

A FAIR DEAL FOR CONSUMERS

Modernising the Framework for Utility Regulation

Public Consultation Paper

on

The Future of Gas and Electricity Regulation



RESPONDING TO THIS CONSULTATION

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Context

1.1. This document fulfils the Government's undertaking, in its response¹ to consultation on the Utilities Review Green Paper², to consult on a range of issues surrounding the future framework for regulation of the gas and electricity industries. It concentrates on those aspects of the review that are specifically or primarily relevant to gas and electricity. In the main, other issues which range across all utilities are being dealt with in the wider context of the Utilities Review. This document addresses in particular the alignment of the electricity and gas regimes, and also the adjustments to the electricity regime which will be needed in consequence of the decision to license the supply and distribution of electricity separately. It looks at the arrangements for England, Scotland and Wales. It does not address those for Northern Ireland.

1.2. Many of the changes discussed here will require legislation, while others can be brought about by administrative action. Where legislation is envisaged, it will be included in the legislation that the Government intends, when parliamentary time allows, to introduce to implement the Utilities Review as a whole.

The future of regulation

1.3. The gas and electricity markets have developed rapidly since the current regulatory framework was put in place – perhaps to a greater extent, and at a quicker pace, than was foreseen at the time the regulatory regimes were first established. This has been marked, domestically, by increasing convergence in gas and electricity markets, and greater realisation of the possibilities and benefits of unbundling activities, and, internationally, by developing openness and interaction of energy markets. At the same time, developments in information technology have made new market structures technically feasible. Liberalisation has allowed companies to become increasingly active and innovative in seeking to create additional value through new sources of efficiency, synergies and customer services across the utility sectors and beyond. These developments, in which the United Kingdom has led the way, have brought and will continue to bring significant benefits to consumers.

1.4. The need now is to update the regulatory regime both to recognise the changes that have already taken place and to ensure sufficient flexibility to adapt quickly to changes that may take place in the future. The principle which underpins the Government's approach remains to protect the interests of consumers, including the disadvantaged, where possible through competition and otherwise through effective regulation.

1.5. It is not possible to predict accurately how the market will develop or the degree of regulatory intervention that will be required. In principle, as competition develops, it should be possible to adopt an increasingly light regulatory touch. Equally importantly, the regulatory framework should be designed to promote competition and to avoid locking the gas and electricity industries into structures (for example integrated electricity distribution and supply) which become inappropriate as the market evolves and further opportunities for introducing competition become apparent. The overall thrust of the changes to the legislation proposed is to create a more flexible framework for regulation, to give the

¹ A Fair Deal for Consumers: the Response to Consultation – DTI July 1998

² A Fair Deal for Consumers: Modernising the Framework for Utility Regulation – CM 3898 March 1998

regulator greater discretion to respond quickly and appropriately to events and changing circumstances, while safeguarding the legitimate interests of regulated businesses.

1.6. The Government will continue to encourage the development of competition in sectors where this is possible. This is the thrust of the discussion of the separation of electricity supply and distribution in this document. Price regulation will continue to be necessary in sectors that are beginning to open up to competition until the regulator is satisfied that normal competitive market forces can be relied upon to bring about fair and competitive prices. Even when controls are lifted, the general provisions of competition law, including the enhanced powers included in the Competition Bill, will be available to protect, in particular, against abuse of a dominant market position. In general it will be a task for the regulator to determine when price regulation can be eased and ultimately lifted in any particular sector. Competition in electricity supply is currently limited to a few areas of the country, but the benefits will be rolled out to all consumers in the coming months. As this sector becomes more widely contested, customers will feel the benefits of lower prices and new services, as they are in gas. Given the importance of gas and electricity both to economic activity as a whole and to individual members of the public, it will nevertheless be necessary to retain the licensing framework for competitive activities to regulate behaviour of market participants in areas such as safety and the terms under which services are offered to customers.

1.7. Some developments can be predicted with reasonable certainty: for instance, it is clear that for the foreseeable future some elements of the energy network businesses (the gas transportation pipeline network and the electricity transmission and distribution wires) will continue to operate as monopolies, and for these elements price regulation will need to be retained indefinitely. Nevertheless, these businesses will continue to be looked at carefully to identify the irreducible minimum of the monopoly elements and cost-effective opportunities for introducing further benefits of competition to the rest.

PROPOSAL 1.1: The Government invites views on how the gas and electricity markets might look after further development over the coming period, say in five to seven years.

The Utilities Review

1.8. The Government's response to consultation on the Utilities Review Green Paper announced a wide range of decisions on its agenda to modernise the framework of utilities regulation. They cover the areas of general regulatory principles, the interests of consumers, competition, social and environmental issues and better regulation.

1.9. Among the key decisions are:

- to place a single primary duty on the regulators requiring them to protect the interests of consumers, incorporating the existing duty to ensure that the regulated companies can finance their functions;
- to issue statutory guidance on social and environmental objectives, including energy-efficiency objectives;

- to establish consumer representative bodies on an independent statutory basis, and to create a single body for gas and electricity;
- to merge OFFER and OFGAS under a single energy regulator;
- to provide for separate licences for the supply and distribution of electricity;
- to replace individual regulators by full-time executive boards composed of a chairman and two others;
- to place a duty on the regulators to give collective consideration to matters of common interest.

1.10. The response also flagged the Government's intention further to consider or consult on a number of issues with a specific application to gas and electricity. These issues, which are among those dealt with in this document, are:

- the changes necessary to align and integrate the gas and electricity regulatory regimes;
- options for legislation to separate electricity supply and distribution;
- the appointment of an administrator for the energy network businesses;
- provision for deemed contracts for electricity;
- extending the rule-based approach to licence modification procedures in the energy sector, building on the rule-making power which already exists in the gas sector.

Other reviews

1.11. Other recent reviews and consultation besides this consultation also have a bearing on the framework for gas and electricity regulation. This document addresses some aspects of them but for full consideration of the issues it will be necessary to refer directly to the relevant documents. They are:

1.12. White Paper on energy sources for power generation: On 25 June 1998 the then President of the Board of Trade announced proposals for consultation on the review of energy sources for power generation. Representations in response to the consultation have been carefully considered and the Government published its final conclusions in a White Paper³ on 8 October.

1.13. OFFER's Reviews of Public Electricity Suppliers 1998 to 2000: In February 1998, the Director General of Electricity Supply set out his programme of the reviews of Public Electricity Suppliers (PESs), outlining the issues to be considered as part of the programme of work and reviews envisaged for the 14 PESs over the next two years. In May, as part of that programme, he published a

³ Conclusions of the Review of Energy Sources for Power Generation and Government Response to fourth and fifth Reports of the Trade and Industry Committee – Cm 4071, 8 October 1998

consultation document⁴ focusing on the issues surrounding the separation of activities, particularly PES distribution and supply businesses, the transmission business in Scotland, and the future treatment of metering. Issues raised there relate directly to a range of those discussed in this document. Another related paper, for publication shortly, is OFFER's consultation paper on trading arrangements in Scotland.

1.14. Consumer Councils: The response to the Green Paper announced the Government's intention to consult further on the precise duties and functions of the consumer councils that will be needed in order to ensure that they play a full and influential part in the regulatory process and that there is a transparent, effective and professional relationship between the councils and the regulator. This is the subject of a separate consultation document published by DTI⁵ in September 1998

1.15. Electricity Trading Review: In July 1998, the Director General of Electricity Supply published proposals⁶, based on extensive consultation, for the reform of electricity trading in England and Wales. The legislative implications are discussed below.

1.16. Implementation of the EU Electricity Directive: In July 1998, the Government published a consultation paper⁷ on implementation of Directive 96/92/EC on common rules for the internal market for electricity. This imposes obligations on the operators of distribution networks and makes no distinction between public and private networks. The consultation paper sets out the Government's proposals for implementing the Directive, which include the introduction of licensing for private electricity distribution networks, to which there is connected at least one customer with a maximum demand of more than one megawatt. The Government is currently considering the responses received.

1.17. Implementation of the EU Gas Directive: Directive 98/30/EC on the internal market in natural gas came into force in August this year, and Member States will have two years to implement it. The Government will be considering separately whether this will require any changes to the gas regulatory regime.

⁴ Reviews of Public Electricity Suppliers 1998 to 2000: Separation of Businesses: Consultation Paper – OFFER May 1998

⁵ A Fair Deal for Consumers: Public Consultation Paper on Consumer Councils – DTI September 1998

⁶ Review of Electricity Trading Arrangements: Proposals – OFFER July 1998

⁷ Consultation Paper: Implementation of Directive 96/92/EC of the European Parliament and of the Council of 19 December 1996 Concerning Common Rules for the Internal Market in Electricity – DTI July 1998

CONSISTENCY BETWEEN GAS AND ELECTRICITY REGULATION

New combined regulator and regulatory regime

CONTEXT

2.1. In the July response to the Utility Green Paper, the Government reaffirmed its commitment to merge OFFER and OFGAS under a combined energy regulator. It also confirmed that the existing gas and electricity regimes would be aligned and integrated. In addition, the response concluded that for energy and telecommunications, the individual regulator would be replaced by executive boards consisting of a chairman and two others⁸.

SINGLE REGULATOR

2.2. The Government has already announced the appointment of the new gas regulator from 1 November 1998, who will also take on the position of the electricity regulator from 1 January 1999. This is an interim measure until legislation can be put in place – following which he will become the chairman of the new combined executive board.

PROPOSAL 2.1: The Government proposes to provide in legislation for the appointment by the Secretary of State of a combined energy regulator (in the shape of an executive board) in place of the Directors General of Electricity Supply and Gas Supply.

HOW TO ALLOW THE REGULATOR TO REGULATE THE TWO MARKETS TOGETHER

2.3. The decision to combine the gas and electricity regulators reflects the fact that the two markets are increasingly difficult to consider in isolation, and that regulatory developments in one market increasingly have effects in the other. For example, gas will continue to be an important fuel for electricity generation and, as the market opens to competition, supply companies are increasingly offering customers both gas and electricity, often as a package.

