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Sent by mail to: karron.baker@ofgem.gov.uk

5 October 2008

Dear Karron

Response to Ofgem's consultation on Electricity North West Limited's Modification Proposal ENW/2009/001.1: "Proposal to amend the Distribution Reinforcement Model to deliver Network Operator tariffs and HV and LV Distributed Generation Tariffs."

This letter is written for and on behalf of the Electricity Network Company, a subsidiary of GTC, and is in response to Ofgem's consultation on ENW's proposal, ENW/2009/001.1.

As Ofgem will understand our concerns are primarily about the tariffs offered to IDNOs. The primary issues have always been with the margins arising from connections at LV. There is much less of an issue in respect of connections at HV. Therefore, the main thrust of our comments is in respect to that part of ENW's proposal which relates to the introduction of IDNO specific tariffs and in particular those at LV. We support the need to introduce IDNO specific tariffs because current methodologies and tariff structures lead to margin squeeze. However, we believe ENW's proposals fail to address the concerns we have raised in respect to these points.

Also, we believe that ENW's approach to use the DRM to determine IDNO charges is fundamentally flawed. In summary our views are:

- ENW's and Ofgem's analyses fail to identify all the relevant costs faced by IDNOs seeking use of system from DNOs' upstream networks. At present all DNOs insist that, in all instances, metering is fitted at the boundary to the IDNO network. Therefore, the cost associated with fitting and operating such metering is an essential upstream cost. This is irrespective of whether it is the IDNO or the DNO who fits the metering.
- The analyses ignore the impact on small developments. In many cases developments comprise of fewer than 50 properties. In these instances the margin is much reduced (as illustrated by Ofgem's graphs). Where metering costs are considered the margins are negative in some cases.
- Using an avoided cost approach is synonymous with an approach that uses ECPR. Competition case law does not support such an approach in emergent or immature markets because it is unreliable and likely to result in margin squeeze. This is the case with ENW's proposal.

- IDNOs are required to charge the same all the way charges to consumers as the host DNO. Such charges are not dependent on the length of network. Implementing a distance related tariff structure means that ENW will treat IDNOs differently from its own (notional) downstream business. Under this proposal the income an IDNO will receive will be determined by the length of the upstream network not by the length or the costs of operating its downstream network.
- IDNOs are required to charge the same all the way charges to consumers as the host DNO. Such charges are not dependent on the length of network. Implementing a distance related tariff structure means that ENW will treat IDNOs differently from its own (notional) downstream business. Under this proposal the income an IDNO will receive will be determined by the length of the upstream network not by the length or the costs of operating its downstream network.

Our more detailed comments are provided at Appendix 1. In Appendix 2 we provide our analysis of the margins available to IDNOs for different sizes of developments. This analysis considers the impact of the costs from boundary metering. Responses to Ofgem questions are provided at Appendix 3. In Appendix 4 we provide extracts from the judgements by the Competition Act Tribunal (CAT) and the Court of Appeal in respect of Albion Water, along with web links to the appropriate documents.

We will be happy to meet with Ofgem to discus further the points in this letter in more detail.

Yours sincerely

Michael Harding
Regulation and Compliance Manager
GTC

Appendix 1

ENW's and Ofgem's analyses fail to identify all the relevant costs faced by IDNOs seeking use of system from DNOs' upstream networks. At present all DNOs insist that, in all instances, metering is fitted at the boundary to the IDNO network. Therefore, the cost associated with fitting and operating such metering is an essential upstream cost. This is irrespective of whether it is the IDNO or the DNO who fits the metering.

At present all DNOs insist that boundary metering is fitted at all boundaries to IDNO networks. In some instances the DNO provides and operates the boundary metering, in other instances the DNO requires the IDNO to install and operate the metering. DNOs refuse to energise connections unless such metering is fitted. Where the IDNO incurs such cost, be it directly or through a charge from the upstream DNO, then it is an essential upstream input cost. Such costs have not been considered as part of ENW's or Ofgem's analyses. This is a significant flaw. Our illustration in Appendix 1 shows the effects of such costs in different scenarios. In our illustration we have assumed an annual cost of £100 where boundary metering is fitted and an annual cost of £300 where CT metering is fitted. We recognise that ENW's charges from metering may differ (up or down) from this.

