Promoting choice and value
for all gas and electricity customers

Decision to accept binding commitments from Electricity North West Limited over connection charges

Final decision

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Contact: Nenad Njegovan, Head of Economic Analysis

Team: Enforcement & Competition Policy

Tel: 020 7901 7385

Email: nenad.njegovan@ofgem.gov.uk

Overview:

This document explains Ofgem's decision to accept commitments offered by Electricity North West Limited (ENW) in relation to our competition law investigation. Our investigation looked into the charges ENW imposed on Independent Power Networks Limited (IPNL) for connection into ENW's distribution service area. Our decision follows a consultation exercise which closed on 18 January 2012 during which we sought views on the commitments offered.

Formal acceptance of the commitments by Ofgem results in the termination of our investigation, without the need for any decision on whether or not competition law has been infringed by the company under investigation.

Context

Ofgem has concurrent competition law enforcement powers for the energy sector. This means that we can enforce both domestic and European competition law and address collusive behaviour, or abuse of a dominant position within the energy sector. We have used these powers on a number of occasions. This document relates to an investigation into possible abuse of a dominant position in the setting of charges for connecting to a distribution network.

Associated Documents

Notice of intention to accept binding commitments:
http://www.ofgem.gov.uk/About%20us/enforcement/Investigations/CurrentInvest/Documents1/Consultation%20on%20commitments%20for%20ENW.pdf

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Executive Summary

Ofgem is committed to ensuring that network businesses provide their customers with the best possible service at fair prices. Where appropriate, we have taken action to open up aspects of network business to competition so that consumers have a choice, and so that competition or the threat of it keeps prices down and stimulates innovation. We will consider using the range of our tools as regulator – competition law enforcement, price controls, and licence obligations and enforcement to help markets deliver benefits for consumers.

Independent Power Networks Limited (IPNL) complained to us about aspects of the Distribution Use of System (DUoS) charges levied on it by Electricity North West Limited (ENW) for connection into the ENW's Distribution Service Area (DSA). IPNL alleged that the level of ENW's charges gave it no opportunity to earn any margin and as such amounted to a vertical margin squeeze by a dominant company.

Following consideration of the allegation, we launched a formal investigation in January 2009 into possible infringements of Chapter II of the Competition Act 1998 (the Act) and/or Article 102 of the Treaty on the Functioning of the European Union (TFEU). ENW offered commitments to address our outstanding concerns.

Pursuant to section 31A and Schedule 6A of the Act, we conducted a consultation exercise (the 'Consultation') to seek views on the commitments offered by ENW. This took the form of publication of a Notice to accept binding commitments issued on 23 November 2011. Having taken account of representations made to us during the Consultation, we consider that the commitments offered fully address our competition concerns, and we have therefore decided to accept them. The text of the commitments is set out in Annex 2.

The remainder of this document describes our investigation, the market context in which the investigation has been carried out and our competition law concerns with reference to both the legal and economic context.

As far as general deterrence is concerned, we consider that our decision will assist in promoting compliance with competition law. Together with other significant developments since the opening of our investigation, including steps taken proactively by ENW, we consider that our decision will send a strong indication to other distribution network operators (DNOs) of matters they should have regard to when assessing whether their behaviour constitutes infringements under Chapter II of the Act and/or Article 102 of the TFEU.

A decision by us to accept the commitments does not amount or imply any findings as to the legality or otherwise of the conduct of ENW either prior to acceptance of the commitments or once the commitments are in place.

More generally, we would expect all DNOs to be proactive in keeping charging methodologies under review and for industry parties to explore mechanisms for changing industry arrangements, including charging methodologies, to ensure they are fit for purpose. We stand ready to use our competition law and sectoral powers in future where appropriate and if the circumstances warrant it.

1. Ofgem's investigation

Decision to open an investigation

1.1. We received a complaint by IPNL about the charges levied on it by ENW for use and connection to its electricity distribution system. Following this complaint we launched a formal investigation on 9 January 2009 under section 25 of the Act, through the issue of section 26 Notices, on the basis that we had reasonable grounds to suspect that Chapter II of the Act and/or Article 102 of the TFEU was being infringed.

1.2. In particular, we considered that there were reasonable grounds for suspecting that ENW's behaviour could be considered conduct on the part of an undertaking which amounted to abuse of a dominant position (Chapter II prohibition). Such conduct includes the direct or indirect imposition of unfair purchase or selling prices/charges and other unfair trading conditions.

1.3. The relevant charges in this case, called the DUoS charges, are contained in Connection Use of System Agreements (CUSAs) signed by ENW and IPNL. The complaint related to all IPNL-connected sites in the ENW DSA. The list of these sites is provided in Annex 1.

Parties

1.4. ENW is a wholly owned subsidiary of North West Electricity Networks Limited. It holds a distribution licence under section 6(1)(c) of the Electricity Act 1989 and is the incumbent ex-public electricity supply (PES) DNO for the DSA in which the sites that are the particular subject of the complaint are located.

1.5. IPNL is part of the INexus Group, which is controlled by a consortium headed by the Challenger Infrastructure Fund. It holds a distribution system operator licence granted under section 6(1)(c) of the Electricity Act 1989. IPNL carries on the business of an electricity distributor within the ENW DSA. IPNL also acts as an IDNO in the distribution service areas of all 13 other ex-PES DNOs.

Ofgem's criteria for opening an investigation

1.6. In order to make the best use of our resources in terms of real outcomes for consumers, we need to ensure that we make appropriate decisions about which projects and programmes of work we undertake across all areas of our enforcement powers.

1.7. We aim to ensure that possible infringements that are likely to cause the greatest harm to consumers or competition, or give rise to the most serious concerns, are prioritised.

1.8. The criteria that we consider fall under two broad categories:

i. whether Ofgem has the power to take action and is best placed to act; and
ii. whether it is a priority matter for us, due to its apparent seriousness and impact or potential impact on consumers and competition.

Application of Ofgem's criteria in this case

1.9. We have concurrent powers with the Office of Fair Trading (OFT) to investigate potential infringements of the prohibitions in Chapter I and II of the Act and/or Articles 101 and 102 of the TFEU.

1.10. At the time of opening the investigation, we considered that the features of this case were such that it was appropriate to take this case forward as it met our prioritisation criteria. The following factors were of particular relevance:

- the development of competition for the provision of new electricity networks had been relatively limited but could potentially lead to the improvement of the performance by DNOs as well as a source of innovation to help facilitate the delivery of a low carbon economy. Competition in networks could also facilitate competition in the market to provide new connections to the distribution networks; and

- the case presented an opportunity for us to deliver a message to all DNOs about our concerns regarding aspects of their charging methodology, and the effect on competition at a time when progress of discussions for an enduring common charging methodology for IDNOs (CDCM) was slow.

The focus of our investigation

1.11. IPNL suggested that we investigate compliance with either licence obligations (undue discrimination) or with competition law.

1.12. We decided that use of competition law was more appropriate to address the allegations being made. In particular, the focus of our investigation was on whether the DUoS charges imposed upon IPNL by ENW under the terms of the CUSAs amounted to a margin squeeze in respect of IPNL's operation of sites within the ENW DSA in the context of Chapter II of the Act and/or Article 102 of the TFEU.

Process

1.13. We used our formal information gathering powers, knowledge of the sector and of regulatory developments, meetings with ENW and IPNL, and economic analysis to form a view about the case.

1.14. We identified a number of competition concerns. Many of these have been addressed by industry developments and actions by ENW. We consider that our remaining concerns about this case are addressed by the commitments offered by ENW.

1.15. We considered ENW's proposed commitments, and IPNL's views on those commitments. We were of the view that the binding commitments offered, when considered in the context of the wider developments and other actions taken since we opened our investigation, would address our competition concerns, for the reasons set out in this document.

1.16. Therefore, on 21 November pursuant section 31A and Schedule 6A of the Act, we issued a Notice of an intention to accept binding commitments (Reference: Ofgem 158/11) in which we invited interested parties to make representations on our proposed course of action. The consultation process closed on 18 January 2012.

