



**REVIEWS OF
PUBLIC ELECTRICITY SUPPLIERS
1998 to 2000
SEPARATION OF BUSINESSES
CONSULTATION PAPER
MAY 1998**

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FOREWORD

In February 1998 I published a consultation paper setting out the programme of the PES reviews, “Reviews of Public Electricity Suppliers 1998 to 2000”. This outlined issues that will need to be considered as part of the programme of work and reviews envisaged for the 14 public electricity suppliers (PESs) over the next two years.

The first consultation paper set out the eight main components of the programme of work. These are:

- Distribution Price Control
- Quality of Supply Standards
- Competition in Supply
- Separation of Activities
- Metering and Meter Reading
- Regulatory Accounts
- Prepayment Meter Customers
- Scotland

This second paper focuses on the issues surrounding the separation of activities, particularly PES distribution and supply businesses and the future treatment of metering and meter reading. It also summarises the response to the first consultation paper on these issues. In all, there were 39 responses from a wide range of organisations. A full list of respondents is attached at the Annex.

Since the first consultation paper the Government has published its views on a wide range of related matters in its Green Paper “A Fair Deal for Consumers”. In that paper the Government notes the increasing convergence of the gas and electricity markets and the significance of this for policy. It sets out its proposals to amend the Electricity Act 1989 to require the distribution businesses of the PESs to be licensed separately from their supply businesses. The Government also places emphasis on the further development of metering services for customers, particularly in relation to prepayment meters, and on the development of competitive markets in the provision of these services.

Against this background the present paper develops the issues raised in the first consultation paper including OFFER’s observations on:

- the need for separation of PES distribution and supply activities;
- the means by which separation could best be achieved and its implications for PESs, customers, competitors and regulation;
- future arrangements for metering and meter reading;

- the separation of activities in Scotland; and
- options for legislative reform to change the responsibilities and rights of suppliers, distributors and customers.

Conclusions on these matters will provide a framework within which further detailed work on these issues can be undertaken and will inform work on other aspects of the PES Reviews.

It would be helpful to hear from all those with an interest in any aspect of the separation of activities and the future treatment of metering and meter reading, including customers, their representatives and other interested groups as well as the companies themselves and other suppliers. I am seeking comments by 15 June 1998. These comments should be sent to:

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Electronic mail responses to the consultation paper should be sent to:

General@offer-supply.demon.co.uk

Responses will be published by placing them in the OFFER Library.

PROFESSOR S C LITTLECHILD
Director General of Electricity Supply

May 1998

1. SUMMARY OF RESPONSES TO PREVIOUS CONSULTATION

- 1.1 In the February 1998 consultation paper OFFER explained the benefits of a greater separation of activities, noting that it would be an advantage in setting price controls and would promote competition in generation and supply and other activities, provide for greater specialisation and efficiency in the provision of services and would facilitate future beneficial development of the industry. In all, 39 responses were received to the consultation paper. Most commented on the issues of separation and of metering and meter reading. The views expressed are summarised below.

Views of the Public Electricity Suppliers

- 1.2 The majority of PES respondents acknowledged the need for greater separation of activities, agreeing that as supply competition has developed, the activities of distribution and supply have increasingly been seen as requiring different approaches. Many actively welcomed the prospect as a means of allowing the industry to evolve. They noted that if implemented appropriately, greater separation would limit cross subsidy, aid competition and provide further benefit to customers.
- 1.3 All PESs voiced some concerns about the practical implications of separation. A major concern, shared by many, was that the unbundling of activities would create significant extra costs, could result in wasteful duplication and whilst in progress might harm customer service. Many of the PESs suggested that any timetable for action should not disrupt the development of supply competition. Another common theme was that organisational structures have developed differently between PESs and that OFFER should consider the value of such diversity rather than seek a single organisational solution. However, most argued that at least for price control purposes there was a need to define more clearly what is meant by distribution, supply and metering.
- 1.4 Most PESs accepted that the unbundling of metering and meter reading was necessary. Several PESs have stressed their wish to compete in these markets and welcomed a separation of natural monopoly from potentially competitive elements of the industry. However, some remained unconvinced of the benefits of competition in this area and several raised concerns, arguing that metering and meter reading are a fundamental part of the infrastructure required for distribution. There was a view that it would not be sensible to consider changes to arrangements so soon after market opening. There was also concern about the recovery of investment in existing meters and many PESs argued that there should be an allowance to cover these “stranded assets”.

Views of Consumers' Committees

- 1.5 The Electricity Consumers' Committees (ECCs) that commented on these issues argued that the separation of supply and distribution was desirable both in terms of reducing the scope for discrimination and in changing the perceptions of entrants, and importantly, customers.
- 1.6 The promotion of competition in metering was also welcomed. One ECC emphasised the need to consider the issues that joint meter reading may bring and the possibilities for growth of remote meter reading technology. Another ECC suggested that it is important that the responsibility for detecting meter interference in any new regime is clearly defined.

Views of Other Parties

- 1.7 Many of the responses from other organisations welcomed the prospect of separation of activities to improve transparency and eliminate potential for cross-subsidy. As an interim step, one supplier suggested that there should be a clear separation of a PES's accounts and that there should be moves towards separate branding of supply and distribution activities. Another second tier supplier was concerned that so long as the activities remained under common ownership, further measures would continue to be necessary to ensure that all PES services are being provided on a non-discriminatory basis.
- 1.8 Independent providers of data collection and meter services commented that they should be allowed to enter the market as soon as possible to provide a flexible and competitive means of servicing meter installations and of data collection. They noted the challenges facing new entrants competing with PESs. They agreed that suppliers should have primary responsibility for meter operation and related services but suggested that to protect competitors PESs should be encouraged to outsource non half-hourly meter reading, data collection and aggregation activities.

2. NEED FOR GREATER SEPARATION OF PES ACTIVITIES

Background

- 2.1 At Vesting in 1990 the structure of the public electricity suppliers, which replaced the old Area Electricity Boards, remained largely unchanged. They continued to have responsibility for both the supply and distribution of electricity. Their position as providers of these services was reflected in the particular status given to public electricity suppliers under the Electricity Act 1989.
- 2.2 The Electricity Act 1989 does not refer to the distribution of electricity. Instead there are two categories of supply licence - public electricity supply (PES) licences and other supply licences, usually known as second tier supply licences. Holders of PES licences have a statutory duty to supply persons in their authorised areas in certain circumstances. This includes providing connections and metering equipment. Whilst the Act does not describe a distribution function many of the powers and duties it gives to PESs are related primarily to distribution.
- 2.3 The main formal distinction between PES distribution and supply arises in the licences. The PES licence requires the PES to have separate businesses for accounting and certain other purposes. Each PES must have separate businesses for distribution, supply, second tier supply (that is, the PES's supply business out of area) and generation, and must keep these distinct for accounting purposes from any other business of the PES (or of its affiliates and related undertakings) such as a retailing business or a gas supply business. For each business the PES must produce separate accounts.
- 2.4 Notwithstanding the licence conditions, the legal responsibility for all PES functions rests with the PES itself as a single entity. For the purposes of this paper it is more helpful to describe existing responsibilities as resting specifically with either the distribution or supply business. These differing roles are described by reference to licence obligations and the related commercial agreements, even though in some cases the PES may have outsourced a part of the service to another company within the PES group or to a third party.
- 2.5 On this basis the distribution business of the PES has responsibility for all matters connected with the development, maintenance and operation of the distribution network. It provides for connection to the network and deals with customer enquiries about all distribution-related matters. The distribution business also operates and maintains all metering equipment of the PES and conducts all meter reading services. To facilitate competition the distribution business is required to operate a registration system (the meter point administration system) to record the suppliers using its network and to help administer the change of supplier process.

- 2.6 The PES supply business is responsible for customer billing and account collection. It maintains customer records. It purchases electricity for sale to customers and arranges for that to be transported to customers by the distribution business.
- 2.7 In broad terms, for a typical domestic customer with an annual electricity bill of about £250, the charges associated with distribution and metering amount to about £80 (about 30 per cent of the bill). The charges associated with the PES's supply business (that is excluding the costs of power purchasing and use of system charges) amount to about £15 to £20 a year (or less than 10 per cent of the bill). The balance is accounted for by about £10 for transmission and levy charges, with the remainder (£140) associated with the supplier's power purchase costs.
- 2.8 The PES licence provides for separate price controls on distribution and electricity supply business activities and prohibits cross-subsidies between businesses. PESs must offer use of their distribution systems on non-discriminatory terms to all suppliers.
- 2.9 As part of the arrangements that are being put in place to facilitate competition in 1998 PESs are required to make available on request various metering-related services to suppliers on request. These services are provided under agreements separate from the use of system agreements but also must be offered on non-discriminatory terms.
- 2.10 None of the existing conditions provide for the physical separation of PES distribution and supply activities. PESs are however restricted in the use to which information received by them as a distributor can be put and must not use any such information in a way which gives commercial advantages to their own supply activities. The initial PES licence condition which restricted the use of information provided to the distribution business, was strengthened as part of the amendments put in place for 1998. It now requires each PES to set out a public statement of its practices, procedures and systems for complying with the provisions on the use of information and with its obligations not to distort competition in providing metering and related services. The first statements to be produced under this condition will be published shortly. Typically they include descriptions of IT and other systems in place to ensure confidentiality of information, a Code of Conduct which provides guidance for staff on how confidentiality affects their work and details of how the PES will monitor the use of confidential information provided to its distribution business.

Developments in Electricity

- 2.11 This account of the background to the present situation shows that PES licences and businesses presently cover a mixture of activities of various different natures. Some activities like distribution have been and are expected to continue to be monopolies. Other activities like supply and metering services have been

monopolies but are increasingly open to competition and it is an aim of policy to make them fully competitive in future. In considering how to take forward the statutory and regulatory framework for the PES businesses, it is helpful to compare the experience of other companies in the electricity and gas markets. In these other areas there has been greater separation of monopoly and competitive activities. Increasingly, experience is accumulating about the need for such greater separation, and the advantages of doing so.

- 2.12 Following the unsatisfactory experience of the attempt to facilitate competition in generation via the Energy Act 1983, it was recognised that to encourage competition in generation it was necessary to separate transmission from generation and supply interests. The Electricity Act therefore provided for the separate licensing of transmission and generation. In England and Wales NGC was established as an independent provider of transmission services with a statutory duty to facilitate competition.
- 2.13 The neutrality of the transmission system operator in England and Wales has been an important component in the development of competition in generation, for example, through ensuring no discrimination in the provision of connections and the publication of assessments of the likely requirements for new generation. The fact that the transmission system has been operated independently of incumbent generation interests has given confidence to entrants. In addition, the separation of transmission and generation interests has meant that there have been more informed and open debates about the role and efficiency of transmission and the conduct of generators. This has assisted the regulatory process in these sectors and led to improvements in operating practices and procedures.
- 2.14 The increasing recognition of the importance of this independence resulted in further restructuring of NGC in 1995 when it was floated separately from its initial PES ownership and required to divest itself of its residual generation interest in the Pumped Storage Business (now First Hydro).
- 2.15 The benefit of an independently owned and operated transmission system in England and Wales can be contrasted with the position in Scotland. There the transmission systems are owned and operated by the two integrated generation, transmission, distribution and supply companies. The statutory duty on the Scottish transmission licensees to facilitate competition is markedly weaker. This position, which has not been conducive to new entry in generation in Scotland or to competition in supply, is discussed further in section 5.

