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Dear Colleague,

**Decision letter on regulation of independent electricity distributors: affiliates of existing licensees and price control issues**

***Introduction***

Ofgem has been approached by an affiliate of a Distribution Network Operator (DNO) regarding a potential application for a distribution licence<sup>1</sup>. If the affiliate receives an electricity distribution licence it intends to build and operate networks within that DNO's distribution services area. No affiliate of a DNO has previously applied to become licensed as an independent distribution network operator (IDNO), and this potential application raises a number of issues.

On 13 April 2006 Ofgem published a consultation letter<sup>2</sup> and invited responses on these issues.

This letter reports on the views of respondents to Ofgem's consultation and sets out Ofgem's decision and the reasons for it.

***Respondents' views***

We received twenty responses to the consultation: six from DNOs, three from IDNOs and eleven from other interested parties.

Several of the responses suggested that competition is likely to be negatively impacted by affiliate IDNOs. Various concerns were cited, namely that the affiliate could gain an unfair advantage through:

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<sup>1</sup> Ebbsfleet Valley Utilities (previously represented as Multi-Utility Joint Ventures Ltd), the potential applicant, is a joint venture between EDF Energy, which holds three distribution licences, and Thames Water.

<sup>2</sup> Regulation of independent electricity distributors: consultation on implications of licence applications from affiliates of existing licensees, 71/06, 13 April 2006.



- receiving favourable treatment from the host DNO with regards to the provision of information. The timely provision of information is critical when competing for new business. Greater access to information would give the affiliate IDNO a competitive advantage over other IDNOs and DNOs operating out of area.
- sharing overhead services and costs with the host DNO such that they are able to make savings through economies of scale. Further, where services are shared, there is the potential for costs to be misallocated such that the host DNO could utilise revenues obtained through its price control to cross-subsidise the affiliate's activities.

Several respondents suggested that affiliate IDNOs would be less effective than IDNOs at placing competitive pressure on the host DNO as they have less incentive to provide enhanced levels of service relative to that provided by the host DNO.

In addition, some respondents suggested this would negatively impact independent connection providers as an affiliate would be more likely to offer a package that would preclude the services offered by independent connection providers.

Most responses agreed that there is an incentive for affiliate IDNOs to seek out the lowest cost networks in order to maximise margins under the relative price control which over time will lead to an increase in the DNO's average costs. Responses also noted that non-affiliated IDNOs have similar impacts in relation to cherry picking networks as affiliate IDNOs.

A number of responses argued support for affiliated IDNOs (and IDNOs generally) on the basis that they are able to provide a service to developers which incumbent licensees are unable to offer. Developers are seeking flexibility over changes to design and construction over a prolonged period and are also looking for multi-utility offerings. It is argued that existing licensed incumbents are unable to provide this type of offering.

Other respondents argued that the current arrangements were such that DNOs were unable to compete on a level playing field within area with IDNOs, as a result of the relative price control and the ability of IDNOs to offer adoption payments. Therefore establishing an affiliate IDNO is a means of being able to compete for these developments.

### ***Ofgem's decision***

We have carefully considered the issues and responses to the consultation. In coming to our decision we have considered the options against our principal objective and general duties.

Some of the responses to the consultation letter question the general basis of price controls applying to all IDNOs. For reasons set out in annex 1, we do not consider that it is appropriate to change the basic structure of the IDNO price control at this point, or that this supports the case for allowing groups that hold a DNO licence to undertake distribution activities in the area covered by that licence under two alternative sets of terms. However, we do consider that DNOs need to ensure they meet their licence and statutory obligations with respect to boundary tariffs.

Other responses suggest that a primary concern is operational independence of the affiliate from the DNO. A possible response to this would be to strengthen SLC 39 to extend the provisions to affiliate or related IDNO businesses. However, we consider that this would not of itself necessarily address all of the concerns raised. Our review of

competition in connections<sup>3</sup> may also raise issues in respect of SLC 39 and we would therefore intend to revisit this issue later in that review.

In our view, a key consideration is whether a company that owns a DNO licensee should be bound by that licence in terms of its operations or should be able to undertake distribution activities in the same area through another subsidiary under the terms of an IDNO licence. We have developed the provisions of the distribution licence, including price controls, to protect the interests of consumers. We have also concluded that different licence requirements are appropriate for IDNOs and DNOs operating out of area.

We therefore consider it important that a group that has the benefits of owning a DNO is not able to avoid its licence obligations by operating through another subsidiary as an IDNO within the distribution services area. While we do not suggest that this is the intention of the current prospective applicant, Ofgem can not determine a general approach to regulating affiliate IDNOs on the basis of the intent of a particular applicant.

In general, we want to ensure that DNOs are responsive to the needs of network users, without unduly discriminating between them. Where appropriate, we would like to support innovative and flexible approaches. If licensees consider that the terms of their licence or charging methodologies act as a barrier, we would be happy to discuss this further. Further, we recognise that in some circumstances there may be benefits from joint venture operations or other new structures and we would therefore prefer not to preclude the possibility of granting licences to affiliates of existing DNOs.

We consider that it may be possible to meet all of the above concerns by capturing the activities of the affiliate IDNO within the terms of the DNO's price control. The intention would be to ensure the same result for the customers of the host DNO as if the DNO undertook the activity itself. It seems likely that this would also remove the financial incentive on the group to establish an affiliate licensee, except where the affiliate is genuinely able to offer a more efficient or better service. Our initial thoughts on the mechanics of this arrangement are set out in annex 2. If an affiliate of a DNO does successfully apply for a distribution licence, we would intend to implement this through the next price control review.

