information Separation	14
Call centres.....	16
Branding	17
New Connections	19
5. Other Considerations.....	21
Mergers and acquisitions.....	21

Joint ventures	21
Multi utility work.....	21
Future role of the compliance officer.....	22
Conclusions	22
6. Future work	24
Monitoring activity	24
Transfer schemes	24
Review of condition 12 of the PES licence	25
Appendix 1 – Duties of Compliance Officers.....	26

1. Introduction

- 1.1 This document reports on the progress of the managerial and operational separation of the PES distribution business from all other PES businesses.

Background

- 1.2 The Electricity Act 1989 provided for a PES licence covering both supply and distribution. Many PESs ran these functions together as a single business. In 1998, competition in electricity supply was introduced for small business and domestic customers. This made the separation of PES activities more important. It promoted competition by reducing the scope for cross-subsidy and for discriminatory treatment that might favour one or other PES business activity to the detriment of customers or competitors.
- 1.3 In May 1998 OFFER consulted¹ on proposals for the separation of, and reform to, the functions of supply and distribution. This was followed by a further consultation paper in November 1998 and a proposal paper in May 1999. Meanwhile Midlands Electricity became the first PES to split these functions by selling its supply business. This required its licence to be rewritten to define which activities were supply and which distribution.
- 1.4 The May 1999 paper proposed that PESs be obliged to manage and operate the distribution business separately from other businesses and to appoint a compliance officer. It further proposed that each PES should prepare a plan to show how they intended to attain separation. A time limited derogation from the licence condition could then be granted against this plan. The intention of these changes was to:
- ◆ ensure only use of system contracts were established between the distribution business and the PES supplier;
 - ◆ avoid the sharing of facilities between the businesses, including restricting staff transfers between businesses;

¹ "Reviews of Public Electricity Suppliers 1998 to 2000: Separation of Businesses: Consultation Paper." OFFER May 1998.

- ◆ ensure that staff had responsibilities within one business only, thereby requiring separate management teams for the businesses;
- ◆ minimise the scope of any corporate headquarters activities;
- ◆ ensure that each business operated its own IT and call centre facilities; and
- ◆ require each business to develop its own distinct branding and customer communications.

This would ensure that the monopoly electricity distribution system was neutral and seen to be neutral with respect to competing suppliers.

- 1.5 Confirmation of Ofgem's decision to proceed with the proposals was published in October 1999². On 24 February 2000 a section 11 notice was published, which resulted in the implementation of changes to all PES licences with effect from 1 April 2000.

References

- 1.6 The following documents are referred to in this consultation paper
- ◆ "Reviews of Public Electricity Suppliers 1998 to 2000: separation of businesses: consultation paper" OFFER May 1998
 - ◆ "Reviews of Public Electricity Suppliers 1998 to 2000: separation of businesses: second consultation paper" OFFER November 1998
 - ◆ "Separation of businesses: proposals and consultation" OFFER May 1999
 - ◆ "Reviews of Public Electricity Suppliers 1998 to 2000: Distribution price control review: update" OFFER October 1999
 - ◆ "Utilities Act standard licence conditions - final proposals" Ofgem October 2000.

² "Reviews of Public Electricity Suppliers 1998 to 2000: Distribution price control review: update." Ofgem October 1999

Rationale

- 1.7 Managerial and operational separation of the distribution business helps the development of competition in electricity supply. Ofgem had agreed that separation of the distribution business could be introduced over a period of time and monitoring was put in place to check the progress of each PES. Since the PESs' detailed separation plans are not publicly available, this document aims to give an overview of the changes being made by the PESs to achieve separation. It also provides an initial indication of the progress to date and analyses the need for future action.

Structure of the document

- 1.8 The next two chapters of this document give more information about the legal framework that supports separation and describe the monitoring activity undertaken by Ofgem. Chapters 4 and 5 set out our findings in detail and Chapter 6 describes Ofgem's view on the way forward.

Ofgem Contact

- 1.9 If you have any queries about the information contained in the report please contact Brigitte Faubert.

(Tel: 020 7932 6387); email: brigitte.faubert@ofgem.gov.uk).

2. PES Obligations

- 2.1 This chapter refers to a number of PES licence conditions. Where the PES licence has been restructured following the sale or purchase of a supply business, or in one case following merger activity, some of the conditions referred to in this chapter are numbered differently. Where this is the case the licence amendments referred to in paragraph 2.2 took place at the time of the transaction.

