

November 2001

**Licence Fees: calculation and cost
recovery principles**

Discussion document

Executive summary

In April this year, Ofgem consulted on the revised arrangements for calculating licence fees following the proposals by the Secretary of State to modify the licence fee payment condition in establishing Standard Licence Conditions. The Standard Licence Conditions were introduced on 1 October 2001 and place the obligation for payment of licence fees solely on the network businesses. It is now necessary to consider in detail how licence fees will be calculated under the revised arrangements and the cost recovery implications for network operators.

It is envisaged that Ofgem will issue initial invoices in respect of the financial year beginning on 1 April 2001 to licensees in December 2001. In future years licence fees will be collected in two tranches in June and December. Ofgem proposes that licence fees are allocated relative to the number MPANs in electricity and meter supply points in gas as a proxy for the number of customers connected to electricity and gas networks respectively. It is intended that network businesses provide initial estimates of customer numbers at 1 April of each year. These will be used in calculating initial invoices, nevertheless certified values will be required to establish the correct proportion of costs attributable to each network operator.

Traditionally, each price control has incorporated an allowance for the costs incurred by each business in respect of licence fees. However, many of the existing price controls were established under the previous licence fee payment regime. As a consequence, the additional licence fee costs to some network businesses, as a result of the revised licence fee regime, are not recognised in the price controls. This document reaffirms Ofgem's commitment to the principle of full cost pass-through in respect of the revised licence fee regime. Ofgem proposes to modify the price control licence conditions from 1 April 2001 to allow pass-through of the additional licence fee costs. Draft modifications are set out in Appendices 1 and 2.

Following consideration of the responses to this paper and discussions with interested parties, it is anticipated that licence modifications to give effect to the pass-through of licence fees will be published for formal consultation at the end of November 2001.

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1. Introduction

- 1.1 This document summarises Ofgem's present thinking on the key issues relating to the recovery of licence fees from network businesses. The main purpose of this consultation exercise is to identify the different approaches for ensuring that network businesses are able to recover the additional costs that will be imposed by the revised licence fee arrangements and seek views on the most appropriate way forward. It develops and expands on points discussed at the July 2001 Licence fee workshop.
- 1.2 It is envisaged that Ofgem will issue initial invoices in respect of the financial year beginning on 1 April 2001 to licensees in December 2001. In future years licence fees will be collected in two tranches in June and December. Following consideration of the responses to this paper and discussions with interested parties, it is anticipated that licence modifications to give effect to the pass-through of licence fees will be published for formal consultation at the end of November 2001. Given the tight timescales for taking these matters forwards, Ofgem is willing to meet with licensees individually to discuss these proposals before the formal licence modification is issued.
- 1.3 It would be helpful to receive comments from all interested parties on the overall approach and the suggested draft licence modifications by 14 November 2001. Responses should be sent to:

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- 1.4 Any questions regarding the pass-through mechanism should be directed, in the first instance, to Colin Green. All other enquiries regarding the licence fee regime should be directed to Andrew Reed (020 7901 7315)

2. Recovery of licence fees

Introduction

- 2.1 Ofgem operates within the public expenditure framework laid down by HM Treasury. These arrangements require us to recover the full accounting costs of our activities under utilities legislation. Ministers have determined that Ofgem will be a self-financing body. Almost all of Ofgem's expenditure is financed by income from licence fees.
- 2.2 In previous years, licence fee income has been recovered from all parties licensed to operate within the gas and electricity sectors. This has traditionally meant that licensed generators, transportation businesses (electricity transmission, distribution, and gas transportation companies), shippers and suppliers have contributed directly to the running costs of Ofgem. The standard licence conditions introduced on 1 October 2001 place the obligation for payment of licence fees solely on the network businesses. It is now necessary to consider in detail how licence fees will be calculated under the revised arrangements and the cost recovery implications for network operators. This section addresses the first of these issues.
- 2.3 The funds recoverable from licensees will be the aggregate amount of Ofgem and DTI costs (primarily energywatch) less income from all other sources (e.g. meter services). Such costs fall into two distinct categories:
- ◆ core costs – the costs of ongoing regulatory functions in the gas and electricity sectors, including energywatch; and
 - ◆ exceptional costs – the costs of significant one off initiatives that can be attributed to a specific sector, e.g. NETA costs.

Hypothecation of costs

- 2.4 It is proposed that core costs will be attributed to licensees proportionate to the number of final customers. The contribution of core running costs attributed to each licensee will therefore reflect the proportion of total customers connected to its network (either directly or indirectly via downstream networks). As such,

the general costs of regulating the gas and electricity sectors are smeared across all customers that benefit from Ofgem.

- 2.5 Ofgem recognises that this standard formula approach would not be an appropriate mechanism for allocating exceptional costs, as these are typically specific to one sector. To attribute these costs according to the standard formula could prove inequitable. For example, it would not be appropriate to hypothecate some part of the costs of the NETA programme to gas customers. In the light of this, it is proposed that exceptional costs are hypothecated between licensees operating in the electricity and gas sectors respectively according to a formula pre-determined by the Authority. It is anticipated that this will reflect the relative proportion of customers affected.