1.17. Having considered the representations made to us during the Consultation, we consider that the proposed commitments offered by ENW address the competition concerns identified in the investigation. As a result, we now accept the commitments as offered by ENW in the form set out in Annex 2 and close this investigation.

1.18. Our decision to accept the commitments does not amount to or imply any finding as to the legality or otherwise of the conduct by ENW either prior to acceptance of the commitments or once the commitments are in place.

2. Background - the electricity distribution service markets

2.1. There are historic monopoly elements in the electricity distribution services markets. These are subject to economic regulation by Ofgem. We have also sought to make some of the markets involved contestable. The following paragraphs describe these markets and the relative roles of DNOs and IDNOs.

2.2. The vast majority of the existing electricity distribution network is owned by the privatised PES companies now commonly referred to as DNOs. The DNOs operate in defined DSAs where they are obliged to offer distribution services to customers.

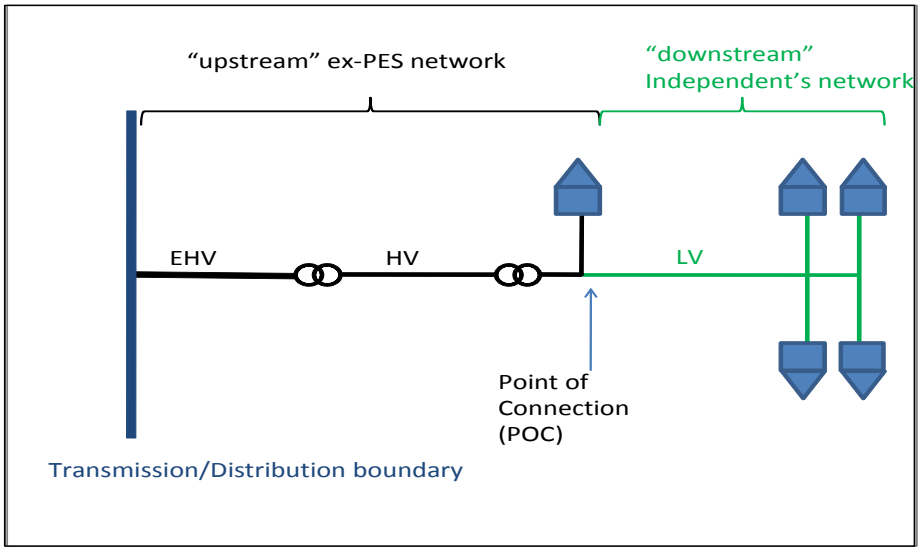
2.3. Under the current regulatory framework competition is permitted between DNOs and IDNOs[1]. IDNOs are able to compete with the DNOs to build, adopt, operate and maintain extensions to the electricity distribution network. For example an IDNO and a DNO may compete to extend the network to a new housing development.

2.4. The capacity of IDNOs, such as IPNL, to compete with incumbent DNOs, such as ENW, is dependent upon their ability to convey electricity to the point at which the connection feeds into the customer's premises (whether domestic or commercial). In order to be able to do this the IDNO needs to be able to connect into the pre-existing network normally owned by the incumbent DNO which connects to the GB wide transmission system of National Grid Electricity plc.

2.5. The diagram below shows a typical network operated by an independent and its relationship with a DNO network.

[1] IDNOs are licensed distribution network operators. However, unlike DNOs, they do not have a defined DSP where they are obliged to offer distribution services.

Figure 1: Example of DNO and IDNO networks



2.6. The revenue for the supply of electricity distribution services to newly constructed electricity connections, both for incumbent DNOs and IDNOs, is derived from charges levied upon the suppliers of electricity for the distribution of electricity to their end-users on their behalf.

2.7. On the basis that customers connected to an IDNO should be no worse off than if they were connected to a DNO network, IDNOs are subject to a relative price control (RPC). RPC limits charges by IDNOs for network use to being no greater than would have been charged by the local DNO to an equivalent customer.

2.8. The income available to the IDNO is determined by the difference between the RPC limited charge it levies to end customers (all the way charge – ATW charge) and the payment it makes to the upstream network (boundary charge). The charges levied by the ex-PES network to the IDNOs are therefore crucial as they have the potential to prevent efficient market entry, or alternatively, to encourage inefficient companies to enter the market.

2.9. One of the consequences of introducing competition in the last mile of distribution is that it requires some assessment or measurement of the electrical flows across the network boundary. This is primarily required in order to calculate the charges which the downstream distributor owes to the upstream incumbent for use of its network. The incumbent may also wish to use the measurement from the upstream equipment to report accurately the losses on its network so that it can efficiently manage its network and does not suffer financial harm due to any abnormal losses on the IDNO network.

General concerns about various DNOs' charging methodology

2.10. At the time we opened this investigation in January 2009, we had general concerns about aspects of various DNOs' charging methodology, as well as about the funding arrangements for equipment to measure the flows of electricity between the DNO and IDNO networks (i.e. boundary metering).

2.11. On the issue of the charging methodology, we were concerned that DNOs did not have a specific charging methodology for IDNOs. Instead, DNOs were charging IDNOs in the same way that they charged for large industrial connections to the DNO network. This meant that:

- the charges imposed by DNOs on IDNOs at the boundary did not reflect IDNOs' particular characteristics (in terms of energy flows and capacity requirements) and therefore did not accurately reflect the costs that IDNOs impose on DNO distribution networks upstream of the point of connection or the cost to the DNO of providing similar downstream services; and

- the capacity used by DNOs for use of system charging purposes from energisation of a connection to an IDNO network was the maximum capacity applied for by the IDNO. In practice IDNO networks generally experience a period of growth, as customer numbers develop, prior to reaching a settled level of demand.

2.12. On the issue of boundary metering, we were concerned that the DNO requirement for almost universal metering of flows between the boundary was a discriminatory and disproportionate response to measuring electrical flows between DNO and IDNO networks. We estimated that this requirement placed a cost on IDNOs of between £400-£700 per site per year. This cost is not incurred by DNOs as they do not install metering at equivalent points on their own networks. To put this into perspective, the boundary metering charges can be equivalent to more than 50 per cent of the IDNO revenues at a typical site.

2.13. Both these issues were raised by IPNL as part of its specific complaint against ENW.

2.14. Since the Government introduced the prospect of independent distribution network operators, we have put in place measures to facilitate competition. We have introduced licence obligations for DNOs to produce network charges that are compatible with competition in distribution. DNOs have been encouraged to introduce IDNO-specific charges, and were requested to have "interim" methodologies in place by 1 April 2009. Alongside the development of interim methodologies we also emphasised that IDNO charges were to be central to the development of a common

charging methodology that DNOs were required by licence to develop which was implemented on 1 April 2010[2].

2.15. As our investigation under the Act progressed, the DNOs first put in place arrangements to address the handling of capacity usage ("capacity ramping"), then an interim solution and finally an enduring common charging methodology. As a result, one of the principal concerns that provided the impetus for the investigation has already been largely addressed. We note that ENW has also retrospectively applied the capacity ramping modification to IDNOs in this area. We note that several of the other DNOs have not retrospectively applied the capacity ramping modification to IDNOs. ENW's voluntary action to apply retrospectively the capacity ramping modification to IDNOs has been a relevant factor in our consideration of whether to accept the commitments.

2.16. The current competition law investigation was launched at a time when there was protracted delay in DNOs putting into place both a longer term and an interim common charging methodology. The developments since then and the commitments offered by ENW need to be seen in this context.

[2] The DNO were required by 1 April 2010 to implement a common methodology for charging customers connected to their HV and LV networks (the "CDCM"). A similar requirement was placed in their licence to develop a common methodology to charge customer connected at the EHV level (the "EDCM") at a later date. The EDCM was implemented on 1 April 2012.