Condition 12

- 2.2 Prior to 1 April 2000, Condition 12 of the PES licence (Condition 9 in Scotland) prevented the Licensee from using confidential information provided to the distribution business for the commercial advantage of the supply business. Licence amendments agreed with the PESs, which took effect from 1 April 2000, extended the obligations of this condition. Condition 12 now requires the immediate and complete managerial and operational separation of the distribution business from all other PES businesses and the absolute confidentiality of information relating to the distribution business, unless it is publicly available.

Other relevant conditions

- 2.3 Condition 4 of the PES licence prohibits separate businesses from giving or receiving cross subsidies. This prevents costs incurred by the supply business being allocated to the monopoly distribution business, which would give the supply business a competitive advantage.
- 2.4 Conditions 8A and 11D of the PES licence prohibit the distribution business from discriminating between suppliers in the way it offers terms for and provides distribution and metering and data services. Condition 11D also requires the PES not to restrict, distort or prevent competition in the supply of electricity when offering or providing metering and data services.
- 2.5 Activities of PESs are further restricted by a licence condition imposing a financial ring fence. When separate licences are introduced as a result of the

Utilities Act, it is expected that a similar financial ring fence will apply to the separate distribution business.

Derogations

- 2.6 Ofgem recognised that implementation of full operational and managerial separation would take time and that each individual PES would be starting from a different position. Ofgem worked closely with each PES to agree a separation plan specific to that PES's circumstances. Once the plan was agreed, the PES was allowed a derogation against the requirements of Condition 12 provided it continued to use all reasonable endeavours to comply with its plan.
- 2.7 All derogations were timebound. There are two distinct timetables which apply within a derogation:
- ◆ The first allowed the PES time to implement agreed changes to achieve managerial and operational separation. Changes must be achieved by a given date before the end of March 2002.
 - ◆ The second allowed some shared services or activities, such as corporate functions or pensions, where the most efficient and economical course for the distribution business is to continue to share provision of the service with other parts of the PES group. In these cases the distribution business must show that the arrangements do not involve cross subsidy and do not restrict, distort or prevent competition in the generation or supply of electricity and that the services are obtained efficiently. These activities have generally been allowed by derogation until 31 March 2005.
- 2.8 The agreed separation plans largely focus on the following key areas:
- ◆ Managerial separation
 - ◆ Information separation
 - ◆ Operational separation
 - ◆ Common Services

◆ Branding

Progress in each of these key areas is discussed later in this document.

Compliance officers

- 2.9 A separate licence condition requires each PES to appoint a compliance officer who reports annually to the board. The compliance officer is responsible for supporting the Licensee with its compliance with the separation licence condition. A list of duties and tasks assigned to the compliance officer may be found in Appendix 1. Compliance officers have now been appointed for all PESs.
- 2.10 On receipt of the compliance officer's annual report the PES is required to produce a report covering its compliance during the previous year. This report is available on request direct from the PES.
- 2.11 The same licence condition requires each PES to produce a statement outlining the practices and procedures it had adopted or intended to adopt to ensure its compliance with separation licence conditions. Ofgem has received statements from each PES.

Utilities Act

- 2.12 At present the PES distribution function does not have a separate licence. The obligations on the distribution business are within the Public Electricity Supply licence. The Utilities Act 2000 provides for separate licences for distribution activities and prohibits one person from holding both a supply licence and a distribution licence. This means that those companies who at present carry out both functions will have to arrange for one or both of the licences to be held by a separate company or companies, which may or may not be an associate of the present licensee. These provisions will take effect from a date to be decided by the Secretary of State. Transfer schemes will be available for those companies that wish to take advantage of them.

