Our ref :
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22nd August 2003

Dear Maxine

Electricity Distribution Price Control – Metering Issues

This letter, together with the attached document, provides the response of East Midlands Electricity to the Ofgem consultation paper "Electricity Distribution Price Control – Metering Issues", published July 2003.

EME welcomes the paper and believes it provides a sound basis to explore the complexities of this segment of the distribution price control. Whilst we support many of the points raised, especially those relating to promotion of competition, we are of the opinion that the overall direction and thinking behind the paper may be judged contradictory and confused, arguing for both effective and open competition and, at the same time, strict regulation.

We believe that there is a misunderstanding of the market for distribution metering services, which leads the paper to erroneous conclusions. In particular there seems to be an over-emphasis on the protection of the individual consumer which, whilst important, is not the primary issue here as the customers for metering services are Suppliers who have the opportunity to acquire these services from other providers. In addition there is no recognition of the nature and extent of developing competition in the meter operations market. There have been significant changes since the introduction of the last price control; the split of MAP and MOp, the separate pricing of metering services and BGT's recent tender process which will result in a change of meter operator for up to 25% of the market in the near future. This competition is being driven by a few key suppliers, some of which are believed to be going out to tender for MOp in the near future and, as a result, it is not inconceivable that some DNOs will have lost over 90% of their current market share by 2005. In such a market environment there is little requirement for price regulation of any kind; indeed it may be more appropriate to treat MOp in the same way as Data Collection at the last Review, i.e. treat it as a supplier cost subject to normal competition law.

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We believe that Ofgem therefore should review these proposals on the basis of removing the price control for MOp and relieving the DNOs of the obligations for the provision of MOp under Condition 36 of the Distribution Licence.

With regard to the specific questions raised in the paper we would summarise our views as:

- We continue to support the DNOs' proposal discussed with Richard Ramsay;
- However, if this proposal is ultimately rejected, we believe Ofgem's proposal for valuation using depreciated replacement cost may provide an alternative way forward, subject to the exclusion of installation costs;
- the scope of price control should be limited to NHH metering and for MAP services only;
- the form of this price control could be price or revenue caps but should reflect - the competitive market, taking account of market risk, actual meter lives, un-avoidable costs and costs of on-going licence obligations; and
- the duration of the price control should be limited to a period of two years after which the extent of competition and the need for price control should be reviewed.

I look forward to discussing the views expressed in this response at your convenience. If you wish to do so or wish to seek further clarification please contact me via email or telephone, on 01332 393301.

Yours sincerely,

Paul Eveleigh
Commercial and Regulation Manager

Electricity Distribution Price Control – Metering Issues
Response by EME, 22nd August 2003

Introduction and Summary
We are concerned about the potential impact of the separation of metering and its inclusion in the overall Regulatory Impact Assessment. The allowance for metering revenues for MOp in the current price control was insufficient to cover the full costs and it has been clear, especially in those DNOs who had separated their metering businesses that these services have been significantly under-funded. This needs to be taken into account when MOp revenues are separated from the main price control from 2005. This issue is dealt with more fully in the appropriate sections below.

Background
Ofgem's premise that the legal and commercial environment provides the context that having a separate price control is justified is flawed. Certainly the background does support the view that metering should be separated from distribution price control – but it also reinforces the assertion that metering should be excluded from price control altogether.

Paragraph 2.2 contrasts the obligations for "metering services" with those for meter reading. In fact, as illustrated by Ofgem's 'Industry Guidance' document published in May 2003, the obligations for the provision of a meter and its maintenance lie with the Suppliers (unless provided by the customer). DNOs only have an obligation to publish terms for the provision of those services and provide them where requested. The Suppliers obligations in this area therefore do not differ from meter reading and as such the two should be treated similarly for price control.

Ofgem's meter strategy (2.4) [and DNO licence requirements (2.6)] has now brought about active competition for metering. Not only have Suppliers the right to change metering providers (MAP and MOp), but the market and industry structure is in place and there is competition for services put out to tender.

