

Electricity distribution licensees
and interested parties

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Dear colleague,

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

We have been approached by Distribution Network Operators (DNOs) on the potential of an affiliate business applying for and holding an electricity distribution licence. We are inviting views on the potential implications of this and what effect it might have on consumers.¹ We are also inviting views on what, if any, additional measures might be appropriate in such a case.

Please send responses to this letter to David McCrone (david.mccrone@ofgem.gov.uk) by 3 September 2018.

Background

The Utilities Act 2000 introduced electricity distribution as a separate activity that requires authorisation either by licence or exemption. We are able to grant licences authorising the distribution of electricity for the purpose of giving a supply to any premises.

DNOs evolved from the Public Electricity Suppliers (PES) in 2001 following the introduction of a legal bar on the same legal entity holding both an electricity supply and distribution licence. Electricity distribution licences are granted to authorise the licence holder to distribute electricity across Great Britain. However, for DNOs, their licences include a number of licence conditions that have effect by reference to a specific geographic area. This area is referred to as the Distribution Service Area (DSA).

Independent DNOs (IDNOs) own and operate smaller networks located within the areas covered by the DNOs. IDNO networks are mainly connected to the host DNO networks and serve new housing and commercial developments. IDNOs are authorised by licence to carry out the activity of distribution across GB. A number of conditions within the electricity distribution licence are not in effect or are modified for IDNOs. These cover:

- Provision of legacy metering equipment and data services
- Treatment of payment claims for last-resort supply
- Independence of the distribution business

¹ The terms "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day-to-day work.

- Credit rating and indebtedness
- Provision of regulatory information
- Innovation strategy
- Losses management
- Competition in connections

IDNOs are also obligated by a set of Amended Standard Licence Conditions including the requirement that charges to domestic consumers for use of their network do not exceed those of the DNO in whose DSA they are operating. This is referred to as a 'Relative Price Control' (RPC).²

The introduction of IDNOs has facilitated the opening up of the electricity new connections market to competition. A consumer can choose to use an alternative provider for some connections work known as "contestable work". Contestable work can be carried out by a DNO, an IDNO or an Independent Connection Provider (ICP).³ Effective competition in connections should improve the quality of service received by connection consumer, reduce the cost of connections and encourage the development of innovative connection services.

The electricity distribution licence also uses the term Licensed DNO (LDNO). An LDNO is defined as an IDNO or a DNO operating outside of its DSA.

There are currently 14 DNOs and 14 IDNOs licensed to operate across GB.

Potential precedent for applications by affiliates of existing licensees

We have previously considered an application for an electricity distribution licence from an affiliate of an existing DNO. The applicant, EdF Energy (IDNO) Ltd applied in 2006 and 2008 for an electricity distribution licence.⁴

We recognised at the time that an increase in IDNO activity may have a benefit (at least in the short term) to consumers through increased competition in connections. However, we also identified some potential unintended consequences of granting a licence. These included:

- access to preferential treatment or information by the IDNO through its DNO affiliate
- incentive on the DNO to take on (lower cost) work through the affiliated IDNO rather than the DNO business

Our view was that these could have an adverse impact on competition and or increase the costs faced by all consumers.

We considered, after consulting on the first application, that the concerns associated with granting an IDNO licence to an affiliate of a DNO might be addressed by capturing the activities of the IDNO within the DNO's price control. This would ensure, as far as possible, that the results would be the same as if the DNO undertook the activity itself. The licence application was however not progressed further at the time.

² DNOs are regulated through the RIIO (Revenues = Incentives + Innovation + Outputs) price control framework. RIIO sets the DNOs' allowed revenues which are recovered through the use of system charges that consumers face. IDNOs are not covered by RIIO so RPC is used to ensure domestic consumers are no worse off than if they were to be connected to a DNO network.

³ An ICP will hand over the new connection and any associated network to a DNO or IDNO upon completion who will then own and maintain the network in the future.

⁴ EdF Energy (IDNO) Ltd was affiliated to three existing DNOs at the time of application; EdF Energy Networks (LPN) plc, EdF Energy Networks (SPN) plc and EdF Energy Networks (EPN) plc.

We consulted on a second application from EdF Energy (IDNO) Ltd on 16 March 2008.⁵ We considered that the interests of consumers could be protected by granting the licence subject to certain modifications. These modifications would place the same requirements on the applicant as other IDNOs but also:

- prohibit cross-subsidy between the IDNO and any other business
- restrict the applicant's business activity to the developments specified in the application
- allow the treatment of the IDNO's activities within the DNO's price control.

We also placed additional licence conditions on the affiliate DNO to allow IDNO revenues to be deducted from the DNO price control.

We published our decision to grant EdF Energy (IDNO) Ltd an electricity distribution licence subject to the modifications described above on 26 November 2008.⁶

Potential implications of granting a licence to an affiliate of an existing licensee

While there are some differences, we consider that a number of issues raised during EdF Energy (IDNO) Ltd's application that are relevant when considering future applications by affiliates of existing licensees.

Competition in connections and electricity distribution networks

We are keen to explore the impact of us granting an electricity distribution licence to an affiliate of an existing licensee on competition in connections. This includes competition between the affiliate and the DNO within the same group, other unrelated DNOs, and between the affiliate and other IDNOs.

