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Direct Dial: 020 7901 7194
Email: rachel.fletcher@ofgem.gov.uk

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Dear Sir/Madam

Re: Licence Amendments Relating to PPM Premature Replacement and Removal of Electricity Metering Obligations – Update

This letter updates you on the status of Ofgem's consultation process on the premature replacement of electricity prepayment meters, and sets out our intended way forward for your consideration and feedback. It also asks DNOs to indicate whether they intend to submit an application for recovery of PPM stranding costs once the licence amendment process is completed.

In addition, we address some concerns that have been raised by DNOs regarding our proposal to amend aspects of the distribution licence as a consequence of the removal of metering obligations from 31 March 2007. These proposed amendments were outlined in our recent letter of 20 December 2006.

Results of PPM Premature Replacement Consultation

We have now carefully considered all responses to the consultation document and have undertaken follow-up discussions with a number of respondents. A detailed description of our analysis and conclusions will be provided in a public document that we will release at the time the draft licence amendments are notified for statutory consultation. In advance of this however, a summary of our current position is set out below.

Mechanism for Recovery of PPM Premature Replacement Costs

We continue to believe that our proposal to allow DNOs to recover PPM premature replacement costs via a tariff increase across all price-controlled meters represents, on balance, the best mechanism available. Recovering costs through distribution charges, as proposed by some respondents, would be inconsistent with Ofgem's previous decisions to progressively separate metering from distribution. Similarly, recovering costs through termination charges risks sending mixed signals to suppliers regarding the importance of changing out token PPMs – which Ofgem has strongly supported to date because of the potential benefits to vulnerable customers.

We have seriously considered the suggestion that stranding costs could be calculated on a retrospective rather than a forward-looking basis, in order to increase certainty and transparency. While this approach has a number of advantages, a key disadvantage is that it may not allow sufficient time for adequate cost recovery before the price controls on legacy meters are reviewed in 2010. It is also likely to be administratively complex. We therefore intend to retain the forward-looking approach, but allow DNOs to apply for subsequent adjustments to the price control if suppliers' PPM changeout plans accelerate faster than anticipated. We may however also require DNOs to cease charging rental for token PPMs if they remain installed beyond the anticipated replacement period.

Cost-sharing Arrangement between DNOs and Suppliers/Consumers

The majority of DNO respondents argued that the proposal to allow recovery of only 30% of PPM premature replacement costs was inadequate. Arguments put forward on this point included: (1) a 30% cost-sharing arrangement is not equivalent to a 30% cap on asset-life adjustment under the current licence mechanism; and (2) the 30% cap under the existing mechanism was not translated into the licence and/or was never formally agreed to by DNOs.

We accept the point that a 30% cost-sharing arrangement under our proposed mechanism is not functionally equivalent to a 30% asset-life adjustment under the existing mechanism. Nonetheless, our analysis suggests that given the pace of changeout of token meters that suppliers are currently planning, almost all DNOs would be better off under our proposals than under a 30% asset-life adjustment for token meters within the existing licence – particularly in light of the increased certainty over revenue recovery provided by the tariff uplift across all meters. We therefore believe that our proposal is already relatively generous, and do not intend to increase the level of cost recovery above our initial figure of 30%.

Moreover, we do not accept the argument that the 30% cap on asset-life adjustment under the existing licence mechanism was never formally agreed to by DNOs. While the licence does not refer to it directly, the 30% cap was explicitly mentioned on two separate occasions, in the Distribution Price Control: Final Proposals document and the September 2004 Update Paper that preceded it. DNOs agreed to the distribution price control at this time, and in our view they would (or should) have taken into account Ofgem's stated intentions with regards to the asset-life adjustment mechanism in deciding whether to accept the overall price control offer.

It should also be noted that the current licence mechanism gives Ofgem the final say on the allowed reduction in asset-life for prepayment meters in cases of premature replacement. We intend to apply the 30% cap on adjustment to asset life should the existing licence mechanism remain in place.

Stranding Protection for Other PPM Technologies (Key and Smartcard)

We have taken on board the concerns expressed by many respondents regarding removal of stranding protection for other PPM technologies. Having considered the issue further, we now accept that there is a genuine risk of stranding for smartcard PPMs due to technological consolidation, and there may also be some risk of older key PPMs being replaced with newer key PPMs. We therefore propose to retain stranding protection for all PPM technologies, but only in cases where they are replaced prematurely *in favour of another existing PPM technology*. We do not intend to allow stranding protection (either

under our proposals, or in our application of the existing mechanism should it remain in place) in cases where PPMs are replaced with an entirely new technology such as smart meters. We do not believe this was the intention of the mechanism currently in the licence, nor is there any protection afforded to DNOs with regard to stranding of credit meters as a consequence of new metering technology.

