British Gas' response to Ofgem's consultation on the proposed restructuring of NGT's metering business

Executive Summary

British Gas welcomes the opportunity to comment on NGT proposed restructure of its metering business. British Gas considers that:

- the consultation process adopted by NGT has been specifically designed to minimise discussion i.e. short timescales, bilateral meetings, and play down the potential consequences, leaving no practical choice for suppliers;

- that metering competition is far from being effective and so NGT's proposed restructure will reinforce NGT's existing dominance in this market;

- the appropriate market conditions do not exist to allow a rebalancing of meter charges notwithstanding the conflict with addressing fuel poverty issues – as such, adopting the disapplication approach to ensure further consideration would be appropriate;

- rebalancing of charges towards prepayment meters would increase financial pressure on suppliers to raise gas prices again probably focused on the customer base most likely to include vulnerable consumers;

- if rebalancing is permitted:
  - it is impractical and unreasonable to implement such significant change immediately from the date of novation – accordingly it should be at least delayed to early 2006 with a minimum of six months lead time;
  - it is unacceptable for NGT to gain significant cash flow benefits - a revised rebalancing financial profile should be adopted;

- the Gas Act Ownership issues must be resolved before the novation is permitted;

- the potential liability under the Weights & Measures Act 1985 should remain with NGT as a pre-condition of the restructure;

- performance service levels should, as a minimum, be maintained;

- NGT should provide a parent company guarantee to assure sufficient financial capacity to meet any contractual liability; and

- an offer to transfer, or rent, the metering asset on reasonable terms on change of supplier should be mandated for all MAMs including NGT.

The reasoning behind these views is explained in the following response which British Gas is content to be placed on the Ofgem website (with the exception of the confidential Appendix 1).

Introduction

The proposed restructuring of NGT's metering business could potentially have significant effects on the further development of the competitive market in meter operation and the obligations placed on gas suppliers. As such, British Gas welcomes Ofgem's consultation to seek market participant's views on these implications.

This response is structured in line with Ofgem's five key issues as outlined in the consultation document but also includes some additional comments on specific issues not covered by the consultation.

Issue 1 – what are suppliers' views in respect of the extent to which they have been made aware of the proposed sales and the contract options they have been offered by NGT?

British Gas first became aware of NGT's intention to restructure its metering businesses at the end of November 2004 when it was mentioned at a bilateral Executive overview meeting. A more detailed explanation of the proposed restructure was subsequently set out when British Gas met with Transco Metering on 15th December 2004. Following this discussion, British Gas received a notice dated 20th December 2004 stating that the existing MSA contract would be novated to UMS with effect from 1st April 2005.

British Gas has subsequently held two further meetings with Transco Metering to further understand the proposals but there has been a lack of clarity over a number of key issues such Gas Act Ownership (GAO) and the actual figures for rebalanced tariffs. This has not helped to gain an early clear and comprehensive picture of the proposals to enable British Gas (and other suppliers) to undertake full impact assessments. The constricted timeframe from first being informed to the novation notice to implementation has not been conducive to full and proper consideration of such a significant initiative.

It is understood that NGT followed a similar approach with other suppliers i.e. discussing the issue via one-to-one meetings. Discussions at multilateral supplier industry meetings have not at any time been instigated by NGT – such discussions would have been helpful to encourage debate over the impact of the proposed changes.

British Gas accepts that the MSA contract includes provisions for novation (and tariff rebalancing i.e. price revisions). However, this issue was highly contentious when raised under RGMA discussions – so much so the matter was referred to Ofgem for review and opinion. Ofgem's view, issued on 6th May 2004, was that it….''would be concerned with the potential inclusion of a novation provision whose purpose was not sufficiently clear as this would run the risk that the appropriate safeguards envisaged by contract signatories would be inadequate.'' This risk has been realised as within 6 months NGT announced its intention to novate the contract in a way that provides suppliers with no effective choice. It is even possible that NGT had firm plans to undertake this restructure at the time of these discussions and, it appears, chose to withhold this critical information from the supplier community and Ofgem.

Turning to the contract options, British Gas acknowledge that NGT have outlined the choices available. However, these are effectively limited to agreeing the novation at current MSA terms and prices or revert to a standard "industry contract" at higher prices. In any practical terms, suppliers have no real alternative but to accept the novation.

In summary, the consultation process adopted by NGT has been specifically designed to minimise discussion i.e. short timescales, bilateral meetings, and play down the potential consequences, leaving no practical choice for suppliers.

Issue 2 – whether suppliers consider that they can effectively access the price controlled tariffs for gas meters under NGT's proposals?

British Gas understands that the existing requirements on NGT within its Transporter Licence (SLC8) to provide meters on request will continue. In addition, this activity will be subject to the existing metering price controls but as these prices are inferior to the MSA contracts (although these are also price controlled at present) this does not currently present a viable alternative.