Customer numbers

- 2.6 The allocation of Ofgem's costs across licensees depends on the availability of accurate information on direct and indirect customer numbers. The reference point for the calculation will be the customer numbers on 1 April. There are a number of ways of defining a customer. Moreover, it appears that the method for hypothecating licence fees may be sensitive to the definitions adopted.
- 2.7 Ofgem proposed the use of MPANs in electricity and meter supply points in gas as a proxy for the number of customers connected to electricity and gas networks respectively. Further discussions with interested parties have confirmed that the use of MPANs and meter supply points will meet the dual requirements of certainty and equity. Nevertheless, Ofgem recognises that it may be appropriate to refine the definitions from time to time as network information systems develop.
- 2.8 Several interested parties have expressed concern that network businesses face little or no incentives to provide accurate information on the number of customers served by the network, which may in turn result in an inappropriate allocation of licence fees. In light of these concerns, Ofgem proposes that licensees provide suitably certified information on the number of customers served by its network. Nevertheless, careful consideration must be given to the timing of the information provision both in terms of the additional burden placed on licensees and the timing of invoices.

- 2.9 Ofgem recognises that electricity transmission businesses and Transco may not have access to information about the number of customers downstream of their networks. Ofgem proposes to use the customer numbers provided by connected networks businesses where appropriate. However, since there are very few customers connected directly to the high voltage transmission systems it is intended that 50 percent of the licence fee amount payable by the electricity sector be recovered from transmission businesses, with the remainder recovered by licensed distributors. A similar approach will be adopted in respect of the allocation of licence fees between Transco's National Transportation System and the Local Distribution Zones and Independent Gas Transporters (IGTs).
- 2.10 Ofgem recognises that several local transportation systems are interconnected with similar classes of network operators. For example, IGTs may be connected to other IGTs. As a consequence, it may not be possible to ascertain accurate values on the number of customers indirectly connected to each network. In light of this, Ofgem proposes to allocate the appropriate proportion of licence fees to local networks based on directly connected customers only.
- 2.11 The licence fee payment condition sets out an obligation for network businesses to make payments in two instalments in 2002-03 and subsequent years. In these circumstances, it may be appropriate to base the initial licence fee invoices on estimates of the number of customers connected to each network. Such estimates would be required by no later than 30 April of each relevant year. Final invoices would include a reconciliation adjustment based on final customer numbers. It is envisaged that this approach would ensure an appropriate degree of accuracy at a minimum cost to network businesses.

Transitional arrangements for 2001/02

- 2.12 It is anticipated that invoices for licence fees will be issued in December 2001. Ofgem recognises that it would not be practicable for network businesses to provide certified customer numbers at short notice. In these circumstances, Ofgem proposes to use estimated values in respect of 2001/02. Furthermore, Ofgem intends to carry-forward a reconciliation adjustment for licence fees in 2001/02, when calculating liabilities for 2002/03.

2.13 Details of the calculation of licence fees will be notified separately. Meanwhile we are requesting that network businesses provide estimates of customer numbers at 1 April 2001 by no later than 20 November 2001.

3. Cost pass-through regimes

Introduction

- 3.1 Many of the services provided by network businesses, such as use of system, are not subject to competition and so Ofgem has typically put in place price controls to constrain the overall level of charges that each business is able to earn from its activities. These constraints typically reflect the levels that charges would need to be set at to recover those costs efficiently incurred by each business in undertaking its activities.
- 3.2 Traditionally, each price control has incorporated an allowance for the costs incurred by each business in respect of licence fees. However, many of the existing price controls were established under the previous licence fee payment regime. As a consequence, the additional licence fee costs to some network businesses, as a result of the revised licence fee regime, are not recognised in the price controls. This section discusses the issue of cost recovery under the revised licence fee regime.
- 3.3 Several network businesses have expressed concern that the existing controls on revenues prohibit them from recovering the additional liabilities they will face under the new licence fee payment obligations. It has been noted that the NGC Transmission Price Control is structured to facilitate full cost pass-through of licence fees and that a similar approach should be adopted in respect of other network businesses. Ofgem is supportive of the principle of full cost pass-through under the revised licence fee regime.
- 3.4 This section discusses the possible mechanisms for facilitating full cost pass-through for each of the price controlled network businesses. There are, however, a number of differences in the extent to which licence fees are already reflected in the cost base underpinning the price controls of each business. In these circumstances, it may be appropriate to develop transitional pass-through arrangements over the remaining life of the price controls. Nevertheless, it will also be appropriate to set out detailed proposals in respect of longer-term pass-through arrangements.

- 3.5 There are two broad approaches for achieving full cost pass-through of licence fee costs; an explicit adjustment to the price control formula to reflect the additional costs of licence fees, or an implicit pass-through mechanism treating cost recovery outside the scope of price controls. These approaches are discussed in detail below.

Explicit pass-through regimes

- 3.6 The NGC price control includes an explicit adjustment to the level of regulated revenues equivalent to its liabilities in respect of licence fees. As such, NGC is able to set charges to recover the full costs of licence fees. Moreover, over or under recoveries of price control income are captured within the price control correction factor. Several interested parties support this approach in respect of all network businesses.
- 3.7 Ofgem recognises that an explicit adjustment to revenues to facilitate the full cost pass-through of licence fee income has the advantage of providing regulatory and commercial transparency. However, network businesses are already able to recover an element of licence fee costs as part of the ongoing revenue controls, although these allowances are not explicitly identified. As a consequence, an explicit adjustment to allowed income is significantly more complex in its construction.
- 3.8 Several interested parties have commented that the mechanism for achieving full-cost pass-through should be simple in construction. An explicit revenue adjustment is unlikely to meet these requirements in the short-term. In these circumstances, it may be appropriate to adopt an alternative pass-through mechanism.

Implicit pass-through regimes

- 3.9 As highlighted above, an alternative approach for achieving full cost pass-through involves an implicit pass-through mechanism, where additional revenues from cost recovery are outside the scope of the price controls. In practical terms, an implicit pass-through regime is a pass-through mechanism constructed without explicitly stating the amount of additional revenue that is

recoverable through charges. This approach has been adopted in respect of the recovery of transmission exit charges by electricity distribution businesses.

