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31<sup>st</sup> August 2018

Dear David

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

I refer to the letter of the 24<sup>th</sup> July 2018 from Chris Brown inviting views on the potential implications of an affiliate business of a Distribution Network Operator (DNO) applying for and holding an electricity distribution licence.

Leep Electricity Networks Limited owns and operates an IDNO licence and our response to your questions are shown in the annex attached to this letter.

Our main concerns to the questions you raise are on how competition could potentially be distorted by the DNOs unless there is robust business separation and unbundling arrangements in place within the licence conditions of both the IDNO and its affiliate DNO. Moreover, particularly as the IDNO is to be subject to a different price control from its affiliate DNO.

We also have concerns as to the driver behind DNOs wishing to operate under an IDNO licence as there are no current restrictions in place that would not allow a DNO to operate outside its own DSA. We would therefore question why a DNO would wish to do this and whether this could be used as an opportunity by a DNO to 'game' by creating opportunities for both the DNO and its affiliate. Such 'gaming' would risk and distort competition in the market. We therefore believe that granting IDNO licences to affiliates would have a negative impact on competition and IDNOs per se.

However, were such licences to be granted we believe it is essential that robust and rigorous provisions are enshrined within the license itself to address the aforesaid issues, without which

it is inevitable that competition will be distorted. Our belief is that ownership and operation of electricity networks must be delivered on a level playing field and that consumers are not impacted negatively. As such, the proposal undermines this.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Kathryn Dodgson', with a long horizontal line extending to the right.

Kathryn Dodgson  
Director of Regulatory and Legal Affairs

## ANNEX

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

Introduction and development of competition in the connections market has delivered significant benefits to both developers and consumers which has had a positive impact on both the services and connection charges. We also believe that IDNOs, supported by ICPs, have played a pivotal role in developing an effective market for competition in connections by:

- driving the development of use of system charging methodologies that avoid margin squeeze;
- Improving the quoting process for points of connection (POCs) to the DNO network;
- Driving for the removal of boundary metering;
- Leading on improving access to DNO network information;
- Providing significant input into development of the Competition in Connections Code of practice; and
- Engaging with Ofgem and DNOs to improve connection processes arrangements.

DNOs may be of the opinion that the granting of IDNO licences to affiliates will bring increased competition with the introduction of more “players”. However, we believe that this only holds true if IDNOs affiliated to DNOs will operate on the same level playing field as non-affiliated IDNOs. We do not believe this will be the case.

We have already seen that some DNOs behaviours and actions (and inactions) have had an impact on frustrating, inhibiting and delaying the development of competition. This could have a detrimental impact on competition unless appropriate robust arrangements are established.

Were such licences to be granted, an IDNO would be competing with its affiliate DNO if it operated in the DNOs DSA and, without sufficient protection in place, an IDNO and its affiliate DNO could place undue pressure on other market participants and reduce competition.

There is also the risk that an IDNO affiliated to a DNO could be promoted over the host DNO resulting in an inferior service being delivered to consumers than the service required under ICE arrangements, which the DNO must follow.

We have a major concern in understanding what benefits a consumer or developer would receive if the IDNO was competing with its DNO affiliate within the affiliate DNOs DSA.

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DNOs are subject to a price control that *inter alia* establishes efficient operation costs and sets allowed revenues accordingly. We struggle to understand how a DNO, through setting up an IDNO, would be able to offer a more attractive proposition for consumers (and developers) connecting within its DSA than it is otherwise able to do through its DNO business. This leads us to suspect that our concern relating to cross subsidy may crystallise and, if so existing DNO customers would be impacted by this.

IDNOs with an affiliate DNO could also gain an undue competitive advantage in areas of system constraints or interactive competitive quotes since they may have access to information that is not available to competitors, or if it is, in advance of other competitors, or simply to standalone IDNOs. This could be through systems or resources shared with the affiliate DNO.

To address the risk of IDNO with an affiliate DNO having an advantage over a stand-alone IDNO, we believe robust requirements for unbundling and business separation between an IDNO and its affiliate DNO should be in place. Without which competition will be distorted.

When entering the market, IDNO face considerable start up and ongoing costs and have obligations to ensure that they comply fully with all the regulatory requirements. Should a DNO provides support services to its IDNO, then the affiliate DNO will already be giving preferential treatment, even if it starts to offer such services more widely as existing IDNOs have had to sink investment as a consequence of previous actions and policies. Even if the affiliate DNO were to charge its IDNO for the provision of such services, the IDNO will have an undue competitive advantage over existing IDNOs, particularly if the amount it pays for such services is less than the efficient sunk costs that stand-alone IDNOs have had to incur.

### **Are you aware of any other potential impacts on competition?**

An IDNO of an affiliate of an IDNO may be able to rely on indirect support by being members of organisations via its membership of its affiliate DNO, which a non-affiliated IDNO would not have the benefit of without, in some cases, additional costs.

Many IDNO cannot rely on having an investment grade credit rating which results in that party having to provide credit cover. An affiliated IDNO may be able to rely on indirect support of its affiliated DNO business by being able to rely on the investment grade credit rating of that business to avoid having to provide credit cover. Again, this is not operating on a level playing field.

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

There are differences between operating in area and out of area. For example, an IDNO operating in the DSAs of affiliate DNOs would have a distinct advantage over other IDNOs if it had different access to information, systems or resources that other stand-alone IDNOs did not have.

### **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?**

There are potential issues in that an IDNO mirroring the RPC of an affiliate DNO could have greater access to information in DNO charging models and use that information to unduly

influence the development of charging methodologies. There is also the opportunity of double recovery of the costs of providing services, once by the affiliate DNO through its price control and then again by the IDNO through the RPC mechanism. This would happen where a cross subsidy existed. We believe that policing of such practices will be very difficult to carry out.

To mitigate the risk of any cross-subsidy behaviours, organisations will require complete business separation akin to where organisations operate distribution and generation, or distribution and supply businesses totally separate and independently.

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

We fail to see how granting of such a licence will have a positive impact on existing consumers. However, we do believe there is the risk of a negative impact on such customers from the burden of costs because of cross subsidies to the IDNO licensee.

**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?**

No. Should such licences be granted we believe that, as a minimum, they should be drafted to exclude the licensee from operating within the DSA(s) of its affiliate DNO(s).

Furthermore, we believe that Section B of the Electricity Distribution Licence needs to be amended to put in place provisions that DNOs with a DSA should be fully separate from any affiliate IDNO.

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

No. Whilst we think prohibitions from operating within specified areas is part of the solution; we believe arrangements requiring full separation between the IDNO and the affiliate DNO are required.

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