IDNOs have put forward proposals that would allow boundary metering to be dispensed with. However, progress on this is slow. Until a solution that dispenses with the need for boundary metering is in place then such costs must be considered in undertaking analyses on the incomes available to IDNOs.

The analyses ignore the impact on small developments. In many cases developments comprise of fewer than 50 properties. In these instances the margin is much reduced (as illustrated by Ofgem's graphs). Where metering costs are considered the margins are negative in some cases.

We recognise that ENW's proposed tariffs remove the negative margins (if one excludes the costs of boundary metering) that the IDNO currently has to live with when it is charged under ENW's current tariffs for very small developments. However, as argued above, the costs of boundary metering cannot be excluded.

Also, the analyses in both ENW's and Ofgem's proposals, use 50 properties to illustrate the margins available. Whilst the graphs published for LV networks give IDNO incomes up to 400 properties, technical constraints mean that the number of properties that can be connected to a single LV feeder will be significantly less. No work has been published as to the average size of development connected to a single LV feeder.

Many developments comprise of significantly fewer properties than 50. Therefore, even if metering costs are excluded, the net income available to an IDNO (per property) for many developments is significantly less than that illustrated in the examples provided. When the cost of boundary metering is included in the upstream costs, the income available to IDNOs in respect of small developments is negative; or, to put it another way, it is impossible for the DNO to operate such networks on the same negative income and make a profit unless it receives a cross subsidy. This is a clear breach of competition law.

Our analysis in Appendix 1 illustrates the impact for developments of different sizes charged on the LV band 1 and LV band 4 tariffs. In our illustrations it can be seen that when metering costs are taken into account a development falling in band 1 must comprise of at least 15 properties before a an IDNO receives a positive margin.

Using an avoided cost approach is synonymous with an approach that uses ECPR. Competition case law does not support such an approach in emergent or immature markets because it is unreliable and likely to result in margin squeeze. This is the case with ENW's proposal.

ENW's use of an avoided costs approach to determine distance related tariffs is similar to that taken by WPD. Other DNOs have followed WPD's approach, not because they have any belief or support in the underlying philosophy, but because their proposal was "not vetoed" by Ofgem. We continue to assert that Ofgem's decision to "not veto" WPD's methodology was fundamentally flawed and are concerned that the use of an avoided cost approach appears to be an approach supported by Ofgem and touted around as the baseline going forward.

There is much case law on the use of avoided costs and on margin squeeze in circumstances similar to those in which IDNO's find themselves (Genzyme, Napier Brown, Deutsche Telekom, to name a few). In previous correspondence we have referred to the Albion Water case[1]. Whilst we recognise that each case in law has to be judged on its own particular merits, there are aspects in that case which have relevance to the issues currently faced by IDNOs. Additionally, the judgement by the CAT, together with the Court of Appeal's decision[2], published in May this year, provide a robust analyses of the current case law. The general discussion and conclusions in respect of case law should not be ignored by Ofgem or by DNOs.

Whilst in the Albion Water case it was outside the remit of the Tribunal to decide in the abstract on the main arguments for and against an ECPR approach to access pricing, pages 187 to 248 of the Tribunal's judgement of the 6 October 2006 discuss at length the use of ECPR in respect to that particular case. The Tribunal commented that:

> *"…the evidence put before it was to the general effect that ECPR is in fact a controversial methodology…";*

and that the tribunal stated that it had:

> *"…been provided with no examples or case studies of ECPR being successfully used."*

We provide limited extracts from the judgements by the CAT and Court of Appeal at Appendix 4. We also provide web links to these relevant judgements so that the judgements and the discussions in the judgements can be considered more fully and in context. These judgements provide a useful link to other competition law cases.

