

October 2000

**Sales of metering businesses of
Public Electricity Suppliers**

Decision document

Executive summary

In April this year Ofgem issued a consultation document seeking views on regulatory and competition issues associated with Public Electricity Suppliers (PESs) selling their metering businesses. This was prompted by public announcements from two PESs of their intentions to sell their metering businesses. Where a PES wishes to sell its stock of installed meters, Ofgem must give formal consent for the sale to proceed.

This document sets out Ofgem's policy conclusions, and establishes the principles whereby consent for sales will be granted. Ofgem may, however, wish to consult separately on the merger implications of any individual business sale.

In summary:

- ◆ it is Ofgem's view that the sales can be expected to stimulate competition in metering and data services and, to a lesser extent, competition in supply – to the benefit of customers;
- ◆ any licence obligations in respect of metering and data (in the current PES licences, and as to be established through the Standard Licence conditions consequent to the Utilities Act 2000) should be retained by the relevant licensed body. A purchaser of a PES metering business will not, for the time being, be separately regulated;
- ◆ where a PES is meeting its licence obligations through contract with a third party, Ofgem will not accept such arrangements as a mitigating factor in the event of a licence breach; and
- ◆ Ofgem's consent to a proposed sale of a PES's stock of installed meters will be conditional upon a licence modification to identify a separate price control for metering within the overall distribution price control.

These principles provide a framework within which companies can make efficient investment and divestment decisions in respect of PES metering businesses, while ensuring appropriate regulatory protection for consumers.

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1. Introduction

Background

- 1.1 The Utilities Act 2000 creates a single principal objective for Ofgem to “protect the interests of consumers..., wherever appropriate by promoting effective competition”. Metering and data services are activities where the promotion of effective competition seems appropriate. Competition can be expected to deliver improved value for money and stimulate innovation – to the benefit of consumers.
- 1.2 At the present time metering and data services are provided to electricity suppliers in most instances by the relevant regional Public Electricity Supplier (PES). These activities are regulated. The PES has licence obligations in respect of providing these services, and revenue from some metering services falls under the scope of the distribution price control. These regulatory safeguards are in place to protect consumers in the absence of competition.
- 1.3 A sale of a PES metering business raises a number of issues in terms of continuing regulation and the development of competition. Where such a sale involves the disposals of a PES’s stock of installed meters, Ofgem’s formal consent is required for the sale to proceed.
- 1.4 Ofgem consulted on the regulatory and competition issues associated with PES metering business sales in April 2000. This consultation was prompted by announcements by two PESs, TXU Europe¹ and Powergen Energy². Additional background material on the provision of metering and data services and the associated regulatory framework is provided in Appendix 1.
- 1.5 The key issues on which Ofgem sought views were:
 - ◆ the impact on competition in metering and data services, and electricity supply;

¹ Holder of the PES licence for Eastern Electricity

² Holder of the PES licence for East Midlands Electricity

- ◆ the licence obligations and enforcement where a PES has sold the physical capability to meet its obligations; and
 - ◆ the need for modifications to a PES's distribution price control.
- 1.6 This document records responses to Ofgem's April 2000 consultation paper, and sets out Ofgem's policy conclusions.
- 1.7 This document relates to the metering businesses of Public Electricity Suppliers (PESs). It should be noted that the Utilities Act 2000 provides for the abolition of PESs as a class of licensee, to be replaced by separately licensed distributors and suppliers. Ofgem recently issued its final consultation on Standard Licence Conditions for electricity distributors and electricity suppliers.

References

- 1.8 Ofgem has published a number of documents that relate directly or indirectly to issues discussed in this document. Ofgem's views on PES separation and the development of electricity metering competition were published in May 1999. Final proposals in respect of the latest distribution price control review were published in December 1999. Final proposals on gas metering and meter reading competition were published in May 2000.
- 1.9 Ofgem has also recently published its survey of competition in metering and meter reading services. This survey will inform Ofgem's review of competition in these services. Ofgem intends to publish the review findings in December 2000.

Rationale

- 1.10 It is Ofgem's role to establish industrial structures that promote competition. This was highlighted as a priority area in Ofgem's Plan and Budget for 2000/01. Competition in metering and data services forms part of this work.
- 1.11 Competition in metering and data services can be expected to deliver value for money and technological innovation – to the benefit of consumers. Sales of PES metering businesses could have a significant impact on the development of such competition.

- 1.12 This document sets out Ofgem's policy in respect of metering business sales. It is important that policy does not distort incentives for PESs to retain or divest their metering businesses, or result in sales that distort the future development of competition in metering and data services or competition in electricity supply.
- 1.13 Ofgem's policy objective is to provide a framework which ensures that companies can make efficient investment and divestment decisions in respect of metering businesses, while retaining appropriate regulatory protection for consumers. This document sets out such a policy framework.

Structure of the document

- 1.14 Chapter 2 summarises responses to Ofgem's April 2000 consultation document, and sets out Ofgem's response to these comments. Chapter 3 sets out Ofgem's policy conclusions.
- 1.15 Appendix 1 provides background information on the current provision of metering and data services, and the associated regulatory framework. Appendix 2 lists non-confidential respondents to Ofgem's April 2000 consultation document.