3. Our competition concerns

Legal Analysis

Legal framework for assessing abuse

3.1. The assessment of whether the conduct of a dominant undertaking amounts to an abuse requires consideration of whether the undertaking has engaged in practices which have the effect of restricting the degree of competition it faces and/or exploiting its dominant market position unjustifiably. This will include consideration of (i) whether the relevant conduct constitutes competition on the merits; and (ii) whether it tends to restrict competition in a relevant market.

3.2. Chapter II of the Act and Article 102 of the TFEU prohibit conduct by one or more undertakings which amounts to the abuse of a dominant position in a market if it may affect trade within the UK or between EU Member States respectively.

3.3. The Act and TFEU enumerate, without being exhaustive, a number of practices by dominant firms which may constitute an abuse of their position.[3]

3.4. In order to find an infringement of the Chapter II prohibition, Ofgem must establish that:

- at the time of the alleged infringement the undertaking held a dominant position within the UK or any part of it;
- the undertaking abused that dominant position; and
- such abuse may have affected trade within the UK or any part of it.

Application of Section 60 – consistency with European Union law

3.5. Section 60(1) of the Act sets out the principle that, so far as is possible (having regard to any relevant differences between the provisions concerned), questions arising in relation to competition within the UK are to be dealt with in a manner which is consistent with the treatment of corresponding questions arising in European Union (EU) law in relation to competition within the EU. In particular, under section 60(2) of the Act, Ofgem must act (so far as is compatible with the provisions of the Act) with a view to ensuring that there is no inconsistency with the

[3] The Chapter II prohibition does not apply in cases in which it is excluded pursuant to section 19 of the Act. None of the excluded cases are applicable in respect of the alleged infringement that is the subject of this investigation.

principles laid down by the TFEU and the European Courts and any relevant decision of the European Courts.

3.6. In addition, under section 60(3) of the Act, Ofgem must have regard to any relevant decision or statement of the European Commission (the Commission).

3.7. Article 102 TFEU is the provision in EU competition law equivalent to the Chapter II prohibition. Accordingly, the interpretation of Article 102 TFEU in the case law of the European Courts is relevant when applying the Chapter II prohibition. This is independent of Ofgem's separate duty to apply Article 102 TFEU in the present case, as to which see paragraphs below.

Application of Article 102 TFEU

3.8. Article 102 TFEU prohibits, as incompatible with the common market, any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it, insofar as it may affect trade between Member States.

3.9. Since the entry into force of the Modernisation Regulation on 1 May 2004,[4] Ofgem is required to apply Article 102 TFEU in addition to the Chapter II prohibition if an abuse of a dominant position 'may affect trade between Member States'.[5]

3.10. Since the conduct that is the subject of this investigation occurred after 1 May 2004, Ofgem considers that it is under an obligation to apply Article 102 TFEU if ENW's conduct 'may affect trade between Member States'. Since we have not reached a decision as to infringement in this case, we have conducted our analysis to date (as summarised in this document) on the basis of a possible infringement of both Chapter II of the Act and Article 102 of the TFEU.

Relevant case law in relation to 'undertaking'

3.11. The Chapter II prohibition and/or Article 102 TFEU apply to conduct on the part of one or more 'undertakings'. The term 'undertaking' is not defined in the Act or in the TFEU. It is a wide term that the Court of Justice has held to cover 'every entity engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed'.[6]

3.12. Accordingly, the key consideration in establishing whether an entity is an undertaking is whether it is engaged in 'economic activity'. The Court of Justice has

[4] Article 45 of the Modernisation Regulation.
[5] Article 3 of the Modernisation Regulation.
[6] Case C-41/90 *Höfner and Elser v Macroton* [1991] ECR I-1979, paragraph 21.

defined 'economic activity' broadly as activity 'of an industrial or commercial nature' consisting in offering 'goods and services' on a given market.[7]

3.13. The term 'undertaking' therefore includes any natural or legal person that is capable of carrying on commercial or economic activities.

3.14. We consider that ENW is engaged in economic activity and constitutes an undertaking for the purposes of the Act and the TFEU.

Market definition

3.15. In order to determine whether ENW has a dominant position, it is first necessary to identify the relevant market.[8] Market definition provides a framework for competition analysis and is a key step in identifying any competitive constraints that an undertaking may face for the purposes of the Chapter II prohibition and/or Article 102 TFEU.

3.16. The definition of the relevant economic market(s) in which an undertaking operates is usually the first step in assessing whether that undertaking has market power. The relevant market typically has two dimensions: the relevant goods or services (the product market) and the geographic extent of the market (the geographic market).

3.17. The European Commission has stated that the product market comprises "all those products or services, which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use".[9]

3.18. The relevant geographic market comprises the "area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas."[10]

3.19. For competition law purposes, it is often helpful to define a market by determining the smallest product or service group, and geographical area, within which a hypothetical monopolist could profitably sustain prices that are at least a small but significant amount (i.e. 5-10 per cent) above the competitive level (the SSNIP test).

[7] Case C-118/85 *Commission v Italy* [1987] ECR 2599, paragraph 7.
[8] Case 27/76 *United Brands v Commission* [1978] ECR 207, para 10.
[9] Commission notice on the definition of relevant market for the purposes of Community competition law(OJ C 372, 9.12.1997).
[10] Commission notice on the definition of relevant market for the purposes of Community competition law(OJ C 372, 9.12.1997).

3.20. This process involves considering demand- and supply-side substitutes which would prevent a hypothetical monopolist from sustaining prices that are 5-10 per cent above competitive levels.

3.21. There are two markets relevant to this matter (i) the market in which ENW is dominant and (ii) the market affected by the alleged abuse (the affected market). It is not necessary to show that the alleged abuse occurred in the market where the undertaking is dominant if that alleged abuse occurred in a different but related market.

The market in which ENW is dominant

3.22. In our view, ENW holds a dominant position in the market for connections of newly constructed electricity networks in its DSA to the National Grid, via its distribution system and for use of its distribution system in this respect ("the upstream market").[11]

3.23. In terms of demand-side substitution, it does not appear that customers requiring newly constructed electricity networks in ENW's DSA would be able to switch to another product/service if prices were raised by a small but significant amount above competitive levels. These customers require connection to a low voltage (by this we mean at least below transmission voltage) electricity network in order to obtain electricity. ENW is effectively the monopoly provider of these services in its DSA.

3.24. For the overwhelming majority of electricity customers there are no cost effective alternatives to connecting to a distribution network in order to procure a reliable source of power. Potential demand substitutes such as building a dedicated source of reliable generation, including back-up generation is an expensive alternative and would be unlikely to take place. Indeed, even in the relatively few cases where electricity demand is met through locally-based generation, customers generally maintain a connection to a distribution system. This is to cover for times when the local generation is offline.

3.25. In terms of supply-side substitution, in theory an IDNO or other potential DNO/ICP/supplier could, as an alternative to using ENW's services, build a connection all the way to a point of connection to the transmission network. However, this is unlikely to be a viable option, as duplication of ENW's distribution and GSP connection assets is likely to be prohibitively expensive. In addition, it may be impractical and inefficient because of difficulties in obtaining wayleaves etc. For these reasons we do not consider that there are viable supply-side substitutes for the connection of newly-constructed electricity networks.

[11] Dominance is discussed in more detail below.

3.26. The lack of demand- and supply-side substitutes for ENW's distribution system in the ENW DSA makes it highly likely that the conditions of the SSNIP test are satisfied i.e. that a hypothetical monopolist/ENW could profitably sustain a price which is a small but significant amount above the competitive level.

3.27. Across Great Britain the provision of electricity distribution networks is dominated by a small number of firms who between them own the networks of the 14 PES. The ex-PES companies provide the vast majority of distribution network in the areas they used to serve as PESs and which are now designated as their DSAs. ENW's DSA covers most of the North West of England.

3.28. In theory, connection to the distribution network in one region can be substituted for connection to the network in another. However, in practice this is not the case as the decision of most energy customers about where to locate is only marginally influenced (if at all) by the service provided by the local DNO in their region. Other factors are far more relevant to this decision[12]. Therefore in terms of the geographic scope of the market, we consider that it is likely to constitute the ENW DSA.

