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Metering Price Control Review

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A Response by Centrica

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EXECUTIVE SUMMARY

Centrica welcomes the opportunity to respond to Ofgem's consultation on metering price controls. In general, we believe that the competitive metering market is the best means of meeting the interests of suppliers and customers. However there are structural challenges to the operation of this model in the electricity market, which Ofgem should investigate and address as part of its price control review.

Gas Metering Price Controls

- We agree that the present gas metering controls should be retained and any review deferred until the Competition Act investigation is concluded and outcome known.

- We do not believe the current gas prepayment cross-subsidy should be unwound at this time, in view of the customer impact.

- However the advent of new, lower cost gas PPMs will be the opportunity to remove the cross-subsidy for new and replacement PPMs, retaining the present caps on existing meters until they are displaced.

Electricity Metering Price Controls

- Similarly we believe that electricity price controls on legacy meters should be retained at least until 2010.

- However the current electricity meter price caps on new & replacement meters should not be removed from April 2007, as Ofgem have proposed.

- Before these caps can be removed, Ofgem must take steps to ensure there are no barriers to metering competition in the current integrated electricity structure and to provide greater transparency and reassurance that there is no discriminatory behaviour on the part of the companies involved.

- Removal of existing price controls would not be appropriate while there is the possibility of mandating smart meters as a result of the Energy Review or the Energy Services Directive.

INTRODUCTION

Before dealing with the specific questions posed in this consultation, it would be useful to set out our overall perception of the metering markets in gas and electricity.

Centrica remains committed to competitive metering markets in both gas and electricity, in which we have been a pioneer, and we welcome Ofgem's recent decision document on domestic metering innovation. We are convinced that the competitive model is appropriate, both in a static sense (efficient provision of traditional metering and meter reading services) and in a dynamic sense (the best framework to stimulate innovation and further improve services to customers).

As happened with energy liberalisation, industry and regulatory focus was initially on creating the right mechanisms for a competitive market. Now that they are in place, attention rightly turns to addressing the obstacles to the operation of the market – e.g. Ofgem's current Competition Act investigation.

This consultation on price controls is therefore an opportunity to review the operation of the competitive metering market, to identify shortcomings and their root causes, and to propose remedies which will improve its functioning.

Our general perception is that while the competitive model has proved itself in its design and in other respects, and is already contributing significantly to overall customer welfare, there are some structural challenges to the effective operation of the market which Ofgem must now address to ensure competition is effective.

Symptoms we have encountered of market problems (which affect electricity rather than gas) include:

- a reluctance on the part of some of our competitors when acquiring our customers to enter rental agreements with the existing meter operator, preferring particularly in the case of prepayment meters, to remove these meters and to replace them;

- limited use by some of our competitors of new entrant meter asset providers, despite apparently attractive rental prices;

- no competitors using our commercial meter operators ('CMOs') to manage their meters; and

- continued use of last resort agents out-of-area, where our CMOs might be expected to have been competitive on price.

We refer to possible causes for these outcomes in our answers to some of Ofgem's specific questions, and suggest steps which Ofgem should take to address these problems.

GAS METERING PRICE CONTROLS

1. Is it necessary to review the price controls on gas meters prior to the conclusion of the Competition Act investigation?

No. It is neither necessary nor desirable. The Competition Act investigation will determine market definition, dominance and potential abuse, and this logically feeds into a review of gas metering price control, which is a remedy.

It would not be possible to complete a price control review while the Competition Act investigation is still running without pre-empting the outcome of the latter, and even doing them in parallel would be problematic, given National Grid's right of appeal against Ofgem's eventual Competition Act decision.

We note that Ofgem have yet to consider National Grid's response to Ofgem's preliminary findings in the Statement of Objections. It would prejudice the process if as a part of a price control review, Ofgem were now to invite (further) comments on the state of competition.

We therefore agree with Ofgem that the most sensible course of action is to continue with the present controls at least until the conclusion of the investigation, and then to take into account any changes to the Metering Services Agreements and National Grid's proposed restructuring plans.

2. Is it necessary to reset the level of the cap on gas PP meters prior to conclusion of the investigation?

Ofgem believe that National Grid are recovering their shortfall on PPM costs from credit meter charges, so there would appear to be no urgent reason to address NG's concerns about the level of the price cap. Any adverse competition effects resulting from the PPM price cap should be considered within the formal price control review, when it takes place.

Whilst National Grid ownership of assets remains at current levels, it would certainly not be reasonable to consider the PPM price cap in isolation, if this is being suggested. Raising the PPM price cap alone would be to provide National Grid with a windfall profit. But to reassess both credit and prepayment caps would in effect be to carry out a full price control review, which we do not see as desirable in advance of the Competition Act investigation, for the reasons noted above.

