



Electricity Distributors and  
Interested Parties

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*Promoting choice and  
value for all customers*

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6 August 2008

Dear Colleague,

**Application by EDF Energy (IDNO) Ltd for an electricity distribution licence –  
Formal proposal of licence modifications**

1. On 16 May 2008 we published a consultation letter (65/08) referring to an application by EDF Energy (IDNO) Ltd [‘the Applicant’] for an electricity distribution licence, and asked for responses. The letter outlined the background to the application and set out Ofgem’s proposed regulatory approach including draft modifications to the distribution licence that could be granted to the Applicant, and to the distribution licences currently granted to EDF Energy Networks (LPN) plc [‘LPN’] and EDF Energy Networks (SPN) plc [‘SPN’]. We received ten responses that can be reviewed on the Ofgem website<sup>1</sup> except for one which the respondent asked not to be published. The issues raised are summarised below with our comments.
2. Our policy is that, the granting of a distribution licence to the Applicant should not:
  - mean that consumers pay more than would be the case if a licence were not granted
  - prejudice the appropriate promotion of competition in electricity distribution
  - allow existing distribution service obligations to be circumvented

Summary of issues from the consultation

3. Issues raised by respondents are summarised below, followed by our comments (marked “R”).
  - a) Several respondents said that the Authority should consider refusing the application because the services required by the developers (of the Olympic Park/Stratford City development and the Ebbsfleet Valley development) could be provided by LPN and SPN under the terms of their existing licences. They argued that this could avoid the risk of detriment to consumers or of anti-competitive effects, given the absence of apparent benefits for the developers. One respondent raised the point that the general restriction of activity under standard condition 29 of the distribution licence would prevent the Applicant from acting as a multi-utility services provider.

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<sup>1</sup> <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=105&refer=Networks/ElecDist/Policy/IDNOs>

- R We have argued before that we consider that LPN and SPN could undertake these activities and therefore have sympathy with these comments. However, we do not consider that it would be appropriate to refuse the application if the interests of consumers and other stakeholders can be adequately protected through licence modifications and policy implementation. To do so would, to an extent, restrict the contractual choices available to the developers of these major projects. Our decision in this case is based on the particular circumstances and will not set a general precedent. The Applicant will have to comply with its distribution licence conditions (including standard condition 26 with regard to any disposal of assets forming part of its electricity distribution system) but is not prevented from entering into a service level agreement with an associated third party which has itself contracted to provide multi-utility services.
- b) One respondent referred to a passage from Ofgem's earlier decision letter on the regulation of independent electricity distributors who are affiliates of existing licensees (ref no 156/06 dated 24 August 2006 ) that, "*...Ofgem can not determine a general approach to regulating affiliate IDNOs on the basis of the intent of a particular applicant.*" Another respondent argued that there should be no general restriction on affiliates of DNOs holding electricity distribution licences.
- R We would be required to evaluate any further application for a distribution licence from an affiliate of an existing distribution network operator (DNO) on its merits. However, we would have the same regard to our principal objective (to protect the interests of consumers) as we have had in this case, considering, as appropriate, measures to nullify any economic disadvantage to consumers if a licence were granted. We would expect to apply similar criteria if a successful licence applicant were to seek consent to extend its activities after a licence was granted and would consider the need for further consultation in that instance.
- c) Some respondents felt that the long term interests of electricity consumers should be ranked ahead of the shorter term needs of developers who have at least some choice in terms of network provider. There was concern that the requirement for an IDNO licensee might be driven by contractual conditions such as agreements for asset adoption payments and it was suggested that Ofgem should scrutinize the terms of such arrangements before granting a licence.

Conversely, one respondent expressed the view that developers should not be fettered in their choice of network provider and that the 'specific restriction of activity' proposed for the Applicant's licence was therefore unnecessary. Another respondent felt that there should be no restriction on DNOs having affiliate-IDNOs, subject to appropriate price control treatment.

