CAPITAL METERS LIMITED

Ms Jenny Boothe
Markets
Ofgem
9 Millbank
LONDON SW1P 3GE

Name	Duncan Southgate
Direct phone	01473 839073
Direct fax	01473 839080
E-Mail	Duncan.Southgate@Capitalmeters.co.uk
Your reference	
Our reference	DS Ofgem L 080405
Date	8th April 2004

Dear Jenny,

Response by Capital Meters Limted to Ofgem consultation
Proposed restructuring of NGT's metering business

As per the Consultation Document (March 2005) 78/05, Capital Meters Limited (CML), as an interested party, would like to make a number of comments on National Grid Transco's (NGT) proposals to restructure its gas metering business by consolidating its two existing metering businesses into a single meter operator organisation, NGT Metering.

<u>Summary of areas of concern</u>

Our concerns are mainly in relation to the issues related to competition arising from the proposed re-structuring and are categorised as follows:

1) Consultation;
2) Competition Issues; and
3) Re-balancing of Meter Charges.

<u>Consultation</u>

We have a particular concern that we have had no previous notice of these proposed changes. We are not aware that Ofgem has consulted, as it indicated it would in April 2003 in "The provision of metering information by Transco Update Document" on previous concerns raised by the industry.

<u>Competition Issues</u>

Background

In October 1998, Ofgas published initial proposals for securing effective competition in the provision of gas metering and meter reading services. While standard industry-wide processes to support competition in gas metering services were successfully introduced as part of the review of gas metering arrangements (RGMA) project, it is arguable that competition in the gas metering market is still embryonic. Furthermore, the competitive and regulated market has developed in such a way that NGT's market share far exceeds that of the other market participants combined. Some key points to note are:

- Competition in the gas metering market to date has only been facilitated through British Gas' competitive tendering process for the provision of domestic sized meters. The resulting MAP/MAM contracts will ultimately account for approximately 30% of the gas metering market of which NGT will retain approximately 17% through the current Onstream contracts. This means after 5-7 years NGT will still retain 87% of the market.
- NGT continues to dominate with at least 95% of the total gas metering market. Without major industry change, it will be many years before this dominant market position is eroded and effective competition in this area is secured.
- Aside from NGT's competitive metering business (UMS, trading as OnStream), who also dominate the competitive market having won four of the seven British Gas metering areas, there are only two other competitive providers of metering services: Meterfit (two British Gas metering areas) and CML (one British gas metering area).
- A number of other competitive gas metering contracts have been, or are shortly about to be, released by energy suppliers. There are only a limited number of parties who have the perquisite qualifications to respond to such tenders, one of which is OnStream (UMS). Onstream will be keen to win these tenders to protect their existing market share and further consolidate their strong market position.

NGT Metering and the Competitive Metering Market

CML acknowledges that Ofgem has raised a number of important and specific issues for comment through the consultation process. The critical issue that Ofgem does not seem to have addressed, however, is the adverse effect this proposal will have on the development of a competitive market for the provision of metering services. CML considers that the formation of NGT Metering as proposed will encourage or result in the following adverse effects:-

1. **Concentration of market power in a single, competitive entity.** By allowing NGT to merge their regulated and competitive businesses into a single entity, Ofgem are effectively allowing the creation of a dominant competitive provider of metering services. This will result in the concentration of market power in a single entity in a number of geographic areas.
2. **Suppliers entering competitive market without tendering:** The existing MSA contracts in place with suppliers and NGT may be reviewed or revised with the agreement of suppliers and NGT. With the creation of NGT Metering and the transfer of MSA contracts into this entity, suppliers will effectively be allowed to enter the competitive market without going to tender, thereby decreasing the potential for competition in the market.
3. **Cross-subsidisation.** With the creation of NGT Metering, including the preceding sale of regulated TMS metering assets to NGT Metering, an entity with a substantial book of assets and steady cash flows will be created. Given its size and underlying

Registered Office:
Level 30
CityPoint
1 Ropemaker Street
London EC2Y 9HD

Please reply to:
Unit 7a Hill View Business Park
Old Ipswich Road
Claydon
Ipswich IP6 0AJ

Fax +44(0)1473 839073

Registered No: 04800317
VAT Reg No : 824050856

cash flow, this new entity may have the ability to secure new competitive tenders by using the substantial cash flow from its regulated and competitive portfolios to underprice smaller competitors in regions of geographic significance.