- 3.10 In effect, such a network business is able to deduct from regulated turnover an amount equal to the cost it has incurred, thus ensuring full cost recovery. Once all other adjustments have been made, the remaining revenue is set against the target allowed by the price controls, whereby under and over-recoveries are treated in the traditional manner. It may be appropriate to adopt similar arrangements in respect of licence fees for a transitional period.
- 3.11 Ofgem recognises that such an approach is less transparent than an explicit revenue adjustment. Nevertheless, in the short-term it has the benefit of a relatively simple construction.

Application to network businesses

- 3.12 As described in paragraph 3.1, Ofgem has put in place price controls to constrain the levels of charges that most network businesses are able to levy for their activities. Moreover, these controls will typically have duration of around five years. Nevertheless, it is commonplace for such controls to have overlapping periods to enable effective management of the extensive workload associated with introducing revised controls at the end of each period. As a consequence, the network businesses are at different points in the regulatory cycle.
- 3.13 Table 1 sets out where companies are in respect of the five-year regulatory cycle. Price controls that have been put in place from 1 April 2001 have incorporated a simple explicit pass-through term. IGTs are not subject to explicit price controls and therefore will have the choice of either absorbing the costs of licence fees or raising charges to recover the additional licence fee costs. However, the existing price controls in place for electricity distribution, Scottish electricity transmission, and Transco do not fully reflect licence fee costs.

Table 1 - The Regulatory Cycle

Network Business	Start Date	End Date	Full Pass-through?
Electricity Distribution	1 April 2000	31 March 2005	No
Scottish Transmission	1 April 2000	31 March 2005	No
NGC Transmission	1 April 2001	31 March 2006	Yes
Gas Transportation (Transco)	1 April 1997 1 April 2002	31 March 2002 31 March 2007	No Yes

- 3.14 Careful consideration should be given to the remaining duration of the price controls when determining an appropriate mechanism for cost pass-through.

Electricity Distribution

- 3.15 The existing price controls incorporate allowances of between £210,000 and £731,000 (in 1997/98 prices) in respect of the costs of licence fees. Under the revised licence fee payment regime it is anticipated that electricity distribution businesses will face costs of between £0.5m and £2m in respect of 2001/02. As a consequence, Ofgem anticipate that distribution businesses will incur additional licence fee costs of between £1.25m and £0.25 (in 2001/02) above the existing allowances.
- 3.16 There is a balance to be struck between simplicity of the adjustment and transparency. Ofgem considers that regulatory transparency and certainty should be an important feature of the adjustment mechanism. While a simple implicit mechanism might be appropriate, there is a significant lack of transparency. In light of this, Ofgem proposes to have an explicit revenue adjustment within the price control formula. An initial draft of the licence modification can be found in Appendix 1.

Electricity Transmission

- 3.17 As noted above, the NGC transmission price control that was implemented from 1 April 2001 includes an explicit adjustment to revenues for licence fee costs. In contrast, there is presently no equivalent adjustment to revenues in respect of the cost of licence fees as part of the Scottish transmission price controls. This is similar to the position of the local distribution businesses and Ofgem proposes to adopt a similar explicit revenue adjustment.

3.18 The price controls for the Scottish Transmission businesses were established from an aggregate view of operating expenditure. As a consequence, the existing price controls do not include an explicit allowance for licence fee costs. Nevertheless, Ofgem did not adopt an approach to licence fee costs that was fundamentally different from that expressed as part of the distribution price control review, in forming a view on the level of efficiently incurred expenditure. Therefore, to ascertain the level of the allowance implicit within the price control formula, Ofgem has estimated the level of Ofgem's core costs consistent with the assumptions made in 1999. An initial draft of the licence modifications can be found in Appendix 2.

Gas Transportation

3.19 Ofgem published final proposals in respect of the price control on Transco's gas network. This control is due to take effect from 1 April 2002. It is envisaged that the price control formula that will be put in place will include an explicit revenue adjustment in respect of licence fees.

3.20 Nevertheless, careful consideration should be given to the recovery of licence fee costs in 2001/02, as these are not recognised within the existing price controls. It is also important to recognise that Transco are in the last third of the remaining formula year, making it impracticable to introduce significant changes in charges to recover costs incurred for a full year. In these circumstances, Ofgem propose to pass-through the additional costs of licence fees as a one-off adjustment to revenues. This adjustment can be achieved through an amendment to the existing price control or alternatively the adjustment can be captured within the licence modification that gives effect to the revised price controls that come into force from 1 April 2002. Views are invited in respect of the most appropriate manner of achieving cost pass-through.

3.21 There are a number of gas transportation businesses that do not presently face formal price controls. These network service providers have sufficient flexibility to ensure full cost recovery of licence fee income through their Standard Condition 4 charges. Nevertheless, it may be necessary for these businesses to consult on how their network charging methodologies will be modified to

recover licence fee costs. Where IGTs seek to raise charges they should provide appropriate notice to the Authority.

Conclusions

- 3.22 Views are invited on the proposed mechanisms for achieving full cost pass-through of licence fees, including whether it is appropriate to adopt a relatively complex explicit adjustment mechanism for a transitional period until revised price controls are put in place for electricity distribution. Ofgem would also like to hear from interested parties in respect of the draft licence modifications set out in Appendices 1 and 2.

4. Issues for consideration

Introduction

4.1 There are a number of specific interested parties that have identified a range of related issues for consideration. Of these, two issues are particularly relevant:

- ◆ retrospective cost pass-through; and
- ◆ the publication of network charges.