2.4. In order to allow the regulator flexibility to tackle this convergence as effectively as possible he will need to have an ability to take a broad view across both sectors. In particular, in taking action in one market he will need to be able to take into account any effects this action might have in the other market. It may even be appropriate, in some cases, to achieve a desired result in one market by taking action which is primarily directed at the other, although such cases would probably be rare.

PROPOSAL 2.2: The Government proposes that the regulator should have a power to take a broad view in the exercise of his duties across both electricity and gas markets. This power would have to be exercised reasonably, in accordance with normal provisions of administrative law. Views are sought on whether any additional safeguards on the exercise of such a power might be desirable.

⁸ NB – The term “regulator” is used in this document, when describing the existing regime, to refer to the individual regulators under current legislation and, when looking to the future, to refer to the proposed executive board.

ALIGNMENT OF THE TWO REGIMES – GENERAL PRINCIPLES

2.5. There are numerous differences between the gas and electricity legislative regimes. In some places this is because of the different natures of the two different energy sources, sometimes this is because of differences in the structures of the two markets. However in many cases no such reason exists. The Government intends to align the two regimes where this makes sense. Where provisions exist that have a similar purpose, these should be brought into line – where different provisions reflect physical or market differences, then these differences should be respected. It is not the intention of this document to cover every potential change in the legislative regimes. It is however intended to flag up and discuss the main changes which are considered necessary.

ALIGNMENT OF THE DUTIES ON THE REGULATOR

2.6. It should be noted that the duties of the regulator will reflect the changes proposed in the Utility Green Paper and response, which include the new primary duty to protect consumers' interests – subsuming the duties to ensure reasonable demand is met, to ensure companies can finance their licensed activities and to promote competition – and the new secondary duty to have regard to statutory guidance. Reflecting these changes will itself bring a significant degree of consistency. Beyond this, the existing duties of the regulators under the Gas and Electricity Acts are in most respects similar, and alignment will present no difficulties. There are however some exceptions. For instance, three elements of the regulator's duties currently apply only to the electricity regulator:

- the duty to take into account the protection of rural customers' interests with regard to price and the other terms of supply;
- the duty to promote research and development by electricity licence holders;
- the duty to secure the establishment and maintenance of machinery for promoting the health and safety of persons employed in the generation, transmission or supply of electricity.

2.7. The Government would welcome views on the practical consequences of adopting them for both sectors or repealing them altogether, or on whether there is a continuing justification for maintaining the distinction between gas and electricity in any of these areas.

PROPOSAL 2.3: The Government believes that the new energy regulator should operate under one combined set of duties. It invites views on whether there are certain distinctions between the duties which should be retained.

COMBINED ENERGY LICENCES?

2.8. As outlined above, the Government believes that a combined energy regulator operating in a broadly aligned regime with proper flexibility is essential to tackle the convergence in the gas and electricity markets. Some have argued that a further step should be taken in that the existing gas and electricity licences should be replaced with combined energy licences – such as an energy supply licence.

2.9. It is not clear, however, what value such a new form of licence would have. There would be very little practical difference between one combined licence and two existing licences – the combined licence would still need to retain conditions which are specific to one or other energy source.

Introducing such a licence would require overhauling existing licences without good cause and would increase the administrative burden in that companies which wish to operate in only one market would still need to have a combined licence.

PROPOSAL 2.4: The Government does not propose to move from separate gas and electricity licences to combined energy licences.

Licence issuing/standard conditions

2.10. The electricity and gas regimes differ in important respects in the provisions relating to the issue of licences. Under the electricity regime, the authority for a licence flows from the Secretary of State: the Secretary of State can issue a licence, but the regulator can only issue a licence either with the consent of the Secretary of State or under a general authority given by the Secretary of State. The general authority given by the Secretary of State effectively sets out the way in which a new licence should be issued, listing the conditions which must be included. This general authority could in theory be varied, although in practice there has only been one since privatisation. The Secretary of State retains the power to grant a licence himself, although this power has not been exercised since 1992.

2.11. Under the gas regime, the Secretary of State cannot issue licences – only the regulator can. However, in issuing a licence, the regulator needs as a rule to follow the **standard conditions** for that type of licence. These standard conditions came into existence by being ‘determined’ by the Secretary of State. The regulator can impose additional conditions but can only modify the standard conditions themselves after consultation and with the agreement of a specified proportion of licence holders.

2.12. In practice, there is little difference between the power of a regulator to issue licences under a “general authority” and his power to issue a licence in accordance with “standard conditions”. However, one significant practical difference between the two regimes lies in the residual power of the Secretary of State, under the electricity regime, to issue a licence himself.

2.13. It would be inconsistent with the overall objective of harmonising the gas and electricity regimes to retain this distinction. The options are either to abolish the Secretary of State’s reserve power to grant a licence under the electricity regime; or to extend this reserve power to cover the granting of gas licences.

2.14. The arguments in favour of abolishing the reserve power for electricity are that it would clarify the respective responsibilities of the regulator and the Secretary of State and would remove the risk that an unsuccessful applicant for a licence would seek to undermine the regulator’s authority by seeking to apply separately to the Secretary of State. The original justification for such a power – that in the early days after privatisation it enabled Ministers to influence the rate at which the market for electricity became open – no longer applies now that the markets are or are about to become fully open to competition. Against that, it might be argued that the reserve power provides a useful mechanism for granting licences for particular limited purposes. However, even in such a case the Secretary of State would be under an obligation to have regard to the same matters as the regulator, and so long as the regulator’s powers to grant licences otherwise than in accordance with standard conditions are suitably flexible there is no reason to suppose that the absence of a reserve power would seriously hinder any

applicant. The limited use of the reserve power to date suggests that the regulator's powers are inherently sufficiently flexible to deal with the full range of applications. The Government is therefore inclined to align on the gas model of standard conditions, with no reserve power for the Secretary of State to issue licences, but would welcome comments on any implications this might have for licensees or applicants.

LICENCE EXEMPTIONS

2.15. An analogous concept to standard licence conditions are standard licence exemptions. In both the gas and electricity frameworks, there are powers to create individual exemptions. In electricity, however, it has been the practice of successive governments to provide *class* exemptions, where every party who meets the criteria may benefit from the exemption. This practice means that the licence exemptions granted in electricity have always been – in effect – standard licence exemptions, although in gas individual exemptions have been used in a number of circumstances.

PROPOSAL 2.5: The Government proposes that there should be a system of standard licence conditions for electricity (following the gas model). It invites views on whether or not the power to grant individual licence exemptions should be continued, and on the abolition of the Secretary of State's reserve power to grant electricity licences.

Collective licence modifications

2.16. Detailed conditions in licences provide the framework within which the utilities conduct their businesses: rights, obligations, objectives and constraints (including price restraints where appropriate) are defined in these documents, and compliance with the licences is monitored by the regulators.

2.17. In the gas market, the regulator has powers under the Gas Act 1986 (as amended) to modify certain licence conditions provided a specified proportion of the licensees approve the modification. For electricity (in most instances), water and telecommunications at present it is necessary for the regulators to agree any modifications to licences with each licensee individually. If there is a failure to agree, and the regulator wishes to pursue the proposed modification, there is no alternative but to make a licence modification reference to the Monopolies and Mergers Commission (MMC). That process may take six to twelve months before the outcome is known, and becomes more cumbersome and inappropriate as the number of licensees rise as a result of increased competition in the former monopoly utility markets. It means that key parts of the framework within which the market operates cannot be changed quickly to meet new challenges and opportunities arising from developments in the market.

THE "ELECTRICITY MODEL"

2.18. The Electricity Act 1989 provides that a licence may provide for conditions to be modified or cease to have effect by a mechanism and under circumstances specified in the licence. This provision has been used for the latest versions of the electricity supply licences to make provision for the collective modification of the contract terms conditions. A similar mechanism is provided by the Gas Act.

THE "GAS MODEL"

2.19. The Gas Act specifies an approach to the modification of standard conditions in a *class* of licences which requires (in broad terms) the consent to the regulator's proposal by at least 90% of

licensees (by number) *and* also the consent of those licensees who supply at least 90% of the volume of gas in the relevant market. If that degree of consent is obtained, the regulator can modify all the relevant licences as proposed. If not, a reference to the MMC is necessary if the regulator still wants to make the modification.

2.20. The regulator may also modify the standard conditions contained in an individual licence with the consent of the licensee, or following a licence modification reference to the MMC. However, he must be satisfied that such modifications are necessary in the circumstances and, in the case of a gas supply or shipper's licence, that none of the licensee's competitors is put at a disadvantage.

AN "ENHANCED GAS MODEL"

2.21. The collective licence modification procedures for gas currently require the specified majority of licence holders actively to consent to the regulator's proposals. A more flexible regime might result if it were to be the case that a modification could not take place unless a specified proportion of affected licensees actively objected to it, rather than the regulator having to obtain the necessary level of consent from the licensees.

2.22. This approach has the advantage that those who object to a proposed modification must take positive steps to make their objections known, and the focus of subsequent consideration will be on the issues raised in objection.

2.23. This approach could be further refined by adopting different blocking minorities in respect of proposed licence modifications depending on whether the modifications were primarily concerned with supplies to domestic and/or small business customers or to the industrial and commercial market or to other markets, e.g. the electricity generation or gas transportation markets. It might be argued, for instance, that in the industrial and commercial markets the blocking minority should be computed on the basis of the objectors' percentage of the volume of trade in the relevant market while a better test for licence modifications which affect supplies to the domestic and/or small business market would be the proportion of such customers served by the objectors. This approach would avoid a company with a significant number of larger customers having disproportionate influence in the outcome compared with a company with a large number of very small customers. Under these proposals, it is envisaged that the regulator's ability to refer to the MMC any proposed amendment which failed to secure the necessary consent would continue.

2.24. An outline of a possible procedure under these principles could be:

- (a) licence modification proposals which relate to a entire class of licensees should be subject to a collective procedure, and should succeed unless a blocking minority of licensees object;
- (b) the blocking minority should be in two parts:
 - (i) a percentage of all affected licensees; *or*
 - (ii) a percentage of the total volume of trade in the relevant market accounted for by the objecting licensees, except in the case of a licence modification which relates to supplies to domestic and/or small business customers, where the percentage of such customers served by the objectors should be used as the test;

- (c) the percentages would be set in legislation (following consultation) – we would anticipate these being the range of 15% to 20%.