Whenever the issue is considered, it is important to recall the reason for the current caps, which was to set a maximum differential between credit and prepayment charges. The aim was to limit the extent to which (vulnerable) prepayment customers were facing higher gas bills than their credit counterparts purely as the consequence of a high-cost legacy metering solution, and by limiting National Grid's prepayment revenue, to encourage the development of lower cost PP meters and/or cheaper ways of working.

Creating a cross-subsidy at the monopoly 'distribution' level was widely seen to be preferable to seeking to constrain supplier prices in a competitive market.

Unwinding this cross-subsidy would result in higher retail tariffs for prepayment customers, and increase the differential between credit and prepayment prices that the cross-subsidy was designed to limit.

Ofgem's consideration of the PPM price cap cannot therefore be undertaken without a full examination not just of the full costs of providing the current gas prepayment meter, but of the customer/social impact of fully cost-reflective prices, the likelihood of new, cheaper gas prepayment meters, and the extent to which the current cap is an impediment to their eventual deployment.

This does not mean, however, that the present cross-subsidy has to be accepted as a permanent feature of the domestic gas metering market. Metering innovation is already bringing new and cheaper prepayment metering solutions, some of which are already being trialled, and we fully expect new gas prepayment meters to result from this wave of technical development. Assuming these PP meters can be successfully brought to market, the new and replacement meter sectors would immediately benefit from lower prepayment costs, allowing the cross-subsidy to be removed for this part of the market. Cost reflectivity would be likely to generate more innovation, to further reduce costs and/or to improve the customer experience.

The effect would be that over time, expensive legacy prepayment meters would be progressively removed, and with them the current cross-subsidy, without customers being faced with a sudden increase in their prepayment tariffs, which would be likely if the current cap were to fall away immediately.

ELECTRICITY METERING PRICE CONTROLS

3. Have Ofgem identified the key characteristics and dynamics of the electricity metering market?

4. Have Ofgem identified the key developments in the electricity metering market over recent years?

We agree with Ofgem's analysis of the electricity metering market, which in our view gives cause for concern. We believe there are a number of key issues to be considered if effective and sustainable competition is to be fully realised in this market.

<u>Ownership affiliation</u>

We are concerned that effective competition in the electricity metering market may be being inhibited by the ownership links between incumbent suppliers and their associated DNOs, which generally have their own in-house metering businesses. This position has persisted despite the acquisitions and takeovers which have characterised the UK electricity market in recent years.

We conclude from the present industry structure (and in particular from the existence of these in-house electricity metering businesses) that the companies concerned continue to see benefits from this form of vertical integration, and that the economics of participation in the liberalised metering market are for them outweighed by other factors.

We urge Ofgem to give detailed consideration of how far these benefits are legitimate from a regulatory viewpoint, and if not, whether increased separation/Chinese walls or other remedies might be desirable to address adverse impacts arising from these relationships (see also our answers to Q6 and Q10 below).

Sale of existing meter bases

Section 4 of Ofgem's consultation makes reference to the possibility of incumbents selling off some or all of their existing meters to a competitor, by which Ofgem imply that the base of electricity meters will remain in the hands of the distribution network operators. This is to overlook the readiness of banks to acquire physical assets of this kind (cf gas distribution networks) and to drive business improvements, to the benefit of customers.

We fear that the lack of movement in this direction hitherto may indicate that some current electricity meter owners are content to take value at the metering level (taking advantage of their regional dominance) rather than acting commercially and seeking to source the lowest cost asset for all their customers, including their supply competitors.

In this connection, we believe that the lack of cost pressure on DNOs is encouraging them to invest in unnecessarily expensive meters, which offer little or no benefit to customers.

We urge Ofgem to investigate these aspects further.

Meter replacement and asset stranding

In the same section, Ofgem note that the potential growth in metering competition is limited not just by the preparedness of incumbents to sell all or part of their meter base, but also by the rate of 'policy replacement' and asset stranding concerns.

We would point out that Centrica, through its meter operators, is actively replacing meters, reducing the legacy base of electricity meters operated by the ex-PESs, and that the falling cost of meters is likely to encourage faster replacement of meters, by ourselves and potentially by others.

It is true that faster replacement introduces stranding risks; we would note however that whereas new entrant meter operators generally bundle the cost of installation into the overall rental price for the supplier, DNOs charge meter installation up-front, giving DNOs greater protection from the risk of stranding.

Obsolescence concerns are increased by the emergence of more sophisticated metering. The resulting stranding can be addressed through 'churn contracts' and through current industry work on smart meter interoperability and meter transfer.

We would encourage Ofgem's continuing interest in these matters, in order to facilitate not just smart meters but metering competition generally.

5. **Have Ofgem identified the factors which determine whether suppliers use the competitive market to meet their electricity metering needs?**

6. **Have Ofgem made a fair assessment of the prospects for further development of the electricity metering market?**

As Ofgem recognise, Centrica has been a key mover in the liberalised metering market. In the contracts that we have negotiated with commercial metering companies we have secured improvements to prices and service levels, and we are convinced that the success of metering competition can and should be maintained.