Contact details

- 1.16 If you wish to comment on the issues raised in this document the please write to:

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1.17 If you have any questions about this document, or wish to discuss the issues raised, then please contact Colin Sausman (020 7932 5939; Colin.Sausman@ofgem.gov.uk) or Adrienne Monroe (020 7932 6314; Adrienne.Monroe@ofgem.gov.uk).

2. Summary of responses

Introduction

2.1 Ofgem's April 2000 document, 'Sales of the metering businesses of Public Electricity Suppliers – A consultation document', sought views on a number of competition and regulatory issues associated with the sales of PES metering businesses. These were organised under the following three headings:

- ◆ competition;
- ◆ licence obligations and enforcement; and
- ◆ price control.

2.2 There were 34 responses, of which four were marked as confidential. This chapter summarises responses, and sets out Ofgem's views in respect of respondents' comments.

Competition issues

2.3 A sale of a metering business raises issues in terms of how competition in metering and data services may be affected, and what knock-on effect there may be on competition in supply. These issues were discussed in detail in Ofgem's April 2000 consultation paper.

2.4 Ofgem invited views on:

- ◆ the impact of PES metering business sales on competition in metering and data services;
- ◆ how the scope and duration of contracts forming part of a sale will influence the development of competition; and
- ◆ the impact of PES metering business sales on competition in electricity supply.

2.5 These three issues are discussed in turn below.

- 2.6 Most respondents did not differentiate between metering services and data services in providing comments. It should be assumed, unless otherwise stated, that the comments recorded below apply equally to metering services and data services.

Impact of metering business sales on metering and data services competition

Respondents' views

- 2.7 Almost all PESs who responded thought that the sales would have a positive effect on competition. Reasons cited included: increased transparency resulting from the separation between PES and the purchaser; market entry by a credible non-PES metering business; facilitation of national service providers; and the implementation of new ideas which would stimulate further innovation. One PES supply business stated that market entry and restructuring were key to the development of competition in data services.
- 2.8 However, three PESs voiced concern about the potential for metering business sales to create market power in the joint provision of gas and electricity metering and data services, with a potential negative impact on competition. One PES noted that the sales may simply transfer existing dominance to the purchaser, with a negligible impact on competition. One PES stated that while competition in metering would be promoted by the sales, further regulatory action is necessary to promote investment in new metering technologies.
- 2.9 Three consumer councils considered that metering business sales would stimulate competition, although one respondent expressed concern that the development of competition could constrain the implementation of advanced metering technologies. One consumer council thought that the sales would facilitate the development of specialist metering companies. Another consumer council expressed concern that added complexity implied by competition in metering could prove confusing to customers and slow down complaint handling. One user group stated that the benefits of greater competition in the longer term would outweigh a reduction in competition in the short term.

- 2.10 Four independent metering organisations stated that business sales were key to the development of competition. Two of these organisations viewed separation as vital to increase transparency and 'level the playing field' for other new entrants. One independent metering organisation noted that a purchaser was likely to be more 'outward looking' than a PES metering business, thereby stimulating competition. In contrast, one organisation believed it unlikely that a purchaser could expand outside the PES area.
- 2.11 However, four independent metering organisations highlighted other significant barriers to competition. Specifically, uncertainty over asset ownership, and lack of incentives to implement new metering technologies. One provider was concerned that the sales, by facilitating multi-utility work, might give rise to anti-competitive behaviour. Another independent metering services provider expressed doubt that smaller companies would survive the short-term absence of competition.
- 2.12 One non-PES supplier noted that the sales could reduce competition in the short term, but considered that the transparency resulting from separation would be beneficial in the longer term. A Public Gas Transporter (PGT) noted that the sales could stimulate competition even in the short term through the creation of a credible non-PES market entrant. A trade union expressed concern about the maintenance of terms of employment and working conditions following any sale.

Ofgem's view

- 2.13 Ofgem agrees with the views of the majority of respondents that the sales will stimulate competition in metering and data services. While it true that competition between metering companies within the vendor PESs authorised area may be reduced in the short term through a sale, in Ofgem's view any such short term diminution of competition is not significant relative to the potential stimulus to competition in other areas through the presence of a non-PES metering business and the likely increase in competition at the end of the initial contracting period.

- 2.14 The separation between PES and metering business brought about by a sale could be expected to increase transparency and reduce perceptions of cross subsidy or potential discrimination, thereby promoting further market entry.
- 2.15 Ofgem notes respondents' concerns about the sales potentially increasing market power in 'dual fuel' metering and data services provision. Ofgem may choose to consult separately on the merger implications of any specific sale. Further, Ofgem's powers under the Competition Act 1998 provide safeguards against abuses of a dominant position. Using a dominant position in one market as a means of sustaining anti-competitive behaviour in another market is an exemplar abuse under the Competition Act.
- 2.16 Ofgem also notes respondents' comments about how metering competition may interact with the development and deployment of advanced metering technologies. In Ofgem's view, the proposed sales *per se* will not reduce incentives to innovate – and the presence of a significant non-PES metering business with a desire to expand could stimulate new innovation, to the extent that such innovation is valued by users of metering and data services.
- 2.17 In response to comments on other barriers to competition, Ofgem does not believe that sales in themselves will exacerbate the concerns raised. Ofgem is presently reviewing the wider issue of barriers to competition in metering and meter reading across the gas and electricity industries. The findings of this review will be published later this year. Ofgem will ensure that comments raised through this consultation on wider competition questions feed in to the review.