In general, both of these issues impact upon the calculation of liabilities and cost recovery.

Retrospective cost pass-through

4.2 Electricity distribution businesses have expressed concern about the differential treatment of licence fee costs in 2000/01 and the proposals for full cost recovery from 2001/02. It has been suggested that the distribution price controls implicitly establish a principle of cost pass-through in respect of licence fees. Despite this, the allowances presently reflected within the distribution costs base did not adequately reflect the significant increase in costs during 2000/01. In contrast, Ofgem has established the principle of full cost recovery in respect of similar future increases in licence fee costs above the allowances underpinning the price controls. In light of this, it has been suggested that Ofgem should retrospectively apply full cost pass-through to 2000/01 costs.

4.3 The price controls put in place prior to April 2001 have provided revenue targets based upon an estimate of the costs incurred by an efficiently operated business. These estimates of costs have a number of components that with hindsight may be higher or lower than actual costs incurred. Nevertheless, the regulatory framework focuses on the aggregate levels of costs to provide broad incentives to increase efficiency. As a consequence, the existing price controls treat licence fee costs merely as a component of a broader cost base rather than a cost component that is guaranteed to be recovered.

4.4 Ofgem recognises that the costs associated with licence fees were significantly higher than the costs assumed in determining the cost base. Nevertheless, it is

also envisaged that some elements of the cost base may be significantly lower than assumed in determining the cost base. While these cost reductions may reflect increased efficiency by distribution businesses they may, in part, reflect the impact of external factors. Therefore, it is not clear that an increase in one component of costs is sufficient to re-open the price controls when the basis on which those costs are derived is consistent with the approach adopted in previous years.

- 4.5 The revised licence fee regime is aligned with the full implementation of the Utilities Act 2000. Since the principle of full cost pass-through is aligned to these changes in legislation it would not be appropriate to consider retrospective changes before the Utilities Act 2000 took effect in law. The introduction of the revised licence fee payment condition places the obligation to meet the ongoing costs of Ofgem solely on network businesses. The estimates of licence fee costs are therefore no longer consistent with the basis on which the price controls were set. In view of this, Ofgem has established the principle of full cost pass-through coincident with the implementation of the new licence fee regime.
- 4.6 Any adjustment to revenues would require consistency of treatment across those affected. It would be necessary to adjust all controls retrospectively to a similar coincident point or to the point at which the industries were privatised. Ofgem is generally opposed to such an approach, as it would typically increase regulatory uncertainty and risk in respect of future retrospective adjustments to the detriment of customers' interests. In light of the points set out above, Ofgem does not propose to retrospectively apply the principle of full cost pass-through.

Publication of network charges

- 4.7 Several network businesses have expressed concern about the timing of the initial estimates of the licence fees. It has been suggested that initial estimates of the running costs of Ofgem (and the DTI) will not be available until after the regulatory deadline for publishing indicative charges for use of the network. As a consequence, some network businesses may find it difficult to set charges to accurately recover their costs. This exposes suppliers and their customers to unavoidable price volatility. In light of this, it has been suggested that Ofgem should waive the charge notification procedures set out in the standard licences.

4.8 The revised corporate planning process will provide high-level forecasts of the running costs of Ofgem over a three-year time horizon. Energywatch will also be producing three-year projections. In light of this, network businesses should have sufficient information to project, with reasonable accuracy, the appropriate level of cost recovery in respect of future licence fees. There also appears to be sufficient scope within the licence conditions to enable network businesses to revise charges to reflect material changes in cost assumptions, before final publication of their terms. In these circumstances, Ofgem does not consider it appropriate to waive the change notification periods set out in the standard licence conditions.

Appendix 1 Draft modification to special condition B of the standard distribution licence.

- 1.1 Ofgem proposes to introduce the following modification to the distribution special licence condition to give effect to full cost pass-through of licence fees.

Special Condition B: Restriction of distribution charges

[Amendments shown in bold]

Basic Formula

1. Without prejudice to Special Condition E (Allowance in respect of security costs), the licensee shall in setting its charges for the provision of distribution services use its best endeavours to ensure that in any relevant year the average charge per unit distributed shall not exceed the maximum average charge per unit distributed calculated in accordance with the following formula:

$$M_{dt} = P_{dt} + PN_{dt} + LF_{dt} - PM_{dt} - K_{dt}$$

2. For the purposes of paragraph 1, M_{dt} means the maximum average charge per unit distributed in relevant year t.

Formula for P_{dt} as used in paragraph 1

3. For the purposes of paragraph 1, P_{dt} is derived from the following formula:

$$P_{dt} = \frac{(PUM \cdot GR_t \cdot PID_t) + (PL \cdot (AL_t - L_t) \cdot PIL_t)}{D_t}$$

where:

PUM means the amount set against that term in the part of Annex A to this Condition that applies to the licensee.

GR_t in the eleventh relevant year has the value of 1 and in each subsequent relevant year is derived from the following formula:

$$GR_t = 0.5 \left(\frac{\sum P_{oi} \cdot D_{it}}{\sum P_{oi} \cdot D_{it-1}} + \frac{C_{dt}}{C_{dt-1}} \right) GR_{t-1}$$

where

- Σ means the summation across all regulated distribution unit categories i as described in the definition of the term P_{oi} .
- P_{oi} means, in respect of each regulated distribution unit category i set out in column 1 under that term in the part of Annex A to this Condition which applies to the licensee, the value opposite that category in column 2.
- D_{it} means that number of units in each regulated distribution unit category i distributed in relevant year t .
- D_{it-1} means that number of units in each regulated distribution unit category i distributed in relevant year $t-1$.
- C_{dt} means a notional figure, representing the number of customers in the authorised area (for the purpose of this term C_{dt} only) for each relevant year, given in the table appearing under that term in the part of Annex A to this Condition that applies to the licensee.
- C_{dt-1} means the number equal to C_{dt} in relevant year $t-1$.

