



**REVIEWS OF
PUBLIC ELECTRICITY SUPPLIERS
1998-2000
SEPARATION OF BUSINESSES
SECOND CONSULTATION PAPER
NOVEMBER 1998**

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FOREWORD

In May 1998 I published a Consultation Paper on the separation of PES businesses. The paper set out initial views on the issues surrounding the separation of activities, particularly PES distribution and supply businesses and the future treatment of metering and meter reading. These issues form a major component of the programme of work and reviews envisaged for the 14 public electricity suppliers (PESs) during 1998 to 2000.

The consultation document in May set out OFFER's initial observations on:

- the need for separation of PES distribution and supply activities;
- the means by which separation could best be achieved and its implications for PESs, customers, competitors and regulation;
- future arrangements for metering and meter reading;
- separation of activities in Scotland; and
- options for legislative reform to change the responsibilities and rights of suppliers, distributors and customers.

Since the May consultation the Government has published its response to the Green Paper on Regulation.¹ It has confirmed its intention to legislate to provide for the separate licensing of distribution and supply activities. It has now issued a Consultation Paper on the issues involved.² OFFER will contribute actively to that consultation process and welcomes strongly the prospect of new legislation in this area.

The purpose of this present paper is to take forward the other aspects of the May Consultation Paper. In all 55 responses were received to the Consultation Paper. A list of parties responding to the consultation is set out at Annex A. The present paper reviews those responses and sets out the next steps for consideration.

It would be helpful to hear from all those with an interest in any aspect of the separation of activities and the future treatment of metering and meter reading, including customers, their representatives and other interested groups as well as the companies themselves and other suppliers.

Comments are invited on the general issues raised in this paper. In particular, it would be helpful to have comments on the proposals made in the paper and on the various specific areas where views have been invited.

¹ "A Fair Deal for Consumers: the Response to Consultation" - DTI, July 1998.

² "A Fair Deal for Consumers: the Future of Gas and Electricity Regulation" - DTI, October 1998.

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Electronic mail responses to the Consultation Paper should be sent to:

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Comments are requested by 15 January 1999.

OFFER would prefer to publish all responses to this consultation by placing them in the OFFER Library. All responses will be published in this way unless they are clearly marked as confidential. Any general queries about the contents of this paper can be raised with Craig Halsall at the above address in the first instance (telephone contact 0121 456 6290).

PROFESSOR S C LITTLECHILD
DIRECTOR GENERAL OF ELECTRICITY SUPPLY

November 1998

1. NEED FOR GREATER SEPARATION OF PES ACTIVITIES

Consultation Paper: May 1998

- 1.1 The public electricity supply licences require the public electricity suppliers to have separate businesses for accounting and certain other purposes. They contain separate price controls for distribution and supply activities and prohibit cross-subsidies between the businesses. However, the present Electricity Act does not provide for separate licensing of PES supply and distribution functions.
- 1.2 The Consultation Paper in May 1998 outlined the developments in electricity and gas which pointed towards the advantages of separating network monopolies from the competitive activities of the industries. It noted that in electricity PESs are increasingly recognising the separate nature of supply and distribution. Many are considering wide-ranging corporate restructuring including the possible sale or acquisition of supply or distribution businesses as separate entities. This offers potential efficiency benefits. However, without a change in legislation it might be difficult to provide for separate ownership of supply and distribution even where the companies wished to achieve this.
- 1.3 There is a second major reason for greater separation between distribution and supply. Whilst the present PES licence conditions provide for some separation of supply and distribution activities, many respondents consider that this is not sufficient to ensure the neutrality of the distribution system between competing supply and/or generation interests. The Consultation Paper described a range of circumstances where distribution could effectively deter new suppliers. It explained that, whilst there may be no overt or intentional discrimination, it was inevitable that so long as the PES remained an integrated business the decisions made by the PES distribution business would be influenced by the interests of the PES supply business. Accordingly, the present position seemed likely to deter entrants and reinforce the dominant position of PESs in supply, to the detriment of customers and competition.
- 1.4 The paper concluded that it was important to ensure that the monopoly distribution system is neutral and seen to be neutral with respect to competing suppliers. This would be furthered if electricity distribution businesses, like other monopoly businesses such as electricity transmission and gas transportation, were fully separated from trading activities such as electricity supply and generation and gas supply, which are potentially competitive.
- 1.5 The paper argued that the various problems identified with the integrated nature of the PES business would best be resolved by separate ownership of supply and distribution. The paper also raised for consideration whether steps short of full separation of ownership would be appropriate as an interim measure. One approach would be to place supply and distribution businesses in separate subsidiary companies operating independently of each other and capable of being

under separate ownership. A further range of measures could then be instituted to ensure that the subsidiaries operated at arm's length, reflecting as far as possible the arrangements other suppliers would have with the distributor.

- 1.6 The paper then discussed a range of measures that could be implemented to provide for a greater separation of activities. These included issues relating to contractual matters, staffing and location issues, customers services and IT support and branding.
- 1.7 On contractual matters, the previous consultation proposed that a PES's supply and distribution businesses should in due course be required to contract each one with the other for the provision of distribution use of system services. It was noted that this could not be achieved until new legislation was in place because the distribution and supply businesses are part of the same legal entity. As an interim measure the paper proposed the establishment of service agreements between the two businesses to mirror as far as legally possible the contracts that PESs were agreeing with third party users of their distribution system.
- 1.8 On staffing and location issues, the previous Consultation Paper proposed that PESs should establish separate management and staffing structures for the two businesses, basing staff at different locations and ensuring that the number of staff with dual business responsibilities was minimised.
- 1.9 With respect to customer services, the paper noted that PESs presently operate largely integrated systems of handling customer enquiries through a call centre dealing with both supply and distribution issues. The paper proposed that distribution businesses should make separate provision for call centre services. Similarly, it proposed that distribution IT requirements should be separated as soon as practicable from supply requirements. The guiding principle of reform would be to ensure that no information could inadvertently or otherwise be shared between the businesses.
- 1.10 Finally, the paper suggested that there would be advantage in moving towards the establishment of separate corporate identities for the distribution and supply businesses.

Views of Respondents

Public Electricity Suppliers

- 1.11 PESs agreed with the idea of having separate licences for supply and distribution businesses. They also emphasised the importance of having clearly defined businesses for price control purposes. However, there was strong resistance to the idea that the supply and distribution businesses should be placed under separate ownership. If this were to take the form of a forced sale, the PESs argued that they

would not realise the true value of the business being sold and in any event such sales were unnecessary.

- 1.12 In the view of most PESs, the comparison with the separation of British Gas was inappropriate, as was reliance on the Monopolies and Mergers Commission's conclusions on British Gas in 1993. British Gas acted as a nationwide supplier and distributor whereas each PES is regionally based. In addition, British Gas in 1993 did not have regulatory arrangements in place to separate businesses such as those presently in place in respect of the PESs.
- 1.13 Most PESs argued that in any event their present position did not represent a significant detriment to competition. Competition had developed well in the 100kW market and there was little evidence of the present integration of PES activities having given rise to significant levels of complaint by competitors. PESs noted that the existing licence regime already provided for separation of activities for regulatory purposes, restricted the use of information held by the distribution business and prohibited actions likely to distort competition. In such circumstances, the regulator should be able to take action if difficulties arose. Significant structural change was not therefore required to safeguard competitors. However, PESs should have the option to dispose of supply businesses in future.
- 1.14 Some PESs argued that focusing on the reform of PES activities should not be a priority for regulators. They argued that Centrica, and, in particular, its subsidiary British Gas Trading (BGT) represented a greater threat to competition in the energy sector. This arose because of its significant market share and existing national activities. Several PESs argued that competition from Centrica was "unfair" because of these and other factors.
- 1.15 A forced sale of supply businesses and the separation of activities was, in most PESs' views, likely to increase costs to customers and disadvantage PESs in the face of competition from Centrica. Some PESs argued that if supply businesses were to be owned separately from distribution, it would be necessary to allow existing supply businesses to merge.
- 1.16 PESs argued that if the businesses were separated operationally there may be losses of efficiency in the way work is performed. For instance, at present many of the IT systems are shared between supply and distribution businesses. Creating separate systems for each business would in the view of most PESs incur considerable expense. A second major area of expense would be providing separate call centres for supply and distribution. By combining work on supply and distribution PESs are able to transfer call centre staff from one area to another immediately when the need arises, for instance when an extensive power cut occurs in the region. If the distribution business had a separate call centre which was staffed to provide a response to the small number of distribution queries each day, it would be difficult to provide a rapid response to a major incident without having the opportunity to use supply staff. Customer service could suffer as a result.

- 1.17 Many PESs said that it was important to allow one business to provide services for the other on a flexible basis. This allowed the greatest benefits to be obtained. Cost savings could be shared with customers through price controls. Competitors would be safeguarded, in the view of PESs, through the enforcement of non-discrimination provisions. Some PESs used Service Level Agreements to specify the terms of the arrangements between their businesses. However, most PESs argued that greater separation of activities could lead to poorer customer service and increased costs.

Second Tier Suppliers

- 1.18 Second tier suppliers welcomed the proposed separation of businesses. They argued that it would help ensure that there was no discrimination in the provision of services to suppliers. One company suggested a compliance regime could be put in place to prevent any commercially useful information being passed from the distribution business to the PES supply business as an interim measure. This company took the view that separate subsidiaries were desirable but separation of IT systems, accounting systems and the physical separation of businesses together with a strict compliance regime would provide many of the necessary safeguards for competitors. There was some concern about the level of costs which PESs would claim were being incurred through separation.

Consumers' Representatives

- 1.19 There was strong support from consumer groups for separation of supply and distribution businesses. The businesses should be licensed separately and operated independently of each other. It was felt that separation would prevent cross-subsidies between businesses and improve the environment in which second tier suppliers compete. By enhancing competition customers would benefit. Some Electricity Consumers' Committees considered that separate licensing of supply and distribution businesses might lead to larger supply businesses being formed. These might be in a better position to negotiate with generators and hence could lead to more competitive prices for customers.
- 1.20 Many Committees stressed that it was important to limit the costs of restructuring which could be passed on to customers. Particular attention needed to be given to the costs of changing call centre and IT arrangements. However, many Committees felt that on balance the benefits of having a better climate for competition made changes to the businesses important.

OFFER's Observations

- 1.21 Most parties accept that further measures are required to clarify the distinct role of electricity distribution. It is also widely accepted that greater separation of existing PES distribution and supply activities is required.
- 1.22 The initial Consultation Paper argued that the various problems associated with the integrated nature of the PES businesses would best be resolved by separate ownership of supply and distribution. The points made by PESs in response to the consultation do not represent a sufficient case for retaining the present ownership structure. The value of supply businesses can only be disclosed by a sale process. Whilst a sale of all the existing businesses at the same time might not be practicable, there is no reason to suppose that an adequate market does not exist for supply businesses. Indeed, it is reported that several PESs in any event are presently considering the sale of their supply activities.
- 1.23 In assessing the development of competition in the above 100kW market it should be noted that most active competitors are PESs supplying out of area. Whilst the level of formal complaints about PES activity has been low, this does not demonstrate that the present position is satisfactory. Suppliers have expressed concern about the role of PESs' distribution activities in the 100kW market, for example in the context of difficulties in obtaining metering information to facilitate second tier supply. OFFER believes that such difficulties are likely to be more acute in the domestic and small business sector. Early indications from the competitive market suggest that this is the case.
- 1.24 Whilst the existing regulatory regime addresses the separation of activities for regulatory purposes, it allows the PESs to remain largely integrated for operational purposes. Staff in a wide variety of PES activities will wish to promote the interests of the company as a whole over those of its competitors. Given the complexity of the interaction between suppliers, customers and the distribution business necessary to facilitate competition in supply, discriminatory behaviour by the PES can arise in a wide variety of circumstances. This is likely to give rise to significant barriers to entry by competing suppliers. Continued regulatory action and oversight is required to protect entrants. There is already evidence of the need for such action. In July 1998 over 1200 disputes arising from the PESs' proposed agreements with suppliers for use of system and metering related services were referred to OFFER by suppliers. These disputes resulted in some 700 formal determinations. Such difficulties are likely to continue whilst the businesses remain largely integrated.
- 1.25 Concerns about the position of BGT in the energy supply market do not seem relevant to the present discussion. PESs argued in effect that their competitive advantage in supply arising from integration with distribution was appropriate as a counter-weight to the dominance of BGT arising from its scale. Ofgas has recently conducted a review of the development of competition in the domestic gas market.

