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Dear Maxine

Electricity Distribution Price Control Review – Metering Issues.

Ofgem have invited views on the above document and I am pleased to attach our response.

In our view, there is already evidence that competition in metering is established. One major supplier is already going through the process of de-appointing the host DNO as meter operator (and as meter provider when the meter is replaced). Other suppliers are believed to be considering doing likewise and there are no remaining barriers to suppliers taking that choice.

Against this background, we see no compelling reason to continue with any price control regulation of metering. The DNOs nonetheless recently put forward a proposal to Ofgem that would involve retaining the residual protection of the current price control. Under this approach, the cost of *existing* meters on circuit could be recovered through the distribution price control, as is the case now. New meters would be supplied under normal commercial terms and would not be subject to price controls. It is also important to note that following removal of price controls, customers would continue to be protected under general competition law.

We continue to believe that this is the optimum approach and we are not convinced by the arguments put forward by Ofgem for a separate metering price control. The existing metering prices of the DNOs are currently regulated by Ofgem (through the charging statements) and Ofgem have put forward no specific evidence that those charges contain a cross-subsidy. In any event, if such evidence existed, Ofgem have sufficient powers to address any cross-subsidy through approval of the charging statements and general competition law. We would therefore strongly urge Ofgem to reconsider the DNO's proposal to retain the exiting distribution price control for existing meters.

However, Ofgem appear to be committed to a separate price control for metering. In these circumstances, the prime concern for DNOs remains the risk of the premature replacement of viable metering assets ("stranded" assets). In our view, it is vital that

DNOs are certain of recovering these stranded costs, since the provision of metering has been undertaken in pursuit of a regulatory obligation. We have had to provide meters to suppliers at regulated prices since privatisation and hence the cost of these meters is unavoidable. DNOs must therefore be allowed to recover these costs going forward. If this is not the case, we believe that it would raise significant issues of regulatory risk going forward which will need to be reflected in the cost of capital.

Ofgem believes that its proposed approach to the valuation of assets, Depreciated Replacement Cost (DRC), and the balance between meter provision and meter installation costs will address the issue of stranded assets.

We would agree that DRC is the most appropriate of the alternative methods put forward for consideration (although we believe that since installation costs are now a transactional charge and hence no longer included in the RAV, past installation costs should not be included in the metering RAV going forward).

However, DRC does not protect DNOs from the risk of stranded assets – there is still considerable risk that we would not be able to recover these costs. As a consequence, we are firmly opposed to the transfer of any metering value from the current distribution business RAV in respect of historic investments made to satisfy regulatory requirements.

We have provided our more detailed comments in the attachment. I hope that you find these helpful and we would be pleased to discuss any of the views expressed. In the meantime, we look forward to continuing to play an active and constructive part in the ongoing work on the price control review.

Yours sincerely

Rob McDonald
Director of Regulation

Electricity Distribution Price Control Review – Metering Issues

Response by Scottish and Southern Energy plc

Policy Considerations For Evaluating Metering Price Controls

It is clear that the Authority's duty to allow licence holders to efficiently finance their activities should be a vital consideration. This will be particularly relevant to the valuation of the metering RAV. We firmly believe that the introduction of competition should not prevent DNOs from recovering the costs of meters already on circuit and installed under the licence requirement.

As a consequence, we would consider it unacceptable if DNOs were retrospectively prevented from recovering such legitimately incurred costs. We believe that this would raise significant issues of regulatory risk going forward that would need to be reflected in the cost of capital. We also believe that exposing DNOs to the risk of stranded assets would be inconsistent with Ofgem's duty to ensure that licensees can finance their functions.

We also note Ofgem's view that it is important to reduce the cost of metering to consumers. Table 1 of the consultation paper shows the variation in current metering prices. From this, Ofgem seem to draw the conclusion that metering charges could increase as a result of separation of the price control, in as far as they are not cost reflective, but that the total metering and distribution charge should not increase.

This implies that Ofgem's view is that metering charges are already low and may be artificially low due to possible cross-subsidy. However, provided that a DNO is pricing on the basis of the current market price of a modern equivalent asset, then there is no cross-subsidy. Indeed, Ofgem's guidance on metering charges is to this effect, and the variation in charges is more likely to be due to differences in the services included in the price. In any event, these figures suggest that metering competition will not deliver significant reduced costs to consumers and certainly do not provide any justification for separate metering price controls.

Metering Controls

Ofgem put forward a number of points rejecting the DNO's proposal in favour of separate price controls on metering. We comment on each of these in turn below.

(i) Ofgem consider that some form of price control will be necessary until sufficient competition exists, and that a price control must be flexible to the loss of market share. The current price control arrangements achieve this. In particular, the DNO's proposal would address this by retaining the price control for existing meters in circuit with new meters not subject to formal price regulation. This would achieve an appropriate balance between price control arrangements that reflect changing market share without exposing DNOs to the risk of stranded assets.