A “QUALITATIVE MODEL”

2.25. An alternative approach could be to move away from the gas model altogether and adopt a more qualitative approach. In such a model, the regulator would be under a duty to ensure that all relevant licensees were aware of his intention to make a licence modification, and have a reasonable opportunity to comment. If all relevant licensees – those whose licences would be changed by the modification – consented to the change, the regulator would make a statement confirming that he intended to make the licence modification and that there were no outstanding objections. Silence would be deemed to be consent.

2.26. If objections were made, and not withdrawn, the regulator would be under a duty to consider whether sufficient objections in number and quality had been raised to cause him to abandon the modification; revise the proposal and re-consult; or to make a reference to the MMC.

2.27. If the regulator considered that the objections raised were insufficient to deter him from making the licence modification, he would be under a duty to issue a statement setting out his decision to make the proposed modification in 42 days time. The statement would set out his reasons for considering on the evidence given to him that the objections were not sufficient to warrant a reference to the MMC or re-consideration of the proposal. The statement would also set out why the licence modification could genuinely be considered to have the support of a substantial majority of the industry, and why the regulator considered the outstanding objections could be disposed of.

PROPOSAL 2.6: The Government supports the principle of collective licence modifications for certain licence conditions. It invites views:

- (i) as to how this can best be achieved to ensure that the licensing regime can evolve to meet the changing needs of the market, while retaining fairness and transparency for market participants;**
- (ii) on the models for collective licence modification set out in this document, and – in the case of the “enhanced gas model” – the percentages which should be applied to determine the level of the “blocking minority”;**
- (iii) on whether different procedures might apply to different types of licence and, if so, what they might be.**

Types of licence

2.28. Primary legislation is an elaborate process and not ideally suited to rapid adaptation. In the case of the Gas and Electricity Acts considerable flexibility is built into the legislation, primarily through the mechanisms of the scope of the powers of the regulator, the licensing mechanism itself and certain powers given to the Secretary of State. Nevertheless, the current need to create separate electricity supply and distribution licences illustrates the ability of developments in the energy market to outstrip the legislative framework. And it may now be possible to envisage redundancy of gas shippers’ licences. On

the other hand, the possibility of introducing metering licences is discussed in Chapter 5. A balance needs to be struck between the certainty and stability of measures enacted directly in primary legislation and the need for greater flexibility in the face of a rapidly changing market. Three possible mechanisms for adapting the structure of licences are outlined below.

SECONDARY LEGISLATION MECHANISM

2.29. A mechanism might be introduced to allow changes in the types of licences that are set out in the Acts through secondary legislation. The power could be used to:

- a) remove some activities entirely from the definition of activities for which a licence is required;
- b) provide for some activities for which a licence is required to be divided into one or more discrete activities for which separate licences could be issued; and
- c) possibly, to prohibit the holding by one legal person of specified combinations of licences in different classes (as is already the case, for instance, in gas).

2.30. The power would need to be wide enough to allow consequential changes to the relevant legislation and existing licences to be made also. For example, where duties attach to any particular licence, and it is proposed to issue separate licences for identifiable components of the relevant activity, it will be necessary to establish to which licence-holders, if any, the corresponding duties attach after the change has been made.

MECHANISM FOR A “SPECIAL LICENCE”

2.31. A secondary legislation mechanism would relate to whole categories of licence. An alternative mechanism might be appropriate in cases where only one individual licence was thought necessary. For instance, it has become clear that over time, activity which might have been considered part of an irreducible monopoly can actually be separated out and made competitive. In the interests of promoting competition, it could be desirable, where cost-effective, to allow such activities to be unbundled from the core monopoly, operated separately and subsequently opened to competition.

2.32. Such activities, being only ancillary to the core monopoly, may not require the level of regulation implicit in the creation of a new type of licence to cover it. Nonetheless, at the time of unbundling, this activity will initially at least be a monopoly, and it may be appropriate for the licence provisions that apply to it before unbundling to continue to apply after unbundling. However, the current legislation and licensing regime makes no provision for such unbundling to take place and the activities to remain regulated under the Acts – they are either regulated under the licensee’s special licence conditions, or not at all. Alternative regulatory mechanisms, such as the offering and acceptance of undertakings, are not likely to be as effective as the provisions of the licensing regime.

2.33. A new mechanism might allow for a new ‘special’ licence to be created. Such a licence would effectively be created by carving out the relevant conditions from the existing licence into a new licence – along with any necessary additions. It would only be used to allow a licensed activity to continue to be licensed (but in a different place) and would not be used to extend licensing to new activities. This type of licence would be used to regulate a residual monopoly in this activity – so it would only apply to those already carrying on the activity under their present licence. Any other company could take up this activity without needing to apply for a licence. Such a licence would have provisions for its expiry if and when competition is established.

CLASS LICENCES

2.34. An alternative to removing particular types of licence altogether could be to provide for the issuing of class licences – that is licences issued to all persons or to classes of person – as well as individual licences. This is used for example in the Telecommunications Act. The mechanism would impose a standard licence, with its associated constraints on the behaviour of the licensee. It would avoid the necessity of establishing individual licences for activities which are generally constrained through other mechanisms, and would appear particularly appropriate for activities in those areas in which a competitive market is developing, including electricity and gas supply. Amendments to class licences would be made using the “qualitative model” discussed above.

PROPOSAL 2.7: The Government invites views on whether it would be of benefit to introduce mechanisms for adapting types of licence, such as any or all of those described above, without the need to resort to primary legislation.

GAS SHIPPERS’ LICENCES

2.35. Under the current regime, a shipper’s licence is required if a person wishes to arrange with any Public Gas Transporter (PGT) for gas to be introduced into, conveyed by means of, or taken out of a pipe-line system operated by that PGT. The main obligations of a shipper’s licence relate to

- conveyance of gas otherwise than on Network Code or similar terms (the legacy agreements that Transco entered into before the Network Code came in to effect);
- their behaviour with respect to using a pipe-line system;
- emergencies.

2.36. Shippers contract with PGTs via the Network Code which each PGT is obliged to draw up to cover the terms and conditions of transportation arrangements. Shippers also contract with gas suppliers. There are some shippers which do not supply gas and there are suppliers which do not act as shippers. In normal circumstances, customers (even very large customers) do not have a direct contractual relationship with Transco.

2.37. The gas regulator has been examining the current relationship between PGTs and shippers with a view to establishing whether it would be more appropriate for a number of the activities currently undertaken between Transco and shippers to be undertaken instead between Transco and suppliers and/or customers. Such activities include the allocation by Transco of transportation capacity, interruptibility, access to and verification of site-specific data. It is thought that many of these issues could be addressed by introducing the concept of a “connection agreement” between Transco and the customer.

PROPOSAL 2.8: The Government invites views on whether some of the activities currently undertaken by shippers should instead be undertaken by suppliers and/or customers; and/or whether gas shippers’ licences might be abolished altogether.

Assignment of licences

2.38. Under the Gas Act licences can be assigned with the consent of the regulator. There is no corresponding provision in the Electricity Act. There seems little reason for having different approaches in relation to the two sectors.

2.39. At first sight a power to assign licences provides a useful flexibility in a changing and restructuring market. On closer examination, however, this advantage is less apparent. It is clear from section 8AA of the Gas Act that in deciding whether to approve an assignment the Director General has to have regard to all the matters he would have had to consider were he deciding whether to issue a new licence; and in approving an assignment he may attach new conditions not attached to the original licence. In other words, to all intents and purposes an assignment of a licence is treated in exactly the same way as the cancellation of an existing licence and its replacement with a new one – which is the approach that would have to be adopted under the Electricity Act powers. On that analysis, rather than extending the power to approve assignments of licences to the electricity sector it would make as much sense to abolish it in the gas sector.

PROPOSAL 2.9: The Government invites views on the proposal to bring the two regimes into alignment either by abolishing the ability to assign gas licences or by introducing it to electricity licences.

SEPARATION OF SUPPLY AND DISTRIBUTION OF ELECTRICITY

Supply and distribution

3.1. The Green Paper on Utility Regulation noted the anomaly that exists between the gas and electricity regimes in that gas distribution is licensed separately from supply, while electricity distribution and supply are regulated in the same licence.

3.2. The Green Paper proposed that separate licences should be introduced for the supply and distribution activities of the Public Electricity Suppliers in order to help ensure the establishment of a vigorous, competitive market. This would be done through legislation to amend the Electricity Act 1989.

3.3. After the Green Paper was published, OFFER published a consultation document which discussed how the supply and distribution businesses should be separated. The OFFER paper suggested that licence separation should be reinforced by requiring the PESs to separate out their operations. It also suggested that to ensure competition it would be necessary for supply and distribution to be put into separate ownership. The Government's response to the Green Paper confirmed the intention, when parliamentary time allows, to introduce legislation aimed at separating supply and distribution activities, and to consult on the options for that legislation.

OPTIONS FOR LEGISLATION

3.4. The three main options for legislation are:

- (a) supply and distribution to be licensed separately;
- (b) supply and distribution to be licensed separately *and* in addition supply and distribution businesses must at least be in separate Companies Act companies;
- (c) supply and distribution to be licensed separately *and* in addition the supply and distribution businesses must be separately owned.

3.5. The most basic option, option (a), would simply entail changing the legislation so that supply and distribution were defined as discrete activities which were to be licensed separately. This would in itself have many benefits. First, separate licences would enhance the regulator's ability to distinguish between regulation of supply and distribution. Increasingly, economic regulation could be focused on the monopoly distribution business, with a progressively lighter touch being adopted towards the emerging competitive market in supply – moving eventually towards the removal of price controls. Second, separate licences would give the industry more scope to restructure. Without legislation there would still only be one licence for each PES and the ownership of both supply and distribution assets would have to remain with the PES. However, with the introduction of domestic competition it may be that some PESs will wish to sell their supply businesses. The industry restructuring, which could follow from this proposal, could benefit consumers, first as companies focus on their core business activities and second, as existing cross-subsidies between distribution and supply are forced out into the open. Finally, this would bring the electricity regime more closely into line with that for gas.