Ofgas concluded that the prospects for competition in gas were good. However, it raised a number of concerns about BGT's actions in the market.³ Ofgas was seeking views on whether these actions represent a significant impediment to competition and, if so, what steps if any should be taken.

- 1.26 Several PESs are presently amongst the most active and successful competitors in the gas market. Similarly it appears likely that BGT will be an active and successful competitor in electricity. Competition concerns arising from the dominance of BGT or any PES in the supply markets, will need to be addressed by the regulators as they arise. The success of PES supply businesses in the energy market will depend on their competitiveness. It should not rest on receiving cross-subsidies or discriminatory support from the PESs' distribution businesses.
- 1.27 In its Consultation Paper the Government recognises that separate ownership is likely to enhance competition.⁴ It sets out further views on developing the legislative framework for electricity. It confirms its intention to legislate to provide for separate licensing of supply and distribution. It proposes that forthcoming legislation should require supply and distribution businesses to be placed in separate legal entities, although these might be separate subsidiaries of the same company. The approach matches that taken under the Gas Act 1995 - as a result of which the supply and transportation businesses of British Gas were initially separated into two companies under common ownership. The decision to demerge the two gas companies was a voluntary decision by British Gas and came after the new legislation was in force.
- 1.28 The Government's proposal would facilitate the separate ownership of distribution and supply. As noted in OFFER's May 1998 Consultation Paper, some PESs might then actively wish to separate their businesses, others might not. For those which did not separate their ownership, various measures would need to be put in place as an interim measure. The initial Consultation Paper noted in these circumstances, "It would be possible to evaluate the position at a later date in the light of further experience and prospective market developments. Increasingly, however, the position of integrated companies may become anachronistic and the focus of concern about the satisfactory development of the market in their area, particularly if they were perceived to use their position to secure advantages not open to others. Further action might then be required in the light of experience. The Fair Trading Act gives the Government power to require divestment if an MMC report indicates that this would be an appropriate remedy to a public interest detriment. It would also be helpful for reserve powers to be provided under legislation to require separate ownership if this was considered appropriate". OFFER continues to believe that reserve powers in this area could be helpful given the number of parties involved.

³ "A Review of the Development of Competition in the Domestic Gas Market": Ofgas, October 1998.

⁴ "A Fair Deal for Consumers: The Future of Gas and Electricity Regulation" - DTI, October 1998, Section 3.

- 1.29 As noted in the previous Consultation Paper, new legislation may take some time to implement. Some steps however, can be taken against the background of the existing legislative regime to enhance the effective separation of supply and distribution activities within PESs. In particular, consideration needs to be given to appropriate changes to obligations in licence conditions and associated industry agreements on PESs to provide for supply and distribution activities to be clearly and separately established. The objective should be to ensure that the businesses operate wholly independently of each other with an arm's length relationship reflecting as far as possible the arrangements that other suppliers would have with the distributor.
- 1.30 The need for greater operational separation of supply and distribution activities was discussed in the DTI Consultation Paper. The DTI noted that, "Having placed supply and distribution activities in separate legal entities, it is expected that these businesses should operate separately from each other. The businesses would be organised so that the core functions of supply and of distribution are correctly assigned to the respective entity and are carried out separately from activities in the other entity".
- 1.31 The Government accepts that "Further separation may also be necessary to prevent distortions". It outlines OFFER's proposals in the Consultation Paper in May and comments: "There are clearly advantages in this approach - by separating as far as possible the activities of the two businesses, the potential for distortion is reduced. On the other hand, customers may benefit from efficiencies arising from common services; indeed, the PESs argue that forcing the pace of such separation could lead to significant costs if PESs were forced to duplicate systems which presently are shared. The balance between the costs of separation and the competition advantage to be gained will no doubt form part of OFFER's consideration in developing its proposals further." The Government concludes that it "accepts the logic behind operational separation, and recognises that the detailed aspects are a matter for the regulator to pursue".⁵
- 1.32 As noted above, all PESs at present exhibit significant integration across many of their supply and distribution business functions. The picture varies between PESs but respondents have expressed a concern that commercially sensitive information does or might flow between the businesses, to the detriment of competitors and customers. Such practices can be difficult to detect. Suppliers are concerned that distribution pricing and service policies may be discussed with the PES supply business prior to publication; indeed, in some cases supply tariffs and distribution use of system charges are set by the same (or overlapping) groups of staff within the PES. It seems inevitable that without strict restrictions on the transfer of information and staff deployment, PES supply businesses will have preferential access to the commercial policies of the local distribution business. This would,

⁵ "A Fair Deal for Consumers: The Future of Gas and Electricity Regulation" - DTI, October 1998, paras 3.14-3.15 and Proposals 3.2.

for example, give the supply business better and earlier information upon which to base its own pricing decisions. It would also provide the supply business with opportunities to influence distribution prices and services that are not open to other suppliers.

- 1.33 Independent generators have also been concerned that the PESs' own generation businesses may have preferential access to information about technical issues affecting the local network, connection costs and timescales. Some independent generators have argued that PESs give preference to schemes involving their own generation business.
- 1.34 The development of competition in metering, discussed in Chapter 3, is likely to add further concerns. There is already some evidence that PESs' distribution policies can have a marked impact on the commercial position of third party meter service companies. Slow production of essential information, over-complex safety approval procedures and special local practices, can all deter entrants and reinforce the incumbent's market power to the detriment of customers.
- 1.35 Initially, the integration of distribution and supply reflected the pre-privatisation arrangements of the Area Boards. At privatisation there was some benefit in the maintenance of existing practices given the changes being introduced elsewhere in the industry. Some parties also considered integration to be necessary to maintain satisfactory services to customers. The development of competition in supply has shown integration to be unnecessary. However, from a customer perspective the present full integration of supply and distribution activities by PESs may be seen as implying that a lower level of services will be provided by the distribution business to those customers who choose competing suppliers. It is noteworthy that in the gas market many PESs in their marketing material stress to potential customers the independence and continued distinct role of Transco.
- 1.36 In electricity it is difficult for non-PES suppliers to integrate their services effectively with the local distribution business. Few PESs have developed systems which allow their distribution business to communicate with other suppliers and their customers as effectively as they do with their own supply business and its customers. As competition develops other suppliers can be expected to serve several hundreds of thousand customers in a PES area. It is important that the services provided by the distribution business are effective and coordinated with the service provided by all suppliers.
- 1.37 In all these areas the present position is far from satisfactory. Customers, their suppliers and other parties in the competitive market need greater assurance that the local distribution businesses will operate effectively and independently of other PES energy interests. A sharper definition of distribution functions is required and these functions need to be operated as far as practicable separately from PES energy trading interests to provide an effective service to all suppliers and their customers.

- 1.38 The steps necessary to achieve the appropriate separation of supply and distribution businesses are discussed in Chapter 2. They would be desirable as a way of minimising market distortions arising from the present position. They would also be in keeping with the Government's legislative proposals. In addition, they would provide a robust basis for the separation of ownership of the businesses when this is undertaken.

Proposals

- 1.39 The separate ownership of supply and distribution would be desirable. It would enhance competition and consequently bring benefits for customers. However, until new legislation is in place separate ownership may not be fully achievable. New legislation might take some time to implement. In these circumstances it is appropriate to take some preparatory steps as part of the PES Reviews.
- 1.40 In particular, consideration needs to be given to appropriate changes to obligations in licence conditions and associated industry agreements on PESs to provide for supply and distribution activities to be clearly and separately established. The objective should be to ensure that the businesses operate wholly independently of each other with an arm's length relationship reflecting as far as possible the arrangements that other suppliers would have with the distributor.

2. IMPLEMENTING THE SEPARATION OF DISTRIBUTION AND SUPPLY BUSINESSES

- 2.1 Possible steps to enhance the present separation between supply and distribution should be seen in the context of the present licence obligations on separate accounts and on restrictions of information exchange between businesses and of the PESs' existing operational arrangements.

Present Licence Requirements

- 2.2 The PESs are required under their licences to produce separate accounts for each separate business. Separate businesses means each of the distribution, supply, second tier supply and generation businesses and, in the case of Scottish PESs, the transmission businesses, separated from other businesses of the licensee (which might include for example appliance retailing and gas supply). A PES is also prohibited from cross-subsidising any separate business from another or from any other business of the licensee (or an affiliate or related undertaking of the licensee).⁶
- 2.3 To facilitate competition the PES is required to offer use of system terms to any other authorised electricity operator and terms for the provision of metering-related services. These terms are brought together in four main agreements: the use of system; meter operation; data collection and data aggregation agreements. The form of these agreements is largely standardised between PESs. Collectively these agreements are often referred to as the Standard PES Agreements. A description of the main terms of the agreements is set out at Annex B.
- 2.4 In providing use of system and these other services to suppliers the PES's charges are limited by price control. In addition the PES is prohibited from discriminating in the provision of use of system "as between the licensee (in provision of use of system by the licensee as part of its distribution business to itself for purposes of its supply or second tier supply business) and any Authorised Electricity Operator [in essence any other licensee] or class or classes thereof". Specifically, PESs are prohibited from making different charges to different users "except insofar as such differences reasonably reflect differences in the costs associated with such provision". In setting charges for use of system, the PES must not "restrict, distort or prevent competition in the generation, distribution or supply of electricity".⁷ Similar provisions apply in relation to metering services.⁸

⁶ PES Licence Conditions 2 and 4 (England and Wales);
Conditions 3 and 4 of Part II in Scottish Generation, Transmission and PES Licence

⁷ PES Licence Condition 8A (Condition 2A of Part VI in Scotland)

⁸ PES Licence Condition 11 E (Condition 8E Part V in Scotland)

- 2.5 The provision of these services by the PES distribution business has given rise to concerns about access to confidential data about competitors by the PES supply and generation business.
- 2.6 A licence Condition is included in the PES licence to prevent information gathered by the distribution business from being passed to the supply business for its commercial advantage.⁹ The information covered by the Condition was initially limited to details received under the Distribution Code but with the introduction of competition in the domestic market the restrictions now apply to information received under the Master Registration Agreement, Metering and Data Services agreements and Standard Terms of Connection.
- 2.7 Each PES must prepare a statement, at least once a year, showing what practices, procedures and systems it has in place to comply with the licence Condition prohibiting passing confidential information from the distribution business to the supply business. The statement must also show how the licensee will provide services so as not to restrict, distort or prevent competition. Accordingly, the statements address issues such as the location of businesses, protection of confidential information on shared IT systems and staff training.
- 2.8 At present there is no licence requirement for PESs to operate their businesses under separate legal, operational or managerial arrangements. Supply and distribution functions can be carried out as a combined activity, subject to keeping information confidential and so long as separate accounts are prepared for each business and there is no cross-subsidy between businesses.

Present PES Arrangements

- 2.9 Compared with the position at Vesting PESs now have a wide range of organisational and corporate structures. Of the 14 PESs in Great Britain, two PESs have merged and two more propose to do so. Seven PESs are presently part of a US-owned parent company. Four PESs are part of multi-utility groups. In addition to the two PESs in Scotland, two PESs in England and Wales are now vertically integrated. Further proposals for change in industry structure are under discussion.
- 2.10 Under this increasingly diverse pattern of ownership, managerial and operational arrangements within the PESs have many common features. However, each PES has its own individual organisational structure which has been influenced by the way it has been structured in the past and by its present ownership. Typically, there will be around four to six main business areas each headed by a director reporting to the Chief Executive. Many PESs have their supply and distribution businesses under separate operational management although not all do so. In all cases these businesses rely on a range of services provided at corporate level. These services are usually provided for both distribution and supply and also for other PES

⁹ PES Licence Condition 12 (Condition 9 of Part V in Scotland)

activities. Typically, these corporate services include legal, company secretarial, regulation, corporate strategy and human resource functions. In most cases there is also a separate financial director responsible for group financial returns and controls. Some PESs will also have a Director in charge of Information Technology as well as other Directors in charge of other areas of business, such as generation. In a few PESs the individual businesses will be responsible for human resources or Information Technology. Similarly, in some PESs much of the finance work is carried out within each individual business with the Finance Director responsible for Group level activities.

- 2.11 Many PESs have separate management arrangements for the customer service function covering the provision of the customer call centre, billing and related activities.
- 2.12 Some PESs have established metering functions as a largely self-standing business. In other PESs these functions are integrated within the distribution business, whilst some PESs have operational responsibility for metering functions under supply business management.
- 2.13 In Scotland each PES's transmission business is included within its power systems business which also covers its distribution business. In the case of multi-utility companies the position is often more complex with management groups having responsibilities for functions which cross several utilities. Some services, such as customer services, may be provided from a separate subsidiary within the multi-utility group.
- 2.14 In all cases there is a complex pattern of cross-charging between activities and the apportionment of costs to provide for separate accounts for the supply and distribution businesses.