Developments in Gas

- 2.16 Further evidence of the need for and benefits of separating network monopolies from the competitive sector of an industry has arisen in gas. The Monopolies and

Mergers Commission (MMC) report on Gas¹ and British Gas² in 1993 discussed these issues. The MMC said that British Gas (BG) was:

“both a seller of gas, and owner of the transportation system which its competitors have no alternative but to use. In our view, this dual role gives rise to an inherent conflict of interest which makes it impossible to provide the necessary conditions for self-sustaining competition”.

2.17 The MMC concluded that

“BG’s conduct in undertaking its business as an integrated business, and its failure to provide for neutrality as between its trading and transportation interests, may be expected to reduce the effectiveness of competition and to operate against the public interest by inhibiting choice, restricting innovation, and leading to higher levels of gas prices than would otherwise be the case. In our view, BG’s proposals to establish separate trading and transportation units still under the ownership of BG would not be sufficient fully to remedy these adverse effects even though they represent the most that can be achieved in our report made under the Gas Act. If such a limited remedy were introduced, we see a wide spectrum of decisions relating to transportation and storage that would still be influenced by the interests of BG’s trading activities.”

2.18 Accordingly, the MMC recommended the divestment of BG’s trading activities. It said:

“Such a measure would not, in our view, put at risk security of supply or safety. It would involve considerably less costs and organizational change than many other remedies put to us. Although some increase in costs in the short term may result, the development of self-sustaining competition would bring significant benefits to users. We regard separation of the businesses as essential to ensure that transportation and storage can be made available to all shippers, including the trading activity currently carried out by BG, without undue discrimination. Such a measure would remove the existing conflicts of interest, provide the incentives necessary to ensure the neutrality of transportation and storage, and bring about the transparency necessary for the regulation of the system.”

¹ “Gas”, Monopolies and Mergers Commission report under Fair Trading Act 1973. August 1993, Cmnd. 23 14

² “British Gas plc”, Monopolies and Mergers Commission report under the Gas Act 1986, August 1993, Cmnd. 23 15

- 2.19 Following an initial period when financial, physical and information separation of activities between transportation and supply within British Gas was required by Ofgas, legislation provided for the separate licensing of gas supply, shipping and transportation. Subsequently, the two arms of the company decided to de-merge. Transco as the monopoly provider of gas transportation services is now separately owned and physically separated from gas suppliers, including its ex-British Gas partner, Centrica.
- 2.20 The revised arrangements in the gas industry appear to be working better than before. As predicted by the MMC, customer service and safety has been maintained. Competition has been promoted and regulatory effectiveness enhanced through the full separation of transportation from supply interests. Increasingly Centrica has become able to provide an independent analysis of the services provided by Transco. In turn Transco has demonstrated its ability to make independent comment on the position of all suppliers.

PES Proposals for Restructuring

- 2.21 In electricity the PESs themselves are increasingly recognising the separate nature of supply and distribution. Several PESs have re-organised to provide greater management focus on the separate businesses. Other PESs have been considering the options for more wide-ranging corporate restructuring, including the possibilities of establishing joint ventures with other companies or of merging or selling supply businesses.
- 2.22 Several PESs have argued that such changes would be beneficial by providing for more effective management of the different activities resulting in efficiency and service improvements. They have also argued that merging supply businesses would increase efficiency and their ability to compete. The option to sell supply businesses could also provide a valuable opportunity for new entrants to enter the supply market without the need to purchase distribution businesses. Of course set against these potential benefits there may be some potential detriments to consider. In any event merger activity would need to be appraised in the particular circumstances of each case. The responsibility for deciding whether to allow particular mergers or to refer them to the Monopolies and Mergers Commission rests with the Secretary of State.
- 2.23 The present legislative regime for electricity has constrained such supply market developments. The legal position is complex. The statutory rights and obligations of the PES supply business cannot readily be separated from those in relation to distribution because the Electricity Act does not distinguish between these activities. Consequently, without a change in legislation it may be difficult to put in place sufficient customer and regulatory safeguards to provide for full ownership separation even where the companies wished to achieve this.

Relevance to Competition in Generation and Supply

- 2.24** Whilst the present PES licence conditions provide for some separation of distribution and supply activities, most non-PES respondents considered this was not sufficient to ensure the neutrality of the distribution system between competing supply and generation interests. The extension of supply competition has made these concerns of second tier suppliers more acute.
- 2.25** Suppliers have been concerned that the PESs' work on facilitating competition in supply may have been accorded a lesser priority by the PESs than their preparations to compete or to defend existing dominant market positions. There is evidence to suggest that those companies which have the best developed plans to compete as second tier suppliers have also been quickest to develop the systems necessary to facilitate competition in their own areas. Non-PES suppliers are concerned that the terms on offer for the provision of distribution and metering services provide advantages to PESs not available to second tier suppliers. This includes questions about how customer appointments are prioritised and whether PES supply business requests for changes of supply are treated advantageously by the PES registration process because of the integration of these systems within the PES.
- 2.26** Similarly the increasing focus by PESs and others on embedded generation - that is, small scale generation plant including combined heat and power (CHP) which is connected to the distribution system - has raised concerns about the role of distribution. Most PESs have made investments in embedded generation. In most cases plant has been embedded within the PES's own distribution system. The provision of information from the distributor is an important factor in locating embedded plant. Careful location can avoid the need for reinforcing the network and hence avoid significant costs for generators. Concerns have been expressed about the ability of non-PES generators to get access to such information on the same terms as the PES. Equally concerns have arisen about the costing and timeliness of work conducted by the PES for third party generators.
- 2.27** The Monopolies and Mergers Commission faced a similar situation in the context of gas.

“We see a wide spectrum of decisions, for example matters of pricing, investment, cost allocation, and operation of the network such as the regime for balancing supply and demand, which involve large elements of judgement. As long as BG remains an integrated business, even if its units are run separately as BG has proposed, these decisions are likely to be influenced by the interests of BG Trading. There may be no overt or intentional discrimination. Such a situation is likely to involve constant appeals to the regulator, and lack of confidence on the part of both shipper and the regulator that decisions are being taken on an objective basis, rather

than from the perspective of favouring BG's contract and trading interests."³

- 2.28 These points are also relevant to the circumstances in electricity. The present position seems likely to deter entrants and reinforce the dominant position of PESs in supply to the detriment of customers and competition.
- 2.29 By contrast to the position in gas and that in electricity transmission in England and Wales, most suppliers using the PES distribution systems are themselves network providers with little incentive to challenge the nature of distribution services. This will tend to protect inefficient or anti-competitive practices by distributors to the detriment of customers. As part of the 1998 process new insights have already been provided by prospective suppliers who are not PESs. This has revealed barriers to entry which PES suppliers have largely been prepared to tolerate. With well informed and resourced independent suppliers, distribution businesses will need to improve services and to make the network available on a fully non-discriminatory basis to all users.
- 2.30 There would be benefit in greater consistency of approach between electricity and gas networks. Increasingly, suppliers are planning strategies involving the supply of both fuels. Similar processes and industry structures in the two industries would help facilitate such arrangements. Suppliers would be able to streamline their own processes and customers would benefit from more integrated services. Different industry structures and processes could hinder this.
- 2.31 Against this background, it is important to ensure that the monopoly distribution system is neutral and is seen to be neutral, with respect to competing suppliers. The accumulating experience in gas and electricity discussed in this chapter, and the views of the MMC cited here, suggest that this would be furthered if electricity distribution businesses, like other monopoly businesses such as electricity transmission and gas transportation, were fully separated from trading activities such as electricity supply and generation and gas supply, which are potentially competitive.

Green Paper Proposal

- 2.32 In his submission to the Government's Review of Utility Regulation⁴ the Director General argued for early legislation to bring about the greater separation of supply and distribution. The Government discussed these issues in its Green Paper "A Fair Deal for Consumers". It said that:

"Convergence [between the electricity and gas industries] points to the need for an integrated approach to promoting competition in electricity and

³ Monopolies and Mergers Commission Report on Gas, Cmnd 23 15, paragraph 2.125

⁴ "Review of Utility Regulation: Submission by Director General of Electricity Supply", October 1997.

gas. A key anomaly between these two markets however is that while gas distribution and supply are now separated, electricity distribution and supply remain linked. The situation has arisen because the Electricity Act 1989 does not provide for the separate licensing of distribution.

A partial separation of the distribution and supply functions of the PESs could probably be achieved without legislation, by means of the electricity regulator seeking an agreed licence amendment with the PESs, and, failing agreement, referring the issue to the MMC. However, even if this approach were successful in bringing about a split in the functions, there could still be only one licence for each PES and the ownership of both supply and distribution assets would have to remain with the PES, hindering the restructuring of the electricity supply market in response to competitive pressures after 1998. This would inhibit innovation and the other benefits competitive markets can deliver to consumers.”

2.33 The Government concluded that

“The introduction of a separate licence for PES’s distribution activities, which will remain monopolies, would remove the constraint on the development of the supply market and help to ensure the establishment of a vigorous competitive market. An amendment to the Electricity Act 1989 to require the separate licensing of supply and distribution would be necessary to achieve this”.

Accordingly, the Government proposed that “The Electricity Act 1989 should be amended to require the distribution business of the PESs to be licensed separately from their supply businesses”.

2.34 OFFER strongly supports this proposal, which would provide for the possibility of separate ownership of distribution and supply. Later sections in this paper discuss OFFER’s other recommendations. For example, amendments to the Act should also place new duties on distributors, like transmission operators, to facilitate competition, and provide for other reforms of the legislative background to the industry with a view to facilitating competition and customer protection in the competitive supply market.

Ownership Separation

2.35 Reform of the legislation would provide the companies who wished to do so with an opportunity to place their distribution and supply activities in different ownership. The question arises as to how far, or by what process and on what timescale, separation of ownership should be compulsory.

⁵ “A Fair Deal for Consumers: Modernising the Framework for Utility Regulation”, CM3898, DTI, March 1998, para4.13 - 4.15.

2.36 As indicated by the quotations above, in its report on Gas, the MMC stressed the importance of ownership separation. It considered and rejected a proposal from British Gas to operate its transportation and supply activities in separate units each with its own managing director with a series of Chinese walls put in place to restrict information flows. The MMC commented:

“In our view, BG’s proposals for a separate transportation and storage unit under the same ownership as its trading activities may alleviate but cannot resolve the inherent conflict of interest that arises from BG T&S [transportation and storage] owning facilities on which independent shippers are fully dependent while competing with BG T&S’s own parent company. This conflict of interest would be manifest in many ways. The BG Board would have to be involved in the strategy of BG T&S, and we find it inconceivable that it could do so without taking into account the interests of its other subsidiaries. Even without such an overt influence, the ultimate responsibility of BG T&S must be to the interests of BG as a whole.

