independent POWER networks

Ocean Park House
East Tyndall Street
Cardiff
CF24 5GT

Tel 0870 403 0001
Fax 0870 403 4001

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For the attention of Paul Darby
Distribution Policy Manager
Ofgem
9 Millbank
London
SW1P 3GE

connections@ofgem.gov.uk

Dear Paul

Application by EDF Energy (IDNO) Ltd for an electricity distribution licence

Introduction

Thank you for allowing us the opportunity to comment on EDF's application for an IDNO licence.

We agree that important issues flow from this application and that the Authority must carefully weigh the various interests at stake when considering whether to grant a licence to EDF.

Summary

We do not agree with the Authority's conclusion that the interests of consumers can be protected by including new licence conditions in any IDNO licence granted to EDF.

Licence conditions are only of use if they can be enforced effectively and we do not believe that this will be possible in the circumstances. This is not a criticism of the Authority but an acknowledgement of the relative ease with which a licensee can manipulate the cost information it provides to the regulator. While we do not under any circumstances suggest that this is EDF's intention, we agree that:

> "*Ofgem can not determine a general approach to regulating affiliate IDNOs on the basis of the intent of a particular applicant*"[1]

As will be seen from the attached Appendix, we believe that the Authority's inability to verify the costs reported to it by any IDNO affiliated to a DNO (a "related DNO" or "RIDNO") means that it cannot effectively enforce the licence conditions proposed.

On that basis, we believe that the application should be refused.

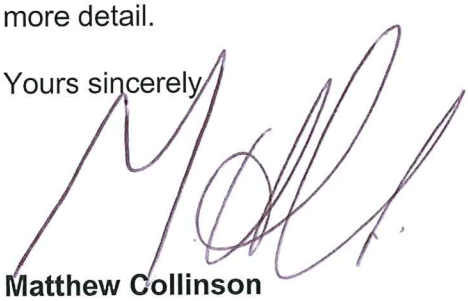
We believe that the Authority has the power to do this. If the Authority does not agree with our analysis, we suggest that the licence conditions proposed should be strengthened considerably.

[1] *"Decision Letter on Regulation of Independent Electricity Distributors: Affiliates of Existing Licensees and Price Control Issues" dated 24 August 2006 (the "Decision Letter").*

Next Steps

Please do not hesitate to contact us if you would like to discuss this response in more detail.

Yours sincerely



Matthew Collinson
Legal Adviser

APPENDIX

Why does EDF want an IDNO licence?

The Authority states that EDF's application for an IDNO licence is driven by contractual arrangements with the developers at the Olympic Park / Stratford City and Ebbsfleet Valley developments.

The Authority does not describe the "contractual requirements" driving EDF's application in its consultation but states that "*the contractual arrangements ... in both cases, call for the provision of electricity infrastructure by an IDNO licensee.*" The Authority states that it has received letters from the developers in both cases confirming this position.

The Authority has considerable scope to request information when determining a licence application and we would strongly urge the Authority to request the opportunity to examine the relevant documents in this case, if it has not done so already.

The "Overall Policy" section of the Authority's *Gas and Electricity Licence Applications* Guidance (ref 200/07a)[2] states that:

> *"The criteria …. do not set out prescriptive standards which must be met, but indicate to applicants the nature of information that they are expected to supply"*

This clearly suggests that the Authority can go beyond the "minimum criteria" set out in the Guidance.

This is important because the EDF RIDNO proposes to operate in the DSA of an existing EDF DNO and it would appear that to all intents and purposes, the EDF DNO may as well do the work itself. The EDF RIDNO will presumably use the same resources as the EDF DNOs in order to provide the services requested and will also, presumably, be connecting to an EDF DNO incumbent network, The Authority has noted that:

> "*It might be feasible for EDFE to provide electricity infrastructure services through its existing DNO licensees. From a regulatory perspective this might present a lower risk scenario, raising the question of whether the present application ought to be rejected.*"

We therefore believe that the Authority should really be asking when it might not be feasible for the EDF DNO to provide what we assume are identical services its own DSA.

EDF's application suggests that the EDF DNOs are either failing to deliver in some way or that an EDF RIDNO can provide something an EDF DNO cannot. The Authority must understand what this is before granting a licence to any RIDNO, not just the applicant.