Contractual Matters

- 2.15 The first step is to provide greater transparency in the relationship between the PES distribution and supply businesses. Many PESs have already gone some way towards establishing detailed service level agreements between their supply and distribution businesses. However, progress is by no means uniform. Many of the internal agreements are in place for company management reporting and budgeting purposes and do not necessarily fully or accurately reflect present use of system agreements offered to third parties. Many other companies do not have any formal internal agreements between supply and distribution but rely on existing working practices to ensure service is maintained.
- 2.16 The present position is not satisfactory. Without clear statements of the relationship between the two PES businesses and the respective responsibilities of those businesses, there is a significant risk of a distinct and discriminatory service

being provided to the PES's own supply business. The introduction of agreements replicating the use of system agreements offered by the PES to second-tier suppliers would assist in the monitoring of compliance with non-discrimination provisions and any cost-allocation within the PES. It would provide a focus to the separate management of the supply and distribution functions and provide both with a clear statement of what they can expect from each other. It would also facilitate a move to a full contractual relationship once separate subsidiaries are established following new legislation.

- 2.17 To be effective, such an agreement between the PES distribution and supply businesses would need to be monitored carefully within the two businesses. This would include at least the same reporting requirements as are presently in place for second tier suppliers. This would also enable OFFER to review performance under the agreement to ensure appropriate services are being maintained and to act as a benchmark in assessing use of system services provided to non-PES suppliers.
- 2.18 Some PESs have expressed concern that a requirement to put in place such agreements and monitor performance against them could be onerous and could cut across existing agreements within the PES's group of companies or with third party suppliers. It is not accepted that such a requirement would be onerous to implement. PESs should already have in place contract compliance and monitoring arrangements to oversee their use of system agreements with third party suppliers. Many of the reporting requirements under the new use of system and related agreements already include a requirement to monitor service to the PES supply business.
- 2.19 Given the significance to competitors of the relationship between the PES distribution and supply business there would be value in providing for greater transparency in that relationship by requiring the PES to publish the agreement between the distribution and supply businesses whilst these remain in common ownership. It would also seem appropriate to ensure the views of other suppliers and other interested parties are taken into account by the PESs in finalising the agreements. The existing use of system and related agreements have been developed as part of the programme of work preparing for competition in supply in 1998. PESs, other suppliers and customer groups have been involved in developing the agreements. Accordingly, there is no reason to suppose that publication of agreements between a PES supply and distribution business should disadvantage the PESs. Instead this should provide a public benchmark for discussions by new supply entrants with distribution businesses and an assurance to existing suppliers of non-discriminatory behaviour by the distribution business.
- 2.20 To ensure that such agreements within the PES are established and appropriately maintained, licence modifications may be required. OFFER will need to review with companies any difference between the PES internal agreements and those use of system agreements offered to third parties. As a general proposition the only differences between the documents should be limited to those which are not legally

possible to implement whilst the PES supply and distribution businesses remain in common ownership.

- 2.21 Work on the new use of system and related agreements for 1998 has provided a firm basis upon which these new agreements between each PES's supply and distribution business could be developed. To enable the early implementation of new arrangements and to provide a more transparent basis for further work on the separation of activities, OFFER proposes that each PES should develop draft agreements by March 1999 for discussion with OFFER and other interested parties. The new agreements should be capable of implementation by July 1999. It is likely that changes will be required to those agreements over time to reflect developments in the separation of PES activities.
- 2.22 It is for consideration whether the requirement to establish and publish agreements between the distribution and supply business in respect of use of system matters should also cover meter-related services. OFFER's initial view is that this should be the case where the distribution business is providing any metering services to the PES supply business. It is also for consideration whether a similar approach should be adopted in the case of PES owned embedded generation, or whether as is the case of East Midlands Electricity a more general prohibition on the PES constructing and operating embedded plant should apply.

Operational Separation

- 2.23 If management, staffing and operations of the two businesses are not separated it seems inevitable that operational decisions will be taken to maximise the joint benefits of the businesses or of the PES business overall. To give substance to the proposed agreements between supply and distribution, the distribution business needs to have its own managerial, staffing and operational arrangements independent of other PES energy trading activities. This would help minimise the transfer of information between businesses and help to ensure that the distribution businesses developed policies and practices that are neutral between competing suppliers. In addition it would facilitate more accurate accounting for the distribution business, hence increasing regulatory effectiveness and reducing the risk of cross-subsidies from distribution benefiting PES energy trading and metering activities in the competitive market.
- 2.24 Several PESs already have separate managing directors (MDs) for their supply and distribution businesses, with largely separate staff and reporting structures. Several PESs have also ensured that supply and distribution functions are separately located. It would seem desirable to build on the steps already taken by such PESs to provide for greater separation of management teams, staffing, locations and operations.
- 2.25 Some PESs argued in their responses to the previous Consultation Paper that it was inappropriate for OFFER to dictate detailed management structures and operational

arrangements for their companies. In particular, multi-utilities were concerned that requirements to separate staffing structures should not detract from the multi-utility approach. It is not OFFER's wish to impose detailed management or staffing requirements on companies. It is for the companies to manage and operate their businesses as they see fit subject to the need to maintain effective services and to ensure the neutrality of the distribution system in the face of competing system users. However, in the present circumstances of common ownership of the distribution and supply businesses, OFFER considers that it is appropriate to place certain requirements on PESs' organisational arrangements in order to safeguard customers and competitors.

Management

- 2.26 It would be desirable to require all PESs to ensure that the distribution business is managed independently of any energy trading interests (that is, electricity or gas supply or generation). This may best be achieved by appointing a managing director of distribution responsible to the PES Board (or where appropriate the Group Board) for delivering all distribution business functions. This MD would be responsible for obtaining and managing the necessary resources to undertake the distribution business. The licensee (the PES) would be required to ensure that sufficient resources were made available. Subject to Companies Act and other legal requirements the MD distribution should be allowed to manage distribution activities as a discrete business. In particular all decisions about distribution pricing, investment and operational matters should be made as far as legally practicable within the confines of the distribution business and should not be discussed or developed with any person with energy trading responsibilities for the PES.
- 2.27 To underpin the independence of the MD of distribution, all staff dealing with distribution matters would be restricted from working on matters associated with energy trading activities. In effect this would require the establishment of a discrete staffing unit for distribution activities separate from energy trading activities. Staff being transferred between distribution and energy trading activities would be subject to a quarantine period to guard against the inappropriate transfer of sensitive data. To assist in this process it may also be appropriate to identify senior personnel responsible for energy trading functions.
- 2.28 There is already some precedent for this in electricity. The original arrangements for the National Grid Company were designed in an attempt to avoid the then owners (the 12 regional electricity companies) having any say over the day-to-day management of the transmission business. Whilst those arrangements were not fully satisfactory they did provide other transmission system users with some protection against any attempt by the owners to distort transmission business decisions in favour of the regional companies. Similar provisions were also

introduced in the case of British Gas prior to the formal establishment of Transco and British Gas Trading.

- 2.29 The principle of discrete management and staffing units for distribution functions should be generally applicable. However, the precise application of this approach will need to be considered in individual cases, given the varying corporate structures concerned. In particular, consideration will need to be given to multi-utility companies where operational matters between utilities are often combined. OFFER's initial view is that the proposals should not prevent the combined management of the distribution business and, for example, water and sewage 'network' functions. Financial 'ring-fencing' and separate accounting for the distribution business would continue to be required. It would be helpful to have views on this issue.

Consultation

- 2.30 A separately-managed distribution business would be expected to consult all users on an impartial basis - including the PES supply business and other suppliers - on developments in its policies and practices which might impact system users. This would include pricing decisions. Regulatory compliance and future regulatory proposals relevant to distribution would be for discussion with the MDs of the distribution businesses. It would be helpful to receive views on the scope and nature of the respective responsibilities of the MD of distribution and the PES Board.

Accommodation and Other Services

- 2.31 To demonstrate and enhance the separation of the two businesses it would also be desirable to achieve a greater degree of operational separation than is presently observed in the PESs. This would involve separate locations for distribution and energy trading personnel.
- 2.32 In addition to accommodation it will be necessary to provide for the separation of all PES activities and services. In many cases this will be relatively straightforward given existing PES arrangements. The definition of which activity should fall within which business should also be straightforward in most cases. As a general rule, the allocation of activities will need to reflect the commercial agreements. However, OFFER may need to resolve disputes where activities cannot readily be allocated to one business or another. More generally PESs have a range of services which are presently shared between the businesses. These will require close attention in the separation process.

Shared Services

- 2.33 It would be desirable to minimise the extent of any shared services (including shared resources) provided for the distribution and energy trading activities. Such shared services can give rise to cross-subsidies between the businesses or provide a conduit for the inappropriate transfer of information. Shared services may also distort competition by providing PES supply businesses with operational savings or services not available to other suppliers.
- 2.34 PESs and some other respondents expressed concern that prohibiting the joint provision of services such as IT, call centres and certain corporate functions would give rise to a need to duplicate resources and could, in consequence, add significantly to the costs of both the distribution and supply businesses to the detriment of all system users and customers. PESs also argued that rapid implementation of any change could be costly and might result in disruption of services. Some PESs drew attention to particular local circumstances which they argued meant that separation would be more difficult to implement than in other areas. Issues here included the nature and timing of past and likely future IT developments, the scale of the existing businesses and the availability of suitable accommodation within the present businesses.
- 2.35 Full separation is likely to take some time to implement successfully and the position may vary from PES to PES. However, it is not accepted that separation need lead to inefficiency in the provision of services or to significant additional operating costs. Alternative sources of the necessary services could give rise to new opportunities for efficiencies. To assist in gathering more information about these issues and to help analyse the extent of any disruption that might be required to implement operational separation, OFFER is appointing consultants to review each PES's existing arrangements.
- 2.36 One important issue to review will be the nature and continuing appropriateness of existing shared services. One guideline might be that the distribution business should not share services with a single supplier, especially where that supplier is in common ownership with the distributor. Moreover, staff and support services involved in setting distribution charges and determining service levels should not be used for supply business activities. Commercially sensitive data held by distribution should be held separately from that used for supply business purposes and should not be accessible to any person making supply business decisions. In general this will mean that corporate functions should be separated.
- 2.37 It will be for PESs to demonstrate that in some limited and clear cases other shared services might be allowed a continuing role at least on a transitional basis. This might be permitted, for example, where the commercial sensitivity of the services is low and where the costs associated with separation are significant.

- 2.38 It is for consideration whether guidance should be provided about the circumstances in which such derogations might be permitted and if so what form that guidance should take. It would seem sensible to provide for derogations where the contravention was shown to be trivial in nature and unlikely to be detrimental to competitors or to give rise to cross-subsidy between the businesses. It is for consideration whether derogations might also be allowed, on a transitional basis, in circumstances where:
- the PES is able to demonstrate that the continued integration of services does not give rise to any cross-subsidy from the distribution business to any energy trading business;
 - the arrangement, compared with any other means by which the service could be provided, can be shown to result in the most economical provision of the service from the perspective of the distribution business; and
 - there is no danger of significant distortion of competition.
- 2.39 In the case of such common services it is for consideration whether these should be limited to those managed outside of the distribution business (but providing some services to distribution) and whether provision should be made for those services provided to the distribution business to be subject to market testing or otherwise subject to the possibility of third party providers. It might also be appropriate to determine other conditions in the case of particular derogations to ensure non-discriminatory provision of the service to minimise other potential distortions to competition.
- 2.40 OFFER would welcome views on whether PESs should be permitted derogations in such cases, and on what terms.
- 2.41 Some of the issues involved in assessing the need and scope of any derogation can be illustrated by considering the particular cases of call centres and IT facilities.
- 2.42 In the case of call centres the proposals in the metering chapter of this paper would imply a marked decrease in the extent of routine contact between the distribution business and end users, as most contact on metering issues would be with the customer's supplier. As noted in the previous Consultation Paper, however, an important area of contact between customers and PESs arises during supply interruptions. PESs argue that sharing call centre facilities between distribution and supply businesses gives rise to significant cost savings for distribution and a more effective response to major supply interruptions.
- 2.43 Some PESs argue that their operational response to major supply incidents is closely integrated with their customer service database. This allows them to locate customers and plan effectively for the early restoration of supplies. Other PESs dispute this, arguing that their response to supply emergencies is largely

independent of their customer services database, with the distribution business operating separate fault identification, analysis and reporting systems.