Scope and duration of term contracts – effects on competition

Respondents' views

- 2.18 The majority of respondents viewed term contracts as necessary to make a sale a viable investment, and that a period of 3-5 years seemed reasonable.
- 2.19 Three PESs noted the supply business of the vendor PES would not wish to be tied to a lengthy contract which turned out to be uncompetitive, thereby providing a safeguard against anti-competitive arrangements. One PES stated that

contracts longer or shorter than this could stifle innovation. Another PES noted that competition law provides a constraint on excessively restrictive contracts.

- 2.20 A PES argued that the contracts would not restrict competition even in the short term as suppliers do not need to use the services provided by the host PES. However, some PESs had reservations about the contracts. One PES believed that the contracts could deter second tier suppliers from supplying in the PES area. Another PES argued that the prices and service standards should be no more onerous than at present. One PES believed Ofgem should monitor the contracts, in order to protect second tier suppliers.
- 2.21 The majority of metering organisations who expressed a view also believed that contracts were necessary to facilitate a sale, and as such would benefit long term competition. Two independent metering businesses believed competition would intensify after the initial contracts expired. However, one metering organisation stated that term contracts would not facilitate competition in the short term.
- 2.22 Another metering organisation stated that other barriers to competition, related to the potential implementation of advanced meter reading technologies, were much more important in terms of constraining the development of competition than the length or scope of any contract forming part of a metering business sale.
- 2.23 A user group thought that competition would increase after expiry of the initial contracts. A consumer council believed the contracts would not disadvantage customers any more than existing arrangements. Another consumer council believed the term of the contracts should be closer to three years than five.
- 2.24 A non-PES supplier believed that the impact of these contracts on short term competition should be minimised by strictly limiting the period for which they would be exclusive, to no more than 3 years. A PGT considered that although the contracts may restrict short-term competition, the sales will benefit competition in the long term. Another PGT believed that 3-5 years created the right balance between promoting competition, protecting consumers and facilitating market entry.

Ofgem's views

- 2.25 Ofgem agrees with the widely held view that contracts for the purchaser to provide services to the vendor PES are necessary to facilitate a sale. Ofgem also agrees with the view expressed by one PES that competition law will constrain any potential anti-competitive excesses in terms of the form and duration of contracts forming part of a sale.
- 2.26 Ofgem agrees with respondents who noted that a PES supply business, as a customer of the purchaser of the metering business, would not wish to be tied to an uncompetitive service provider in the long term – since such an arrangement would harm the PES commercially in the supply market. This could therefore be expected to represent a constraint on the length and form of any contract.
- 2.27 Ofgem notes concerns that in meeting its licence obligations through contract, a PES does not in effect introduce onerous terms and conditions for second-tier suppliers. Ofgem would like to make it clear that the protection afforded for second-tier suppliers through the licenses will not be affected by the sales. For example, it would still be possible to bring particular terms and conditions in respect of metering and data services to the Director General for determination. A vendor PES's contract with the purchaser would need to be sufficiently flexible to allow for this.

Competition in electricity supply

Respondents' views

- 2.28 Relatively few respondents commented on the impact of metering business sales on electricity supply competition. Almost all respondents that did comment thought that the sales would have a neutral or positive effect on supply competition.
- 2.29 Four PESs believed the sales would not adversely affect competition in supply. Three PESs considered that suppliers and competition in supply would benefit from the sales. Three PESs also considered that competition in metering and data services would benefit competition in supply. Two PESs believed separation would level the playing field for suppliers and encourage new

entrants. One PES expressed concern that the sales should not limit the ability of new entrants to obtain metering and data services.

- 2.30 Two consumer groups considered that the sales would not adversely affect competition in supply. Three independent metering businesses, as well as a second tier supplier, believed the sales would benefit competition in supply.

Ofgem's views

- 2.31 Ofgem agrees with the general consensus that metering business sales are unlikely to have an adverse effect on supply competition. In the longer term, Ofgem considers that the development of metering competition will stimulate supply competition by increasing the range of services offered to customers by suppliers.

- 2.32 In response to concerns about protection for second-tier suppliers, existing licence obligations upon PESs to offer services on a non-discriminatory basis will not be affected by a metering business sale. A sale will simply imply that a PES meets such obligations through contract with a third party. In the first instance this will be the purchaser of the business.

Licence obligations and enforcement issues

- 2.33 PESs have licence obligations to provide metering and data services on a non-discriminatory basis to all suppliers within their authorised area. A sale of a PES metering business raises questions of where such obligations should lie, and how this may affect Ofgem's ability to regulate. These issues were discussed in detail in Ofgem's April 2000 consultation document.

- 2.34 Ofgem invited views on:

- ◆ potential problems in respect of licence obligations and enforcement with a PES meeting its obligations through contract with a third party; and
- ◆ whether Ofgem should seek direct enforcement-type power over the purchaser, for example through voluntary undertakings or separate metering licences.