3. Monitoring Activity

Separation Plans

- 3.1 As part of the work on separation all PESs were asked to draw up plans showing how they expected to implement the new requirements. Midlands Electricity sold its supply business in June 1999 and its plan was agreed before the sale of the business was completed. Other PESs who sold their supply businesses in advance of a separation plan being prepared were asked to submit such a plan in advance of the sale.
- 3.2 Ofgem set a two year time limit on changing the management and organisation of the companies to comply with the proposed licence conditions. After this time the distribution business should be managerially and operationally separate from all other businesses. For example, they should not share premises, staff, equipment or systems. However, at the end of the initial two year period the PES may operate some common services so long as they do not provide a cross subsidy to or from the distribution business, the services are efficiently purchased and there is no restriction, distortion or prevention of competition in the supply or generation of electricity.
- 3.3 Most of the work on the preparation of the plans took place between June 1999 and December 1999. During this period PESs prepared their plans which covered a wide range of subject areas including managerial separation, information systems, physical separation, branding and common services. While all companies addressed the same issues the individual plans were very different to each other. Each PES's circumstances were unique and therefore the company needed specific plans to address those circumstances.

Compliance Officers

- 3.4 One of the new licence conditions required PESs to appoint a compliance officer. The officer's duties were set out in the licence. They included providing advice to the company on complying with the confidentiality and separation obligations placed on the distribution business; monitoring the effectiveness of practices, procedures and systems adopted by the company; investigating any

complaints about breaches of confidentiality of information and recommending remedial action where necessary. A full list can be found at appendix 1.

- 3.5 The compliance officers have a very important role to play in the separation of the distribution businesses from other businesses. They have an objective role in supervising and investigating the separation work. The compliance officer should be free to move throughout the organisation talking to anyone who he feels is relevant to, or affected by, the work on separation. For the compliance officer to do his job effectively he needs to have access at all levels through the company. Several have emphasised that they have the full support of the Board and this helps to demonstrate commitment of the company to separation work.
- 3.6 When the role of the compliance officer was first proposed it was emphasised that the post should be filled by someone who was independent and had sufficient stature to be able to deal with PES staff at all levels. PESs have taken different approaches to filling the post. Some appointed consultants to act as compliance officers, some appointed individuals from outside the organisation and others appointed staff from within the company. Generally Ofgem preferred external appointments, as they would have no preconceived ideas about the operation of the distribution business. Some appointments were made on a temporary basis and will be reviewed at a later date.
- 3.7 Ofgem has been holding quarterly meetings with compliance officers and PES representatives as a way of monitoring progress on separation. The updates received in these meetings are very important. Generally these meetings are straightforward and report progress against the plan. Occasionally it is reported that deadlines in the plan have been or are about to be missed, and reasons are given for the changes. Where these reasons are valid Ofgem would agree a revised timetable, wherever possible maintaining the original end dates. The meetings give the compliance officer the opportunity to discuss any areas of uncertainty, such as quarantine periods for staff who are transferring from distribution to supply.

PES Visits

- 3.8 Following the agreement of the separation plans it was important to ensure that the PESs followed the schedule of work proposed. Visiting the PESs gave Ofgem

the opportunity to review the operation of the distribution business and to see how plans were being implemented. The visits were carried out between May and October this year.

3.9 In line with expectations the PESs were all at different stages of separation. Some had finished work on many areas of separation. The PESs who had made the most progress included Western Power Distribution (WPD), who had separated the distribution business from the supply business following the sale of the supply business, and Northern Electric's distribution business NEDL.

3.10 Some PESs had carried out very little of their separation plan. This was sometimes because the target dates in the plan were relatively late when compared to other PESs, or were simply after the date of the visit. In the majority of cases the agreed timetable was being met and Ofgem was satisfied that progress was according to schedule. In some cases areas of work had not been completed on time because of changes in ownership. Here Ofgem accepted that there would be some delay to intermediate milestones, but PESs were reminded that all work must be completed within two years, as agreed in the plan.

3.11 A great deal of valuable information was collected from these visits. They allowed Ofgem to discuss areas of concern in detail and to look for acceptable ways forward. Similar issue areas were reviewed on each visit. These included the physical separation of the distribution business, branding, service level agreements, training, call centres and work on metering and connections. Ofgem made recommendations where it felt it would be helpful.

3.12 Details from the visits are included in Chapter 4. Common problems identified were:

- ◆ inadequate access controls where sites were shared with other businesses;
- ◆ poor training material on confidentiality;
- ◆ incomplete branding arrangements;

In addition almost all PESs were found to have arrangements for new connections that favoured the host PES supply business.

3.13 Where problems were identified remedial action was agreed. Ofgem will continue to check that such action has been taken.

