

PJ/SA

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Ms Maxine Frerk
OFGEM
9 Millbank
London
SW1P 3GE

Dear Ms Frerk

ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW – METERING ISSUES: INITIAL CONSULTATION

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL). The views expressed in the attached paper represent the response of CE, NEDL, and YEDL to Ofgem's publication of July 2003 *Electricity distribution price control review – metering issues: Initial consultation (the Metering consultation)*.

We welcome the opportunity to comment upon the *Metering consultation*. Based on our analysis of the current state of the metering market we consider that Ofgem's overall objective of securing competition in metering services may be closer to being achieved than is recognised in the consultation paper. Our detailed comments reflecting this are set out in the attached paper. In summary our overall conclusions are:

- no price control should be established for meter operator (MOP) activity;
- Meter asset provider (MAP) activity, aligned with the Review of Electricity Metering Arrangements (REMA) definition, can be effectively price controlled based upon the principles that govern the existing treatment of metering costs;
- any price control for MAP should be structured on the existing industry model that distinguishes between non-half hourly and half hourly meters to avoid distortion in an area of the market that is already competitive; and
- economic depreciated replacement costs should be used to value the assets.

Yours sincerely

Phil Jones
Director of System Investment

**ELECTRICITY DISTRIBUTION PRICE CONTROL
REVIEW METERING ISSUES: INITIAL
CONSULTATION**

***The response from CE Electric UK Funding Company (CE,
Northern Electric Distribution Ltd (NEDL) and Yorkshire
Electricity Distribution plc (YEDL)***

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ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW
– METERING ISSUES: INITIAL CONSULTATION

The response from CE Electric UK Funding Company (CE,) Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL)

1.1 ANALYSIS OF THE METERING MARKET

It is our view that the markets that are being considered (namely meter asset provision (MAP) and meter operator (MOP)) have fundamentally different characteristics. Within Ofgem's publication¹ these characteristics seem frequently to become blurred, leading to a confusing picture of what the appropriate course of action is for each market.

Our own internal review process on the metering market has provided us with a clear insight into the drivers for each of these markets which we have detailed below.

1.1.1 Drivers within the MAP market

In the main the requirements of servicing an asset base are the main drivers in the MAP. In the case of MAP the need to maintain certified meters at customers' premises, to replace faulty or damaged meters and to provide additions to the asset base are the key elements.

In a post-Review of Electricity Metering Arrangements (REMA) world this market has been established to consist solely of making a certified meter available. It is our view, therefore, that the only means of achieving this are through either purchase or refurbishment of meters to make them available for someone (the MOP) to call off.

In considering the opportunities for this market to open there are two clear paths available. The first of these is to accept that the market opportunity for MAP arises at the point when existing meters reach the end of their certification life (British Gas Trading (BGT) have taken this view). Based on NEDL/YEDL figures the whole asset base is re-certified roughly every 20 years – making around 100,000 meters available per licensee available to be competitively procured). Combined with the opportunity for divestment of assets this approach should ensure that competitive activity in MAP can develop at a significant rate.

¹ *Electricity distribution price control review – metering issues: Initial consultation (the Metering consultation)*

The second option, and the one favoured by the *Metering consultation*, is to put in place a control process that will see meters being changed at any point in their life-cycle. This introduces the risk of stranded costs - not only for the distribution network operators (DNOs) but for all organisations participating in this market. This may inhibit the development of competition or result in increased unit prices for MAP. For these reasons it is not our preferred option.

The REMA definition of MAP also has implications for the potential for innovation and form of the price control. These will be discussed later in sections 1.1.4 and 1.2.2, respectively.

1.1.2 Drivers within the MOP market

In contrast to the MAP market, the development of competition in MOP market is likely to be determined by the ability of competing MOPs to enter into contracts with suppliers at the best cost/benefit level. DNOs are not in control of this and, whilst we may carry licence obligations for MOP, it is likely that by 2005 the major suppliers will have selected alternative MOPs.

The steps taken by BGT in this regard are, obviously, the first steps along this path. It is now clear, following the publication of OJEC notices by both Innogy and Powergen, that other major suppliers are seeking to follow this approach.