- R We view the two developments referred to in relation to this application as exceptional in terms of their size and the long term relationship which the developers will have with the sites over their life cycles. To the extent that the Applicant proposes to make any asset adoption payments, our proposal to apply a homogenous DNO/IDNO price control will ensure that such payments are not at the expense of consumers. Specifically, the cost of any asset adoption payments (or equivalent) will not be admitted to the relevant DNO's regulatory asset value (RAV). The proposal to apply a 'specific restriction of activity' balances the needs of stakeholders in these developments with Ofgem's principal objective to protect the interests of consumers.
- d) Several parties raised concerns that the Applicant might be cross subsidised by its affiliate DNOs if it were not economically viable in its own right, either directly or through the offer of more favourable terms than a non-affiliate independent distribution network operator (IDNO) would receive. There were also concerns that EDF Energy (EDFE) might divert resources to support the Applicant, affecting the ability of third parties to obtain, for example, connection services. Some

respondents considered that any facilities or information made available to the Applicant by its affiliates should also be offered on equal terms to other IDNOs.

- R The approach we have set out applies the distribution price control to aggregate costs and revenues in each distribution services area (DSA), emulating the outcome consumers could have expected if the relevant DNO had undertaken the two major developments referred to. However, in addition, both LPN and SPN are prohibited from providing any cross subsidy to the Applicant and are subject to external audit procedures in this regard. Furthermore, under the proposal, the Applicant will also be prohibited from cross-subsidising any affiliate. We will monitor compliance with these requirements through the cost and revenue reporting regime which applies to all three companies. In this context it would not be appropriate for us to require proof from the Applicant that its activities would, in isolation, be profitable from inception. The Applicant will, however, be required to comply with the credit cover requirements contained in its licence. Under the conditions of their licences, LPN and SPN are required to have sufficient resources for their distribution businesses (which include the provision of connections) and, under standard condition 19 of the distribution licence, are prohibited from discriminating in providing use of their systems and connection to those systems.

It would not be practical or appropriate for us to suggest that shared services/information within the EDF Energy group should be made available to third parties on equal terms. We have made clear that we would not make allowance for any avoidable/inefficient costs associated with the DNO/affiliate-IDNO business structure when considering efficient levels of costs in the next price control (DPCR5). We expect to issue a direction to the Applicant under standard condition 25 of the licence requiring preparation of a long term development statement in respect of its distribution system.

- e) Three respondents questioned whether Ofgem would have the resources to assimilate the information necessary to monitor compliance with the financial licence conditions and to take enforcement action if required.
- R The Applicant will be required to complete and submit comprehensive regulatory returns equivalent to those required from DNOs. As with other licensees we would take investigatory/enforcement action if appropriate. The proposed conditions in the Applicant's licence mirror existing conditions in DNO/IDNO licences, for which compliance regimes already exist. The exception is the proposed 'specific restriction of activity' which takes the form of a mandate. We will hold regular compliance meetings with EDFE.
- f) Some concern was expressed that affiliate-IDNOs could be used by DNOs and their parent groups as a mechanism to restrict competition within their DSAs, by offering a subsidised 'IDNO solution' where a developer had chosen not to contract with the DNO. In that context it was possible that other DNO groups would follow suit and apply for IDNO licences. One respondent suggested that an affiliate-IDNO should be subject to the same boundary metering requirement as other IDNOs.
- R In proposing to issue a modified distribution licence we have been influenced by the exceptional nature of the developments involved and the particular views expressed by the developers. As mentioned above, the specific restriction of activity within the proposed licence reflects our view that there could be circumstances in which activity by an affiliate-IDNO could have anti-competitive effects and be contrary to the interests of consumers. We are separately considering the more general issues which may affect the ability of independent distributors to compete with DNOs and we will monitor the competition position in respect of end connections to the affiliate-IDNO networks where applicable.

