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Dear colleague

Transco's Economic Purchasing Obligation (EPO) for Non-Daily Meter Reading

Transco's price control formula includes a provision that enables it to recover costs incurred in providing meter reading services at Non-Daily Metered (NDM) supply points to shippers, subject to demonstrating that such costs are efficiently incurred. This letter sets out Ofgem's decision on the level of costs for 1998/99 and 1999/2000.

Transco is required to provide the Director General (DG) with a report six weeks after the end of each Formula Year (which, in Transco's case, ends on 31 March), setting out the level of costs for the past year and providing evidence as to the efficiency of such costs. The relevant costs include an appropriate share of 'overheads'. This report can be investigated by Ofgem, and if necessary, the DG can determine that Transco is in breach of its economic purchasing obligation and name an 'overspend amount' by which Transco's submitted costs are reduced.

Following Transco's submission for 1998/99, Ofgem and Transco have been in detailed discussion about the appropriate level of Transco's internal costs attributable to NDM meter reading. Ofgem was concerned that Transco's report included internal costs that could not be attributed to NDM meter reading activities. In the light of these discussions, in October 2000 Ofgem invited Transco to resubmit the internal costs included within its reports for 1998/99 and 1999/2000. Transco provided Ofgem with its revised reports in November 2000.

In summary, Transco submitted revised costs of £26.07m for 1998/99, and £23.53m for 1999/00. In Ofgem's view, Transco's revised submissions embody an appropriately attributed level of internal costs. However, in respect of 1998/99, Ofgem was concerned about the efficiency of a small proportion of Transco's total payments to its appointed meter reading agencies. There was evidence, on a relatively small scale, of Transco continuing to read meters after the relevant shipper had instructed Transco not to do so. Ofgem has determined an 'overspend amount' of £182,000 for 1998/99 to reflect this inefficient purchasing.

In all other respects, Ofgem was content that Transco had procured its NDM meter reading services on an efficient basis over the period 1 April 1998 to 31 March 2000. The annex to this letter sets out Ofgem's decision in more detail.

If you have any questions about the issues raised in this letter, then Colin Sausman (020 7901 7339, or colin.sausman@ofgem.gov.uk) will be pleased to help.

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Annex: Ofgem's decision

- 1.1 This note sets out Ofgem's decisions on Transco's Economic Purchasing Obligation (EPO) for meter reading services at Non-Daily Metered (NDM) supply points in respect of 1998/99 and 1999/2000.
- 1.2 The first section below provides some background information on the issues involved. The following two sections set out Ofgem's decision for 1998/99 and 1999/2000, respectively.

Background

Transco's price control

- 1.3 Transco's revenues are regulated through an RPI-X form of price control. The price control is defined in Special Condition 9C of Transco's PGT licence. Broadly speaking, this requires that Transco's transportation charges increase each year by no more than the rate of inflation less two percentage points.
- 1.4 However, within this price control, Transco is allowed to recover its costs associated with Transco's NDM meter reading activities, provided that Transco can demonstrate such costs have been incurred on 'the most economically advantageous terms reasonably available having regard to all the available sources of each of the services necessary to procure those readings'. In effect, these costs are 'passed through' in full to shippers. The amount to be 'passed through' to the price control in respect of NDM meter reading activities is termed 'F' in Transco's price control formula.
- 1.5 This 'pass through' mechanism only includes NDM meter reading costs. It therefore excludes, by definition, costs associated with Transco's provision of a Daily Metered (DM) meter reading service, 'must reads' and other reads obtained for the purpose of operating an efficient network.

Process

- 1.6 In order to comply with its licence, Transco is required to provide the Director General (DG) with a statement setting out relevant costs for each Formula Year and a statement of the steps taken to ensure that such costs have been incurred efficiently. The statements must be submitted to the DG no later than six weeks after the end of the formula year.
- 1.7 Once the Director General has received all the required information from Transco, he has up to ten weeks to notify Transco of his intention to carry out an investigation into its compliance with the licence condition. Following this notification, the DG has up to six months to determine whether Transco has failed to comply with its licence and, if so, the amount by which Transco's submitted costs exceed the value he could have reasonably expected. The amount 'passed-through' for the formula year then becomes the value submitted by Transco less the 'overspend' amount determined by the DG.

