

3 September 2018



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Dear David,

Independent Distribution Network Operators – licence applications from affiliates of existing licensees

ESP Electricity Limited (“ESPE”) welcomes the opportunity to respond to Ofgem’s consultation “Independent Distribution Network Operators – licence applications from affiliates of existing licensees”, dated 24th July 2018.

ESPE agrees with the concerns raised in Ofgem’s open letter, and strongly oppose the granting of licences to affiliates of existing licensees. We believe Distribution Network Operators (“DNOs”) are still in a position of market dominance. Allowing licence applications from affiliates of DNOs could create an environment where this dominance can be exploited, and introduce incentives for anti-competitive, or at the very least, distortions in the market for new connections. Of particular concern is the impact of preferential access to information and resource not available to non-affiliated Independent Distribution Network Operators (“IDNOs”); the impact on industry’s confidence in the DNO’s ability to remain neutral when participating in and leading industry change processes; and finally, the impact of this activity on the administration of price controls.

Preferential access to information and resources

ESPE believes there is a risk that a DNO could use knowledge and systems (funded by RIIO)- e.g. forecasting tools, to gain advantage for its IDNO affiliate, even if they are ring-fenced to a different geographical area. It is possible to argue this kind of information asymmetry has contributed to the slow development of competition in the EHV connection market (e.g. determining POC, reinforcement cost, access to power flow models etc.). ESPE sees the introduction of affiliate licences as only exacerbating this situation with affiliates so long as incentives exist for this sort of behaviour.

The new affiliate IDNO could also have access to preferential contractual treatment through its DNO. For example, this could be in the form of more generous terms, or the DNO may choose not to “rigorously” exercise its standard rights when compared to non-affiliated IDNOs. In any event we would not have sight of any bespoke contracts they may have between themselves, and believe it is unlikely that Ofgem would be able to effectively

monitor and audit this activity without incurring significant costs, which ultimately would be passed through to customers.

There would, as Ofgem point out, also be an incentive on the DNO to take on lower cost work through the affiliated IDNO rather than the DNO business. This would place the existing IDNO community at a competitive disadvantage by virtue of poor regulatory design.

Industry confidence in DNO-led change programmes

DNOs are currently responsible for calculating UoS charges (using the PCDM, CDCM & EDCM), and are in a position of trust as custodians of the charging methodologies and data. The data used to populate the models and establish tariffs is considered commercially sensitive to DNOs, and whilst they are able to model the impact of charging methodology Change Proposals (at least for their distribution area) IDNOs cannot. ESPE is concerned that granting licences to DNO affiliates may compromise industry's confidence in the DNO's ability to (impartially) advocate for cost-reflective and efficient charging arrangements. Whilst restricting affiliate activity to outside the Distribution area may minimise this risk, the DNO will still have access to models and analytical tools not otherwise available to IDNOs.

For new markets, the impacts of de-carbonisation policies are significant for the development of electricity networks. If the DNOs are involved in the design of new policy, they may be able to favour their own affiliates for new business. For example, Government commitments to move to EV's allow greater scope for contestability than was previously thought. The benefit of 'opening up' competition in this market could effectively be reversed via the affiliate taking the business back into the monopoly's business ownership group.

Administration of price controls

The existence of affiliates would introduce further complexity to the administration of the current and future price controls. Since the key concern is the scope and incentive for cross-subsidy between the DNO and affiliated IDNO, it may become almost impossible, or at least very difficult, for the regulator to attribute costs or the more intangible knowledge transfers (cited above) that we know to confer competitive advantage between the DNO and the affiliate.

There may also be some policy implications for future price controls if it appears the same company can offer two prices for identical work.

