



*Bringing choice and
value to customers*

Direct Dial: 020 7901 7276
Email: distributionpolicy@ofgem.gov.uk

13 April 2006

Dear Colleague,

Regulation of independent electricity distributors: consultation on implications of licence applications from affiliates of existing licensees

Introduction

1. Ofgem has been approached by an affiliate company of a Distribution Network Operator (DNO) regarding a potential application for an electricity distribution licence¹. If the affiliate company receives an electricity distribution licence it hopes to build and operate networks within that DNO's distribution services area. No affiliate of a DNO has previously attempted to become licensed as an independent distribution network operator (IDNO), and this potential application raises a number of new issues.
2. Ofgem has decided to consult on the general issues that would be raised by such an application. This letter:
 - sets out the background to IDNOs;
 - outlines the potential implications for customers were an affiliate of a DNO to be granted a distribution licence; and
 - considers options on how a DNO affiliate would be licensed.
3. This letter considers only electricity distribution issues. The position in gas transportation is considered briefly in Annex 3.
4. We would welcome views on the issues raised in this letter. Responses should be sent to Heather Glass by **26 May 2006**.

Background to IDNOs

5. The Utilities Act 2000 introduced distribution as a separate activity requiring authorisation. We are responsible for granting licences authorising a person to

¹ Multi-Utility Joint Ventures Ltd, the potential applicant, is a joint venture between EDF Energy, which holds three distribution licences, and Thames Water.

distribute electricity for the purpose of giving a supply to any premises (a distribution licence) to any company fulfilling our criteria². Distributors whose licences were granted after 1 October 2001 are known as independent distribution network operators (IDNOs).

6. Ex-PES DNOs evolved from the Public Electricity Suppliers on 1 October 2001. These companies have distribution services areas corresponding to the areas in which they were formerly the incumbent distributor³. Within these areas they have certain licence obligations such as the requirement to offer basic metering services. IDNOs do not have distribution services areas.
7. There are three IDNOs at present, all of which currently have limited networks and few customers. We are considering a further distribution licence application from the Electricity Network Company Limited. None of these four companies is affiliated to any other licensed distributor.

Implications for customers from IDNOs

8. Ofgem's principal objective is to protect the interests of consumers, where appropriate by promoting effective competition. Protecting the interests of consumers connected to distribution networks relies in part on the development of appropriate charging arrangements for IDNOs.
9. IDNOs are subject to a relative price control, which prevents them from charging more than the local ex-PES DNO charges equivalent domestic customers for the use of its distribution system. Details of and the basis for the relative price control are set out in Annex 1. There are currently no surcharges levied by suppliers to consumers on IDNO networks similar to those seen on independent gas transporter networks.
10. An increase in IDNO activity may lead to benefits for developers and large users in the short term through more competition in the installation and adoption of networks. IDNOs provide another alternative for developers in this competitive area.
11. The existing IDNOs began connecting customers only in mid-2005 and are currently very small operations. Evidence for the effects of competition, particularly any longer-term benefits, is therefore very limited at present.

Implications for customers of a DNO affiliate becoming licensed as an IDNO

12. There are a number of potential effects on consumers that could arise were an affiliate of a DNO to be granted a distribution licence similar to that granted for the current IDNOs. There may also be adverse competitive effects. These effects may be different to those for IDNOs that are not affiliates of the DNO; this is considered further below.

²These criteria are set out in Ofgem's licence applications guidance document (86/05), available on our website, www.ofgem.gov.uk. They include requirements that the applicant must provide adequate information about how it will comply with particular licence conditions, and must submit information about the safe operation of its proposed system.

³ Ex-PES DNOs are also able to establish licensed networks outside their distribution services areas. Some, notably Scottish and Southern Energy, have pursued this opportunity. We have applied very similar arrangements to these networks as to those owned by IDNOs, to provide consistent regulation across all distribution networks.

Impact on existing DNO customers

13. IDNOs, and DNOs operating out of area, are subject to a relative price control, which allows them to set their charges in line with those charged by the host DNO to equivalent domestic customers. Unlike the host DNO, IDNOs are able to choose which network extensions they compete for and subsequently adopt. The relative price control arrangement incentivises IDNOs to compete for the lowest cost network extensions, on which their margins per customer will be highest.
14. If the DNO builds and operates these low cost network extensions, its customers will benefit as the reduction in average costs will be passed on to consumers through the DNO's cost-based price control. If these extensions are operated by IDNOs, the DNO will be left with the higher cost elements of the network to develop and manage, potentially leading to increased bills for consumers in the long run.
15. If an IDNO is affiliated to a DNO, the opportunity for IDNOs to profit by operating lower-cost networks places an incentive on the holding company to take on work through its IDNO subsidiary where low cost network extensions are involved, and through its DNO subsidiary where the cost per customer is higher. This may worsen the situation described above leading to increasing DNO costs in the long run and higher costs to consumers.