### ***Implications for gas***

Some of the issues discussed in this letter do not apply to gas transportation because of the different arrangements in the two sectors – for example, boundary tariffs are a particular issue associated with relative price control in electricity. However, Ofgem will want to consider potential implications of the issues discussed above for Independent Gas Transporters (IGTs), in particular where there are existing affiliate IGTs.

Yours sincerely,



**Martin Crouch**  
**Director, Electricity Distribution**

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<sup>3</sup> Open consultation letter: Review of competition in gas and electricity connections, 81/06, 4 May 2006.

## ***Annex 1: Are changes to relative price control required for all IDNOs?***

The existing relative price control was introduced as an interim arrangement. It caps the price IDNOs can charge domestic customers. Under arrangements in the electricity sector, IDNOs are also required to pay the host DNO use of system charges (the so-called boundary tariff).

In July 2005, we set out proposals for a new arrangement whereby the IDNO's prices follow the DNO's prices, subject to a five per cent floor and ceiling. This has not been supported by existing IDNOs and we have since given further thought to a number of alternative price control options, the details of which were set out in our consultation letter.

We have concluded that it is not appropriate to change amended standard condition BA1 at this time. Experience in gas transportation, where IGT charges can diverge from the host DN's charges, has revealed some of the risks of such divergence.

Instead we consider that attention should focus on the boundary charge. Setting these charges is the responsibility of the DNO, in the light of various licence and statutory obligations. In order to comply with its licence obligations, DNOs must ensure that the boundary tariffs charged to IDNOs, as far as is reasonably practicable, reflect the costs imposed by the IDNO's activities on the DNO's network. Further, licensees have a statutory obligation to comply with the Competition Act 1998. If current charging structures do not sufficiently reflect the costs that parties impose then it is expected that this would be reviewed by the relevant DNO and, where appropriate, modifications to the DNO's charging methodology be proposed. Ofgem has the opportunity to veto any modifications proposed and in doing so will have regard to whether they better achieve the relevant objectives<sup>4</sup>.

Views have been presented to Ofgem that the gaps between boundary tariffs and end-user charges are too great (distorting the market in favour of IDNOs) in some cases or too narrow and therefore distorting the market against IDNOs, in other cases.

The threat of entry by IDNOs, balanced by the DNO's Competition Act obligations, may encourage a DNO to set boundary tariffs at the appropriate level. We note that were an affiliate of a DNO able to operate under the same arrangements as an IDNO, this may alter such incentives at least in respect of the combined group.

In July 2006, the DNOs (through the Energy Networks Association) published their third consultation paper<sup>5</sup> on the Longer Term Charging Framework. We note that the consultation paper identifies the potential development by the DNOs of a specific IDNO customer group and tariff. The DNOs have proposed to take this issue forward through open dialogue with IDNOs and Ofgem. While this process does not in any way absolve the DNOs from meeting their ongoing obligations, it does seem likely that further dialogue would indeed help identify issues. We would hope that this process could also establish more predictability for IDNOs in the levels of boundary tariffs going forward.

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<sup>4</sup> The relevant objectives are set out at standard condition 4(3) and standard condition 4B(3) of the Electricity Distribution Licence.

<sup>5</sup> ENA Longer Term Charging Arrangements Consultation Paper 3, July 2006, available from the ENA's website ([www.energynetworks.org](http://www.energynetworks.org)).

## ***Annex 2: Mechanics of inclusion of affiliates within host DNO price control***

As noted above, we consider that it is appropriate to view the DNO's activities and the affiliated IDNO's activities as a single distribution business. This approach seeks to look through the corporate structure of the entities and assess the distribution activities undertaken by the group within area as a single entity.

To protect the customers of the affiliate, its distribution licence would include a relative price cap (per BA1, Charging Arrangements).

In setting the price control for the host DNO, we would expect to base this on the efficient costs of operating the entire network. We would not expect this to include allowance for any additional costs incurred by the affiliate that would not be incurred by an efficient DNO. For example, we would not expect to provide additional revenue to recompense the licensee for any discounts offered to developers compared to the DNO's connection charging methodology. However, in principle, if the affiliate can operate at lower cost than an efficient DNO, its shareholders should benefit from this.

As we currently do for other related parties that provide services to a distribution business, we would expect to look through any intra-group charges to the underlying costs.

Once the revenue allowance is determined, we would then expect to net off any revenues received by the affiliate in determining the allowed revenue of the host DNO.

The intention is to minimise the effect on the host DNO's customers resulting from the affiliate IDNO's activities.

If the activities of the affiliate are not expected to be material prior to the next price control taking effect in April 2010, we would not intend to re-open the existing price control but would monitor any revenues received by an affiliate licensee and, if appropriate, take them into account in the next price control review.

Where the affiliate is a joint venture, we would still expect to consider the entirety of its electricity distribution business in area – so 100 percent of the revenues would be netted off.

It is not currently clear the extent to which we could utilise cost information from the affiliate in setting the price control. However, to retain this option we would expect to require the affiliate to submit cost and revenue data on the same basis as the current arrangements for DNOs.

Specific implementation details will be discussed and agreed with individual licence applicants during the licensing process.