In paragraph 2.5 Ofgem states that separate price control would be warranted for companies in order to facilitate future divestment. Whilst this obviously would help DNOs who were considering divestment, a full removal of price control would be more beneficial. As Ofgem are aware, acquisition of meters from DNOs is the most likely way for third party providers to build-up critical mass to effectively compete in the market. Even with separate price control, any uncertainty as to the period of future price control or any misalignment between price control and the market may reduce the likelihood of divestment.

The current price cap for prepayment meters (2.12) is no longer appropriate and the need for such a control should be reviewed. Under the current split of MAP and MOp, it is the Suppliers who hold the key to the costs of prepayment metering. The ex-PES dictates the type of meter to be provided through the PPMIP (i.e. card, key etc.) and therefore the DNO may not have an opportunity to cap the additional costs of provision (it is interesting to note the prepayment meters have not been subject to the same reduction in market prices as normal credit meters). For MOp, the costs are dictated by the type and frequency of services requested by Suppliers. Much of the costs associated with prepayment MOp is due to the frequent changes of tariff and numbers of customer service visits requested by Suppliers. Some Suppliers already have reduced their requests for these services – but others will not, relying on the price cap to control their costs at the expense of the DNOs.

Policy considerations for evaluating metering price controls

We believe that whilst Ofgem is correct, in stating that the objective of introducing effective competition is to benefit consumers, this section confuses the customers of metering services (Suppliers) with the end consumer. DNOs do have policies to meet the Act's requirements with regard to specified categories of individuals; however it is the Supplier's responsibility to meet these requirements in regard to metering. They may do this through competitive tendering or, if they believe that a DNO's terms for provision of metering services are unfair they have the right to appeal to the Authority under SLC 36 of the Distribution Licence.

The paper states that "competition can be expected to deliver increased value for money, improved standards of service and greater choice" (3.3), yet in paragraph 3.8 it states that "In the absence of effective competition, price controls should therefore be designed to create incentives for increased efficiency". It appears that Ofgem has created the competitive environment but still wishes to retain control over it. There are definitely the elements for effective competition in place; the ability to compete, the market framework and actual competition already underway. If Ofgem place price controls on an emerging market, it can at best be ineffective, if the controls are above market prices, and at worst block competition if price controls and efficiency incentives lead to lower prices than the market can support.

The view that efficiency gains are available to all companies (3.11 and 3.12) may not be correct. Several DNOs (EME included) have long-term metering contracts with outside agencies which were negotiated at market rates during this price control. Some of these extend beyond March 2005. Costs could rise rather than fall when these contracts are renegotiated.

In a competitive market it is not necessary (and not desirable) to control market power through price control, especially where such control would only impact on certain parties within the market (ref. paragraphs 3.13 and 3.14). Not only would Suppliers seek other service providers, but the Authority would have a number of measures at its disposal should there be any abuse of market position by a DNO. These include the enforcement of standard licence condition 36 (paragraph 4) as well as the Competition Act.

The investment in and implementation of new technology (AMR etc.) will not be driven by the DNOs. Given the national presence of Suppliers and their need to differentiate service, innovation must be driven by them – or by national metering businesses working with Suppliers. Price control will not aid implementation of these technologies. Ofgem however needs to be aware that implementation of new technologies by Suppliers may accelerate meter changes leading to substantial under recovery of costs for Distribution businesses. As any meters being changed early are likely to have been investment made as a result of license obligations and in a regulatory environment where recovery of the efficient costs involved was guaranteed, Ofgem should ensure that there is protection or compensation for DNOs from such losses in the price control review.

Metering Controls

Ofgem state (paragraph 4.2) that there is a requirement for price control "to protect consumers until sufficient competition exists in the market". These services are being supplied to Suppliers and not consumers – the suppliers have an open market opportunity already to reduce costs to their consumers by tendering for these services. To date BGT, who account for up to 25% of the market have already put in place competitive contracts. Powergen have issued an Official Journal notice as a precursor to going out to tender for metering services and it is understood that at least one other Supplier may shortly be going through the same process. It is not inconceivable that in excess of 90% of the market in some regions may be under competitive contracts before April 2005. We therefore do not support Ofgem's view that "sufficient competition" will not exist by the start of the next price control.