‘Chinese walls’ below the level of senior management are likely to be insufficient, particularly because they would obstruct flows of information that naturally occur and would continue to occur; hence there would be pressure to circumvent them. They may in time be expected to prevent desirable information flows that would otherwise occur between independent businesses, hence complicating decision-taking and reducing efficiency. Moreover, the natural promotion of managers within a single integrated structure would itself involve, over time the weakening of such barriers.

We further believe that the separation proposed would not be sufficient to allow to allow the change in culture at all levels of BG T&S, which the Chief Executive acknowledged was necessary if there is to be even-handed treatment of BG’s trading and contract activities and its competitors, particularly among middle managers used over many years to working together and giving priority to the interests of BG as a group.”⁶

2.37 The MMC also commented on the regulatory benefits of ownership separation. It said

“In our view, greater ease and clarity of regulation is itself an important argument for adopting a fundamental structural remedy to the adverse effects identified, which result from the conflict of interest inherent under common ownership. Separation of ownership is important in terms of the generation of adequate information, both for shippers and the regulator,

⁶ Monopolies and Mergers Commission Report on Gas, Cmnd 23 15, paragraphs 2.161-2.163

eliminating incentives to suppress and distort information relating to individual sectors. By separating ownership the established boundaries of the businesses would also prevent any shifting of financial returns between sectors.”

The MMC noted that the problems it identified would become “particularly acute” if the tariff monopoly was removed threatening BG’s core trading business.

- 2.38 Similar points would seem to apply to electricity, particularly now that the core PES trading businesses of supply to tariff customers is being exposed to competition. Against this background OFFER’s view is that the various problems identified with the integrated nature of the PES businesses would best be resolved by separate ownership of supply and distribution.
- 2.39 Some PESs might actively wish to separate their businesses, others might not. It is for consideration whether some steps short of full ownership separation would be appropriate as an interim measure. For example, whether or not full ownership separation was initially put in place, it would seem desirable to establish arrangements to ensure separate companies for distribution and supply, each operating wholly independently of the other and capable of being under separate ownership. These arrangements would include placing distribution and supply activities in separate subsidiaries. It would also seem appropriate to institute a range of further measures to ensure that the subsidiaries operated at arms length, reflecting as far as possible the arrangements that other suppliers would have with the distributor. The nature of these revised arrangements is discussed in more detail in the next section.
- 2.40 It would be possible to evaluate the position at a later date in the light of further experience and prospective market developments. Increasingly however the position of integrated companies may become anachronistic and the focus of concern about the satisfactory development of the market in their area, particularly if they were perceived to use their position to secure advantages not open to others. Further action might then be required in the light of experience. The Fair Trading Act gives the Government power to require divestment if an MMC report indicates that this would be an appropriate remedy to a public interest detriment. It would also be helpful for reserve powers to be provided under legislation to require separate ownership if this was considered appropriate.
- 2.41 At this stage, Government has not yet taken a view on the detailed requirements and the nature and timing of legislation is uncertain. New legislation could also take time to implement. In the meantime, it is relevant to consider the appropriate licence and other changes needed to put greater separation into effect. In any event, the extension of competition in supply to domestic customers and the introduction of full competition in metering in 2000 necessitate reassessing the degree of separation of activities presently required. Most respondents to the first

consultation paper, including several PESs, agreed that this was a priority area for action in the Reviews.

- 2.42 Accordingly, as part of the PES Reviews urgent consideration needs to be given to appropriate changes to the requirements to be placed through licence conditions and associated industry agreements on PESs to provide for the separation of distribution and supply activities.

3. IMPLEMENTING THE SEPARATION OF DISTRIBUTION AND SUPPLY

Present Arrangements

- 3.1 Since Vesting, several PESs have reorganised to give greater emphasis to the regulatory separation of distribution and supply. Many companies now have separate executive directors for supply and distribution functions. However, in practice all PESs continue to exhibit strong links between supply and distribution functions, with both sharing the use of many activities within the company.
- 3.2 Typically a PES structure will involve single functions for finance, customer service and IT which serve both businesses. Some PESs have merged operational activities, leaving the supply function as the contracting vehicle for the PES with little or no direct customer contact. Some PESs have outsourced some corporate services and many customer services to other organisations either within or outside the PES's group of companies. At working level in most PESs a full separation between supply and distribution activities is not evident, although some PESs suggest that they have moved significantly towards this. Beyond some limited common themes no single corporate structure predominates.
- 3.3 In considering the greater separation of distribution and supply activities it is relevant to contrast the present position in respect of PES supply businesses with the position of a new entrant supplier. A new supplier would need to provide for a range of functions associated with trading - contract risk management, pricing strategy, marketing, and so forth. The new supplier would also need to provide for most, if not all, metering services as discussed in the next section. As with all businesses the supplier would require a range of corporate or headquarters services, including finance. Finally, the supplier would need to maintain a major customer service unit to record customer data, process and issue bills and deal with customer enquiries. This is likely to include a large information technology infrastructure.
- 3.4 This can be contrasted to the present position of the PESs where metering services are presently distribution activities and where significant corporate and customer services costs are either borne entirely by or shared with the distribution business.
- 3.5 Against this background, this section discusses how the greater separation of distribution from other PES activities should be implemented. It assumes that the two businesses are placed in separate subsidiaries as discussed in the previous section. In achieving a full separation of activities, however, it is necessary to consider all existing interrelationships between the businesses. These can be grouped for convenience into the following areas, which are analysed in turn:
- contractual matters
 - staffing and location

- customer service and IT support
- branding

Contractual Matters

- 3.6** The relationship between the distribution businesses and second tier suppliers is defined by a series of contracts including the use of system agreement. In accordance with the new arrangements from 1998 the master registration agreement will also be introduced. This will continue to be relevant to the services provided by distribution businesses. Metering services are considered in more detail in the next section.
- 3.7** In providing distribution services, PESs are obliged not to discriminate between their own supply businesses and those of other suppliers. There is, however, no specific requirement in the case of use of system and meter operation agreements for the distribution and supply businesses to contract with each other on the same basis as the distribution business does with other suppliers. This is because in legal terms the supply and distribution businesses of the PES are at present the same legal entity, and a legal entity cannot contract with itself. Were the two businesses to be held in different legal entities this problem could be overcome.
- 3.8** As noted previously, a change in legislation might be required to enable PES supply and distribution businesses to be held under different licences by different legal entities and hence for them to be able to contract one with the other in the normal way. The provision of non-discriminatory contracts by the distribution system to all suppliers in a transparent way would provide all parties with a greater assurance that the contractual arrangements surrounding distribution did not discriminate between suppliers. Placing distribution and supply in separate subsidiaries would allow this to happen.
- 3.9** Within the confines of the present legislative arrangements it would be possible to make some preparatory steps. Agreements could be established to reflect the requirements of legal and contractual separation. The agreements would be based on the agreed distribution contracts offered to other suppliers. The agreement would then need to be managed as other contracts, with inter-business processes, standards and payments all defined. Disputes and change proposals that could not be agreed directly between the businesses would be settled by the Director General. To enhance confidence in this process the agreements and any subsequent changes to them could be made public to other system users.

Staffing and Location Issues

- 3.10** To make contractual arrangements effective there is a need to have parties to the contract with clearly delineated responsibilities and separate objectives. This suggests the establishment of separate management and staffing structures. To facilitate separation and restrict any possibility of inadvertent information

exchange or preferential treatment it would be desirable for management and staffing of the businesses to be based at separate locations to reinforce the IT restrictions discussed below. Many companies have already gone some way towards this but it would seem desirable to implement this across the country as an explicit requirement on the companies. One area for potential concern would be if staff were routinely exchanged between the businesses, particularly where they had access to sensitive information. It would seem sensible to place restrictions on the transfer of staff between distribution and supply functions.

- 3.11 At present many staff in PESs have responsibilities which span distribution and supply functions. This is undesirable if full separation is to be achieved. The rationalisation of arrangements surrounding metering services proposed in the next section should help reduce the extent of such multi-business staff. It would be desirable for PESs to put in place arrangements to ensure all staff have responsibilities for one business only.
- 3.12 In the short term this may not be possible in all cases. The role of corporate headquarters staff is likely to need careful attention. The corporate function is of particular importance as it will control the activities throughout the company. Plans made by the Corporate Office will affect how the individual operations are run and the extent to which they interrelate. Decisions made at this level may affect the profitability of every area of the company even if they are managed separately within the business. Corporate functions such as finance, human resources and regulation may also have access to sensitive information from both businesses. As part of the preparations for separation the scope of such corporate level responsibilities should be minimised. Many PESs have already taken action to reduce the size and scope of headquarters activities and have placed greater responsibility in operating units.

Customer Services and IT Support

- 3.13 A critical issue for the separation of activities is the future treatment of PES customer service and information technology systems. Most PESs presently operate largely integrated systems of handling customer enquires through a call centre and of maintaining customer and other records in a centralised customer information system. It is for consideration how these activities should be handled when separating activities.
- 3.14 These functions are at the heart of the present link between distribution and supply. PESs argue that the sharing of these facilities between the two businesses gives rise to efficiency gains in both businesses that can be shared with customers and all users of their distribution system. They also stress the benefits of integration in terms of the services made available to customers. They argue that separating these activities could be costly and would bring little benefit to customers.

- 3.15 Second tier suppliers note that to the extent that there are benefits associated with supply and distribution integration these are only available to PESs. This distorts competition to the longer term disadvantage of customers. Customer representatives welcome the separation of activities but seek assurance that effective services to customers will be maintained by PES supply businesses.
- 3.16 In assessing these issues it is necessary to consider the service presently provided and how the service could be provided in future. As has been noted previously, the contacts that most customers have with PESs concern billing and related supply matters. If meter and meter reading queries are treated as supply matters then less than one in five customer contacts involve distribution matters. Data from some PESs suggests that this proportion may be even lower. Overwhelmingly, contact on distribution matters is concerned with customer enquiries during power cuts.
- 3.17 A similar picture emerges in respect of customer information systems. The size and complexity of these systems relates primarily to the holding and processing of customer data associated with meter reading records and billing. Engineering records associated with distribution, are relatively static and small in scale. The distribution business does not need to hold detailed records on final users, but does need to provide its own system for billing use of system to suppliers. Provision was made for this in the data management services charge.
- 3.18 If the supply business took overall responsibility for existing PES systems a question would arise about how best the distribution business would access the call centre and information system facilities it needs. In some cases existing PES facilities may be capable of adaptation to provide full separation from supply systems - this might apply for example in the case of some engineering record systems in some companies or where there are multiple call centres. Full separation in this context would mean the full physical separation of the systems in terms of location, interoperation and staffing support.
- 3.19 Retaining a link between distribution and supply activities in this crucial area would be a matter of concern. It would seem preferable to require distribution businesses to move as soon as practicable to the separate provision of these services. Call centre services are widely available from a range of commercial providers. Similarly information technology requirements can be outsourced competitively. The precise means by which this was achieved may depend on the precise circumstances of the individual company, but PESs would need to demonstrate that there was no longer any joint provision of these services either within the PES or from a related party. It should be possible to make such changes in a relatively short period. A guiding principle here would be to ensure that no information could inadvertently or otherwise be shared between the businesses through these arrangements.