3.6. However, some argue that separating the licences alone is not enough. They believe that the introduction of competition to the domestic market increases the need to ring-fence monopoly from competitive activities, if competition is not to be distorted. The PESs will retain a monopoly on distribution in their area. If, in addition, they continue to operate their supply business (which have

until now had a monopoly of customers in the area), it is possible that they could – consciously or unconsciously – gain unfair advantage over their competitors in the supply market from running both businesses. This might happen through:

- the distribution business giving preferential treatment to its own supply business at the expense of a competitor supply business. As long as a company runs both distribution and supply, the staff in the distribution business will have a tendency to see other supply companies as competitors rather than their customers;
- the distribution business passing on commercially sensitive information to its own supply business;
- cross-subsidies from the distribution business, which is used and paid for by all, to its supply business;
- the perception by potential new market entrants that they will be discriminated against;
- the perception by customers that they will receive a poorer distribution service if they are 'disloyal' and switch to a new supplier;
- PES distribution activities, to which all local customers will necessarily be exposed, could unfairly reinforce the PES supply brand image.

3.7. For these reasons, some believe that proper competition will not develop while supply and distribution are under the same ownership and that therefore option (c) is necessary.

3.8. The Government recognises that separate ownership is likely to enhance competition. Indeed this is a major motivation for separate licences, as this would *allow* PESs to sell off one of their businesses where currently this is not feasible. However, the Government does not believe that the forthcoming legislation should *force* the PESs to put their supply and distribution businesses into separate ownership. Such a requirement would prevent the competition between different types of ownership structures which would be allowed under options (a) or (b).

3.9. An alternative approach would be for the legislation to reinforce the separate licensing by requiring that these licenses are held in separate Companies Act companies. The supply and distribution businesses would have to be placed in separate legal entities but these *could still be held under common ownership* – for example as separate subsidiaries. This approach was taken with the gas industry in the Gas Act 1995 – as a result of which the supply and transportation business of British Gas were separated into two companies in common ownership (the decision to fully demerge was voluntary and came later on).

3.10. Requiring that supply and distribution be placed in separate companies would make the relationship between these businesses more transparent and would make clearer how the separate activities were being financed. It would force these relationships to be put on a contractual basis, enabling these contracts to be compared with contracts that the distribution business has with other suppliers. Also, with distribution in a separate company from supply, the regulator would be better able to concentrate regulation on the monopoly distribution business. He would be better able, for example,

to tighten up the 'ringfence' condition, if appropriate, in the interests of promoting competition in supply and facilitating more effective regulation of monopoly distribution. For these reasons, such a requirement is an attractive option.

3.11. However, if separate companies were required by legislation, then it would also be necessary to move from the current situation where one company runs both businesses to this new situation where two companies (albeit in common ownership) are needed. It would be necessary for the assets and liabilities of the current single company to be properly apportioned between the two companies needed. In the case of the Gas Act 1995, the legislation provided for a *transfer scheme*. This provided for a public gas supplier to nominate an associate company, and then to make a scheme for dividing up the property, rights and liabilities between the supplier and the associate. This transfer scheme then had to be approved by the Secretary of State, following which it became legally binding – including on third parties.

3.12. Under such an option, the supply businesses of the PESs would need to become stand-alone companies. This might raise difficulties in that while supply businesses are exposed to a significant risk in relation to input costs and customer base, they do not have major assets to maintain a level of creditworthiness equivalent to the current PESs (the majority of a PES's assets are in the distribution business). On the other hand exposing this difficulty could be seen as a positive step for competition – a supply business in a competitive market should not benefit from the backing of the assets of a monopoly distribution business which have been or will be paid for by all. Separating out the supply company from the distribution company would force the issue of risk management into the open. Nonetheless it would be important that the initial separation should be done in such a way that the supply company is financially viable from the outset – this might require a restructuring of the balance sheet or, perhaps, other commercial measures.

3.13. Following the Gas Act model of a transfer scheme could have unfavourable consequences for third parties. This is because the transfer scheme would allow the transfer of the assets and liabilities of a PES *without the consent* of a third party. Thus, third parties who had negotiated a contract with a PES could find their contract transferred to a separate supply company subject to higher risk. However it is thought that a transfer scheme is a key requirement – without it such a third party could block the separation of the PES into two companies, frustrating the achievement of the underlying policy. On the other hand, there may be ways to mitigate the effects on third parties – perhaps through transition periods.

PROPOSAL 3.1: The Government does not propose, in legislating for separate licences for supply and distribution, to require the supply and distribution businesses to be held separately. Instead, the Government is attracted to the proposal that the supply and distribution businesses should be required to be held in *separate legal entities* (which could be in common ownership). It nevertheless notes that there may be issues involved with this proposal – in particular with the transfer schemes needed to effect the separation into two companies of a PES's assets and liabilities. The Government invites views on this proposal, in particular on any difficulties involved in such a separation and how they might be mitigated, and on the associated costs.

OPERATIONAL SEPARATION

3.14. Having placed supply and distribution activities in separate legal entities, it is expected that these businesses should operate separately from each other. The businesses would be organised so that the core functions of supply and of distribution are correctly assigned to the respective entity and are carried out separately from activities in the other entity.

3.15. Further separation may also be necessary to prevent distortions. OFFER have argued in their 'Separation of Businesses' paper that a greater operational separation is necessary. This would mean, for example, that the supply and distribution businesses would not be able to share common services such as call centres or IT systems. There are clearly advantages in this approach – by separating as far as possible the activities of the two businesses, the potential for distortion is reduced. On the other hand, customers may benefit from efficiencies arising from common services; indeed the PESs argue that forcing the pace of such separation could lead to significant costs if PESs were forced to duplicate systems which presently are shared. The balance between the costs of separation and the competition advantage to be gained will no doubt form part of OFFER's consideration in developing its proposals further.

PROPOSAL 3.2: The Government accepts the logic behind operational separation, and recognises that the detailed aspects are a matter for the regulator to pursue.

Scotland: supply, distribution and transmission

3.16. The electricity industry in Scotland has evolved differently from that in England and Wales, and generation, transmission, distribution and supply are carried on within a vertically integrated structure. This reflects a number of factors: for instance, the small size of the Scottish market when compared to that in England and Wales, the particular problems associated with a relatively high proportion of remote rural electricity consumers and the balance between electricity capacity and demand in Scotland.

3.17. The demographic arguments for a different regime in Scotland remain: but developments in the market suggest that it may now be appropriate to reconsider the detail of this regime. There is, for instance, evidence that demand may be increasing over time in relation to capacity.

3.18. Evidence as to the effect of competition in the Scottish market is mixed. On the one hand, some generators and suppliers report greater difficulty in gaining access to the Scottish market than elsewhere in Great Britain; and the proportion of large consumers changing supplier in Scotland is very much lower than in England and Wales. Whether, and if so to what extent, this reflects the significant amount of generation over-capacity and/or vertically integrated structure in Scotland is not clear. And despite the lack of new entrants to the generation market, electricity prices in Scotland have fallen in line with those in England and Wales, although it must be a matter of speculation whether greater competition might have led to even greater benefits.

3.19. The Government has already announced that, in Scotland as in England and Wales, supply and distribution will in future be separately licensed. Additional steps which might be necessary to achieve the desired result of greater competition in the supply market are discussed elsewhere in this document. In addition to these measures, the Government would welcome views on whether competition and

transparency in the Scottish market might be enhanced by further measures. One step might be to require that the generation, transmission, distribution and supply activities of the existing integrated companies should be carried on by separate Companies Act companies, even if they remained under common ownership. This would introduce greater transparency into the relations between the different businesses. A further step, and one which would bring the structure of the industry more into line with that elsewhere in Great Britain, would be to require the operation of the transmission system in Scotland to be separated out and carried out independently of the Scottish electricity companies. This would remove the potential for a conflict of interest when competing generators sought access to the system; and would thus enhance the prospect for competition in both the generation and supply markets.

3.20. There is a further difference between the position in England and Wales and that in Scotland. Section 9 of the Electricity Act imposes a duty on holders of transmission licences in England and Wales to facilitate competition in the supply and generation of electricity. In Scotland this duty is qualified, insofar as it relates to the integrated companies, and becomes a duty to make the transmission system available to competitors on terms which neither prevent nor restrict such competition. With the further opening up of the electricity market to competition throughout Great Britain it is arguable that this special provision in relation to Scotland alone, which, it has been argued, places the integrated companies at an advantage in relation to others seeking access to the system, is no longer justifiable.

PROPOSAL 3.3: The Government believes, as in England and Wales, that steps should be taken in Scotland to improve the transparency and effectiveness of the regulatory regime and provide for greater competition. It therefore invites views on the proposals to:

- (i) require the generation, transmission, distribution and supply activities of the integrated Scottish companies to be carried on by separate Companies Act companies;**
- (ii) require independent operation of the transmission activities of the integrated companies; and**
- (iii) to remove the qualification of the duty on transmission licence-holders to facilitate competition in the supply and generation of electricity.**

CHANGES CONSEQUENT ON SEPARATE ELECTRICITY DISTRIBUTION AND SUPPLY LICENCES

Context

4.1. The Electricity Act 1989 does not distinguish between electricity supply and distribution and both activities are combined in the Act's definition of supply. The Act provides for separate licensing of the PESs and second tier suppliers (suppliers of electricity other than a PES in its own authorised area) and there are differences in the way each is treated. The discussion above on separation of electricity distribution and supply makes clear that the Government will provide for separate licensing of the two activities, and proposes that a single legal entity should not hold both a distribution and a supply licence. This chapter considers the scope of the two separate activities and the possible future partition of rights and obligations between the two. This will have important implications for the relationship between customer and electricity supplier, particularly for domestic customers, where the statutory basis for the relationship is based on the now superseded model of a monopoly PES supplier.