Ofgem's approach

- 1.8 Ofgem's decision whether to investigate the level of costs included in Transco's submission is based on a combination of preliminary analysis of the cost data provided, and feedback from shippers in respect of the period under review.
- 1.9 Where Ofgem decides to investigate, the approach taken has two aspects. First, an assessment of whether costs have been appropriately allocated to NDM meter reading. Second, whether such costs represent efficient procurement.
- 1.10 Transco's internal costs are reviewed against Ofgem's established cost attribution methodology. This methodology involves a review of each individual cost category to assess whether the activity is relevant to NDM meter reading, and whether an appropriate proportion has been allocated to NDM meter reading given the available information as to the nature of the costs. Details of this methodology are

set out in Ofgas' decision document on the 1997/98 NDM meter reading pass through¹.

Ofgem's treatment of Transco's submissions for 1998/99 and 1999/00

- 1.11 Following Transco's original submissions in respect of 1998/99 and 1999/2000, Ofgem decided to investigate the level of costs being included within the pass through. Ofgem's concerns related primarily to the attribution of Transco's internal costs to non-daily meter reading activities, rather than the efficient level of costs *per se*.
- 1.12 Following lengthy discussions with Transco, in October 2000 Ofgem invited Transco to resubmit its internal costs for 1998/99 and 1999/2000. Ofgem considers that the period of ten week allowed for its initial consideration started, in respect of each Formula Year, only from this date.
- 1.13 Transco provided Ofgem with its resubmission in November 2000. In comparison with Transco's original submissions, the level of internal costs was reduced by £3.24m in 1998/99 and £1.27m in 1999/00. These reductions were primarily driven by a change, on the basis of new information, in Ofgem's view since its 1997/98 review as to the allocation of meter reading query and reject handling costs to the 'pass through'. In Ofgem's view, a proportion of such activities, while carried out by Transco NDM Meter Reading staff, did not relate to Transco's provision of an NDM meter reading service to shippers.

¹ "Ofgas' review of Transco's Economic Purchasing Obligation for Non-Daily Meter Reading Services for 1997/98: The Director General's Determination", Ofgas, April 1999.

Formula Year 1998/99

Transco's submission

- 1.14 Transco's revised submission in respect of Formula Year 1998/99 included total costs of £26.07 million. This was broken down as follows:

	£m
External costs	£17.19
Internal costs	£6.97
Overheads	£1.91
Total	£26.07

- 1.15 'External costs' related to Transco's procurement of services from meter reading agencies (MRAs). 'Internal costs' and 'overheads' relate to activities directly relevant to NDM meter reading, such as query and reject handling and MRA contract management, plus a share of 'support costs' (i.e. site costs, and the costs of providing system, functional and administrative support).
- 1.16 Transco's submission also included evidence to demonstrate the efficiency of its NDM meter reading service provision. The following factors were cited:
- ◆ Despite a significant increase in meter read volumes, overall costs were stable between 1997/98 and 1998/99;
 - ◆ Manpower reductions, with full-time equivalent (FTE) staff numbers falling between March 1998 and March 1999;
 - ◆ Following the introduction of Transco's Incentive-Based Contract (IBC) with shippers, Transco introduced a similar incentives regime to its contracts with MRAs; and

- ◆ Meter read performance has increased across the board, most notably in respect of domestic sites (where performance rates have improved 35%, albeit from a low base).