3.20 The provision of dedicated IT and call centre resources for distribution need not adversely impact customer service or security of supply. The service provided by the PES supply business to its customers would be of similar scope to that of second tier suppliers. In most cases the supplier would resolve matters for the customer contacting the distribution business on the customer's behalf as necessary. In cases involving supply failures or safety problems customers will need contact the distribution business direct. This could be provided by a dedicated service - perhaps a national freephone service number run by the distribution business. This would provide full information about any supply failures and could deal with other distribution issues such as connections. In cases of supply emergencies distributors could cooperate to provide the necessary scale of call centre facilities. Arrangements for this would need to be put in place in advance.

Branding

3.21 The common branding of distribution and supply services may distort competition in supply. If the local distribution business is associated with a particular supplier, customers may infer that a greater efficiency or reliability of service will be made available to customers of that supplier than to customers of its competitors. Customers who have changed supplier may be confused by meter readings apparently still being taken by staff of the former supplier. Any marketing or information provision conducted on behalf of the PES's distribution business is likely to benefit the PES's supply business.

3.22 This suggests that there would be advantage in moving towards separate corporate identities for the distribution business and the supply business. This would indicate to the customer that the distribution business was not associated with one particular supplier. Similar changes have occurred in the gas industry with Transco and Centrica both operating distinct corporate identities, separate staff uniforms, and their own customer communications. Many companies have adjusted their corporate liveries over the past few years, making changes to company vehicles, advertising and customer communications. Although it will be relevant to consider the timescales for implementing such a change and the steps required to inform customers, providing for similar changes to produce an independent brand for distribution activities seems readily achievable.

4. METERING AND METER READING

Significance of Metering Services

- 4.1 Metering services are significant components of the total service to electricity customers. These services cover the installation, maintenance and ownership of metering assets, the reading of meters, checking the accuracy of meters and the provision of meter reading data to suppliers and other interested parties.
- 4.2 At present all these activities are treated as part of the distribution business for separate business accounts and price control. Charges for the services are bundled within distribution charges. Consequently the costs of providing these services are not transparent. Some indication of the significance of these costs can be seen from the previous reviews of the distribution business where a metering component was included in the distribution price control. A notional revenue allowance was included in the control calculated by reference to a sum based on the proportion of business process costs which companies then assigned to metering and on the number of customers of different types with different types of meter. The metering component amounted on average to about 10 per cent of each company's allowed distribution revenue.⁷
- 4.3 On this basis, the metering businesses of the PESs would amount on average to about £10 to £15 a year per customer, although further detailed work would be required to calculate this more precisely. With the introduction of full competition in supply, the scope of the metering business will be further increased as it will include various data processing and aggregation activities now required for electricity trading. An allowance for the cost of providing these services was included as part of the Data Management Services charges provided for in the revised Distribution Price Controls of the PESs.
- 4.4 It is relevant to compare this with revenues associated with supply business. The calculation used in setting the present Supply Price Restraint suggested supply business costs and margin of about £15 to £20 a year per domestic customer with an annual bill of about £250. Whilst these two calculations are not directly comparable they suggest that the financial significance of the metering business is of nearly the same magnitude as that of the supply business.
- 4.5 The metering business is significant from the perspectives of the customers and competitors. Metering provides one of the main means of contact between the customer and the industry. In addition to regular visits from meter readers, meter and meter reading enquiries are a significant cause of contact between domestic customers and the PESs. In the MORI survey conducted for OFFER and published in March 1993⁸ customers were asked about contact with the PES in the

⁷ "Distribution Price Control Proposals", August 1994, para 3.21.

⁸ "Electricity Services: The Customer Perspective", MORI report prepared for OFFER, March 1993,

past two years. Some 40 per cent had contacted the PES in that period. The meter or meter reading accounted for 27 per cent of such contacts, the second largest category of contacts. The table shows the subject matter of their last contact.

Table 1: Subject of Last Customer Contact with PES

	%
Problems or query with bill	39
Meter/Meter Reading	27
Power cut	16
Problems/query with supply (not wiring)	8
Other	3
Don't know	7

Base: All who contacted PES in previous two years

- 4.6** Competition in metering services will put downward pressure on the costs of providing these services and will enable suppliers to differentiate their product. Metering services provide important opportunities for more targeted services. For example, customers' views on the appropriate frequency of company meter readings vary widely suggesting scope for products tailored to meet different customers' needs more closely. Metering is also an area where significant technological advances can be expected. New metering technologies, improved prepayment meter systems and remote meter reading systems are all under active consideration and have the potential to significantly alter and improve the nature of electricity supply services to customers.
- 4.7** In the Green Paper, the Government has stressed the need for a competitive market in the procurement of prepayment and other meter services as soon as practicable in order to obtain the best possible value for money for customers.'
- 4.8** Competition will encourage innovation in metering and meter reading. The continuation of a PES monopoly in these services could restrict the range of services that a competing supplier could offer its customers and distort competition in supply. Competition in metering services will bring benefits to customers through greater choice and through the ability of suppliers to more accurately reflect their customers' needs. Accordingly, OFFER proposes to pursue actively the full introduction of competition in metering services by April 2000.

p.76.
⁹ "A Fair Deal for Consumers: Modernising the Framework for Utility Regulation", CM3898, DTI, March 1998, para 5.36

Developments in Metering Services

- 4.9 In 1990 half-hourly metering for 1 MW customers was provided through the Pool by the local PES. Amendments to the Electricity Act in 1992 gave all customers the opportunity to provide their own meters, subject to the agreement of their supplier.
- 4.10 From 1994 competition was introduced into the provision and maintenance of half-hourly metering equipment. Customers of second tier suppliers in the 100 kW market were made responsible for arranging for the meter to be installed and maintained by appointing a meter operator to carry out these activities. In addition to PESs, a number of independent meter operators entered the market to provide meter operator services to customers. Since 1994, a single agent, UKDCS, has carried out data collection functions in the half-hourly market on behalf of the Pool. Neither suppliers nor customers were allowed to collect their own data for Pool purposes.
- 4.11 In planning for supply competition in 1998 it was generally agreed that the existing arrangements needed reform. It was agreed that greater emphasis should be placed on the role of the supplier in ensuring that meter operator and data collector services are made available. From 1998 suppliers will have the primary responsibility for ensuring the effective provision of meter operation, data collection and the new service of data aggregation. This is reflected in the processes being put in place for 1998 and underpins the legal and other arrangements being made in the Electricity Pool and by other industry bodies.
- 4.12 In the half-hourly market competition is being introduced into these activities, with suppliers free to choose who will provide the services, subject to them having been accredited by the relevant accreditation authority. To smooth the introduction of competition in supply it was agreed that in respect of non half-hourly metered customers competition in these activities would be deferred until April 2000. Until then PESs retain a monopoly in the provision of these services for settlement purposes. PESs are however required by the terms of their licence to provide meter operator, data collector and data aggregator services on a non-discriminatory basis to all suppliers. PESs are in the process of completing the necessary agreements under which they will provide these services to other suppliers when the supply market opens to competition later this year.

Developments in the Gas Market and Joint Meter Reading

- 4.13 Under the Gas Act 1986 (as amended by the Gas Act 1995) the Director General of Gas Supply has a statutory duty to secure effective competition in the carrying out of activities ancillary to gas shipping and supply including metering and meter reading. Arrangements for meter reading in the gas market were revised as part of the changes introduced by the Gas Act 1995. In summary, suppliers are

responsible for obtaining meter reading services.” Competition has been introduced and suppliers have a choice of service provider. Transco provides a meter reading service to shippers on request or shippers can select an independent meter reading agency (IMRA).

- 4.14 Centrica has decided to use the services of AccuRead.¹¹ Other IMRAs are taking part in the market, many but not all of which are associated with the PESs. Transco has contracted out its meter reading service provision. In seven of the 12 areas covered in the Transco contracts, services are provided by AccuRead. In the other five they are provided by IMRAs associated with PESs.
- 4.15 In its December 1997 report on metering¹² Ofgas noted the inter-action between the development of competition in gas metering with developments in electricity. As both supply markets open to competition this convergence is likely to increase. Several suppliers will be supplying both gas and electricity. Such suppliers may be able to make significant savings which can be shared with customers if they can use a metering service provider which is able to read both the gas and electricity meters in one visit. In addition, service providers may be able to obtain economies by offering joint services with the water sector. Joint meter reading agencies may be able to make investments in new technology, including providing for remote meter reading, which would be more difficult to justify for one fuel. In this joint utility metering market the position of electricity is likely to be critical as it covers the largest number of customers in any area.
- 4.16 If such options are only available to one category of supplier or are provided to other suppliers on less favourable terms, competition in both electricity and gas supply will be distorted to the disadvantage of customers and competitors. OFFER and Ofgas have taken action to ensure that the position is safeguarded while competition is being introduced in electricity meter reading services. However, the wider implications of joint metering will be among the issues considered by the Regulators in their action plan which the Government asked them to undertake in response to the Green Paper. These developments are also an important factor in considering the reform of the present regulatory and legislative arrangements.

Third Party Providers and Licensing

- 4.17 From April 2000 all electricity metering services will be subject to competition. In many cases suppliers will use their own metering business to provide a service. But there is no reason why all or any metering services should be provided in-house. As the arrangements for 1998 demonstrate, these services can be provided

¹⁰ Under their licence, gas suppliers are responsible for obtaining meter reading services. Under Transco's Network Code, shippers are responsible for providing readings of a sufficient quality to Transco. Transco themselves are required to offer a meter reading service to all shippers on non-discriminatory terms.

¹¹ AccuRead was formed in October 1996 as a joint venture between British Gas Trading and Group 4.

¹² "Competitive Gas Metering: Potential impediments to the development of effective competition". Follow up to Ofgas' consultation document. Ofgas December 1997

by the local PES acting as a third party provider and there is no reason why choice of metering service provider should be limited to existing parties from within the industry.