4. Findings

- 4.1 This chapter details Ofgem's findings from quarterly compliance officer meetings and a first round of visits. Tables 1 to 5 lists the criteria used to judge the effectiveness of separation achieved in the key areas of managerial separation, physical separation, information separation, call centres and branding.

Managerial Separation

Reasons for Separation

- 4.2 It is vitally important to the process of separation that the distribution business is managed separately from other PES businesses and in particular from the supply business. For the distribution business to be run at optimum efficiency, decisions made about the business should be taken after considering the effects on that business alone. The operation of the distribution business could be distorted if decisions were made to maximise the profits of the company as a whole. The most obvious area of concern is the interaction of the supply and distribution businesses.
- 4.3 There is already a prohibition on cross subsidies between the distribution business and other businesses and a prohibition on discrimination in the provision of services. However the managerial separation of the distribution business places further restrictions on the PES.
- 4.4 Ofgem has sought that the distribution business has its own management team and has full control of its own finances, strategy, regulation, information technology and human resources. Staff within the distribution business should report to managers within the same business. All decisions relating to distribution should be made within the business.
- 4.5 PESs have said that the Board is legally obliged to know and understand what is happening in all businesses including the distribution business. It is important that the Board carries out its work correctly. The separation obligations do not prevent this.

4.6 However, Ofgem would be concerned if recommendations made by the distribution business were challenged or amended by members who represented other businesses. One PES has put in place arrangements whereby if a decision made by the distribution business is overturned by the Board the compliance officer is notified. He can then investigate and take action if necessary. Another PES has a Board that holds separate meetings for the distribution and supply businesses.

4.7 While visiting the PESs it was noticed that there were different attitudes to separation. Some PESs were very keen to demonstrate how quickly they had made changes to comply with the obligations. Others took a more measured attitude to the work and, while keeping within the deadlines in the timetable, did not appear to be giving separation a high priority. Talking to distribution business staff also showed different attitudes to separation. In some companies there was a strong culture of separation, in others staff still seemed to consider the PES as a single entity. We would expect the culture of separation to improve as the new arrangements are put in place.

Table 1

POSITIVE INDICATORS	NEGATIVE INDICATORS
<ul style="list-style-type: none"> • Board structure: separate reporting path for distribution and supply • Financial control: distribution business including meter operations has separate financial control, subject to company law restraints. • Cross subsidy: Service Level Agreements in place for all shared services • Cross subsidy: comparative costing and openness to outsourcing • Separate representation at industry meetings • Board level training in place. 	<ul style="list-style-type: none"> • Supply directors present when distribution business being discussed at board or executive levels. • Group financial controller manages routine finance operations of distribution business. • No system exists to identify and cost shared services • Business managers have no discretion on sourcing of services. • One delegate represents both distribution and supply.

4.8 As with other areas the quality of training varied. Some PESs' training schemes were thorough and well timed so that new members of staff were quickly informed about the Condition 12 obligations and how they applied to them. We asked some companies to change the training material where it was too focussed on Data Protection or gave misleading examples of how the Conditions should be applied. There was often a difficulty in explaining the relationship between distribution and the provision of metering services. It is imperative that proper training is carried out at the right time so that staff do not accidentally breach the obligations.

4.9 Ofgem recognises that training has a key role in strengthening the culture of separation. Whilst some companies have adequate training in place to address these issues others could be doing more. Therefore Ofgem proposes to review the training material of all companies next year.

Physical Separation

4.10 Operational separation requires the distribution business to be located in separate premises from supply and any other PES business. This assists in its compliance with non-disclosure of confidential information relating to the distribution business. No other business should use or have access to the premises or parts of the premises occupied by the distribution business. Security measures should also be in place to prevent any unauthorised access to these premises.

Table 2

POSITIVE INDICATORS	NEGATIVE INDICATORS
<ul style="list-style-type: none"> • Individual buildings contain staff from one business only. • Controls prevent staff from other businesses accessing distribution buildings. • Access doors to distribution areas are locked (subject to Health and Safety and Fire regulations) • Service Level Agreements cover use of shared premises 	<ul style="list-style-type: none"> • No access controls or security procedures. • Other staff can enter distribution business areas (including meter operations) • Doors are propped open or use of short cuts to other areas is condoned. • Staff can make unofficial use of the premises.

