

DCP 266 WORKING GROUP REQUEST FOR LEGAL OPINION

1. COMPETITION LAW AND DCP 266

- 1.1 Following a review of the responses to the second consultation, the Working Group agreed that it would be beneficial to seek legal opinion on if there are any implications of DCP 266 with respect to competition law. Specifically, question 2 of the consultation, sought views from Parties with respect to two general interpretations as to what revenues a party which is providing substitute services in place of a dominant party should be entitled to. Paragraphs 4.36 to 4.39 of the consultation document (refer Attachment 2) provides the rationale behind the question and details the two interpretations set out by the Working Group. This is also provided in section 3 below. The Working Group agreed that prior to issuing the following questions to the DCUSA Ltd lawyers, that it should first be confirmed if the questions are suitable enough for them to be able to provide their legal opinion. The group agreed that the following questions should be asked:

QUESTION 1 - WHAT ARE THE COMPETITION LAW IMPLICATIONS OF THIS CP?

QUESTION 2 - WOULD THIS CHANGE PROPOSAL, IF APPROVED AND IMPLEMENTED, PUT PARTIES IN BREACH OF COMPETITION LAW?

Some of the responses received by the Working Group to their second consultation highlighted competition law concerns. The following legal arguments and case law were presented:

LEGAL ARGUMENTS

(1) Arguments presented in response

It is alarming that the Working Group turned its mind to “*what revenues a party which is providing substitute services in place of a dominant party should be entitled*” (paragraph 4.36). This illustrates a fundamental misunderstanding of the purpose of the CDCM and of competition law, which is reflected in the fact that neither interpretation is an accurate reflection of the law.

The CDCM is a methodology “*for determining certain of the Use of System Charges of the DNO Parties that are to be recovered pursuant to ... Section 2B [Distributor to Distributor/OTSO Relationships]*” of DCUSA. It is a methodology for calculating the charges made by DNOs to LDNOs at the network boundary. It uses terms such as “*Revenue to Share*” to make it easier to conceptualise the allocation of the all-the-way (“ATW”) price between the DNO and the LDNO, but it is a methodology for calculating DNO boundary charges. The question of LDNOs’ entitlement to revenue is reserved to Ofgem under the LDNOs’ price control.

We expect that the Working Group's interpretations are based on a mis-recollection or a misunderstanding of the margin squeeze test set out in the cases beginning with C-280/08 P, Deutsche Telekom v Commission [2010] ECR I-955.

These cases establish a minimum margin in circumstances where (as here) a dominant undertaking provides an indispensable input on an upstream market (i.e. distribution of electricity to the DNO's network boundary with the LDNO) and competes on the downstream market (with the LDNO, to build, own and operate the network extension).

The test is that the differential between the dominant undertaking's input price on the upstream market (the boundary charge) and the retail price on the downstream market (the ATW charge) must be at least enough to allow a reasonably efficient competitor to operate profitably on the downstream market; as a minimum, the DNO's own downstream operation must be able to operate profitably on the downstream market if taken as a standalone economic entity.

It is entirely inappropriate – both in terms of the purpose of the CDCM, and as a matter of competition law – for the Working Group to take it upon themselves to decide *“what revenues a party which is providing substitute services in place of a dominant party should be entitled”*, except to the extent necessary for DNOs to satisfy themselves that their pricing allows the minimum margin necessary to avoid an unlawful margin squeeze.

By misapplying the question and seeking to set an allowed revenue/margin for their downstream competitors, DNOs are at risk of infringing section 18 of the Competition Act 1998. The fact that implementation of DCP 266 would require Ofgem approval provides no shelter from the DNOs' competition obligations. On the contrary, and as previously noted, DNOs have a “special responsibility” in competition law to pro-actively avoid abuses of dominance, which in a potential margin squeeze scenario such as this, includes a positive obligation to adjust its own pricing methodology to avoid the margin squeeze.

(2) Arguments presented in response

We do not agree that either of the interpretations is correct under the principles of competition law.

We have previously provided the working group with our view of the correct interpretation based on competition law. Such interpretations are readily available in competition law guidance or in case law for the working group to gain an ‘independent’ understanding. We are not sure why the working group seeks to develop a cut down or different interpretation of the margins that an IDNO is entitled to under competition law when such guidance already exists. We believe that this may be down to the difficulty within the working group of understanding the concept of a notional business – a concept used in competition law. **(See Attachment 4 for additional document provided by this respondent)**

(3) Arguments presented in response

We believe the most important considerations in relation to this point are the requirements of competition law. It is our view that the potential for 'margin squeeze' is the most relevant competition law concern in the consideration of this change. It is our understanding that margin squeeze occurs if the 'as-efficient competitor' test fails. This test compares the integrated firm's retail price, p , to its upstream price, a , and its own downstream costs, c , and is satisfied when $p \geq c + a$.

p would be the all-the-way tariff, a would be the IDNO tariff, and c the notional downstream cost of the DNO.

In the particular case of IDNOs competing with DNOs this situation is somewhat complicated the possibility of IDNOs competing at all voltage levels of the distribution network. Hence there is a requirement to ensure that sufficient margin is available to as efficient competitors at all levels of the distribution network.

There is also difficulty in reconciling end user prices based on forward looking cost signals, with the total cost view used in the allocation of this charge.

On balance, we do not believe either interpretation set out under para 4.37¹ is entirely correct. The consideration of notional revenue is not relevant to the test for margin squeeze which is based on retail price (all-the-way tariff), upstream price (the IDNO tariff), and the downstream cost of the integrated firm (DNO). It is in the consideration of cost only that it is necessary to consider the split between notional upstream and downstream businesses of the integrated firm.