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[1] Case No 1046/2/4/04; Albion Water v Water Services Regulation Authority Neutral citation [2006] CAT 36;

[2] Case No C1/2007/0373 and C1/2007/0374; Albion Water v Dŵr Cymru Cyfyngedig Neutral citation [2008] Civ 536, 22/05/2008

Ofgem has, on several occasions, urged DNOs to bring forward proposals for IDNO charges and reminded them of their obligations to comply with competition law. More than this needs to be done to ensure proposals are compliant with the relevant objectives in SLC 13 of the distribution licence.

In respect of margin squeeze the appropriate test used in case law is consistent with that used in the Office of Fair Trading guidance note OFT 414a and with the definition of margin squeeze in the Telecommunications Notice. Both of these definitions require margins to be those that the incumbent would need in order to operate the business and make a profit as a stand-alone business. Using an avoided marginal cost approach is consistent with the approach described in these notices.

Additionally, using an avoided cost approach is further exacerbated by the way these costs are determined under ENW's charging methodology. We have argued on previous occasions that charging models based on reinforcement costs skew costs to the deeper assets resulting in costs at the LV part of the network being understated. This is particularly the case with the allocation of common costs of operating the business. How avoided costs are derived is one of the issues identified by case law in using such an approach.

The principle objective of the Authority is to:

> *"…protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity."*

In addition to the general requirements of competition law, paragraph 13.3(b) of SLC 13 in the distribution licence sets out as a relevant objective:

> *"…that compliance with the methodology facilitates competition in the generation and supply of electricity, and does not restrict, distort, or prevent competition in the transmission or distribution of electricity".*

In order to demonstrate that any DNO modification better achieves the relevant objectives it is essential that, inter alia, robust tests on margin squeeze are carried out. This should use the margin test rule prescribed by OFT guidance and used in case law. The proposal put forward by ENW, and the consultation published by Ofgem, makes no reference to such analyses.

As such neither ENW nor Ofgem have demonstrated, one way or the other, that this relevant objective in the licence condition is better met as a consequence of this proposal.

IDNOs are required to charge the same all the way charges to consumers as the host DNO. Such charges are not dependent on the length of network. Implementing a distance related tariff structure means that ENW will treat IDNOs differently from its own (notional) downstream business. Under this proposal the income an IDNO will receive will be determined by the length of the upstream network not by the length or the costs of operating its downstream network.

If the use of distance related tariffs is deemed to be the way forward then why hasn't ENW or other DNOs introduced such tariffs for their own consumers?

The costs associated with operating an IDNO network are not determined by the length of the DNO network. For a given IDNO network the cost of operation will be the same irrespective of the length of the IDNO network. In charging its own notional downstream business the DNO adopts an average price approach.

Why does ENW propose to depart from this approach in respect of IDNOs and treat them differently from their own notional downstream business?

The charging of IDNOs should be consistent with the appropriate approach that DNOs use in respect of their own notional downstream businesses, i.e. an average price approach. We have promoted the case for such an approach previously, in discussions with DNOs and Ofgem, in industry forums and in papers and consultation responses.

We provide our own analysis of the margins available to IDNOs in Appendix 2. Whether metering costs are included or not, the margins available constitute a margin squeeze. This is particularly the case for smaller developments. If such an arrangement is allowed then ENW will be excluding IDNOs from a significant segment of the market.

ENW propose rebalancing the split between fixed and unit charges. ENW argue that this is done to recognise the removal of tariff support and the move to a connection charge methodology based on shallow connection charges. However, we do not accept the logic put forward by ENW. The effect of rebalancing the domestic tariffs so that they are more heavily weighted towards the unit charge component has the effect of reducing the margins available to IDNOs.