Based on data from our MPAS system, the current market share in our distribution services areas is summarised below:

- Innogy – 56 per cent;
- Powergen – 12 per cent;
- BGT – 20 per cent

The loss of the 20 per cent of the market in the third quarter 2003, due to BGT's choice of an alternative service provider, is clearly a significant step. While YEDL/NEDL will still have a dominant share of the market, the loss of a material proportion of the market will reinforce the significant pressures to improve our service offering. The loss of a further 68 per cent would fundamentally alter the dynamics of the market, leaving us as a marginal player. YEDL and/or NEDL would then be in the position of having only a 12 per cent share of the MOP market, with the other 88 per cent dominated by three supply companies. Under the industry procedures introduced through the REMA process, this loss of market share could happen overnight.

In the face of such moves a number of significant questions arise:

- firstly, if suppliers are determining the future of the MOP market then perhaps consideration needs to be given to understanding whether seeking to apply a price control to DNOs for these services is inappropriate. When the analogous situation of meter reading was dealt with, in an effective manner, it was determined to be a supplier cost. Ofgem may wish to consider, therefore, whether a similar treatment, effectively taking MOP costs out of the DNO price control completely, is appropriate;
- secondly, if a DNO price control is established for metering and large shifts in the market take place, what will be the mechanics for ensuring that the new MOP does not abuse its dominant position? This would appear to lead to the same conclusion as the point above, namely that the appropriate place to deal with the regulation of MOP services is through the powers vested in Ofgem under normal competition law, rather than through a price control; and
- thirdly, continuing to maintain MOP as part of the overall revenue of a DNO, when in reality it has no control over it, seems to be illogical.

In conclusion we believe that the overall objectives established by Ofgem² of seeking to establish competition in metering could best be accomplished through:

- establishing MAP competition at lowest cost to customers in Great Britain through a combination of organic change and divestment of assets;
- recognising that forced introduction of MAP competition will lead to increased costs to customers to reflect the increased risk associated with the investment;
- enabling MOP competition to be determined by suppliers, rather than price-controlled DNOs; and
- effectively governing the MOP marketplace by the adoption of similar principles to those applied to meter reading in 2000.

1.1.3 Efficacy of competition

The efficacy of competition is a significant factor in determining the relevance of price controls. As demonstrated above, there is little doubt that by 2005 competition will be emerging in both the MAP and MOP markets.

² Ofgem's *Metering Strategy* document and *Competition in metering services – Industry Guidance v2.1, August 2003*

In the case of the MAP market it seems unlikely that the level of competitive activity would be sufficient to satisfy any reasonable competition assessment on which to base a judgement to disapply price controls from 2005. In the case of MOP, as identified above, as the appointment of alternative MOP providers can be achieved very rapidly this is unlikely to be the case.

Given that within the OJEC notices published by Innogy and Powergen the target implementation dates are January and August 2004, respectively, YEDL and NEDL will no longer be in control of the vast majority of the MOP market in their respective service areas by April 2005.

This is, however, subtly different to competition being established, as the prime movers will be the three suppliers who are moving, or have moved, in this direction. In such a case a competition assessment will need to focus on the relationship between these suppliers and the MOP providers, again highlighting that DNOs have little role in this market going forward.

The question therefore arises over the provision of services to the remaining (25 – 30) suppliers who make up the final 20 per cent of the market. Clearly DNOs will have the obligation to provide services to these suppliers, through the obligations set out in the standard conditions of the electricity distribution licence. As competition develops it may be possible to disapply these licence obligations but, for the time being, the opportunity is therefore available to any of these suppliers to seek the determination of Ofgem on the reasonableness of the prices they are being charged. This provides an effective control mechanism without the complexity and drawbacks of a full price control operating in conjunction with a competitive market.

1.1.4 Competition and innovation

One of the assertions made within the Metering consultation is that the introduction of competition is likely to lead to innovation. Specifically, this relates to the provision of the assets and additional functionality such as automatic meter reading (AMR), metering of distributed generation and advances in pre-payment meter technology.

We believe that there are difficulties with such assertions, at least as far as the DNOs are concerned. Of the three outlined the only one that the DNO, in a REMA MAP context, has any interest in is the accurate metering of distributed generation. AMR and improved pre-

payment technology are technologies that, under the current industry design³, provide benefit to suppliers and not to DNOs.

A conflict then arises between the ability of a DNO to respond to the innovation requirements of individual suppliers, whilst maintaining a cost-effective procurement process for all.

The suggestion within the document that there should be a distinction between 'basic' and 'advanced' functionality seems therefore to provide an appropriate method of dealing with this issue. We believe that, in developing this proposal, Ofgem may wish to consider what regulatory asset value (RAV) impact the 'advanced' meters would have. More specifically should DNOs be entitled, as an incentive for innovation, to take the full value of the 'advanced' meters onto the RAV?

