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14th February 2011

Dear Steve

National Grid's response to Ofgem's Review of Metering Arrangements Initial findings and consultation - Ref 162/10

We welcome the opportunity to elaborate on some of the issues that appeared in Ofgem's ROMA request for information last year. There are undoubtedly some lessons to be learned from the first few years of competition in domestic metering and some important issues to be managed as the transition to smart metering moves ahead. The changes in the strategic approach of suppliers to sourcing metering services is having a profound effect on the market; greater emphasis on 'in-sourcing' by energy suppliers is causing meter providers and operators to review the scale and scope of metering as a commercial opportunity.

We are not surprised that Ofgem finds that competition has developed well in electricity metering but has not established to the same extent in gas metering. We believe that the role of regulation in these markets and the impact that it can have should not be overlooked. We therefore welcome Ofgem's acknowledgement of the risk that price controls can distort a market and thereby inhibit competition. Gas metering has remained a licenced and price controlled activity in contrast to electricity metering. We have previously pointed to indications that the combination of MPOLR and tariff caps has led to suppliers relying on the 'last resort' facility thereby suppressing market entry by competitive operators.

Whilst recognising Ofgem's concern that the gas metering market may need a 'safety net' provider we welcome Ofgem's proposal to introduce new controls such that gas suppliers should be able to demonstrate they have explored the competitive market before requesting services under MPOLR. However, if the MPOLR obligation is continued then it must be matched with a review of the rental charges.

We ask that Ofgem sets out more clearly the extent of the MPOLR obligation. Maintaining a capability to provide services, for an unknown duration and potentially on a decreasing scale may be very costly. This issue stretches across into Post Emergency Metering Services; emergency service providers may not have capability to deal with smart meters and so timely reconnection of a consumer's supply may depend on installation of a 'dumb' meter.

We welcome the proposal to review the new/replacement dumb credit meter tariff cap. Whilst we would have preferred to see the constraint removed, if it is retained it is important that it is set at a level to avoid interfering with market and also recognise that new/replacement assets will be removed prematurely and so must be subject to accelerated depreciation. We argue that ensuring networks are able to recover their investments is entirely consistent with Ofgem's duty to fund licensee for its obligations.

We are disappointed that Ofgem is not proposing to address the prepayment meter (ppm) tariff cap for new and replacement meters. We have provided details to show that the tariff cap is significantly below our cost and also evidence of the market distortion that this is causing. Currently the tariff caps operate in tandem, the domestic credit meter (dcm) charges carry the burden of the cross subsidy for ppms and the level of the caps is predicated on the ratio of ppms and dcms being installed.

It appears perverse and highly questionable for Ofgem to suggest continuing a situation that causes conflict between licence conditions because the tariff caps force a cross subsidy that is elsewhere prohibited. If Ofgem's concern with setting the tariff cap to its correct level rests in the potential for higher charges to flow through to vulnerable consumers then this concern should be properly addressed through oversight of the energy retail market.

There is a serious logical inconsistency in the proposals to ignore the legacy meter tariff caps whilst Ofgem clearly accepts the need to review rentals for new / replacement meters. There is no justification for an arbitrary horizon which separates assets that may be permitted to repay their investment and those that may remain constrained by a tariff cap that will inevitably result in value stranding.

We believe Ofgem is wrong to argue that most legacy assets are full depreciated. Ofgem's definition of 'legacy' includes meters being fitted today (and will include any new meters fitted up until any new caps are agreed) so some of the assets will be brand new and these will suffer premature replacement as smart metering rolls out. Ofgem should therefore consider carefully at what point a meter could be regarded as a legacy asset, particularly given the inability of gas networks to exercise any discretion in meter provision due to the licence obligation placed upon them.

The investment in 'legacy' assets has been made under regulatory obligation and fair recovery of that investment is an essential part of the 'regulatory contract'. It is a fundamental in the 'deal' that networks accept obligations and in return Ofgem sets out arrangements by which investment, identified in the RAB, may be recovered. Where replacement of assets is accelerated as a result of a change in government policy then it is right to adjust the depreciation of the RAB.

