



IDNO licence applications from DNO licensees

Northern Powergrid's response to Ofgem's consultation

KEY POINTS

We can see no legitimate reason for Ofgem to reject an application for an IDNO licence from a company within a group that already holds a DNO licence; although we also consider that Ofgem should undertake a wider review of the IDNO model.

- To address the consultation questions, it is necessary to separately assess two distinct activities:
 - the construction of the new electrical assets for a connection; and
 - the ongoing ownership and operation of those assets.
- Competition in the **construction** of new connections is working well.
 - It has been improved significantly since the 2006 and 2008 consultations that Ofgem cites, and obligations placed on DNOs ensure other companies can compete.
 - Whether or not an IDNO licence is granted to a DNO affiliate is not directly relevant to this market, since a distribution licence is not necessary to enter it.
- The IDNO licence application is instead relevant to competition over the ongoing **ownership and operation** of new connection assets. Here we can still see no cause for Ofgem to reject it.
 - Outside of the relevant DNOs' areas, the relevant group of companies would not hold a dominant position in any relevant market; by definition it couldn't abuse its dominance.
 - Even inside those areas, the restrictions placed on the DNO by its licence would prevent it from cross-subsidising the IDNO, or giving it preferential access to information; Ofgem can impose significant fines if companies break these rules.
 - Within the markets in which IDNOs predominate, granting this licence can only increase competition; meaning the parties most likely to oppose it are the incumbent IDNOs.
- Ofgem also granted an Independent Gas Transporter licence to an affiliate of a gas-DNO in 2007; it seems likely the same reasoning will apply to the present application.
- But beyond this specific question, we think Ofgem should review and reform its IDNO model.
 - IDNOs are subject to less onerous regulation than DNOs but charge the same distribution use of system charge (DUoS) as the host DNO.
 - In practice IDNOs adopt networks where the annual running costs are less than the average costs the host DNO's DUoS charges cater for; rather than bringing average costs down, the difference is split between extra profit for the IDNO and an adoption payment to the developer. Energy consumers do not benefit.
 - This model causes money to leak out of the system and causes the host DNO's DUoS charges (to all consumers) to rise, relative to the level they would otherwise be set at, since DNOs cannot compete to adopt new network with low running costs that would help reduce average DUoS charges. All energy consumers suffer (including those connected to the IDNO). It is difficult to see this as being consistent with Ofgem's principal objective.

Response to Ofgem's consultation questions

Questions on competition in connection and distribution

Question 1 - What are your views on the potential impacts on competition in connections and/or consumers that we have identified?

1. Ofgem lists a number of potential impacts that it identified in its review of applications made by EDF in 2006 and 2008 for an IDNO licence. Since these original licence applications, the market for the provision of connections to the electricity distribution system has evolved considerably. This is supported by Ofgem's letter dated 10 November 2017 which reaffirmed the importance of competition in connections and explained why a further review of the market would not be undertaken at that time.
2. The potential impacts identified in Ofgem's 2008 consultation are not an issue in today's market as, insofar as they may have been an issue in 2008, they have been resolved by the work carried out by Ofgem and industry stakeholders. In **appendix one** we provide our views on the specific potential concerns the consultation raises, and give examples of how they are addressed by the licence arrangements. In short summary, licence restrictions mean that DNOs couldn't provide and affiliated IDNO with:
 - a. any form of cross-subsidy (Standard licence condition, SLC, 4);
 - b. preferential access to information (SLC4); or
 - c. discriminatory access to non-contestable services (SLC19 and SLC52).
3. We would also highlight in **appendix two** a number of issues that were raised by respondents to the 2008 consultation, but which are not mentioned in the present consultation. To the extent these could limit the profitability of IDNOs, these have since been addressed. One, which potentially creates an advantage to IDNOs through access right distortions, remains.
4. Lastly, Ofgem highlights that, where an IDNO takes on the ownership and operation of a new piece of network, it would not be subject to the same obligations as a DNO. This is already the case as connection customers can already ask one of the existing IDNOs to adopt the network instead of the DNO. Therefore, like Ofgem's analysis of distribution charges, the granting an IDNO-type licence to a DNO-affiliate would raise no new issues in relation to this specific issue (noting, as set out at paragraph 2 above, that the DNO could not give its affiliated IDNO a cross-subsidy or preferential access to information).