3.29. Customers with newly constructed electricity networks in this area have no other realistic option but to connect to the distribution network in this area. Where customers do seek connection to the distribution network in the ENW DSA then for reasons of cost and efficiency they will choose to connect to the network closest to where they are located. In the ENW DSA this will overwhelmingly be a network that is owned and operated by ENW.

The affected market

3.30. Our view is that the relevant affected market appears to be the market for building or adoption and operation of newly constructed electricity networks in the ENW DSA ("the downstream market").

3.31. In this downstream market, the relevant customer in relation to the ownership and adoption of a newly constructed electricity network would be, for example, the developer of the newly constructed network. Once the network has been adopted, the relevant customer in relation to the operation of the new network is likely to be the end user of the electricity, for example, property developers and large industrial customers.

3.32. ENW, IDNOs (like IPNL) and other DNOs operating out-of-area (that is other DNOs not operating in the ENW DSA) are the market participants who compete to own and adopt the newly constructed networks by putting in competitive tenders.

[12] In the case of domestic customers, one such factor may be proximity to the place of work. In the case of a non-domestic customers, factors could be proximity to the market they serve or good transport links.

For example, these participants can compete to adopt a newly constructed network extension from the existing electricity distribution network of the incumbent DNO to a new housing development. It is worth noting that the choice of who owns and adopts a network is generally only available where the new networks are relatively large.

3.33. There are also opportunities for customers in limited circumstances to own and operate new network extensions as an unlicensed entity. In these cases of small one-off connections, options other than adoption by the incumbent DNO are likely to be uneconomic.

3.34. For the most part, at the stage of ownership and adoption for a newly-constructed network, the relevant customer will have competing options through the tendering process. In accordance with the SSNIP test it appears that they should be included in the market definition. The geographic extent of the market is likely to be the UK. This is because the relevant customer, i.e. the developers of newly constructed electricity networks, are able to use the products/services of IDNOs and DNOs acting out-of-area across the whole of the UK.

3.35. However, once a newly constructed network has been adopted and is owned and/or operated by a particular DNO or one or more IDNO(s), the end user, for example the property developer or large industrial customer, has little choice in terms of switching away from that DNO since there is only one network. With respect to demand-side substitution and the SSNIP test there are no substitute products/services for these customers to switch to, if the price of operating the newly-constructed networks in the ENW DSA increased by a small but significant amount.

3.36. In order to compete in this market, IDNOs are dependent on the upstream services from the incumbent DNO. This is because the capacity of IDNOs, such as IPNL, to compete with incumbent DNOs, such as ENW, in the downstream market is dependent upon their ability to connect/convey electricity from the pre-existing network of the incumbent DNO (the upstream market where ENW is dominant) to the point at which the connection feeds into the end user's premises.

3.37. IPNL contends that without the ability to connect to and use ENW's pre-existing network on a cost effective basis it will be unable to operate in the downstream market.

Definition of dominance

3.38. The next step in applying the Chapter II prohibition and/or Article 102 is to define the relevant degree of economic power or dominance. The European Court of Justice has defined a dominant market position as "a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being

maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers".[13] In *United Brands,* the European Courts defined dominance as follows:

> *Undertakings are in a dominant position when they have the power to behave independently without taking into account to any substantial extent, their competitors, purchasers and suppliers. It is not necessary for the undertaking to have total dominance such as would deprive all other market participants of their commercial freedom, as long as it is strong enough in general terms to devise its own strategy as it wishes.*[14]

3.39. We will generally not consider an undertaking to be dominant unless that undertaking has substantial market power. Market power is not an absolute term but a matter of degree, and the degree of market power held by an undertaking will depend on the circumstances of each case. According to OFT guidelines, market power can be thought of as the ability to profitably sustain prices above competitive levels, restrict output or quality below competitive levels, weaken existing competition, raise entry barriers or slow innovation.[15]

3.40. Factors relevant to assessing whether there is dominance include market shares, existing competition, potential competition and barriers to entry.

Market share and existing competition

3.41. In assessing whether an undertaking has substantial market power within the relevant market, we will first consider market shares. There are no market share thresholds for defining dominance, nor can an undertaking's market share, on its own, determine whether that undertaking is dominant. However, market shares are an important factor in assessing dominance, and the Court of Justice has stated that dominance can be presumed, in the absence of evidence to the contrary, if an undertaking has a market share persistently above 50 per cent.[16] The Commission has stated that dominance is not likely if the undertaking's market share is below 40 per cent (except where competitors are not in a position to constrain effectively the conduct of a dominant undertaking) in the relevant market.[17]

[13] Case 27/76, *United Brands Co. & United Brands Continental BV v. Commission*, 14.2.1978, (1978) ECR 207.
[14] Case 27/76, *United Brands Co. & United Brands Continental BV v. Commission*, 14.2.1978, (1978) ECR 207.
[15] OFT 402 Abuse of a dominant position guideline, p13.
[16] Case C62/86, AKZO *Chemie BV v Commission* [1993] 5 CMLR 215.
[17] Communication from the Commission — Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (2009/C 45/02).

3.42. An undertaking is more likely to be dominant if it enjoys a high and stable market share or if its competitors enjoy relatively weak positions.[18] In the market for connections of newly constructed electricity networks in its DSA to the national grid, via its distribution system and for use of its distribution system in this respect, ENW had effectively close to 100 per cent market share for the period covered by IPNL's complaint. In this respect ENW was a monopoly provider of this service in its DSA.

Entry barriers and potential competition

3.43. In general, the lower the barriers to entry into a market, the more likely it is that potential competition will constrain undertakings within the market from exerting market power.[19] Ofgem considers that there are high barriers to entry in this market, including sunk costs, regulation, first mover advantage (costs and time for duplication) and economies of scale.

3.44. Given ENW's market share and the significant barriers to entry which we believe exist, our view is that ENW holds a dominant position in the market for connections of newly constructed electricity networks in the its DSA to the national grid, via its distribution system, and for use of its distribution system in this respect (the upstream market).

The concepts of abuse and abusive margin squeeze

3.45. The holding of a dominant position is not in itself prohibited under section 18(1) of the Act and/or Article 102 of the TFEU. It is the abuse of a dominant position which is prohibited. In *Michelin*, the Court noted that:-

> *Article 86 (now Article 102) covers practices which are likely to affect the structure of a market where, as a direct result of the presence of the undertaking in question, competition has already been weakened and which, through recourse to methods different from those governing normal competition in products or services based on traders' performance, have the effect of hindering the maintenance or development of the level of competition still existing on the market.*[20]

3.46. The Court of Justice has also held that the actual scope of the special responsibility imposed on a dominant undertaking must be considered in the light of the specific circumstances of each case.[21]

[18] OFT 415 Assessment of market power guideline, p7.
[19] OFT 415 Assessment of market power guideline, p15.
[20] Case 322/81, *Michelin — Nederlandsche Banden-Industrie Michelin v. Commission*, 9.11.1983, (1983) ECR 3461, para. 70.
[21] Case C-333/94 P *Tetra Pak v Commission* [1996] ECR I-5951, [1997] 4 CMLR 662, para. 24.

3.47. Section 18(1) of the Act and/or Article 102 give examples of abuse, which will be prohibited. The list of abuses is illustrative and not exhaustive. The Chapter II prohibition and/or Article 102 of the TFEU apply equally to conduct not specifically listed where that conduct has the potential to exploit customers or exclude competitors from the market.

3.48. To establish an abuse, it is necessary to take account of whether the dominant undertaking has had recourse to methods different from those which condition normal competition and whether that conducts has the effect of weakening or distorting competition. In *Hoffmann-La Roche* the Court, held as follows:-

> *The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.* [22]

3.49. In addition, there is a 'special responsibility' for dominant firms not to allow their behaviour to impair genuine undistorted competition on the market: conduct which may be permissible in a normal competitive situation may amount to an abuse if carried out by a dominant firm.[23] Therefore an undertaking in a dominant position may be deprived of the right to adopt a course of conduct or take measures which would be unobjectionable if adopted or taken by non-dominant undertakings.