We support the arguments put forward in paragraphs 4.4 and 4.5 with regard to the separation of metering from the distribution price control. However as stated above we do not believe that there is a need for Mop to be price controlled.

Furthermore, it is not necessary to have price control to give signals about prices (paragraph 4.6). DNOs have a licence requirement to publish terms, which would provide potential new entrants far more detail than any price control would be able to.

The assertion that separate metering price controls would facilitate DNOs selling their metering businesses is only partially correct. We agree that the identification of a metering asset value and its separation from the Distribution RAV term is an essential part of helping any DNO (and potential purchasers) in valuing the businesses. However, the retention of price control could be counter productive. Not only would any uncertainty as to the period of future price control lead to issues with valuation but also a separate price control will complicate a disposal. Many questions remain unclear, for example:

- Would the control be lifted if a DNO sells its business?
- Would the control be imposed on the buyer?
- Would the obligation to provide metering be lifted in the event of a disposal?

We are concerned that Ofgem have dismissed the proposal by the EA's Distribution Metering Group without adequately addressing the fundamental issue that the proposal sought to address. The key issue for DNOs under any future metering regulatory framework is the risk of costs being stranded. It is therefore of concern that the paper concedes that DNOs could be exposed to future stranding due to competition.

Whilst DNOs accept that any future investment made under a competitive environment without regulatory obligation should rightly be exposed to full commercial risk, past investment should not be put at risk without adequate compensation. DNOs have been required through a statutory obligation to invest not just in metering assets but in providing a capability to provide metering services either directly or through contractual arrangements with outside agencies. This investment has been made in a regulatory environment where recovery of the efficient costs involved was guaranteed either through incorporation in the RAB or an operating cost allowance in the price control.

The Ofgem proposals change the regulatory environment for past investment by not guaranteeing its recovery going forward. This significantly increases regulatory risk that this is inconsistent with normal regulatory practice where investments made in good faith in expectation of low, monopoly returns are not stranded by changes in market structure initiated by the regulatory body.

Ofgem's assertion that the DNO's concerns can be addressed by the methodology of valuation ignores the reality of the operating environment. Regardless of valuation methodology, there will be stranding. We are already aware of Suppliers looking to change meters whenever a property is visited – regardless of reason. This would impact significantly on prepayment meters where the cost of the meter is much greater than the cost of fitting and there are currently a substantial number of both customer service visits where a meter is not changed and functionality changes. With only a small loss of market share (25-30% through BGT) there could be a greater number of meters being removed from premises than could be re-used elsewhere.

We support the DNOs' proposal but, should Ofgem not accept this, it should ensure that this real risk of loss of value through stranding should be compensated through another mechanism. .

Valuation of Metering Assets
If the DNOs' proposal is ultimately not acceptable, we believe that Ofgem's proposal on the valuation of Metering Assets for the split of RAV using depreciated replacement cost may be an effective way of ensuring that the valuation place on the assets neither penalises the DNOs or distorts the future market.

The success of this method of valuation depends upon how it is applied. Depreciated Replacement Value can only provide an appropriate valuation if it is lower or equal to the future economic value of the assets.

Following the split of MAP and MAM, the future economic value of the meters is limited to the rental (or sale value) of the meter or time control device itself.

We note that the current BPQs issued by Ofgem request the cost of installation and ancillary costs to be included in the depreciated replacement valuation. However, in the current market, installation and ancillary costs will be charged for by the MAM. Replacement meter rentals will not include these costs. DNOs will therefore not be able to recover higher values for existing meters, as these would be effectively priced out of the market (hence reducing their future economic value further). This would also lead to inefficiencies in the use of assets ultimately increasing costs to the consumers.

Installation (and ancillary) costs should therefore not be included in any replacement valuation as this would lead to an overvaluation of the assets.