Supply

A SINGLE CLASS OF SUPPLIER

4.2. The Government intends to continue to promote a competitive market in electricity supply, with due regard to the needs of all customers including the disadvantaged and those in remote rural areas. This requires that factors that distort competition should be eliminated as far as possible, in order to ensure that customers receive the fullest possible benefits in terms of reduced prices and better service. The differences in the current regulatory framework between the treatment of PESs and second tier suppliers would, if preserved in the future regime, be a significant distortion to competition. It is the Government's view, therefore, that all suppliers under a separated supply regime should be placed on an equal footing as regards the applicable statutory provisions and licence terms that govern their activities, i.e. the distinction between PES suppliers and second tier suppliers would be removed. It is nevertheless important in particular that many aspects of the protections given to domestic customers under current PES licences are preserved. This is especially so during the transition to full competition in the supply market, when special licence conditions might be applied to dominant suppliers, after which normal market mechanisms should become the main means of protecting customers. The principal elements of a new structure for supply are discussed below.

MOVE TO CONTRACT SUPPLY

4.3. All but large customers of PESs are supplied on the basis of terms that are set out by statute (commonly known as tariff supply), rather than in a contract. Customers of second tier suppliers are supplied on the basis of a contract. Meanwhile in the economy as a whole, contracts are the normal means of establishing the relationship between customer and supplier, and indeed this is the case for gas. An important body of consumer protection law continues to develop which gives customers significant protections in relation to contracts which are not available to them under tariff supply. Statutory terms for supply appear to offer consumers few compensations for the loss of the benefits provided by general consumer law. It seems desirable therefore, both to enhance the consumers' position in their relationship with suppliers and to place all suppliers on an equal footing in the market, that all supply is moved to a contract basis and that the statutory basis for tariff supply is removed. Legislation would have to provide for the transition of existing customers from tariff to contract supply on standard contract terms.

OBLIGATION TO SUPPLY

4.4. It will nevertheless be necessary to ensure that all classes of customers, including the disadvantaged, should have access to electricity supply on reasonable terms. The primary mechanism for achieving this will be to maintain the existing obligation on all suppliers to supply on request on standard contract terms. Nevertheless, the costs of providing a service to certain customers, who may be disadvantaged, for instance those using pre-payment meters or other relatively costly payment methods, may be greater than for other domestic customers. In the response to the Utilities Green Paper, the Government recognised the measures in hand by the regulators and companies to drive down costs and improve efficiency and choice, as an important mechanism which should benefit disadvantaged consumers. As stated then, the Government will act further through the regulatory system if these market developments do not allow disadvantaged customers to receive a fair share of the benefits of liberalisation.

PROPOSAL 4.1: The Government considers that all suppliers should be placed on an equal footing in the competitive electricity supply market, on the basis of a requirement to offer contract terms on request. It invites views on the best way to achieve this, while ensuring that all groups of customers have access to electricity supply on reasonable terms.

DEEMED CONTRACTS

4.5. It is proposed that all relationships between a customer and a supplier are put on a contractual basis. In the normal case, a customer wishing to take a supply from an electricity supplier will seek their agreement and sign a contract. However, in some cases a customer will take a supply without having made an agreement (for example if someone moves into an empty house where the supply has not been cut off). In a non-competitive situation, current arrangements have proved adequate to cater for this situation, but in the new circumstances of competition an alternative is necessary, at least for smaller customers. It is for consideration whether an provision is required for large contracts.

4.6. In gas, there is provision for 'deemed contracts' with the appropriate supplier in the situations above. For example, if someone moves into an empty house and continues to take gas without notifying any supplier, the customer is normally deemed to have contracted with the last supplier that supplied those premises. All suppliers will have already made a scheme setting out the terms and conditions that will apply to such deemed contracts – and whenever a contract is deemed then these will be the terms and conditions that are deemed to apply. Such schemes must be published and sent to the regulator.

4.7. The provision also covers the eventuality that the previous supplier is no longer operating. In this case there would be a further supplier that would have either taken on the licence of the previous supplier, or would have taken on their customers – and it is this supplier that would be the party to the deemed contract.

PROPOSAL 4.2: The Government proposes to extend to electricity the provision for deemed contracts that exists in gas. It invites views on the operation of this scheme, and on any threshold to the size of contract above which it might not apply.

SUPPLIER OF LAST RESORT

4.8. A further requirement which becomes necessary once tariff supply is abolished is for the provision of a supplier of last resort. If a supply company ceases to trade then it will be important to ensure that their customers have continuity of supply. This is only likely to happen when a supply company suddenly becomes insolvent. In the case of a planned exit from the market, the regulator should seek to ensure that arrangements are put in hand to ensure continuity of supply before a supply company is permitted to exit.

4.9. The question then is who should take on the customers. In the existing situation the answer might be the PESs – but in the future regime, the intention is to place all suppliers on an equal footing. Also, it would not be possible to use the deemed contract provision proposed above as in some cases there would not have been any other previous supplier (e.g. where the supply has always been made by the PES which is now ceasing to trade).

4.10. The Government recognises that once the special status of the PES is removed, it will be crucial to have an effective mechanism in place to ensure that there is a supplier of last resort. A sensible approach would be to give the regulator the power to order electricity suppliers to take on the customers of other licensees. This is broadly the position in gas.

4.11. It would then be open to question which supplier the regulator should choose. One solution might be for the regulator regularly to seek indications by suppliers of the scope of their willingness to act as supplier of last resort, to provide the basis for a rapid auction in the event of the service being required, or even to hold a regular bidding round for the right to act, which – other things being equal – would be won by the company with the lowest prices.

4.12. Although the discussion above is framed in terms of all customers, it is not expected that this provision would be necessary for larger customers – although it is to be established where the dividing line might be drawn.

PROPOSAL 4.3: The Government proposes that a mechanism be put in place to ensure that there is a supplier of last resort. It invites views on which mechanism would be best, and which customers should be protected by such a mechanism.

Distribution

4.13. The Government's starting point is that distribution should be a separate licensable activity and distributing electricity without a licence would be an offence. The definition will need careful consideration. In principle, it is the transport of electricity over low or medium voltage lines for the purpose of its supply to the customer. It is for consideration whether the existing concept of mutually exclusive authorised geographical areas should be retained. An alternative would be to define the scope by reference to a specified system or systems. The concept of a 'Public Electricity Distributor' might supersede that of a 'Public Electricity Supplier' to maintain the emphasis on the public duty aspects of the PES distribution function.

4.14. The extent to which smaller distribution systems (that is those that do not belong to the PESs) should be licensable is one of the issues addressed in DTI's consultation on the implementation of EC Directive 96/92 (referred to in the introduction). It is envisaged that any interim legislative action the Government may take to implement the Directive will later be subsumed in legislation to implement the Utilities Review as a whole. It should be noted that the consultation proposes a definition of 'distribution' which offers a statutory *de minimis* exclusion of smaller systems. An alternative could be to make use of existing statutory provisions to grant exemptions to small systems from the requirement to be authorised by licence. If smaller systems are to be licensed, a distinction may be required between them and PES distribution activities and different rights and obligations may apply.

4.15. The distribution activities of the PESs can be expected to remain a monopoly and will therefore continue to be subject to price control regulation. The main elements of those activities could under a separated regime in future be:

- to develop and maintain an efficient, co-ordinated and economic system of electricity distribution;
- provisions related to acquisition of land, works, wayleaves and the maintenance of wires;
- to provide a connection to the distribution network on established terms;
- to promote competition in supply and generation.

PROPOSAL 4.4: The Government invites views on the definition, scope, rights and obligations of the separate activity of electricity distribution.

Other issues

4.16. A range of other measures in the electricity legislation are based on the model of a monopoly PES provider of supply and distribution, which will no longer be valid following separation of supply and distribution and measures to introduce full competition in the electricity supply market. While some of the more important ones are discussed below, the Government is interested in views on all consequential implications for legislation that separation might have.

POWERS AND RIGHTS GRANTED TO THE PESs

4.17. Under current legislation, powers and rights are given to the PESs to enable them to fulfil a range of functions. Important among these are rights of entry to customers' property to effect such operations as installation, inspection, maintenance and removal of a company's electricity plant, wires and meters and to cut off or reconnect supply. To the extent that these rights are related to the distribution function, for example for safety reasons and the maintenance and installation of electrical plant, it seems sensible that they should be assigned to holders of distribution licences. Rights in relation to disconnection and reconnection, for example for non-payment of bills or for theft of electricity, would appear to rest with suppliers. In the gas regime, all licensed suppliers have equal rights of entry. This may be appropriate for electricity. However, it is for consideration whether it would be desirable to grant rights in such a

widespread manner or whether, as a possible alternative, the distribution companies should be required to act on a supplier's behalf, subject to adequate compensation.

PROVISION OF METERS

4.18. Competition in metering in gas and electricity is discussed in chapter 5. As a consequence of the introduction of competition, it can be envisaged that a range of parties, including electricity suppliers and distributors and independent suppliers of metering services could be involved in the provision of meters. As metering is an essential adjunct to supply and distribution, it appears possible that the rights discussed in the previous paragraph, in as far as they relate to metering, should still remain with either suppliers or distributors, rather than also being given to independent meter providers. A separate question is the basic duty to provide a meter, which currently rests with the supplier. The three main alternatives appear to be to place specific obligations on suppliers, or to place them on distributors, or to place obligations on all providers of metering services. It is proposed that existing statutory rights of customers to provide their own meter will be maintained.

NON-FOSSIL FUEL OBLIGATION

4.19. The Non-Fossil Fuel Obligation (NFFO) for renewable energy generation requires the PESs to contract for specified amounts of new generating capacity using renewable energy. The Government is considering separately how the NFFO might be adapted to the new circumstances.

STANDARDS OF PERFORMANCE

4.20. Legislation currently gives the regulator power to apply standards of performance (for example concerning quality of supply, response times to customer requirements or energy efficiency) on the PESs but not to other suppliers, with compensatory payments to consumers in some cases for failure to meet them. As they are currently framed, many apply to the distribution function. Others apply to both distribution and supply. Since distribution will remain a monopoly activity, not subject to the normal incentives of the market, it would appear sensible to retain this power in relation to this activity. In keeping with the general principle of placing all suppliers on an equal footing following separation of PES distribution and supply, it is for consideration whether standards of performance should be applicable to all suppliers or to none. It may also be necessary to cater for transitional circumstances, where local market dominance persists. In a fully competitive market, standards of performance should not need to be imposed by the regulator⁹. As in other areas of the economy, the market should provide sufficient incentive for companies to provide a level of performance acceptable to their customers. Moreover, imposed standards would lock suppliers into particular modes of behaviour and could stifle innovation in service delivery. If considered necessary, other arrangements could be envisaged, for instance a requirement for companies to establish their own standards and to measure and publish their own performance against them, rather than meet imposed standards.

