

Laing Energy
Consultation Response Paper
Regulation of Independent Distribution Network
Operators (July 2004 180/04)

1 Introduction

Laing Energy Limited welcomes the opportunity to comment on the consultation into the regulatory arrangements for IDNOs. Having recently been awarded an IDNO licence, LEL is keen to ensure that the regulatory regime provides the correct incentives for efficient IDNO entry and hence achieves the maximum long-term benefits to consumers from improvements in:

- the economic, timely and efficient development and operation of distribution networks;
- quality and reliability of supply; and
- competition in connections, networks and retail supply.

We believe that, for this to be achieved, two outcomes are required:

- host DNO charging arrangements must be transparent, predictable, efficient, and cost-reflective; and
- IDNOs should not be exposed to levels of risk significantly different than that of the DNOs.

Thus, in LEL's view, the development of the regulatory arrangements discussed in this consultation cannot be seen in isolation from the likely outcome of the ongoing Ofgem work programme on the structure of DNO charging arrangements since the risks faced by IDNOs under the existing and many of the proposed charging options are a function of the host DNO charges.

Our detailed comments on areas where views were invited are covered later in this paper, but we would like to take this opportunity to expand on three key points, which, as a new IDNO licence holder, we feel, must be understood in assessing the effectiveness of any long-term regulatory regime:

- the level of risk IDNOs face under the existing arrangements creates inefficient barriers to entry;
- any long-term sustainable regime is dependent on transparent, cost-reflective, charging by DNOs; and
- there are differences in the nature of IDNO and DNO businesses that must be recognised.

1.1 Risks under the Current Arrangements

LEL's major concern with the current charging arrangements is that they expose IDNOs to an inappropriate level of risk, creating a barrier to efficient entry of new network providers.

The current contractual arrangements require the IDNO to collect use of system charges on behalf of all the distribution businesses whose networks are used to convey electricity to the end use customer and to pay use of system charges to the upstream distribution network to which it is connected (the upstream DNO). Thus:

- IDNO revenues are determined by the difference between the end user DUoS and the use of system charge it must pay to the host DNO; and
- IDNOs are liable for all upstream use of system charges.

Although LEL accepts that the nature of the business means that IDNOs and DNOs risk profiles may not be identical, we believe that the current arrangements impose inefficient incremental risks, which adversely impact on IDNOs:

- the IDNO has not control or certainty over its future revenue streams or the level of its upstream costs;
- the IDNO is exposed to the DNO adjusting the pricing between the exit point and higher voltages in order to restrict entry of IDNOs; and
- the IDNO remains liable for all upstream DUoS charges and therefore bears all the risk of payment default from a supplier (effectively isolating the upstream DNO from any risk).

1.2 Transparency of DNO charging

Transparent, cost-reflective DNO charging regimes are necessary to ensure efficient network expansion and configuration in the future. Transparency and predictability in the charging regime would, in LEL's opinion, serve to reduce the incremental uncertainty that we currently face under the existing arrangements. Our own analysis shows there is a wide variation in the implied revenues for an IDNO dependent on the host DNO. However, the lack of transparency and predictability in the DNO charging methodologies prevents us understanding the reason for these differences. This increases our risk through unnecessary uncertainty on long-term revenue streams.

On its own, however, transparency is not sufficient. Without cost-reflectivity, the development of competition in networks and the consequent benefits to consumers may still be stymied as signals of the true costs of expansion may not emerge in the market. Thus, it is important that costs are appropriately allocated between different voltage levels and that there is no scope for cross-subsidisation from IDNOs linked to vertically integrated groups (at either network or retail level). This issue is particularly important when considering the case of DNOs operating outside of their host area. For this reason we believe that all distribution operators competing with a host DNO should be subject to the same regulatory arrangements and that the operations of DNOs operating out of area must be ringfenced from their regulated activities.

LEL notes that a number of workstreams are currently being progressed in order to address many of the concerns relating to DNO charging. We firmly support the objectives of reform in these areas and would welcome the opportunity to participate in further industry development of the detailed arrangements. Of particular concern to all IDNOs will be the arrangement to ensure viable competition in connections. While LEL welcomes the removal of Tariff Support Allowances, we are concerned that the retention of network adoption payments may still provide scope for DNOs to cross subsidise costs between contestable and non-contestable parts of their business. This would clearly restrict the development of competition in connections, limit the contestability of network adoption and provide a barrier to entry for IDNOs.