- 4.18 Increasingly metering services can be seen to involve different business issues from those arising in supply or distribution, with specialist companies providing services to suppliers and customers. As has been seen in the half hour market and in the gas market, new entrants can make a valuable contribution by introducing new ideas and experience from other sectors. Developments in communications and metering technology may best be harnessed by independent service providers.
- 4.19 Subject to appropriate safeguards for customers and suppliers such independent service providers should be encouraged. For larger customers there may be benefits in dealing direct with metering service companies. Indeed some customers such as retailers with established communication links between their sites may wish to provide the services themselves. Smaller customers may continue to prefer a bundled service obtained on their behalf by their supplier. But with effective competition in both supply and metering services customers should be able to select for themselves a package of supply and metering services that best meets their needs. Arrangements in the industry need to facilitate this.
- 4.20 Some PESs have already reflected these developments by placing their metering activities in separate subsidiaries. For half hour metering most PESs are using third party service providers. Some PESs have considered the options for tendering out the provision of all metering services or of merging their activities with those of other metering service providers. Meter manufacturers, communications companies and other utility providers are amongst a range of parties keen to explore the opportunities to take part in these markets. However, the present legislative framework restricts the ability of third party providers to enter the market and compete.
- 4.21 To promote competition in this area third party providers will need the same relevant rights and powers as the PES. This includes consideration of issues such as access to customers' premises and powers to install replacement equipment. Equally the third party provider should have similar relevant obligations in respect of customer protection and safety matters.

Regulating Metering Services

- 4.22 In the early stages of the introduction of competition in metering services, the PES-related service providers can be expected to retain significant market power. The PES is likely to retain for some time a dominant position in supply to designated customers which is likely to have knock-on implications for the metering services market. In addition the nature of meter reading and some other metering services suggests that established parties in a dominant position in a large geographic area will have significant market power. In part this will because

entrants may find it difficult to build market share in the designated market without customers switching to new suppliers. However the local service provider will also benefit from economies of scale and scope not readily open to competitors.

- 4.23** New regulatory and industry arrangements need to be developed in respect of metering services. The new arrangements need to protect customers where this is necessary, and promote competition in the provision of metering services and in supply. The arrangements must ensure that metering services continue to be provided to high standards, particularly in respect of accuracy and safety. Account also needs to be taken of new opportunities for enhancing the efficiency of the provision of metering services, for example by harnessing beneficial new technologies, and of the desirability of providing for flexibility in the way these services can develop in future.
- 4.24 In reviewing these issues it is necessary to consider in turn the various components of the metering service to identify how the service should be provided in future, and the extent to which regulatory measures are likely to be required to provide for change and to protect customers and competitors from any dominant positions in the market.

Meter Operation

- 4.25** At present around 26 million meters are installed and maintained by PES distribution businesses. This meter operation function has been established under the 1998 arrangements as a distinct activity for which separate agreements are entered into by the PES and suppliers. Meter Operation is open to competition where half hour meters are installed and will be subject to full competition from April 2000.
- 4.26** In many cases suppliers and customers will wish to change the existing metering equipment over time to take advantage of new tariffs and new meter technologies. To protect customers, for example from metering arrangements designed to tie customers into long term supply relationships, all suppliers are under an obligation in providing meter operating services not to distort, restrict or prevent competition in supply.
- 4.27** It can be assumed however that, at least initially, most designated customers and their suppliers will wish to retain present metering equipment. The ability of customers to change supplier without the need for a meter change is valued by many customers and suppliers. The annual cost to the customer of metering equipment is relatively low. This is because the capital cost is spread over a number of years. The cost of replacing the meter or purchasing it from the previous supplier might represent a significant barrier to new suppliers and a deterrent to customers considering switching supplier.

- 4.28 Competing suppliers need to be assured that the metering stock will continue to be made available to them for use with their customers on transparent and non-discriminatory terms. Were a dominant supplier to own and maintain the existing metering stock the availability of the service might be restricted or other barriers placed on competing suppliers. In principle, PES metering assets could be transferred to the supply business and then subject to regulatory constraints to provide for open access or transfer of the assets on change of supplier. However, this could be complex to oversee in practice and competing suppliers are likely to be concerned if they have to rely on their competitor for meter operation services.
- 4.29 Given the difficulties of associating meter operation with a dominant supplier it would seem preferable to give responsibility for the existing metering stock to a metering business either in distribution business ownership or provided by a regulated independent third party. This business would be responsible for the maintenance of those meters and would be required to offer a meter operation service on transparent and non-discriminatory terms to all suppliers. This service might focus on the provision of existing metering equipment to designated customers¹³ where the rate of change in metering equipment might be expected to be slower and potential restrictions imposed through meter ownership by a supplier might represent a more significant barrier to competition than would be the case with larger customers. At least initially the charges for the provision of this service would need to be regulated.
- 4.30 In the case of non-designated customers however the need for such safeguards is less clear cut. For most non-designated customers the cost of metering represents a small proportion of the costs of supply and many of these customers already have half hourly metering. Other meter developments may also be of interest to these customers and so the rate of change of metering equipment may be greater. There may nonetheless be benefit in providing for the distribution business or third party provider to offer meter operation services in respect of many of these customers especially when they are using conventional (that is non-half hourly) metering systems.
- 4.31 With an effective initial monopoly over meter operation services in its area the existing meter provider may be able to reinforce that position, for example by introducing new services or imposing conditions on its competitors through the operation of the distribution system. To guard against such concerns it may be appropriate to require distribution businesses to tender for meter operation services or elements of the service (such as installing new meters) on transparent and agreed terms. It is also for consideration whether restrictions should be placed on the range of meter operation services that can be provided by a distributor, for example to exclude half hourly metering or other new technology meters.

¹³ Designated customers is defined as all domestic customers together with non-domestic customers using below 12,000kW a year. Non-domestic customers supplied on a multi-site contract or through half hour metering are treated as non-designated customers.

- 4.32 At a minimum competing meter operators will need assurance that the technical and other conditions placed upon meter operators who wish to connect or disconnect meters from the distribution system are necessary, appropriate and do not discriminate in favour of any meter operation activity associated with the distributor. Conditions are already in place in the licence to require PESs to offer meter operators terms for undertaking such work. The present EASL Code on these issues may require further review.
- 4.33 In sum, under these arrangements suppliers would have a choice of obtaining a basic service from a regulated meter operation business or installing new equipment and obtaining meter operation services from a wider range of parties. Over time metering equipment might be increasingly provided by suppliers with the regulated provider acting as a meter operator of last resort which made available a basic service to those suppliers who were unable or unwilling to obtain a service from other operators. This regulated meter operation function might either be within distribution business ownership or provided by a separately regulated third party. The implications of this are considered further in the section on price control and metering.

Data Handling and Meter Reading

- 4.34 Data handling includes the data collection and data aggregation activities, that is, reading meters, and the various data processing tasks of validating readings, processing meter reading data for settlement and other purposes and communicating that data to relevant parties. In practice those activities are closely related to supply issues such as billing and billing enquiries and to the settlement of trades in the Pool and all are scheduled to be fully open to competition in 2000.
- 4.35 All suppliers will need to undertake data processing activities to check their settlement and use of system bills and to prepare bills for customers. Insofar as suppliers decide not to undertake the data processing services themselves there appears to be no locational or other significant barrier to a range of parties providing the service on a competitive basis. Accordingly, these activities should in future be treated as supply business activities.
- 4.36 There are some further issues that apply to meter reading. Whilst obtaining meter readings will become a supplier responsibility some suppliers may not have the expertise or the wish to provide this service themselves and may otherwise be unable to do so. Initially, suppliers may have difficulty in obtaining a cost effective independent service. Unless suppliers are able to obtain an effective meter reading service they will be unable to compete and provide the necessary service to customers. It is for consideration therefore whether provision needs to be made for a meter service provider of last resort, that is a service provider who is obliged to offer a service to any supplier on request.

- 4.37 Without a service provider of last resort there is some risk that suppliers may not be able to fulfil their obligations to customers and other industry parties and that competition in supply may be distorted. This may occur for two main reasons.
- 4.38 First, a supplier may be unable to obtain a service because it fails to provide an appropriate meter reading service itself or is unable to enter an agreement with a third party to provide one. Where there is an effective competitive market in both supply and meter reading services this should not present a problem. A supplier who was unable or unwilling to provide its own meter reading service would face a range of competing service providers willing to offer their services. The position initially however is likely to be different. Many service providers will be associated with the supplier's competitors. They may be unwilling to assist the entrant supplier to compete. In addition the incumbent PES service provider may have material advantages which would give rise to distortions in supply were those benefits not available to all suppliers.
- 4.39 Second, a supplier may face circumstances where having commenced supply its chosen meter reading service provider fails to meet appropriate service levels and is no longer able to offer a service (this can happen for example when the service provider loses his accreditation status with the Pool). Whilst such circumstances might be rare they could have important consequences for the supplier and its customers. In such a case the supplier would need to make immediate arrangements to find a replacement service provider to maintain service to customers and other industry parties. Again in a fully competitive market place this might not result in particular difficulties (although the need for a prompt change might handicap the supplier in seeking the best arrangement for the longer term). During the transition to competition, however, suppliers and customers would benefit from increased confidence that fall back arrangements could be put in place in the unlikely circumstances that they were required.
- 4.40 During the transition to competition it would seem desirable to provide for a meter reading service of last resort. To give confidence to suppliers this should be obtained at arms length from any supply interests. The nature of the service provided and its charges would need to be subject to regulatory oversight.
- 4.41 One means of achieving this would be to require the distribution business to procure a specified metering reading service to be made available to suppliers on request on a non-discriminatory basis. The service would have to be provided in accordance with strict rules which protected a supplier's customer data from being released to other suppliers. To facilitate competition in metering services this service would not be provided from within the distribution business itself. Instead it would be for the distribution business to invite tenders to carry out the work. Subject to being able to provide the required service any authorised meter reading service provider would be able to tender for the work. A similar approach has been adopted in the gas industry where Transco has contracted for meter reading services with independent meter reading agencies.

Price Control and Metering

- 4.42** Distribution charges will need to be unbundled to allow for suppliers to decide whether or not to use the regulated meter operation service and/or the meter reading service. Where the services are provided through or by the distribution business, price control arrangements will need to facilitate the appropriate pricing of these services. This will be particularly important in the case of meter operation services.
- 4.43** To help achieve this it would seem desirable to require any metering activities of the distributor to be treated as separate businesses for licence and accounting purposes. This would include prohibitions on cross-subsidy between the distribution and metering business. This would facilitate price controls and effective comparison of regulated businesses and would provide for greater transparency in the distributor's costs. It would also distinguish more closely between the natural monopoly and potentially competitive elements of the businesses. It would also assist in the assessment of tenders for provision of meter operation and meter reading services and of pricing proposals.

Arrangements for Prepayment Meters

- 4.44** The provision of prepayment meter services is presently split between the supply and distribution businesses. The precise approach varies according to the technology adopted but in essence the distribution business provides the meter whilst the supply business is responsible for the payment infrastructure. Under the new arrangements for 1998 PESs must make both the meter and the payment infrastructure available for use by other suppliers.
- 4.45** It will be important to ensure that new prepayment technologies can be introduced to benefit customers. It will also be important to ensure that existing prepayment meter customers have ready access to competing suppliers. These issues will be subject to further analysis in the context of OFFER's work on the action plan for disadvantaged customers set out in the Green Paper. The costs of existing systems will also be analysed further in the price control reviews. For the purposes of the present paper however it is relevant to note that new technologies provided by third parties independent of suppliers can be expected to be of particular value in the context of prepayment meter customers.