(4) Arguments presented in response

Furthermore, we are concerned that the proposed solution distorts competition in the distribution of electricity, particularly at higher voltage levels.

In cases where the PCDM cost is higher than the CDCM tariff the higher voltage tariffs need to be capped. This applies to 26.9% of tariffs under the proposed change and includes tariffs applied to voltage levels as low as HV plus level.

Previously only a small number of tariffs were capped at 100% and this capping applied only at 132kV or above and affected only two DNO areas. Hence, under the current methodology the potential impact of tariff capping is limited but under the proposed change it is much greater.

The effect of capping at voltage levels below the highest level is that no additional margin can be earned by a competitor entering the market at voltage levels above that point.

¹ Paragraph 4.37 of the consultation document (refer Attachment 2) – the two interpretations are also set out in the two bullet points under paragraph 3.2 below.

For example, a 100% discount cap applies to the HV plus: LV Network Non-Domestic Non-CT tariff in the LPN network area. No extra revenue can be earned by an IDNO connecting to the DNO network at higher voltage levels, even at 0000.

It is our view that such a structure of tariffs would be a form of margin squeeze because the notional cost of the upstream business is certainly greater than zero but the margin available to a competitor business entering the upstream market would be zero.

We are of the opinion that as the existence of the margin squeeze would make market penetration more difficult for competitors this could constitute anticompetitive behaviour under the relevant law.

We recognise that the working group has correctly identified that there are few IDNOs currently providing services that would be affected by the issue we have raised regarding the 100% tariff cap. However, it is our understanding that even potential anticompetitive effects in pricing conduct may be sufficient to breach competition law.

We accept that issues of competition law are complex, and that we have not sought any legal opinion in this matter. We would therefore advise the working group to obtain expert legal opinion on this matter, and broader competition law concerns, before proceeding further with this change.

CASE LAW SIGHTED

C-280/08 P, Deutsche Telekom v Commission [2010] ECR I-955

Case 322/81, Nederlandsche Banden-Industrie-Michelin v Commission [1983] ECR 3461

2. BACKGROUND INFORMATION – INTENT OF THE CHANGE

DCP 266 - The calculation and application of IDNO discounts

- 2.1 DCP 266 seeks to change the way in which Distribution Network Operator (DNO) tariffs to Licensed Distribution Network Operators (LDNOs) are calculated in the Common Distribution Charging Methodology (CDCM). Instead of calculating an LDNO percentage discount by comparing the avoided total cost (p/kWh) with the total cost (p/kWh) in the CDCM Price Control Disaggregation Model (PCDM), the intent of this change proposal is that the avoided total cost (p/kWh) calculated in the PCDM is compared with the average p/kWh figure for each All The Way (ATW) CDCM tariff in order to determine the LDNO % discount factor to be applied to each of the tariff components of the CDCM ATW tariff. A consultation seeking views from Parties regarding the proposal was issued, this included a modification to the intent of the change to include the Extra High Voltage Distribution Charging Methodology (EDCM).

3. BACKGROUND INFORMATION: INCLUSION OF COMPETITION RELATED TEXT IN CONSULTATION DOCUMENT

- 3.1 During its review of responses to the first consultation the Working Group noted respondents' concerns around the implications to competition as a result of DCP 266. The Working Group was specifically interested in how DCP 266 interacts, if at all, with competition law and questioned, in general, to what revenues a party which is providing substitute services in place of a dominant party should be entitled.
- 3.2 The Working Group discussed two interpretations:
- The party providing the substitute service should be entitled to the same level of revenue which the dominant party derives in respect of the service which is being substituted; or
 - The party providing the substitute service should be entitled to the level of revenue which the dominant party would derive in respect of the service which is being substituted if the dominant party's business were notionally split into an element which provides the service being substituted and an element providing the remainder.
- 3.3 In the context of a DNO being the dominant party and an LDNO substituting the provision of services at (for example) low voltage, the two interpretations result in the following:
- The LDNO should be entitled to the revenue which the DNO derives in respect of the provision of services at low voltage. Such revenue is determined by the CDCM which generates forward looking cost signals and so does not necessarily reflect the cost incurred in providing the service to each group of users; rather it generates cost signals to incentivise user behaviours which can reduce the long-run costs of operating the DNO's network, with the DNO's total costs and return recovered in aggregate across all user groups through 'revenue matching' or 'scaling'; or
 - The LDNO should be entitled to the revenue which the DNO would derive from providing low voltage services if the DNO's business were notionally split into a portion providing higher voltage services and a portion providing lower voltage services. In order to approximate the revenues which the notional entity providing low voltage services would derive, it may be reasonable to assume that such a notional entity would be subject to a similar price control mechanism as the DNO is itself, and so such revenues would be determined based on an analysis of the costs and required return of providing low voltage services.
- 3.4 The Working Group set out their view that the solution for DCP 266 aligns to the second of these interpretations and sought views/comments from Parties on the two interpretations set out in the consultation document (paragraph 4.37).

The Working Group note that their consideration of revenue entitlements was a conceptual aid used following its review of responses to the first consultation, where respondents' voiced concerns around the implications to competition as a result of DCP 266. The first interpretation represented the approach inherent in the current methodology and the second the approach proposed by this CP. The Working Group does not have any control over IDNO revenues as these are governed/controlled by Ofgem.

4. LIST OF ATTACHMENTS

- Attachment 1 – DCP 266 Draft Legal Text
- Attachment 2 – DCP 266 Second Consultation
- Attachment 3 – Collated Consultation Responses
- Attachment 4 – Differences Between a Notional & and Actual Business