- g) One respondent made the point that once a licence has been granted, its amended standard conditions cannot be modified without the licensee's consent.
- R This is correct but we believe that the proposed modifications to the Applicant's licence will be appropriate going forward. The modifications to the special conditions of the LPN/SPN licences (which give effect to the homogenous price control treatment) are subject to the distribution price control review (DPCR) process. If DPCR proposals are not accepted, matters can be referred to the Competition Commission.
- h) One respondent noted that the Applicant would not be subject to the terms of the losses incentive scheme specified in Special Condition C1 of DNO licences and might therefore be incentivised to install cheaper rather than low loss equipment.
- R It is correct that the Applicant will not itself be subject to the losses incentive scheme. However, it will have to comply with the requirement under section 9 of the Electricity Act 1989 to develop and maintain an efficient, co-ordinated and economical system of electricity distribution and with requirements under standard condition 24 of the distribution licence (Distribution System planning standard and quality of performance reporting). In ascertaining 'adjusted units distributed' for LPN and SPN (for the losses incentive scheme) units will be counted at the point at which they exit the LPN/SPN distribution systems and enter the Applicant's distribution system.
- i) In their response, EDFE raised a point concerning the price control treatment which would apply to the Applicant and to LPN/SPN during the remainder of the current price control period. Since the proposed modifications to LPN's and SPN's licences would reduce their allowed demand revenues by an amount equal to the relevant revenues of the Applicant, EDFE sought confirmation that units distributed by the Applicant and exit points (with a valid MPAN) on the Applicant's distribution system would be counted in the respective totals for LPN and SPN for the purposes of the growth term which increases or decreases a DNO's base demand revenue depending on changes in the size of its distribution system. One other respondent also raised this point. EDFE also made several suggestions concerning the style and formatting of the proposed licence modifications.
- R As referred to above, our overall approach is intended to aggregate costs and revenues in each DSA to emulate the outcome consumers could have expected if the relevant DNO had undertaken each of the two major developments. We therefore consider it would be appropriate to include units distributed by the Applicant and exit points on the Applicant's distribution system in the values used for the price control growth term and this is reflected in the formal proposal notices. We have also incorporated some minor formatting changes suggested by EDFE.

#### Formal proposals

4. Having carefully considered the issues raised in the consultation, the Gas and Electricity Market Authority ('the Authority') is minded to grant a distribution licence to the Applicant subject to the Applicant's consent to the proposed modifications. We recognise the concerns raised by respondents to the consultation but consider the licence conditions proposed are adequate. However, we will keep this matter under active review to monitor developments, and if any issues come to light or parties identify any evidence of anti-competitive behaviour then they should bring this to our attention.
5. The proposals no longer include the omission of the whole of Section B of the licence. Instead, in common with existing IDNO licenses, the conditions in Section B would remain incorporated in the licence but not in effect, since the Authority does not propose to give a Distribution Services Direction under standard condition 3 of the

licence. We now propose to number the amended standard conditions consecutively after Section B of the licence - from '51' to '57'<sup>2</sup>.

6. It is now proposed to include a requirement for the Applicant to prepare and publish audited regulatory accounts (financial statements) equivalent to those required to be prepared by LPN and SPN, except that the Applicant's regulatory accounts will have to include segmented data relating to activities carried out in the LPN/SPN DSAs. This replaces the requirement for the Applicant's statutory accounting reference date to be changed to 31 March.
7. The Authority also proposes to modify special conditions B1, B2, D1 and D2 of the distribution licences of LPN and SPN. Details of the proposed modifications, the reasons for them and their effects are contained in the relevant statutory notices which have been published on the Ofgem website (reference numbers 117/08, 118/08 and 119/08). The closing date for representations or objections in respect of those proposals is Tuesday 9 September 2008.
8. Queries relating to the content of this letter should be sent to the above address for the attention of Paul Darby, Distribution Policy Manager, or emailed to [connections@ofgem.gov.uk](mailto:connections@ofgem.gov.uk).

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is written over a light grey rectangular background.

**Rachel Fletcher**  
**Director, Distribution**

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<sup>2</sup> Leaving number '50' available in case any further standard condition is inserted at the end of Section B for all licensees