Question 2 - Are you aware of any other potential impacts on competition?

5. To assess the potential impacts on competition, it is necessary to separately assess two distinct activities:
 - a. the construction of the new electrical assets for a connection; and
 - b. the ongoing ownership and operation of those assets.
6. Competition in the construction of new connections is working well for consumers. It has been improved significantly since the 2006 and 2008 consultations that Ofgem cites, and obligations placed on DNOs ensure other companies can compete. **Appendix one** to this response, also referred to in our response to **question 1**, provides further details of the many steps Ofgem has taken to ensure this. Whether or not the IDNO licence is granted is not directly relevant to this market, since an IDNO licence is not necessary to enter it. Affiliates of DNOs are already free to compete in this market, and many already do.
7. Turning to the market for the ongoing ownership and operation of new connection assets, it is likely that granting an IDNO licence to an affiliate of a DNO will *increase competition* for certain types of network assets.
 - a. It is difficult for DNOs to compete to operate certain types of new connection assets under the current regulatory framework.
 - b. IDNOs are free to operate a 'tariff support' model whereby assets newly installed by ICPs are adopted by the IDNO and an adoption payment made to the land developer (either up-front or on ongoing basis as energy is used at the site).
 - c. DNOs are prohibited from making similar payments which renders them uncompetitive; at least in respect of the types of connections that IDNOs offer adoption payments for.
 - d. We are not aware of any Ofgem assessment of the levels of competition *between* IDNOs in respect of these types of connection.
 - e. Granting an affiliate of a DNO would directly raise competition in this market.
8. Lastly, we would also highlight that, in Ofgem's letter dated 26 February 2007, Fulcrum Pipelines Ltd was granted an IGT licence on the basis that competition was well developed in gas connections, with barriers to competition having been resolved. Fulcrum was an affiliate of National Grid Distribution, a Gas Distribution Network, and this sets a comparable precedent for this latest consultation. Ofgem considered that the extent and established nature of the competition in the IGT market would prevent the affiliate IGT from being able to exploit potential customers. Given the similar models of competition in gas distribution as compared to electricity distribution, and given that competition in both markets is likely to be similarly mature (particularly in light of the further development of competition in electricity distribution over the last decade), companies affiliated to DNOs can have a reasonable expectation that they would be granted a licence on a similar basis.

Question 3 - Do these change whether the IDNO is operating in or outside of the affiliated DNO's DSA(s)? If so, how?

9. Outside the affiliate DNOs' DSAs, special competition concerns, associated with granting an IDNO licence to a DNO affiliate, cannot exist. The relevant group of companies will not have a dominant position in any relevant market, so could not abuse a dominant position.
10. Inside the affiliate DNOs' DSAs, appropriate ring-fencing and safeguards are in place which mitigate any risks that the relevant group of companies could abuse any dominant position that it holds.
11. A number of Ofgem's concerns over affiliate IDNOs are also relevant to non-affiliate IDNOs such as bidding for low cost work and ensuring adoption payments are not detrimental to existing consumers. Imposing specific restrictions on an affiliate IDNO would provide non-affiliate IDNOs with a prolonged competitive advantage and reduce the strength of competition from which land developers (that want an IDNO to adopt new connection assets) can benefit. To the extent competition is weakened by Ofgem choosing not to grant a licence, the incumbent IDNOs would benefit from higher profits. The IDNO incumbents in this market are therefore the parties which are most likely to argue for restrictions on new entry from DNOs

Questions on the impact on existing consumers

Question 4 - 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?