PID_t in the eleventh relevant year has the value of 1 and in each subsequent relevant year is derived from the following formula:

$$PID_t = \left(1 + \frac{RPI_t - Xd_t}{100}\right) PID_{t-1}$$

where

RPI_t means the percentage change (whether of a positive or a negative value) in the arithmetic average of the Retail Price Index numbers published or determined with respect to each of the six months July to December (inclusive) in relevant year t-1 and the arithmetic average of the Retail Price Index numbers published or determined with respect to the same months in relevant year t-2.

Xd_t shall equal 3.

PL means an amount equal to 2.9p.

AL_t means an amount (in units) representing allowed distribution losses in relevant year t, being the allowed percentage of the adjusted units distributed (calculated as provided in paragraph E5 of Part E of Schedule A) where, in respect of each relevant year t, the allowed percentage shall equal that percentage which the aggregate of adjusted distribution losses (calculated as provided in paragraphs E2 to E5 of Part E of Schedule A) over the 10 preceding relevant years bears to the aggregate of adjusted units distributed (calculated as aforesaid) over the corresponding relevant years

L_t means in respect of relevant year t, adjusted grid supply point purchases less adjusted units distributed (calculated as provided in paragraphs E2 to E5 of Part E of Schedule A).

PIL_t is derived from the following formula:

$$PIL_t = \left(1 + \frac{RPI_t}{100}\right) PIL_{t-1}$$

where, for the eleventh relevant year, PIL_{t-1} equals 1.

D_t means the regulated quantity distributed in relevant year t.

Formula for PN_{dt} as used in paragraph 1

4. For the purposes of Paragraph 1, in the eleventh and subsequent relevant years the term PN_{dt} shall be calculated in accordance with the following formula:

$$PN_{dt} = \frac{(PS + PR)PIR_t}{D_t}$$

where:

PS means an amount equal to £3.25 million for each of the eleventh to the fifteenth relevant years, and thereafter shall be 0.

PR means, in the eleventh and all subsequent relevant years, the amount given against the licensee's name in Annex B to this Condition.

PIR_t is derived from the following formula:

$$PIR_t = \left(1 + \frac{RPI_t}{100}\right) PIR_{t-1}$$

where for the ninth relevant year PIR_{t-1} equals 1

Formula for LF_{dt} as used in Paragraph 1

5. For the purposes of paragraph 1, LF_{dt} is derived from the following formula:

$$LF_{dt} = \frac{LP_{dt} - LA_{dt}}{D_t}$$

where:

LP_{dt} means an amount equal to the payments made by the licensee, in the relevant year t , in accordance with its obligations set out in Standard Licence Condition 3.

LA_{dt} is derived from the following formula:

$$LA_{dt} = PF \cdot PIF_t$$

PF means, in the twelfth and all subsequent relevant years, the amount given against the licensee's name in column PF of Annex C to this Condition.

$$PIF_t = \left(\frac{1 + RPI_t}{100} \right) PIF_{t-1}$$

where for the ninth relevant year PIF_{t-1} equals 1.

Formula for PM_{dt} as used in Paragraph 1

6. For the purposes of paragraph 1, PM_{dt} is derived from the following formula:

$$PM_{dt} = \frac{RM_{dt}}{D_t}$$

where:

RM_{dt} means an amount equal to the licensee's relevant reduction in costs in relevant year t , resulting from the fact that the licensee has ceased to provide meter provision services and meter operation services (as defined in paragraph 1 of standard condition 36B (Requirement to Offer Terms for the Provision of Distributor Metering and Data Services)) in respect of

customers in respect of whom it provided meter provision services and meter operation services at 31 March 2000. The licensee's relevant reduction in costs shall be calculated in real terms, and shall be the amount, if any, by which the licensee's cash operating costs (excluding costs of a non-recurring nature) of providing such services in the relevant year t fall short of its cash operating costs (excluding costs of a non-recurring nature) of providing such services in the tenth relevant year, to the extent that such shortfall is attributable to the fact that the licensee has ceased, since 31 March 2000, to provide (whether directly or through an agent acting on its behalf) meter provision services and meter operation services in respect of such customers. The licensee's relevant reduction in costs shall exclude the amount of any reduction in costs in providing any services which constitute excluded services.

Formula for K_{dt} as used in Paragraph 1

7. For the purposes of paragraph 1, K_{dt} means the correction factor per unit (whether of a positive or a negative value) derived, subject to paragraph 3 of Special Condition C (Restriction of distribution charges: adjustments), from the following formula: provided that the value of K_{dt} for the eleventh relevant year shall be the value of K_{dt} arising for that year from the application of the formula applicable under Licence Condition 3A of the Public Electricity Supply licence previously granted to South Western Electricity plc in the form of that condition in force on 31 March 2000, but adjusted by adding the amount of TA_{dt} for the tenth relevant year, calculated by the application of the formula applicable under Licence Condition 3A of that Public Electricity Supply licence as then in force:

$$K_{dt} = \frac{R_{dt-1} - (D_{t-1} \cdot M_{dt-1})}{D_t} \left(1 + \frac{I_{dt}}{100}\right)$$

where:

R_{dt-1} means the distribution revenue in relevant year t-1.