- 2.44 Several PESs and other suppliers pointed out that there were further steps that could be taken short of full separation of call centre facilities to provide greater clarity over the distinct roles of all PES call centres. Several companies already specify different telephone contact numbers depending on whether the customer is raising a supply business enquiry or reporting a power cut. Many companies also separate staff within call centres along similar lines, only providing a joint service during periods of severe supply interruptions. In essence, using spare supply business capacity elsewhere, giving rise to many of the same economies that might be expected from out-sourcing the service.
- 2.45 Such further steps to ring fence distribution services would seem appropriate as interim measures for all PESs to adopt. The objective is to enable an effective distribution service to be maintained whilst ensuring that the service is provided and is seen by customers to be provided on a neutral and non-discriminatory basis irrespective of the identity of the supplier. It is for consideration whether such steps are sufficient or whether separate provision of call centre services should be required.
- 2.46 OFFER's consultants will need to analyse these various statements with a view to determining the extent of common service provisions, if any, that are necessary in the short term to maintain an effective response to supply problems. They will also explore the practicability of alternative approaches including the provision of dedicated national call centres for distribution businesses; ringfencing of services within call centres and the more general use of competing suppliers' call centre facilities to support the distribution businesses in meeting their customer service needs. A further important issue is the savings to be made, if any, by out-sourcing services. It may be that a requirement for separation would have the effect of creating new opportunities for PESs to provide services covering more than one company.
- 2.47 Similarly, in respect of IT facilities many PESs argued that full separation would be costly and result in duplicated systems and customer databases. Others disputed this and argued that the distribution businesses' need for IT support was relatively limited and that the systems distribution required were already largely separate from supply businesses' IT systems.
- 2.48 Again this is an area where OFFER's consultants will need to analyse the position. Where full separation is not practicable in the short term it should be possible however to reinforce restrictions on access to data held on common systems.
- 2.49 In the context of the general discussion on the appropriateness of providing for derogations from the overall requirement to provide for separate services, OFFER would welcome views on whether steps short of separation might be appropriate in

the case of call centre and IT common services and, if so, what conditions would be appropriate in such cases.

Compliance

- 2.50 To pull the various threads together it will be necessary for each PES to develop a plan for implementing separation over a reasonable timescale, seeking agreement where necessary to temporary derogations from the requirement to have separate locations and to ensure distribution staff and facilities are not used for energy trading activities. This compliance plan will need to be agreed in outline by May 1999, with detailed plans in place by later next year. OFFER's initial view is that the compliance plan should be required under a new licence condition which specifies the general approach to operational separation described above and the circumstances in which any derogation would be permitted. OFFER's initial view is that the plan should be published at each stage to enable third parties to comment. OFFER would welcome views on the form the compliance plan should take.
- 2.51 The compliance plan will need to be maintained and enforced. The underlying principles would be reflected in a new licence condition. However, compliance will need detailed monitoring. To supplement OFFER's own work on this it may be helpful to require each PES to appoint a compliance director, responsible to the PES Board for ensuring that the compliance plan is being carried out and that the distribution business is operating independently in accordance with the principles underpinning the plan.
- 2.52 This approach was adopted in the case of British Gas prior to the formal separation of British Gas Trading and Transco. The compliance director would report to the PES Board and then to OFFER on the progress made and would raise with OFFER particular issues arising from the more detailed implementation of separation. It is for consideration whether these reports should be public once approved by the PES Board.
- 2.53 One benefit of this approach would be that the compliance director would act as a focal point within the company and with OFFER for discussions on implementation and compliance issues. This would help minimise the need for widespread direct contact between supply and distribution staff during the implementation phase.
- 2.54 OFFER would welcome views on the desirability of requiring PESs to appoint a compliance director and the role of such a director. It would also be helpful to have views on the extent to which any reports on compliance should be required to be public and on the content of such reports.

Separation in Scotland

- 2.55 The May 1998 Consultation Paper commented on the issues raised by the differences in structure and the regulatory framework in Scotland. The paper noted that the two Scottish host companies (ScottishPower and Hydro-Electric) are fully integrated in that their supply, distribution, generation and transmission businesses are operated by the same company. The paper also noted the wide-ranging differences in the nature of the trading arrangements in Scotland compared to that in England and Wales. Against this background, a number of emerging problems were identified. These illustrated some of the difficulties new entrants have experienced in the supply and generation markets in Scotland where competition is presently significantly less well developed than it is in England and Wales.
- 2.56 The paper concluded that the arguments for greater separation of distribution, supply and metering businesses apply equally in Scotland as in England and Wales. The paper argued that there would also be advantage in putting the transmission business of each company, including the interconnector, into separate ownership. As an interim step, the transmission businesses should be placed in separate subsidiaries with the associated separation of staff and facilities. The paper invited views as to whether this transmission business might be combined with the distribution business in each area or, alternatively, whether the two Scottish transmission businesses might be combined.
- 2.57 Many of the respondents to the Consultation Paper who commented on the situation in Scotland stressed the need to develop more effective and transparent trading arrangements. ScottishPower and Hydro-Electric argued that the further development of trading arrangements would need careful consideration. They did not believe that the separation of transmission ownership was necessary or appropriate.
- 2.58 In its Consultation Paper on The Future of Gas and Electricity Regulation, the Government has concluded that “steps should be taken in Scotland to improve the transparency and effectiveness of the regulatory regime and provide for greater competition”¹⁰. It has sought views on proposals “to:
- i) require the generation, transmission, distribution and supply activities of the integrated Scottish companies to be carried on by separate Companies Act companies;
 - ii) require independent operation of the transmission activities of the integrated companies; and
 - iii) remove the qualification of the duty on transmission licence holders to facilitate competition in the supply and generation of electricity”

¹⁰ The Future of Gas and Electricity Regulation: DTI: October 1998 Proposal 3.3

- 2.59 OFFER has welcomed these proposals in its response to the Government's consultation¹¹. OFFER has also commented on the implementation of the EU Directive and proposed new separate accounting requirements on the Scottish PESs in respect of their interconnector businesses¹². Many of the issues raised by the proposals for reform of the arrangements in Scotland relate to the need to develop more effective trading arrangements in Scotland. OFFER will be consulting shortly on the issues surrounding the possible development of trading arrangements.
- 2.60 In the context of the present paper OFFER proposes that the separation arrangements between distribution and supply and the new arrangements for metering described in this paper should apply across Great Britain. It is also proposed that similar operational separation should apply to the transmission and interconnector businesses of the two companies. It is for consideration whether at this stage operational separation should be required between the transmission and distribution businesses.
- 2.61 The Scottish PESs in response to the previous Consultation Paper noted that the transmission system in Scotland operates at lower voltage than that in England and Wales. They said that, in practice, both companies closely integrate the operation of their respective distribution and transmission activities. Operational separation of transmission from distribution would be disruptive and would not give rise to advantages for competition.
- 2.62 Whether the present integration of the network businesses should continue will need further discussion as part of the review of Scottish trading arrangements. It will also be necessary to take into account price control considerations and compliance with EU Directive. But whether or not it would be appropriate to allow the combined management and operation of the transmission and distribution businesses in the two Scottish companies, it is important that these businesses operate separately from the supply and generation businesses. In particular, it will be important to ensure that as a first step all commercial and operational decisions are taken within the confines of the transmission and distribution businesses without reference to or involvement with any energy trading business and the clear information, managerial and operational separation of the network business is achieved.

Cost Allocation

- 2.63 The present definitions of the distribution and supply businesses will need to be changed to reflect the change in responsibilities of the businesses proposed in this paper. This suggests some changes in cost allocation arrangements. For example,

¹¹ OFFER's Response to the Government's Consultation on the future of Gas and Electricity Regulation: OFFER November 1998.

¹² Reviews of the Public Electricity Suppliers 1998 to 2000: Regulatory Accounts consultation paper: OFFER: October 1998

at present the accounting guidelines developed at privatisation (CSC 194 and 195) provide that half of the total PES customer service cost (broadly equivalent to the costs of the call centres) should be allocated to distribution and the other half to supply. This no longer seems appropriate.

- 2.64 In setting distribution price controls and any price restraints on metering and on supply it will be necessary to reach revised conclusions on the way in which costs should be allocated between distribution, metering and supply. These revised allocations will need to be consistent with the requirements for the separation of activities.
- 2.65 In reaching conclusions on the cost allocations underpinning price controls it will be necessary to take account of a range of evidence, including the present and prospective future level of costs for shared services. It would seem appropriate to limit the proportion of funding by the distribution business of any residual shared services to no more than the attributable costs of an efficient operator in providing the services it requires. These factors would seem to suggest a significant reduction in the proportion of costs appropriately borne by the distribution business in respect of customer service and billing costs.
- 2.66 It will also be necessary to ensure that PESs develop separate accounting arrangements which reflect the revised business structures required as a result of separation. These matters are discussed in more detail in the Regulatory Accounts Consultation Paper¹³.
- 2.67 Views are invited on any further considerations that OFFER should take into account in re-assessing cost allocations between PES businesses in the light of the proposals in this paper.

Proposals

- 2.68 OFFER proposes that each PES should be required to:
- a) establish agreements between its supply and distribution businesses mirroring as far as legally possible the contracts PESs are agreeing with third parties for use of system;
 - b) publish those agreements for so long as the businesses remain in common ownership;
 - c) present draft use of system agreements for discussion by March 1999 with a view to implementing the agreements by July 1999;

¹³ Reviews of Public Electricity Suppliers 1998 to 2000: Regulatory Accounts consultation paper: OFFER: October 1998

- d) establish discrete units for the management of distribution functions including the establishment of a managing director of the distribution business;
- e) ensure all distribution business, commercial and operational decisions are taken within the confines of the distribution business without reference to or involvement with any energy trading interests of the PES except through open consultation processes or to the extent that the PES Board is legally required to be involved;
- f) establish in agreement with OFFER a plan for implementing the separation of operations between distribution and other businesses, including the separate location of distribution and energy trading staff;
- g) produce initial proposals for such plans by May 1999; and
- h) establish monitoring and compliance arrangements approved by the Director General to ensure that the terms of the agreement between the distribution and supply business and the principles of the compliance plan, are fully adhered to.

It is also proposed that similar operational separation should apply to the transmission and interconnector businesses of the two companies in Scotland.

Views Invited

2.69 OFFER would welcome comments on these proposals and specifically views on:

- a) whether the requirement to establish and publish agreements between the distribution and supply business in respect of use of system matters should also cover meter-related services. OFFER's initial view is that this should be the case where the distribution business is providing any metering services to the PES supply business. It is also for consideration whether a similar approach should be adopted in the case of PES owned embedded generation, or whether as is the case of East Midlands Electricity a more general prohibition on the PES constructing and operating embedded plant should apply;
- b) the scope and nature of the respective responsibilities of the MD Distribution and the PES Board;
- c) the extent to which restrictions should be placed on the sharing of operational and management functions between distribution and non-energy utility interests;

- d) the circumstances, if any, in which derogations should be granted to permit common services to be maintained by PESs; whether such common services should be limited to those managed outside the distribution business; whether such services should be subject to competitive tendering or to other conditions to ensure non-discriminatory provision of the service. In particular, views are invited on whether steps short of full separation might be appropriate in the case of call centres and IT common services and, if so, what conditions would be appropriate in such cases;
- e) the form of the compliance plan to be developed by PESs and the basis upon which this should be published;
- f) the need for a compliance director, and the role and reporting responsibilities of any such director;
- g) the appropriateness of publishing content of any public reports on compliance and their content;
- h) whether any further steps should be taken to enhance the effective operational separation of the distribution and supply businesses;
- i) whether at this stage operational separation should be required between transmission and distribution businesses in Scotland; and
- j) the considerations that OFFER should take into account in re-assessing cost allocations between PES businesses in the light of the proposals in this paper.

3. METERING AND METER READING

3.1 The Consultation Paper published in May 1998 discussed the significance of metering services to customers and suppliers. Metering services include the provision and maintenance of the meter, meter reading and the various data handling functions required primarily for settlement purposes. The paper reviewed the developments in metering services, particularly in respect of the staged introduction of competition and noted that industry arrangements now placed primary responsibility for metering services on the supplier. The paper also noted the growing significance of interactions with the gas market and the development of joint electricity and gas meter readings. Finally, the paper noted that increasingly third party providers of metering services would become involved and may be significant competitors as the market opened to competition.

3.2 Against this background, the May 1998 paper set out a number of proposals for the further development of metering services, with the aims of:

- promoting competition in both metering services and supply;
- maintaining good quality services;
- protecting customers interests from any residual market power in the provision of metering services; and
- promoting the development of new structures within the industry geared to the efficient provision of metering services.