Who would benefit from a RIDNO licence?

We agree that it is quite right to take the views of the two developers for the proposed sites into account but we do not believe that these interests should take precedence over the interests of the consumers who are the ultimate users of the

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[2] *Gas and Electricity Licence Applications – Guidance (Office of Gas and Electricity Markets, 2 August 2007) ("Licence Applications Guidance")*

network.

Limited through competition in electricity distribution is, developers do have some choice as to which distributor will provide infrastructure to their development. End users, however, have no choice about the network they are connected to. The distributor exists in a *de facto* monopoly position in relation to these consumers and it is for their benefit that the Authority exists as an economic regulator.

We suggest that when the Authority is considering whether to grant an IDNO licence to a RIDNO it is the interests of the "x" million consumers under the monopoly of the RIDNO's DNO affiliates that should be given the greatest weight.

The risks identified by the Authority as being associated with RIDNOs clearly include inappropriate cross-subsidisation as between a RIDNO and an affiliate DNO, as evidenced by the Authority's proposals to introduce modified licence conditions to deal almost exclusively with this issue.

It is the connected customer base of the DNO that would fund any cross subsidy and it is therefore the interests of those customers that should be given the greatest weight, over and above those of the Stratford City and Ebbsfleet developers.

RIDNOs increase the risk of cross-subsidy

Under a "shallowish" connection charging policy:[3]

> *"... the connection charge will include the 'shallow' element of connection costs[4] and a contribution to reinforcement costs based on a reinforcement contribution rule."*[5]

Because connection charges are only intended to cover the cost of the assets required to make the new connection (plus a limited contribution to reinforcements), every other aspect of the Distribution Business must be funded from transportation / use of system charges.

Each new connection therefore represents a risk for the distributor in that these other aspects can only be recovered after the investment in the connection has been made and the capital costs of connection are sunk. A distributor will seek to off-set this risk by increasing the volume of connections it makes in order to access transportation / use of system revenue from as wide a range of sources as possible.

An established DNO can achieve this by pooling the newly constructed / adopted assets with the pre-existing depreciated or partly depreciated assets gifted to it on privatisation. Each new tranche of investment income becomes blended with pre-existing streams of use of system income from assets of up to 40 years old. The effect of this is that the cost base acts as a kind of insurance fund with new risks becoming hedged against older, negatively correlated ones.

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[3] *In "Structure of Electricity Distribution Charges: Initial Decision Document" (Gas and Electricity Markets Authority, November 2003) ("Structure of Electricity Distribution Charges") the Authority decided that all distributors should move to a "shallowish" connection charging policy by 1 April 2005.*

[4] *Being the costs of the new assets required to supply the connecting customer plus reinforcement up to one voltage level above that at which the customer connects, subject to a de minimis threshold (Page 13, Structure of Electricity Distribution Charges).*

[5] *Page 16, Structure of Electricity Distribution Charges.*

If volume can be added in a way which does not affect the cost of capital, all things being equal the main effect of pooling new with old will be to increase throughput for a DNO. Since DNOs have spare capacity, the resulting scale benefits of adding new loads will mean additional income streams at reduced unit cost. This increase in size will enable access to finance at cheaper rates and thereby increase DNO profit margins until the end of the price control period.

For a genuinely standalone IDNO, this is not possible; it takes time to develop the sort of scale necessary to achieve this hedging effect. As a result, the IDNO is exposed to a greater volume risk than the DNO and is incentivised to compete for new connections.

The implication of this is that if the RIDNO can survive on the revenue from only one or two networks it must somehow be "super efficient". This raises important questions, not least of which being why the RIDNO's customers should benefit from this super efficiency and not the DNO's customers.

Energy prices to consumers should not be a "postcode lottery".

If the RIDNO is not "super efficient" in its own operations, the implication is that the RIDNO can survive on one or two sites because the volume risk is somehow being cushioned by the RIDNO's DNO affiliates.

The DNO's consumers would bear the RIDNO's risk

It is true that the RIDNO's new connection assets would be housed within a distinct legal entity and that, from the point of view of that particular legal entity, the volume risk would be the same as for all IDNOs.

