

Reference



Maxine Frerk  
Director  
Office of Gas and Electricity Markets  
9 Millbank  
London  
SW1P 3GE

Date

22 August 2003

Dear Maxine,

### **Electricity distribution price control review: metering issues: July 2003**

Thank you for the opportunity to comment on the above paper. We are responding on behalf of EDF Energy. EDF Energy has significant interests in gas and electricity supply, electricity generation and owns the three electricity distribution businesses serving London, East Anglia and the south of England:

EDF Energy Networks (LPN) plc (formally London Power Networks plc)  
EDF Energy Networks (EPN) plc (formally EPN Distribution plc)  
EDF Energy Networks (SPN) plc, (formally Seeboard Power Networks plc)

#### **Summary of impact assessment**

Ofgem wants to bring competition into metering ownership (MAP) and operation (MOP). However, Ofgem appears to have overlooked the need to check how competition would work if other companies entered the metering business. Given the doubts about the feasibility or value of competition in metering explained below, it is perhaps unwise of Ofgem to try to skip the need for a separate Regulatory Impact Assessment (p1.3). Indeed, as we have been recommending for some time, Ofgem should carry out a regulatory impact assessment of its entire competition in metering policy suite before proceeding any further.

#### **Barriers to entry**

Ofgem notes (p6.29) that "The barriers to entry are higher in MAP than they are in MOP due to the fact that the DNOs have these assets already in place and they are not due for replacement for some time." Because of these barriers to

**Atlantic House  
Henson Road  
Three Bridges  
Crawley  
West Sussex  
RH10 1QQ**

entry, Ofgem believes that competition will not develop immediately and that therefore the DNOs should be regulated for some time. However, the barriers to entry listed (p6.29) will apply equally to any meters actually put in place by new entrants. Hence, if Ofgem thinks these barriers make it necessary to regulate DNOs, it must also be necessary to regulate new entrants. This conclusion does not bode well for competition to work efficiently or in consumers' interests.

We believe that a new supplier could fit a new meter as a way of entrenching its hold over the customer. Unless Ofgem regulates the terms of access to and charge for this new meter, the supplier could use its ownership of the meter as a barrier to discourage the customer from switching supplier, or to discourage other meter operators from taking over the meter. In practice, Ofgem is in danger of creating, not competition, but millions of tiny natural monopolies.

Ofgem has encountered similar problems as a consequence of Ofgas's desire to promote competition in gas connections. Instead of creating a competitive market in "connection services", this policy created 150 or so "independent gas transporters", each of which Ofgem now has to regulate. Ofgem's latest policy is to set prices for these connections by reference to Transco's charges for similar facilities and services. This policy has not, therefore, created competition, nor has it captured any benefits of competition in the construction of connections that could not have been captured by putting construction of new connections out to tender, or by adopting new connections after their construction by others.

Similar problems are likely to arise with metering, unless Ofgem sets down now the conditions under which future meter owners will be required to make their meters available to others. In fact, the definition of such terms would be no more than is necessary to define the future (regulatory, rather than competitive) basis of metering asset provision.

The scope of any separate metering control should be determined by the extent to which competition is unlikely to encourage efficient choices by suppliers and consumers. This can only be determined by understanding how meters provided by suppliers will be regulated, i.e. if a price control is needed to protect consumers from incumbent meter providers, it will equally be needed to protect consumers from new entrants, once they become incumbents, because the extent of their market power in relation to the consumer concerned will be the same. Ofgem needs to determine an enduring regime for protecting consumers, in order to ensure that the commitment to "competition" does not simply produce a number of inefficiently priced monopolies. Given the predictability and frequency of the problem, simple reliance on the Competition Act is unlikely to be sufficient. At the very least, meter providers should carry an obligation to make their facilities available to other suppliers on reasonable terms. Ofgem may even want to consider setting down guidelines in advance which determine what terms would be reasonable.