5. ARRANGEMENTS IN SCOTLAND

- 5.1 Before Vesting the structure of the industry in Scotland was different from that in England and Wales. To a large extent these differences were retained after privatisation. Moreover, although a similar regulatory framework was put in place in both countries, there were certain significant differences in that respect too. It is therefore necessary to consider whether the analysis and proposals in the previous chapters of this paper apply equally to Scotland, particularly with respect to distribution, supply and metering activities. It is also appropriate to consider additional issues associated with transmission.

Differences in Structure and Regulatory Framework

- 5.2 Before privatisation, the industry in Scotland was vertically integrated. The South of Scotland Electricity Board and the North of Scotland Hydro Electric Board were each responsible for generation, transmission, distribution and supply of electricity in their own part of Scotland. This was in contrast to England and Wales, where transmission and generation were provided on a national basis by a single entity, the Central Electricity Generating Board (CEGB), and both activities were separate from the distribution and supply activities carried out by the 12 Area Boards. At Vesting, the structure in Scotland was left essentially intact, except that the nuclear stations were put into a separate company, Scottish Nuclear, which entered into exclusive long term contracts with the successor companies ScottishPower and Scottish Hydro Electric. In contrast, the CEGB was broken up: transmission was separated out into a separate company (NGC) and generation was split into three major separate and competing companies. Since then the pumped storage generation capacity left with NGC has been transferred to become a separate generation entity.
- 5.3 A second significant difference is in the statutory regulatory framework. Section 9(2) of the Electricity Act gives each transmission licensee a duty to develop and maintain an efficient, coordinated and economical system of electricity transmission; and to facilitate competition in the supply and generation of electricity. Section 9(3) qualifies this second duty in the case of the Scottish transmission licensees. In their case the duty is to be interpreted as to make the transmission system available to competitors on terms which neither prevent nor restrict such competition.
- 5.4 A third difference is that there is no Pool in Scotland. Trading between generators and suppliers is on a bilateral basis, with arrangements put in place to relate the terms offered by the Scottish PESs to Pool price. In addition, the Scottish PESs have obligations under conditions 23 and 24 of their composite licence to implement and maintain a settlement system.

Changing Circumstances

- 5.5 There may have been a number of reasons for the different approach in Scotland. A general theme may have been a questioning whether the prospects for competition in Scotland were sufficiently promising to merit the substantial restructuring that was being undertaken in England and Wales, and that might have implied even greater changes in Scotland. Reasons for this prospective lesser extent of competition might have included the relatively small size of the system in Scotland (about one tenth the size of that in England and Wales); the smaller prospective initial number of generators to compete into a Pool, the less scope for new entry given the greater extent of capacity in Scotland in relation to demand; and the fewer the number of identifiable potential entrants given the initial absence of independent regional companies there who might wish to acquire an interest in generation.
- 5.6 Over the last eight years, circumstances have gradually changed, and the position now needs to be reviewed in the light of experience. The experience in England and Wales has confirmed that the restructuring there has proved very important in securing the benefits of competition. The need now is to move further in this direction, as set out in the previous sections of this paper.
- 5.7 In Scotland, conditions are changing in ways conducive to competition: for example, demand is increasing over time in relation to capacity, particularly with the expansion of the interconnector to England and Wales and prospectively to Ireland, and as gas from the Miller field used at Peterhead power station approaches depletion. New technology has meant that entry on a relatively small scale, for example using CHP and smaller CCGT plant, now appears to be economic, so the size of the market is not necessarily a barrier to entry. The experience in Scotland is that market participants increasingly want to compete, in both generation and supply, and are trying to do so. However, the industry structure and regulatory framework in Scotland are increasingly being perceived as obstacles to this.

Emerging Problems

- 5.8 Potential competing generators, suppliers and some larger customers increasingly report problems in Scotland of a more serious and continuing nature than those experienced in England and Wales. In important part these problems may be attributable to the integrated nature of the two incumbent companies and the qualified nature of their duties as transmission licensees to facilitate competition.
- 5.9 Some examples of the difficulties reported by competitors are as follows.

- Potential generators report a number of barriers to entry, including more onerous connection agreements, and lack of clarity about the costs of ancillary services and transmission use of system changes. They argue that these barriers reflect the ability of decisions made by the transmission licensee to frustrate new entrants to the benefit of existing generators.
- Whereas Hydro Electric’s application for planning consent for an extra 1,000 MW of capacity at Peterhead was unopposed, and was granted, PowerGen’s application to build a 300 MW plant at Gartcosh, later rising to 700 MW, was strongly resisted by ScottishPower and made the subject of a Public Inquiry.
- Whereas indicative charges associated with Hydro-Electric’s transmission constraints south of Peterhead have reportedly deterred new connectees in its area, Hydro-Electric now proposes to alter its connection policy to facilitate the provision of more transmission capacity, with a likely benefit to the dispatch of its own new capacity at Peterhead.
- The Scottish Grid Codes have not been developed to provide adequate rules on the schedule and despatch of independent generators, leading to commercial uncertainty for such generators.
- Access to the interconnector to trade in England and Wales is perceived to be limited or denied to potential entrants into Scottish generation, or offered only on less attractive terms than to incumbents. Two requests for formal determinations have recently been made.
- Although short term trades between generators must be made under the Trading Code, both within Scotland and for use of the interconnector, potential applicants have been advised by Hydro-Electric and ScottishPower that the arrangements are not sufficiently robust to accommodate trades other than by these two incumbent companies, thereby limiting the trading options available to potential entrants.
- Aspects of the settlement system are still seen as giving an unfair advantage to the incumbents’ generation businesses, especially the “differencing approach” to measuring first tier suppliers take and the constitution and governance of Scottish Electricity Settlements Limited.

5.10 These examples illustrate the difficulties that new entrants have found in entering the market. Some of these problems may go beyond issues of separation of transmission, distribution and supply, which are dealt with in this paper. Where appropriate these problems are already being dealt with as part of the regulatory process. For example, two determinations are in process and consultation papers are forthcoming on interconnector access trading arrangements. Nevertheless they

suggest the scope is for a vertically integrated company to take advantage of its favoured position, by frustrating the activities of existing and potential competitors. In such circumstances, regulation of the companies to protect consumers and promote competition is likely to become more difficult, as was experienced in the gas industry.

- 5.11 The situation in Scotland is now different from what it was expected to be at Vesting, and from what it was in the first few years thereafter. New entrants are now trying to compete in both generation and supply. But the experience in Scotland, and the concerns that have been expressed particularly about transmission, stand in contrast to the situation in England and Wales. In England and Wales, the independence of the transmission company and the unqualified duty to facilitate competition, have worked with the grain of regulation and competition. In Scotland, the absence of these factors have tended to work against it.

Separation of Businesses

- 5.12 These considerations suggest that it would be appropriate to bring the transmission situation which now exists in Scotland more into line with the transmission situation in England and Wales. This would also be in line with the transmission situation now obtaining in the gas industry, reflecting the conclusions of the Monopolies and Mergers Commission. It will also be necessary to take due account of the EU Directive 96/92/EC which became law in February 1997. Specifically, there would be advantage in putting the transmission business of each company, including the interconnector, into separate ownership. In the interim, the transmission businesses should be put into separate legal subsidiaries with associated separation of staff and activities along the lines set out in earlier sections. In addition, there is a strong case for removing the qualification on the Scottish transmission licensees' duties to facilitate competition.
- 5.13 STAG has proposed consideration of an independent system operator to facilitate development of competitive trading arrangements in Scotland. This would be consistent with the measures just mentioned, but would need additional consideration in the light of the Review of Electricity Trading Arrangements in England and Wales.
- 5.14 The arguments for greater separation of distribution, supply and metering businesses apply equally in Scotland as in England and Wales. Indeed, to the extent that the development of competition in supply has been less vigorous in Scotland, it is more important to remove or reduce any potential barriers or costs associated with the ownership and operation of all these activities by two integrated companies.

- 5.15 If greater separation of distribution and supply leads to separate ownership in Scotland, it is for consideration whether the transmission business might be combined with the distribution business in each area, as is the case with Transco in the gas industry, or alternatively whether the two Scottish transmission businesses might be combined. This would of course be a matter for merger policy.
- 5.16 Conditions 23 and 24 of the PES Licence for Scott&Power and Hydro-Electric include the obligation to implement, maintain and operate a settlement system to facilitate supply competition. This has been taken forward through the Scottish Electricity Settlement Limited which is jointly and equally owned by the Scottish PESs. These licence obligations would seem appropriate to the separate transmission business.

6. OPTIONS FOR LEGISLATIVE REFORM

6.1 This section discusses options for legislative reform of the electricity regime in the light of the Government's proposal in the Green Paper to amend the Electricity Act to require the distribution businesses of the PESs to be licensed separately from their supply business.

6.2 Changes to legislation are of course matters for Government and Parliament. OFFER will be making its proposals in response to the Green Paper with a view to securing benefits for customers and promoting competition. Changing the legislative background to the industry in a number of respects would assist in ensuring the effective separation of activities. Licence conditions will need to be adjusted to reflect any such changes. Some initial views on these matters are set out below.

6.3 This section reviews the present position and suggests possible changes in the following areas:

- general duties and licensing of transmission and distribution;
- duties and functions of distributors;
- future status of PES supply;
- tariffs and contracts; and
- metering services.

6.4 In accordance with the Green Paper proposal, this section assumes that a new category of licence is introduced to cover distribution. Such distributors might be referred to as public electricity distributors.

General Duties and Licensing of Transmission and Distribution

6.5 At present both PESs and transmission licensees have a general duty under the Act "to develop and maintain an efficient, co-ordinated and economical system".¹⁴ In addition, the transmission licensee in England and Wales has a duty "to facilitate competition in the supply and generation of electricity". The Director General can enforce compliance with these duties using his powers under the Act.

¹⁴"Electricity Act" 1989, section 9.

- 6.6** It would seem appropriate for distribution licensees to have general statutory duties equivalent to those presently applied to transmission. This would provide that in addition to a duty with respect to efficiency, the distributor also had a duty to facilitate competition in generation and supply and in metering.
- 6.7** As noted previously, the duty of transmission licensees to facilitate competition in Scotland is significantly qualified in favour of the incumbent integrated companies. This is increasingly seen to be inadequate to deal with the difficulties faced by entrants. Reform here to put Scotland on the same basis as England and Wales would be desirable.
- 6.8** In considering the licensing of distribution and transmission companies two further issues are relevant. First, at present the Act provides for the transmission and PES licences to be exclusive - that is each licence covers a particular area and within that area the holder is assumed to have a monopoly. In practice however alternative owners can be involved in the provision and operation of such networks in a particular area. The definition of what is to be licensed needs to take account of such developments and provide for multiple licences in a particular area where this is appropriate.
- 6.9** The second and related point concerns the position of persons providing connection to these networks. In both transmission and distribution it has been possible to start the process of introducing competition into the provision of connections. This is a helpful safeguard for customers and has suggested the potential for wider efficiency gains in the development of the network. Presently the providers of connections are not required to be licensed as they do not operate a “system”. This has the advantage of minimising the regulatory burden, which would be a barrier to entry. However, such providers of connections do not have the rights and powers such as the provision of wayleaves and rights of access which are presently given to PESs. This may distort competition in this area. It is for consideration whether the powers available to all connection providers should be put on a more comparable basis.