Many other suppliers, perhaps for the reasons noted earlier, have been slower to embrace metering competition and as a consequence commercial metering companies have less than 1% of this part of the market. We believe it is significant that despite going out to tender for metering services, other suppliers have not appointed any alternative metering providers; moreover that in some cases they have sought to displace prepayment meters installed by British Gas, replacing them with older token meters.

So while continuing to support metering competition generally, we are less optimistic than Ofgem in considering the prospects for further development in the electricity metering market and we do not ascribe as much weight as Ofgem to the competitive tenders which other suppliers have undertaken. The fact that some suppliers are considering taking over metering activities from the DNO in their ex-PES region suggests to us that this is more repositioning metering at a market rate within an integrated group rather than proving any readiness in practice to engage non-affiliated metering companies.

To address this problem and to ensure the further development of metering competition, it is essential that Ofgem requires much greater transparency in the relationship between electricity suppliers and their affiliated metering businesses. This could take the form of the metering businesses publishing performance standards distinguishing the service levels they provide to their supply affiliate compared with others, and being able to demonstrate that metering is provided on a non-discriminatory basis (see also our answer to Q10). Ofgem might also consider requiring the companies to justify decisions to appoint an in-house metering provider following competitive tender.

7. Should the electricity meter price caps be allowed to fall away on 31 March 2007 in respect of meter operation and the provision of new & replacement meters?

We do not believe that it would be appropriate for these controls to fall away in March 2007. Notwithstanding the fact that there are now around 10 metering companies with a presence in the market, these companies are regionally dominant and there is no evidence yet that they will wish to be active out-of-area. If there are problems with high cost-to-serve regions, these can be addressed by modifying the level of the control in those regions.

Ofgem argue that in the absence of metering price controls, retail competitive pressures will help keep metering prices from rising. But since in ten of the fourteen regions, the metering businesses are parts of groups that include a retail supplier, it is far from certain that the metering businesses are sufficiently independent of the local incumbent supplier to guarantee a correct allocation of costs or management independence.

As Centrica becomes more confident with competition in the electricity market, as a result of greater transparency in the relationship between electricity suppliers and their affiliated businesses, we would support a move towards removing these price caps; we therefore suggest this issue is reviewed again in 2008.

Ofgem observe that the prospects for electricity metering competition could be affected by the Government's decision on how to implement the Energy Services Directive, a fact which they also mention in their recent decision on domestic metering innovation. While we would strongly oppose any transposition of the Energy Services Directive which in any way changed the present competitive metering framework, Ofgem should not contemplate the removal of price controls while the possibility exists that the transposition of the Directive could fundamentally affect metering competition.

8. Should the price controls on legacy electricity meters be maintained at least until 2010?

Irrespective of the view taken about competition for new and replacement meters and the uncertainty regarding the Energy Services Directive, the slow pace of meter replacement means that particular consideration should be given to the pricing of legacy meters. Ofgem acknowledge the weaker competitive pressures applicable to such meters, and in the absence of any sale of legacy meter portfolios, this situation will not change in the medium term.

Consequently, we agree with Ofgem's proposal to retain controls on legacy meters for the time being, and to re-assess the appropriateness of such controls in 2010, taking account of any possible erosion of market share in the meantime and other progress as a consequence of the present review.

9. Are the concerns over potential issues for small and/or out-of-area electricity suppliers valid?

We fully agree with the concerns raised regarding the difficulties which small or out-of-area suppliers will face in the absence of price controls. We believe that price controls represent a valuable safeguard in such circumstances, and ensure that the new supplier can obtain competitively priced services from the incumbent DNO (or affiliate). It follows therefore that removal of price caps would jeopardise supply competition.

10. If so, would a non-discrimination obligation on suppliers be an appropriate response to these concerns?

As is clear from the above, we believe that electricity price controls generally should be maintained until 2010. If notwithstanding the arguments to the contrary it is decided to lift these controls, then some form of general non-discrimination obligation must be introduced to avoid abuse of (regionally) dominant positions and resultant damage to/distortion of supply competition.

Indeed we believe this would be desirable in any event, to help address some of the problems already referred to.

However Ofgem talk about inserting an obligation into supplier licenses, requiring suppliers with in-house metering businesses to offer metering services to third parties on the same terms as they do in-house. This would presumably work only where the metering business is part of the supply business. To cover all situations, we believe the obligation should be framed on the lines that the supply business does not procure metering services from any affiliated metering business on any more favourable terms than that metering business provides to third party suppliers.

We also urge Ofgem to require in-house metering businesses to provide reports on their performance/service levels, to ensure greater transparency and enable other suppliers to have confidence in the non-discriminatory operation of the liberalised metering market.

Ofgem note that another option would be to rely on competition law rather than ex ante regulation. Unlike the supply license route, this could be applied in any situation. However we would prefer there to be clear business rules rather than having to rely on the threat of action under the Competition Act.