A failure by Ofgem to recognise networks' entitlement to recover their investments that have been efficiently made in accordance with licence obligations, and which subsequently face stranding as a result of changes in government policy, would introduce a fundamental new regulatory risk that would increase the cost of capital. This is particularly important given signals Ofgem may be sending to investors on asset lives, depreciation and financeability in the RIIO price control review.

If Ofgem is reluctant to raise the tariff cap for legacy assets then perhaps it should consider a transfer of RAB to the Gas Distribution asset base of an amount equivalent to the stranded value in metering.

We agree that fundamental reform of RGMA is not justified because benefits in dumb metering competition will be short lived. In addition, it is not clear how smart service provision will be structured, (bundled or unbundled). Any attempt at significant reform of RGMA has huge risk that resources will be distracted from smart deployment.

We have set out in an attachment our responses to the specific questions in the consultation document. If you have any questions regarding our response please contact Eric Fowler or Paul Rogers.

Yours sincerely

[By e-mail]

Paul Whittaker
UK Director of Regulation

Attachment National Grid's detailed response based on the table of questions

Chapter: One

Question 1: Do you have any views on our assessment of the current arrangements for the gas and electricity metering markets?

We believe that the effects of regulation may have played an important part in creating the differences between the markets for gas and electricity metering. The contrasts to be drawn are that Ofgem removed price controls and allowed all participants, including DNOs to develop commercial offerings whereas gas has continued under regulation, MPOLR and cross subsidies that have interfered in development of market. We would align with Ofgem's hypothesis that the existence of regulated services may reduce the incentive for suppliers to seek alternative metering service providers.

A significant additional and linked factor that may have inhibited competition is the prolonged uncertainty regarding smart metering. The market has anticipated some form of government or regulatory intervention since 2006. Suppliers will undoubtedly have wanted to minimise their commitment to rent new 'dumb' meters on commercial contracts given the high likelihood that those assets would need to be prematurely displaced when the smart meter mandate is finally implemented.

We are disappointed that Ofgem has chosen to repeat the ungrounded assertion made in footnote 5 of the ROMA document. Evidence flies in the face of Ofgem's assertion that the "*MSAs severely restricted the rate at which suppliers can replace even National Grid's older meters*". In fact, most suppliers that were signatory to the MSA have chosen to replace meters at a slower rate than the contracts permitted and have chosen to replace meters with a range of ages. In addition, customers that did not sign the MSA and thus would not have been influenced by the alleged constraint did not in fact exchange meters any faster than the MSA signatories.

There is also no evidence to support Ofgem's claim that suppliers would have replaced National Grid's meters with "*smarter meters from rival competing CMOs*". Where National Grid's meters have been displaced by CMOs the replacement has been on a like-for-like basis (with the small number of exceptions where meters formed smart meter trials). The Competition Appeals Tribunal rejected Ofgem's claim that the MSAs had frustrated the roll-out of smart meters so we are surprised that Ofgem has chosen to repeat it.

We have accepted Ofgem's conclusion regarding the effect of the Competition Appeal Tribunal decision to uphold Ofgem's earlier decision in the Competition Act investigation, that is, the Legacy MSA contracts are now void. National Grid notified customers that this was the effect of the decision and that consequently the rental of legacy meters would revert to the default regulated contract which has no term conditions.

National Grid has discussed with customers a proposal for a new contract to cover the meters installed prior to 2004 (known as Legacy gas meters). However, prior to making a formal offer to customers National Grid wishes to minimise any risk that a new contract will be found to breach competition legislation. National Grid is seeking guidance from Ofgem.