1.3 Differences between DNOs and IDNOs

While the ultimate service that is provided by DNOs and IDNOs is largely the same, there are several substantive operational and regulatory differences that should be taken into consideration. On an operational basis, the different scale, mix and geographic dispersion of an IDNO suggests that the use of a relative regulatory regime (such as implied by option A or D) over an RPI – X control would represent a more cost-effective means of regulating charges. However, these same differences also imply that the IDNO and DNO costs are not perfectly correlated and therefore this factor would need to be accounted for in the regulatory regime.

It also needs to be taken into account that the ultimate risk associated carrying out a given network expansion would differ between a DNO and an IDNO due to the different regulatory regime that the investment is subject to. For example, the price control regime for DNOs

means that they would receive a greater degree of certainty over the recovery of efficient investment than would be provided to an IDNO under the current arrangements.

1.4 Summary

In light of these high-level considerations, LEL would conditionally support further development of the arrangements proposed in Option D (a relative price control). We believe that this option embodies the correct principles to ensure consumers and network operators bear the appropriate risks, but must be developed in conjunction with the structure of charges for DNOs.

We would be happy to discuss any of the issues raised in our response with you in person and look forward to contributing to future development of this regime.

2 Specific responses to consultation questions

2.1 Contractual arrangements

2.1.1 Whether similar contractual arrangements as those that exist in the gas sector should be applied to the electricity sector?

LEL sees that there would be a number of benefits in moving towards similar contractual arrangements as those that exist in gas, namely:

- clearer and more transparent definition of DNO charges at different points on the network;
- reduced administrative burden on IDNOs with respect to invoicing and contractual relationships;
- removal of liability for upstream DUoS charges (and hence obviating some of the issues with respect of financial ring fencing and residual supplier default risk).

However these benefits must be weighed against the cost of changing the arrangements, the increased burden on other market participants e.g. suppliers and a consideration of whether the above benefits could be achieved within the current industry framework.

It should also be noted that changing the contractual arrangement alone will not mitigate the major risks and barriers to entry faced by IDNOs, this is the uncertainty in future revenues due to DNOs changing regimes at different points on the network. It should be noted that the contractual arrangements in the gas sector benefit from a much simpler and transparent charging structure for contestable parts of the network. This is not currently the case for electricity distribution.

Therefore, while LEL would not be against a move towards the contractual arrangements in the gas industry we believe it would be more appropriate to concentrate on addressing the risks and burdens under the current arrangements.

2.1.2 The governance of inter-distributor relationships and the appropriate agreements between the two parties

IDNOs are able to provide end use customers with an efficient alternative the DNO provided the DNOs charges at different points in their network are clear, transparent, efficient and non discriminatory. These factors need to be reflected in the governance arrangements between distributors. The governance arrangements need to be consistent with the fact that IDNOs and DNOs may sometimes be in direct competition to provide specific network extensions. Therefore it is essential to ensure that DNO connections of IDNO networks are subject to a guaranteed delivery programme and cost.

Contractual arrangements between the DNO and IDNO that share the burden of downstream default would also help to reduce the barriers to entry for IDNOs (this point is covered more fully in the section on financial ring fencing).

2.1.3 Whether boundary metering should be required between a DNO's network and an IDNO embedded network?

LEL is concerned that imposing the cost of boundary metering on IDNOs could create a barrier to entry for IDNOs as works carried out by a DNO would not require metering. The implications of this differential treatment would be that customers of IDNOs would face more cost reflective charges than equivalent customers of the DNO. It is LEL's opinion that if boundary metering provides a better allocation of system charges and losses than all the

beneficiaries of the more accurate data should share in the costs of its provision. The potential beneficiaries would include:

- DNOs
- users of the DNO system
- the IDNO; and
- users of the IDNOs system

LEL is in favour of arrangements that allow for boundary metering in situations where the benefits can be shown to outweigh the costs provided these costs are shared between all beneficiaries.

2.1.4 Which parts of the IIP reporting arrangements requirements should apply to IDNOs and how would these need to be modified to reflect their circumstances?

Economies of scale will mean that the burden of reporting will be greater for IDNOs.

LEL believes that requirements for IIP reporting should be proportional to the extent to which Ofgem intends to use an IIP structure to determine an IDNOs charging allowance.