3.3 The paper confirmed the need to introduce competition in all metering service functions by April 2000 as planned. This would mean that a supplier would not have to rely on the PES to provide a service. Instead the supplier could, subject to certain safeguards, provide all metering services directly or through a third party agent. In preparation for competition the PES would need to unbundle charges for its metering services. The paper also proposed that:

- the existing metering stock be maintained in distribution business ownership (or be provided by a regulated third party); that the distribution business should be required to offer a meter operation service on non-discriminatory terms and that the provision of the meter and meter operation service by distribution should be subject to price controls; and
- all data handling and meter reading functions should be open to competition. However, to provide a safeguard during the transition to competition the distribution business should be required to procure a meter reading service of last resort. The paper envisaged that existing PES meter reading functions would become supply business activities. In procuring a supplier of last resort service for meter reading, the distribution business

would need to consider third party providers in addition to the service provided by the PES supply business.

Views of Respondents

Public Electricity Suppliers

- 3.4 The PESs generally accepted the proposal that metering should be opened to competition in April 2000. There was also acceptance that charges should be unbundled in readiness for competition. Most PESs felt that existing metering assets should remain part of the monopoly distribution business.
- 3.5 Some PESs said that they had considered investing in new metering systems. However, they believed that if they did so they might not be able to finance such investment from existing price control allowances. The cost of installing new metering systems could not readily be justified by savings from the new system. Nevertheless, there might be other benefits to customers which could, on balance, make investment in new technology worthwhile. Some PESs argued that unless they were able to recover costs through the distribution price control they would not be able to make widespread changes to metering systems.
- 3.6 A further concern was that suppliers would change customers' meters and PESs would be left with a stock of old meters that they could not use, with no opportunity to recover the cost of those meters. Some PESs argued that to protect their position, use of system and metering charges should not be reduced when a meter is provided by a third party.
- 3.7 Most PESs supported competition in meter reading, but pointed out that it might be more difficult to introduce competition in some metering services which are more heavily dependent on interaction with PES IT systems. There was agreement that suppliers should be able to choose who to contract with for the provision of metering services. PESs said that they should be able to choose the form of their future metering activities without any further restrictions, for instance on the type of meters that they could offer.

Meter Reading Agencies and Meter Manufacturers

- 3.8 The meter reading agencies were keen to see competition introduced as early as possible, especially as competition in the gas market had already opened and there were distinct advantages in being able to serve more than one group of customers in a location at one time. They wanted to be certain that PESs would not introduce cross-subsidies into their meter reading businesses and disadvantage independent agencies. They pointed out that if the meter reading cycles were standardised across suppliers, and even across utilities, the opportunities for running an efficient

operation would be greater. The meter reading agencies suggested that the PES should not be able to provide the meter reader of last resort service.

- 3.9 Meter manufacturers were keen to promote the benefits of advanced metering systems. They said that such metering could produce better information for network management and more choice for customers by allowing new time of day tariffs, tailored billing options and remote meter readings on demand. They argued that the cost of advanced metering should be recovered through the distribution charges with PESs obliged to provide the meters to second tier suppliers on a non-discriminatory basis. Second tier suppliers would be able to provide meters at their own cost, and continue to pay for the PES metering unless a half-hourly meter was installed. If meters were replaced with modular versions, whereby the basic meter was owned by the distribution business, the second tier supplier could add on extra features at low cost where required by the customer. One manufacturer suggested that OFFER should introduce guidance on minimum standards for advanced metering capabilities to help new technology be introduced at low cost to customers.

Second Tier Suppliers

- 3.10 Second tier suppliers were keen to see competition introduced in metering. They said that any services provided by the PES should be made available on a non-discriminatory basis.

Consumers' Representatives

- 3.11 The Consumers' Committees which commented on metering considered that metering services could be best developed by independent service providers. They said that the metering function should be separated out from the PES supply and distribution businesses. They stressed that there must be a focus on the customer to ensure that they receive a high level of service from those providing metering services. This was especially important when different companies are responsible for providing individual areas of work. There must be no opportunity for a supplier to avoid responsibility for aspects of work that it has contracted to a third party.
- 3.12 Committees recognised that new technology may be introduced by independent service providers. The customers would benefit from being able to install new equipment or obtain metering services from a range of parties. Committees considered that different arrangements might be appropriate for the designated and non-designated markets and this might be reflected in a different regulatory treatment of the meter operators.
- 3.13 Committees argued that meter readers should become the responsibility of the supply business. They said that it was important that PESs should not be able to

provide a poorer service to second tier suppliers in the expectation of winning customers for the PES supply business.

Competition and New Metering Technologies

Views in Response to the Consultation

- 3.14 Some respondents to the initial Consultation Paper expressed concern about the possible impact of competition in the provision of meters on the development of new metering technologies. These concerns were raised primarily by meter manufacturers and suppliers of related services and by some PESs.
- 3.15 These respondents argued that the effective introduction of new metering technologies, particularly those associated with automated (or remote) meter reading, typically require large scale introduction with nearly 100 per cent coverage in any area to provide the necessary economies of scale to make the introduction of the technology financially viable. Competition in the provision of meters, they argued, would inevitably result in the loss of those economies because alternative meter providers would not co-operate to introduce a single automated system. Proponents of new metering technology argued that it could provide substantial benefits to suppliers and their customers. Depending on the details of the proposed technology, they said that these would arise through more regular and accurate meter readings, including on change of tenancy or change of supplier; the easier application of multi-rate tariffs; better communication with customers; the provision of up-to-date account and consumption details; better information about fault conditions on the network; and, the earlier identification of meter interference. They said that the application of this type of technology may be particularly attractive to multi-utility suppliers where remote readings can include a range of utility services.
- 3.16 Many of these respondents argued that competition in metering was of itself unlikely to produce significant benefits. They said that domestic and other small customers would not wish to provide their own meters and that most suppliers would not wish to invest in new meters where they might supply the site only for a short period. Those suppliers who did wish to provide their own meters might be motivated more by a desire to deter customers from switching their supplier in future than from an interest in developing services for customers.
- 3.17 Accordingly, these respondents argued that competition in meter provision should either not be pursued at all or should be discouraged (perhaps only applying in special circumstances) or should be subject to conditions requiring new meter providers to facilitate automated metering reading. Some respondents proposed that to facilitate the stated benefits of new metering technology the distribution businesses should be required to embark on an accelerated programme of meter

installation. This would, for example, provide that over a 10-year period all meters were capable of providing remote communications.

- 3.18 Other parties suggested that the benefits of remote reading and new metering technologies may not in practice be as significant as the proponents claimed. They said that, in particular, the value customers would place on the various potential services that two way communication might provide, was uncertain. To date multi-rate tariffs have only had a limited appeal to domestic customers. Similarly, the provision of more regular meter readings and fuller information about electricity usage, might be of little significance to many customers. This was not to argue that no customers would find such facilities of value. However, they argued that it would seem more appropriate for customers to choose the level of facilities they require rather than to impose a general blueprint.

OFFER's Observations

- 3.19 In assessing the arguments it should be noted that not all new metering and remote reading technologies share the same underlying requirements. However, many of the existing technologies have been developed against an assumption of integrated monopoly service provisions.
- 3.20 OFFER does not consider that retaining a monopoly in any of the metering services would be in the interests of customers. Monopoly provision of these services is likely to stultify innovation and distort competition in electricity supply. Prohibiting or restricting third parties from providing meters, and giving the distribution business with its existing metering stock a major role in development of new technology, would distort competition throughout metering services. It would seem likely to reinforce the dominance of the PES in the provision of metering services and would in consequence be likely to discourage the development of competition in supply. Given the overall significance of electricity in the multi-utility sector such a policy would also be likely to distort competition in metering services across all utilities.
- 3.21 Conversely, competition would enable new economies to be explored by a range of competing service providers - for example, in the context of dual fuel meter reading. It would also enable services to be more closely tailored to individual customer/supplier requirements. It can be assumed that other technologies will develop to meet the needs of a competitive market.
- 3.22 The Government reviewed these issues in its recent Consultation Paper on The Future of Gas and Electricity Regulation. It noted that "formalising a PES monopoly on metering would stifle wider technological innovation and would stand in the way of innovation by suppliers in establishing new metering arrangements, for instance". The Government concluded that it "supports the efforts of the gas and electricity regulators to introduce competition in metering

services and looks to them to take this forward in consultation with the industry and other interested parties”.¹⁴

- 3.23 Against this background OFFER concludes that it should actively pursue the introduction of full competition in metering services.

Metering Standards

- 3.24 A further issue for consideration in the context of promoting new metering technologies is the development of metering standards.

- 3.25 Some respondents to the OFFER Consultation Paper suggested that minimum technical standards should be established for new metering to ensure that regardless of by whom it was provided, the meter was capable of providing for a future communications system. Some respondents suggested that this might be achieved by requiring all new meters to have a readable pulsed output upon which communications could be added. However, if this approach were to have a material impact on services to customers it would appear to require an accelerated programme of meter replacement. One respondent estimated the additional costs of such a programme at approximately £30 million a year over 10 years. OFFER has not reviewed this estimate in detail but a number of the underlying assumptions appear unduly optimistic. It should also be noted that this investment would only provide a meter stock capable of remote communication. The costs of installing and operating the necessary communications equipment might more than double the quoted costs. Such a programme of meter replacement might distort the development of competition in meter reading as it would tend to subsidise remote meter reading technologies and operators most closely associated with the party responsibility for the meter replacement programme.

- 3.26 To ensure full compatibility of different systems might require detailed and prescriptive requirements to be imposed on meter manufacturers. It could in consequence add to the costs of metering equipment and distort the international market for meter production. However, ‘communication ready’ meters could facilitate a variety of technologies and ensure the full inter-operability of metering products with various communications methods. The Government in its recent Consultation Paper discusses the need for “meter manufacturers agreeing a common interface or interconnection”. OFFER would welcome views on the practicality and implications of any new requirements of this type and what role, if any, OFFER should have in setting such requirements.

¹⁴ “A Fair Deal for Consumers: The Future of Gas and Electricity Regulation”, Section 5, DTI, October 1998.

Facilitating Competition in Metering Services

- 3.27 Further steps are necessary to promote competition in metering services in the electricity industry. In particular all metering services - that is, meter provision and operation, meter reading and data processing and aggregation - should be the responsibility of the supplier.¹⁵ This does not mean that the supplier itself should necessarily provide these services. Indeed it can be expected that a range of independent service providers will emerge over time to meet suppliers' requirements.
- 3.28 In assessing the best way forward on metering issues OFFER has noted the responses to the Consultation Paper in May. Other relevant developments have included the Government's paper on The Future of Gas and Electricity Regulation and Ofgas's recent paper on metering issues¹⁶. In its paper Ofgas proposes the separation of the current Transco price control into separate controls to cover transportation, metering and meter reading activities. Ofgas also proposes the full physical, financial and informational separation of Transco's metering and meter reading businesses from its core transportation business. Ofgas believes that consideration should also be given to an alternative approach. This would involve the auction of Transco's metering assets. This would mean that Transco did not inherit a 100 per cent share of the national market for meter provision. Ofgas notes that such an approach may be more conducive to the development of effective competition.
- 3.29 There would be benefits in securing greater convergence between gas and electricity arrangements. Metering and meter reading may develop as dual fuel activities in many instances. Whilst there are technical and other differences between the two sectors the general provisions on metering could be brought more closely together. This could provide significant benefits to customers in terms of joint meter readings and would facilitate positive structural change in the metering sector.
- 3.30 Against this background, and given the initial dominance of the PES metering businesses in the market, it will be important to ensure that the PESs are not in a position to distort the development of competition in metering services or otherwise disadvantage customers. Accordingly OFFER considers that it would be desirable to minimise or remove any role of distribution businesses in providing metering services.
- 3.31 Distribution services would focus on the provision of use of system terms and the provision of a registration service to facilitate competition in supply.

¹⁵ These terms are defined under the PES Licence and are reflected in industry agreements.

¹⁶ Securing Effective Competition in Gas metering and Meter Reading Services: The Director General's Initial proposals: Ofgas October 1998.

- 3.32 Two broad approaches could achieve these objectives. The first would develop the approach set out in the May 1998 Consultation Paper taking account of the views of respondents and other relevant developments. In essence this approach (Approach A) reflects the present arrangements in the gas market. The second approach (Approach B) builds on Approach A and the metering assets auction arrangements considered by Ofgas in its paper.

