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Dear Heather,

Regulation of Independent Electricity Distributors: Consultation on Implications of Licence Applications from Affiliates of Existing Licensees

I am writing in response to the Ofgem open letter on the implications of licence applications from affiliates to existing licensees.

Each application for an independent distribution network operator (IDNO) licence from an affiliate of a licensed DNO may impact the end customer to different degrees, depending on how the affiliate is structured and on how it is related to the DNO. Licensing of an IDNO to operate within its affiliated DNOs distribution services area will therefore always need very careful attention in order to protect both the development of competition and end customers' interests.

Because of this, we believe that the licensing of any affiliate of a DNO needs to be considered on a case-by-case basis. Light touch regulation would be appropriate where it is clear that the affiliate is a completely separate entity, clearly ring-fenced from the DNO. More stringent regulation may be required where this is not the case

For example, an IDNO applicant that is, say, 80% owned by a licensed DNO is very different to a licence application from a 50:50 joint venture company that has a completely separate management structure and separate business systems from its affiliated DNO. With the former, the potential for the affiliated IDNO to receive preferential treatment on access to information is very real and would require strict regulation. With the latter, however, there is unlikely to be any scope for anti-competitive behaviour and the licensing of such a company may not need to be any different to any other IDNO applicant.

With this in mind, we have the following comments on the possible approaches to such a licence application that have been identified in the open letter.

Treat DNO affiliates in the same way as other IDNOs

As noted above, this option would depend very much on how the DNO affiliate is structured. We believe this would only be a viable option for a legally separated joint venture company with 50% or less ownership in the hands of the affiliated DNO. In

such a model, any network services (i.e. network control and emergency services) would be offered and contracted to the affiliate on a similar basis to other IDNOs.

With this type of joint venture, the current ring-fencing and non-discrimination provisions are likely to be sufficient to prevent any competition in connections problems and to ensure there is no adverse impact on the end customer.

For any other joint venture structure, we agree that any competitive benefits may not be sufficient to outweigh the potential detriment to the DNO's customers that have been identified in the open letter. In such cases, modifying either the IDNO or the DNO licence may be appropriate.

Refuse to grant a licence

On the face of it, refusing to grant a licence may not be an option available to Ofgem if the applicant meets their standard criteria.

However, this option should not be dismissed completely out of hand. Ofgem's proposed review of competition in connections will, in our view, need to address competition in network provision as well. As such, the review could look at the standard criteria for granting a distribution licence and whether or not they should be amended for applicants that are closely affiliated to a licensed DNO. We will be addressing this further in our response to the review of competition in connections.

Modify the affiliate's licence conditions

Ofgem have proposed four options for modifying the IDNO price control. Each one adds complexity to the existing regulatory regime, to a greater or lesser extent, and therefore each needs to be carefully considered in light of the type of affiliated IDNO applicant. We believe that these options should be considered as part of a 'toolbox' for use by Ofgem on a case-by-case basis where more stringent regulation is considered appropriate. Our comments on each option are therefore as follows.

1. Discounted relative price control

Whilst this option may be relatively straightforward to administer, any assessment of what the discount should be will be subjective. Furthermore, as noted by Ofgem, suppliers may not pass on the discount to the end customers. In our view, therefore, this option will not adequately address the potential competition problems or potential adverse impact on customers identified in the open letter.

2. Short-term relative price control

In our view this option is only likely to be viable if it is linked with increased reporting requirements for the affiliated IDNO in order to reduce any potential for competitive advantage from its affiliated status. A further concern would be the potential for the IDNO to gain better returns during the period the price control is in place i.e. during the five years.

This option may therefore be more appropriate for an affiliate of a DNO where the ownership is, say, greater than 50% (but less than 75%), and where the management and business structures are clearly separated.

In such a model, the legal separation and increased reporting could mitigate against the potential for the IDNO to exploit its affiliated status. Furthermore, on a case-by-case basis, if it becomes clear that the combination of a relative price control and increased reporting is sufficient to mitigate against any potential anti-competitive behaviour, then there may be no need to move to a more cost-based control.

3. *Retail-minus relative price control*

This is the most complex of the options proposed. Calculation of the costs that the DNO can reduce or avoid will change over time as the IDNO network develops (or indeed if the IDNO develops other networks in the DNO's distribution services area), requiring the price control to be revisited on a regular basis. This adds uncertainty and thus increases risk, which may dampen any potential willingness to enter the market.

As such its implementation may not be proportional to the risk posed by an affiliated IDNO, given that there are less complex alternatives that could be implemented.

4. *Cost-based approach*

We believe this approach would be most appropriate for an IDNO that is very closely affiliated to a DNO (say, greater than 75% owned by that DNO) and who wishes to build and operate networks in the DNO's distribution services area.

In our view, assessing the extent to which average costs to the host DNO have risen would be subjective, and separating out data on the affiliate IDNO's costs may not be readily achievable in the short-term to enable a 'standard' RPI-X price control to be carried out. However, treating the DNO and IDNO as a combined business is unlikely to be overly burdensome if the IDNO is so closely associated with the DNO. Therefore, conducting a single RPI-X price control may not be too difficult to implement, and may be the most appropriate for setting the allowed income of such a closely affiliated IDNO.

Modify the DNO's price control

We assume that Ofgem's intent would be to include the current relative price control condition when granting the IDNO's licence but to collect data on the IDNO's costs in order to include in the affiliated DNO's next price control review.

On this understanding, we believe that this approach would be most appropriate for an IDNO that is closely associated to the DNO but has clearly separated management and business structures.

Other licence modifications

With regard to requiring the IDNO to match its affiliate DNO's connection charging methodology when connecting customers within that DNO's area, this may be an appropriate alternative to modifying the relative price control of a closely affiliated IDNO. As noted in the open letter, it could reduce the scope for the DNO holding company to 'load' profitable business on to an affiliate IDNO.

However, we believe that such a licence modification would also require some form of agreed termination/disapplication clause similar to that available to IDNOs and DNOs under current price control licence conditions. Furthermore, if the affiliate

IDNO wished to operate out-of-area, it would require a separate licence condition (with a relative price control) to do this. This would add further complexity to the regulatory regime. On balance, therefore, we believe that this option is more complex than others in the 'toolbox' and is unlikely to provide any advantage over some of the simpler options discussed above.

With regard to modifying the DNO licence, in our view, changing standard condition 4C or requiring further reporting from all licensees would not be a proportionate solution to the issue identified. Ofgem have provided alternative proposals that target either the licence applicant directly or the affiliated DNO. We can see no justification therefore in extending the regulatory burden of other licence holders when more direct solutions are available.

In summary, we agree that licensing an affiliate of a DNO to build and operate networks within that DNO's distribution services area raises a number of new issues. We believe that each case will have to be considered on its merits. In our view, at one end of the continuum is a completely ring-fenced joint venture company, where the DNO is only an equal partner. Such a joint venture is unlikely to have any competition implications or adverse impact on the end customer and should be treated as any other IDNO. This is very different from the other end of the continuum which we see as an 80:20 joint venture set up to exploit opportunities in the lower-cost network market, potentially at the expense of other IDNOs. In such a case, a cost-based approach to IDNO regulation would appear to be appropriate.

Other business models may elicit different forms of regulation and/or other licence modifications from the 'toolbox' of options proposed by Ofgem. What is important, is that the licensing of any affiliate of a DNO is treated on a case-by-case basis.

If you have any queries on any of the points raised in this letter please do not hesitate to contact me.

Yours sincerely,

Rob McDonald
Director of Regulation