PROPOSAL 4.5: The Government invites views on the changes that will be necessary to adapt the electricity legislation as a consequence of separate licensing of supply and distribution.

⁹ But this would not apply to any statutory standards of performance mechanism being contemplated by the Government to promote energy efficiency.

5.1. Arrangements for metering services (meter provision – the provision, installation, and maintenance of meters; and meter reading – the arrangements for collecting data from meters, and, in electricity, the additional function of data aggregation for electricity trading) will be an important factor in the further development of competition in the gas and electricity markets.

5.2. Under current arrangements, in electricity large industrial customers can make their own arrangements for both meter provision and reading but domestic customers must use the meter reading services of their local Public Electricity Supply company (PES), whether or not that company is their supplier. Under the arrangements for the further extension of competition in the electricity market, which will be completed by 2000, both meter provision and meter reading will be open to competition. Legislation already allows all customers, including domestic, to provide their own meter, although in practice domestic meters are owned by the local PES. Current arrangements for gas provide for competition in metering services, although impediments to competition remain.

5.3. The regulators have established additional measures, such as the provision of metering services of last resort, to ensure that obstacles to competition in supply arising from the current structure of metering services are removed. In gas, the regulator is developing proposals for a separate metering price control for Transco and for the physical, financial and information separation of Transco's metering business. In electricity, there is a case for adopting a similar regulatory approach to the PESs' metering operations. Similar arguments apply to separation of metering as apply to the separation of electricity supply and distribution, discussed elsewhere in this document. Indeed some PESs have begun to develop self-standing metering businesses aimed at exploiting opportunities in the competitive market.

5.4. Competition in meter reading has already been set in train in gas and preparations for its introduction in electricity are under way. However, the introduction of competition in meter provision is still at an early stage. The two need to go together if the full benefits of innovation in service provision, reduction of costs and widening of consumer choice are to be realised. It has nonetheless been argued by some PESs and providers of metering technology that the prospect of competition in meter provision is inhibiting rather than promoting the introduction of improved meter technology in the domestic market. This is on the basis that the current major providers (the PESs in electricity and Transco in gas) are unwilling to invest in new metering given the risk of being unable to recover their investment in a competitive market. Thus an alternative approach of monopoly, price-controlled provision of meters, possibly coupled with mandatory minimum levels of sophistication, would better assure the spread of advanced metering. The Government is not attracted to this approach, which would introduce a formal monopoly where none now exists, would stifle wider technological innovation and would stand in the way of innovation by suppliers in establishing new metering arrangements, for instance joint utility metering.

5.5. The Government supports the efforts of the gas and electricity regulators to introduce competition in metering services and looks to them to take this forward in consultation with the industry and other interested parties. The introduction of competition should serve a number of purposes. It should remove potential obstacles to the development of competition in gas and electricity supply. It should open the way for cost reduction and innovation in metering services themselves and it should stimulate the introduction of new and innovative metering technology, where commercially viable. The Government considers that the scope for the cost-effective introduction of innovative metering technology might be improved by meter manufacturers agreeing a common interface for interconnection. That could avoid nugatory investment in metering stock which becomes obsolete through the adoption of an alternative standard for communications from the meter.

5.6. It is important that the benefits should accrue to all classes of customers, including the disadvantaged. The Utility Green Paper proposed an action plan, which has now been published by the regulators, to achieve efficiency, choice and fairness in the provision of gas and electricity to disadvantaged consumers. In it, companies were called on to drive forward the development and introduction of new, cheaper and more robust meter technology in order to reduce the capital and maintenance costs of meters, and the regulators were called on to bring about a competitive market in the procurement of pre-payment and other meter services as soon as is practicable, in order to obtain the best possible value for money for consumers. In the response to consultation, the Government stated its view that in principle the introduction of competition in the provision of meters and meter reading services should help to ensure cheaper and better services.

5.7. In addition, it is for consideration whether, with the development of competitive metering services separate from other licensable activities, metering should be made a licensable activity in its own right to ensure it remains within the regulatory framework. On the other hand, it might be envisaged that metering services would remain primarily an adjunct to the supply businesses, through whom any necessary obligations could be imposed. This could be supplemented by accreditation to ensure suitability of meters and appropriate competence of meter installers and/or readers.

PROPOSAL 5.1: The Government supports the introduction of full competition in meter reading and meter provision. It invites views as to how this can best be achieved to ensure that its benefits accrue to all consumers including the disadvantaged. It further invites views on any necessary restructuring of gas and electricity legislation to reflect the development of competition and on the desirability of introducing separate licensing of metering.

Appointment of an administrator for energy networks

6.1. The response to the Utility Review Green Paper proposed that consideration should be given to making statutory provision for the appointment of an administrator for monopoly energy network businesses (those which operate the gas transportation pipeline network and the electricity transmission and distribution wires), to prevent interruption of supply in the event of insolvency or licence revocation. Interruption of energy supplies could be extremely serious particularly, perhaps, for some disadvantaged consumers. Hospitals and many business users tend to have standby supplies of electricity for basic needs but large industrial consumers could be badly hit and rail services would be disrupted. There are two circumstances in which the appointment of an administrator can be envisaged: the insolvency of a network provider and enforcement of licence conditions.

INSOLVENCY

6.2. The prospect of a monopoly network provider (Transco, NGC, or one of the 14 PESs) becoming insolvent is very remote. As monopoly providers they have a captive customer base and their income is regulated.

6.3. In the very unlikely event that things should progress to the point of insolvency, under existing arrangements there are a number of ways in which the company might be treated under insolvency law. These might not result in the company ceasing to trade. Actions which could allow the company to continue to trade and not result in interruption of supply are: the appointment of an administrative receiver by a bank or other secured creditor with a floating charge over the assets of the company (where this was not prohibited by licence conditions); the appointment of an administrator by the court on petition from the directors of the company or a creditor; or a voluntary arrangement agreed between the company and its creditors. These all offer a good prospect of the company continuing to trade with no interruption to supply. However, it is also possible that a creditor could obtain a winding up order against the company if it were in very serious difficulties. Although the prospect is that a monopoly business would be sold on to another party very quickly by a liquidator, there could be an interruption of energy supplies in such a case.

6.4. This issue has been addressed in the case of water and rail regulation by provisions in the Water Industry Act 1991 and the Railways Act 1993 for the appointment of a special administrator. The provisions enable the Secretary of State (or the regulator with the permission of the Secretary of State) to apply to the High Court to appoint a special administrator. The principal grounds on which an application may be made include where the company is unable to pay its debts and, in the case of the Water Act only, where the company is in serious breach of its general duty to maintain an efficient and economical system of water supply or to provide a sewerage system or of an enforcement order made in respect of its licence conditions.

6.5. The special administration order arrangements in the Water and Railways Acts draw heavily on the administration arrangements in the Insolvency Act but with a number of important modifications. The aim of the special administrator is to transfer the existing undertaking's business to other companies as a going concern and, whilst the transfer is being arranged, to manage the company. This aim applies both in the case of insolvency and, in the case of water, a serious breach of an undertaker's general duty or of an enforcement order.

6.6. Without immediate financial support for their cash flow, insolvent companies in special administration might not be able to continue to trade. In the case of water and rail the Government has accepted the financial risk that goes with the ability to appoint a special administrator.

6.7. This overall approach could be used to provide a backstop should an energy network company become insolvent. If such an event occurred, the cost could initially be quite high in cash terms but the size of the potential liability would depend on the circumstances of the case. Immediate cash flow demands would come from wages and essential operating costs. However, the prospect of recovering loans or grants made to the company in these circumstances are good, although not assured. And even this low risk could be considered very small indeed compared to the degree of disruption caused by the withdrawal of energy supplies.

6.8. In the case of water and rail the Government has taken powers to provide public funds to meet the immediate cash needs of an insolvent company. However, in some other sectors outside of the utilities, notably the travel industry and banking, a fund is established to deal with such circumstances. The effect of this approach is that the cost of 'insuring' against the insolvency of a network operator would fall on those at risk. Such a fund could be established before or after the event.

6.9. In the case of insolvency, there is a small risk to continuity of supply which would be overcome by the ability to appoint a special administrator.

PROPOSAL 6.1: The Government proposes to introduce a provision for the appointment of a special administrator in the event of the insolvency of an energy network business. The Government seeks views on funding arrangements.

ENFORCEMENT OF LICENCE CONDITIONS

6.10. Interruption of supply could also occur, in principle, as a result of the withdrawal of a monopoly network company's licence. Licence revocation might be considered if the company were in serious dispute with the regulator. However, in such cases the powers given to the regulator by sections 25 – 27 of the Electricity Act and 28 – 30 of the Gas Act would be available to secure compliance before revocation of the licence were considered. These provisions provide for the regulator to make orders to secure compliance with licence conditions and allows for civil damages claims to be brought in certain circumstances. The regulator can bring civil proceedings to enforce licence conditions. Failure to comply with the Court's decision could also result in fines and ultimately, in extreme cases, to the imprisonment of the company's officers. In the case of gas, the regulator has the power to impose monetary penalties to prevent continuing licence breaches. The size of such penalties depends on what the regulator determines is appropriate in each case. At the moment this power is not available to the electricity regulator.

6.11. Currently there would be significant difficulties in imposing the sanction of licence revocation for breach of a gas or electricity licence condition against a network business. Were there to be a revocation of a licence the assets used in undertaking the licensed activity would be likely to remain under the ownership of the company, but if the licence had been revoked then those assets could not be used. In the case of a monopoly network business the effect would be to prevent the supply of energy. The revocation of the licence in such cases may therefore be a threat the regulator would be unable to

carry out because to do so would contravene the regulator's duties. Consequently licence enforcement relies on the above remedies. The possibility of revocation of the licence cannot therefore easily be used as a means of enforcing compliance. However, the establishment of a route to special administration would make such an outcome easier to achieve. Furthermore, the ability of the regulator to seek the appointment of a special administrator is a substantial enforcement tool in its own right. The creation of a route to special administration could provide an additional enforcement option.