2.1.5 Which of the standards of performance should apply to IDNOs and how would these need to be modified to reflect differences in size and other circumstances between incumbent DNOs and IDNOs?

LEL believes that it can provide benefits to customers by providing better levels of service than incumbent DNOs. We would therefore be happy to be faced with the same minimum standards of performance as DNOs for equivalent parts of the business and for the areas of the distribution network we are responsible for.

We also believe that IDNOs should not be penalised/rewarded for poor/good DNO performance. This has two elements.

- Ensuring any link to DNO charges for an IDNO is made prior to any adjustments for service incentives.
- Passing through the benefits/costs of incentives on upstream performance to end use customers of the DNO (as they too face the consequences of DNO performance).

LEL also believes that appropriate incentives should exist for IDNOs to improve the level of service provided on their part of the network. The form of such an incentive scheme would need to be compatible with the structure of the final charging arrangements.

2.1.6 What arrangements need to be put in place between IDNOs and DNOs to enable IDNOs to report appropriately?

Clearly the identification of responsibility for supply interruption will have commercial implications for the DNO and IDNO. LEL believes clear methodologies will need to be developed prior to any commencement of works.

LEL is willing to work with Ofgem and DNOs to develop suitable methodologies.

2.1.7 To what extent will the existing reporting arrangements for DNOs need modifying to reflect the existence of IDNOs?

LEL has no comment on this issue.

2.2 Charging Arrangements

2.2.1 The existing IDNO charging arrangements

LEL sees the main benefits of the existing charging arrangements are that they provide a relatively simple regime with low regulatory burden whilst still ensuring customers of the

IDNO do not face charges above those that would have been incurred if connected to the incumbent DNO. However, these arrangements do recognise the different operational characteristics and risks faced by IDNOs

The current regime places a large degree of risk on IDNOs, which could act as a barrier to entry and hence prevent the realisation of the benefits arising from competition in the development of distribution networks. These risks arise from:

- unpredictability of revenue streams due to uncertain DNO charges;
- incentives on DNOs to rebalance charges towards non contestable parts of the network, hence reducing IDNO revenues (cross subsidisation could occur between connections and use of system charges or between different voltage levels on the network);
- IDNO revenues being linked to the performance of the DNO via the quality of supply incentives; and
- changes in allowed revenues being linked to changes in the efficient costs of the DNO rather than the IDNO. Because of averaging across the DNO and the potentially different nature of the IDNOs network (e.g. a higher proportion of underground cabling) there could be significant differences in the cost structures of DNOs and IDNOs.

The first two of these risks on IDNOs could be partially mitigated through strong regulation on DNOs to provide transparent, predictable, cost reflective charges for all points on the DNO network. As well as being a necessary condition for the entry of IDNOs this will also be important for the development of embedded generation.

2.2.2 Whether the options discussed for long term charging arrangements have other strengths and weakness, what the relative (and where possible quantified) value of the strengths and weaknesses are and how Ofgem should evaluate the options?

LEL's opinions on the strengths and weaknesses of the current regime have already been outlined above.

LEL believes that charging options based on an IDNOs efficient costs (Options B and C) would provide a greater level of certainty for IDNOs and more cost reflective pricing for end use customers. However, the complexity and regulatory burden of these approaches are likely to outweigh any benefits and given the smaller size of IDNOs would constitute a barrier to entry.

Similarly, while we can see the benefits for the IDNO of instituting a regime based on rate of return regulation (Option E), we believe that consumers are best served by a system that has stronger incentives on cost and quality of performance.

On balance, LEL believes that a form of relative price control (based on the principles outlined in Option D) has the potential provide an appropriate balance between mitigating the risks faced by IDNOs and protecting the interests of customers, provided that DNO charges are set on a transparent, consistent and cost-reflective basis.

Clearly further work would be required to develop the details of any future charging regime. LEL would welcome the opportunity to work with Ofgem and the rest of the industry in developing such arrangements.

2.2.3 Any other suitable options for the long term charging arrangements

On the basis of our existing analysis we believe that a relative price control could potentially be the most effective form of regulation for IDNOs. However, this will require detailed arrangements that address the unnecessary risks currently faced by IDNOs. If a practical solution cannot be found to address these risks within a relative price control framework alternative arrangements would need to be investigated

2.2.4 Whether a tiered approach to charging arrangements is appropriate and if so, how the threshold should be determined?

