



# SP Transmission & Distribution

Mr Martin Crouch  
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Your ref

Our ref

Date

26 May 2006

Contact/Extension

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Dear Martin

## **Regulation of Independent Electricity Distributors: consultation on implications of licence applications from affiliates of existing licensees**

I am writing on behalf of SP Distribution and SP Manweb in response to your open letter dated 13 April 2006. We welcome the opportunity to comment on the issues raised in this area.

You will be aware that our two operating areas are amongst the most competitive for connections in Great Britain. We have been at the forefront in promoting competition in connections, including playing a leading role in the Ofgem-chaired Electricity Connections Steering Group. We have pioneered the development of a regime for live jointing by accredited third parties. We are fully supportive of a fair and robust regime for both connections and independent networks.

Your letter suggests that there are a number of concerns that would apply where a licensed independent electricity distributor ('IDNO') is an affiliate of a Distribution Network Operator ('DNO'). These concerns appear to apply in particular where the IDNO operates in the Distribution Services Area of an affiliated DNO, i.e. 'in area'. Your letter goes on to suggest a number of possible measures to address these concerns, including amendments to IDNO price control.

We believe that these concerns are misplaced, and that no special treatment is merited in respect of affiliated IDNOs. Any such proposals could have a serious adverse impact on competition in electricity distribution (and in connections) and should therefore be resisted.

We would be particularly concerned at any proposals to consolidate the revenue and costs of an IDNO with its affiliated DNO. This would effectively destroy any incentive

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for affiliated IDNOs to operate and compete in the DNO's distribution services area, and would accordingly seriously damage the prospects for competition in distribution.

### **Implications for customers of IDNOs affiliated to a DNO**

The paper suggests that customers may be adversely affected in three different ways from an affiliated IDNO operating 'in area '.

1. The cost base of the DNO may rise as lower cost network extensions are carried out by the IDNO.
2. The affiliated IDNO may receive preferential treatment thus damaging competition in connections.
3. The affiliated IDNO may not compete with the DNO in terms of level of service.

As regards the first of these points, the incentive on IDNOs to seek out low cost networks in order to maximise margins under relative price control seems equally strong to us whether or not the IDNO is affiliated to the DNO concerned. We would therefore expect an upward impact on the cost base of a DNO stemming from the operations of IDNOs regardless of their affiliation. Accordingly, restrictions on affiliated IDNOs will not resolve this concern.

The second point above concerns the suggestion that the IDNO may receive preferential treatment from the DNO. However, such treatment would seem to be in clear breach of distribution licence condition 4C, which prohibits discrimination in the provision of connection services and distortion of competition in distribution. Behaviour which amounted to abuse of a dominant position in the market for connections would fall under the Competition Act 1998. We therefore believe that existing provisions are more than adequate to address potential concerns in this area.

Turning to the third point above, this suggests that the affiliated IDNO may not be as effective at competing with the DNO in terms of level of service. However, if a given level of service is needed to win business from developers and others, we would expect an affiliated IDNO to be as likely to offer this as others. Otherwise the IDNO would lose the business in question. It is therefore not clear to us that this is a valid concern.

From the above points, we do not see that there are adverse implications for customers from the operations of affiliate IDNOs given existing licence and legal provisions. If anything, the reverse applies, as an affiliate IDNO 'in area' will expand the number of competitors in the connections market and therefore be more likely to sharpen competition in distribution.

We set out below more detailed comments on the options set out in the paper for licensing and licence changes in respect of affiliated IDNOs. Our conclusion is that the first option (to treat IDNO affiliates like other IDNOs) is the most pro-competitive and should be supported. Taking the other three main options in order our comments are as follows.

#### **(1) Refuse to grant a licence or restrict it to exclude the affiliated DNO's area**

We agree that neither of these should be supported. They would reduce the number of potential competitors in the market. This would discriminate against Groups that own DNO businesses as against Groups that do not. It is not a proportionate response to the concerns mentioned in the letter and would not promote competition.

## **(2) Grant a licence with modifications**

The paper mentions a number of options for special treatment of affiliated IDNOs, including price control provisions. In the latter case, the argument is made that the aim of such changes would be “... *to remove incentives on the DNO not to compete for business with an affiliate IDNO*”.

The in-area DNO has a statutory duty to offer to connect, and a licence obligation to charge for connections in accordance with an approved charging methodology. It is therefore unclear in what sense the DNO may not “compete” for connections with an affiliate DNO. The DNO is obliged to offer to connect by law.

For similar reasons, we do not see the case for a discounted relative price control, with the discount set to “*reflect any lesser competitive benefits compared with true independents*”. We do not see on what basis it can be asserted that there are lesser competitive benefits from affiliated IDNOs. Such a discounted price control would disincentivise affiliated IDNOs from competing in the market, and would amount to special treatment for non-affiliated IDNOs. In addition, this would be tantamount to a subsidy paid to suppliers, as it is most unlikely that any such discounts would be passed on to end-customers.