We encourage competition in areas where this can make a positive difference for consumers. The aim of opening the new connections market to competition, including the introduction of IDNOs, is that consumers connecting to these network benefit from better prices and customer service (for example through lower upfront connection charges which should be passed onto consumers). We have seen a number of new entrants enter the market and an increasing number of consumers are connecting to IDNO networks. We note that within the DNO's DSA(s), the affiliate would, if granted a licence, be competing for new connections with another entity in its wider group.

We are concerned that without sufficient protection in place, an IDNO and its affiliated DNO could place undue pressure on other market participants and reduce competition. This could result in worse outcomes for consumers than would otherwise be the case.

Furthermore, the DNOs' price control contains a package of incentives aimed at encouraging the DNOs to provide a better service for connecting consumers, including those connecting low carbon technologies and distribution generation. This is referred to as the 'Incentive on Connection Engagement' (ICE). The aim of this incentive is to replicate the effects of competition and drive licensees to understand and meet the needs of larger connection consumers.

IDNOs are currently not within the scope of ICE and cannot be rewarded or penalised through this scheme. One potential concern with an affiliate of an existing DNO being granted a licence therefore is that the IDNO is promoted over the host DNO when

⁵ <https://www.ofgem.gov.uk/sites/default/files/docs/2008/05/edf-energy-%28idno%29-ltd---licence-application-consultation.pdf>

⁶ https://www.ofgem.gov.uk/sites/default/files/docs/2008/11/edf-energy- idno -ltd_decision-on-licence-application.pdf

competing for new connections. In the absence of any incentive to engage fully, consumers may receive an inferior service than they would if the DNO took on this work. This should not occur if effective competition exists between the affiliated IDNO and DNO (and other IDNOs). However, we consider that the creation of an IDNO should not encourage or allow the affiliated DNO to avoid its existing obligations.⁷

We are also mindful of the impact of granting a licence to an affiliate of an DNO on competition between IDNOs. Without appropriate mitigation in place, we consider there could be a risk of a cross subsidy between different parts of the group. While we note there can be benefits passed through to consumers through economies of scale, sharing resources and or a misallocation of costs associated with regulated revenue may result in an unfair advantage damaging competition.

The IDNO and its affiliate DNO must ensure that sufficient arrangements are in place to prevent preferential treatment within the DNO's DSA(s) compared to another IDNO (for example, when contracting for provision of emergency services). We consider that it is crucial that all IDNOs are treated on a fair and impartial basis.

- **What are your views on the potential impacts on competition in connections and or consumers that we have identified?**
- **Are you aware of any other potential impacts on competition?**
- **Do these change whether the IDNO is operating in or outside of the affiliated DNO's DSA(s)? If so, how?**

Impact on existing consumers

We consider that any impact on existing consumers would be the Distribution Use of System charges (DUoS) they face.⁸ DUoS charges allow the DNOs and IDNOs to recover the efficient cost of operating and maintaining their networks and currently make up approximately 18% of a typical domestic consumer's electricity bill.⁹ DNOs calculate their DUoS charges for low and high voltage connected consumers using a Common Distribution Charging Methodology while IDNOs have their own individual methodologies which are approved by us. In practice, IDNOs meet their obligations under the RPC by choosing to mirror the DUoS charges for domestic consumers of the DNO within whose area they are operating. We consider it is reasonable to expect that an affiliate of an existing licensee would also follow this approach.

We do not consider therefore that granting a licence to an affiliate of an existing licensee raises any new issues with DUoS charges.

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

Potential ways forward

If granting a licence, we consider there are several ways we could approach an application by an affiliate of an existing licensee given what we have described above.

⁷ For the avoidance of doubt, this principle applies to all obligations and not just those related to ICE.

⁸ Existing consumers includes those once they have connected to the affiliate's network, and those connected to other DNOs and IDNOs.

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https://www.ofgem.gov.uk/sites/default/files/docs/2015/10/reg_charges_final_master_version_23_october_2015.pdf

Firstly, we could grant the licence with no other modifications than would otherwise be the case if it were an applicant with no link to an existing DNO. In this case, we would monitor the affiliate IDNO and DNO's compliance with existing licence obligations.

A second option would be to grant the licence but explore what modifications would be required to mitigate the risks described above. For example, the Electricity Act 1989 states that '*A distribution licence may authorise the holder to distribute electricity in any area, or only in an area specified in the licence.*' We could therefore authorise the affiliate to distribute electricity only within prescribed geographic areas or outside of specified geographic areas. This would be consistent with the approach taken with EdF Energy (IDNO) Ltd which was restricted to the London Olympic Park. We do not currently have a view on what form other potential modifications might take.

- **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?**
- **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?**

Next steps

We welcome responses to questions set out in this letter, as well as any wider concerns on this topic. These should be sent to David McCrone (david.mccrone@ofgem.gov.uk), by 3 September 2018.

We will carefully consider the comments that we receive and publish our response, setting out any further work we plan to undertake, by the end of this year. Any application for an electricity distribution licence that we receive will be assessed in accordance with our published guidance while complying with our principal objective, taking into consideration the issues raised in this letter and responses that we receive.

Yours faithfully

**Chris Brown
Head of Electricity Strategy and Emerging Issues, Systems and Networks**