Implications for competition

16. Other IDNOs and independent connections providers have expressed concern over affiliated IDNOs. They are concerned that affiliated IDNOs will receive preferential treatment or access to information, thus damaging competition in connections. For affiliated IDNOs it may be necessary to consider whether the current ring fence around licensed companies, and non-discrimination provisions in their licences, are sufficient to prevent any problems (in combination with competition law), or whether they need to be strengthened. This issue was considered as part of gas distribution network sales (see Annex 3).
17. It may also be argued that affiliated IDNOs may be less effective than non-affiliates at placing competitive pressure on DNOs in areas such as levels of service.

Possible approaches to a licence application from a DNO affiliate

18. Based on the above issues, we consider that any competitive benefits from affiliated IDNO businesses operating within area are likely to be weaker if the same regulatory framework were to be applied than for 'true' independent network operators, and may not be sufficient to outweigh the detriment to the host DNO's customers. This may suggest taking a different approach for these entities or alternatively reviewing and amending the current relative price control for all IDNOs.

Options

19. We have identified the following options in relation to distribution licence applications from DNO affiliates:
 - Treat DNO affiliates in the same way as other potential IDNOs;
 - Refuse to grant a licence, or restrict any licence to exclude the affiliated DNO's area;
 - Grant a licence to a competent applicant but with modifications to provide additional protection for consumers; or

- Modify the DNO's licence and/or price control.

20. We would welcome views on these options but our initial view is that one of the final two options, or a combination of the two may be the most appropriate. Refusing to grant a licence may not be an option available to Ofgem if the applicant meets our standard criteria. In light of this, Annex 2 sets out a number of alternatives for modifying the IDNO's price control and / or modifying the DNO's licence or price control.

Responding to this consultation

21. We would welcome views on the issues addressed in this letter, and in particular on the options set out above, by 26 May 2006.
22. Responses should be sent to Heather Glass, preferably by email:
distributionpolicy@ofgem.gov.uk
23. If you have any questions, please contact Heather using this email address, or by phone on 020 7901 7276.

Yours sincerely



MARTIN CROUCH

Director – Distribution

ANNEX 1 - Relative price control

IDNOs, and DNOs operating out of area, are subject to a relative price control, which allows them to set their charges in line with those charged by the host DNO to equivalent customers. This approach was favoured because of its simplicity and transparency, and because consumers are not disadvantaged depending on whether or not they are connected to an independently owned network.

However, this approach has a number of disadvantages, arising from the fact that it is not cost-reflective. Most notable from a customer perspective is the incentive on IDNOs and DNOs operating out of area to 'cherry pick' new networks on which they believe the operating costs per customer will be lowest. They are allowed under the relative price control to charge 'average' prices to these customers, so their returns from such networks will be highest. In the short term, the average age (and therefore operating cost) of IDNO networks is likely to be lower than those of the DNO, increasing margins further.

These higher margins enable IDNOs to offer incentives to developers. Such incentives would be expected to increase the number of new networks being operated by IDNOs.

A relative price control arrangement therefore has the potential to increase bills for consumers as an increasing number of new, low-cost, networks are adopted by independent distributors and the average operating cost of the host DNO's networks rises.

The relative price control is an interim arrangement. Separately from the issues around DNO affiliates, we are currently considering the most appropriate long-term form of price control for all existing and new IDNOs. In our July 2005 decision document on IDNOs⁴, we set out our preferred option of a price control that followed the host DNO's prices, subject to a 5% floor and ceiling. Existing IDNOs have raised objections to this proposal and we are continuing to consider and discuss alternative options. These will include the options set out in Annex 2.

⁴ Regulation of Independent Electricity Distribution Network Operators – Decision Document, 176/05, July 2005

ANNEX 2 – Possible changes to the price control arrangements and other licence conditions

This Annex sets out potential modifications to the price control arrangements and other licence conditions for IDNOs that are affiliates of DNOs, and DNOs that are affiliates of IDNOs.