2.35 These two issues are discussed in turn below.

Meeting licence obligations through contract with a third party

Respondents' views

2.36 The majority of respondents who expressed a view did not perceive any problems with a PES meeting its licence obligations through contract with a third party. Some respondents pointed out that this approach was not without precedent.

2.37 Most PESs who responded did not perceive any problem with meeting licence obligations through contract. One PES stated that companies should have commercial freedom to meet licence obligations in whatever was the most efficient manner. Another PES believed it was not a serious concern, as suppliers could contract directly with the purchaser.

2.38 However, one PES believed that meeting obligations through contract was undesirable as it would require complex contract negotiation. They also argued that customer services could be at risk, if the PES had to take remedial action against the purchaser. Another PES believed that Ofgem should monitor the disposals, to ensure continuing licence compliance.

2.39 One independent metering organisation pointed out that PESs are already meeting obligations in half-hourly metering through contract. A PGT noted that meeting obligations through contract was standard commercial practice. However, another metering organisation believed that enforcement would be more difficult if obligations were met in this way, and that Ofgem should ensure the contracts are sufficiently detailed in this respect. A non-PES supplier also believed Ofgem should monitor the sales, to ensure service level standards are maintained.

Ofgem's view

2.40 Ofgem agrees with the majority of respondents that, in principle, it is acceptable for a PES to meet its obligations through contract with a third party. The 'make or buy' decisions of PESs should not be artificially constrained. Such an approach would reduce a PESs ability to make legitimate efficiency savings.

- 2.41 However, a PES's decision to procure services from a third party rather than provide services themselves does not in any way reduce its responsibility to meet its licence obligations. Neither can it be held up in mitigation in the event of a licence breach.
- 2.42 While Ofgem notes the comments of one PES about the complexity of contracts, it is not Ofgem's role to determine what is and is not contractually possible. It is Ofgem's role to ensure that all PESs continue to comply with licence obligations to provide metering and data services to second tier suppliers on a non-discriminatory basis, regardless of how any individual PES chooses to do this.

Whether Ofgem should seek direct enforcement-type powers over a purchaser

Respondents' views

- 2.43 Opinion was split on whether it is necessary to regulate a purchaser of a PES metering business directly, potentially through the creation of separate metering licences. Some respondents saw value in separate licences as a means of clarifying obligations, while others support the continuation of PES licence obligations.
- 2.44 A number of respondents also commented on the related issue of regulation of metering and data services more generally. The majority of respondents stated that the development of competition should facilitate the removal of licence obligations. A number of PESs supported the removal of licence obligations in respect of data services in the short term.
- 2.45 Four PESs favoured the introduction of separate metering licences, believing they would benefit competition and clarify responsibilities. Of these respondents, one PES thought that a transfer of obligations from a PES to a purchaser would sharpen incentives to comply with such obligations. Another PES argued that although separate metering licences might deter market entrants, requiring PESs to retain all obligations could deter the sale of metering businesses.
- 2.46 Five PESs argued against the introduction of separate metering licences, viewing it as unnecessary additional regulation. One of these PESs considered existing licence obligations, together with Ofgem's powers under the Competition Act

1998, as sufficient. A number of PESs argued that effective competition should make separate licensing unnecessary. One PES stated that if separate metering licences were to be introduced, then any licence obligations should not restrict the positioning of such a business.

- 2.47 One independent metering organisation considered that direct enforcement powers over the purchaser of a metering business would hamper competition. Another saw no value in licensing new entrants. Another independent metering organisation considered voluntary undertakings more appropriate than separate metering licences. One metering organisation believed that although separate metering licences were not needed at present, the possible introduction in the future should not be ruled out.
- 2.48 A consumer group pointed to the problems arising after the 1994 opening of the 100 kWh market as evidence of the need for separate metering licences. Another consumer group believed that no new licence conditions should be imposed on purchasers. One consumer group considered that licence obligations should be retained for the shortest possible period, and that the sale contracts should be monitored to ensure licence obligations were met.
- 2.49 A second-tier supplier also believed Ofgem should not extend the scope of regulation to include direct powers over purchasers of PES metering businesses. In contrast, a PGT supported separate metering licences as a means of transferring obligations and harmonising the regulatory regime between electricity and gas.
- 2.50 Several respondents commented on the wider regulatory policy framework. Both a PES and an independent metering business suggested that industry accreditation of third-party providers would ensure high quality standards. One PES said that Ofgem must ensure non-discriminatory service provision. An independent metering business argued that regulatory policy should focus on supply competition, and provide clear rules on meter cost recovery and unbundling.
- 2.51 A number of respondents highlighted the need for regulatory action to promote the implementation of advanced metering technologies. They considered that the existing regulatory framework acted to deter such investment.

Ofgem's views

- 2.52 Whilst some respondents have argued for direct regulation over the purchaser of a PES metering business, this would entail a significant extension of regulation. Ofgem's view is that existing licence obligations together with Ofgem's powers under the Competition Act 1998 provide adequate protection for customers.
- 2.53 Ofgem would hope that the development of competition in metering and data services will facilitate the removal of licence obligations in respect of metering. However, if competition fails to develop, then it may be necessary to review the regulatory regime. Such a review could consider the introduction of separate metering licences. This would represent a significant development and would require extensive consultation. Ofgem hopes that such steps will prove unnecessary.