1.2 REQUIREMENT FOR A METERING PRICE CONTROL

The consultation identifies a number of issues in relation to the requirement for a metering price control, the scope, form and duration being the key elements. Each of these is considered in turn below.

1.2.1 Scope of the price control

In defining a price control for metering, cognisance needs to be taken of the overall industry design and current market conditions.

As the overall industry design is structured on a NHH and HH split, scoping a price control on a similar basis appears to be rational.

As is recognised within the Metering consultation effective competition is already established within the HH market for metering. Introducing a price control that would impact on this would, therefore, be inappropriate. It is also unclear how many DNOs are participating in the HH market – YEDL and NEDL, as examples, do not.

In relation to which elements of the MAP and MOP markets should be within the scope of a control, as discussed above, it is our belief that the NHH MAP market could be price controlled, whilst the NHH MOP market should not be.

³ DNOs are not entitled to individual NHH meter readings under the current industry design.

1.2.2 Form of the price control

If there is to be a price control to cover remuneration of the MAP element of metering costs it should be modelled upon the principles that govern the existing treatment of metering costs. At the last review Ofgem recognised that it was inappropriate to prevent DNOs from recovering costs that they had incurred in meeting statutory duties. The price control therefore included a term that reduced the allowed income of the DNO by the same amount as the avoided costs that resulted from any change in the market share of the DNO. This ensures that a DNO that loses market share does not enjoy a windfall gain (because regulated income falls in proportion to the fall in cost). However, it provides appropriate protection against stranded costs as the market is opened up to competition in an area that has previously (and will continue to be) subject to statutory duties.

It follows that a price control for the MAP element that followed these principles would be dominated by the fixed element (since the avoided costs of any loss of market share would be confined to the avoided capital investment in future meter procurement).

If there is to be a price control for the MOP element (which we think is unnecessary) it should also be modelled on the current approach so that DNOs lose income in proportion to the diminution in costs that they experience as they lose market share.

1.2.3 Duration of the price control

One of the issues raised within the Metering consultation is the duration of a price control. Again, it is our belief that the consideration of this requires splitting between MAP and MOP. For MAP it is reasonable that, if a separate price control is introduced, then it should align with the period of the main distribution control. Whilst it is our belief that MOP does not require a price control as competition will be widespread by 2005, in the event that this does not occur we can see no alternative other than to establish the duration based upon competitive market assessment.

Again our views on this are driven by who we believe will determine behaviour in this market – namely suppliers. Therefore, once suppliers have moved away from DNOs, as described above market dominance will no longer be an issue and protection to suppliers can be provided without the complexity of a price control.

1.3 VALUATION OF METERING ASSETS

We support the view that the depreciated replacement cost valuation method provides the most appropriate means of valuing the assets. There are two areas that require more detailed assessment consistent with this approach. The first of these is whether the valuation is providing an indication of the accounting or economic value of the assets. The second is the assessment of installation costs.

In relation to value, we believe that it is appropriate to aim for the economic value. For the avoidance of doubt, the distinction between the two methods is that the economic value is an assessment which is linked to the actual remaining life of the meters, whilst an accounting value would relate the value to the accounting depreciation policy of the organisation.

The benefits of the use of the economic value are:

- consistency of application across all DNOs – the actual life of meters is governed by statutory instrument; and
- in any divestment of the assets it is likely that the economic value would be more relevant.

In comparison, the accounting value would be inconsistent across DNOs due to the different internal statutory accounting policies.

The assessment of installation costs represents a major issue in assessing the value of the assets due to the coincidence of the change from a combined MAP+MOP environment to one where they are separate, within the price review process.

Installation costs have hitherto been considered to be capital expenditure of the DNO. Such costs would therefore be included in the RAV and the price control would ensure adequate funding. As we move towards transactional charging for installation (and all MOP) work the capital treatment of the costs is less clear. It is possible that these costs could be seen to have moved from capital to revenue costs (as the charges are paid at the point of use). If so a discrepancy arises between the historic, price controlled, return and the operating cost instant return, which could result in the under-funding within the price control of the historic investment.

Whilst it may seem logical to enable the funding of these returns through including them in a MAP price control, this would lead to a market distortion between DNOs and new entrants – in effect making DNOs inefficient in comparison.

Whilst the consultation document dismisses the notion that all historic MAP+MOP activity can be left within the main price control, we would suggest that a more selective application, that would not hinder the development of competition, could be adopted for the treatment of installation costs.