D_{t-1} means the regulated quantity distributed in relevant year t-1.

M_{dt-1}	means maximum average charge per unit distributed in relevant year t-1.
I_{dt}	means that interest rate in relevant year t which is equal to, where K_{dt} (taking no account of I_d for this purpose) has a positive value, the average specified rate plus 4, or where K_{dt} (taking no account of I_d for this purpose) has a negative value, the average specified rate.

ANNEX C TO SPECIAL CONDITION B (RESTRICTION OF DISTRIBUTION CHARGES)

	PF
	£m
EASTERN ELECTRICITY LTD	0.731
EAST MIDLANDS ELECTRICITY DISTRIBUTION PLC	0.579
LONDON POWER NETWORKS LIMITED	0.492
MANWEB PLC	0.452
GPU POWER NETWORKS (UK) PLC	0.575
NORTHERN ELECTRIC DISTRIBUTION LIMITED	0.352
NORWEB PLC	0.527
SEEBOARD POWER NETWORKS PLC	0.442
SOUTHERN ELECTRIC POWER DISTRIBUTION PLC	0.649
WESTERN POWER DISTRIBUTION (SOUTH WALES) PLC	0.269
WESTERN POWER DISTRIBUTION (SOUTH WEST) PLC	0.317
YORKSHIRE ELECTRICITY DISTRIBUTION PLC	0.529
SP DISTRIBUTION PLC	0.496
SCOTTISH HYDRO-ELECTRIC POWER DISTRIBUTION LIMITED	0.210

Special Condition D: Information to be provided to the Authority in connection with the charge restriction conditions

[Amendments in bold]

1. Where the licensee is intending to make any change in charges for the provision of distribution services regulated under Special Condition B (Restriction of distribution charges) the licensee shall (unless otherwise agreed by the Authority) not later than the date of publication of such charges provide the Authority with:
 - (a) written forecast of the maximum average charge per unit distributed, together with its components, in respect of the relevant year t in which such a change is to take effect and in respect of the next following relevant year $t + 1$; and
 - (b) a written estimate of the maximum average charge per unit distributed, together with its components, in respect of the relevant year $t-1$ immediately preceding the relevant year in which the change is to take effect unless a statement complying with paragraph 7 in respect of relevant year $t-1$ has been furnished to the Authority before the publication of the proposed change.
2. [No longer used]
3. If within three months of the commencement of any relevant year t the licensee has not made any such change in charges as is referred to in paragraph 1, the licensee shall provide the Authority with a written forecast of the maximum average charge per unit distributed, together with its components, in respect of the relevant year t .
4. The Authority may issue directions providing that any forecast or estimate provided in accordance with paragraphs 1 or 3 shall be accompanied by such information as regards the assumptions underlying the forecast or estimate as may be necessary to enable the Authority to be satisfied that the forecast or estimate has been properly prepared on a consistent basis.
5. Subject to as provided in sub-paragraph (b) below, not later than six weeks after the commencement of each relevant year t , the licensee shall send to the Authority a statement as to:
 - (a) whether or not the provisions of Special Condition C (Restriction of distribution charges: adjustments) are likely to be applicable in consequence of the average charge per unit distributed in the preceding relevant year $t-1$ or the two preceding relevant years $t-1$ and $t-2$; and

(b) its best estimate as to the relevant correction factor K_{dt} to be applied in calculating the maximum average charge per unit distributed in respect of the relevant year t .

6. [No longer used]

7. Not later than three months after the end of a relevant year the licensee shall send to the Authority a statement, in respect of that relevant year, showing the specified items referred to in paragraph 9.

8. The statement referred to in the preceding paragraph shall be:

(a) accompanied by a report from the Auditors that in their opinion (i) such statement fairly presents each of the specified items referred to in paragraph 9 in accordance with the requirements of the charge restriction conditions and (ii) the amounts shown in respect of each of those specified items are in accordance with the licensee's accounting records which have been maintained in respect of the distribution business in accordance with standard condition 42 (Regulatory Accounts) of this licence; and

(b) certified by a director of the licensee on behalf of the licensee that to the best of his knowledge, information and belief having made all reasonable enquiries:

(i) there is no amount included in its calculations under Special Condition B (Restriction of distribution charges) and Schedule A which represents other than:

(aa) bona fide consideration for the provision of distribution services in the course of its distribution business; or

(bb) an amount permitted under the charge restriction conditions to be so included;

(ii) *there is no amount included in its calculations of allowed security costs under Special Condition E (Allowance in respect of security costs) which represents other than an amount permitted under the charge restriction conditions to be so included;*

(iii) no service has been treated as an excluded service which was not properly so treated and no amount included in the revenues in respect thereof represents other than bona fide consideration for the provision of the excluded service to which it relates;

- (iv) all amounts which should properly be taken into account for the purposes of the charge restriction conditions have been taken into account.
9. The specified items to be contained in the statement referred to in paragraph 7 shall be the following:
- (a) the regulated quantity distributed;
 - (b) the quantity distributed in each regulated distribution unit category;
 - (c) the average charge per unit distributed;
 - (d) the amount in respect of the Terms AL_t and L_t , in paragraph 3 of Special Condition B (Restriction of distribution charges) calculated as therein provided;
 - (e) the value of the term TA_{dt} in respect of the tenth relevant year only, together with the value of each of its component parts, as detailed in paragraph 4 of Special Condition B (Restriction of distribution charges) in the form of the licence in force on 31 March 2000";
 - (f) ***the value of the term LF_{dt} together with the value of each of its component parts, as detailed in paragraph 5 of Special Condition B (Restriction of distribution charges).***
 - (g) the information referred to at paragraph 8 of Special Condition E (Allowance in respect of security costs);
 - (h) the statements and information referred to in paragraphs A5, B2, C7, D1 and E10 of Schedule A.
10. Where the Authority issues directions in accordance with paragraph 9 of Special Condition E (Allowance in respect of security costs) or paragraphs A6, B3, C8, D5 or E11 of Schedule A then such directions shall not have effect from a date earlier than the commencement of the relevant year to which the statement last furnished to the Authority pursuant to paragraph 7 prior to the issue of the directions related, unless such statement (or the accompanying report or certificate under paragraph 8) or any statement, report or certificate in respect of an earlier relevant year was incorrect or was misleading in any material respect.