However British Gas does have a significant concern at the availability of price controlled meter provision going forward as it is unclear how long NGT will be required to offer such services. This concern is exacerbated by Ofgem's previous comments that such price controlled provision may not be necessary once metering competition becomes effective.

British Gas strongly believes that metering competition is far from being effective (it is intimated in the consultation document that Ofgem concur with this opinion). NGT's proposed restructure will, in our view, reinforce NGT's existing dominance in this market. If the price controlled provision is prematurely removed there will be no safety net for suppliers and NGT restructured metering business will be able to capitalise on its dominant position. While it is recognised that the Competition Act 1998 will be able to be used to counter abuse of that position, it is clear that suppliers will be exposed to further risk particularly through further potential rebalancing and pricing levels (noting that the MSA contracts will become unregulated and so not be subject to any price control).

Issue 3 – what issues arise from the rebalancing of meter charges?

It is acknowledged that NGT have, for some time, stated that current prices for prepayment meters do not cover the cost for providing such meters. However, Ofgem have made clear that the existing price differential between credit and prepayment meters would continue “until there was effective choice over prepayment systems”. The earlier discussion above and Ofgem’s recognition that “….metering competition in gas [is] developing at a slower rate than anticipated…” clearly demonstrates that effective choice is not yet available for suppliers.

Notwithstanding this, any rebalancing will disproportionately impact those suppliers with a greater proportion of prepayment meters within its total portfolio. These increased costs can only detract from the attractiveness of prepayment customers even if all these additional costs are passed through to the customer. This is directly in conflict with the objective to maximise the benefits of competition to prepayment customers and minimise any further costs pressures on the fuel poor (although it is accepted that there is not an absolute correlation between the existence of a prepayment meter and fuel poverty).

The precise impact of the rebalancing could not be modelled until NGT published final prices on the provision of credit and prepayment meters which where only released on 24th March 2005. Our calculations (provided on a confidential basis to Ofgem in Appendix 1) demonstrate that British Gas will be exposed to significant additional costs not budgeted for in this year’s, and future years, financial projections. This will lead to increased pressure to raise gas prices again probably focused on the customer base most likely to include vulnerable consumers. Suppliers, and so customers, will also need to cover the administrative costs in implementing such price revisions.

This immediate adverse impact on suppliers is contrasted with the cash flow benefit to NGT over the next four years. While the consultation document states that UMS must remain NPV neutral over the duration of the contract, our financial projections (see Appendix 1) indicate that it will be significantly cash positive particularly in the period 2005-2009 – our estimates[1] suggest up to £30m benefit.[2] This is unacceptable.

In light of the above significant impacts, Ofgem have suggested that Transco utilise the disapplication process as provided under the price control conditions of its Transporter licence. British Gas wholly support such an approach as this would allow a comprehensive and transparent review of the impacts of removing metering from the price control (which NGT’s proposal effectively achieves) and, if receiving regulatory consent, facilitate the

[1] based the limited information that has been made available by NGT and certain assumptions.
[2] although it is acknowledged over the remaining period to 2022, UMS will be cash negative (but only by a relatively small amount each year and could change positively if assumptions are amended in later years).

development of a considered migration of this activity to the unregulated arena.

In summary, British Gas do not believe the appropriate market conditions exist to allow a rebalancing of meter charges notwithstanding the conflict with addressing fuel poverty issues – as such, adopting the disapplication approach to ensure further consideration would be appropriate. If, however, rebalancing is to be implemented, it is impractical and unreasonable to implement such significant change immediately from the date of novation and unacceptable for NGT to gain significant cash flow benefits in the early years – accordingly it should be at least delayed to early 2006 with a minimum of six months lead time and a revised financial profile.

Issue 4 – whether there are any issues raised by the proposal in respect to the transfer of the status of 'Gas Act Owner' and the associated responsibilities that are passed on with this transfer?

British Gas acknowledge that there is an argument that a strict interpretation of the Gas Act 1986 (as amended) can suggest that the GAO responsibilities falls on the consumer – however, this would raise significant concerns over the increased safety risks. It is also recognised that, in practice, suppliers arrange meter maintenance (the primary responsibility of GAO) where it does not default to the transporter – this is the case for the contracts that British Gas has entered into with its commercial meter operators. Furthermore, it is accepted that maintenance is covered within the MSA contract.

However, there is an important difference between commercial contracts where the meter models are specified by British Gas[3] and are brand new meter stock, and the meters covered by the MSA which comprise of multiple models/versions with a wide age profile. As such, British Gas has concerns over the implications of accepting GAO for MSA meters. In particular, there could be substantial increased exposure for suppliers if a problem arose with the existing NGT metering stock as currently provided under the MSA contract. For example, this could be a fault with a certain meter type and manufacturer e.g. the current problems with E6 meters, GWI Version 3 ETMs susceptible to tampering. Another example relates to the Weights & Measures Act issue - this is discussed further under Issue 5. While a debate can be had over the extent of these risks, the reality is that the transfer of GAO to suppliers' intrinsically transfers the ultimate liability with it. In addition, any protection provided under MSA is undermined if UMS does not have the financial capacity to meet the potential backed-off liability (see Other Issues below).