Approach A

Developing the Approach in the May 1998 Consultation Paper

- 3.33 The approach proposed in the Consultation Paper in May reflected the existing arrangements in the gas industry. On that basis existing PES meter reading and data handling functions should no longer be seen as distribution managed services. In the case of meter provision and operation the May 1998 consultation proposed that the existing service would be retained within the PES distribution service. In response to the consultation some respondents suggested that some or all of these functions could also be transferred out of the distribution business.
- 3.34 Meter operation services (essentially the maintenance, fixing and changing of meters) could be a supply function. This would mean that even if the supplier (or customer) chose not to provide the meter, the distribution business role could be limited to that of a provider of metering assets. The supplier (or his agent) would then be able to provide all operational services associated with metering, including fixing and changing meters as well as meter reading. This approach would require the distribution business to agree with suppliers the terms upon which its meters could be changed and the basis upon which they were to be maintained. The advantages of this approach would be to minimise the role of the distribution business, reflect the operational arrangements for metering in many PESs, and enable suppliers to provide a fully integrated service to customers where meter changes are required. The potential disadvantages include the need for a further refinement of industry agreements and the possible difficulty of maintaining accurate records of metering installations where the supplier for a site changes frequently. On the basis of these proposals the residual operational role of the distribution business in respect of metering would be to provide a range of basic meters based on the existing meter stock. OFFER would welcome views on this proposal.
- 3.35 A further issue raised in response to the initial consultation was the treatment of data processing and related activities, that is, the validation of meter reading data, the production of appropriate estimates where these are required and the summation of meter reading data for settlement and other industry purposes. The May Consultation Paper suggested that these activities should be treated as supply activities. Some respondents noted that these activities are different in form to the other metering-related services of meter provision, operation and meter reading.

The data processing activities are closely associated with the supplier's own billing activities and can require significant IT capabilities beyond those that might reasonably be required for meter reading. However, unlike metering and meter reading these data processing activities can be readily undertaken by service providers remote from the customer and, once the data is collected, there are no significant economies arising from geographical concentration. This suggests that a national market is likely to be established for such services and that special protection for the PES's competitors may not be necessary once full competition is introduced.

- 3.36 There would be advantage in treating these data processing functions differently from the other metering-related activities. Not all industry arrangements presently make the distinction between meter reading and many of the data processing activities. However, the existing conditions in the PES licence do distinguish between these activities. Under Approach A data processing would be a supply business function. Subject to any necessary transitional provisions and in particular to the revision of industry agreements to separate data processing from meter reading activities, PESs would no longer be required under licence conditions to provide data processing services to third parties. This would mean that the data processing activities would be excluded from the tendering process proposed under Approach A for meter reading and meter operation services provided through the distribution businesses to suppliers.
- 3.37 Under Approach A the existing meter reading functions of the PES would be transferred to the PES supply business. That meter reading business would meet the needs of the PES supply business. If meter operation functions were also to be transferred out of the distribution business as proposed above, this supply business meter reading service would include meter operation functions.
- 3.38 To ensure that a service is available to all suppliers on reasonable terms, the distribution business could be required to procure last resort services in respect of meter reading and meter operation. The distribution businesses will need to develop transparent arrangements to ensure that the service provider is chosen on a non-discriminatory basis. The terms of the tender(s) would need to be developed following consultation with potential independent meter service providers (MSPRs). Insofar as practicable it would be desirable to establish a national model for the tender. Indeed, it might be appropriate for distribution businesses to collectively appoint an agent to develop and conduct the tendering process to maximise transparency. A number of other issues would need to be determined in preparing the tender process including:
- what constraints, if any, should apply to any one party's involvement in the provision of these meter reading and meter operation services;

- how tender packages should be defined, including whether meter reading and operation services should be combined under a single tender and whether separate tenders should apply for different metering types or reading frequencies; and
 - the safeguards necessary in the tender design and assessment processes to ensure all potential service providers are considered on a non-discriminatory basis in comparison with the PES's own meter reading activity.
- 3.39 In resolving these issues it will be important to consider the needs of potential service providers. To help ensure an effective and non-discriminatory process it is likely to be appropriate for OFFER to have a role in the tender process.
- 3.40 A further important factor in establishing the tender process will be to ensure that the provider of these metering services can provide full data confidentiality. In particular, it should be a requirement of the tender that the service provider has in place acceptable arrangements to ensure that no unauthorised third party is able to gain access to customer or supplier data such as meter reading records. Similarly, it should be expected that the service provider adopts a neutral brand not associated with any supply interests. In addition, any party providing these services would need to meet appropriate standards to ensure data accuracy and good customer services in keeping with the suppliers' codes on site access required under the licences.
- 3.41 Some PESs expressed concerns that there would be limited competition for such tenders. Concerns were also expressed about the impact of an uncertain demand for the meter reader of last resort service. PESs argued that as a consequence distribution businesses might face relatively large costs for procuring a service which might be of limited use. In so far as the price controls capped the level of revenue that the distribution business could receive for the service, distribution businesses might be subject to unreasonable commercial risks.
- 3.42 Experience from the gas market suggests that there will be a range of parties interested in providing these services on reasonable terms. In addition to the PES's own meter reading agency, other PESs may wish to compete, as may independent meter service providers from outside the sector.

Implications of Approach A for Price Controls and the Structure of Charges

- 3.43 As noted in the May 1998 Consultation Paper the development of competition in metering will have important implications for work on the price controls and related regulatory requirements on the PESs.
- 3.44 On the basis of Approach A, it will be necessary to have clear pricing arrangements to enable those suppliers who wish to do so to provide their own metering services.

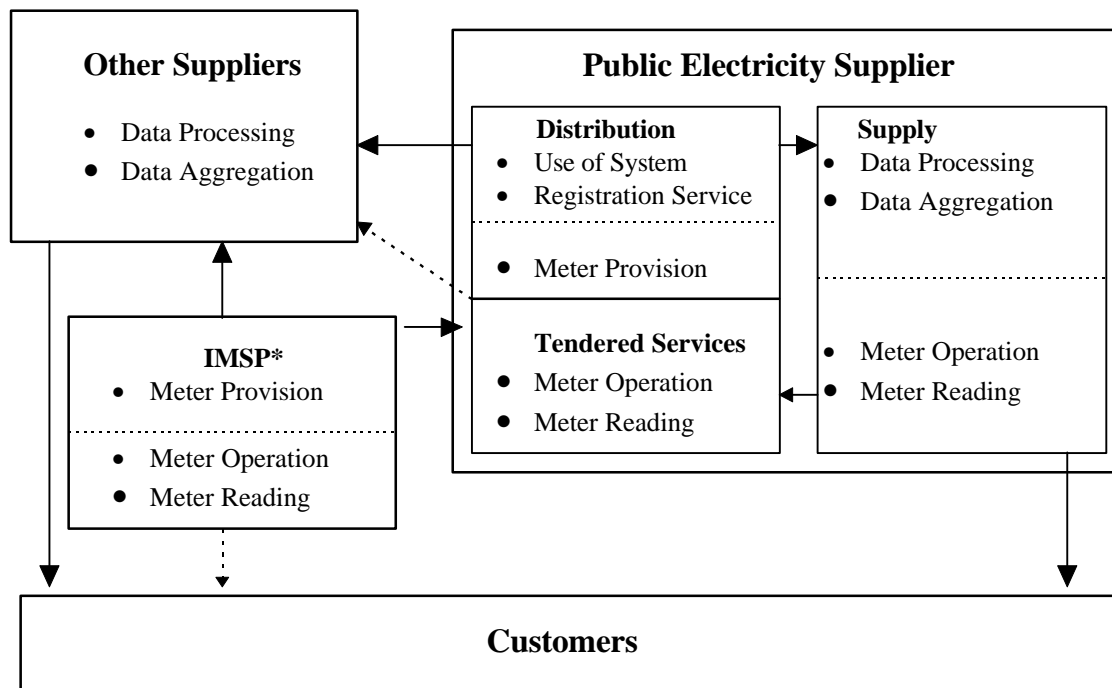
Use of system charges need to be unbundled to remove metering-related charges. However, charges for metering-related services provided by (or procured by) distribution will continue to require some regulatory oversight. OFFER's initial view is that specific provisions should be made for metering services provided by or through the distribution business in the revised price control arrangements. This could either take the form of a specific component within an overall distribution price control or a separate control dealing with metering services. In setting the metering element of the price control (or in setting a metering control) the Director will need to consider the protection of suppliers and customers and the benefits that will arise from facilitating competition in metering services.

- 3.45 To enhance regulatory effectiveness and to guard against any cross-subsidies between the distribution business and its metering services activities (that is, the provider of last resort service and the provision of existing meters) OFFER's initial view is that these activities should be treated as a separate business for regulatory purposes. This would require separate accounts to be produced for these activities and would prohibit cross-subsidies between these metering activities and the distribution and supply businesses of the PESs. It is for consideration whether it would be desirable to move further in this area as Ofgas has proposed. That would involve establishing full operational separation for the residual metering activities of the distribution business and requiring separate accounts for meter provision and meter reading of last resort services. This would require further structural and organisational change within PESs at the same time as other more wide-ranging changes are being required to separate supply and distribution activities. However it could further enhance transparency and would help to avoid the distortions to competition in metering to which Ofgas refers in its paper.
- 3.46 In relation to the supply business, it is for consideration whether it is necessary to require separate accounting for the supply business metering functions. This would be desirable to provide greater transparency. It would also provide for prohibitions on cross-subsidies between the supply and metering activities. Whilst PES distribution, supply and metering functions are in common ownership this might be a valuable safeguard for competitors. OFFER would welcome views on this issue.

Illustration of Approach A

- 3.47 Figure 1 (overleaf) illustrates the main relationships and responsibilities proposed under Approach A once the tender process is completed.

FIGURE 1: Illustration of Metering Arrangements under Approach A



* IMSP - Independent Meter Services Providers

B Approach B

Developing an auction of metering services

3.48 The proposals set out under Approach A provide a basis for the development of competition in metering consistent with the active promotion of competition in supply and securing the separation of PES supply and distribution functions. It may however be appropriate to go further in restructuring the metering sector to facilitate competition and provide benefits to customers. In considering how best to develop Approach A, OFFER has taken into account the alternative proposals in the recent Ofgas paper.

3.49 In particular it would be desirable to provide for an early eradication of the regional dominance of PES metering activities. It would also be desirable to provide for an early opportunity to establish effective competitors in metering activities on a national basis. The presence of dominant regional providers of metering services may distort competition in metering and supply both regionally and nationally. Suppliers acting on a national basis will wish to develop metering service arrangements with a small number of preferred service providers. Some suppliers may wish to have one service provider acting for them on a national basis. Dominant regional service providers can deter such developments and in consequence distort competition in supply in the region and more widely.

- 3.50 The absence of fully effective national metering service providers in electricity will tend to discourage entry in the supply market by effectively requiring suppliers to deal with a multiplicity of metering service providers, each with their own service arrangements and technical requirements. Accordingly, particularly whilst present PES functions are in common ownership, there is a concern that dominant positions in metering and supply, together with the monopoly of distribution services will interact to deter competitors to the detriment of competition and customers.
- 3.51 Against this background OFFER would welcome views on the selective auction of PES metering assets or more widely the full range of PES metering functions. This would involve the transfer of ownership of metering activities from each PES to a number of new owners who would subsequently assume the role of meter services providers. As with Approach A this would place data processing activities with the supply business but the other functions of meter operation and provision and of meter reading would be subject to auction. These metering functions would be separated operationally and financially from other PES functions as part of the transaction. Under this approach no supplier would retain a dominant share in metering activities in any region.
- 3.52 There are a number of other issues that would arise should PESs auction their metering assets. These largely mirror the issues raised on the form of the auction in the Ofgas paper, namely:
- the proportion of metering assets to be auctioned;
 - what constraints should apply to any one party's holding of meters;
 - how auction lots should be defined, by meter type or in a simpler bundled lot which could be repackaged in a secondary market;
 - whether there should be a reserve revenue or price;
 - whether successful bidders should pay what they bid, or whether all successful bidders should pay the lowest successful bid (that is, equivalent to a market clearing price);
 - whether any particular constraints should be placed on the PESs' ability to charge for necessary support services; and
 - whether there would need to be a body responsible for trading in meters in a secondary market.

In the circumstances of electricity it will also be necessary to consider:

- whether such an auction should encompass solely those activities and assets associated with meter provision or whether all or some other subset of PES metering functions should be involved;
- whether auction lots should encompass meter assets and any other metering activities jointly (that is for example the meter and meter reading functions for a set of meters) or whether separate lots should be required; and
- whether assets to be auctioned should be combined nationally initially to provide for national lots and a single national auction rather than regionally based auctions, and, if so, how that should best be achieved.