To impose any such conditions, Ofgem should limit meter provision to companies holding a supply licence, with derogations to minimise the impact of irrelevant conditions. Alternatively, Ofgem may be able to use the supply

licence to ensure that suppliers appoint meter providers subject to certain contractual conditions on access terms for other suppliers. Large customers who appoint their own meter providers can negotiate their own access terms. Such clarity about future obligations will help to facilitate competition, protect consumers and avoid disputes.

Relatively few economic barriers would seem to exist in the MOP market as this activity involves short-term “pay-as-you-go” transactions between service provider and customer. Indeed, competition is already developing in this market and is expected to continue. Subjecting MOP activity to a price control would seem to be unnecessary even now. However, if Ofgem decides to retain some form of price control, it would be beneficial for competition and customers if Ofgem set out a timetable for future reviews of the control (or, alternatively, the competitive conditions in which Ofgem would remove such controls).

### **Value of meters**

The scope of the costs potentially subject to stranding will be determined by the scope of any new control (see below).

Ofgem is aware of the need to avoid stranding meter asset values by exposing them to competition at too high a value (p4.18) and is to be praised for making explicit this requirement of regulation. Ofgem has suggested that valuing meters at depreciated replacement cost (DRC) will avoid such problems, and we would support such an approach. However, the application of the DRC method must take into account a number of real world factors, in order to meet regulatory requirements.

Ofgem recognises that the *gross* replacement costs of electricity meters are considerably lower than the (inflated) historical cost at which they were acquired. This decline in real values represents technical progress, which is likely to continue. To avoid overvaluing meter assets against replacements (and so causing them to be stranded), the rate of depreciation should reflect this rate of technical progress, as well as the general rate of capital consumption.

Any meter, including those being fitted today, depreciates in value at a rate which depends on a number of factors:

- Time (which sets the standard straight-line depreciation);
- Operating costs rising/falling (which requires depreciation to accelerate/decelerate to keep total annual costs comparable with the annual costs of new meters); and
- Continuing technical progress (which accelerates depreciation by, e.g. 1% per annum, to reflect both past declines in the real cost of a meter and anticipated technical progress that will reduce the real cost of a meter in the future.)

Since the second and third of these factors both dictate that depreciation of meter assets should be accelerated (rather than slowed), the depreciated replacement cost of meter assets should use a form of accelerated

depreciation, not straight-line depreciation. Possible methods include “tilting” (higher rates in earlier years), “reducing balance”, or an explicit annual rate of depreciation for technical progress (on top of straight-line depreciation).

The aim in adopting such methods is to estimate a fair market value for meter assets that are about to enter the competitive arena. Differences between this value and a notional RAB value do not indicate any form of inconsistency, but merely the potential for stranding which Ofgem seems keen to avoid.

## **Market structure**

The proposed structure for competitive metering markets is for:

- Meter Asset Providers (“MAP”) – a service providing metering assets; and
- Meter Operation (“MOP”) – covering the installation of meters, and subsequent repair and maintenance.

Going forward, MAP charges will not include installation costs as these will be within the MOP activity. Any DNO metering price control will need to reflect this, i.e. a MAP price control should not include historic or future installation costs as attempts by DNOs to recover installation costs through MAP chargers would distort competition in the MAP market, whilst attempts to price DNO meter assets competitively would hinder recovery of the DNOs’ installation costs. A solution to this problem is to retain historic meter installation costs within the distribution price control. Over time, the quantum of such costs would reduce as they are depreciated away.

