

Your ref:

Our ref: BMcC/GUC/Reg/001

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24th May 2006

Dear Heather,

Consultation on Implications of Licence Applications from Affiliates of Existing Licensees

Thank you for your letter of 13th April 2006 inviting views on the implications of existing DNO's seeking to become an IDNO through an affiliated company.

Looking at the wider implications of this proposal, there are a number of concerns that have to be addressed to ensure that the establishment of a competitive market for the ownership and operation of electricity networks will remain a primary objective for Ofgem.

Specifically, I would draw your attention to the following points: -

1. As a statement of fact, since the model for existing DNO's to own & operate networks outside their franchise area has already been established (your reference to Scottish & Southern), there is clearly no requirement in this area to consider IDNO licence applications.
2. Similarly, on the basis that a newly formed subsidiary or affiliate of a DNO is considering an IDNO licence, there should not be any major concerns from a competition viewpoint provided the licence is limited to areas outwith that particular DNO franchise market.
3. Taking the above points on board, the discussion is then centred on the reasons why an existing DNO, albeit through an affiliated company, would wish to secure an IDNO licence to operate networks in their own franchise area. Perhaps the answer lies in Ofgem's comments under point 15 where you acknowledge the fact that the IDNO subsidiary could target low cost/high value networks for adoption and leave the higher cost/lower value networks for adoption under the 'parent' DNO licence who may in turn look to recover these costs through the Distribution Price Control. Other concerns with this approach are: -

- 3.1 My organisation currently faces many obstacles when trying to secure points of connection, agreement on boundary metering, sub-station layouts and associated costs, treatment of capacity charges etc. I would be very concerned that these so called “issues” were relaxed for an affiliate organisation should they be granted an IDNO licence.
- 3.2 Should Ofgem choose to support the IDNO licence application then the door is open for the other DNO’s to follow suit with their particular nuance of subsidiary/affiliate company. The risk would be that rather than a competitive market emerging for the ownership and operation of network assets, what actually transpires is a degree of protectionism for the DNO’s in their franchise areas.
- 3.3 The comments on the Relative Price Control (RPC) are somewhat misleading in that the suggestion made that IDNO’s will cherry pick networks ignores the fact that the items listed under 3.1 will drive IDNO’s away from these networks and not ongoing O&M costs. The fact of the matter is that IDNO’s will require volumes over a very short period of time to reduce the operating costs per connection and by helping to address these barriers then the issue of cherry picking becomes less of an issue.

When considering the options proposed by Ofgem, I would comment as follows: -

- Treating DNO affiliates in the same way as other IDNO’s is really not a viable option. By definition they are not independent and it would be naïve to think that the DNO and IDNO would remain separate in every sense of the word. The other consequence of this approach will be the resultant reporting requirements to satisfy Ofgem and the wider industry that the IDNO would not be benefiting financially through a more relaxed approach by the DNO.
- Refusing to grant a licence is still an option for Ofgem in the strong belief that this, and future, applications must be viewed in a wider context and not just whether it meets the standard criteria or not. The wider objectives of promoting competition, attracting investment and encouraging innovation must be considered in order to support the ‘true’ independent companies through the start-up phase of this market. Should Ofgem consider refusing the licence to be contentious then the only option is to restrict any licence to areas outside the DNO franchise area.
- Granting a licence, albeit with modifications, will raise a number of challenges for the industry. In the first instance, the RPC for IDNO’s is at a very early stage and time will tell whether this is indeed the appropriate long-term solution. To be considering radical modifications to the price control mechanism and/or licences will probably result in further reporting requirements and a greater degree of uncertainty which in turn could detract investors from this market. Should this be the only option available, then a cost-based approach, although more complex, by its nature would give the industry more confidence that the new IDNO would not be gaining an unfair advantage.
- Finally, modifying the DNO licence and/or price-control could provide some form of protection; however, the timescales involved in implementing these changes could prove cumbersome. The suggestion of changes to licence

conditions 4C and 39 does not fill me with confidence on the experience to date in dealing with host DNO's. If Ofgem were to grant an IDNO licence, with modifications to the host DNO licence, the formal complaints process must also be reviewed to ensure there is a quicker and more robust investigation when anti-competitive behaviour is suspected.

The most recent Ofgem report "Competition in Connections - Industry Review Results 04/05" stated that circa 72% of all new connections in the gas sector were adopted by IGT's. The development of a competitive market for new gas connections has been successful and, given the chance, the electricity sector can develop to the same extent.

As a final comment, I would again express my concern over the underlying strategy of the affiliated company and ask Ofgem to consider either refusing the licence or issuing a licence only to those areas outside the DNO parent franchise market. Over time, if the wider industry and Ofgem can resolve some of the inconsistent technical and commercial practises leading to a more open and transparent market, then the restrictions over geographical areas can be re-considered.

Yours sincerely

Bill McClymont
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