Where the Authority issues such directions as are referred to in the preceding paragraph the Authority may require the licensee to provide a revised statement in respect of such of the

specified items as may be affected by the directions, and the licensee shall comply with such request.

Appendix 2 Draft modification to special conditions J and L of the electricity transmission licence in Scotland.

2.1 Ofgem proposes to introduce the following modification to the distribution special licence condition to give effect to full cost pass-through of licence fees.

SCOTTISH POWER PLC

Special Condition J: Restriction of transmission charges

[Amendments to paragraph 1 in bold]

Basic Formula

1 Without prejudice to Special Condition M (Allowances in respect of Security costs) the licensee shall in setting its charges for the provision of transmission services use its best endeavours to secure that in any relevant year the regulated transmission revenue shall not exceed the maximum regulated transmission revenue calculated in accordance with the following formula:

$$TR_t = R_t - KK_{Tt} + LF_t$$

where:

TR_t means the maximum regulated transmission revenue in relevant year t ; and

R_t in relation to the relevant year commencing 1 April 2000, shall have a value equal to £114.36 million and in relation to any subsequent relevant year the value of it shall be derived from the following formula:

$$R_t = R_{t-1} \left[1 + \frac{RPI_t - X_T}{100} \right]$$

100

where

RPI_t means the percentage change (whether of a positive or a negative value) in the arithmetic average of the Retail Price Index figures published or determined with respect to each of the six months July to December (inclusive) in relevant year $t-1$ and the arithmetic average of the Retail Price Index figures published or determined with respect to the same months in relevant year $t-2$.

X_T means 0.

KK_{Tt} means the correction factor (whether of a positive or negative value) to be applied to the regulated transmission revenue in relevant year t (subject to paragraph 3 of Special Condition K (Restriction of transmission charges: adjustments)) which factor is to be derived as follows:

(a) in the relevant year commencing 1 April 2000:

$$KK_{Tt} = \frac{Q_{t-1}}{100} \times (C_{t-1} - T_{t-1}) \times \left(1 + \frac{IR^t}{100}\right)$$

where

C_{t-1} means the average charge per regulated unit transmitted in relevant year commencing 1 April 1999.

IR_t means that interest rate which is equal to, where KK_{Tt} in relevant year commencing 1 April 2000 (taking no account of IR for this purpose) has a positive value and C_{t-1} exceeds T_{t-1} by more than 2 per cent, the average specified rate plus 4 or, where KK_{Tt} in that relevant year commencing 1 April 2000 (taking no account of IR for this purpose) has a negative value and C_{t-1} does not exceed T_{t-1} by more than 2 per cent, the average specified rate.

Q_{t-1} has the value 30,399 (which represents the regulated quantity transmitted (expressed in GWh) by the licensee in relevant year commencing 1 April 1999).

T_{t-1} means the maximum average charge per regulated unit transmitted in relevant year commencing 1 April 1999; as determined in accordance with Schedule 5 of the form of ScottishPower's transmission licence in force as at 31 March 2000; and

(b) in subsequent relevant years KK_{dt} is to be derived from the following formula:

$$KK_{Tt} = (CR_{t-1} - TR_{t-1}) \left(1 + \frac{I^t}{100}\right)$$

where:

CR_{t-1} means the regulated transmission revenue in relevant year $t-1$.

TR_{t-1} means the maximum regulated transmission revenue in relevant year $t-1$.

I_t means that interest rate in relevant year t which is equal to, where KK_{Tt} (taking no account of I for this purpose) has a positive value and CR_{t-1} exceeds TR_{t-1} by more than 2 per cent, the average specified rate plus 4 or, where KK_{Tt} (taking no account of I for this purpose) has a negative value and CR_{t-1} does not exceed TR_{t-1} by more than 2 per cent, the average specified rate.

LF_{dt} *for the eleventh and preceding years means zero and in the twelfth and all subsequent relevant years, is derived from the following formula:*

$$LF_t = LP_t - LA_t$$

where:

LP_t *means, in the twelfth and all subsequent relevant years, an amount equal to the payments made by the licensee, in the relevant year t , in accordance with its obligations set out in Standard Licence Condition 4.*

LA_t *is derived from the following formula:*

$$LA_t = PF \cdot PIF_t$$

PF *means, in the twelfth and all subsequent relevant years, the amount of £0.59 million¹.*

¹ There was no explicit allowance made for licence fees within the Scottish transmission price control introduced in April 2000. The figure of £0.59 million is derived using the levels of transmission and total licence fees in 2000/01 and the total licence fee net of one off costs in 2001/02. It thereby reflects an

$$PIF_t = \left(\frac{1 + RPI_t}{100} \right) PIF_{t-1}$$

where for the twelfth relevant year PIF_{t-1} equals 1.

expected level of licence fees that would have applied beyond 2000/01 without the change to the structure of the licence fee. i.e. $[\text{£}0.90\text{m} \times (\text{£}53\text{m} - \text{£}10\text{m}) / (\text{£}64\text{m})] / (1.0314) = \text{£}0.59\text{m}$.