3.50. The concept of exclusionary pricing is well-established in case law. Margin squeezing is a separate form of exclusionary pricing prohibited by Chapter II prohibition and/or Article 102. This involves conduct by an undertaking that is dominant in an upstream market and also active in a downstream market.

3.51. An abusive margin squeeze occurs "if the difference between the retail prices charged by a dominant undertaking and the wholesale prices it charges its competitors for comparable services is negative, or insufficient to cover the product-specific costs to the dominant operator of providing its own retail services on the downstream market".[24]

3.52. The Court of First Instance, in *Deutsche Telekom,* noted that to determine a margin squeeze, one must look to the dominant undertaking's own situation, meaning its own charges and costs, rather than to the particular situation of actual or potential competitors.[25] In other words, the 'as efficient competitor test' should be

[22] Case 85/76, *Hoffmann-La Roche & Co. AG v. Commission*, 13.2.1979, (1979) ECR 461, 541.
[23] Case T-203/01 *Michelin v Commission* [2003] ECR II-4071.
[24] See *Deutsche Telekom v. Commission*, [2008] ECR II-477 (para. 191).
[25] *Deutsche Telekom v. Commission*, [2008] ECR II-477 (para. 188).

applied. The Court of First Instance also concluded that a margin squeeze may exist even in situations where the dominant undertaking has no ability to adjust the wholesale prices charged to competitors, provided, however, that it can adjust its retail prices to customers.[26]

3.53. In *TeliaSonera,* the Court of Justice confirmed that the "as efficient competitor test" is the appropriate test for assessment of a margin squeeze. It stated that "*...such an approach is reinforced by the fact that it conforms to the general principle of legal certainty, taking into account the costs and prices of the dominant undertaking enables that undertaking to assess the lawfulness of its own conduct which is consistent with its special responsibility under Article 102 TFEU...*"[27] However, the Court did consider that the costs and prices of competitors may be relevant to the examination of a margin squeeze, including where the particular market conditions of competition dictate it.[28]

3.54. In *Telefónica*, the General Court (previously known as the Court of First Instance) upheld the previous finding in *Deutsche Telekom*, that it is the relationship between the two prices - the spread - that is relevant for assessing the nature of the conduct of the dominant undertaking, and not whether or not either the wholesale or the retail price in isolation are abusive.[29]

3.55. In cases of margin squeeze, the following cumulative effect may be present: (i) it relates to a product or service that is objectively necessary to be able to compete effectively on the downstream market; (ii) it is likely to lead to the elimination of effective competition on the downstream market; and (iii) it is likely to lead to consumer harm.

Effect on competition

3.56. The Court of Justice has held that the concept of abuse covers conduct that has "the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition".[30]

3.57. The General Court has held that to establish an infringement under Article 102 TFEU, it is sufficient to show that the abusive conduct by an undertaking tends to restrict competition, or that the conduct is capable of having that effect. The General Court made clear that it is not necessary to demonstrate the actual effects of the abuse on the market,

[26] *Deutsche Telekom v. Commission*, [2008] ECR II-477 (para. 167).
[27] Case C-52/09 *Konkurrensverket v TeliaSonera Sverige AB,* paragraph 44
[28] Case C-52/09 *Konkurrensverket v TeliaSonera Sverige AB,* paragraph 45
[29] Case T-336/07 *Telefónica and Telefónica España v. Commission*
[30] Case 85/76 *Hoffman-La Roche & Co AG v Commission* [1979] ECR 461, paragraph 91.

... for the purposes of establishing an infringement of Article 82 EC, it is not necessary to show that the abuse under consideration had an actual impact on the relevant markets. It is sufficient in that respect to show that the abusive conduct of the undertaking in a dominant position tends to restrict competition or, in other words, that the conduct is capable of having that effect (Michelin II, paragraph 239, and British Airways v Commission, paragraph 293). [31]

Effect on trade

3.58. Given the outcome of this investigation, it has not been deemed necessary to carry out a full assessment of the effect on trade in this decision.

3.59. For completeness, we consider that the alleged conduct would have affected trade within the UK.

3.60. We also note that the fact that the alleged conduct took place in the North West of England and that both ENW and the complainant provide services only within the UK, does not mean that there can be no effect on trade between Member States. The electricity distribution in the UK is open to competition and electricity distributors from other Member States are able to compete for the provision of connections services in the UK.

3.61. In light of these factors (and as noted above), we have conducted our analysis to date on the basis of a possible infringement of both Chapter II of the Act and Article 102 of the TFEU.

[31] Case T-155/06 *Tomra v Commission*, paragraph 289.

Economic analysis

Margin squeeze analysis

3.62. We have assessed the claim of margin squeeze by comparing the margin available to IPNL at the nine sites identified in the complaint and the wide range of generic/typical sites, with a reasonable assessment of IPNL costs.

3.63. There are two main potential approaches to the assessment of reasonable IDNO costs:

- an assessment of DNO own costs of providing similar services ("as efficient" costs); and
- an assessment of IDNO/new entrant own costs.

3.64. We have investigated both of these approaches for completeness and to understand whether significantly different conclusions would be reached under the different approaches. However, our assessment of margin squeeze has focused on the former for the reasons set out below -

(i) Legal precedent, as set out earlier, requires that the focus of the margin squeeze test should be on whether ENW's own notional downstream business could make a normal profit[32] if it were charged for connection to its network on the same basis as third parties. This test involves establishing the costs of the ENW's downstream business by allocating all ENW costs (including fixed costs) between its notional upstream and downstream businesses.

(ii) Estimating IDNOs' long run efficient costs is inherently uncertain, because:

- an IDNO will have incurred high start up costs including set-up, IT, financing, etc, which will be difficult to establish particularly as each new entrant will be part of a group with different associated companies and therefore will have a varying level of start up costs and capacity to accommodate them;

- as a new entrant network company, an IDNO will suffer from scale diseconomies. These scale diseconomies are difficult to distinguish from genuine inefficiency, and it is therefore difficult to estimate reliably the expected growth of the business and the effect that this will have on the IDNO's costs (and more pertinently for this investigation, their average costs); and

[32] For these purposes, a normal profit can generically be defined as an appropriate risk adjust return for the activities undertaken. We discuss further below what scale might be appropriate in this case.

- the IDNO business model is very young (though similar to that of the DNO differs in a number of ways); it is therefore difficult to estimate directly the efficient costs of such a business. There are particular problems with regard to establishing an objective estimate of the capital employed by the business and an appropriate risk adjusted rate of return.

3.65. For the most part, an IDNO's business involves adopting network extensions (sites) where the end users that are connected consist mainly of domestic customers. Our investigation has therefore focussed on investigating margin squeeze at sites where all of the end users are domestic customers, as is the case with the nine sites identified in the complaint.

Estimates of ENW's "as efficient costs"

3.66. Our approach to estimating ENW's as efficient costs during the period of the complaint has been to:

- estimate the total cost (including a reasonable allocation of fixed costs) of operating the downstream part of the ENW network which approximates the business of IPNL;
- split this cost between customer types (e.g. domestic/non-domestic); and
- calculate the average cost of providing downstream network services to customer types based on average consumption characteristics.

3.67. The vast majority of network extensions, and therefore the market opportunities available to IDNOs, are extensions to the incumbent DNO's low voltage (LV) network. Thus, IDNO businesses currently (and are likely to continue to) consist of largely low voltage network extensions that they have adopted and which are connected to the incumbent DNO LV network or into the HV/LV level of transformation. Therefore the incumbent DNO LV network is a reasonable proxy for the IDNO's business.