Whilst we accept the DNO would need to treat the affiliate as they would any other customer, it would take an intensive surveillance and a detailed audit regime to protect confidence and integrity in the market given the complex nature of the issues identified above. The two options considered in the consultation i.e. restrict the applicant's business activity to the developments specified in the application, or allow the treatment of the IDNO's activities within the DNO's price control, would fall into this category

Finally, given the above, any enforcement action is likely to take a long period of time, which would prolong the commercial disadvantage to the non-affiliated IDNOs.

Our detailed comments are set out in the appendix to this letter. If you wish to discuss any of the issues raised in our response or have any queries, please contact me on 01372 587500.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Seb Eyre', with a large, stylized initial 'S'.

Sebastian Eyre
Regulation & Policy Analyst

Appendix: Answers to Ofgem's Consultation Questions

What are your views on the potential impacts on competition in connections and or consumers that we have identified?

We agree with Ofgem's reasoning on pages 3 to 4 of the consultation i.e. the danger of cross-subsidy and preferential treatment. We note that the arrangements could also have an impact on new entrants if it was perceived by investors the regulations were "tilted" to the incumbent. In our view these concerns amount to a compelling case for preventing the granting of licences to of affiliates of existing licencees.

Are you aware of any other potential impacts on competition?

Non price competition was if anything, a factor underplayed in Ofgem's 2008 consultation regarding EDF Energy's application to create an IDNO affiliate. We believe there is scope for discrimination against non-affiliated IDNO's in the form of (a) contractual terms and conditions (b) enforcement of the contract (c) prioritisation of works (d) unfair advantage in access to information about the home network.

We note that in mainstream economics of merger cases there has been research on what we would argue are similar issues to those posed by the consultation. This relates to the "cannibalisation" of services produced by the same firm as having anti-competitive effects i.e. an affiliate IDNO taking work from a DNO. There are two important conditions for this to happen that is high market share and low product differentiation. In the host region the DNO is clearly a monopoly and the connection service offered is not easily differentiated.

Do these change whether the IDNO is operating in or outside of the affiliated DNO's DSA(s)? If so, how?

Yes, we think they are likely to change out of area, but not enough to allow affiliate licences. Clearly the point of maximum competitive advantage for the affiliate is likely to be within area. This includes the knowledge of the networks standards and access to its information resources as has already been stated. However, some advantages are *not* regionally specific for example, access to the expertise/ information of the parent company or implicit/ explicit cross-subsidy.

Do you agree with our conclusion that granting a licence to an affiliate of an existing licensee does not raise any new issues with DUoS charges?

We broadly agree. However, in theory at least if the affiliate gained a significant market share "within area" it might be possible to "tilt" charges to different classes of customer within the methodology to the Groups (i.e. IDNO and DNO's) advantage.

What other impacts on existing consumers, if any, do you anticipate from granting such a licence?

If granted we could envisage:

- a) Stalling the market for connections and therefore the benefits of this market for consumers including choice. This would also include newer market segments such as HV connections.
- b) Non-affiliated IDNOs still left in the market could have no or little access to technical standards.
- c) Potentially higher assessment and design charges that would place non-affiliated IDNOs at a disadvantage. The extra earnings would be recovered by the company group through the affiliate.
- d) Single source material procurement standards, also impacting infrastructure suppliers e.g. cable manufacturers.
- e) DNO customers would be in effect subsidising new connections for their affiliate.
- f) Changes to the cost of capital if it is perceived there is more regulatory risk created by poor regulation.

Do you think that the current IDNO licence conditions are sufficient to address the concerns raised in this letter? What additional measures do you think would be required?

We do not think this is the case. Any additional measures are as much about the enforcement regime as it is about the licence conditions themselves. Ofgem would need to have a sophisticated surveillance regime to make it work. Additional measures would need to be considered in the RIIO-2 process to prevent knowledge and expertise already paid for by consumers being used to help the competitive advantage of the affiliate.

Do you think prohibiting an IDNO from operating within specified areas (for example the affiliated DNO's DSA(s)) would sufficiently address the concerns we have raised?

No; our competition concerns are as much national as regional.