Appendix 2 Analysis of ENW Charges

Data Used in Analysis

IDNO Charges (excluding metering)

ENW	Fixed p/Day	Day (p/kWh)	Night (p/kWh)
LV Band 1	19.2	1.72	0.1
LV Band 2	19.2	1.76	0.11
LV Band 3	19.2	1.8	0.12
LV Band 4	19.2	1.84	0.14
HV Band 5	88.8	1.18	0.16

All the Way Charges

ENW	Fixed p/Day	Day (p/kWh)	Night (p/kWh)
Unrestricted	2.27	1.65	1.65
E7	2.27	1.88	0.15

Assumptions

ENW	Scenario 1	Scenario 2	Scenario3
Annual Consumption (kWh)	4109	3900	3700
% night units	17	25	15
Annual metering charge (< than 60 kVA)	£100	£100	£100
Annual metering charge (> than 60 kVA)	£300	£300	£300
Assumed admd (kVA)	2	2	2
CT metering boundary (kVA)	60	60	60

A notional cost of £100 per annum has been assumed for whole current metering at the boundary
A notional cost of £300 per annum has been assumed for current transformer metering at the boundary

Scenario 1

ENW Band 1		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08
	Annual kWh Charge £)	£54.03	£270.17	£540.33	£810.50	£1,080.67	£1,621.00	£2,701.67	£4,052.50	£5,403.34	£8,105.00	£10,806.67	£16,210.01
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£124	£68	£61	£59	£58	£56	£55	£55	£55	£55	£54	£54
	Charge per dwelling (inc. metering)	£224	£88	£71	£65	£63	£60	£61	£59	£58	£57	£56	£55
IDNO Charges													
	All the way charge (Unrestricted)	£76	£76	£76	£76	£76	£76	£76	£76	£76	£76	£76	£76
	All the way charge (e7)	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68
	margin excluding metering	-£48	£8	£15	£17	£19	£20	£21	£21	£21	£22	£22	£22
	Margin per property (Unrestricted and inc. metering)	-£148	-£12	£5	£11	£14	£16	£15	£17	£18	£20	£20	£21
	Margin per property (E7 inc. metering)	-£156	-£20	-£3	£2	£5	£8	£6	£9	£10	£11	£12	£12

ENW Band 4		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08
	Annual kWh Charge £)	£38.01	£190.04	£380.08	£570.12	£760.17	£1,140.25	£1,900.41	£2,850.62	£3,800.83	£5,701.24	£7,601.65	£11,402.48
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£108	£52	£45	£43	£42	£40	£39	£39	£39	£38	£38	£38
	Charge per dwelling (inc. metering)	£208	£72	£55	£49	£47	£44	£45	£43	£42	£40	£40	£39
IDNO Charges													
	All the way charge (Unrestricted)	£76	£76	£76	£76	£76	£76	£76	£76	£76	£76	£76	£76
	All the way charge (e7)	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68
	Margin per property (Unrestricted and inc. metering)	-£132	£4	£21	£27	£30	£32	£31	£33	£34	£36	£36	£37
	Margin per property (E7 inc. metering)	-£140	-£4	£13	£18	£21	£24	£22	£25	£26	£27	£28	£29

Scenario 2

ENW Band 1		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08
	Annual kWh Charge £)	£51.29	£256.43	£512.85	£769.28	£1,025.70	£1,538.55	£2,564.25	£3,846.38	£5,128.50	£7,692.75	£10,257.00	£15,385.50
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£121	£65	£58	£56	£55	£54	£53	£52	£52	£52	£52	£52
	Charge per dwelling (inc. metering)	£221	£85	£68	£63	£60	£57	£59	£56	£55	£54	£53	£53
IDNO Charges													
	All the way charge (Unrestricted)	£73	£73	£73	£73	£73	£73	£73	£73	£73	£73	£73	£73
	All the way charge (e7)	£65	£65	£65	£65	£65	£65	£65	£65	£65	£65	£65	£65
	margin excluding metering	-£49	£7	£14	£17	£18	£19	£20	£20	£21	£21	£21	£21
	Margin per property (Unrestricted and inc. metering)	-£149	-£13	£4	£10	£13	£16	£14	£16	£18	£19	£20	£20
	Margin per property (E7 inc. metering)	-£157	-£21	-£4	£2	£5	£8	£6	£9	£10	£11	£12	£12