3.68. We have estimated the average cost of ENW's LV network using a cost allocation model. This model uses a series of cost drivers to split ENW's allowed revenue under regulation (effectively ENW's total long run cost of operating its network) between the network tiers and transformation levels. This allows us to establish the total cost of running the ENW LV network.

3.69. The total costs are then split between customers, using the principles which underpin ENW's charging model (the DRM).[33] The DRM allocates costs between

[33] ENW's charging model, the DRM, produces charges which are based on an allocation of incremental (rather than total) cost between customer groups therefore the allocations on which the charges are based do not accurately represent total cost. However, the principles that underpin this allocation are based on the characteristics of its current customers, and in

customer groups largely on the basis of their contribution towards system peak demand, which is the key driver of network costs. Once the allocation of costs to customer groups is established then the average cost of providing services to customers can be calculated, based on average consumption characteristics.

3.70. Using this methodology, we have estimated ENW's 'as efficient cost for providing services' similar to IPNL's per domestic customer plot.

3.71. We have cross-checked this figure against the IDNOs' gross margins which we calculated using data from investment appraisals, provided by all IDNOs. The gross margins will not be an estimate of IDNO costs per se but, given that all of the appraisals relate to sites that were approved for investment, they should (on average) allow the IDNO to recover all of the costs associated with the investment at those sites.

3.72. Our analysis of the IDNOs' gross margins shows that the estimates of IDNOs' gross margins are consistent with our estimate of the average cost of ENW's own downstream business in that ENW's cost lies toward the middle of the range of IDNO gross margins.

Margin squeeze at the nine sites identified in the complaint

3.73. As a starting point, we have calculated the gross margins available to IPNL at the nine identified sites during the period of the complaint based on the invoiced boundary charges and an estimate of the ATW income IPNL will have received. The ATW estimate is based on the assumption that all end users are on a domestic unrestricted customer tariff[34] (this has been confirmed by IPNL) and on the energy flows recorded by ENW's meter at the boundary between their network and the sites.

3.74. Our analysis suggests that the implied margins are negative for eight of the nine identified sites. We have reached this view without recourse to comparison between reasonable IDNO costs and IDNO gross margin as at eight of the nine sites, and cumulatively across all sites the net income available to IPNL was negative.

ENW's position

3.75. We consider that ENW's position rests principally on:

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particular their contribution towards peak demand. As this is the main driver of network costs, the principles which allocate cost between customers in the DRM are also appropriate to our total cost allocation.

[34] This is the standard ENW domestic customer tariff.

- non-collection of capacity charges by ENW; and
- introduction of the capacity ramping charging modification since the complaint.

3.76. ENW did not collect the capacity element of the boundary tariff during the time of the complaint. After the capacity element of the boundary charge has been deducted, the net DUoS income available to IPNL becomes positive.

3.77. Furthermore, since the complaint ENW have introduced the capacity ramping charging modification and have agreed with IPNL that they will recover unpaid capacity in accordance with this new methodology. Our analysis shows that if the capacity ramping modification is applied retrospectively then the effective net DUoS income received by IPNL is markedly positive.

3.78. The results of our analyses were broadly consistent with ENW's own estimates of the available margins at the nine sites.

Margin squeeze at generic domestic customer sites

3.79. We have also carried out an analysis of gross margin avilable to IPNL for generic new domestic developments across the ENW DSA during the period of the complaint. During the period of the complaint IDNOs were charged according to a standard non-domestic tariff based on their point of connection with the DNO. Capacity ramping did not apply during this period.

3.80. In order to undertake our analysis we have made assumptions regarding typical per plot capacity and commodity requirments of domestic customers. Both IPNL and ENW have submitted their views on per plot capacity/commodity requirements. The assumptions that we have used in our analysis represent our preferred assumptions.

3.81. As IDNO investment decisions are long term, we have considered the margin available to IPNL over the life of their investment. This analysis uses estimates of margins during the site development stage and when they are fully energised to calculate an impled gross margin over the life of the investment. To undertake this analysis we have made assumptions regarding the rate of energisation of plots at a site (year 1:25 per cent, year 2:50 per cent, year 3:75 per cent, year 4+:100 per cent) and assumed an investment life of 30 years. We have also made an assumption regarding the opportunity cost of capital for IPNL.

3.82. Our analysis shows that over the life of IPNL's investment, even using the risk-free rate as the opportunity cost of capital (which is almost certainly too low), sites with less than 44 plots will earn a margin that is lower than reasonable IDNO costs. Using discount rates of 6.9 per cent and 11 per cent, sites must have more than 95 and 181 plots respectively to earn a margin at least equal to or greater than the 'as efficient cost'. This analysis suggests that for the majority of opportunities available to IPNL the application of ENW's charging methodology during the

complaint period would mean that IPNL would be unable to fully recover their reasonable costs over the life of the investment.

Margin squeeze under current charging methodology

3.83. IDNO boundary charges both now (for some customers) and at the time of the complaint include an element of capacity charges. These charges relate to the amount of reserved capacity that is required by a customer. At the time of the complaint ENW charged IPNL as a standard non-domestic customer and it was required to pay full capacity charges from the date of connection. As a result, for the most part IDNOs were charged for all of the capacity that would be required at a site when it was fully developed with all end users energised.

3.84. During the time it has taken to progress this investigation, all DNOs have simultaneously put in place first an arrangement to address the handling of capacity usage, then an interim solution, and finally an enduring common charging methodology.

3.85. Building on the interim solution introduced by the DNOs, the common charging methodology includes IDNO specific charges which are based on an assessment of the DNO's own cost of undertaking the downstream activity for IDNOs connected to their HV and LV networks. The resulting charges represent a discount from the DNO end user charges based on the DNO's cost of providing downstream services. According to this methodology, IDNOs are billed according to the capacity/commodity characteristics of each customer they have connected to their networks rather than the aggregate characteristics of the sites that they have adopted. Consequently, IDNOs are only billed by the DNO when a customer connected to its network begins to consume energy and can therefore be billed by the IDNO.

3.86. Under the CDCM, the charges to the IDNO recognise that an IDNO connection is typically a collection of numerous, often different types of network users. IDNO charges based on a discount from the DNO charges of the individual customers will therefore represent more accurately the characteristics of each IDNO site that a standard non-domestic tariff. Furthermore, under the CDCM there is no issue with a mismatch between the capacity an IDNO is billed for by a DNO and the charges it is able to recover.

3.87. At the higher voltage levels, the EDCM[35] which extends the CDCM method of calculating LDNO charges to the higher (EHV) voltage levels came into force for input or demand charges on 1 April 2012[36]. In the meantime, LDNO charges will continue to be calculated according to the each individual DNOs own site specific EHV

[35] The common methodology that will calculate charges for customers, including IDNOs, connected to DNO EHV network.
[36] The EDCM will apply to export charges affecting generators from 1 April 2013.

methodologies. Since the beginning of the investigation, these methodologies have been adapted to recognise that IDNO networks generally experience a period of growth, as customer numbers and electrical requirements develop, prior to reaching a settled level of demand. Accordingly, capacity ramping has been introduced which allows for an initial period during site development during which IDNOs will be charged only for the capacity that is required at that time.

3.88. Under the CDCM (and the interim methods that proceeded it) LDNO are only liable for charges when a customer is energised therefore there is no mismatch between the capacity that an IDNO is required to pay for and the number of energised customers from which it can collect charges. Prior to the introduction of the interim methods, ENW introduced "capacity ramping" which means for the three years after the connection agreement has been signed IDNOs are charged only for the capacity that is required at that time. Under capacity ramping, the charges now reflect the fact that, for most sites, during the development of the site only a proportion of the fully developed capacity will be required. The CDCM has made ramping unnecessary for HV and LV connected LDNOs[37].

3.89. The introduction of capacity ramping had an impact on IDNO margins during the site development phase because when sites are not fully developed IDNOs can only recover DUoS charges from those customers who are connected to the network extension and importing electricity. Where sites are new domestic developments the number of connected and importing domestic plots will gradually increase over time as plots are completed and occupied.