There is considerable uncertainty regarding the demand for traditional meters before and even during the deployment of smart meters. Whilst many of the installation skills are likely to be similar, the installation procedures and the field and back-office systems to support smart meter installation may be significantly different. The anticipated manpower requirement to achieve the high rates of smart meter installations means that existing meter installers will be retrained and transferred from traditional to smart meter work and in addition many new installers will need to be recruited. Traditional meter delivery is likely to be 'ramped down' as smart meter deployment increases and workers are retrained and redeployed. In this situation, it is conceivable that the market may demand a 'safety net' arrangement for situations where it is not possible to fit a smart meter and where the smart meter installer is unable to fit 'dumb' meters.

A key objective for Ofgem must be to consider how the transition to smart metering can be most efficiently and effectively made taking into account the needs of the different market participants. There may be three different types of participant in the market during the transition, new entrants that will provide smart meters only, existing participants that will transform their businesses as the deployment progresses and 'dumb' meter providers who will withdraw from meter provision. The ability of the energy market to effectively deliver smart meters will be significantly affected by the way in which 'dumb' meter accounts are 'closed down'. Thus, the contribution of all parties, including those withdrawing from the market, will be vital.

While we are disappointed with Ofgem's conclusion that competition is not sufficiently developed to justify the removal of price caps we wholeheartedly endorse the conclusion that tariff caps for new and replacements meters must be increased to reflect the current market prices and the shorter expected lives for these assets. We also believe that Ofgem should consider increasing the tariff caps for the large base of meters already installed as these too will be prematurely displaced. The meters have been installed as a result of the POLR obligation and should therefore be subject to the same approach recognising the accelerated depreciation that will be necessary.

Chapter: Two

Question 1: Do you have any views on our assessment of consumer protection?

We note that the assessment covers only electricity metering. It is interesting to note that the majority of suppliers do not believe that the removal of metering price controls have been detrimental.

Question 2: Do you have any views on our assessment of commercial interoperability?

A variety of commercial offers is a natural consequence of a competitive market where different providers are seeking to differentiate their offering. An obvious parallel is the retail market where many different offers are presented to consumers. We believe a significant factor is the desire by individual energy suppliers to drive the terms of their commercial arrangements with meter services providers. This is an expected outcome under the supplier hub model. As the buyer of the services the energy supplier is able to exert considerable influence on the metering provider to comply with particular contract structures. This leaves the metering services company with a bespoke arrangement in the event that the consumer then initiates a change of supplier.

We agree that it would be wholly inappropriate for consumers to endure a meter change every time they switch supplier. In practice, suppliers have found ways to manage commercial interoperability and we concur with Ofgem's conclusion that there is insufficient evidence to warrant intervention in the 'dumb' meter market.

Question 3: Please provide any evidence you have of meters that were removed unnecessarily due to incompatible commercial arrangements.

We do not have evidence of this; we believe any issues are more likely to be associated with practical difficulties rather than a failure to accept commercial terms. We have on occasions been requested to perform a meter exchange (change of functionality) and in doing so displaced a CMO owned credit meter in order to fit a National Grid provided prepayment meter. This is likely to be driven by the rational commercial choice by the supplier to have a cross subsidised National Grid ppm rather than a CMO meter that would be offered at the true market rate.

Question 4: What are your views on whether a single commercial model is needed? If so, is this something that industry should seek to develop?

We recognise that there may be some merit in simplification. The benefits must be set against the potential difficulty that may be found in renegotiating existing contracts and the potential that commercial innovation and choice is lost. Some high level principles may be receptive to standardisation, e.g. whether the installation cost is amortized. However, there may be valid reasons why different owners depreciate meters over different anticipated service lives.

If Ofgem finds merit in regularising metering contracts then we would expect Ofgem to also ensure that participants are not disadvantaged in the 'levelling' process. Such an exercise would need regulatory intervention to ensure that all participants engage in good faith to agree new terms. The exercise should be framed at securing a more uniform contract structure and not about forcing through other changes that shift the contract value.

Question 5: Do you consider the implementation of UNC297 to have resolved issues relating to asset visibility in gas metering?