ENW Band 4		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08
	Annual kWh Charge £)	£36.08	£180.38	£360.75	£541.13	£721.50	£1,082.25	£1,803.75	£2,705.63	£3,607.50	£5,411.25	£7,215.00	£10,822.50
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£106	£50	£43	£41	£40	£38	£37	£37	£37	£37	£36	£36
	Charge per dwelling (inc. metering)	£206	£70	£53	£47	£45	£42	£43	£41	£40	£39	£38	£37
IDNO Charges													
	All the way charge (Unrestricted)	£73	£73	£73	£73	£73	£73	£73	£73	£73	£73	£73	£73
	All the way charge (e7)	£65	£65	£65	£65	£65	£65	£65	£65	£65	£65	£65	£65
	Margin per property (Unrestricted and inc. metering)	-£134	£3	£20	£25	£28	£31	£29	£32	£33	£34	£35	£35
	Margin per property (E7 inc. metering)	-£141	-£5	£12	£17	£20	£23	£21	£24	£25	£26	£27	£27

Scenario 3

ENW Band 1		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08	70.08
	Annual kWh Charge £)	£54.65	£273.25	£546.49	£819.74	£1,092.98	£1,639.47	£2,732.45	£4,098.68	£5,464.90	£8,197.35	£10,929.80	£16,394.70
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£125	£69	£62	£59	£58	£57	£56	£56	£55	£55	£55	£55
	Charge per dwelling (inc. metering)	£225	£89	£72	£66	£63	£60	£62	£60	£58	£57	£56	£56
IDNO Charges													
	All the way charge (Unrestricted)	£69	£69	£69	£69	£69	£69	£69	£69	£69	£69	£69	£69
	All the way charge (e7)	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68
	margin excluding metering	-£55	£1	£8	£10	£11	£12	£13	£14	£14	£14	£14	£14
	Margin per property (Unrestricted and inc. metering)	-£155	-£19	-£2	£3	£6	£9	£7	£10	£11	£12	£13	£13
	Margin per property (E7 inc. metering)	-£156	-£20	-£3	£2	£5	£8	£6	£9	£10	£11	£12	£12

ENW Band 4		No of Properties											
		1	5	10	15	20	30	50	75	100	150	200	300
DNO charges													
	Annual fixed charge (£)	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08	£70.08
	Annual kWh Charge £)	£38.00	£190.00	£379.99	£569.99	£759.98	£1,139.97	£1,899.95	£2,849.93	£3,799.90	£5,699.85	£7,599.80	£11,399.70
	Annual Metering Charge (£)	£100.00	£100.00	£100.00	£100.00	£100.00	£100.00	£300.00	£300.00	£300.00	£300.00	£300.00	£300.00
	Charge per dwelling (exc. metering)	£108	£52	£45	£43	£42	£40	£39	£39	£39	£38	£38	£38
	Charge per dwelling (inc. metering)	£208	£72	£55	£49	£47	£44	£45	£43	£42	£40	£40	£39
IDNO Charges													
	All the way charge (Unrestricted)	£69	£69	£69	£69	£69	£69	£69	£69	£69	£69	£69	£69
	All the way charge (e7)	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68	£68
	Margin per property (Unrestricted and inc. metering)	-£139	-£3	£14	£20	£23	£26	£24	£26	£28	£29	£29	£30
	Margin per property (E7 inc. metering)	-£140	-£4	£13	£19	£22	£25	£23	£25	£27	£28	£28	£29

Appendix 3

IDNOs

1. Respondents' views on the use of a day/night restricted tariff for IDNOs;

We believe the upstream tariff structures should reflect downstream tariff structures. This is not simply a case of offering unrestricted and E7 and unrestricted tariff structures. We have received requests from suppliers to offer E10 tariffs. If IDNOs offer these then there will be 3 hours of the day where IDNO rates are lower than the upstream rate. In addition, time pattern regimes for upstream tariffs must be coincident with those in downstream tariffs. We have put forward proposals on how this could be achieved.