3.90. We have carried out an equivalent analysis of gross margin to that described at paragraphs 3.79-3.82 above (for margins under the methodology at the time of the complaint) for gross margins under ENW's current charging methodology. Below we summarise our conclusions from this analysis:

- the ramping modification markedly reduces the rate of energisation required at sites for them to break even; and
- over the lifecycle of IPNL investment (using a discount rate of 6.9 per cent) the ramping modification markedly reduces the number of plots on a site required before IPNL can make a gross margin equal to the 'as efficient cost for providing similar services' per plot over the life of their investment (reducing the number from 95 to 44).

[37] Ramping is implicit within the CDCM methodology as IDNOs are charged on the basis of the aggregate requirements of end customers connected to their networks as and when they become energised not on the aggregate required capacity of a whole site.

Remaining concerns

3.91. The adoption of the CDCM and the submission of the EDCM has removed most of our competition law concerns about ENW charging of IDNOs. We also acknowledge that actions taken by ENW such as capacity ramping and the back-dating of ramping charges will have mitigated the impact of any concerns that we have with ENW charges.

3.92. In relation to boundary metering, following a consultation in October 2009, we decided that more proportionate arrangement for measuring flows over the boundary will be achieved if the DNOs fund the equipment. In line with this, from 1 April 2010 our starting position for any connections dispute is that the boundary measurement equipment should be funded by DNOs. It is our understanding that DNOs, including ENW have revised their policy for charging for measurement equipment at the boundary with IDNO sites in accordance with our revised policy.

3.93. We have one remaining concern, namely the continuing implementation of boundary metering policy by ENW consistent with that set out in our boundary metering decision document. ENW has offered us commitments in this area and these are discussed in the next section.

3.94. If our regulatory policy on boundary metering were to change significantly during the period covered by the commitments, we would expect ENW to propose any necessary changes to the commitments.

4. The Commitments

Commitments

4.1. In order to remove our remaining competition concerns, ENW has offered commitments (in the form set out in Annex 2). The commitments offered are analysed below. They would be binding on ENW and enforceable.

4.2. The purpose of the commitments offered by ENW is to remove Ofgem's concerns identified in the previous section. For the avoidance of doubt, a decision by Ofgem accepting binding commitments will not include any statement as to the legality or otherwise of the conduct of ENW under the investigation either prior to acceptance of the commitments or once the commitments are in place.

Appropriateness of this case for commitments

The OFT Guidance

4.3. The OFT Guidance (OFT 407)[38] states that it is appropriate to accept binding commitments in cases where it is satisfied that the commitments offered fully address competition concerns, where the competition concerns are readily identifiable, will be fully addressed by the commitments offered, and the proposed commitments can be implemented effectively and, if necessary, within a short period of time. The Guidance notes that the OFT will not accept, other than in very exceptional circumstances, binding commitments in cases involving secret cartels between competitors which include price-fixing, bid-rigging (collusive tendering), establishing output restrictions or quotas, sharing markets, and/or dividing markets. Nor will the OFT accept binding commitments in cases involving serious abuse of a dominant position.[39]

4.4. The Guidance states that the OFT will not accept binding commitments in circumstances where compliance with and the effectiveness of any binding commitments would be difficult to discern, and/or where the OFT considers that not to complete its investigation and make a decision would undermine deterrence.

4.5. Ofgem is required to have regard to OFT's guidance when considering whether to accept any commitments offered to us. The decision to accept commitments is at our discretion.

[38] http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft407.pdf.
[39] This assessment will be made on a case by case basis, taking account of all the circumstances of the case.

Our views

4.6. We consider that there is an appropriate case for accepting commitments taking into account the following -

- During the period of the complaint, ENW's charges for IDNOs were not based on the characteristics of typical IDNO sites and required capacity charges to be paid in respect of the fully developed site. Our margin squeeze analysis, based on the invoiced boundary charges, showed that, during the period of the complaint, ENW's charges to IPNL at the boundary implied negative gross margins during the period of the complaint for eight out of nine sites IPNL identified.

- Since the period of the complaint, ENW has undertaken a number of actions with regard to its approach to charging IDNOs. It has introduced the capacity ramping charging modification and applied this retrospectively. In addition, it has also introduced the CDCM and submitted the EDCM for implementation from April 2013. These actions have addressed a number of the concerns we had with ENW's method for charging IDNOs during the period of the complaint. When the capacity ramping modification is applied retrospectively, the effective margins earned by IPNL are positive.

4.7. Taking into account all relevant factors and the proposed commitments, we consider that the competition concerns raised are unlikely to continue. ENW is prepared to give commitments to assume all responsibility for costs of boundary metering with effect from 1 April 2010 and to refund charges in respect of boundary metering to any IDNO who has incurred them since that date; and to refund the difference between the charge levied on an IDNO and paid by that IDNO and the amount that would have been payable under its use of system charging methodology on capacity management. We consider that this binding commitment offer addresses our concern about boundary metering discussed earlier in this document. We consider that this commitment can be implemented effectively and within a short period of time and is capable of being enforced.

4.8. When boundary metering costs are borne by a DNO, an IDNO no longer has to net them off its net DUoS income they receive (before other costs). Therefore the income they will receive from each site will be markedly greater. For example, in our boundary metering guidance letter, which was published after the introduction of ENW's interim IDNO charging methodology, we expressed the view that boundary metering charges could be around 25 per cent of an IDNO's net DUoS income at sites located in ENW's DSA. These are costs that an efficient IDNO would have to cover in addition to the "as efficient" costs of undertaking the downstream activity.

4.9. With this commitment, and taking into account other relevant factors, we would therefore consider that our initial concerns in this investigation with ENW's charges to IDNO are fully addressed.

4.10. For the avoidance of doubt, the OFT guidance on commitments and existing case law deal with actions that address competition law concerns identified in the investigation. We note that issues such as loss of market share of competitors or loss of opportunity for competitors are outside the scope of commitments.

4.11. Finally, we do not consider that a commitments decision would undermine deterrence in this case. We consider that our willingness to open and maintain an investigation, the wider changes to charging methodologies and other areas, and the additional binding commitments mean that our decision will assist in promoting a culture of competition law compliance within DNOs and/or IDNOs and more generally. We remain open to taking further enforcement action in future in this part of the energy sector where the evidence merits it.

Responses to our Notice of intention to accept binding commitments – issued on 18 November 2011

As required by paragraph 2(2)(d) of Schedule 6A of the Act, we invited interested parties to make representations on the proposed commitments. The consultation on the commitments, issued by way of the Commitments Notice on 21 November 2011, was completed on 18 January 2012. We received four responses, including two from the complainant IPNL, one from another DNO (SSE), and one from an IDNO which requested that its response was treated as confidential. We consider those responses in turn below.

IPNL's responses

4.12. The first response from IPNL sought clarification on several points in relation to the Commitments Notice, including -

a) Two questions about our calculations of margin squeeze, namely:

   - whether the costs of boundary metering were taken into account in the paragraph 3.82 estimate; and

   - what the figures in paragraph 3.90 would have been had our analysis proceeded on the basis of the charges payable under modification proposal 2009-03 rather than under the CDCM.

b) The legal basis for the statements made in paragraph 4.10 in relation to the issue of market share given that:

   - historic market share will have an impact on the future competitiveness of the market; and

- the impact on competition occurring through the impact on competitors would seem highly relevant to an assessment of the seriousness of the abuse.

c) Our assessment of the seriousness of the abuse, including what factors did we take into account and the weight given to each of them.

d) Steps taken to ensure that other DNOs will apply an approach similar to that which ENW would be obliged to take under the commitments.