Price control issues

- 2.54 In Ofgem's distribution price control review final proposals document in December 1999, Ofgem stated that where a PES sells its meter assets the relevant price control may need to be reviewed.
- 2.55 Ofgem's April 2000 consultation paper on PES metering businesses discussed three issues relating to the consequences of a business sale for the distribution price control.
- 2.56 First, the scope of the price control. The consultation paper set out three possible treatments of the distribution price control where a PES sells its meters:
- ◆ reduce the scope of the price control to exclude metering;
 - ◆ leave the price control unchanged; or
 - ◆ retain the scope of the price control but introduce a split between metering and distribution activities.
- 2.57 Ofgem invited views on the relative merits of the three options above where a PES wished to sell its metering business.

- 2.58 Second, the definition of metering regulatory value. If a price control were to be reduced in scope or split, a method would be required to establish a metering regulatory value. Ofgem set out two possible approaches:
- ◆ defining the metering regulatory value by rolling net assets values indexed by the Retail Prices Index (RPI), with an adjustment made for the difference between market value and book value at the time of vesting ('market to asset ratio' or MAR-adjusted); or
 - ◆ splitting the regulatory value between distribution and metering on the basis of a comparative analysis of forward-looking cash outlays.
- 2.59 Ofgem invited views on the appropriate way of defining metering regulatory value.
- 2.60 Third, the form of the price control in respect of adjustments in price control revenues for loss of metering market share by a PES. Under the distribution price controls, where a PES loses market share in metering, price control revenues are reduced by an estimate of the reduction in avoidable costs. Ofgem invited views on whether this form of control continued to be appropriate where a PES has sold its meters.
- 2.61 These three issues are discussed in turn below.

The scope of the price control

Respondents' views

- 2.62 Opinion was divided on how metering business sales should affect the vendor's distribution price control. All three options had some support from respondents.
- 2.63 Three PESs argued that a sale of meters should be accompanied by a reduction in the scope of the control to exclude metering. Ofgem could provide protection for customers through its Competition Act 1998 powers. Of these respondents, one argued that if removal were not possible then a split between metering and distribution activities would be desirable. An independent metering organisation also favoured excluding metering from the price control.

- 2.64 Three PESs argued that the price control should remain unchanged. Of these, one PES was particularly concerned that a control may be reopened so soon after being finalised, while another PES argued that the control should be split at the next review.
- 2.65 Five PESs and one PES supply business argued in favour of a price control split between metering and distribution activities where a PES sells its metering business. A number of PESs commented on the eventual removal of a price control on metering when competition is developed. Three consumer councils and a user group supported a split price control. A PGT and a non-PES supplier also supported a split price control where a PES sold its metering business.
- 2.66 An independent metering business suggested that meters only be regulated whilst *in situ*, and once physically removed, could also be removed from the regulatory asset base.

Ofgem's view

- 2.67 If a PES is to be able to sell its metering assets then it seems likely that such a sale would in practice only be able to proceed if there is transparency in relation to how the distribution price control will be separated and operate in the future. In the longer term it will be desirable to separate out metering from other distribution activities for all companies. In the light of these considerations it is clear a separation of the existing price control will be required for those companies seeking to sell their metering assets.
- 2.68 This separation will be put in place for all distribution companies at the next price control review. Given that there is only limited competition in the provision of metering assets to many groups of customers it is clear that an element of price control protection will need to be retained, at least for a transitional period. This approach would be broadly consistent with the views of those who responded to the April 2000 consultation paper.

Methods for identifying metering regulatory value

Respondents' views

- 2.69 A number of respondents noted that it is only necessary to identify metering regulatory value where the price control is being split or reduced in scope. Two PESs commented that such an exercise, if desirable, should be left to the next price control review.
- 2.70 Where respondents commented on the method of identifying metering regulatory value, opinion was divided. A number of respondents perceived problems with both approaches set out in Ofgem's consultation document.
- 2.71 Two consumer groups and two PESs supported an approach based on rolling forward MAR-adjusted net asset values. The main reason cited was consistency with how the distribution price control was set. A PES also noted that potential purchasers could reasonably expect such an approach.
- 2.72 An approach based on comparative analysis of forward-looking cash flows gained little support. One PES considered this option inconsistent the manner in which the distribution price control had been set, and could distort competition in metering. This method also appeared unworkable to another PES, and a consumer group expressed concern that it could artificially constrain investment. However, a number of respondents argued that forward-looking costs are more indicative of 'real' costs than historic costs.
- 2.73 A number of respondents put forward alternative views on how to assess metering regulatory values. Three PESs considered that metering regulatory values should be based on the replacement value of the assets. One PES noted that to do otherwise implied 'stranding' previous meter investment. A PGT suggested an approach based on forward-looking operating costs, and depreciation and return from asset values based on replacement costs. The respondent argued that alternative approaches could be distort competition in metering services.

- 2.74 One PES noted that the determination of metering regulatory value was complex, and that any chosen method must be able to be consistently applied. A PES supply business commented that any approach must ensure continuing financial viability.