From the perspective of the common shareholders of the DNO and the RIDNO, however, the RIDNO might as well be the downstream arm of the DNO - at least in terms of the benefit it confers on its shareholders.

There is therefore a strong incentive for the group of distributors to behave as if the RIDNO's volume risk is simply being added the "insurance fund" of the DNO's cost base, so that the volume risk faced by a genuinely standalone IDNO is avoided by the RIDNO and passed on to the DNO's consumers.

We believe that this is what really happens at an economic level. A RIDNO should therefore be treated as part of larger homogenous undertaking.

We agree with the Authority's proposals in this regard but do not believe that the protection the Authority is offering to consumers goes far enough, for the reasons set out below.

Information asymmetry will prevent visibility of RIDNO / DNO costs

The Authority's homogenous price control proposal recognises that the legal form of the relationship between a RIDNO and its DNO affiliates is irrelevant when considering the implications of granting an IDNO licence; the key is the economic structure of the undertaking.

This mirrors both the UK and EC competition law rules relating to "single economic units" and is highly relevant not only to EDF's current application but to applications from prospective RIDNOs generally.

The connection and distribution activities of a RIDNO will be identical to those of its DNO affiliates. The same staff, same insurance, same buying power etc. will be drawn on in carrying out those activities and, when taken together, the DNO and the RIDNO's risk / benefit profiles will be homogenous. The two will be economically indivisible and the Authority is right to treat them as the same undertaking.

While the principle of an homogenous price control recognises the economic reality of a DNO / RIDNO relationship, we believe that the cost of enforcing such a price control will be prohibitive.

Without a significant level of oversight the Authority will be unable to track the relevant costs and revenues within the RIDNO/DNO group to ensure that they are properly accounted for in the homogenous price control. The fundamental problem is that the Authority will be dependant on the information provided to it by the DNOs / RIDNO. The CAA Recommendations to the CC (February 2002) made the very telling point that:

> *"Regulation can never fully overcome the problems of information asymmetry."*

This is because the flow of information remains in the control of those the Authority seeks to monitor. The Authority has no choice but to *"take their word for it"*.

We do not suggest that it is EDF's intention to mislead the Authority (deliberately or otherwise). The Authority must recognise, however, that misreporting is an inherent risk in any arrangement where the regulatory regime provides an incentive to misreport (witness the recent fines in the water and sewerage sectors).

A RIDNO licence represents a risk to consumers

Granting a RIDNO licence increases the risk of harm to the connected consumers of the affiliate DNO. It is these consumers that will fund any cross-subsidy. Granting a licence despite this risk runs counter to the Authority's duty to protect consumers because it puts those consumers at risk of excessively high prices.

In these circumstances, a cross-subsidy is likely to amount to an infringement of Section 18 of the Competition Act 1998. The DNO affiliate occupies a dominant position viz its connected customers. Charging these customers inflated prices in order to fund a cross-subsidy to a RIDNO would mean that the price bears no reasonable relation to the costs the consumers impose on the DNO. Such a price would amount to an abuse of the DNO's dominant position.[6]

We do not suggest that this is EDF's intention. We note, however, that constituents of the EDF Energy group have been the subject of four enforcement investigations since 2002.[7] Even though three of these resulted in non-infringement decisions, the fact that the Authority had a reasonable suspicion of an infringement should weigh heavily in the Authority's assessment of the current application given the potential for harm to consumers.

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[6] *Case 27/76 United Brands v Commission [1978] ECR 207 ("United Brands")*

[7] *These were an investigation re London Electricity PLC in 2002 concerning breach of a licence condition and resulting in a £2m penalty; an investigation re London Electricity PLC in 2003 about an alleged infringement of the Competition Act 1998; an investigation re EDF in 2007 about an alleged infringement of the Competition Act 1998; an investigation re EDF about an alleged infringement of its licence.*

We also consider that the need for a RIDNO to be able to finance its regulated activities is important. If there is a risk of cross-subsidy or misallocation of costs then the Authority cannot be confident that the RIDNO will be able to finance its activities independently. Granting a licence despite this risk will therefore conflict with the Authority's duty to carry out its regulatory functions:

> "*having regard to… the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by order under* [Part I of the Electricity Act 1989] *or the Utilities Act 2000*".[8]

The Authority should refuse the application

The Authority has sought to mitigate the risks to consumers through the use of an homogenous price control. This involves treating the EDF RIDNO as if it was simply an extension of the EDF DNOs' activities by creating a complex licensing and reporting arrangement.