In general, IDNOs will be involved in providing and operating network extensions as individual and separate projects. This contrasts with DNOs who are able to benefit from a contiguous geographically compact network.

The geographic dispersion of an IDNOs business may make it less appropriate to institute a tiered approach based on the total number of connections as these connections could be spread throughout the country. This geographic dispersion could reduce the cost reflectivity of charges to IDNO customers if they are based on the average costs across an IDNO business (as they currently are for DNOs) rather than the specific costs in each region.

A more appropriate arrangement might be to base any tiering on the number of connections within individual geographic or DNO regions. However, it may be appropriate to base some elements of DNO charging, such as performance incentives, on the overall company performance rather than the performance of individual projects.

2.2.5 The desirability and appropriateness of consistency between charging arrangements in the IDNO and IGT sectors

LEL believes it is appropriate for there to be consistency between the principles behind the charging arrangements used in the IDNO and IGT sectors, however, we believe that it may be appropriate for the implementation of these principles to differ.

The charging arrangements set up for IGTs currently benefit from a much clearer and transparent regime for setting distribution charges at different points on the network. This removes much of the risk for IGTs and in combination with the relative price control provides efficient IGTs with a degree of certainty over future financial viability. The same result would not be achieved within the electricity industry simply by adopting the gas arrangements unless something is done about the DNO charging structure.

2.3 Financial Ring-Fencing of IDNOs

2.3.1 The alternative arrangements to condition BA5

LEL agree with Ofgem that, since condition BA5 was designed with circumstances typical of DNOs in mind, it is unlikely to be appropriate for IDNOs whose scale of operations are considerably smaller and whose networks are likely to be non-contiguous. LEL believes that the alternative arrangements go some way to providing the flexibility necessary for IDNOs to remain competitive while also providing financial safeguards. However, there remain several outstanding issues.

- *Current proposals implicitly require IDNOs to provide upstream revenue protection in addition to a high level of consumer protection, and therefore place an undue burden on IDNOs.*

The principle at the heart of the alternative arrangements is that they should protect end-use customers from supply disruptions resulting from financial distress experienced by an IDNO. Current proposals require that, in the event of financial distress, financing is available to cover the portion of DUoS revenue allocated to the DNO. DUoS charges allocated to the DNO but collected by the IDNO do not constitute a bona fide operating cost of the IDNO, and therefore the current arrangements are inconstant with the above-mentioned principle.

- *Current proposals do not allow the degree of financial protection to correspond to the inherent risk of financial distress as the scale of IDNO operations continue to grow, and, as a result, the current proposals may impose undue costs on some IDNOs.*

The alternative arrangements specify an explicit minimum level of financial resources that need to be available at any given time, for the IDNO to be compliant with its license obligations. It is not clear that this is equivalent to the level of protection implied by an investment grade credit rating. Furthermore, as IDNOs expand, the probability of financial distress is likely to decrease due greater diversification of operational and commercial risk. Therefore, maintaining a fixed (albeit proportional to IDNO size) level of financial reserves may be uneconomic as the number of connections rises.

- *Introduction of the special administration arrangements contained within the Energy Act (2004) may make the proposed level of financial safeguards redundant, or at least reduce the level of safeguard required by IDNOs in order to protect customers.*

Energy administration provisions contained in the Energy Act (2004) provide end-users with significant protection by ensuring continuity of supply. Therefore it may be appropriate to relax the level of financial resources necessary for *ex ante* safe guards once the special administration arrangements have commenced.

2.3.2 Any other suitable arrangements that would afford consumers the same protection as the requirement for an investment grade credit rating.

LEL believes that it is unduly onerous to require IDNOs without an investment credit rating to provide cash in escrow to cover six months operating cost and asset replacement expenditure. In our opinion an appropriate level of financial protection can be demonstrated via other measures, for example: minimum net asset values; minimum share capital; or appropriate gearing ratios.

If these arrangements are not deemed to be acceptable then Ofgem should consider reducing the burden on IDNOs via the following amendments to the existing IDNO ring-fence arrangements:

- Varying the level of financial reserves required to comply with the alternative ring-fence arrangements according the size and nature of the risks specific to different IDNOs; and/or
- putting in place arrangements that allow DNOs and IDNOs to collect revenues allocated to them directly, thereby reducing the liability of IDNOs in respect of the transfer of DUoS charges to DNOs.