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Dear Martin,

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

We refer to the above consultation.

Background

Core Utility Solutions was established in 2002 as a joint venture between Alfred McAlpine and Scottish Power. The strategy for Core was to compete in the emerging competition in connections market. Over the last four years, Core has successfully completed over 30,000 multi utility (electricity, water and gas) connections. We are currently working in nine of the original distributors areas and are currently "live jointing" on over 80 sites within the UU area. We are also in discussions with CN and YEDL to participate in live jointing trials in their distribution service areas.

In October 2005, Core became a wholly owned, ring fenced subsidiary of Scottish Power. It is Core's strategy to continue to grow in the connections market and we believe that Core is at the forefront of competition in connections. We have fully supported OFGEM in its objectives of opening the market to competition.

However, the connections market is changing, and increasingly, there is a need to offer a construct and adopt package. This first emerged in the gas market, where ICPs offer assets for adoption to iGTs. Developers award contracts based on the cheapest construct and adopt offer. This has lead to some large asset values being offered by the iGTs. Indeed, in the housing market only 1% of gas connections were adopted by NGG (ref. OFGEM Connections Industry Review 2004).

It is our view that the electricity market will follow the gas market in that ICPs will have to offer a "construct and adopt" package. For Core to continue in the connections market we must have the freedom to compete, on an equal basis, with other ICPs and ICP/iDNO affiliates.

We believe your consultation raises two issues. If a DNO affiliate obtains an iDNO licence:

1. how does it affect Competition in Connections;
2. how is the price control affected.

Competition in Connections

To work in the connections market, an ICP needs the assets to be adopted by an asset owner. Core operates as an ICP and electricity assets are currently adopted by the host DNO. Whilst this has worked quite well up to now, the market has been slow to develop. There are several reasons for this. Live jointing trials have been slow to evolve. For instance, Scottish Power and United Utilities have been running live jointing trials since 2003, but trials have not yet started in any other DNO area. Another key barrier has been the DNOs ability to carry out non contestable work on an indiscriminate basis, to reasonable standards of performance (e.g. point of connection, design approval).

Whilst it is difficult to predict how the market will develop in the future, the best guide is to look at how the gas market has evolved. 99% of domestic gas connections, constructed by an ICP, are adopted by an iGT, who gives an asset value to the ICP. Contracts, by developers, are awarded based on the lowest construction cost. Developers do not choose an iGT, they choose an ICP. In the electricity market in the future, it is our view that new connection assets will be adopted by the iDNOs. An ICP who does not have an iDNO partner will ultimately fail. ICPs, whether independent or DNO affiliates, need the freedom to develop relationships with iDNOs, or obtain an iDNO licence themselves. We believe that to restrict such options on DNO affiliates would prevent the development of a competitive connections market.

There is however, already a precedent for this type of affiliate relationship, in the gas market, with SSE Pipelines and Scotia Gas Networks. SSE Pipelines operates freely, and on an equal basis, with other iGTs, irrespective of whether the gas network is in Scotia Gas Networks area or not. A similar principle should apply to the electricity market. We strongly believe that the provisions of existing distribution licences, together with OFGEMs competition law powers are sufficient to address potential concerns in the electricity market.

If however, OFGEM believe that there may be a perception that DNOs may favour affiliate iDNOs, then OFGEM could address this by extending the provisions of the recent SP Manweb commitments in connections, to all DNO licence holders.

Price Control
In order to protect customers, your consultation suggests reviewing the price control mechanism for either the iDNO (option 3) or the DNO (option 4). It is our view that neither of these is either necessary or desirable at the present time.

Option 3
For current iDNO licence holders, there needs to be some short to medium term stability for forecasting income. This is necessary for investment decisions in the new iDNO business. The same is also true for an affiliate iDNO business.

The provisions of RPC protect the suppliers and end consumers, ensuring that UoS charges are the same “all the way” regardless of DNO or iDNO network owner. It is our view that this status quo should be maintained.

Option 4
If a DNO affiliate obtains an iDNO licence, should the DNO be price controlled in a different manner? Again, the suppliers and end consumers are not disadvantaged, because the “all the way” UoS charge is the same, regardless of whether the customer is on the DNO network all the way, or DNO/affiliate iDNO network. In the long run, the average operating cost of host DNO networks may rise if the iDNO “cherry picks” new networks on which operating costs may be lower. But this is true whether the networks are owned by affiliates or true independents. Therefore to disadvantage the host DNO or its affiliate would be anti competitive. Again, the precedent in the gas market was to allow SSE Pipelines to operate on an equal basis with other iGTs, regardless of whether the networks were in Scotia Gas area or not.

This issue may need to be addressed in the medium term, once iDNOs are established, through a cost based approach to iDNO regulation.

A change to iDNO regulation at the present time may stifle the market and prevent competition in distribution. A change to DNO price control by consolidating the income and costs of the affiliate iDNO, would disadvantage the affiliate, but gain nothing, as the DNO average operational costs will rise as iDNOs win networks.

Summary

In summary, whilst the consultation raises a number of issues, it is our view that:

1. Affiliates are granted iDNO licences on the same basis as “true” independents.
2. DNOs adopt SP Manweb style commitments, to ensure the connections market is stimulated
3. Price control of iDNOs and DNOs is not altered in the short term, until the iDNO market is established, but that iDNO regulation adopts a cost based approach in the medium to long term.

I trust you find the above clear, however should you require any further detail or explanation, please do not hesitate to contact me.

for Core Utility Solutions
David Fort
Managing Director