UNC297 permits valid market participants to obtain details about the supplier appointed to a meter point. This will undoubtedly assist the MAP-only businesses to ensure that they are able to issue rental invoices to the relevant supplier using their assets. The reduction in 'unbilled' meters should improve the operational and financial position for MAPs.

Question 6: Are there any specific aspects of the Review of Gas Metering Arrangements baseline data flows that you consider need to be reviewed?

The costs and effort for a fundamental reform cannot be justified given the limited timescale over which the dumb meter regime will operate. However, there are some issues with the quality of data within the industry systems where improvements could be made. The RGMA processes rely on data being transferred at change of supplier events. There are occasions when the MAM identity is shown as "unknown" if an incoming supplier has not provided the appropriate details to xoserve. It is likely that the incidence of queries will increase during the roll-out of smart meters because the rate at which irregularities are discovered will increase. Resolution of these queries will rely on the co-operation of both the incoming and outgoing meter provider.

Meter operators provide services for their customers to resolve queries with meter asset data. There are identifiable differences between suppliers in query generation. These differences appear to arise as a result of the varying effort that agents make to gather and validate data when dealing with customer enquiries. In the interests of fairness it may become necessary to levy charges for parties that pose a disproportionate number of invalid queries.

Chapter: Three

Question 1: Do you agree with our assessment that the MPOLR requirement remain with GDNs for dumb meters?

We do not agree and are surprised that Ofgem remains reluctant to rectify a situation that has and continues to cause a distortion of competition. However, if this is the preferred option then we would wish to see both of the other features mentioned in the ROMA document; a constraint on suppliers and an increase of the tariff caps. We would prefer that tariff caps are removed so that networks are able to set a cost reflective charge taking into account the diminishing level of dumb meter installation activity and the shorter asset lives. We firmly believe that assets installed under these obligations should be fully remunerated in order to recover the cost of provision, installation and maintenance.

Question 2: At what point of the smart meter rollout would be an appropriate time to remove the MPOLR obligation on GDNs?

National Grid suggests the obligation should be lifted as soon as possible. The obvious waypoints is the date at which smart meter deployment becomes mandatory. The linkage between MPOLR and tariff caps has been recognised by Ofgem so we would expect that if the MPOLR obligation persists then corresponding arrangements will permit networks to set an appropriate charge structure to ensure full recovery of the investment made. Nevertheless, given that smart metering roll-out is a supplier led activity, it should be incumbent on suppliers to ensure customers are protected by a last resort obligation. It is clearly not appropriate to perpetuate an obligation on gas networks who may have no direct interests in domestic smart meter ownership.

Question 3: We intend to place a Licence Condition on suppliers for domestic credit meters (DCM) and pre payment meters (PPM) to ensure that MPOLR is only used in cases of genuine last resort. Do you consider this to be an appropriate solution to the apparent misuse of MPOLR?

We agree that this may be a solution but it is unclear how it may be implemented to be workable. We believe a more effective measure would be to permit GDNs to set charges for new meters on a proper cost reflective basis. Otherwise Ofgem may face the situation where a supplier is able to demonstrate that it has 'tested' the commercial market and found that commercial operators are unable or unwilling to offer terms that beat the regulated offer. Indeed we find it surprising that Ofgem would contemplate continuing to permit a clear cross-subsidy and market distortion when there is an opportunity to rectify it.

Question 4: Small and/or out of area suppliers have expressed concern regarding availability of dumb electricity meters. Are these concerns valid? If so, please explain (and quantify if possible).

We do not have an opinion on this question.

Question 5: Would a non-discrimination obligation on suppliers be an appropriate response to concerns related to access to smart meters during the smart metering rollout? If so,

- a) Would this obligation be better placed on the Big 6, or on all vertically integrated suppliers?**
- b) Should the obligation comprise meter provision services; meter installation and maintenance services; or both?**
- c) Could such an obligation be overly burdensome?**
- d) Should the obligation contain a sunset or review provision once the rollout of smart meters has been completed?**

We believe this question is one that should be addressed under the development of the smart energy code.