SCOTTISH AND SOUTHERN ENERGY

Special Condition J: Restriction of transmission charges

Basic Formula

- 1 Without prejudice to Special Condition M (Allowances in respect of security costs) the licensee shall in setting its charges for the provision of transmission services use its best endeavours to secure that in any relevant year the regulated transmission revenue shall not exceed the maximum regulated transmission revenue calculated in accordance with the following formula:

$$TR_t = R_t - KK_{Tt} + LF_t$$

where:

TR_t means the maximum regulated transmission revenue in relevant year t; and

R_t in relation to the relevant year commencing 1 April 2000, shall have a value equal to £49.15 million and in relation to any subsequent relevant year the value of it shall be derived from the following formula:

$$R_t = R_{t-1} \left[1 + \frac{RPI_t - X_T}{100} \right]$$

where

RPI_t means the percentage change (whether of a positive or a negative value) in the arithmetic average of the Retail Price Index figures published or determined with respect to each of the six months July to December (inclusive) in relevant year t-1 and the arithmetic average of the Retail Price Index figures published or determined with respect to the same months in relevant year t-2.

X_T means 0.

KK_{Tt} means the correction factor (whether of a positive or negative value) to be applied to the regulated transmission revenue in relevant year t (subject to Special Condition K (Restriction of transmission charges: adjustments), paragraph 3) which factor is to be derived as follows:

(a) in the relevant year commencing 1 April 2000:

$$KK_{Tt} = \frac{Q_{t-1}}{100} \times (C_{t-1} - T_{t-1}) \times \left(1 + \frac{IR_t}{100}\right)$$

where

C_{t-1} means the average charge per regulated unit transmitted in relevant year commencing 1 April 1999.

IR_t means that interest rate which is equal to, where KK_{Tt} in relevant year commencing 1 April 2000 (taking no account of IR for this purpose) has a positive value and C_{t-1} exceeds T_{t-1} by more than 2 per cent, the average specified rate plus 4 or, where KK_{Tt} in that relevant year commencing 1 April 2000 (taking no account of IR for this purpose) has a negative value and C_{t-1} does not exceed T_{t-1} by more than 2 per cent, the average specified rate.

Q_{t-1} has the value 12,066 (which represents the regulated quantity transmitted (expressed in GWh) by the licensee in relevant year commencing 1 April 1999).

T_{t-1} means the maximum average charge per regulated unit transmitted in relevant year commencing 1 April 1999; as determined in accordance with Schedule 5 of the form of SSE's transmission licence in force as at 31 March 2000; and

(b) in subsequent relevant years KK_{Dt} is to be derived from the following formula:

$$KK_{Dt} = (CR_{t-1} - TR_{t-1}) \left(1 + \frac{I_t}{100}\right)$$

where:

CR_{t-1} means the regulated transmission revenue in relevant year $t-1$.

TR_{t-1} means the maximum regulated transmission revenue in relevant year $t-1$.

I_t means that interest rate in relevant year t which is equal to, where KK_{Tt} (taking no account of I for this purpose) has a positive value and CR_{t-1} exceeds TR_{t-1} by more than 2 per cent, the average specified rate plus 4 or, where KK_{Tt} (taking no account of I for this purpose) has a negative value and CR_{t-1} does not exceed TR_{t-1} by more than 2 per cent, the average specified rate.

LF_{dt} *for the eleventh and preceding years means zero and in the twelfth and all subsequent relevant years, is derived from the following formula:*

$$LF_t = LP_t - LA_t$$

where:

LP_t *means, in the twelfth and all subsequent relevant years, an amount equal to the payments made by the licensee, in the relevant year t , in accordance with its obligations set out in Standard Licence Condition 4.*

LA_t *is derived from the following formula:*

$$LA_t = PF \cdot PIF_t$$

PF *means, in the twelfth and all subsequent relevant years, the amount of £0.22 million².*

² There was no explicit allowance made for licence fees within the Scottish transmission price control introduced in April 2000. The figure of £0.22million is derived using the level of transmission and total licence fees in 2000/01 and the total licence fee net of one off costs in 2001/02. It thereby reflects an

$$PIF_t = \left(\frac{1 + RPI_t}{100} \right) PIF_{t-1}$$

where for the twelfth relevant year PIF_{t-1} equals 1.

expected level of licence fees that would have applied beyond 2000/01 without the change to the structure of the licence fee.

i.e. $[\text{£}0.34\text{m} \times (\text{£}53\text{m} - \text{£}10\text{m}) / (\text{£}64\text{m})] / (1.0314) = \text{£}0.22\text{m}.$

Special Condition L: Information to be provided to the Authority in connection with the charge restriction conditions.

[Amendments to paragraph 7 in bold]

7. The specified items to be shown in the statement referred to in paragraph 5 shall be the following:
- (a) the regulated quantity transmitted;
 - (b) [no longer used]
 - (c) the regulated transmission revenue;
 - (d) the nature of all services provided as part of the transmission business and treated as excluded services, together with a statement of the revenues derived from each service so treated;
 - (e) **the value of the term LF_t together with the value of each of its component parts, as detailed in paragraph 1 of Special Condition J (Restriction of transmission charges).**
 - (f) [no longer used]
 - (g) the details referred to in paragraph 5 of Special Condition M (Allowances in respect of security costs); and
 - (h) such other items as shall be specified in directions issued by the Authority for the purposes of Special Conditions I to N .