3.53 Once the auction process is completed suppliers would be able to deal with a range of independent meter service providers. At that point it would seem unnecessary to provide for the distribution businesses to procure a service on behalf of suppliers as is proposed under Approach A. Consideration would, however, need to be given to the need for transitional arrangements and whether any conditions should apply to successful bidders to ensure that all suppliers had access to metering services on reasonable terms.

Implications of Approach B for Price Controls and the Structure of Charges

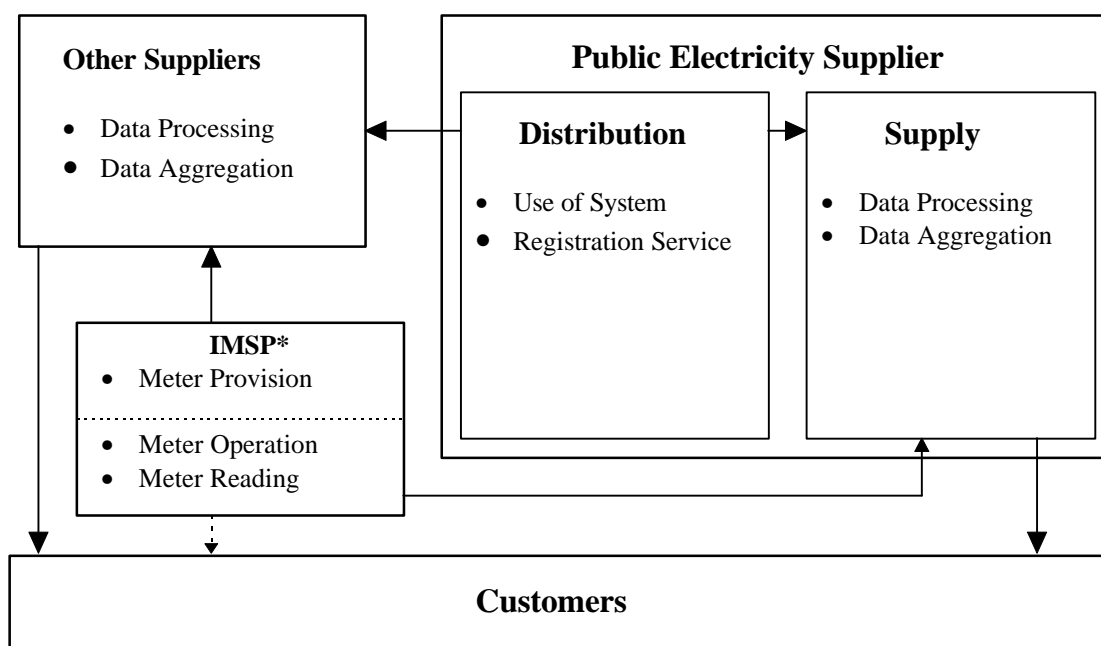
3.54 Once the auction process is completed under Approach B, the PES would no longer have a dominant position in any of the metering services and hence price regulation should not be necessary in respect of these services. Metering would also be entirely removed from the scope of distribution functions. Accordingly, the distribution use of system charges would no longer contain charges relating to metering services.

3.55 Dependent on the scope of the auctions PES supply or other businesses may, however, retain some metering functions. It would seem appropriate to provide for these to be operationally separated from the PES distribution business and subject to separate accounting requirements.

Illustration of Approach B

3.56 Figure 2 (overleaf) illustrates the main relationships and responsibilities proposed under Approach B once the auction process is completed.

FIGURE 2: Illustration of Metering Arrangements under Approach B



* IMSP - Independent Meter Services Providers

Assessing Approaches A and B

3.57 Views are invited on the respective benefits of the two approaches outlined above. In addition to comments on the specific issues raised under each approach it would be helpful to have views on:

- which approach is likely to provide for the most effective competitive environment for metering services and supply and how these compare with the respective costs and ease of implementation;
- the impact of the approaches on services to customers and suppliers;
- the timing of the auctions under Approach B and its relationship to the steps to be taken under Approach A, and to price controls; and
- whether if it were decided not to proceed with the full auction of all metering activities in accordance with Approach B, it would be sensible to enhance Approach A by requiring an auction of meter assets presently owned by the distribution businesses.

Prepayment Issues

- 3.58 At present meter provision, operation and reading in respect of prepayment meters is undertaken by the PES distribution businesses on broadly the same basis as these services are provided in respect of other meter types. However, the provision of the prepayment meter infrastructure (the arrangements for issuing and charging tokens, keys and cards and collecting payment from customers) is a service provided by the PES supply business to other suppliers.
- 3.59 In developing Approaches A and B it has been assumed that this distinction continues and that meter provision, operation and reading in respect of prepayment meters, are handled under each Approach as for other meter metering types. On this basis, the infrastructure service would remain a supply function. Views are invited on whether this is appropriate or whether different provisions should apply in respect of prepayment metering.

Customer Protection and the Promotion of Competition in Metering

- 3.60 The present licence conditions on suppliers include a number of measures designed to protect customers and facilitate competition in metering services. These are in addition to those requiring the PES to provide metering services to third party suppliers. It is for consideration whether in respect of Approach A or Approach B modifications to suppliers' licences are required to develop the existing framework in any respects.
- 3.61 The relevant conditions are:
- **Duty to offer terms for meter provision¹⁷** - which requires second tier suppliers which own meters at the sites they supply to offer those meters for sale, hire or loan to any person requiring them to do so. This might include, for example, the customer or a new supplier at the site.
 - **Agreements for the provision of meters¹⁸** - which prohibits second tier suppliers and PESs as part of their supply business from entering into an agreement with a third party for the provision of a meter which is intended to or is likely to restrict, distort or prevent competition in the supply of electricity. This might be necessary, for example, to prohibit arrangements which unreasonably constrained the customer from changing supplier.
 - **Provisions relating to the connection of metering equipment¹⁹** - which requires PESs to authorise appropriate third parties to connect metering

¹⁷ Second Tier Licence Condition No 10, (England and Wales)

¹⁸ Second Tier Licence Condition 17 (Condition 18 in Scotland);
PES Licence Condition 9D (Condition 7D; Part V in Scotland).

¹⁹ PES Licence Condition 9C (Condition 7C; Part V in Scotland).

equipment to the distribution system. The agreement can provide for safety and other requirements to be imposed on any person making metering connections.

- **Procedures for the detection and prevention of theft, damage and meter interference²⁰** - which requires each supplier to take all reasonable steps to prevent theft, damage and meter interference and requires suppliers and PES distribution businesses to cooperate on such matters.
- **Site Attendance²¹** - which requires all suppliers to comply with a code of practice on site attendance which must cover the appointment of staff visiting customers' premises, and is designed to ensure all visits made on behalf of suppliers are carried out professionally and with proper regard to the needs of customers.

3.62 Some representations have been made that these conditions should be supplemented. In particular some PESs and some customer groups have suggested that all suppliers should be under an obligation to take all reasonable steps to obtain a meter reading from each premises they supply on a regular basis. In the gas market the supplier must ensure that all meters have a meter reading taken and that the meter is inspected at least once every two years. Some customer groups have suggested that a more regular frequency might be appropriate, although others have expressed concern that this might lead to higher costs to be borne by customers and the more frequent exercise of entry warrants. It would seem sensible to provide for all meters being read and inspected within a maximum period to provide a safeguard for customers, distributors and suppliers. Given the likely development of dual fuel meter reading, it would seem sensible to ensure that the time limits are the same in both electricity and gas. It is for consideration what rights the distribution business should then have to obtain meter readings if the supplier has failed to obtain them within the prescribed period.

3.63 Other proposals have included restrictions on suppliers installing metering equipment which cannot readily be used by other suppliers; detailed requirements on handling meter recertifications and the transfer of metering related information between parties. OFFER's initial view is that the present conditions provide an adequate framework for metering competition. Further detailed licence requirements on suppliers may have the effect of deterring innovation in metering services. However, changes may be appropriate to bring electricity and gas arrangements more closely into line. It may also be necessary to review industry agreements to deal with matters such as meter data transfers and meter recertification.

²⁰ Second Tier Licence Condition 16 (Condition 17 in Scotland);
PES Licence Condition 9B (Condition 7B, Part V in Scotland).

²¹ Second Tier Licence Condition 32 (Condition 33 in Scotland);
PES Licence Condition 20A (Condition 14A, Part V in Scotland).

- 3.64 Views are invited on the need for licence modifications to require suppliers to read and inspect all meters regularly. Views are also invited on whether other conditions relating to metering should be placed on suppliers to facilitate competition and protect customers.

Implementation

- 3.65 The implementation of competition in metering services under either Approaches A or B will require action by a range of industry parties. Much of the business requirements for competitive service providers has been agreed as part of the 1998 Programme. However, some development of the relevant industry agreements and systems are likely to be required. It is important that these changes are undertaken promptly, in discussion with interested parties and are effectively coordinated across the industry. OFFER will also need to be assured that the industry arrangements accord with the principles set out in this paper and licence requirements.
- 3.66 In addition, it would be desirable to have a central focus to resolve issues arising from the development of last resort supply arrangements, the unbundling of metering activities and establishing any approvals process. It would also be desirable to facilitate national decisions on the tender process under Approach A or the auction process under Approach B.
- 3.67 To pull these various strands together it would seem desirable to establish a Metering Review Group, chaired by OFFER and made up of industry representatives, including representatives of suppliers, distributors, settlement and registration agreement bodies as well as representatives of existing metering businesses and new entrants. The Group would ensure that the relevant bodies were progressing the necessary changes to existing commercial and technical requirements to facilitate competition; review arrangements for last resort metering services, including the formulation of tenders and/or develop the auctions of metering activities under Approach B and carry out such other work as may be necessary to provide for competition in metering. This work will need to integrate closely with work on price control issues.
- 3.68 Views are invited on the scope of the Group's activities, its membership and any funding requirements.

Summary of Proposals and Areas Where Views are Invited

- 3.69 The main proposals made in this Chapter on metering and the main areas where views are invited are as follows:

- a) OFFER should pursue the introduction of competition in all metering services;
- b) it is for consideration whether new standards should be set to encourage the introduction of meters capable of remote communications;
- c) views are invited on the need for licence modifications to require suppliers to read and inspect all meters regularly. Views are also invited on whether other conditions should be placed on suppliers to facilitate competition and protect customers;
- d) to assist in the implementation of changes a Meter Review Group should be established. Views are invited on the precise membership and role of the group;
- e) views are invited on the respective benefits of the two approaches outlined in the paper for the future development of metering. Approach A, the development of proposals made in the May Consultation Paper, generally reflecting present arrangements in gas, and the further development outlined in Approach B involving the auction of metering assets and activities;
- f) views are invited on the specific proposals and issues raised under Approach A: namely,
 - full competition in all metering services;
 - data processing activities to be a supplier responsibility with no licence requirement on PESs to provide these services to third parties in future;
 - PES meter operation and meter reading to be supply business functions. It is for consideration whether they should be subject to separate accounting requirements and whether prohibitions on cross-subsidy with other supply activities should be introduced;
 - distribution businesses to retain existing meter stocks and provide meters to suppliers on non-discriminatory terms;
 - distribution businesses to tender for the provision of meter reading and meter operation services of last resort for suppliers. It is for consideration:
 - i) whether a national process should be adopted for developing and conducting the tender process;
 - ii) what constraints, if any, should apply to any one party's involvement in the provision of these meter reading and

- meter operation services;
- iii) how tender packages should be defined, including whether meter reading and operation services should be combined under a single tender and whether separate tenders should apply for different metering types or reading frequencies;
 - iv) the safeguards necessary in the tender design and assessment processes to ensure all potential service providers are considered on a non-discriminatory basis in comparison with the PES's own meter reading activity;
- it is for consideration whether distribution metering functions should be operationally separated from other distribution functions and subject to separate accounting requirements.
- g) views are also invited on the further specific proposals and issues raised under approach B, namely:
- the selective auction of PES metering assets or more widely the full range of PES metering functions. This would involve the transfer of ownership of metering activities from each PES to a number of new owners who would subsequently assume the role of meter services providers. As with Approach A this would place data processing activities with the supply business but the other functions of meter operation and provision and meter reading would be subject to auction. These metering functions would be separated operationally and financially from other PES functions as part of the transaction. Under this approach no supplier would retain a dominant share in metering activities in any region;
 - there are a number of other issues that would arise should PESs auction their metering assets and other metering activities.
 - i) the proportion of metering assets to be auctioned;
 - ii) what constraints should apply to any one party's holding of meters;
 - iii) how auction lots should be defined, by meter type or in a simpler bundled lot which could be repackaged in a secondary market;
 - iv) whether there should be a reserve revenue or price;

- v) whether successful bidders should pay what they bid, or whether all successful bidders should pay the lowest successful bid (that is, equivalent to a market clearing price);
 - vi) whether any particular constraints should be placed on the PESs' ability to charge for necessary support services;
 - vii) whether there would need to be a body responsible for trading in meters in a secondary market;
 - viii) whether such an auction should encompass solely those activities and assets associated with meter provision or whether all or some other sub-set of PES metering functions should be involved;
 - ix) whether auction lots should encompass meter assets and any other metering activities jointly (that is, for example the meter and meter reading functions for a set of meters) or whether separate lots should be required; and
 - x) whether assets to be auctioned should be combined nationally initially to provide for national lots and a single national auction rather than regionally based auctions, and, if so, how that should best be achieved.
- h) Views are invited on the respective benefits of the two approaches outlined above. In addition to comments on the specific issues raised under each approach, it would be helpful to have views on:
- i) which approach is likely to provide for the most effective competitive environment for metering services and supply and how these compare with the respective costs and ease of implementation;
 - ii) the impact of the approaches on services to customers and suppliers;
 - iii) the timing of the auctions under Approach B and its relationship to the steps to be taken under Approach A, and to price controls; and
 - iv) whether if it were decided not to proceed with the full auction of all metering activities in accordance with Approach B, it would be sensible to enhance Approach A by requiring an auction of meter assets presently owned by the distribution businesses.
- i) Views are invited on the appropriate approach to prepayment meter issues.