6.12. In the case of rail there is no provision for the appointment of a special administrator in such circumstances and the situation of energy networks is, arguably, more analogous to rail than to water. In the case of water the special administration provisions apply where there has been a serious breach of an undertaker's general duty or of an enforcement order. However, it could be argued that the widespread risks to public health associated with failures of water quality and sewerage require such a backstop.

6.13. Current arrangements allow the regulator to enforce compliance through civil proceedings which contain quite substantial incentives to comply. The appointment of a special administrator in the case of dispute would allow for the transfer of a business to new ownership as a means of resolving a dispute. This is a major penalty and would substantially increase the powers of the regulator.

PROPOSAL 6.2: The Government invites views on whether it should take powers to appoint a special administrator in the case when enforcement proceedings are being taken against a licensed network company.

Review of electricity trading arrangements

BACKGROUND

6.14. In October 1997 the Minister for Energy and Industry initiated a review to respond to mounting criticism of the Electricity Pool. In July, OFFER submitted proposals¹⁰ for new electricity trading arrangements to the Minister.

6.15. The proposed structure of the new market represents a radical change. It does not feature a compulsory Pool nor the central control over plant despatch that the National Grid Company (NGC) currently exercises. Instead it is proposed to establish a number of markets which will allow more opportunities for contracting, easier adjustment of contract positions, better risk management and the balancing and operation of the system. These are common features of other commodity markets, including gas. These arrangements are:

- a forward market in which customers and suppliers can contract bilaterally for electricity. This would be similar to the current Contract for Difference market except contracts will be for the physical delivery of electricity rather than just a financial arrangement. It is expected that most electricity would be traded in this market;

¹⁰ Review of Electricity Trading Arrangements: Proposals – OFFER July 1998

- associated derivatives markets such as futures and options which will enable companies to hedge financial risk;
- a short-term bilateral market which would provide for simple screen-based trading between generators, suppliers and large customers. This market would operate close to the time the electricity is due to be delivered – probably from a day ahead – and would close four hours ahead. It would allow parties to adjust their contract positions in the light of latest information, in particular regarding the weather and the availability of generating sets;
- a balancing market in which the NGC would be the sole counterparty to trades. This market would operate around four hours ahead of the moment of delivery (i.e. from the point the short term bilateral market closes). Generators, and particularly those with flexible plant, would be able to offer increases or decreases from their contracted output into this market and the demand side would be able to offer load reductions. NGC would buy these offers to balance supply and demand on the grid system and to manage transmission constraints;
- a process to deal with the financial settlement of electricity trades made in the markets;
- other markets may be developed if market participants require them

6.16. The Government announced in the Energy White Paper (Cm 4071) that it had concluded that these proposals represent the right overall direction. DTI and OFFER are now leading a project to implement the new arrangements. An early task in that work is to define in detail the operation of the trading arrangements, which are therefore not addressed here.

IMPLEMENTATION

6.17. Although it may be possible to implement the new trading arrangements within the existing legislative framework, the Government is committed to change and intends, when parliamentary time allows, to legislate to support the necessary changes. The Government is now seeking views on the overall approach it should adopt in bringing forward legislation.

SUPPORTING THE PROCESS OF CHANGE TO NEW TRADING ARRANGEMENTS

6.18. It will be necessary to transfer trading from the Pool to the new arrangements, develop new market rules and governance arrangements, institute a balancing market, a settlements process and put in place other essential elements of the new arrangements. Specific proposals to achieve this are still being developed.

6.19. To ensure the implementation of new trading arrangements it may be necessary to amend the conditions in supply, generation and transmission licences. This could be achieved under current procedures for making licence modifications. Alternatively it might be possible for legislation to provide for necessary changes to be made directly to licences in order to put in place conditions required for the implementation of new trading arrangements. Proposals for the inclusion of standard conditions in licences and revised procedures for collective licence modification discussed elsewhere in this document are also relevant. In addition industry agreements such as the Pooling and Settlement Agreement, the Grid Code and the Master Connection and Use of Systems Agreement will need to be amended. Appropriate amendments to electricity licences could facilitate the necessary changes being made to these industry agreements.

AMENDMENTS TO CONTRACTS

6.20. Amendments may also be required to some existing commercial contracts for electricity, some of which use Pool price as a reference price in their contract conditions. It has been suggested that legislation could be used to overcome some of the difficulties that the demise of a recognised Pool price might otherwise cause.

ENDURING ARRANGEMENTS: BALANCING AND SETTLEMENT CODE AND GOVERNANCE

6.21. Once the market is established, arrangements must be agreed for how changes are made to the balancing market rules, how disputes are resolved and what role the regulator should play. These questions are still being considered.

6.22. The Review of Electricity Trading Arrangements proposed that the rules for the balancing market be set down in a Balancing and Settlement Code (the Code) which would be established as a result of a new condition in NGC's licence. The mechanism for drawing up the Code has yet to be agreed, but would include substantial involvement of industry and customers and the final approval of the regulator. The Code would contain the rules of the new balancing market and settlements process. Thereafter modifications to the Code would be subject to the approval of the regulator, who would consider advice from a Balancing and Settlement Code Panel of interested parties. The intention is that the due process followed in making modifications to the Code would ensure changes in the Code properly reflect the overall interests of all parties. An alternative approach could be envisaged where the responsibility for the market rules should rest with an independently established body rather than one established through NGC's licence.

6.23. Consideration must be given to what legislative changes might be necessary both to implement the final governance arrangement and to ensure that the new balancing and settlement arrangements are properly regulated. Regulation may be needed as these arrangements, unlike the other markets proposed, will, in effect, be monopolies. The regulation of the new balancing and settlement arrangements might be achieved through the establishment of a new statutory body, possibly including a Balancing and Settlement Code Panel, regulated by the DGES. Alternatively the balancing and settlements arrangements could be specified as a new licensable activity with the regulator as the licensing authority. In either case the operation of the balancing and settlement arrangements would be an activity regulated by the regulator. An alternative approach would be to establish the new Balancing and Settlement Code Panel through conditions in NGC's licence, as described in the preceding paragraph. Regulation of the market would be undertaken by the regulator through a combination of the rules included in the Balancing and Settlement Code and conditions in electricity licences.

PROPOSAL 6.3: The Government invites views on:

- (i) what legislative changes might be necessary to support the implementation of new trading arrangements;**
- (ii) whether legislation could be used to overcome contractual problems caused by the demise of a recognised Pool price;**
- (iii) what legislative changes might be required to support new governance arrangements and the regulation of the balancing and settlements arrangements.**

Additions to the powers available to the Engineering Inspectorate

INTRODUCTION

6.24. DTI's Engineering Inspectorate administers the Electricity Supply Regulations 1988, made under the predecessor to section 29 of the Electricity Act 1989 to govern the safety, quality and continuity of electricity supply in England, Scotland and Wales. Among its main duties under the Regulations is to monitor and investigate serious accidents and incidents involving the day to day safety of the public and of electricity companies' equipment and works. It is for consideration whether the right balance continues to exist between the powers of the Inspectorate to insist on companies' safety compliance, and increasing pressure on companies to reduce costs in response to competition and price regulation.

6.25. There is a separate set of issues, which are outside the scope of this document, about the adaptation of the Regulations better to reflect the introduction of competition in supply and the separation of distribution and supply. Nevertheless, it may be desirable that duties in respect of safety, quality and continuity of supply should be placed on distributors rather than suppliers and it is for consideration whether and how section 29 might be amended to that effect.

PROPOSAL 6.4: The Government invites views on how statutory duties in respect of safety and continuity of supply should be correctly apportioned.

6.26. The Government is determined that the Engineering Inspectorate should continue to have adequate powers to ensure the safety of the public in the liberalised electricity market. While cost reduction in the electricity industry is to be welcomed, it is essential that necessary expenditure on safety is not compromised. Amendment to powers in relation to certain other safety issues, other than those with implications for companies' costs, may also be desirable. In order, therefore, to ensure the continued successful execution of the Engineering Inspectorate's duties into the foreseeable future, the Government is considering changes to its powers under the legislation. The proposed changes are explained below.

PROPOSED AMENDMENTS TO POWERS

6.27. Access: Currently access over land to an electricity company's equipment must be arranged with the company under the terms of its wayleave and other agreements made with the land owners and occupiers. This often means that an inspector must be accompanied by a company representative while on third party land and precludes unannounced inspections. It is proposed that Inspectors are given powers of access over any land where this is reasonable in order to carry out safety inspections or for any other purpose related to the enforcement of the Regulations.

6.28. Information: Currently the Inspectorate has powers to obtain information from companies but not from third parties, in particular from members of the public where they may have witnessed incidents under investigation. Because the Regulations are directed at protecting the safety of the public and the security of the electricity supplies, it is reasonable that inspectors should have the power, clearly established in legislation, to seek information from any person as necessary to enforce the Regulations. Sometimes it may also be reasonable to require these persons to sign a declaration of truth of their statements for use in court proceedings. Powers similar to that in section 20(2)(j) of the Health and Safety at Work etc. Act 1974 (HSWA) are envisaged. The powers of information gathering should also

be modernised to permit, where reasonable, the taking of photographs and of measurements and such examination or investigation as an Inspector considers necessary for the purposes of enforcing the regulations. Powers along the lines of that currently at section 20(2)(d) and (f) of HSWA are envisaged.

6.29. Enforcement notices: Regulation 38 provides for the Secretary of State to serve a notice where it is considered that an installation or suppliers' works are liable to be a source of danger to others or are liable to interfere with a supply to others. Non-compliance is an offence. However the penalties for such offences are out of step with costs of compliance because the offence is for breach of secondary rather than primary legislation, which usually carries higher penalties. It is therefore proposed that the notice provisions should be placed in primary legislation and also that power is given to the inspector himself to serve the notices. This would be along the lines of the powers currently in sections 21 and 22 of HSWA. An appeals process similar to that which operates for regulation 38 would be necessary.