4.13. We responded to IPNL's questions by way of a separate letter. Our response is summarised below.

4.14. On the first of the above points, the cost of boundary metering was not taken into account in the analysis described at paragraph 3.82. Boundary metering was, however, one of the concerns that we considered as part of the investigation which we articulated at paragraphs 2.12, 3.92 and 3.93. We note that the analysis at paragraph 3.90 relates to the methodology at the time of the complaint which we think is relevant to this investigation. We see no compelling reasons for carrying out additional analysis on the basis of the charges payable under modification proposal 2009-03 as its outcome is unlikely to affect our assessment of margin squeeze nor affect our views on the commitments given by ENW.

4.15. As far as market share is concerned, we note that the Act gives us the power to accept commitments offered to us by a person or persons if we are satisfied that those commitments meet our competition concerns. The consideration of commitments includes whether such commitments address the competition concerns identified during the investigation. The objective of this analysis is not to address issues of potential loss of market share, but rather the specific competition concerns identified during the investigation.

4.16. In relation to point (c) above, namely our assessment of the seriousness of abuse, we note that the Guidance provides that one of the considerations when considering the appropriateness of accepting binding commitments is the seriousness of an abuse and its effect on competition. This assessment includes consideration of the wider developments in the market. The Notice of intention to accepting binding commitments considered these wider developments. Paragraphs 4.6 – 4.11 set out our reasons why the competition concerns identified during the investigation are most appropriately dealt with by commitments.

4.17. In relation to Ofgem's role in ensuring that other DNOs apply a similar approach to that set out in the commitments, we will continue to monitor the behaviour of industry participants and remain open to taking further enforcement action in the future where the evidence and our priorities merit it.

4.18. We also note our decision under DPCR5[40] to introduce the "Competition Test" in order to provide DNOs with an incentive to help support the development of a competitive market. To pass the Competition Test, DNOs must step up their engagement with independent connection providers (ICPs), IDNOs and other relevant parties and demonstrate that have made genuine efforts to remove barriers to competition. We will review any areas of the market that have failed to pass this test by the end of December 2013 and consider what further action may be necessary.

4.19. The second response from IPNL reiterated the earlier point about market share (see 4.12b), and in particular stated that the commitments did not address the issue that a large part of the market had not been available to IPNL. We refer to our response set out at 4.15 above.

Other responses

4.20. SSE told us it had no objections to us accepting the commitments from ENW. SSE views ENW's commitments on boundary metering, applying retrospective Use of System charging and refunds, and the provision of information, as positive steps to address any remaining concerns which we have.

4.21. We also received a response from one IDNO which requested that its submission is treated as confidential. The IDNO expressed concerns about our intention to accept commitments offered by ENW and the message the acceptance of the commitments might send to the industry. In particular, it pointed out that the experience of DNO behaviour suggests that our decision to accept commitments is unlikely to act as a deterrent to DNOs.

4.22. We were, and remain, of the view that our decision to open and pursue the investigation and ENW's commitments, in particular the commitment to refund on request any boundary metering charges levied on a IDNO for any period from 1 April 2010, will assist in promoting compliance with competition law and with the promotion of competition more generally.

[40] Distribution Price Control Review 5 which runs from 1 April 2010 until 31 March 2015.

5. Ofgem's Decision

5.1. In light of the above, we consider that the commitments offered by ENW, as set out in Annex 2 of this document, will fully address our competition concerns and that accepting these commitments and closing the case represents the best use of our resources at this time. We have therefore decided to accept the commitments by means of a formal commitments decision.

5.2. The commitments take effect on 24 May 2012 and will remain in place until 24 May 2017.

6. Annex 1 – List of sites

Site Name

1. Wright Street
2. Sycamore Avenue
3. Boarshaw Clough
4. Langworthy Road
5. Topp Street
6. Coopers Way
7. Weeton Road
8. Dunkirk Lane
9. Chew Valley Road

7. Annex 2 – Commitments text

Competition Act 1998 Investigation into Electricity North West Limited

Commitments given by Electricity North West to the Gas and Electricity Markets Authority pursuant to section 31A of the Competition Act 1998

Electricity North West Limited ("Electricity North West") gives to the Gas and Electricity Markets Authority (the "Authority"), without in any way accepting any infringement of competition law by Electricity North West, the following commitments ("the Commitments") under section 31 A(2) of the Competition Act 1998 ("the Act") in order to meet the Authority's concerns that the terms imposed by Electricity North West between 2005 and 2009 on independent networks connecting to Electricity North West's pre-existing networks might foreclose the market to competitors in the area in which Electricity North West is the incumbent distribution network operator.

Electricity North West shall procure that other Group Companies (as defined below) also adhere to the Commitments.

1. ***Interpretation*** For the purpose of the Commitments, the following terms shall have the meaning ascribed to them below:

   CCS means a close coupled substation or close coupled substations.

   CDCM means the common distribution charging methodology which came into effect on 1 April 2010, a methodology that inter alia required DNOs to bill LDNOs on a portfolio basis.

   DNO means a distribution network operator or distribution network operators.

   EHV means extra high voltage.

   HV means high voltage.

   IDNO means an independent distribution network operator or independent distribution network operators.

   LDNO site means the site of an LDNO within the area in which Electricity North West is the incumbent DNO.

   LDNO means an IDNO or another DNO operating in Electricity North West's area.

   LV means low voltage.

2. ***Commencement and Duration***

   Having been signed by Electricity North West, the Commitments shall commence from the date that the Authority's acceptance of such

Commitments is notified to Electricity North West and shall expire five years after that date.

3. ***Boundary Metering***

With effect from 1 April 2010, and reflecting the Authority's change in policy communicated on 2 March 2010 in Decision 29/10 and the introduction of portfolio billing in 1 April 2010 under the CDCM, Electricity North West has agreed to adopt and maintain in force (subject to any regulatory requirement by the Authority) the following policy:

LV connections: Electricity North West will not require the installation of boundary metering equipment for LDNO sites with LV link box and LV pillar connection points; and will (where requested by an LDNO) consent to the removal of such equipment from such connection points. Where Electricity North West owns the metering equipment at such a connection point, it will remove such equipment when it is undertaking any significant work at that connection point.

HV (including both CCS and non-CCS) connections, and EHV connections: Electricity North West will be responsible for installing and shall bear all costs relating to boundary metering equipment it requires for LDNO sites with HV and EHV connection points. Electricity North West will use all reasonable endeavours to minimise any inconvenience to an LDNO that might otherwise arise on any installation. Electricity North West will make a written offer to each LDNO to assume responsibility and ownership of metering equipment at such connections and any communication equipment for the retrieval of metering data.

Metering Charges: Electricity North West agrees that it will not make any charge to LDNOs in respect of boundary metering at LDNO sites (whether the connections are LV, HV or EHV) for any period on or after 1st April 2010 and that it will within 28 days of written request by an LDNO refund any such charge levied on such LDNO and paid (and not previously refunded) to Electricity North West by such LDNO in respect of any such period.

Provision of Information: Where Electricity North West has (and for so long as it continues to have) boundary metering equipment installed it agrees to make any data obtained from such equipment available on a quarterly basis to an LDNO if an LDNO indicates in writing that it wishes to receive such data.

Electricity North West will keep the above commitments on boundary metering under review to ensure consistency with Ofgem's published policy on boundary metering. In particular, Electricity North West will use reasonable endeavours to make such changes to its operations as may be reasonably required to ensure that it complies with any material changes to that policy during the period covered by the commitments.

4. ***Capacity Ramping***

With effect from the date of first connection by any LDNO site, Electricity North West will retrospectively apply its use of system charging methodology modification proposal 2009-003: *Capacity management for Licensed Distribution Network Operators (LDNOs)* as approved by the Authority on 11 March 2009 and that it will within 28 days of written request by an LDNO refund (unless previously refunded) any difference between the charge levied on such LDNO and paid to Electricity North West by such LDNO and the amount that would have been payable had its use of system charging methodology modification proposal been in force since the date of first connection.

5. ***Provision of Information/Documentation***

Upon receipt of a written request from the Authority, Electricity North West shall, within 28 days of receipt of the Authority's request, provide such information and/or documentation to the Authority as the Authority reasonably considers necessary to monitor compliance with the Commitments.