It is any case unclear in what sense an affiliated IDNO would have a competitive benefit compared to “true independents.” The non-discrimination provisions in distribution licence condition 4C, coupled with competition law, are more than adequate to ensure that the host DNO is required to treat IDNOs equally.

As regards “retail-minus relative price control”, this suffers from similar flaws to discounted relative price control. Additionally, by seeking to claw back all margin available to the affiliated IDNO above ‘avoidable’ downstream operation and maintenance costs, it would effectively destroy the case for an affiliated IDNO to operate in area. This would disincentivise groups with DNOs from entering the market at all and would appear to be discriminatory.

We believe that once the IDNO sector has developed to a significant size, there is a case for moving towards a cost based approach to price control for both affiliated and independent IDNOs, in order to ensure that savings are shared with customers after a period of time.

The paper mentions a number of non-price control related options for affiliated IDNO licences. As regards a possible obligation on the affiliated IDNO to match the DNO’s connection charge methodology in-area, the relevance of this is unclear. If this means that the IDNO operating in-area must make its construction offer on the same terms as if

it were a licensed connection by the affiliated DNO, this appears to imply that the IDNO concerned must not compete for connections in-area. Again, this would not promote competition, as it would disincentivise Group's with DNOs from entering the market.

### **(3) Modifications to the DNO licence and/or price control**

#### **Possible changes to DNO price control**

The paper mentions the possibility of including costs and revenues from the affiliated IDNO when calculating the host DNO's RAV. It is not clear whether this would include 'out of area' activities of the IDNO. The paper says that this method "*...would ensure that a DNO's customers were not worse off in the long run as a result of its affiliate IDNO's activities.*"

To begin with, it is not entirely clear how this approach would apply in practice. A newly constructed IDNO network might involve little or no net investment depending on the level of capital contribution charged to the developer. We assume that what is meant here is that the DNO's RAV is augmented by the net investment, if any, incurred by the affiliate IDNO, and that the latter's revenue, after deducting an allowance for operating costs, is netted off the return and depreciation element of the DNO's allowed revenue.

This approach would effectively treat the DNO and affiliated IDNO together as a 'virtual DNO' for price control purposes. It is tantamount to disallowing affiliate IDNO activity in area, despite the apparent reluctance of Ofgem to grant a licence that does this explicitly.

Under such an approach, there would be little benefit for the DNO group in the affiliate IDNO seeking to win sites in area. Taking domestic housing developments as an example, the margin between the IDNO's domestic DUOS charge and the boundary tariff levied by the DNO, net of IDNO operating costs would be offset against the DNO's allowed revenue. Although any net investment by the IDNO would be added to the DNO RAV, this would (presumably) use the regulated cost of capital. The additional costs to the IDNO, including the cost of capital, of participating in the competitive market are effectively ignored in this approach. Depending on the detailed assumptions applicable under such an approach, there could even be a positive disincentive for the DNO group to contest sites in area.

The second main flaw with this argument is that it assumes that the DNO cost base will tend to rise if an affiliate IDNO wins sites in area, but not if other IDNOs do so. As pointed out above we would expect all IDNOs, regardless of affiliation, to seek out sites that are relatively low cost to construct and maintain. In any case, we do not see why this should be to the disadvantage of customers in the long run, so long as there is some mechanism for cost savings by IDNOs to be shared with customers after a period of time.

We therefore do not accept the case for consolidation of affiliated IDNO costs and revenues with DNO price control. Such an approach will effectively disincentivise participation of affiliated DNOs in area, so reducing competition in distribution. It would also discriminate against Groups with DNOs as opposed to Groups without DNOs.

### **Other possible DNO Licence changes**

We also note the mention of a possible change to condition 39 of the DNO licence to require that the distribution business be operated so as not to prevent or distort competition in the distribution of electricity. This seems to us to go beyond the issue of affiliated IDNO licences. In addition, we do not see the need for any such provision given the existing requirements of Condition 4C (non-discrimination) and competition law.

As regards the possible incorporation of reporting requirements currently applicable to SP Manweb into DNO licences, these relate mainly to the provision of non-contestable connections services where both affiliated and non-affiliated connections providers are operating in the market. There may be a case for incorporating at least some of these provisions into licences in order to provide greater assurance to independent connections providers.

### **Summary**

In summary, we believe that the proposals in the open letter, which treat IDNOs that are affiliated to DNOs differently to IDNOs that are not, and treat Groups with DNOs differently to those that are not, would be damaging to competition and also discriminatory. With the possible exception of changes to DNO licences to include reporting requirements derived from those currently applicable to SP Manweb, we see no case for licensing changes arising from affiliate IDNOs. All IDNO licences should therefore have similar requirements.

I hope that this is helpful but please contact me if you would like to discuss.

Yours sincerely



**Scott Mathieson, Regulation Director**  
**SP Transmission & Distribution**