RESPONSES RECEIVED ON SEPARATION OF BUSINESSES

PESs

East Midlands Electric
Eastern Electricity
Hydro-Electric
London Electric
Manweb
MEB
Northern Electric
NORWEB
ScottishPower
SEEBOARD
Southern Electric
SWALEC
SWEB
Yorkshire

Other Industry

PowerGen
NGC
Association of Electricity Producers
BNFL Magnox Generation
British Gas Trading
Scottish Electricity Settlements
Electricity Association

Consumer Bodies

Consumers' Association
East Midlands ECC
ECC Chairmen's Group
Merseyside and North Wales ECC
Midlands ECC
National Consumer Council
North East ECC
North Scotland ECC
North West ECC
South East ECC
South Scotland ECC
South Wales ECC

South West ECC
Southern ECC
Yorkshire ECC
Central Rail Users Consultative Committee
Chemical Industries Association
Energy Intensive Users Group
Major Energy Users' Council
Royal National Institute for the Blind
BOC Gases

Other

AccuRead
BCN Data Systems
BEAMA
British Wind Energy Association
Coherent Technologies
Electric Data Systems
International Energy Strategy Studies
Lowri Beck
Powermet Limited
Ralph Turvey
RJB Mining (UK) Limited
Siemens
Yogi Dutta

A DESCRIPTION OF THE STANDARD PES AGREEMENTS

1. Background

- 1.1 The Public Electricity Supply (PES) licence obliges a PES to offer to enter into a number of agreements with suppliers. The most relevant in respect of the issues discussed by this paper are the agreements for use of system, meter operation, data collection and data aggregation. Set out below is a general guide to provisions and services included in each of these agreements. This focuses on the arrangements in England and Wales. Arrangements in Scotland are similar in most respects but some variations are necessary to reflect the different settlement and other industry arrangements.

2. Use Of System Agreement

- 2.1 A PES is obliged by Condition 8 of its licence to offer to enter into a use of system agreement with any authorised supplier. The principle service provided under this agreement is the transportation of electricity through the distribution system to each of the premises registered to the supplier under the Master Registration Agreement.
- 2.2 The charges set out in this agreement reflect the costs to the distribution business of the PES of providing, operating and maintaining the distribution system to the standards prescribed by Electricity Act 1989 and the PES licence. At present the charges also recover costs associated with some metering and data services. In addition, the agreement provides for certain transactional charges in respect of services performed under the terms of this agreement which are not presently included in the bundled use of system charge. In the provision of use of system a PES is prohibited from discriminating between suppliers in the service it offers or the charges it makes. For example, a PES must not discriminate in favour of its own supply business. This also applies to the other agreements described in sections 3 to 5.
- 2.3 Although the main purpose of this agreement is to provide that a supplier can use the PES's distribution system, it also includes some general provisions associated with the operation of the distribution system, including metering assets. The main provisions are:
- The agreement includes demand control measures which provide that the distribution business can issue a notice alerting suppliers to particularly sensitive parts of the network where security of supply could be affected if there are significant modifications to customer demand at certain times. Where a notice is issued suppliers must take certain prescribed steps to assist the PES. This can include requiring the supplier to discontinue

demand control and switching arrangements available to its customers. Any notice issued must be copied to OFFER and can be challenged by a supplier. The agreement provides that OFFER can settle disputes.

- Under the terms of the agreement a supplier is obliged to ensure that, when it enters into a supply contract, the customer simultaneously enters into an agreement on the PES's standard terms of connection. A connection agreement recognises that a customer's premises will remain connected to the distribution system even if the customer changes supplier. This provision has been included to reflect a general desire that arrangements on change of supplier are as straightforward as possible for the customer.
- The PES is required to make payments in respect of the performance of its distribution business to the supplier for the benefit of any customers occupying premises with demands of 100kW or less equivalent to such sums as would have been paid pursuant to the standards of performance described by the Director in accordance with Section 39 of the Electricity Act 1989. This provision reflects the obligations set out in Condition 21 of the PES licence.
- The agreement sets out the obligations imposed on both the supplier and the PES in the event that energisation, de-energisation or re-energisation works are to be carried out.
- The distribution business is obliged to provide a revenue protection service in accordance with the provisions of a Revenue Protection Code of Practice. The supplier is required to comply with its obligations set out in this Code in respect of suspected meter interference. The meter operation and data collection agreements include a similar provision.

2.4 In addition, the use of system agreement requires that the supplier and the PES comply with the Distribution Code and that the supplier should ensure that its meter operator complies with the Meter Operator Code of Practice. Under the terms of the agreement a supplier must also become a party to the Radio Teleswitch Agreement where it has customers with meters connected to a radio teleswitch. All suppliers have access to the existing radio teleswitch arrangements. The Radio Teleswitch Agreement allows a supplier to determine the switching regime for a particular Group Code by using a PES's radio teleswitch access service.

3. Agreement For The Provision Of Non Half-Hourly Meter Operation

3.1 Under settlement arrangements the host PES will be the sole provider of meter operation services until 1 April 2000 for all conventionally metered customers (customers without half hourly metering) in its authorised area. A PES is obliged by Condition 11C of its PES licence to offer to enter into an agreement for meter operation.

- 3.2 The main service performed by a PES under the terms of this agreement is the installation, provision and maintenance of metering systems. This includes the investigation of meter faults, whether the supply is interrupted or not, carrying out an accuracy check on a meter, the installation of a check meter and the re-siting of a meter. The agreement also provides that a supplier may ask the PES to change the functionality of a meter to either revise the time pattern regime or the method by which the customer makes payment. This could include the installation of a prepayment meter. The supplier could also ask the PES to energise or de-energise a meter and to replace a meter which has been used for trialing purposes, for example, with a meter which the PES could support across all suppliers. In addition, the PES is obliged by the agreement to reprogramme prepayment meters at the request of the supplier and to visit the premises of a prepayment customer where the supply has been interrupted for a reason other than a meter fault.
- 3.3 Some of the metering services performed by the PES are presently included in the bundled distribution use of system charge and are not therefore presently set out in this agreement. However, the agreement does set out transactional charges for some services which are provided to individual suppliers. Charges are not normally made where the metering system is at fault or is found to be inaccurate. In addition, certain charges are suspended subject to the supplier acting reasonably in its request for certain services.
- 3.4 The services provided under the meter operation agreement are underpinned by service levels which require the PES to provide a service within a defined period. These levels were set after extensive negotiation with relevant parties and in some cases were the subject a dispute resolution process which required OFFER to make decisions on appropriate levels of performance. A fundamental principle in determining these service levels was that they should be at least consistent with the service presently offered to the PES's own supply business. Some services performed under this agreement are covered by the guaranteed and overall standards of performance set by OFFER. In these cases the PES is expected to perform the service within the period defined in those standards.
- 3.5 The agreement includes a provision allowing the PES to issue a notice to suppliers where it considers the volume of requests for certain services constrains its ability to perform a service in accordance with the defined performance targets. The agreement includes provision for a dispute in respect of a notice issued by a PES to be referred to OFFER.
- 3.6 To help ensure that the PES performs the service within the defined period, the agreement includes a liquidated damages regime. The payments made to supplier in the event of service failure were calculated as an estimate of the financial loss which a supplier would incur.
- 3.7 The appointment guidelines set out in this agreement describes the appointments window and booking arrangements for visits to customers premises. These

appointments can be made by second tier suppliers over the telephone or the Data Transfer Network. A liquidated damages payment, reflecting the administrative cost to the supplier, is payable if the PES fails to meet an appointment.

4. Agreement For The Provision Of Non Half Hourly Data Collection Services

- 4.1 As with meter operation, under settlement arrangements until 1 April 2000, the host PES will be the sole provider of data collection services for all conventionally metered customers. Again, it is the suppliers responsibility to ensure that it enters into an agreement with each relevant PES for data collection services. A PES is obliged by Condition 11C of its licence to offer to enter into an agreement for data collection.
- 4.2 The main service performed under the terms of this agreement is meter reading in accordance with the PES's meter reading cycle and validation of such meter readings. The supplier can also request that the PES visits the premises of its customers to obtain a meter reading outside of the normal meter reading cycle. In addition, the agreement provides that the PES carries out data processing on data from unmetered supplies, such as streetlighting, and the calculation of deemed meter reading on change of supplier or where required in accordance with Pool rules.
- 4.3 Where a PES fails to gain access to the premises of a customer for the purposes of obtaining a meter reading, the PES shall, unless otherwise agreed with the supplier, leave a card at those premises advising the customer to make its own reading and pass this onto the PES by using a telephone number specially provided for this purpose. In these cases OFFER has said that the PES must ensure that the PES supply brand is not prominent on any card left at a customer's premises and that the answering service must make it clear to the customer that it is through to a meter reading service operated on behalf of all suppliers.
- 4.4 Transactional charges for some data collection services, including special meter readings on change of supplier are set out in this agreement.
- 4.5 The data collection agreements require that a PES shall read meters in accordance with its scheduled collection rota. The frequency with which meters readings are obtained in respect of each category of meter is defined by schedules determined by the PES during the calendar year. A table included in the agreement sets out the read frequency categories which apply in the PES's authorised area. For each category, the table sets out the minimum access rate and the read window (a number of days before or after the target collection date). The minimum access rate presently set out in the agreement should reflect that achieved by the PES on a historic basis.

- 4.6 Meter reading performance targets are also included in the agreement representing the percentage of customers which the PES expects to gain access to in a particular quarter. Targets are set out for meters read monthly and for those read less frequently.
- 4.7 On carrying out the services, the agreement sets a period of time within which relevant data should be passed to the appropriate persons, including the data aggregator and the supplier.
- 4.8 As with the meter operation agreement, this agreement includes a liquidated damages regime. A payment has to be made to the supplier in circumstances such as failure to obtain a meter reading within the read window, if the meter reading performance is less than the specified target, on failure to pass data to relevant persons within the defined timescales and where a meter reading is found to be inaccurate. Compensatory payments are also payable to the supplier in the event that the supplier incurs a penalty under the terms of Pooling and Settlement Agreement (or the Scottish Settlement Agreement) which results from a failure by the PES to perform a service. This agreement also includes similar provisions to the meter operation agreement where the volume of requests for certain services constrains the ability of the PES to perform a service in accordance with the defined performance targets.
- 4.9 Appointment guidelines in a similar form to those set out in the meter operation agreement are included in this agreement.

5. Agreement For The Provision Of Non Half-Hourly Data Aggregation Services

- 5.1 The host PES will also be the sole provider of data aggregation services for all conventionally metered customers in its authorised area until 1 April 2000. A PES is required to offer to enter into a data aggregation agreement by Condition 11C of its PES licence.
- 5.2 This agreement sets out those services which the PES is required to perform to ensure that data is aggregated in a form specified by the Settlement agent and provided within settlement timescales.
- 5.3 The agreement provides that a liquidated damages payment will be payable to the supplier for each dispute which arises under the Settlement Agreement as a direct consequence of data being allocated to the incorrect Settlement Class. The agreement also includes a compensatory payments regime for when the supplier is required to pay a Pool penalty resulting from failure of the PES to perform certain data aggregation services.