Changes to the IDNO price control

The aim of any changes to the IDNO's price control should be to remove incentives on the DNO not to compete for business with an affiliate IDNO, while allowing affiliates that are genuinely innovative and efficient to make an appropriate return on their investment. Options include:

- **Discounted relative price control:** requires the IDNO to set use of system charges equal to the host DNO's charges, but with a deduction to reflect any lesser competitive benefits compared with true independents. This would be relatively straightforward to administer, but the discount may not be passed on by suppliers to customers.
- **Short-term relative price control:** Grant a licence with a 5-year relative price control to allow this to be re-set at the end of this period, perhaps to a more cost-based control.
- **Retail-minus relative price control:** requires the IDNO to set use of system charges equal to the host DNO's charges. However, the upstream payment by the IDNO to the host DNO would be equal to the DNO's 'all the way' charge (i.e. the charge to the relevant end consumer), minus any costs that the DNO can reduce or avoid as a result of the IDNO operating part of the network. These costs may be calculated on an average basis but could also be location-specific, removing some of the disadvantages created by 'average' charging. This approach may be more complex to implement. It may also reduce the margins available on embedded networks, since the proportion of the DNO's costs that are avoidable is likely to be small, and could therefore affect competition in distribution.

Retail-minus approaches (also known as efficient component pricing and access deficit charging) have been adopted in other utilities, including water and telecoms.

- **Cost-based approach:** this could work in a number of ways, for example:
 - Assess the extent to which average costs to the host DNO had risen as a result of affiliate IDNO activity, and require the IDNO to pay this to the host DNO;
 - Use data on the IDNO's costs to conduct a 'standard' RPI-X price control; or
 - Treat the DNO and IDNO as a combined business, and conduct a single RPI-X price control. This option may not be straightforward to implement.

A cost-based approach would avoid the incentives on companies to exploit a relative price control, while allowing efficient IDNOs to prosper. However, this approach is likely to increase the information burden both on the company and Ofgem in collecting large amounts of data, and has the potential for end customers in the same DNO's area to pay different prices.

Changes to the DNO price control

As an alternative, the IDNO would be granted a licence but any costs and revenues from the affiliated IDNO would be included when calculating the host DNO's RAV⁵. This may not require any licence changes. This method would ensure that a DNO's customers were no worse off in the long run as a result of its affiliate IDNO's activities.

Other licence modifications

It may be appropriate to consider changes to other licence conditions in addition to or as an alternative to changes to the price control. Such modifications could include:

- An IDNO that was affiliated to a DNO could be required to match that DNO's connection charging methodology when connecting customers within that DNO's area. This would ensure that all customers were charged for connection on a consistent basis and could reduce the scope for a DNO's holding company to 'load' profitable business on to an affiliate IDNO by offering different terms for connection or adoption.
- Standard Condition 4C (Non-Discrimination in the Provision of Use of System and Connection to the System) in the licence of all distributors was recently amended to provide stronger restrictions on discrimination between different parties seeking to connect to or use a distributor's system. We may need to consider whether there is any remaining scope for discrimination, and if so, whether modifications to other licence conditions may be appropriate. For example, Standard Condition 39 (Restriction on Use of Certain Information and Independence of the Distribution Business) could be amended to require DNOs to manage and operate the distribution business in a way that does not restrict prevent or distort competition in the distribution of electricity.
- It may also be appropriate to consider changes to reporting requirements, potentially modelled on the recent consents given by SP Manweb plc to address concerns identified by Ofgem in relation to competition in connections.

⁵ The regulatory asset value (RAV) is a key building block of the price control review. It can be seen as a measure of the value of the regulated business, based on past investment, on which the companies earn a return and receive depreciation.

ANNEX 3 – The position in gas distribution

This consultation addresses electricity distribution issues only. However, similar issues already exist in gas, as Scotia Gas Networks (the holding company of the gas distribution networks in Scotland and Southern England) is owned by a consortium that includes Scottish and Southern Energy (SSE), which also owns an independent gas transporter (IGT), SSE Pipelines.

At the time of the sale by National Grid of some of its gas distribution networks, Ofgem considered whether additional provisions were required to address potential discrimination between host gas distribution network operators and affiliate IGTs, and possible competition concerns that might arise. Ofgem concluded at the time that the provisions in the gas distribution licences to address discrimination, together with Ofgem’s competition law powers, were sufficient to address potential concerns.

This consultation mainly focuses on the potential implications of the relative price control in relation to affiliate IDNOs, rather than on discrimination by the DNO against non-affiliated IDNOs. Therefore, Ofgem will consider again whether any changes should be proposed to the gas regulatory framework for affiliate IGTs in the light of responses to this consultation and final proposals for regulating affiliate IDNOs.