The principles of Better Regulation are captured in Section 3A (5A) and include, in particular, a requirement for the Authority to take targeted, proportionate and consistent steps in carrying out regulatory activities. We believe that a more targeted, proportionate step would be to refuse the application altogether. This has the same practical effect as the Authority's intended approach and involves the minimum of regulatory intervention. It would also be consistent with the Authority's 2006 conclusion that:

> *"it [is] 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 [DNO's] distribution services area."*[9]

We query why the Authority would consider granting a heavily modified IDNO licence to a group of DNOs at all when it could achieve the same result more efficiently by declining to grant what appears to be a superfluous licence.

The Authority has the power to refuse the application

The Authority's power to grant a licence is contained in Section 6 of the Electricity Act 1989. The wording of the same provision clearly shows that the Authority has a power to grant a licence, and is not obliged to do so. Section 6 (1) provides that:

> "*The Authority may grant any of the following licenses.*" (emphasis supplied)

The fact that this is a discretionary power is reflected in the Licence Applications Guidance in which the Authority states that:

> *"We may propose to refuse an application…"*[10]

in certain circumstances. One of these is where:

> *"the grant of a licence may conflict with our principal or general statutory duties".*

This reflects the general law with regard to the exercise of a discretion by a public body.[11]

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[8] *Section 3A (2) (b) of the Electricity Act 1989*
[9] *Page 3 of the Decision Letter.*
[10] *Para 6.1, Licence Application Guidance*
[11] *A variety of cases can be cited: Attorney General of Hong Kong v Ng Yuen Shiu [1983] 2 AC 629; R v Liverpool Corporation ex p. Liverpool Taxi Fleet Operators' Association [1972] 2 QB 299; R v SS for the Home Department ex*

The Authority's only has one chance to ensure the right settlement for consumers

If the Authority does not accept our conclusion that the most proportionate, targeted and consistent resolution of this issue is to refuse the licence, we suggest that the proposed licence conditions must be strengthened considerably.

The effect of Section 11 of the Electricity Act 1989 is that modified licence conditions of the kind proposed in the consultation cannot be modified after they have been granted unless the licensee consents.

If it is going to satisfy its principal duty to protect consumers, the Authority must be sure - before it grants a RIDNO licence - that the proposed conditions are right.

This means "right" not only in terms of high level approach but also the drafting and legal effect of their terms.

The Authority's proposals are not right for consumers

Further steps could be taken within the framework of the Authority's intended approach.

Proposed RIDNO condition BA4 (Specific Restriction of Activity) will prevent the RIDNO from procuring, adopting or distributing electricity through what would become "Relevant Assets" without the Authority's consent. This is very similar to the Water Services Regulation Authority's ("WSRA") approach to inset appointments in the water and sewerage sectors.

WSRA is subject to similar duties to the Authority, in particular a duty under 2 (2) (b) of the Water Industry Act 1991 to ensure that appointees[12] are able to finance their regulated activities.

Because of the way the inset regime operates, WSRA has interpreted this duty as requiring an inset applicant to demonstrate that each inset appointment will be economically viable in its own right.[13]

We believe that a similar approach is appropriate in the case of RIDNOs.

If a RIDNO has to demonstrate that its proposed network will be economically viable before the Authority grants consent under proposed BA4, the risk of cross-subsidy will be diminished.

This is because the problems associated with information asymmetry will be reduced.

The Authority will have the opportunity to discuss the proposed network with the RIDNO before, rather than after the fact (as would be the case with an annual cost / revenue reporting requirement).

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p Khan [1985] 1 All ER 40; Council of Civil Service Unions v Minister for the Civil Service [1985] AC 374; R v SS for the Home Department ex p Ruddock [1987] 1 WLR 1482

[12] *Water and / or sewerage undertakers are referred to as "appointees" in the Water Industry Act.*

[13] *See generally Section 6.4 of Inset Appointments: Guidance for Applicants (WSRA, 1999)*

This approach would also allow the Authority to compare the RIDNO's pre-consent business plan with the subsequent cost / revenue reports under the homogenous price control, allowing the Authority to check whether genuine economic independence has been maintained throughout the construction and subsequent operation of the RIDNO network.