Control Arrangements over Multi-Rate Meters

The majority of respondents were of the view that the current control over multi-rate PPMs is already robust and does not require modification (most DNOs indicated that they intended to seek approval from Ofgem for any adjustment to multi-rate PPMs in the same way as for single-rate PPMs). We acknowledge this position, and propose – for the avoidance of doubt – to retain a separate price control for multi-rate PPMs, but set out more explicitly in the licence how the asset life and any adjustment factor should operate for meters. We consider this can be accomplished through some minor drafting changes to the licence.

Guidance on Calculation of Stranding Costs

Some respondents requested guidance on the methodology that should be used for the calculation of PPM stranding costs. We agree that this would be beneficial, and intend to publish some detailed guidelines on this issue at the time the licence modifications are approved. These guidelines will cover both the methodology for calculating stranding costs, and some other issues related to the information DNOs will need to provide when they make an application for compensation through adjustment to the price control (for example, we will expect DNOs to provide supporting evidence regarding the age profile of their installed meter base).

In broad terms, the view we have come to on the methodology for calculating stranding costs is that this should be based on a net book value approach – using the asset value (MEAP) of the relevant PPM as set out in the price control formula, depreciated on a straight line basis over the full life of the meter. A forecast of revenues (based on the expected period that the meters will remain on the walls) should be deducted from the book value to give an estimated stranded cost figure.

There remain a couple of methodological issues which we have not yet resolved. One is the treatment of faults in the calculation of stranding cost. The other is the appropriate asset life for depreciation calculations – for example, whether this should be based on the certified life, or the asset life assumed in the price control formula (in cases where these differ). We may contact DNOs for additional information on these issues and would also welcome informal feedback on the methodology at this time.

Amendments Relating to Removal of Electricity Metering Obligations

In our letter of 20 December 2006, we proposed a series of amendments to the distribution licence as a consequence of the removal of electricity metering obligations (on new/replacement meter asset provision and meter operation) from 31 March 2007. The amendments were intended to clarify the interpretation of certain issues and remove now-redundant provisions from the licence.

Some DNOs have raised concerns with our proposal to redraft the licence to specify that basic metering services (other than the provision of legacy meters) will no longer fall within the definition of a distribution business once the metering obligations are removed

– and hence, that such services will need to be provided via a separate subsidiary in future if they exceed the *de minimis* thresholds. In particular, DNOs have indicated that it may not be feasible to undertake such a separation by 31 March 2007.

We continue to believe that requiring separation of basic metering services (other than the provision of legacy meters) from the distribution business is an appropriate step for a deregulated metering market. However, we appreciate that an adequate transitional period will be required in order to achieve this.

Accordingly, we wish to confirm that we will provide written consent (pursuant to Standard Condition 43, paragraph 3(d) of the Distribution Licence) to any reasonable request from DNOs for carrying on metering activities that exceed the *de minimis* thresholds, for a transitional period until 31 December 2007. We expect that this will provide sufficient time for DNOs to achieve separation as required; however, further requests for consent to carry on metering activities beyond this date will be considered on a case-by-case basis.

Next Steps and Process from Here

We have already begun drafting licence modifications along the lines outlined above, and intend to notify both sets of licence amendments (those relating to PPM premature replacement, and those relating to removal of the metering obligations) for statutory consultation in early February, as previously advised. We will place an early draft of the amended licence conditions on our website on 22 January.

Prior to Christmas, we raised with some of you the possibility of holding a meeting with all DNOs to discuss the PPM licence amendments in more detail. After further internal discussion, we have come to the view that such a meeting is not necessary. We would however welcome feedback from individual DNOs at this stage regarding our PPM proposals, and in particular an indication of whether you would be likely to agree to licence amendments along the lines set out above, or would prefer to retain the existing asset-life adjustment mechanism (bearing in mind our stated intentions regarding application of the existing mechanism, as discussed above).

We would also welcome an indication from DNOs as to whether they are likely to submit an application for adjustment to the price control once the PPM licence amendment process is completed (assuming this is achieved by 1 April 2007 as previously advised). This will allow us to make preparations in advance so that we can turn applications around as quickly as possible.

A response to these points at the earliest opportunity would be appreciated, and preferably no later than 26 January 2007.

If you have any queries, please do not hesitate to contact me.

Yours sincerely,



Rachel Fletcher
Head of Retail Markets