Duties and Functions of Public Electricity Distributors

- 6.10** The main functions of public electricity distribution (PED) licensees will relate to the operation and maintenance of the local distribution network and the provision of services to facilitate competition.
- 6.11** It would seem desirable to provide for a clear obligation on public electricity distribution licensees to provide and maintain connection to any person requiring it. In effect, this would reflect the distribution component of the present duty to supply placed on PESs¹⁵ and would become a duty to facilitate supply through the

¹⁵ “Electricity Act” 1989, sections 16- 17

distribution system. Associated with this duty the PED would need powers to recover reasonable connection charges from customers. The level of those charges would be determinable by the Director General in case of disputes.¹⁶

- 6.12 As now the PED would be under a licence obligation to provide non-discriminatory use of system terms for all suppliers and to provide for meter point registration services to facilitate competition in supply and embedded generation. It would also be desirable to provide for service standards to be set by the Regulator with respect to restoration of supply and other distribution related activities on a similar basis to that presently provided for in the case of PESs.
- 6.13 The distribution licence holder would require various powers presently provided to PESs to be transferred to it. These would include powers of entry to customer premises in certain circumstances, for example for safety reasons, and other powers related to installing and maintaining electric lines and electric plant.
- 6.14 One issue for consideration is whether, following the completion of connection works, the distributor should have to maintain on-going contractual relationships with final customers. At present, for customers of the PES such provisions as are required to cover these matters are included within the tariff or contract. For customers of second tier suppliers, however, the PES as distributor is expected to enter into connection agreements with the final customer. For smaller customers this ‘connection agreement’ has been standardised and suppliers obtain the customers’ consent to the terms of the agreement on behalf of the PES.
- 6.15 The present arrangement in relation to second tier suppliers seems unduly complex and potentially confusing for customers. The present connection agreements appear to provide little by way of protection to customers or the distributor that could not better be handled through other existing agreements. On this basis connection agreements would not be required in future but any necessary terms concerning connection should be dealt with in supply contracts between the customer and supplier and in use of system agreements between the supplier and distributor. This change would place all suppliers on the same basis and would help overcome any perceived barrier to competition caused by differing contractual arrangements for customers. It would however be important to ensure that customers and their representatives had a right to challenge connection-related terms by referring disputes to the Regulator for determination. This will be particularly relevant for larger customers and other cases where non-standard terms are required.

¹⁶ “Electricity Act” 1989, sections 19 and 23.

Future Status of PES Supply

- 6.16 The present legislation makes a range of distinctions between the obligations and duties placed on public electricity suppliers and those on other suppliers described in the Act as 'private electricity suppliers'. Private electricity suppliers include exempt suppliers as well as second tier supply licensees. These distinctions increasingly seem inappropriate to the future structure of the industry.
- 6.17 When the Electricity Act 1989 was enacted it was not clear whether competition would in practice extend to domestic customers. It was widely expected that PESs would maintain their effective monopoly over domestic supply for the foreseeable future. Customer protection would therefore need to be secured by a regime which gave special duties and powers to PESs.
- 6.18 The present prospect is very different from this. Whilst PESs are expected initially to be dominant in their own areas they will not be the only major suppliers at domestic level. Second tier suppliers, including PESs acting outside their own areas and non-PES suppliers, such as Centrica, have plans to supply what, in aggregate, amount to several million customers. The potential for significant numbers of customers switching supplier has been demonstrated in both the telecoms and gas industries. Within a short period some second tier suppliers could supply as many designated customers as some PESs in their own areas. This has already occurred in the above 100kW market.
- 6.19 The new licensing regime for electricity suppliers reflects this changing situation as far as is possible under the present Act. Under the modified licences all suppliers have a duty to supply designated customers on request. This is equivalent to the supply business element of the duty placed on PESs under the Act. The licences also provide for the same general provisions with respect to customer protection. All suppliers must agree codes of practice concerning disadvantaged customers and must comply with the same requirements on the terms of contracts with designated customers.
- 6.20 This does not mean however that all obligations and powers of PESs and second tier suppliers are identical. First, PESs are subject to additional licence conditions covering price control and non-discrimination provisions. These will be necessary for so long as the PESs remain dominant suppliers in their own areas. It would be sensible for such matters to continue to be dealt with under licence conditions rather than under a more detailed Electricity Act. This would provide the Regulator with the necessary flexibility to respond to circumstances, to impose new requirements when needed and, as importantly, to relax requirements as competition increases.

- 6.21 Second, the Act makes various additional powers available to PESs that are not provided to second tier suppliers. These include powers to disconnect supplies and recover charges. The Act also makes special provision for PESs but not second-tier suppliers in relation to a number of other areas including: customer performance standards, complaint handling and the power of the regulator to determine disputes. PESs also have special obligations with respect to the non-fossil fuel requirement.
- 6.22 This statutory distinction between suppliers seems inappropriate in a competitive market. Placing all suppliers on the same basis would ensure that customers could be protected whichever supplier they chose. It would not confer any special status or implied approval on any one category of supplier as is at present the case. Providing a common legal framework for all suppliers would also facilitate competition by increasing customer confidence in the protection available and by ensuring no supplier had powers not available to others or could avoid obligations appropriate to its circumstances.
- 6.23 New legislation should recognise the prospective development of the supply market. Detailed statutory provisions on the terms of supply may restrict beneficial market developments such as the joint sale of electricity and gas. As the market moves towards effective competition increasing reliance should be placed on general consumer law to protect customer interests. Where appropriate the Regulator can also make use of powers under competition legislation in accordance with the Concordat with OFT. During the transition to competition however the licence regime can be used to reinforce statutory provisions. An example of this is the new condition on marketing practices. Licences can also provide for flexibility to reflect the changing commercial position of suppliers, moving from monopoly through a period of diminishing market power to a fully competitive environment.
- 6.24 Accordingly, with provision made for the licensing of distribution, it would seem desirable to abolish the present concepts of Public Electricity Supplier and private electricity supplier under the legislation and instead place all suppliers on a common legislative footing.
- 6.25 One area of potential concern in such circumstances is whether all customers could be assured of obtaining a supply on reasonable terms. At present, this is dealt with by a statutory duty on PESs to supply on request (effectively combining distribution and supply obligations) and a licence requirement on second tier suppliers to supply designated customers on request. The separation of PES supply and distribution functions means that the present provisions need to be reassessed.

- 6.26 As noted previously, it would be sensible to provide for a duty on each PED to connect any person requesting a connection to the system on reasonable terms and to maintain that connection. With such a connection to the network assured it would be for the customer to arrange a supply from their chosen supplier.
- 6.27 In a fully competitive market safeguards to require suppliers to offer supplies should not be necessary: it will be in the interests of suppliers to supply all customers with electricity as is the case with other goods and services. During the transition to a competitive market however the duty to supply provides a valuable assurance to customers. This developing picture is reflected in present arrangements. For larger customers no special provisions are made in respect of supply from second tier suppliers, although PESs retain a formal duty to supply in their own area. In practice customers have not found it difficult to attract suppliers to offer them attractive terms for supply. Over 40 per cent of over 100kW customers now take second tier supply in England and Wales. Specific obligations on suppliers to supply in this market seem unnecessary.
- 6.28 Similar arguments apply to non-designated customers under 100kW. The position may be different in the case of designated customers. All suppliers are under a duty to supply these customers. The present licence provisions on second tier suppliers require that where a designated customer requests a supply from a supplier that supplier will provide a supply. PESs are obliged to supply these customers by virtue of their duty under the Act to supply. These provisions means that no designated customer need be without supply. Over time the form and scope of this safeguard may need to change. Allied to the publication of prices by all suppliers and to price restraints and non-discrimination provisions on dominant suppliers, it means that all groups of designated customers can be assured of access to supply on reasonable terms. It would seem appropriate therefore for a licence obligation to supply, along the lines of the present obligation on second tier licensees, to be included in all supply licences. The inclusion of these obligations under licence conditions would mean that the present PES duty to supply would be unnecessary and could be removed.

Tariffs and Contracts

- 6.29 Under the terms of the present Act PESs within their own area are able in most cases to decide whether to supply customers on tariff or contract terms.¹⁷ The provision of the Act pre-supposed that contracts would only be used by PESs in the case of the largest customers or in special circumstances. In practice, however, contracts now apply generally in the above 100kW market. Although at present the overwhelming majority of smaller customers continue to be supplied on tariffs, some PESs are proposing contracts for domestic customers within their own area. Second tier suppliers by contrast must agree contracts with their

¹⁷The Act requires PESs to offer contracts to all customers with a maximum demand of 1 OMW or more.

customers and are unable to supply on tariff terms. This distinction has given rise to particular difficulties in designing the legal framework for supply competition.

- 6.30 Tariff supply has significant legal advantages for the supplier over supply on contract. The terms of the tariff are as set out by the PES subject to certain rights and obligations of the PES and of the tariff customer being provided for under the Act or subject to determination by OFFER. Customers enter a tariff supply by requesting the PES to supply them. The precise terms the customer is expected to follow do not have to be provided to the individual customer as is the case with contracts but must be published. In practice, PESs have taken these various statutory provisions to demonstrate that a tariff relationship is established whenever one owner or occupier of any premises in their area uses electricity, regardless of whether this person has been in discussion with the PES. The position in respect of supply on contract terms in such circumstances is more complex and some second tier suppliers have expressed concern about the position where supply is taken without a clear contract being agreed between supplier and customer.
- 6.31 The concept of tariff supply was established in the last century and has changed little since then. It assumed that companies have a supply monopoly in an area. Since tariff supply was established the monopoly has been removed and the general law of consumer protection has provided consumers with significant rights in relation to contracts. However, these new rights do not also apply to tariffs. This means, for instance, that PESs supplying on tariff are not subject to the regulations governing doorstep selling or those concerning unfair contract terms. It would be preferable if these general rules of law applied to all suppliers so as to benefit all electricity consumers.
- 6.32 Contacts are the normal means of reaching legal agreements between suppliers and customers elsewhere in the economy. In other utilities, including telecoms, supply is made on contract terms. In the gas industry all supplies are now made on contract and the concept of tariff supply has been abolished. Special provisions have been made to deal with circumstances where new customers have not made contact with the supplier and other cases where the contractual position may be uncertain. This provision for “deemed contracts” is a useful addition to legislation as it helps resolve the present uncertain legal position about a customer’s responsibility for electricity supplies.
- 6.33 The retention of tariff supply in electricity is therefore increasingly anachronistic. With greater emphasis being placed on dual fuel arrangements in the competitive market, customers and suppliers would find it unhelpful if gas and electricity were supplied on a different bases, especially if that supply is by the same supplier. Customers are unlikely to appreciate the different rules applying to tariff and contractual supply. PESs themselves may not wish to supply all customers on tariff whether they want to sell both gas and electricity to certain customers under

a single agreement. The requirement to maintain tariff supply options is likely to create a confusing picture in future which does not encourage customers to shop around in the competitive market.