4. **Significant pricing power.** The creation of NGT Metering will further consolidate NGT's dominant market position in metering and will significantly reduce the distinction between portfolios of regulated and unregulated assets. With time, this may result in the ability of NGT Metering to offer prices which are below that of competitors due to cost savings as a result of their geographic concentration and coverage. Furthermore, NGT Metering will be able to command purchase prices from meter suppliers which are not available to other metering service providers, due to the sheer size of their portfolio and order book. This may be of a short term benefit but will effectively remove long term competition on price and service (see point 5 below).
5. **Adverse impact upon other competitive metering service providers.** Given that NGT Metering would be a such dominant force in future competitive tendering processes, other competitive metering providers (who are already small in number) may decide that the cost of tendering is outweighed by the unlikely chance of winning. Moreover, other competitive metering service providers may choose to withdraw from the market all together because a failure to win other tenders, and/or reach critical portfolio mass.
6. **Untested regulated meter portfolio sale price.** It will be impossible for NGT Metering to determine an "arms length" purchase price of the regulated gas meter portfolio without a competitive sale process.

NGT have stated that the asset transfer will take place at market prices. We do not see how this can be determined without market testing. Condition 4D of Transco's licence requires that Transco's licensed business or any affiliate does not obtain any unfair commercial advantage. We believe therefore a transfer could put Transco in breach of this Condition 4D.

In addition we believe that NGT Metering would almost be a monopoly business in an embryonic market and would likely to be in breach of NGT's Amended Standard Condition 45.

Alternative Solutions

Recognising that Ofgem's mandate is to develop and ensure competition in the market place, and acknowledging that the NGT proposal may lead to cost savings for NGT, Capital Meters Limited considered two alternative potential compromise solutions to meet the needs of all parties. These solutions would allow NGT to gain the efficiencies it requires without severely compromising the development of competition in the gas metering market place.

Given that Onstream have currently won four of the seven British Gas MAP/MAM contracts, Capital Meters believes that the management of four British Gas contracts currently allows NGT Metering to have a viable business in the competitive market with no requirement for

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regulated gas meters to be in the portfolio. On a comparative basis, Meterfit has a viable business with two areas, and Capital Meters has a viable business with one area.

Proposed Alternative Solution

CML propose that the formation of NGT Metering be approved on the basis that the following conditions precedent are met by NGT:-

- The NGT Metering business would divide the combined regulated and competitive gas portfolios into five to seven metering service areas.
- NGT Metering would within 12 months be required to sell three to four of the metering service areas under competitive tendering arrangements.

CML also considered the following structure:

- The regulated gas meters currently owned by TMS be kept in a separate entity ("AssetCo") where, for pricing and governance issues, the regulated assets are clearly separate to the non-regulated assets with respect to asset management, cash flow and future pricing.
- AssetCo will have a requirement to manage its regulated asset base. AssetCo can use the market to purchase services on an arms length basis that will allow them to track assets, invoice customers and perform the other required functions for the existing regulated gas meter portfolio. NGT Metering may be the selected provider.
- By having the services provided on an arms length basis, the possibility of cash flow cross subsidisation between regulated and non-regulated assets is lessened.
- NGT Metering, like any other competitive metering business in the market, would then have to assess risk and reward and arrange funding for competitive tenders based on the merits of individual deals rather than being able to rely on regulated income flows to cover risk/reward mispricing (ie. "A level playing field".)
- NGT would retain the ability, through AssetCo, to refinance or sell the gas metering assets at some future date if they decided to pursue this strategy.

However, CML believe that the structure outlined above could still allow the NGT group to strategically price competitive bids with the aim of increasing business at low margins but reducing risk arising from competition on its existing regulated assets.

Advantages of Alternative Solution

The proposed alternative solution would have the following benefits:-

- NGT can obtain the marketing and operational benefits of combining the businesses.
- It ensures the continued development of a competitive market through the maintenance of a truly competitive market.
- By NGT Metering being required to sell parts of its businesses, it would accelerate the strengthening and development of competition in the market place.

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Re-balancing of Meter Charges

In principle CML supports the re-balancing of meter charges but it does not believe the proposed NGT re-structuring should be the mechanism by which this is achieved. It would leave transporters with a last resort obligation to provide Prepayment meters at price capped levels, and suppliers would be incentivised to take prepayment meters from the transporter's last resort service.

Conclusion

Capital Meters (and its shareholders Siemens Energy Services and Macquarie Bank) would be extremely concerned if the proposed re-structuring as currently put forward by NGT were to proceed as outlined. In particular it is likely that CML and its stakeholders would request the competition authorities to satisfy themselves that this proposal did not prevent or distort competition under Section 131 of the Enterprise Act 2002. Approval of the proposal in its current form would, without doubt, trigger a major internal review as to whether Capital Meters would participate any further in the competitive gas meter market.

However, a modified approval along the lines proposed above would actually strengthen competition in the market and would lead to long term price and service benefits to energy suppliers and end customers.

For and on behalf of Capital Meters Limited

John Wilson
Director

Duncan Southgate
General Manager

Registered Office:
Level 30
CityPoint
1 Ropemaker Street
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