12. We agree with Ofgem's view as stated in the question above.
13. IDNOs pay discounted DUoS charges, but charge connected consumers the full DUoS charge that would be levied applied by the host-DNO. We expect that an affiliate of an existing licensee would also follow this standard industry working practice. No new issues with DUoS charges would be raised.
14. Looking more widely than the scope of this particular consultation, we note that, while this system of light-tough IDNO regulation has facilitated new entry in network ownership and operation, the benefits have flowed to land developers and / or IDNOs. The relative price control does not protect the interests of *energy consumers* because:
 - a. In practice IDNOs adopt networks where the annual running costs are less than the local distribution charges cater for.
 - b. The IDNOs then charge the higher use of system charge that their relative price control permits, and the difference is split between extra profit for the IDNO and tariff support for the land developer (in the form of an upfront adoption payment, or ongoing usage payments). Energy consumers do not benefit.

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- c. This takes money out of the system and causes host DNO DUoS charges to rise, (relative to the level they would otherwise be set at,) since DNOs cannot compete for new network with low running costs that would help reduce average DUoS charges. All energy consumers suffer.
 - d. Overall, it is difficult to see how this is consistent with Ofgem's principal objective.¹
15. The consultation does not address these issues; we therefore think Ofgem should review and reform its IDNO arrangements in order to ensure energy consumers benefit from the competition, rather than suffering.

Question 5 - What other impacts on existing consumers, if any, do you anticipate from granting such a licence?

16. As highlighted in our response to **question 3**, at paragraph 11, granting such a licence would allow future connectees to benefit from stronger competition between IDNOs. This would reduce the profits of existing IDNOs, to the extent these are currently above the competitive level, and it would have no effect on existing consumers (assuming the same set of developments were adopted by IDNOs).
17. We can see no other potential impacts on existing energy consumers. For example, licence conditions prevent DNOs from offering their affiliates any cross-subsidy through how the licensee carries out the activities of its Distribution Business. This means neither the service levels enjoyed by, nor the DNO costs paid by, existing energy consumers could be affected.

Questions on the way forward

Question 6 - 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?

18. Yes, we agree that the current IDNO licence conditions are sufficient to address the concerns raised in the letter. For example, the IDNO licensee itself needs to have available sufficient resources to operate its own business, and there are restrictions on its ability relinquish operational control of its network.²
19. The requirements in the IDNO licence would act in tandem with restrictions placed on DNO licensees to prevent any material prospect of the abuse of any dominant market position, which the relevant

¹ Which is to 'protect the interests of existing and future consumers in relation to electricity conveyed by distribution systems or transmission systems'

² We note that there may be shortcomings of the IDNO licence conditions that apply whether or not an affiliate holds a DNO licence. For instance, if a specific IDNO takes on network responsibilities where, in future, its maintenance obligations exceed its revenues, it is unclear how consumers would be protected from that IDNO defaulting on all its obligations.

group of companies holds as a consequence of DNO ownership. As set out in response to **question 1** (and at **appendix one**), we believe there is a firm legal and regulatory framework to prevent a licensee from cross subsidising or providing any preferential access to information or non-contestable connection services. We believe these safeguards are fit for purpose although we are happy to work with Ofgem and industry stakeholders to review them.

Question 7 - Do you thinking prohibiting an IDNO from operating within specified areas (for example the affiliated DNO's DSA(s)) would sufficiently address the concerns we have raised?

20. If the IDNO licence only permitted it to adopt new pieces of network outside the DSAs of any affiliate DNOs³, then there could be no special competition concerns associated with the presence of DNO affiliates. This is because the relevant group would not hold a dominant position in any relevant market in which the IDNO could adopt new pieces of network.
21. In terms of other possible geographical restrictions that could be applied, a restriction to particular named sites would be inappropriate. The original EDF application was specifically for two major developments in the south-east of England. Any DNO affiliate applying in today's market may not have a specific development in mind or may not have the time to obtain a licence and still be able to win the relevant work on a competitive business.
22. Overall we support the position that affiliates of DNO licensees should be allowed to apply for, and hold, an electricity distribution licence for the whole UK, with no additional requirements compared to IDNOs.

