<u>Response to Consultation Paper 180/04 July 2004 –</u>
<u>Regulation of Independent Electricity Distribution Network Operators.</u>

Introduction

I am making this response on behalf of Energy Networks Ltd., an IDNO applicant. We fully support the need of a regulatory framework that protects the interests of consumers and promotes effective competition in both metering and connections markets. We also support the need for appropriate incentives to encourage the efficient use of networks.
Within section 2, reference is made to the potential positive impact on competition in connections and metering. It is unclear how future regulation of IDNOs can contribute to this without changing the method of regulation of incumbent DNOs who have and will maintain a significant monopoly position while IDNOs establish themselves. Two or three price control review periods may elapse before any one IDNO emerges with anything approaching 500000 connected supply points making it difficult to determine why regulation of IDNOs can be seen as a positive impact on competition in connections. IDNOs can only adopt networks from Independent Connection Providers (ICPSs) so it is imperative for competition in connection to prosper that there is a level playing field in which they compete against incumbent DNO connection businesses or affiliated connection businesses. In section 3.21 and 3.22 reference is made to implementing a long term regulatory framework that provides certainty for IDNOs and protects interests of consumers as soon as possible. We agree with this principle and support the view that incumbent DNOs developing out of area networks should be subject to similar arrangements including the same financial ring fence.

Contractual Arrangements.

The current arrangements whereby the IDNO will be liable for upstream use of system charges will create additional risks on IDNOs as the number of connected supply points increases. The IDNO will be faced with additional costs to cover for the administration that will have to be borne by customers or by the incumbent DNO who receives the revenue. Ideally the supplier should have direct contractual arrangements with each party and be at the hub of the process.
Until connection and use of system agreements between distributors are struck the governance of these relationships appear unclear. The role of the Distribution Code Review Panel and the ENA depend upon whether the IDNO become members of the ENA. IEDA could play a part in the governance arrangements if they are afforded the same status as ENA.
It is our view that the present requirements that boundary metering is not mandatory remain. The terms offered for connection should be no more onerous on the end consumer whoever distributes the electricity. The value of better quality data increases as the voltage level of connection increases and it is arguable that whichever party requires boundary metering should provide it but without cost to the end consumer.
IDNOs should be committed to improving quality of service. ENL would accept the same IIP measures (but not necessarily the same targets imposed on the incumbent DNO) in whose area the embedded network is connected subject to the incumbent DNO performance being excluded in any incentive based measure. Likewise ENL would accept the same guaranteed and overall standards of performance but in both cases will seek modifications to eliminate the additional costs of managing these in multiple DNO areas. Until an IDNO understands the differences in operating across multiple DNO areas, it is impossible to comment on the arrangements that need to be put in place to allow the IDNO to report appropriately. As IDNOs develop networks, these arrangements should be under regular review.

Charging Arrangements

The existing IDNO charging arrangements have been developed and detailed in condition BA1 that reduces the risk of end consumers facing higher charges. It is not yet clear without