- 6.34 A requirement for equal treatment, in this as in other matters, is found in the European Directive on the internal market in electricity¹⁸. Under that Directive member states of the European Union are required not to discriminate between electricity undertakings as regards either rights or obligations.¹⁹ The maintenance of a right for some suppliers to supply on tariff would therefore require justification.
- 6.35 It therefore seems appropriate to adopt a similar approach to that in the gas industry and treat all suppliers and customers equally by abolishing the concept of tariff supply. As in the case of gas, legislation would be required to deem all existing tariff supplies to be supplies under standard forms of contract. This would not in practice disrupt existing arrangements with customers, but would serve to clarify the legal rights of customers and the obligations of suppliers.

Metering Services

- 6.36 The section on metering services noted that it would be desirable to provide for metering services functions to be undertaken by a range of parties including both distributors and suppliers. This suggests that conditions in supply and distribution licences would be designed to ensure that competition in supply and generation was not restricted or distorted. Where service providers were dominant in any market there would need to be provision for price control and related provisions. There may also be a need for customer protection requirements for example to ensure that meter readers acted appropriately when visiting customer premises and to provide special facilities for disabled customers. Service standards with respect to metering would however continue to be primarily a matter for the supplier and any minimum service requirement would be placed on suppliers.
- 6.37 To facilitate third party providers it would be desirable to reform the legislation to provide for suppliers and distributors to have transferred to them many of the special rights and powers related to metering presently given to PESs. This might include powers to take action in cases of meter interference and powers of entry where necessary to maintain and install meters, and disconnect suppliers. Licensees would also have obligations to maintain meters in proper order.

¹⁸ Directive 96/92/EC.

¹⁹ Article 3(1).

Conclusions

- 6.38 This section has identified a number of areas where reform of the electricity legislation would be desirable to reflect changing conditions in the sector; to maintain effective customer protection and to promote competition in supply and metering services. The changes would also facilitate such further restructuring as is conducive to the interests of customers, greater efficiency, and more effective competition,
- 6.39 Changes proposed in this section include the introduction of licences for distributors with new statutory duties to connect customers and general duties for efficiency and to facilitate competition. Other proposals include abolishing the present concept of Public Electricity Supplier and placing all suppliers on the same legislative footing. It would seem desirable for an obligation on suppliers to supply on request to be retained under licence conditions in respect of designated customers. The legal bases of supply should be brought up to date by removing the concept of tariff supply and ensuring that all supply is made under appropriate contractual terms.
- 6.40 The proposed reforms would provide for greater convergence between the electricity and gas regimes. This would assist suppliers, metering service providers and others active in both markets. It would also help harmonise the legal frameworks for the two industries. The Government recognises that this will be necessary to facilitate the work of the new energy regulator. Without such reform there could be a distortion in the energy market, restricting the degree of beneficial convergence that could be achieved and limiting the effectiveness of regulation.

7. OVERVIEW OF PROPOSALS AND NEXT STEPS

- 7.1 The preceding sections have set out general principles and detailed proposals for the greater separation of distribution and supply and the reform of metering services arrangements. This section brings together the various proposals to describe the overall approach being proposed and to summarise the envisaged future functions of supply and distribution.
- 7.2 The background to these reforms is the principle of greater separation between monopoly and competitive activities. There have been related developments in the gas market as well as in electricity, including an unambiguous MMC Report on separation of activities. Increasing convergence between the two markets and the desirability of facilitating competition and the importance of effective customer protection all point to the need for greater separation of monopoly activities and competitive activities, particular of distribution and supply. This paper argues that full separation of ownership of the supply and distribution businesses would be desirable. In the interim, it would be desirable to establish arrangements appropriate for separate companies for distribution and supply, each operating wholly independently of the other and capable of being under separate ownership. This would include placing distribution and supply activities in separate subsidiaries. It would also seem appropriate to institute a range of further measures to ensure that the PES supply and distribution subsidiary operated at arms length from the distribution subsidiary, therefore reflecting the arrangements that other suppliers would have with the distribution business.
- 7.3 The effect of these measures would be to ensure that distribution businesses acted separately from all supply interests. This would be achieved by: ensuring use of system contracts were established between the distribution business and the PES supplier; avoiding the sharing of facilities between the businesses, including restricting staff transfers between businesses; ensuring that staff have responsibilities within the scope of one business only; requiring separate management teams for the two businesses; and minimising the scope of any corporate headquarters activities. In addition, the paper proposes that each subsidiary should operate its own IT and call centre facilities with steps taken to ensure that distributors have sufficient call centre capacity to deal with enquiries in the event of major power cuts. Each business would also develop its own distinct branding and customer communications.

Distribution

- 7.4 The distribution company would be responsible for the maintenance and operation of the distribution network. It would be under a statutory duty to develop and maintain an efficient, co-ordinated and economical system of electricity distribution and to facilitate competition in generation and supply. It would be

obliged to connect any person to the network on reasonable terms, although third parties could undertake connection work if the customer wished.

- 7.5 The distribution business would ensure that a meter reading service of last resort was provided for those suppliers who did not wish to provide the service themselves. This service would be bought in by the distributor from meter reading service companies. Similarly, the distributor would ensure that a regulated meter operation service was provided. Again this might be provided by third party providers or undertaken by the distribution business itself.
- 7.6 The distributor's charges would be structured so that a supplier could choose whether to take any of these regulated metering services or to provide either or both itself. Where the distributor had metering service activities these would be kept within a separate business for licence and regulatory accounting purposes. Price controls would need to be maintained over the provision of these services whilst the provider remained dominant in any area.

Supply

- 7.7 Replacing the present distinctions between PESs and sector tier suppliers, all suppliers would be placed on the same legislative footing. Tariff supply would be replaced by supply under contract. The licence would provide for any designated customer requesting a supply to be supplied on published terms. Additional provisions would be required in the case of the supply businesses of the present PESs given their dominant position in their own area to protect customers and competitors. These provisions will include non-discrimination provisions.
- 7.8 Suppliers would be responsible for the provision of metering services for customers. They could choose to provide those services themselves, obtain a service from an independent metering services provider or make use of the regulated services provided with distribution services.

Metering Services

- 7.9 Metering services would be open to competition. A range of metering services providers, including independent providers, would compete to offer services to suppliers. This would include prepayment meter services. Safeguards would be put in place to ensure providers of metering services did not distort competition.

Scotland

- 7.10 The Scottish transmission businesses, including the interconnector, would be brought into line with NGC in England and Wales. They would be put into separate legal subsidiaries, with associated separation of staff and activities, and

ultimately into separate ownership. They would have statutory duties to facilitate competition in generation and supply. Separation of distribution and supply would be taken forward in parallel to consideration of the PES structures in England and Wales.

Impact of Proposals on PESs

- 7.11 The proposals set out in this paper place significant new requirements on PESs. To adhere to these requirements may involve PESs in some restructuring of their internal arrangements. Many PESs have already taken steps along the lines of these proposals to provide for greater separation. Those PESs which have planned ahead will need to make fewer changes. Several PESs have actively discussed with OFFER the possibility of separation as part of a joint venture or other merger proposal.
- 7.12 Accordingly, any additional costs of making these reforms cannot be estimated with confidence at present and may vary between PESs. In any event, any such costs need to be assessed in the context of the potential improvements in management control and efficiency and the scope for increase in shareholder value which might be realised by the possibility of demerging businesses and of potential merger and acquisition activity.

Timetable and Next Steps

- 7.13 The proposals set out in the paper represent a major programme of work to be undertaken as part of the PES Reviews. Some PESs argued that reforms should be delayed so as to avoid conflicting with the timetable for introducing competition in supply. Certainly the successful introduction of 1998 arrangements needs to be accorded a high priority. Customers and suppliers are looking to the PESs to ensure that new systems work well. However, the logistical and technical challenge of implementing new systems is now nearing completion.
- 7.14 Moreover, the arrangements being made to facilitate competition in 1998 also provide a firm foundation for work on the separation of activities. Trading arrangements and industry design have been prefaced on the need for competition in metering services. The commercial and regulatory arrangements also reflect this and provide for greater separation of these activities from distribution. Plans are already in place for the introduction of competition in metering in 2000.
- 7.15 In addition to its significance for competition the reform of PES arrangements proposed in this paper also has a direct significance for price control arrangements. Work in the Reviews needs to be taken forward to a timetable which allows the revised definitions of distribution, supply and metering responsibilities to be taken into account in setting price controls and revising charging arrangements for 2000. This preparatory work need not disrupt the introduction of competition in supply

and detailed implementation of the proposals can be informed by the experience of competition for domestic customers.

7.16 Accordingly it is sensible to proceed with developing and implementing these proposals as soon as practicable. The precise timetable will be influenced by Government decisions on the timing of any relevant legislation. However, the pace of work will need to be maintained for price control purposes.

7.17 Having considered the comments received on the timetable proposed in the February consultation paper and having taken account of the implications of the Government's Green Paper, OFFER proposes to work to the following timetable in the next stages of the review.

1998

May Consultation papers on key issues for price control reviews covering distribution, metering and supply; transmission price control in Scotland; and quality of supply standards.

June Business plan questionnaires sent to PESs, covering distribution, metering and supply and transmission in Scotland.

Consultation paper on regulatory accounts.

July Further consultation on separation of businesses.

September Outline proposals on separation of businesses.

PESs return business plan questionnaires.

7.18 In assessing the responses to this paper OFFER will consider how best to conduct further consultation during July on the issues raised. Work will also need to take account of the Government's timetable for developing proposals and other developments in the market. The objective however is for the way forward on separation of businesses to be agreed in sufficient detail to inform the consultation paper on the key issues relating to the revised price controls, which is scheduled for Spring 1999.

ANNEX

LIST OF RESPONDENTS TO THE “REVIEWS OF PUBLIC ELECTRICITY SUPPLIERS TO 1998 TO 2000” CONSULTATION PAPER, FEBRUARY 1998

1 **Public Electricity Suppliers**

East Midlands Electricity
Eastern Electricity
London Electricity
Manweb
Midlands Electricity
Northern Electric
Norweb
Scottish Hydro-Electric
ScottishPower
Seeboard
Southern Electric
Southern Western Electric
SWALEC
Yorkshire Electricity

2 **Electricity Consumers’ Committees**

East Midlands ECC
Eastern ECC
Midlands ECC
North West ECC
South Wales ECC
South West ECC
Yorkshire ECC

3 **Other Respondents**

British Gas
CBI
Coalfield Communities Campaign - Yorkshire
Centre for Utility Consumer Law, University of Hull
Consumers Association
Dundee City Council
Electricity Association
Energy Savings Trust
Enron
Findhorn
First Hydro
IVO Energy

Nuclear Electric
Powermet Ltd
Quadrant Consultants
Royal National Institute for the Blind
Scottish Electricity Settlements
Unison Energy