³ The licence drafting of any specific geographical restrictions on activity should not prohibit maintenance of existing connections, or provision of new connections by the IDNO to pre-existing pieces of network, (under Section 16 of the Electricity Act (1989))because licence ownership can change over time.

Appendix one: views on specific concerns raised by the consultation

'Access to preferential treatment or information by the IDNO through its DNO affiliate'

23. In the previous consultations by Ofgem on this subject, the possibility of cross-subsidy and preferential treatment were raised.
24. Ofgem has however put in place many safeguards to address these issues. These effectively mitigate these risks and include:
 - a. Standard licence condition (SLC) 4 of the distribution licence, which prohibits any cross-subsidy from the licensee to (or from) any affiliate through how the licensee carries out the activities of its Distribution Business.
 - b. Further provisions in SLC4 which prohibit preferential provision of information by a licensee to its affiliates.
 - c. SLC19, which prohibits various forms of discrimination by the licensee, including in the provision of non-contestable connection services (between affiliates of the licensee and businesses of any other person).
 - d. SLC52 which requires licensees to facilitate competition in the electricity distribution connections market and maintain a Code of Practice.
 - e. Increased regulatory reporting.
25. Ofgem also has concurrent competition powers, which extend its powers to investigate conduct beyond the exact parameters of the licence. Northern Powergrid has a Competition Act compliance programme in place that includes policies, procedures, a compliance manual and regular training for all relevant employees. This compliance programme is reviewed periodically with the input of external legal advisors. We assume most DNOs would undertake similar programmes.
26. These safeguards provide a firm legal and regulatory framework to prevent a licensee from cross subsidising any affiliate, or providing it with preferential access to information or non-contestable connection services. We believe these safeguards are fit for purpose; however, we are happy to work with Ofgem and industry stakeholders to review them, if required.

'Incentive on the DNO to take on (lower cost) work through the affiliated IDNO rather than the DNO business'

27. DNOs have both legal and licence obligations to provide applicants with a connection offer and could not take steps to pass lower cost work onto any affiliated IDNO. For example, SLC4 prevents preferential provision of information by a licensee to its affiliates. If a DNO received a request for a connection quotation, it would have to provide one; and it could give its affiliate any information about the relevant development on a preferential basis.

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28. We note that any IDNO licensee is likely to target connections which are lower-cost than average, and in particular lower-cost to maintain, since competition between IDNOs depends on the provision of tariff support (and making of adoption payments) to developers. If a DNO affiliated IDNO went on to target low-cost work, it would be because it was competing within the marketplace on a level playing field, with other IDNOs.

Appendix two: other issues similar to the specific concerns mentioned in the consultation

29. Below we address three issues which were raised by respondents to Ofgem's consultations on EDF's IDNO licence applications, but which are not mentioned by the present consultation.
30. Ofgem's decision on '*IDNO/DNO boundary equipment and which parties should fund this equipment*' means that the IDNO/DNO boundary is unlikely to be metered and as such this is no longer a potential barrier to competition.
31. The issue of tariff margin squeeze is also no longer a factor due to the introduction in April 2010 of Ofgem approved national charging methodologies which provided more cost reflective pricing including DUoS tariffs for IDNOs, collected via a portfolio billing arrangement. The portfolio billing arrangement for IDNOs means the capacity agreed between the IDNO and its customer is used for billing use of system as opposed to the agreed capacity at the DNO/IDNO boundary.
32. There is an unresolved issue of portfolio billing which is detrimental to energy consumers. The capacity in the Bilateral Connection Agreement (BCA) relates to the authorised contracted capacity at the DNO/IDNO boundary and can be different from the portfolio billed capacity. If the BCA is for 10MVA and the portfolio billing capacity is 5MVA then there is no cost signal associated with the unused 5MVA. This means there is no incentive for the IDNO to release that capacity for the benefit of other customers seeking to connect but that capacity is available to connect further developments to the IDNOs network. We support any work that Ofgem's review of Network Access rights will carry out to resolve this issue.