6.30. Onus of proof where provisions are qualified by "so far as is reasonably practicable": Many of the provisions in the Regulations are qualified by the term "so far as is reasonably practicable" which is a reflection of the complex balance of risk against cost in electricity safety. Since much of the information necessary to determine this point is held only by the electricity companies themselves, the onus should be on companies to demonstrate that it was not reasonably practicable to do something rather than the reverse. A precedent exists in section 40 of HSWA.

6.31. Unauthorised entry to substations etc. to be an offence: There is a duty in the Electricity Act 1989 on all persons not to damage electrical plant or lines of public electricity suppliers (paragraph 4(1) of Schedule 6) but this provision is directed mainly at meter fraud, illegal extraction and damage caused to suppliers' equipment on consumers' premises. However, there is a particular problem with deliberate entry to substations and other plant areas such as cable tunnels. Incidents of entry to substations and other plant are widespread for the purpose of theft of earth tape and other important and safety-critical components or for the purpose of switching off supplies to an area to facilitate burglary. Electricity supplies and the safety of company employees and the general public are often put at risk. While existing legislation that targets breaking and entering and theft could apply here, in practice arrest and successful prosecution of offenders is difficult. An offence of unauthorised entry to substations and other plant should lead to higher rates of successful prosecution and an increased deterrent effect.

6.32. Power to indemnify inspectors: It is proposed that the power is established to indemnify an inspector against civil claims by third parties for loss through the actions of an Inspector. There is a parallel power in section 26 of HSWA in respect of HSE appointed Inspectors.

6.33. Power to make regulations to enable the recovery of certain costs: It is proposed that the power is introduced for the Regulations made under section 29 of the Electricity Act 1989 to permit the recovery of costs by an electricity company where third parties have commissioned safety-related services of the company under the regulations (e.g. provision of temporary insulation to allow safe working in buildings close to low voltage overhead lines).

6.34. Extension of time for proceedings: It is proposed that a power is introduced to enable the time allowed for bringing summary proceedings under the Regulations to be extended where, for example, the matters have been subject to delay caused by Coroner's Courts or, (in Scotland) a Fatal Accident Inquiry, etc. A precedent for this exists in section 34 of HSWA.

PROPOSAL 6.5: The Government invites views on whether these amendments to the powers of the Engineering Inspectorate should be introduced.

Geographical scope of Public Gas Transporter licences

6.35. Under section 7 of the Gas Act each Public Gas Transporter (PGT) licensee has a monopoly to transport in the area covered by its licence (its authorised area). At commencement Transco held a PGT licence for the whole of Great Britain. Other Independent PGT licence holders who wish to add a new development or infill to their portfolio are required to apply to the regulator for an extension to their licence base, which is then carved out of Transco's licensed area. Because it has a nation-wide licence Transco is not required to make such applications in relation to individual building developments and is free to negotiate with developers without the constraints imposed on its competitors. In addition to the delays imposed by even the most efficient licensing process, a non-Transco PGT is also obliged to give Transco 14 days notice of its application for a licence extension. This gives Transco a competitive advantage in being able to identify potential business opportunities of which it might otherwise be unaware, as well giving it as the opportunity to object to the other PGT's application for an extension – an opportunity which Transco often exercises.

6.36. A better solution may be to remove the geographical exclusivity and allow for any PGT to be granted a national (or smaller) licence base. The presumption that a licence should not cover an area within 23 metres of a main of another PGT could be retained with suitably refined criteria for objections by other PGTs. However there would be no need for licensing by the regulator of each new extension on an individual basis. Instead it would be sufficient for the regulator to receive the map reference of the location of the PGT network. This would greatly reduce administration costs for the independent PGTs. In addition, the advertising requirements in local areas could be removed leaving only the requirement to advertise in the London Gazette. The window for objections would be reduced, perhaps to 7 days

PROPOSAL 6.6: The Government invites views on whether to end the geographic exclusivity of Public Gas Transporter licences.

Invitation for other ideas

6.37. This document has sought to examine how to adapt the framework of regulation to reflect current and potential future developments in the gas and electricity markets, within the scope of the Government's review of utility regulation. The Government wishes to hear views on all aspects of the issues discussed here, including any that have not been elaborated in detail.

PROPOSAL 6.7: The Government invites views on any further aspects of the issues discussed in this document that would be relevant to the adaptation of the regulatory framework for gas and electricity.

1. Introduction

PROPOSAL 1.1: The Government invites views on how the gas and electricity markets might look after further development over the coming period, say in five to seven years.

2. Consistency between Gas and Electricity Regulation

PROPOSAL 2.1: The Government proposes to provide in legislation for the appointment by the Secretary of State of a combined energy regulator (in the shape of an executive board) in place of the Directors General of Electricity Supply and Gas Supply.

PROPOSAL 2.2: The Government proposes that the regulator should have a power to take a broad view in the exercise of his duties across both electricity and gas markets. This power would have to be exercised reasonably, in accordance with normal provisions of administrative law. Views are sought on whether any additional safeguards on the exercise of such a power might be desirable.

PROPOSAL 2.3: The Government believes that the new energy regulator should operate under one combined set of duties. It invites views on whether there are certain distinctions between the duties which should be retained.

PROPOSAL 2.4: The Government does not propose to move from separate gas and electricity licences to combined energy licences.

PROPOSAL 2.5: The Government proposes that there should be a system of standard licence conditions for electricity (following the gas model). It invites views on whether or not the power to grant individual licence exemptions should be continued, and on the abolition of the Secretary of State's reserve power to grant electricity licences.

PROPOSAL 2.6: The Government supports the principle of collective licence modifications for certain licence conditions. It invites views:

- (i) as to how this can best be achieved to ensure that the licensing regime can evolve to meet the changing needs of the market, while retaining fairness and transparency for market participants;
- (ii) on the models for collective licence modification set out in this document, and – in the case of the “enhanced gas model” – the percentages which should be applied to determine the level of the “blocking minority”;
- (iii) on whether different procedures might apply to different types of licence and, if so, what they might be.

PROPOSAL 2.7: The Government invites views on whether it would be of benefit to introduce mechanisms for adapting types of licence, such as any or all of those described above, without the need to resort to primary legislation.

PROPOSAL 2.8: The Government invites views on whether some of the activities currently undertaken by shippers should instead be undertaken by suppliers and/or customers; and/or whether gas shippers' licences might be abolished altogether.

PROPOSAL 2.9: The Government invites views on the proposal to bring the two regimes into alignment either by abolishing the ability to assign gas licences or by introducing it to electricity licences.

3. Separation of Supply and Distribution of Electricity

PROPOSAL 3.1: The Government does not propose, in legislating for separate licences for supply and distribution, to require the supply and distribution businesses to be held separately. Instead, the Government is attracted to the proposal that the supply and distribution businesses should be required to be held in *separate legal entities* (which could be in common ownership). It nevertheless notes that there may be issues involved with this proposal – in particular with the transfer schemes needed to effect the separation into two companies of a PES's assets and liabilities. The Government invites views on this proposal, in particular on any difficulties involved in such a separation and how they might be mitigated, and on the associated costs.

PROPOSAL 3.2: The Government accepts the logic behind operational separation, and recognises that the detailed aspects are a matter for the regulator to pursue.

PROPOSAL 3.3: The Government believes, as in England and Wales, that steps should be taken in Scotland to improve the transparency and effectiveness of the regulatory regime and provide for greater competition. It therefore invites views on the proposals to:

- (i) require the generation, transmission, distribution and supply activities of the integrated Scottish companies to be carried on by separate Companies Act companies;
- (ii) require independent operation of the transmission activities of the integrated companies; and
- (iii) to remove the qualification of the duty on transmission licence-holders to facilitate competition in the supply and generation of electricity.

4. Changes consequent on separate Electricity distribution and supply Licences

PROPOSAL 4.1: The Government considers that all suppliers should be placed on an equal footing in the competitive electricity supply market, on the basis of a requirement to offer contract terms on request. It invites views on the best way to achieve this, while ensuring that all groups of customers have access to electricity supply on reasonable terms.

PROPOSAL 4.2: The Government proposes to extend to electricity the provision for deemed contracts that exists in gas. It invites views on the operation of this scheme, and on any threshold to the size of contract above which it might not apply.

PROPOSAL 4.3: The Government proposes that a mechanism be put in place to ensure that there is a supplier of last resort. It invites views on which mechanism would be best, and which customers should be protected by such a mechanism.

PROPOSAL 4.4: The Government invites views on the definition, scope, rights and obligations of the separate activity of electricity distribution.

PROPOSAL 4.5: The Government invites views on the changes that will be necessary to adapt the electricity legislation as a consequence of separate licensing of supply and distribution.

5. Metering

PROPOSAL 5.1: The Government supports the introduction of full competition in meter reading and meter provision. It invites views as to how this can best be achieved to ensure that its benefits accrue to all consumers including the disadvantaged. It further invites views on any necessary restructuring of gas and electricity legislation to reflect the development of competition and on the desirability of introducing separate licensing of metering.

6. Other Specific Provisions

PROPOSAL 6.1: The Government proposes to introduce a provision for the appointment of a special administrator in the event of the insolvency of an energy network business. The Government seeks views on funding arrangements.

PROPOSAL 6.2: The Government invites views on whether it should take powers to appoint a special administrator in the case when enforcement proceedings are being taken against a licensed network company.

PROPOSAL 6.3: The Government invites views on:

- (i) what legislative changes might be necessary to support the implementation of new trading arrangements;
- (ii) whether legislation could be used to overcome contractual problems caused by the demise of a recognised Pool price;
- (iii) what legislative changes might be required to support new governance arrangements and the regulation of the balancing and settlements arrangements.

PROPOSAL 6.4: The Government invites views on how statutory duties in respect of safety and continuity of supply should be correctly apportioned.

PROPOSAL 6.5: The Government invites views on whether these amendments to the powers of the Engineering Inspectorate should be introduced.

PROPOSAL 6.6: The Government invites views on whether to end the geographic exclusivity of Public Gas Transporter licences.

PROPOSAL 6.7: The Government invites views on any further aspects of the issues discussed in this document that would be relevant to the adaptation of the regulatory framework for gas and electricity.

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