As an example: rational investors will usually want a genuinely standalone IDNO to compensate for volume risk identified on page 5 by paying a higher cost of capital than a cost base business. If a higher cost of capital is not assumed by the RIDNO when applying to the Authority for consent under proposed BA4, the Authority would be entitled to assume that the RIDNO's risks are somehow being cushioned by its DNO affiliates.

This approach could be achieved by adding a new condition BA4.2 (d) to the proposed RIDNO licence. We suggest the following wording:

> *"(d) such information as the Authority may require in order to satisfy it that the licensee will be able to finance the procurement, adoption and / or distribution of electricity through any assets which would be Relevant Assets in an efficient and economic manner for so long as the licensee intends to hold this licence."*

We believe that this condition could be facilitated by an Information Undertaking similar to that imposed on licensees under what is now Standard Condition 6 of the electricity distribution licence.

The new condition would require RIDNOs to obtain Information Undertakings from every person they propose to contract with for the procurement or adoption of what would be Relevant Assets, and every person they propose to provide Relevant Assets to for future use (ie. developers).

We believe that a condition of this type is not only necessary to facilitate our proposed BA4.2 (d), but to place the Authority in a position to decide whether to grant consent under condition BA4 at all.

Our proposed drafting is attached as Annex 1 and is taken substantially from the existing SLC 6.

Conclusions

We do not agree with the Authority's conclusion that the interests of consumers can be protected by including new licence conditions in any RIDNO licence granted to EDF.

Licence conditions are only of use if they can be enforced effectively and we do not believe that this will be possible in the circumstances.

This is not a criticism of the Authority but an acknowledgement of the relative ease with which a licensee can manipulate the cost information it provides to the regulator.

We believe that the Authority's inability to verify the costs reported to it by any RIDNO means that it cannot effectively enforce the licence conditions proposed.

We therefore believe that the application should be refused.

If the Authority does not agree, we suggest that a "financial viability" condition coupled with an additional requirement for Information Undertakings will be necessary to reduce the risks to which consumers will otherwise be exposed.

Matthew Collinson
12 June 2008

ANNEX 1

Condition X. Provision of Information to the Authority

Procurement of Information Undertaking

1. The licensee must procure from each person:

    a. from whom it proposes to procure or adopt assets that would be Relevant Assets; or

    b. with whom it proposes to enter into an agreement, arrangement or undertaking (which need not be contractual) under which the licensee agrees to procure or adopt assets;

    a legally binding undertaking in favour of the licensee in a form specified by the Authority in a direction issued for the purposes of this condition generally and on the terms set out in paragraph 6.3 ("an Information undertaking").

2. Those terms are that the relevant person identified in paragraphs 1 (a) or (b) of this Condition ("the Information Covenantor") will give directly to the Authority all such Information as the Authority may require in order to determine whether to grant consent under Condition BA4 of this licence.

3. The Information undertaking to be procured under paragraph 2 must remain in force for as long as the licensee remains the holder of this licence and the Information Covenantor remains a person with whom the licensee proposes to deal in accordance with paragraph 1 (a) or (b) of this Condition.

Evidence of compliance and duty to enforce

4. Whenever the licensee obtains an Information Undertaking in accordance with this Condition, it must:

    a. give the Authority evidence of its compliance without delay, including a copy of the Information Undertaking in question; and

    b. at all times comply with any direction from the Authority to enforce that Information Undertaking.

Restriction of arrangements

5. Except with the Authority's consent, the licensee must not deal (directly or indirectly) with any person of the descriptions given in paragraphs 1 (a) or (b) of this Condition in the manner identified in those paragraphs at any time when:

    a. an Information Undertaking is not in place in relation to that person; or

    b. there is an unremedied breach of an Information Undertaking that is in place in relation to that person; or

    c. the licensee is in breach of the terms of any direction given by the Authority under paragraph 4 (b).

Sufficiency of Information provision

6. The Authority's power to request Information under this Condition is additional to its power to call for Information under or pursuant to any other Condition of this licence.

7. Standard Condition 6.8 of this licence shall not apply to Information provided under this Condition.