Ofgem's views

- 2.75 It is clear that in order to separate the existing price control between distribution and metering activities it is necessary to identify a regulatory asset value for meters. An approach based on forward-looking cash flows would not be practicable as the intention is to encourage competition, and so it would be difficult to predict the forward cash requirements of such a business. Nevertheless there appears to be some strength in the arguments made by certain respondents that it would be important to consider the replacement values of existing assets, as these would influence the price levels under competitive conditions. It will also be important to consider consistency with the existing price control and therefore it will be necessary to take in to account calculations based on a separation of the existing regulatory asset value at privatisation and adjusting this for net capital expenditure.
- 2.76 In making a final judgement on which approach to use it will be important to bear in mind the Ofgem's statutory duties to protect the interests of customers and promote competition. If these considerations indicate that replacement values of existing assets should determine metering regulatory asset values then it would be possible to ensure a degree of consistency with the existing price control by ensuring that the sum of the separated regulatory asset values equals the existing total.

Form of control: adjustment in revenues with metering market share loss

Respondents' views

- 2.77 Opinion was divided on the appropriate form of control in respect of market share loss where a PES has sold its meter assets.
- 2.78 Three PESs expressed support for maintaining the existing adjustment mechanism. Of these respondents, one PES argued that an approach which reduced revenue in direct proportion to market share loss would create an

artificial incentive to contract directly with the purchaser rather than via the PES. Another PES argued that the existing mechanism should apply directly to the purchaser.

- 2.79 One PES argued that to change the adjustment mechanism would introduce differences between PESs that sell their metering businesses and those that do not. This respondent also viewed it as inconsistent with Ofgem's stated intention to not strand existing meter assets.
- 2.80 This respondent also argued that Ofgem's concerns about the existing mechanism creating a 'windfall' gain where a second-tier supplier decides to contract directly with the purchaser rather than via the PES could be addressed by requiring second-tier suppliers in the PES area to contract via the PES.
- 2.81 Two PESs and one PES supply business supported Ofgem's proposal that, where a PES has sold its metering business, price control revenues should be reduced directly in line with market share loss. This view was supported by two consumer councils, a user group and an independent metering organisation.
- 2.82 Three PESs and a PES supply business, however, expressed concern about a mechanism which involved a *pro rata* reduction in price control revenue, citing the importance of fixed costs. Of these respondents, one PES noted that there were differences between PESs and Transco in terms of scale which meant that PESs were less able to absorb fixed costs.
- 2.83 One PES believed that any such mechanism should ensure that charges to suppliers in respect of metering and data services are the same as they would have been in the absence of a sale.

Ofgem's views

- 2.84 The main advantage of separating metering from distribution in terms of ownership and price control is to encourage the development of competition. In these circumstances it will be important that any residual price control applying to metering does not distort the development of competition.

2.85 Therefore, the form of control should be consistent with the operation of a competitive market where revenue will change with changes in market share. While this will create asymmetries between those companies that sell their metering assets and those that do not, this will only be a transitional situation as metering will be fully separated across all companies at the next distribution price control review. There are legitimate considerations regarding the proportion of fixed and variable costs, which merit further consideration.

3. Conclusions

Introduction

3.1 This chapter sets out Ofgem's policy conclusions in respect of the sale of PES metering businesses. The following three sections discuss Ofgem's conclusions in respect of:

- ◆ impact on competition;
- ◆ licence obligations and enforcement; and
- ◆ price control.

3.2 In Ofgem's view the sales of metering businesses are a positive development which can be expected to benefit customers. However, in order to ensure that customers continue to be afforded appropriate protection, Ofgem considers that where a PES sells its meter assets there should be an adjustment to the scope and form of the relevant distribution price control. This is discussed in more detail below.

Impact of the sales of competition

3.3 In Ofgem's view the sales can be expected to stimulate competition in metering and data services – and should not adversely affect supply competition.

3.4 The split between a PES and its metering business will increase transparency and reduce perceptions of cross subsidy and discrimination. Similarly, a credible non-PES market entrant may also be expected to stimulate competition in other PES areas and promote innovation. All these factors may be expected to contribute to more effective competition.

3.5 Ofgem notes respondents' concerns about the sales potentially increasing market power in 'dual fuel' metering and data services provision. Ofgem may choose to consult separately on the merger implications of any specific sale. In addition, Ofgem's powers under the Competition Act 1998 provide safeguards against potential abuses of a dominant position.

Licence compliance and enforcement

- 3.6 Licence obligations to provide metering and data services on a non-discriminatory basis represent important regulatory protection for second-tier suppliers. A metering business sale will not affect these obligations. It is a question of where such obligations should lie. On balance, Ofgem believes that existing licence obligations should remain with the PES.
- 3.7 Ofgem hopes that the development of competition in metering and data services will enable the removal of existing licence obligations in the future. The creation of metering licences is a significant step which Ofgem does not feel is warranted at this stage, although such an option should not be ruled out if competition fails to develop. Such a step would only be taken after extensive consultation.
- 3.8 Where licence obligations remain with a PES (or, in future a licensed distributor), Ofgem believes that it is acceptable in principle for a PES to meet such obligations through contract with a third party. Indeed these arrangements should be encouraged where they represent greater efficiency. A metering business sale is one means of facilitating such an arrangement.
- 3.9 The fact that a licence holder decides to meet its licence obligations through contract with a third party will not, however, be a mitigating factor in instances of licence breach and the use, if necessary, of Ofgem's powers under the Utilities Act to levy financial penalties.