Ofgem's view

External costs

- 1.17 Transco incurred costs of £17.193m in 1998/99 for payments to MRAs for non-daily meter reading services. This compares to costs of £16.239m allowed for 1997/98. The number of read requests generated by Transco in 1998/99 was more than double the number for 1997/98. On this basis, Ofgem generally considers that a 6% increase in payments to MRAs is justified.
- 1.18 However, Ofgem had two concerns in respect of Transco's MRA costs. First, whether the significant increase in the number of meter reading requests was wholly justified. Second, whether Transco's decision to extend one of its regional contracts rather than go out to tender was justifiable on economic grounds. As a result of these concerns, Ofgem informed Transco of its intention to conduct an investigation of its costs for that Formula Year.

Meter read volumes

- 1.19 In respect of concerns about the number of meter reads being performed by Transco, two shippers had alerted Ofgem to circumstances where Transco continued to obtain a read after being de-appointed as the meter reader. Information provided by the relevant shippers, and corroborated by Transco, indicated that around 15,000 reads had been queried for this reason.
- 1.20 Clearly, reading meters where there is no contractual basis with a shipper for doing so cannot be efficient. As such, Ofgem has decided to deduct £182,000 from the value of 'F' in respect of inefficient purchases of meter readings.

Contract extension

- 1.21 Transco tenders on a regional basis for its MRA contracts. In 1996/97, following competitive tendering, a MRA was appointed for Transco's Northern region. Transco decided to extend this contract for one year with a termination date of 31 January 1999. Ofgem was concerned that it might have been more efficient for Transco to re-tender for this contract, rather than roll it over.
- 1.22 Transco has presented the following reasons for extending the contract for a further year:
- ◆ Lower unit rates were negotiated;
 - ◆ The MRA's consistently high performance;
 - ◆ Costs associated with full competitive tendering for one region; and
 - ◆ Full competitive tendering for all zones would be undertaken during 1999.
- 1.23 In the light of this information, and following analysis of costs and associated risks involved with the alternative option of re-tendering for the Northern region MRA contract, Ofgem considers that Transco's decision to extend the contract over a short time frame was economically justified.

Internal costs

- 1.24 Transco included internal costs of £8.88m within its submission, of which £1.91m related to 'overheads' (including IT and admin support for NDM meter reading activities).
- 1.25 Internal costs which are directly attributable to NDM meter reading include contract management costs, MRA administration costs, and a proportion of query and reject handling costs. In providing its revised submission, Transco has deducted one-third of query and reject handling costs to reflect that a proportion of these activities

which involve asset-related queries and rejects. While Transco NDM Meter Reading deals with these activities for shippers, in Ofgem's view it is not performed in Transco's role as a provider of meter reading services.

- 1.26 In Ofgem's view, Transco's revised submission embodies an appropriate allocation of internal costs. As such, no deduction from the value of 'F' is required.

Conclusion

- 1.27 Ofgem has determined a total 'overspend amount' of £182,000 in respect of Transco's submission for Formula Year 1998/99. A formal determination to this end will be sent to Transco, and a copy placed on the public register.

- 1.28 Therefore, the value of 'F' in respect of Formula Year 1998/99 will be £25.88m.

Formula Year 1999/2000

1.29 Transco's revised submission in respect of Formula Year 1999/2000 included total costs of £23.53m. This was broken down as follows:

	£m
External costs	£15.56
Internal costs	£6.09
Overheads	£1.87
Total	£23.53

1.30 Transco's submission also included evidence to demonstrate the efficiency of its NDM meter reading service provision. The following factors were cited:

- ◆ Despite an increase in meter read volumes, overall costs were stable between 1998/99 and 1999/00;
- ◆ Further manpower reductions, some of which was due to restructuring;
- ◆ Full tendering of Transco's MRA contracts, for two year contracts to start in Quarter 1 2000; and
- ◆ Average performance during 1999 improved in all categories compared to 1998, although performance was affected in the first quarter of 2000 as a result of the re-tendering process and the implementation of new contracts.