close scrutiny of all the DNOs revised SLC 4A how much revenue the DNO is entitled to. Consideration of alternative long term charging arrangements without knowing the relative merits of the existing arrangements would discredit our acceptance of BA1. While there maybe arguments for changing these arrangements we have not argued a case while our application is being processed because we are unable to secure any connection and use of system agreement with any DNO until we are an IDNO. The IDNO uncertainty in predicting long term revenue streams is due to the lack of transparency and we would like to see alternative arrangements being developed over the course of the next price control period when it is Ofgem's intention to review the RPI-X formula. Using price regulation based on either the IDNOs total operating costs (which will increase in line with the number of connected supply points and include a higher cost of capital) or based on the incumbent DNOs charges would not be acceptable over keeping existing arrangements. Option B requires the IDNO to make an accurate estimate over costs in a market where he has no connected supply points. The 2010 DPCR is too far ahead to correct an error and requires an unacceptable level of investor risk if the manner of regulating IDNOs should change. The RPI-X is based on the potential for efficiency savings and it would be wrong to assume that IDNOs start off their business as inefficient. Option C will require the IDNO to maintain separate regulatory accounts in each DNO area (even for each network) in which it operates which in turn will involve significant regulatory resource on both sides. In both cases X could be negative. The important point is that in assessing either option A, B or C is to ensure that consumers are no worse off. The relative price control option has advantages in that it is a known methodology but I would advocate a floor and ceiling set against all the DNO long term charges and not just the incumbent DNO. This provides a framework where a long term regulatory framework against a single set of parameters provides certainty and protection of customer interests. One of the weaknesses cited is the unavailable forecasts of long term DNO charges. This is surprising given that this is fundamental for the DNOs and Ofgem in this and previous round of price control work. The definition of long term in this context need to be known. Finally rate of return method of regulation also provides a means to the long term regulation of IDNO but to develop this requires either an asset base or a reasonable forecast of asset growth neither of which are available to IDNOs from start up position. This method maybe attractive to Ofgem to broaden competition in the provision of network services, connections and metering as the low risk environment could be attractive to investors particularly if the rate of return was favourable as this would would stimulate asset growth.
We favour a tiered approach. Ofgem suggest that a threshold level of 500000 connected supply points trigger alternative arrangements. We would support a three tier approach whereby existing arrangements apply but an interim threshold triggers a review of those arrangements in readiness for a reaching a threshold level of 500000 connected supply points.

Financial Ring Fencing Arrangements

The financial ring fencing of IDNOs covered by BA2 – BA6 are acceptable to ENL. The alternative arrangements laid out in section 6 to investment grade credit rating as defined in BA5 refer to either cash in escrow or an on demand bond. The bond arrangements usually cover for the performance of a contract not the performance of a company whether it is the performance of the licensee or its parent. The cash in escrow requirement must recognise that this places a burden on IDNOs not necessarily reflected on the incumbent DNO. While this arrangement is workable Ofgem have recognised that a credit rating does not in itself afford protection only a measure of an estimate of probability of a default by a rated company. That same argument applies whether the credit rating is BBB-, as required in the licence condition, or a credit rating of BB+ that then requires an up front investment tying up cash that could best be used running the business and delivering a quality service to consumers. We have encouraged Ofgem to consider that lower credit ratings are not necessarily an indicator of financial insecurity and it is the movement of a credit rating that provides the real indicator.

We urge Ofgem to continue to consider this method of measuring financial stability and monitor IDNO performance against licence conditions. While this condition remains in place ENL hope to secure their licence under these arrangements but ask Ofgem to recognise the potential financial burden placed on IDNOs and to review these ahead of changes to the Regulation of IDNOs .

Closing Remarks

The Regulation of Independent Electricity Distribution Network Operators must consider that the financial ring fence imposes additional risks on IDNOs when they are collecting and distributing use upstream use of system charges. The industry needs to develop systems compatible with the IGT sector where the supplier is at the hub of the transactions and responsible for upstream use of system. No discussion has covered the potential liability on IDNOs should a supplier not meet their obligations and consumers continue to enjoy the benefits of an energised supply. The proportion of use of system passed through is undetermined and therefore the risk on IDNO will grow as the number of connected supply points increase. IDNO will seek, through the price control, a means to cover that risk. Investor confidence will impact upon an IDNO ability to achieve investment grade credit rating or attract investment. Taking Ofgem own figures that a typical domestic customer distribution element of their bill is on average £60, the IDNO with 100000 connected supply points will generate £6m per annum in use of system. An undetermined portion of this is passed through to the incumbent DNO but the IDNO has to place security at least to the value of £3m to cover for 6 months operating costs (assuming that 100000 connected customers is the breakeven position of the IDNO). An IDNO investor will think twice about securing the revenue streams of the incumbent DNO unless he achieves a reasonable rate of return on his investment. It will only be through the Price Control Regulation that it becomes attractive to invest further and grow above 100000 connected customers while continuing to secure the upstream revenue streams required by the financial ring fence.
The method of regulation must reflect the investor risk or remove the risk without compromising the interests of customers and Ofgem needs to consider over the next price control period how they can continue to protect customer interests and create an environment in which IDNO can benefit.