(ii) Another justification for a separate control put forward by Ofgem is the perceived scope for DNOs to cross-subsidise to/from distribution charges and to ensure charges are cost-reflective. As explained above, we do not believe that the data supports this assertion. In particular, we would expect Ofgem to put forward robust evidence that metering prices are cross-subsidised before embarking on more detailed price control regulation. Moreover, Ofgem already have sufficient powers to deal with any cross-subsidy through approval of the charging statements and the generality of competition law.

(iii) Ofgem further justify separate controls because they can be removed when sufficient competition exists. However, the DNO proposal satisfies this criteria by flagging up to the market that the provision of new meters will be removed from regulation on 1 April 2005.

(iv) Ofgem also note that separate controls would facilitate DNOs selling their metering businesses. As above, we believe that the DNO's proposal achieves this by giving certainty going forward on the regulatory treatment of metering and therefore enabling businesses to be valued. More fundamentally, we see no justification for "tinkering" with the regulatory regime to anticipate events which may or may not occur and which in any event could be dealt with at that time through Ofgem's existing powers.

(v) We would firmly reject the suggestion that the DNO's proposal would protect all existing meters from competition. Under the DNO's proposals suppliers would still be free to appoint their meter operator of choice. Competition would not therefore be inhibited, but DNOs would (rightly) be protected from the regulatory risk of stranded costs which were incurred in compliance with a regulatory obligation.

(vi) Ofgem also claim that the DNO's proposal would not result in a change in workload in the price review. We would disagree. Indeed, it is apparent that Ofgem's work to separate the metering RAV and cost base is a substantial project as evidenced by the scale of information requested in the business plan questionnaire. We therefore believe that retaining the existing distribution price control would remove a significant uncertainty for DNOs and would also considerably reduce the workload in the price review, the timetable for which already looks challenging.

For these reasons, we would strongly urge Ofgem to reconsider the DNO's proposal to retain the exiting distribution price control for existing meters.

<u>Valuation of Metering Assets</u>

Our general views on separate price metering controls notwithstanding, we would agree that Depreciated Historic Cost (DHC) does not protect DNOs against stranding of assets. We also agree that it would not be appropriate to use the approach to the valuation of Transco's assets (on a DHC basis) as a precedent, particularly bearing in mind that the number of companies and their different depreciation histories will cast doubt on the comparability of the numbers.

Ofgem appear to be committed to a separate price control for metering. In these circumstances, the prime concern for DNOs remains the risk of the premature replacement of viable metering assets ("stranded" assets). Ofgem believe that its proposed approach to the valuation of assets, Depreciated Replacement Cost (DRC), and the balance between meter provision and meter installation costs will make this unlikely.

We would agree that DRC is the most appropriate of the alternative methods put forward for consideration (although we believe that since installation costs are now a transactional charge and hence no longer included in the RAV, past installation costs should not be included in the metering RAV going forward).

However, DRC does not protect DNOs from the risk of stranded assets – there is still considerable risk that we would not be able to recover these costs. As a consequence, we are firmly opposed to the transfer of any metering value from the current distribution business RAV in respect of historic investments made to satisfy regulatory requirements.

Structure of Price Control

In considering the structure of any separate price control and the scope in particular, our view is that there is already evidence that competition in metering is established. One major supplier is already going through the process of de-appointing the host DNO as meter operator (and as meter provider when the meter is replaced). Other suppliers are believed to be considering doing likewise and there are no remaining barriers to suppliers taking that choice.

Against this background, we would agree that multiple controls (each covering a different aspect of metering activity) are preferable to a single overall price control as they can be removed from different activities when it is deemed appropriate to do so, given the development of competition.

Multiple price controls would also be better suited to the particular issue of prepayment meters and recovery of the additional costs. In this regard, the opportunity should be taken in any re-balancing between metering and distribution charges to be consistent across all of the DNOs. As part of that, particular consideration will need to be given to Scottish Hydro Electric Power Distribution which does not have a PPM surcharge but recovers the additional costs of prepayment metering through DUoS charges.

In considering which specific services should be price controlled, as noted above, we believe that existing meters should be retained within the current distribution price control with no price controls applying to new meters. We also support restricting the scope of price controls to the absolute minimum number of basic services.

With regard to meter provision, we see no reason to have any more price controls than domestic credit (a basic meter) and domestic pre-payment. The half-hourly metering market has been open to competition for much longer and competition is well established. We would therefore be particularly opposed to price control regulation of this part of the market.

For meter operation, we do not believe it is necessary to price control the installation charge for new meters since it is particularly easy for suppliers to contract with other parties for this services. Other meter operation costs not covered by the basic MAP and MOP service are de minimis and hence should not be price controlled.

Ofgem is concerned that it may be difficult to estimate the costs of each activity. We do not believe this is the case, particularly for the examples above. The current purchase price of meters is readily available from DNOs. We would agree that in setting the price control, commercial confidentiality will have to be maintained, but this should not be a relevant issue if the focus is on setting a cap with sufficient "headroom" to encourage new entrants into the market.