- 4.11 Some PESs argued that this was not always the most economical and efficient way to operate the business. Ofgem, therefore, agreed to the sharing of premises or sites where good security measures were in place to prevent unauthorised access to the distribution areas. There must be effective security measures at entrances. There must be strict adherence to these measures for them to be effective. Several PESs had security doors at the entrance to buildings, but also had open doors adjacent to them.
- 4.12 Progress on physical separation varied widely between PESs. At one end of the scale a few PESs had achieved full physical separation of their distribution business. At the other, some PESs had made little or no progress on physical separation. However, in the latter cases plans were in place to introduce security controls in early 2001. In these cases Ofgem expects compliance officers to carry out a full and detailed check on premises. A report on progress should be included in the quarterly meetings.

Information Separation

- 4.13 Condition 12 maintains that information provided to the distribution business should be treated as confidential except in certain limited circumstances.
- 4.14 Ofgem considers that security of information for customers and competitors could only be safeguarded through the separation of data and the implementation of strict controls on access to data. In addition, Ofgem considered that codes of conduct supported by contractual terms should highlight an individual employee's responsibilities to maintain confidentiality of information. The distribution business should also prevent the supply business having access to information not available to other suppliers.
- 4.15 In considering the separation of information, Ofgem took into account the nature of the information being held. Of critical importance is the information normally held in customer information systems and billing systems, the Metering Point Administration System and Distribution Use of System (DUoS) systems.
- 4.16 For information that is not commercially sensitive and held on a shared system, such as internal telephone lists and notices on interruptions, the in-area supply

business should not secure competitive advantage and Ofgem requested that such information be equally available to all suppliers.

4.17 Ideally, information separation would be achieved by installing separate stand alone software and hardware or by contracting out all or part of IT services to separate independent third parties. Some PESs argued that this would be expensive. Ofgem therefore agreed that separation could be achieved by separate databases, data streams or by access controls at a variety of levels. Controls would reflect the ownership of the data and an individual's need for access to information.

Table 3

POSITIVE INDICATORS	NEGATIVE INDICATORS
<ul style="list-style-type: none"> • Separate intranet systems for distribution and supply • Database administrators understand requirement for distribution information confidentiality • When staff change responsibilities access profiles are altered • Failed access attempts through firewalls are monitored and managed • Permitted information is available to all suppliers 	<ul style="list-style-type: none"> • No unauthorised access to distribution business's intranet • No means of modifying access codes • No access controls or firewalls. • Internal phone contact lists and procedural instructions are only made available to the PES supply business.

4.18 Whilst several PESs have effective access controls at staff induction, the procedures on staff transferring within the company are less robust, relying on line management to inform the IT department that access rights need to be changed or withdrawn. Ofgem has asked these PESs to review their procedures on access controls.

4.19 Additional safeguards on the transfer and use of distribution information can be achieved by introducing an appropriate quarantine period on staff who leave the distribution business. The compliance officer plays an important role in determining the length and nature of the quarantine. Some compliance officers

have had difficulty establishing an appropriate quarantine period for staff. In these cases, Ofgem has asked to be consulted on future transfers.

Call centres

- 4.20 The call centres are a primary interface with electricity customers and it is essential they reflect the separate responsibilities and identity of the distribution business. The call centres generally have customer information systems that contain both distribution and supply information. Before April 2000 it was common practice for PESs to operate integrated call centres for distribution and supply.
- 4.21 Ofgem had asked for a separate distribution call centre to deal with all day to day distribution enquiries. These include loss of supply and meter faults calls. The service should be managed separately and have separate staff, telephone numbers and access controlled IT systems.
- 4.22 PESs have yet to achieve an acceptable degree of separation in this area, with many distribution and supply call centre staff still working in the same room. Some PESs are also still answering the telephone using the common brand name for distribution and supply. This can be confusing for customers who have changed their supplier. There should also be physical access controls securing the new call centre.
- 4.23 Some PESs have been allowing supply staff answering distribution business calls to take the opportunity to market for the supply business. This practice is not acceptable to Ofgem. Overall, these practices revealed there was still a strong presence of an integrated culture within some PESs and inadequate separation of responsibilities.
- 4.24 Distribution call centres can experience considerable extra demand on resources at times of a major supply fault, for example during periods of extreme weather conditions. At these times extra staff are needed quickly to cope with the calls. In the past PESs could call on staff whose main job was to deal with supply business enquiries. With fully separate call centres this would be no longer possible.