Question 6: Are there any unintended consequences of introducing a non-discrimination obligation on suppliers to offer metering services on equal terms; or consequences that we have not considered?

We believe this is a question best answered by suppliers.

Question 7: Do you consider a MPOLR is required for smart meters?

In a supplier led roll out, an MPOLR obligation on networks to provide smart meters would appear to be inappropriate. If there is a concern about access to meters, this could be remedied by an obligation on suppliers rather than networks. Only if a supplier remedy cannot be constructed should an obligation on networks be considered and then only if the regulatory treatment permits full recovery of the necessary investment.

It should be borne in mind that there may be significant set-up costs to enable networks to provide such smart meter services and a smart MPOLR obligation does not guarantee the number of meters that networks will be called to install. Thus, the funding for the obligation must allow for the fixed set-up costs which would be incurred regardless of usage.

Chapter: Four

Question 1: Do you agree that legacy meters (credit and pre-payment) should remain under price control?

We understand the reasons why this may be considered desirable. However, it is important to note that the financial treatment for these assets must recognise that they have been installed under

regulatory obligation. It is therefore incumbent on Ofgem to recognise the stranding of asset value that is likely to occur as smart metering is deployed causing these assets to be replaced before the end of their anticipated service life.

We believe Ofgem is wrong to argue that most legacy assets are full depreciated. Ofgem's definition of 'legacy' includes meters being fitted today (and will include any new meters fitted up until any new caps are agreed) so huge numbers of the assets will be brand new and these will suffer premature replacement as smart metering rolls out. The solution is to accelerate the financial depreciation of this asset base, recognised in the RAB, and align it with the smart meter deployment timetable, i.e. fully displaced by 2020. Thus, whilst the rental charges will remain under tariff constraint, they will need to be adjusted up to accommodate the accelerated depreciation.

Question 2: What is the impact on customers if we reset price controls for:

- a) PPM meters?**
- b) DCM meters?**

The gas meter rental forms a tiny part (typically less than 3%) of the final retail price for energy. Suppliers have shown through their pricing policies that it does not matter whether a meter is provided by a CMO or by a gas network – the retail charge for energy is the same. Additionally, some suppliers have levelled their tariffs between credit and prepayment.

The two price controls act in unison, and suppliers will take a view across their portfolio of customers. As long as a supplier has a portfolio that is aligned with the general population, i.e. about 91% credit meter and 9% ppm, then resetting of the price controls, and unravelling the cross subsidy within meter rental will be broadly neutral. However, from the perspective of the meter owner, given that the cross-subsidy links credit and prepayment meter tariffs it would be inappropriate to make adjustments to one without considering adjustment of the other.

Question 3: We seek views on whether there is any advantage in setting a cost reflective price cap for new and replacement dumb meters, which also accounts for unnecessary meter replacement.

- a) We are also interested to understand whether an allowance beyond a purely cost-reflective level would encourage competition?**

We believe that the tariff caps for any new and replacement meters should be cost reflective. This would avoid the potential distortion that could be introduced by a tariff cap that is 'incorrect' and set too high or too low. This is echoed in comments made elsewhere by Ofgem that price control interventions should avoid interfering with competitive markets.

The risk with a low tariff cap is that it would appear to step away from a fundamental principle in price controls underpinned by the Gas Act requirement for the Authority to have regard to the ability of the licensee to adequately fund its obligations.

A tariff cap which is set at a level greater than the cost reflective level might have the effect of encouraging market entry and competition but only if the network has set its charges at the level of the cap, i.e. at a level beyond cost reflective. We also feel that there may be significant risks that such an approach to price controls would be challenged. Ofgem has never in the past attempted to set a 'generous' price control allowance and indeed to do so may breach its statutory duty to protect consumers.