Structure of price control
Scope
As discussed above, we are of the opinion that the development of competition by 2005 will be such that the inclusion of MOp in the price control would be counter productive. In our comments below, we have therefore restricted our views to the scope of price control for MAP.

We concur with Ofgem's view that HH metering should not be brought into price control. There is established competition both in terms of MAP and MAM.

For NHH MAP, we consider that splitting price control between domestic and non-domestic would serve no real purpose and the costs of implementing such a split within systems and processes could exceed any benefits. Therefore, we would suggest that any form of price control should be applied to NHH meters in total.

We agree with the view that only 'basic meter' provision should be subject to price control. This should be limited to the meters and terms offered by the DNO's within the Condition 36 statements. Where any supplier requires a different metering solution, this could be provided under a separate commercial agreement if the DNO wished to tender for such services. The DNO should not be obliged to offer such additional services.

Similarly with regard to embedded generation, we believe that there may be significant benefits to be gained by implementation of more technical metering solutions (e.g. combined import / export metering). Such solutions would be better provided under separate commercial agreements.

Form
As discussed above, the impact that competition will have by April 2005 is far in excess of that considered in the consultation document. It is anticipated that at least the three largest

Suppliers will have all placed competitive contracts on a national basis by that date. This would affect over 60% of the market nationally and over 90% in some areas. Whilst the change in MAP will be driven by meter changes, MOp agent transfer will be more immediate. With competition of this extent the only appropriate option is the removal of price control for MOp. If such removal was under the guise of ex-post regulation, this may well be appropriate provided that the parameters of such regulation were well understood.

For MAP, any form of price control will need to take into account a number of issues

- Variation in expected volumes
- Market risk
- Meter life
- Potential for 'cherry-picking' by Suppliers
- Un-avoidable costs
- Licence obligations

To this extent both revenue controls and price caps have advantages and disadvantages. Price caps alone would penalise DNOs in a falling market where there are significant un-avoidable costs and on-going licence obligations. Average revenue caps additionally have a similar issue; furthermore DNO's would be at risk from cherry picking where Suppliers appoint other MAPs for cheaper meters leaving DNOs to fund more expensive meters from an average revenue cap. Ofgem will need to ensure that any form of price control will allow the DNOs to recover un-avoidable costs and be specific enough to ensure that adequate revenue can be collected if there is any form of 'cherry picking' by Suppliers.

The main issues that any such price control should address is the market risk and the actual life of the meters over which any income may be recovered i.e. any price control should reflect the pricing policy which any third party would adopt. Ofgem should ensure that any cost of capital used to calculate price controls and the depreciation period for assets fully reflect the market conditions. It should be noted that any increase in cost of capital for metering should not be at the expense of Distribution. This increase would be to reflect new risks imposed by Ofgem on metering alone and not a rebalancing of the old cost of capital position. If the price control does not reflect true market conditions price control would be set too low and this would have two effects; firstly it would prevent fair competition and secondly it would result in an under-recovery for the DNOs.

We consider that the expectation of revenue or price caps to creative incentives for DNOs to reduce costs may not be the case for MAP. As MAP is an over the counter service for meters, there is little scope for reduction in costs. The greatest cost is the purchase price of the meter itself and in a position where there is a falling demand DNOs will start to lose the benefits of scale in negotiation with manufacturers.

In terms of pre-payment metering, as stated in 2.4 above, there is an issue over the way that the current price control works. The ex-PES dictates the type of meter to be provided through the PPMIP (i.e. card, key etc.) and therefore the DNO may not have an opportunity to cap the additional costs of provision – often being limited to the acquisition of a single type of meter. The form of control for prepayment metering should take this into account. We consider that it would be appropriate in this case to have recovery based on cost pass through for the additional excluded service costs associated with prepayment.

Duration
We believe that the duration of any price control for MAP should be limited until there is sufficient competition in place. Given the pace of change in MOp and the resultant impact on MAP we do not feel it appropriate to set the price control for the full five year term. We believe that competition will have developed sufficiently within two years of the

commencement of the price control to be lifted at that stage. Therefore we would propose a review of the extent of competition and the need for price control at that time.