- 4.25 Ideally PESs would contract out the emergency overflow service to a third party, other than the supply business, thus demonstrating that there is no cross subsidy to or from the distribution business. However, Ofgem has agreed that the supply business may continue to provide this service where there is no cross subsidy to or from the distribution business, it is provided economically and that the arrangements do not restrict, distort or prevent competition. It is not expected that this overflow service will be called on more than two or three times a year. Now that there is a growing interest in providing call-handling facilities it is anticipated that more PESs will consider outsourcing as an option.
- 4.26 It is particularly important for call centre staff to receive appropriate training in compliance issues, especially when a member of staff may deal with both supply and distribution calls. These staff are frequently exposed to potential confidentiality issues and should be provided with appropriate training to deal with these areas correctly.

Table 4

POSITIVE INDICATORS	NEGATIVE INDICATORS
<ul style="list-style-type: none"> • Call centres on separate sites • Restricted overflow arrangements (preferably outsourced) • Complaints monitoring involves compliance officer or regulation department 	<ul style="list-style-type: none"> • Integrated "customer service" centre • Supply providing overflow service without formal arrangements in place • Inadequate understanding of separation issues amongst complaints handling staff

Branding

- 4.27 Where PESs have sold their supply businesses, the new owners have, with one exception, retained the original supply brand. Therefore the distribution business has had to develop its own brand. Where the PES owns both the supply and the distribution businesses, Ofgem has asked that there be distinct identities for the supply and distribution businesses. With separate brands the link between supply and distribution becomes weakened and the culture of separation is reinforced in the minds of staff and customers alike. This reduces the potential to distort competition in supply.

- 4.28 As part of its assessment of branding, Ofgem considered the style and colour of the proposed logos. Ofgem also looked at the PESs' strategies to introduce the brand and the timetable for changing stationery, vans, uniforms, ID cards and re-signing of distribution buildings.
- 4.29 Ofgem considered that a separate brand promoted better understanding of the concept of business separation by the staff. It helped to move from a culture of integration to one of separate working identities and responsibilities.
- 4.30 Several PESs have already introduced new brands for the distribution business and one has introduced a separate brand for its supply business. Others are in the process of selecting new brands and implementing them. Some PESs have experienced delays following restructuring of the business. Where branding is not yet in place Ofgem will be closely monitoring the strategies and timetable for future work. All PESs have given a commitment that the work on branding will be complete by the end of March 2002.

Table 5

POSITIVE INDICATORS	NEGATIVE INDICATORS
<ul style="list-style-type: none"> • Clearly identifiable separate brands: style, logo, colour and font. Corporate plan to introduce brand. • New stationery in use • External signage installation in place • Vehicles in new livery and new uniforms issued and being worn • Brochures/advertising – no distribution business literature shows the supply brand • Internet – separate identities for distribution and supply. 	<ul style="list-style-type: none"> • No progress towards separate brands • Old stationery in use • Old signage remains prominently on display.

New Connections

- 4.31 It was evident during the visits that the majority of PESs had arrangements for new connections that disadvantaged suppliers competing with the PES, or ex PES, supply business. Work on new connections is carried out by the distribution business. It is responsible for making new connections to the distribution network. Most work of this type is requested by builders or larger industrial customers who are building new premises. Problems seemed to arise in two main areas, the first being the information being sent to customers and the second being the way in which the connections were dealt with.
- 4.32 With the introduction of competition in supply, people requesting a connection to the distribution system must nominate a supplier. Several pieces of correspondence sent out by PESs could be interpreted as promoting the PES supply business (or ex PES supply business) by making reference to it on the forms. It appears that forms had not been updated to fully reflect the present market conditions. All the affected PESs are making arrangements to correct the literature. In other cases staff sent out to make the connection were asked to recommend a supplier and had recommended the PES supply business.
- 4.33 The second area of concern was where the distribution business treated customers differently depending on who was nominated as the supplier. Several PESs automatically notified their own supply business of the date when the connection would be made. This allowed the PES supply business to make arrangements to have the meter installed at the same time. If a second tier supplier was going to supply the site, a letter was sent to the customer which advised them of the connection date and ask them to notify the supplier of the connection date. This meant that customers who chose to take a second tier supply were less likely to get the meter installed on the same day as the connection is made. They also had to pass messages to the supplier, whereas customers with the first tier supplier did not. The distribution business was therefore providing a better service to customers who were supplied by the host PES.