- b) In the transition to smart metering, what consideration should be taken into account when setting a new price control tariff for dumb meters?**

Any tariff cap must take into account the fundamental costs, and the capability for rental of the asset to repay those costs including an appropriate return. Clearly this equation will be very complex, bearing

in mind the uncertainties relating to the amount of activity, which will affect the unit charges, and also the potential service life for the asset.

Alternative approaches that could be considered are to permit networks to identify where value stranding has occurred and to provide a mechanism to collect that unrecoverable RAV through another charge. An obvious candidate is to 'transfer' the unrecovered RAB to the network business so that the cost recovery can be made over a number of years so there is no spike in consumer charges – which could trigger an adverse reaction to smart metering.

An alternative mechanism more obviously aligned with the commercial offerings would be to terminate the evergreen regulated contract that permits MPOLR and to replace it with a new commercial contract that has premature replacement charges. This type of contract would permit networks to set annual rental charges at a level consistent with a normal service life and would also satisfy Ofgem's duty to adequately fund the networks for that duty.

The introduction of this type of contract would need to be linked with a mandatory 'churn' obligation such that a supplier 'winning' a supply point would be obliged to enter into the standard terms and would be contracted to pay any premature replacement charges if they chose to displace the meter.

Question 4: What is your view on the total costs for the provision of PPM and how they are passed onto customers?

We provided details on our costs to provide prepayment meters in our earlier RFI response. The rental charges for provision of the meter form only part of the cost to the energy supplier who must also consider the 'back office' and PPMIP costs. There appear to be differing arrangements for reflecting these costs in energy retail tariffs. Some suppliers have equalised their charges so there is no difference between credit and prepayment.

Question 5: What are the likely tradeoffs between the implications for the price for providing PPMs, especially for vulnerable customers versus the incentives for PPM smart rollout and cost reflectivity? For example, if we choose not to review the PPM tariff cap, would this weaken and slow the case for investing in smart PPMs?

The current PPM tariff cap is set at a level significantly below cost. We believe that on a prospective basis the cap should be raised to a cost reflective level. Failure to address this issue could create a greater perverse incentive for suppliers to rely on network-provided ppm services knowing that competitive providers are unable to match the tariff cap rental. It might also discourage installation of smart meters if ppms which are to a degree 'smart' and tariff capped are available for less than the cost of a smart meter.

We can understand why Ofgem might wish to maintain the current tariff caps for prepayment meters already installed to avoid a risk of price change for consumers until the assets are displaced by smart meters. This policy would give effect to a transition between ppm and smart meter regimes and should not unduly hamper the roll-out of smart meters if that is driven by wider supplier obligations and market appetite to achieve the anticipated smart metering benefits.

However, it must be remembered that the funding of ppms depends on a cross subsidy from credit meters and therefore the credit meter caps might need to be further raised to continue to support the ppm population until customers are ready to displace them.

Question 6: We are aware that National Grid Metering is renegotiating the MSA contracts. Can you please indicate what your metering arrangements are likely to be going forward?

The decision of the Competition Appeals Tribunal has made void the Legacy MSA contract that for some gas suppliers covered rental of National Grid domestic sized meters installed prior to January 2004. As a result, all meters that were covered under the Legacy MSA are now provided under the

standard regulated contract (known as the P&M contract). Subsequently, National Grid has sought to develop a new alternative to the regulated default contract.

The new proposal includes premature replacement charges that become payable if a meter is removed before the end of its anticipated service life. This is an essential feature of the proposal because it acts to mitigate the value stranding inherent in the regulated contract. The certainty that this mechanism provides allows the offer of a rental charge that is lower than the current tariff cap.

In order to avoid the possibility of litigation, National Grid is formally seeking advice from Ofgem on whether the new contract proposal complies with competition legislation. If Ofgem is able to provide an appropriate level of comfort that the new contract complies with competition law then National Grid would like to offer to its customers a mutually beneficial alternative to the standard regulated contract.