National Grid Transco's response to Ofgem Consultation "The proposed restructuring of National Grid Transco's metering business" - March 2005

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

Transco developed and negotiated the Meter Services Agreements (MSAs) during 2003 and 2004 with suppliers being given the choice to sign or not from early 2004. To date, a number of suppliers have chosen to sign both the "Legacy" and "New & Replacement" MSA. Some suppliers have chosen not to. In choosing to sign such contracts, we believe that suppliers would have considered all of the terms of the contract and recognised that in signing the contracts they were agreeing to those terms. As such, signatories should have been aware of Transco's right within the contract to novate them to another party, and the right of the novatee to rebalance credit and prepayment charges upon novation. The sale of meter assets to a third party is also provided for within contract, and the lengthy negotiations around the terms for bailment indicate that the possibility of such a sale was clearly understood.

In terms of acting upon the rights in the contract, NGT wrote to all suppliers and interested parties in early December 2004, notifying them of its restructuring proposal. This was done almost immediately after the internal governance processes had endorsed the restructuring proposal. In addition, NGT offered to visit all suppliers in order to explain its proposals and to answer any specific questions. The majority of suppliers took up the opportunity to meet with NGT and a number of follow-up meetings have also taken place.

A requirement of both the "New & Replacement" and "Legacy" MSAs is that at least 90 days notice is given in respect of a novation to a third party. This was duly issued to the Company Secretary of all the MSA signatories by 22nd December 2004, thus giving 129 days notice of the novation which is due to occur on 1st May 2005. Draft novation documentation was provided to suppliers in January 2005, and supplier meetings have been ongoing throughout the process. NGT intends to issue engrossed copies of the novation documentation on 8th April 2005.

A further point worth noting is that in the run up to the RGMA industry cut-over, Transco sought to include a novation provision in the Provision and Maintenance Agreement (PMA). This was to have been subject to the suppliers consent (not to be unreasonably withheld or delayed) and was described to suppliers as being requested to provide flexibility for future restructuring possibilities. This novation provision was not accepted by suppliers and, at Ofgem's request, it was not included in the PMA. However, during this negotiation process, some MSA signatories commented that they had accepted the novation rights within the MSAs as it was part of the MSA package, and that they had had the opportunity to consider this prior to signature.

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

The novation of the MSAs from Transco to OnStream has no effect on the availability of meters that are subject to the price caps set out in the Transco's gas transporter licence. Transco will continue to offer meters through the PMA for both domestic and non-domestic use. Transco is required by its licence to provide and install meters at

domestic premises at the request of a supplier, and is obliged by the PMA to do the same in respect of non-domestic premises. The meter services provided by Transco will continue to be subject to the tariff caps set out in Special Condition 31 of its gas transporter licence.

Suppliers who have chosen to sign the MSA agreements have in doing so chosen to pay different (lower in the case of credit meters) tariffs to those that apply to the PMA. These rentals are set out in the contract and are governed by the contract for the whole life of the meter. The only adjustment being by reference to the retail price index as a reflection of any general change in the costs of servicing and maintaining installed assets.

One of the key drivers for Transco offering the MSAs was to minimise the risk of stranded investment in the developing competitive market. The PMA, and the terms and conditions that preceded it within the Network Code, have no term or exit payments. A supplier can request Transco to install a new meter and then instruct a third party to remove that same meter the following day with no sanction. To mitigate this stranding risk, Transco offered a reduced tariff on all existing meters in return for greater revenue certainty (the Legacy MSA), and also offered a contract whereby suppliers could request new meters at a lower rental, again in return for revenue certainty (the New & Replacement MSA).

Suppliers are able to opt to use the New & Replacement MSA, or their own meter provider at three months notice, but are required by the MSA not to return to the PMA. However, a supplier can choose to terminate the New & Replacement MSA by paying the relevant termination charges for installed meters and then return to the PMA.

There is therefore no restriction on a supplier accessing tariff-capped services via the PMA from Transco. Where a supplier has contractually agreed not to access such services, as is the case with the New & Replacement MSA, a supplier could still access tariff-capped services via the PMA provided they had paid the relevant termination charges set out in the MSA.

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

The existence of a cross subsidy for prepayment meters from credit meters has been the subject of debate since before the 2002 price control. Transco has argued on a number of occasions that the existence of a subsidy is only appropriate if monopoly service provision is the accepted norm, and is inconsistent with the development and operation of a competitive market. It creates incentives for "cherry picking" of work by competitors (providing credit meters only) and provides a disincentive for innovation in the development of new prepayment technology. Ofgem itself has expressed this view in its recent consultation – "*Prepayment meters – Consultation on new powers under the Energy Act 2004 and update on recent developments*". In this document Ofgem refers to the current situation with electricity prepayment meters in Scotland, where the existence of a requirement to hold prepayment meter rentals below actual cost has proved a disincentive to investment and old token meter technology is more prevalent in this area than any other electricity distribution area. Ofgem goes on to say that making the MAP (provision charge) cost reflective is in the best interests of consumers. NGT supports this view and believes it is equally relevant to the gas market as it is to electricity.