4.34 Where problems have been found the PESs have agreed to change their procedures to prevent discriminatory practices in the provision of new connections.

5. Other Considerations

- 5.1 The structure of the industry and the way in which some companies' distribution activities are managed and operated have changed rapidly since the separation licence amendments were proposed. Many of these changes have led to further derogations from licence Condition 12 being granted.

Mergers and acquisitions

- 5.2 Since the sale of Midlands Electricity's supply business to National Power there have been a number of such sales. électricité de France bought the South Western Electricity (SWEB) supply business through London Electricity. British Energy bought South Wales Electricity's supply business (SWALEC), which was later sold to Scottish and Southern Energy. Recently, Norweb sold its supply business to TXU, who owns Eastern Electricity, and it is expected that the provision of some services will be combined in running the two supply businesses. Western Power Distribution (owners of the distribution business covering the South West) have bought Hyder, which owns Infracore, the distribution business operating in South Wales. In most cases the rationale behind such acquisitions assumed synergies to be obtained by joint operation of supply or distribution businesses. In all cases there was some impact on the separation plans of the distribution businesses of the companies involved.

Joint ventures

- 5.3 Eastern Electricity and London Electricity have set up a joint venture, 24seven, to manage the operation of activities on behalf of their distribution businesses. Therefore 24seven have access to information from both distribution businesses. At present both companies have a specific derogation allowing for joint operation of 24seven in addition to the general derogation relating to their separation plans.

Multi utility work

- 5.4 A number of companies have declared their preference for combining the management and operation of electricity distribution with that of other utility networks. They argue that this enables considerable efficiency savings. At

present four distribution companies have been granted specific derogations allowing for joint operation, and where necessary the joint management, of their electricity distribution business with one or more other utility networks. More companies have expressed a potential future interest in this type of arrangement and Ofgem will consider each case on its merits.

Future role of the compliance officer

5.5 The role of the compliance officer will naturally change as actions agreed in the separation plan are completed. A large part of their role has been to ensure that the PES implements the separation plans it has agreed with Ofgem, and therefore complies with Condition 12 of the PES licence. However, compliance officers have wider responsibilities, such as complaint investigation and monitoring the effectiveness of procedures, practices and systems in ensuring separation and these are likely to remain, even once the actions agreed in the separation plan have been achieved. It is possible that in the future the role will be changed and may be reduced.

Conclusions

5.6 When the separation condition was introduced, some PESs were already more advanced than others. The separation plans agreed with the PESs reflected this state of affairs. Table 6 gives an idea of the present position of the PESs on separation, judged against the criteria identified in Chapter 4. For this reason it does not necessarily reflect the level of progress made against the agreed plans.

Table 6 - Company progress towards complete separation:

Companies which have made most progress on separation	London Power Networks Northern Electric Distribution Limited (NEDL) TXU Western Power Distribution
Intermediate companies	East Midlands Electricity GPU Norweb Seeboard Yorkshire Electricity
Most integrated companies	Infralec Scottish and Southern Energy Scottish Power (including Manweb)

- 5.7 It is perhaps unsurprising that WPD, as one of the three PESs who had sold their supply business prior to 1 April 2000, has led the field. Of all the companies they set themselves the most ambitious separation plan. By comparison Infracore, who sold their supply business in February 2000, had made relatively few changes at the time of Ofgem's visit. However, the business has since been sold to WPD who are reviewing progress.
- 5.8 Ofgem notified each PES of the findings from its monitoring visits. Where deficiencies in progress against the separation plan were identified remedial action was recommended. PESs have been actively involved in proposing solutions and Ofgem have found their responses to be constructive. Follow-up visits are planned for the New Year.
- 5.9 Given the developments in industry practice and structure discussed elsewhere in this chapter, it would seem sensible to consider further the scope and wording of Condition 12. To this end the next chapter sets out a timetable for a further period of consultation.

6. Future work

Monitoring activity

- 6.1 Ofgem expects to continue meeting with PES representatives and compliance officers to review the progress of companies towards managerial and operational separation. There will also be a further round of visits. The focus of these visits will vary from PES to PES, depending on what had been discovered on the previous visit. Attention will be concentrated on those PESs who remain most integrated.
- 6.2 PESs will continue to be required to produce yearly reports setting out the practices, procedures and systems they have adopted to ensure the separation of the distribution business. PESs will also have to report annually on their compliance with Condition 12.

