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in electricity supply and distribution

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Sent by email to: distributionpolicy@ofgem.gov.uk

Dear Ms Glass

Regulation of IDNOs: Consultation on Implications of Licence Applications from Affiliates of DNOs

Following consideration of the issues raised in the above consultation dated 13 April 2006 and other issues, we are concerned about the implications of affiliates of DNOs being granted IDNO licences. We are of the strong view that companies who hold a DNO licence (or hold one in a related company) should not be allowed to undertake activities under the guise of an IDNO. We see the granting of such licences as being detrimental to the still emerging competitive market for the provision of network services and connections.

Our views on key issues are as follows:

Market Immaturity

The IDNO market is relatively new and immature and needs a stable development period. If DNO affiliated companies are allowed entry into the market this will be to the detrimental of the emerging IDNO market because:

- DNO affiliated companies would immediately have an advantage over independent operators (via the existing expertise and skills of the DNO);
- Independent IDNOs need to be encouraged during this market development period; and
- DNO market power will be strengthened through their activities in related companies.

DNO Market Power

DNOs enjoy a position of market dominance (through financial strength, number of customers, mature networks, stable markets, first choice connector, brand, etc.).

Affiliations will increase this dominance and reduce the potential for effective competition to the detriment of customers.

Why form a DNO Affiliate?

In addition to the issues of customer benefits and competition, it is worthwhile considering possible reasons behind a DNO wanting to pursue the IDNO route when it already has a business and licence obligation to provide networks and connections in its designated area.

An overriding factor might be that the affiliated IDNO can perform at a more profitable basis. It can do this by retaining higher use of system margins than are possible within the DNO. (See the Affiliated IDNO section below).

Also, it might be that the affiliated IDNO has a lower cost base. This raises the issue of why the DNO does not have comparable costs.

Usurping the Price Control

After privatisation, during the first price control period, the then Regional Electricity Companies could retain all marginal income. Thus they retained all the extra income from distribution to new connections. This was seen to be excessive and all the following Price Controls reduced the incremental proportion to 50%.

The affiliated IDNO would act as a vehicle to usurp the DNO Price Control. This is because under current arrangements, the affiliated IDNO would keep all the DUoS income whereas the Price Control only allows the DNO to retain half its DUoS income.

IDNO Incentive

We do not agree that IDNOs will target low cost connection. The components of the new network and the available use of system margins will be important incentives for IDNOs.

The type of network most profitable for an IDNO will be one where the connection to the DNO is at high voltage and consumer connections are made at low voltage. If IDNO prices are equated to the local DNO’s prices, this allows the IDNO to recover the margin between the DNO’s HV and LV prices. The expectation is that typical IDNO networks will comprise HV/LV transformation and LV networks in urban areas where DNO network reinforcement costs are less likely to occur.

IDNOs will also be inclined to target sites where the margins might be highest depending on the new load mix and the differential between the LV and HV tariff prices of the DNO.

Offsetting High Cost Connections

Connection charge policies were revised in 2005 when the full capital costs of the connection became the connection charge. This change produced a wide range of typical connection charges. In the housing market, for example, the lower end of charges will be infill housing requiring little or no LV mains and the high end charges being to housing estates where HV and LV mains and substations are required. To an extent, these higher charges for housing estates are unfair because DNO DUoS tariffs are priced to fit the average situation on the existing network as though the HV and LV mains and substations already exist.

For the housing estate connections, the full cost of the HV and LV network and substations will be paid in the connection charge by the developer but the excessive connection charge can now be offset by the profit on the IDNO‘s margin from the use of system charges it makes. In cases where the IDNO is an affiliate, the affiliated IDNO would be able to keep the use of system margin. Such a situation would place the affiliated IDNO in an advantageous position to the detriment of the competitive connections market and customers generally.

In summary, our overall view is that affiliated IDNOs will be detrimental to competition in the provision of network services and connections and such applicants should not be granted a licence at this time. The situation could be reviewed later when effective competition from non-affiliated DNO companies has been established.

I hope the above is helpful in forming a view about the appropriateness of having affiliated IDNOs operating in the electricity connections market at this time.

Yours sincerely

Adrian Callaby
Director