## **Risks and costs**

In the past, DNOs have invested in meters and Ofgem has awarded a rate of return determined by a “low risk” cost of capital. This cost of capital will only be sufficient to attract capital for investment, if the DNO business is demonstrably low risk. However, Ofgem’s plan to separate out the metering business and to expose it to competition expressly creates the risk of asset stranding, which would mean that past investments were not in fact low risk. Such an outcome for past investment would undermine claims that future investment in the distribution business is low risk and merits a low risk cost of capital. Since Ofgem wishes to encourage investment in DG connections and the quality of supply, it is necessary to find a way around this potential “time-inconsistency” in regulatory policy:

- Either Ofgem can minimise the risk (by allowing DNOs to recover the meters’ asset value without any risk of stranding\*, as anticipated by the award of a low risk cost of capital); or else
- Ofgem can provide proper compensation for the risk that any DNO investment will become stranded in the future, by raising the allowed rate of return.

We discussed above how Ofgem can minimise the potential for stranding meter assets by calculating the DRC using accelerated depreciation. However, even this approach exposes the business to the risk that some meter assets will be stranded (eg, if technical progress proceeds faster than expected in future.) Hence, the potential for competition will expose DNOs to risk. In order to avoid the need to raise the allowed cost of capital, Ofgem might all DNOs either:

- to retain potentially “strandable” costs within the distribution price control; or
- to recover outstanding meter asset values through termination payments (as in many competitive contracts).

In either case, the decision of a customer to switch to another meter provider would expose the DNO to no additional risk, above that for which past revenue allowances have provided due compensation. Without such a scheme, however, DNOs will have to take into account the potential risk of stranding for future investments and a “low risk” cost of capital will no longer be sufficient to encourage investment.

### **Cost shocks**

We explain the need for robust and enforceable price control mechanisms to deal with external cost shocks in our response to Ofgem’s June 2003 paper on developing network monopoly price controls. These arguments are equally relevant to any metering price controls (for example, to address any unforeseen increases to meter prices).

### **DNO proposal**

Ofgem notes (p4.12), the DNO’s proposal lacks any safeguard against cross subsidies from the distribution charges. However, Ofgem does not take care to define cross subsidies in this context. Given the competition from new meters, Ofgem should encourage any meter pricing policy that ensures suppliers and customers make efficient choices. In this context, that means that meter charges should be allowed to fall to any level sufficient to cover the avoidable cost of keeping the meter in operation (The DNO can set meter charges higher than that, but risks the asset being stranded if its meter charge is higher than the net cost of fitting a new meter.) Since avoidable costs of meter ownership tend to be very low, the DNOs may well need to rely on distribution charges to recover fixed and sunk costs of meters. Such an outcome is efficient and should not therefore count as a “cross-subsidy”. It is also consistent with Ofgem’s designation of the DNOs as “low risk”.

Ofgem may fear that DNOs might go further than this rule implies, and set meter charges *below* avoidable costs. Such a pricing strategy might be contrary to competition policy, which defines predatory pricing in terms of prices set below “average variable cost”. However, if Ofgem wants to ensure that DNOs don’t engage in “predatory pricing” by setting prices below avoidable cost, Ofgem could impose special licence conditions on the DNOs. Such licence conditions would require the DNOs to show the avoidable cost of metering in

the regulatory accounts (so that Ofgem can check that meter charges at least cover them).

Indeed, if Ofgem is concerned that the DNOs engage in different pricing strategies for metering (see table 1 on page 13), Ofgem has only to define the costs that each DNO should allocate to its metering charges. Even detailed accounting guidelines might prove less costly to introduce than competition in metering.

## **Conclusion**

Having embarked on a policy of developing metering competition, Ofgem should address how it is to protect consumers in the face of potential abuse from suppliers or meter providers. The answer to this question will then be the answer as to how to regulate the DNO's metering services. In this context, it is difficult to comment on the scope of a potential price control since it is not obvious that such a control could be applied to other (unlicensed) meter providers. Indeed, in these circumstances it may be more practicable for Ofgem to protect consumer interests by limiting meter provision to operators holding a supply licence, to provide a means to imposing obligations in addition to using its powers under the Competition Act.

If you have any queries or comments on this response, please call me on 01293 509373.

Yours sincerely

Paul Delamare  
Head of Price Control  
EDF Energy Networks Branch