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Dear Martin,

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

Your letter of 13 April has caused much discussion within United Utilities, reflecting our strong interests as both a licensed distributor and an active player in the multi-utility connections market. It is important that the issues raised are considered quickly and that a clear basis for future business development is established for distributors and connections providers.

Implications of the introduction of IDNOs

It is helpful that you set out the implications on various parties of the emergence of independent electricity distribution network operators (IDNOs). What does not come across as clearly as it might is the potential transfer of value from electricity consumers (whether connected to DNO or IDNO networks) to site developers. You rightly identify the 'cherry picking' opportunities for IDNOs, which will allow them to choose only relatively low cost sites for future ownership. In this way they can maximise their returns, calculated as the difference between revenues based on the host DNO's price controlled prices and their own costs.

The impact of this will, as you recognise, be higher average costs for the DNO, and therefore higher future prices for all consumers. The increase in the DNO's costs will, at future price control reviews, lead to higher allowed revenues. The relative price control will pass this effect to the IDNO, even though its costs are likely to remain lower. Hence, it is not only the customers connected to the DNO network that will face higher prices, but also those on the IDNO's new network.

The beneficiaries of these higher margins can only be either the IDNO or the developer from whom it has adopted the network assets. In a world of competition between IDNOs, we would expect most of this benefit to be captured by the developer who is able to auction the right to adopt the new assets. Some of this may flow through to property prices on the site, but most is likely to be completely lost for the electricity sector and its customers.

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The DNO's competitive position is parlous. Even if it were able to offer adoption payments in an attempt to secure the new assets, it would need to demonstrate that these were not discriminatory and therefore directly linked to the yardstick costs within its DUoS tariffs. This would make no allowance for the additional benefits available to its customers from being part of a portfolio that included low cost as well as high cost connections.

The only conclusion from this assessment is that it was a mistake to propose the introduction of relative price controls as they will distort the market in ways which are damaging to the interests of customers, whether connected to DNO or IDNO networks. Only price controls that reflect the costs of the licensee can avoid this problem, and they will not overcome the impact of IDNO cherry picking on the average costs borne by all DNO connected customers.

Possible approaches to a licence application from a DNO affiliate

The discussion above demonstrates the overwhelming advantage likely to be available to an IDNO in many new connection developments. These should be overcome by changing the approach to price control for IDNOs. However, in principle there is no more reason to prevent any one company from taking out an IDNO licence than any other. If there are advantages available, it does not seem right to prevent DNO affiliates from enjoying them too. Indeed companies within the same group as a DNO may be well placed to provide high quality services to developers and therefore to be able to compete effectively with other IDNOs. However, for the reasons outlined above, it is unlikely that a DNO would be able to do so directly, whilst the price control regime is so severely tilted against them.

It should be the case that DNOs and IDNOs can compete fairly and that the result is beneficial for customers. If this is not so, particularly because of differences in the nature of regulation of the two entities, it is only reasonable to allow affiliate companies to enter the market. The challenge to Ofgem should be to create a level playing field where such entry is not necessary. Your suggestion that DNO licence modifications may be needed seems to be aimed at the wrong issue. It is the nature of IDNO price control that is at the root of the problem. This was also the case in the gas market, where independent network ownership was encouraged by artificial regulatory stimuli that have proved detrimental to energy consumers.

Conclusions

Your consultation is most welcome, since the issues within it have already been the subject of considerable debate within our company. The unavoidable conclusion is that the current regulatory framework is excessively favourable towards IDNOs and damaging to the longer-term interests of all customers. Any resolution of this problem must begin with an approach to IDNO price control that is based on their actual costs rather than those of the local DNO. With such a change, we would hope that the inherent advantages of an IDNO would be

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greatly reduced, but in any event there seems no need to prevent affiliate companies from taking out IDNO licences on standard terms so long as they meet your normal qualification criteria.

I hope that you find these comments helpful. I would like to discuss the implications with you.

Yours sincerely,

Mike Boxall
Electricity Regulation Director