Price control

- 3.10 If a PES is to be able to sell its metering assets then it seems likely that such a sale would in practice only be able to proceed if there is transparency in relation to how the distribution price control will be separated and operate in the future. In the light of these considerations it is clear a separation of the existing price control will be required for those companies seeking to sell their metering assets. Given that there is only limited competition in the provision of metering assets to many groups of customers it is clear that an element of price control protection will need to be retained, at least for a transitional period.

Methods for identifying metering regulatory asset value

- 3.11 It is clear that in order to separate the existing price control between distribution and metering activities it is necessary to identify a regulatory asset value for meters. There appears to be some strength in the arguments made by certain respondents that it would be important to consider the replacement values of existing assets, as these would influence the price levels under competitive conditions. It will also be important to consider consistency with the existing price control. If these considerations indicate that replacement values of existing assets should determine metering regulatory asset values then it would be possible to ensure a degree of consistency with the existing price control by ensuring that the sum of the separated regulatory asset values equals the existing total.

Modifications to the form of the control

- 3.12 The main advantage of separating metering from distribution in terms of ownership and price control is to encourage the development of competition. In these circumstances it will be important that any residual price control applying to metering does not distort the development of competition. Therefore, the form of control should be consistent with the operation of a competitive market where revenue will change with fluctuations in market share. There are legitimate considerations regarding the proportion of fixed and variable costs, which merit further consideration.

Way forward

- 3.13 A separation of the existing price control will be required for those companies seeking to sell their metering assets. In Ofgem's view, the development of a method for separately identifying metering regulatory value requires further consultation. Any chosen method must be able to be consistently applied to all PES, and must act to promote rather than distort competition.
- 3.14 In order to identify a method it is therefore necessary to test empirically the different options, using costs information from all PESs. Where possible, this will be informed by cost data provided at the last distribution price control review process and in response to Ofgem's recent survey of competition in

metering and meter reading. However, it may be necessary to request additional data to be supplement this information.

- 3.15 Draft proposals will be developed for separating metering within the distribution price control on the basis of this analysis of different options. These draft proposals will be issued for consultation. Following consultation, Ofgem will publish a decision document. It is hoped that this process will take no more than six months in total to complete. Subject to identifying the resource required to complete this work, Ofgem's present intention is to publish its decision document no later than April 2001.

Appendix 1 Additional background

Metering and data services

- 1.1 The provision of metering and data services forms part of a PES's licensed activities. The PES provides these services to itself and to second tier suppliers operating in its authorised area. Metering services include the provision and operation of meters, and data services include the retrieval, processing and aggregation of meter reading data.
- 1.2 Competition in the provision and maintenance of half-hourly metering equipment was introduced in 1994. For non-half-hourly (NHH) meters, PESs have had a monopoly in metering and data services. This monopoly was granted by derogation from the relevant provisions within the Pooling and Settlement Agreement (P&SA). These derogations ended on 1 April 2000. Therefore it is now possible for suppliers to choose from alternative providers of metering and data services.

PES licence obligations

- 1.3 A PES's obligations in respect of metering services are set out in Condition 11C (or equivalent) of its licence. This requires a PES to offer five services: the metering services of meter provision and meter operation, and the data services of data retrieval, data processing and data aggregation. Condition 11D (or equivalent) requires the PES to offer the services in a non-discriminatory manner. Condition 11E (or equivalent) requires the PES to publish a statement of its metering and data services charges, together with an explanation of the basis upon which charges will be made.

Distribution price controls

- 1.4 A PES's provision and operation of meters (excluding prepayment meter surcharges and certain special metering) are included in its distribution price control. As such, PESs' revenues from meter provision and operation services contribute to allowed revenues under the price controls.
- 1.5 In Ofgem's distribution price control review final proposals document, published in December 1999, an adjustment mechanism was proposed to allow

for the development of competition in meter provision and operation services. It was proposed that distribution price control revenues would be reduced by an estimate of the savings in avoidable costs associated with reduced activity in these areas, in comparison with the costs of providing these services in 1999/2000.

- 1.6 In its final proposals document, Ofgem highlighted the broader set of issues and concerns associated with PESs wishing to sell meters. In such circumstances it is necessary to consider whether the price control should be modified. It is also necessary to consider how the adjustment mechanism should operate. These issues are discussed in detail in Chapter 3.

Supply price controls

- 1.7 Ofgem published its final proposals for electricity supply price controls in December 1999. In deriving the price controls, an allowance was made for the costs of providing data services being transferred from distribution to supply. These costs were then compared across PESs and used to derive a per domestic customer allowance. This in turn was included in cost projections to set maximum prices for standard and Economy 7 customers.