2. Whether respondents consider the lack of an IDNO commercial tariff would influence the development of IDNO commercial connections;

No analysis has been carried out on how the application of ENW's tariffs to commercial developments will impact on IDNO margins. There is a significant risk that unduly thin or negative margins will result from commercial developments. In addition the additional cost of boundary metering will further exacerbate the problem

3. Whether respondents agree with the approach to avoided costs attributed to IDNOs?

We disagree with the use of an avoided cost approach. We believe this goes against the requirements of competition law and requires an IDNO to be super efficient to able to operate and make a profit under such a regime.

HV/LV Generation Charging

4. Whether respondents consider generation should be treated as the reverse of demand?

Generation is not the reverse of demand. Generation in the vast majority should be considered as a substitution activity for the provision of upstream network and upstream reinforcement. The contribution that distributed generation makes in reducing system losses should also be considered

5. Whether respondents consider average generation load factor is an appropriate proxy for the coincidence factor?

No comment

6. Whether respondents agree with the allocation of benefits to generators with a load factor either side of 50%?

No comment

DRM Modifications

7. Whether ENW's approach to scaling is appropriate? Do respondents consider any distortions will arise when moving from a fixed percentage to a fixed adder?

Conceptually the DRM methodology is fundamentally flawed and leads to incorrect allocation of the allowed revenues permitted under the price control. We believe that use of the DRM fails to reflect accurately where costs are incurred.

The effect of the DRM modification proposals would appear to shift costs towards deeper assets. Whilst a fixed adder approach may seem sensible, the key issue is where such costs should be allocated on the yardstick. The existing approach is unfair to IDNOs and is exacerbates the avoided cost approach adopted by ENW in its proposed IDNO charges.

8. Do respondents have any thoughts or comments on the fact that ENW currently scale down, i.e. they propose to apply a negative fixed adder?

No comment.

9. Do respondents consider the use of the RRP data is sensible for the O&M percentage?

O and M costs should lie where they fall. We are concerned that such costs (particularly common costs) are incorrectly allocated in the yardstick. In allocating such costs all O and M costs should be considered. Many of these costs are directly related to customers and should be allocated on a per customer basis rather than being smeared across the whole network on a p/KW or p/KWh basis. How such costs are allocated has particular relevance to IDNO tariffs.

10. Do respondents consider the changes to the network yardsticks for connection costs and subsequent changes to the availability charges are sensible?

It is three years since tariff support was removed. If there is a flaw in the model then it is a concern that it has taken so long to address. This approach further skews the recovery of costs to deeper assets and further compromises margins available to IDNOs.

11. Do respondents consider ENW's approach to model the minimum costs of connection for the future asset replacement cost is sensible with regard to their service models?

No comment

12. Are licence fees something that can be attributed per customer that reflect costs incurred by the licensee?

Licence fees are common costs care has to be taken on how these costs. We disagree that an IDNO should have to contribute to the upstream licensees fees as well as paying for its own. Similarly, in respect of network rates we do not see why IDNOs should pay contribute towards the network rates of the IDNOs downstream business.

Further Issues

13. Are these changes sufficiently transparent?

No. The asymmetry between the information available to IDNOs and DNOs makes it difficult to make objective detailed comparisons in respect of many of the questions.

Appendix 4

Extracts from Albion Water Case Law.

Judgement by the Competition Appeal Tribunal, Albion Water v Water Regulation Authority, 6 October 2006.