The rebalancing of rentals following the proposed restructure will only occur in respect of meters subject to the MSAs (prepayment meters subject to the PMA remain unaffected). The circumstances under which rebalancing can take place are clearly described in the contracts and, as with the novation itself, it seems reasonable to assume that suppliers would have considered the likely impact of such an event prior to signature. Whilst the impact for each supplier will differ depending on its portfolio of meters, a requirement of both the Legacy and New & Replacement MSAs is that the novatee (OnStream in this case) is financially neutral on a Net Present Value basis over all like contracts. Whilst the formal contractual notification of rebalanced rentals cannot take place until the MSAs have been novated, OnStream provided indicative proposed rentals to MSA signatories on 24th March 2005.

A supplier may choose to pass on the changes in rental in whole or in part, to absorb the increased prepayment meter rental, or to recreate the cross subsidy through its own tariffs. However, NGT believes this is the business of suppliers, in much the same way that it was a decision for suppliers who signed the MSA contracts to pass on, or otherwise, the savings arising from the reduced rental charges for credit meters within those contracts.

Ofgem has suggested, in its consultation document, that Transco could have chosen to seek a disapplication from tariff caps (as provided for in Special Condition 31 (5) of its gas transporter licence) as a means to rebalance credit and prepayment rentals. NGT is of the view that the existence of a cross subsidy is inconsistent with the operation of a competitive market, regardless of whether a meter is subject to the PMA or the MSAs. However, the purpose of this restructure is not to review the existence and level of the tariff caps that currently apply to Transco, and any such review should be carried out independently of this process.

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

The Gas Act gives rise to an obligation on the consumer, the relevant supplier or the transporter to keep the meter in proper order for correctly registering the quantity of gas. The Gas Act, when read in conjunction with both the gas suppliers' and gas transporters' licences sets out the circumstances under which any of the above parties has this obligation. Whilst there is no defined term, the industry has come to describe the holder of this obligation as the "Gas Act owner".

In addition to there being no definition of a "Gas Act owner", there is no description of what is required to keep a meter in "proper order" and for as long as Transco has been the "Gas Act owner", the maintenance activities set out in its meter provision contracts have, by custom and practice, been accepted as sufficient to meet this obligation. Both the MSAs and the PMA go as far as to say that their respective maintenance schedules include such activities as are required to meet the relevant obligation of the Gas Act.

Following the restructure, Transco will not own the meters subject to the MSA contracts and therefore can no longer be the "Gas Act owner". As noted in the consultation document, NGT believes that the consumer is most likely to become the "Gas Act owner", unless the definition of "ownership" in the suppliers' licence is interpreted as including meters that the supplier rents, or the supplier treats the MSAs as lease agreements for financial reporting purposes.

However, the obligations of the "Gas Act owner" are the same regardless of which of the three potential parties has the role, and the terms of the MSAs' maintenance schedules will be unchanged by the novation. As such, OnStream will be contractually required to carry out activities that meet the obligations of the "Gas Act owner", regardless of whether the supplier or the consumer has that role. Therefore, NGT does not believe that, in practice, any issues arise as a result of the restructure in terms of the change in the "Gas Act owner".

A major driver of RGMA was to better facilitate the "supplier hub" whereby the supplier takes the lead in arranging for meter provision. Indeed, the supplier deciding to enter into the MSA agreements after consideration of its options in terms of remaining with the PMA or a more aggressive meter replacement programme through a third party meter provider is evidence of the supplier hub at work.

In taking this lead in arranging meter provision, a number of suppliers have expressed the view that they do not wish to be asset owners, and that they would therefore prefer not to own (in the absolute legal sense) or lease the meter. As such, their arrangements may be simple rental or hire agreements. However, one interpretation of the gas suppliers' licence is that this does not meet the criteria of "ownership" and reference to the Gas Act then leaves the responsibility of keeping the meter in proper order to the consumer. In practice, the emerging competitive market and metering legislation may not, therefore, be wholly aligned.

NGT sees some benefit in Ofgem's suggested "backing off" of obligations, or its suggestion that the definition in the gas suppliers' licence includes a rental agreement, as this helps to address this mis-alignment. Furthermore, NGT believes that any interpretation of the definition of "ownership" in the gas suppliers' licence should equally apply to the gas transporter licence as this would allow Transco to meet its SC8(1) obligations via a rental agreement as opposed to a more complex leasing arrangement.

However, NGT does not believe that any changes to the gas suppliers' licence are a pre-requisite to its restructure. The management of a supplier's relationship with its consumers is the supplier's business, and any legislative changes in this area should be considered independently.

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

A number of meters currently owned by Transco register the volume of gas consumed in imperial units. Transco does not believe that the proposed restructure has any bearing on the ongoing use of such meters. The obligation of the "Gas Act owner" is to keep the meter in proper order for correctly measuring the quantity of gas, and no reference is made to the unit of measurement. In any event, the volume is simply a component of the calculation that is performed to derive a consumer's bill, which is expressed in units of energy. Following extensive dialogue with interested parties, Transco has concluded that the continued use of such meters is legal, and it is difficult to see how a change of meter ownership (from Transco to OnStream) can have any effect on the ongoing use of installed meters. Furthermore, the use of imperial meters currently has no detrimental effect on the operation of the gas supply business in Great Britain. As such, it is difficult to see how both the cost of replacement and the inevitable inconvenience caused to consumers could be of benefit to any party other than perhaps meter manufacturers.