Transfer schemes

- 6.3 The Utility Act 2000 separates the single PES licence into distribution and supply licences and prevents the same legal person from holding both licences. This can be seen as a natural progression from separation activities. Service Level Agreements will become formal legal contracts and standard licence conditions will be introduced which, it is proposed³, will include a financial ring fence for the distribution business. This will restrict the percentage of the distribution business's aggregate turnover derived from activities other than distribution.
- 6.4 To simplify the legal separation of supply and distribution, the Utilities Act allows for schemes, subject to the Secretary of State's approval, to transfer their property rights and liabilities to new nominated companies. In Scotland this mechanism also allows the transfer of generation and transmission activities. The timetable for this activity will be set by the Department of Trade and Industry and has not yet been published.

Review of condition 12 of the PES licence

- 6.5 Ofgem has agreed to review Condition 12 in the light of the industry developments outlined in the previous chapter. It may be appropriate to amend the present licence condition to reflect the changes in PES structure. There may be an argument for a more comprehensive revision to give the distribution business the freedom to form alliances which are not presently possible without derogations. It is expected that, if the licence is amended in this way, there will still be special restrictions on the relationship between the supply and distribution businesses.
- 6.6 Most PESs have derogations based on separation plans that include actions to be completed by 31 March 2002. It would therefore be inappropriate to introduce any necessary amendments to Condition 12 before this date. In the meantime any new proposals will be assessed on their merits.
- 6.7 The timetable for this review is set out below:

Table 7

PAPER/ACTION	PUBLICATION DATE
Initial consultation document	February 2001
2 nd consultation document	July 2001
Final proposals (to include draft licence amendment if needed)	December 2001
Section 11 Notice	February 2002
Implement amendments	April 2002

Eight weeks will be allowed for comment after each consultation and proposals paper is published.

- 6.8 The measures outlined in this chapter will allow Ofgem to continue monitoring PES progress towards separation whilst taking into account the changing structure of the industry.

³ Ofgem consultation paper "Utilities Act Standard Licence Conditions Final Proposals" published October 2000.

Appendix 1 – Duties of Compliance Officers

- 1.1 The duties and tasks assigned to the Compliance Officer shall include:
- (a) providing relevant advice and information to the Licensee for the purpose of ensuring its compliance with the Relevant Duties;
 - (b) monitoring the effectiveness of the practices, procedures and systems adopted by the Licensee in accordance with the statement referred to at paragraph 1 of the licence condition;
 - (c) investigating any complaint or representation made available to him in accordance with paragraph 7 of the licence condition;
 - (d) recommending and advising upon the remedial action which any such investigation has demonstrated to be necessary or desirable;
 - (e) providing relevant advice and information to the Licensee for the purpose of ensuring its effective implementation of:
 - (i) the practices, procedures and systems adopted in accordance with the statement referred to at paragraph 1 of the licence condition; and
 - (ii) any remedial action recommended in accordance with sub-paragraph (d); and
 - (f) reporting annually to the directors of the Licensee - in respect of the year ending 31 December 2000 and of each subsequent year - as to his activities during the period covered by the report, including the fulfillment of the other duties and tasks assigned to him by the Licensee.
- 1.2 As soon as is reasonably practicable following each annual report of the Compliance Officer, the Licensee shall produce a report:
- (a) as to its compliance during the relevant year with the Relevant Duties; and
 - (b) as to its implementation of the practices, procedures and systems adopted in accordance with the statement referred to at paragraph 1 of the licence condition.
- 1.3 The report produced in accordance with paragraph 1.1 shall in particular:

- (a) detail the activities of the Compliance Officer during the relevant year;
- (b) refer to such other matters as are or may be appropriate in relation to the implementation of the practices, procedures and systems adopted in accordance with the statement referred to at paragraph 1 of the licence condition; and
- (c) set out the details of any investigations conducted by the Compliance Officer, including:
 - (i) the number, type and source of the complaints or representations on which such investigations were based;
 - (ii) the outcome of such investigations; and
 - (iii) any remedial action taken by the Licensee following such investigations.