Transco's price control

- 1.8 Transco has a similar obligation to PESs to provide and operate a meter if requested by a gas shipper. Transco's price control covers its provision of metering services to gas shippers.
- 1.9 Transco's price control also includes a provision for loss of market share in these services. This is known as the 'notional revenues' provision. This specifies that where parties other than Transco provide metering services, Transco's allowed revenues would be reduced by an amount equal to the revenue that would have been realised had Transco provided these services.
- 1.10 Ofgem published final proposals to split Transco's price control in May 2000. The proposed licence modifications would create separate price controls for Transco's metering activities and Transco's meter reading activities. This will have the effect of formalising the notional revenues provision. Under the proposed metering price control, Transco's allowed revenues would move in

line with the number of meters it provides. For example, if Transco provides 10% fewer meters its metering allowed revenues would be reduced by 10%.

PES business separation

- 1.11 The separation of PES businesses into supply and distribution may involve the physical separation of the PES metering business from the PES data services business³. The stock of meter assets, and the facilities and staff associated with operating those assets, will generally be within the distribution business. The supply business will generally be responsible for the facilities and staff associated with data retrieval, processing and aggregation. The exception to this arrangement is where a PES has chosen to create a combined metering and data services business, separate from both the distribution business and the supply business.

Utilities Act 2000 – proposals for standard licence conditions

- 1.12 Ofgem is presently consulting on draft Standard Licence conditions to be introduced pursuant to the Utilities Act. Under these proposals all suppliers would be required to ensure that metering and data services are provided for the meter points they supply. Suppliers can provide these services themselves, or appoint agents to act on their behalf.
- 1.13 The ex-PES Distribution business would be obliged to offer terms on a non-discriminatory basis for the metering services of meter provision and meter operation. The licence would also require the ex-PES Distribution business to prepare statements, in a form approved by Ofgem, setting out a schedule of charges, and the basis upon which charges will be made.

Consent of the Director General for the disposal of assets

- 1.14 Condition 27 of a PES's licence states that a PES can only dispose of the operational control of assets forming part of its distribution system, including meters, if it has the approval of the Director General. In considering whether to consent to such a disposal of assets, the Director General will have regard to his

³ These issues are discussed in more detail in 'Separation of Businesses: Proposals and Consultation', OFFER/Ofgas, May 1999

statutory duties under Section 3 of the Electricity Act 1989 (as amended by the Utilities Act 2000).

PES proposals for metering business sales

- 1.15 Two PESs, Powergen Energy plc and TXU Europe Group plc, have publicly announced intentions to dispose of metering businesses. TXU has now completed its sale. Details of these two proposals are set out below.

Powergen's proposal

- 1.16 Powergen Energy (PGE) is proposing to sell its entire interest in its existing in-house metering business. The sale will include PGE's meter assets, including those installed at customers' premises. The business provides almost all metering and data services in the non-half hourly market within the East Midlands Region. The metering business also provides services to some five thousand half-hourly sites.
- 1.17 The metering business is managed within the Powergen group as a stand-alone business. It has operated as a separate unit within the distribution business since 1996. There are, however, some shared systems and services. Powergen state that these common systems and services will be separated or replaced prior to the sale. In advance of the proposed sale, PGE has already relocated its metering business, and separated a number of IT links between the metering business and other parts of PGE.
- 1.18 The metering business has service agreements with Powergen's supply and distribution businesses for meter provision, meter operation, data retrieval, data processing, data aggregation and credit management for the non-half-hourly market within the East Midlands Region. These service agreements would be translated into contracts with a purchaser of the business.
- 1.19 Powergen's sale may include the disposal of operational control of meter assets. As such Powergen would be required under Condition 27 of its licence to have the consent of the Director General to proceed with the proposed sale.

TXU's proposal

- 1.20 TXU have completed the sale of its existing in-house metering business, Eastern Metering Services (EMS) to Siemens Metering Services. TXU retained operational control of the meter assets within the distribution business. The business provides almost all metering and data services in the non-half-hourly market in the Eastern Region. The metering business also provides services to around ten thousand half-hourly sites.
- 1.21 EMS was an operating division of Eastern Electricity plc. In advance of the proposed sale, EMS's assets (mainly IT and office equipment) were hived off into a subsidiary of TXU, 'Eastern Metering Services Limited'.
- 1.22 The sale included EMS's assets, existing contracts and employees. TXU has required as a condition of the sale that the metering business be re-branded on a neutral and independent basis after completion of the sale. The contracts included within the sale cover the in area provision of data services for TXU's supply businesses (both gas and electricity), meter operation and asset management services for TXU's distribution business, and TXU's obligations to provide metering services to other suppliers 'in area'. These contracts last for 2-3 years, with options to extend.
- 1.23 TXU's proposal did not involve the sale of meter assets. TXU did not therefore require consent from the Director General to proceed with the sale.

Appendix 2 List of non-confidential respondents

BEMCA
British Energy
ECC – East Midlands
ECC – North West
ECC – Yorkshire
Excelergy Corporation
GPU Power
Gas Transportation Company
Hyder
Invensys
London Electricity
MEUC
NEAG (Distribution)
NEAG (Supply)
NECC
Norweb
npower
Olameter
Olive Domestic Metering
Pilot Systems
Powergen
Scottish & Southern
Seeboard
Siemens Metering
Transco
TXU
Unison Energy
WPD
Yorkshire Electricity (Distribution)
Yorkshire Electricity (Supply)