Another approach which could be considered further is whether GAO could be transferred to the Meter Asset Manager (MAM). In this approach, NGT Metering (UMS) could become the GAO essentially maintaining the current position in all but name. However, it is recognised this would require amendment to Schedule 2B of the Gas Act 1986 (as amended).

Irrespective of who becomes the GAO, there are significant implications for industry data by amending the GAO. At present, under RGMA, MSA meters and those under "non-commercial" contracts have the GAO flagged as the transporter. Transfer of GAO to the supplier will require the amendment of approximately 19 million meter records - the cost of which is likely to fall onto suppliers. Accordingly, if a GAO transfer was to happen (as would be necessary under NGT's proposals), British Gas would expect NGT to fully finance the consequential updating of records.

In summary, the complexity of the GAO issues particularly regarding safety and liability clearly demonstrates that it is critical that clarity is provided and resolution is achieved for these matters before the novation is permitted.

[3] And obtained by our commercial MOs under a framework agreement developed by British Gas with selected manufacturers.

Issue 5 – are there any issues concerning the Weights and Measures Act 1985 that should be considered as part of this proposal?

British Gas acknowledge that the issue of legacy imperial meters has been under discussion between NGT, DTI and Ofgem for some time and, in particular, note NGT's view that continued use of these meters is legal. It is also noted that Ofgem's view is that it would not be in the interests of consumers to force a comprehensive replacement of imperial meters.

However, British Gas has not been party to these discussions or the legal advice – accordingly we cannot comment on the robustness or validity of that advice. As such, we are unable to make a risk assessment on the likelihood of a legal challenge through the courts but, notwithstanding this assessment, it is clear that a risk exists.

NGT's apparent mitigation for this risk as outlined in the consultation document i.e. domestic customers can request for these meters to be replaced, totally misses the point. The fundamental issue here is funding of a replacement programme suggested by Ofgem to be in excess of £1 billion. British Gas has concerns that the transfer of GAO will mean any liability associated with this risk will fall onto the supplier. This is not acceptable and British Gas would expect that this liability to remain with NGT – this may require a variation to the MSA agreement to specifically cover this. If this risk is as low as intimated by NGT, this should not be an onerous pre-condition of the restructure.

Other Issues

There are several other issues not included in Ofgem's specific questions which British Gas wishes to highlight.

Service Levels

It is a given that British Gas would expect the current agreed service levels would, as a minimum, be maintained as a consequence of this proposed restructure. In fact, if one of the primary reasons for the restructure, is to improve the effectiveness of NGT's metering business, then an increase in performance should follow.

However, there is a risk that service performance will deteriorate without the protection afforded under a regulated regime. Clearly British Gas, and other suppliers, would rely on the MSA contract provisions to secure improvement but it may mean that stronger provisions will be required to mitigate the loss of direct regulatory oversight. In particular, British Gas is concerned that a combined metering business may have a conflict of interest when allocating resources between the MSA and commercial contracts. For example, force majuere may be invoked under one contract (as recently happened following the Luton incident) in order to transfer meter staff to meet the contractual commitments under another.

Financial Capability

The current MSA contract is provided via Transco as the transporter and such has the considerable financial backing of that activity. Novating this contract to UMS, albeit a wholly owned subsidiary of NGT, would reduce the financial capability of the party with whom suppliers are directly contracting. This brings into question whether UMS, as the contracting party, has adequate finance to carry out its activities and/or cover the liabilities and indemnities under the MSA contract. As such, British Gas would expect NGT to provide a parent company guarantee to underwrite UMS to demonstrate the required financial security – it should be noted, to date, that NGT have staunchly refused to offer such a guarantee.

Asset Transfer

At a recent industry metering seminar (SGBI) one of the issues raised as an important barrier to metering competition was NGT's refusal to date to sell, or even rent, its meters to another MAM on change of supplier. This is contrary to commercial meter operator arrangements where this is common practice. British Gas believes that an offer to transfer, or rent, the asset on reasonable terms should be mandated for all MAMs including NGT – any move of NGT's metering assets to an unregulated business makes this requirement even more critical to the successful development of metering competition.

Risk Premium

This response has highlighted British Gas' concern over increased liability on suppliers while, in contrast, the potential liability on NGT would reduce. In the normal commercial world, the level of risk is a key factor in determining the contract price. As such, either the MSA contract prices should be adjusted to reflect this lower risk on NGT or suppliers may need to build a higher risk premium into their prices.