Web link:
http://www.catribunal.org.uk/documents/Judge1046Albion061006.pdf

574. OFT 422 refers at paragraph 4.14 to the "stand-alone" costs of an activity, and paragraph 107 of the Telecommunications Notice, cited above, refers to the importance of allocating relevant costs where a company is engaged in a number of activities. In OFT 414, September 1999 version, not cited to the Tribunal at the previous hearing, reference is made to the "stand-alone" cost in the context of an assessment of supranormal profits "as being the least cost which would be incurred by a hypothesised efficient undertaking supplying only that product or service from a fully utilised plant of optimum size". OFT 414a, a more recent version of OFT 414, refers to stand-alone costs as "those costs that would be incurred if the company undertook only the line of business in question". A discussion paper by Oxera, an economic consultancy, published as OFT 657 in July 2003, defines "stand-alone" cost as: "The costs of an activity or line of business that would be incurred if the company undertook that activity only. All common costs are attributed to the activity in question."

909. The Authority's essential argument is that there is no scope here for a margin squeeze since Albion is duplicating, rather than replacing, services offered by Dŵr Cymru. To create a margin would be artificial, and would amount to subsidising Albion. According to the Authority, Albion has not come up with an innovative business model which gives rise to efficiencies. Cases such as *Napier Brown/British Sugar, Deutsche Telekom* and *Genzyme* implicitly

910. To take the last point first, it is true that in the margin squeeze cases cited above, the incumbents did not incur the costs of the downstream activities in question when supplying third parties with the upstream inputs. However, in *Genzyme (remedy)* [2005] CAT 32 the Tribunal did not determine the appropriate margin on the basis of Genzyme's avoided costs, but on the basis of the margin required by a reasonably efficient homecare services provider to supply its services and earn a competitive return (paragraph 249 of that judgment) i.e. an amount sufficient to cover the entrant's total costs. Neither *Napier Brown/British Sugar* nor *Deutsche Telekom,* nor the Guidance issued by the OFT and the Commission, appear to proceed on an "avoided costs" basis. An "avoided cost" approach in our view would not be a satisfactory basis for a margin squeeze test, because it takes no account of the incumbent's fixed costs, takes no account of the entrant's total costs, and requires the entrant to be more efficient than the incumbent, as already shown above. In addition there are the problems of determining "avoided" costs. These difficulties are illustrated by the fact that the Authority's position seems to have swung during these proceedings from arguing that no retail costs are avoided to submitting that all retail costs are avoidable.

Judgement by the Competition Appeal Tribunal, Albion Water v Water Regulation Authority, 18 December 2006.

Web link:
http://www.catribunal.org.uk/documents/Jdg1046Albion181206.pdf

292. On the specific issue of margin squeeze, the accepted tests for a margin squeeze are set out in both the *Telecommunications Notice* and OFT 414a, cited at paragraphs 845 and 864 of the main judgment. Those tests are either (a) that the dominant company's own downstream operations could not trade profitably on the basis of the upstream price charged to its competitors by the upstream operating arm of the dominant company; or (b) that the margin between the price charged to competitors in the downstream market for the input product and the price which the dominant firm charges in the downstream market is insufficient to allow a reasonably efficient downstream operation to earn a normal profit (*Telecommunications Notice*, at paragraphs 117 and 118). OFT 414a at paragraphs 6.2 and 6.3 emphasises the second of these tests. The underlying principle is spelled out in various decisions of the European Commission, culminating in *Deutsche Telekom,* cited at paragraphs 866 to 869 of the main judgment

Judgement by the Court of Appeal, Albion Water v Water Regulation Authority, 22 May 2006.

Web link:
http://www.catribunal.org.uk/documents/Judg1046Albion22.05.08.pdf

Paragraph 58.

> "…There is nothing in the Commission's guidance, the OFT's guidance, the decided cases (including "network" cases similar to this) or the textbooks to support the view that the margin squeeze tests as formulated have to be qualified by reference to avoided costs or an equivalent concept. The Tribunal was entitled to find that both tests in the standard formulation were satisfied: a zero or negative margin is the limiting case of an abusive margin squeeze, since it means that no downstream competitor, however efficient, could trade profitably, nor could the downstream arm of the vertically integrated incumbent…"