Ofgem's view

External costs

1.31 Transco incurred costs of £15.56m in 1998/99 for payments to MRAs for non-daily meter reading services. The number of read requests generated by Transco in 1999/00 increased compared to 1998/99.

Competitive tendering

- 1.32 The key development in 1999/2000 was the full tendering of Transco's twelve regional contracts for MRA services for the next two years. Transco placed a notice in the European Journal on 3rd February 1999 inviting companies to enter Transco's pre-qualification process. Subsequently, Transco issued eleven invitations to tender (ITTs), of which nine were returned. Tenders were invited on the basis that the successful party would perform reads by read type or by region on behalf of Transco. In the event, all bids were received on a regional basis.
- 1.33 Tenders were evaluated on the basis of financial, operational and IT criteria. Following two stages of scoring against these criteria, Transco invited four MRAs to a negotiation stage. Following this negotiation Transco allocated six regional zones to one MRA, and three zones each to another two MRAs.
- 1.34 Transco has contended that the revised contracts create more effective incentives for its appointed MRAs, and should deliver improved performance levels.

MRA withdrawal

- 1.35 Immediately prior to the start of the new contracts on 1 February 2000, one MRA (provisionally responsible for three zones) announced its unwillingness to sign Transco's contract. In accordance with the relevant legislation, Transco approached the remaining two MRAs to assess whether they were capable of providing the service in the three affected zones. Following this discussion, Transco arranged short-term extensions to existing contracts in two of the three zones, and awarded the contract for the remaining zone to one of the remaining MRAs on the basis of the information provided through the tendering process. Subsequently, Transco awarded two year contracts for the outstanding two zones to the same MRA.
- 1.36 The final outcome of the tendering exercise is that Transco has two appointed MRAs, each handling six regional zones.

- 1.37 In Ofgem's view, Transco has taken reasonable steps through this process, and in the light of such unforeseen circumstances, to ensure that it procures meter reading services from MRAs on the most economically advantageous terms. Ofgem does not therefore intend to deduct anything from the value of 'F' for Formula Year 1999/2000 in respect of Transco's payments to MRAs.

Internal costs

- 1.38 Transco included internal costs of £7.96m within its submission, of which £1.87m related to 'overheads' (including IT and admin support for NDM meter reading activities). This represents a reduction of £0.92m between 1998/99 and 1999/2000.
- 1.39 Internal costs which are directly attributable to NDM meter reading include contract management costs, MRA administration costs, and a proportion of query and reject handling costs. In providing its revised submission, Transco has deducted one-third of reject handling costs. While Transco NDM Meter Reading deals with these activities for shippers, in Ofgem's view it is not performed in Transco's role as a provider of meter reading services.
- 1.40 In Ofgem's view, Transco's revised submission embodies an appropriate allocation of internal costs. As such, no deduction from the value of 'F' is required.

Conclusion

- 1.41 In Ofgem's view, Transco's revised submission demonstrates that external costs have been incurred efficiently, with regard to all available alternatives, and an appropriate amount of internal costs has been allocated to the pass through. Ofgem does not, therefore, intend to carry out a formal investigation or to determine an 'overspend' amount in respect of Transco's revised submission for 1999/2000.
- 1.42 Therefore, the value of 'F' in respect of Formula Year 1999/2000 will be £23.53m.

Summary

1.43 Ofgem's conclusions in respect of Transco's revised costs for its provision of NDM meter reading services during 1998/99 and 1999/00 are as follows:

	Submitted costs	less 'overspend'	Costs 'passed through'
1998/99	£26.07m	£182,000	£25.88m
1999/00	£23.53m	-	£23.53m

1.44 Therefore, for 1998/99, Ofgem found that Transco was in breach of its economic purchasing obligation in respect of NDM meter reading, and identified an 'overspend' amount of £182,000. A determination to this end will be sent to Transco, and a copy placed on the public register.

1.45 For 1999/2000, Ofgem found that Transco complied with its economic purchasing obligation in respect of NDM meter reading.