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Dear Rachel,

Electricity Distribution Price Control Review 'DPCR5' Consultation Document 32/08

This is our response to the above consultation. It is not confidential and we are happy for this to be posted on the Ofgem website and in the Ofgem library.

Unlike the majority of the other large domestic suppliers, we do not hold any distribution interests in the UK or elsewhere. This means we can provide a unique, unconflicted perspective on this price control. Our bill for electricity distribution charges is about £600 million (in excess of £3 billion over the current price control period 'DPCR4'). We therefore pay, on behalf of our customers, a substantial portion of the revenues that the DNOs earn in total.

Centrica takes substantial price risk on distribution costs when we enter into fixed contracts with domestic and non-domestic customers. So, particularly for these customers, but also for our portfolio as a whole, we need to be able to aggressively manage and forecast all our costs. In this sense we treat distribution costs no differently to any other costs we face. The commercial exposures we face in managing and forecasting these costs should be fully factored into Ofgem's approach to this review, particularly given that however good our forecasting, the distribution costs that we face are beyond our control, once the price control is set. Indeed, we believe these considerations entitle us to as great a say into this process as the organisations whose operations are funded as a result.

We have organised this response into a number of separate appendices that discuss specific issues raised by Ofgem's consultation. These are:

- Appendix 1: Financial Issues in DPCR5
- Appendix 2: Network, Environment and Customer Issues
- Appendix 3: An Assessment of the Distribution Losses Incentive
- Appendix 4: Considerations in Reviewing Pension Costs

Appendices 1 and 3 have been prepared for us by CEPA. Appendix 1 provides our perspective on how, if it at all, the credit crunch should be factored into Ofgem's thinking and how, taking its cue from some of the parameters used in GDPCR, Ofgem has scope to deliver better value for customers than the deal agreed under DCPR4. Network, environment and customer issues are the subject of Appendix 2. Here with the help of CEPA we have provided some analysis of how the existing opex and capex appear to influence DNO behaviour.

We comment briefly on environment and customer issues in the rest of Appendix 2, and then explore in detail one of the major environmentally-driven incentives built into the current control in Appendix 3, the treatment of electricity distribution losses. The analysis suggests the existing losses regime has not been good value for money for customers. With Ofgem's pensions review planned for 2008 and the need for a view on the treatment of pension costs to be taken in DPCR5, we also include a short

Appendix 4 on pension costs. This sets out some key considerations and questions for Ofgem to ask in moving towards a regime for DNO pensions that better reflects their obligations to put in place for their customers, shareholders and employees an efficient package of pay and benefits, including pensions.

The annual costs of providing electricity distribution are estimated by Ofgem at £62 per annum per typical domestic customer. The major drivers behind the costs are set out in the table below. These are Centrica estimates based on publicly available information. In some cases, it is not easy to reconcile individual costs to the overall revenue allowance (e.g. incentive schemes). This illustrates the need to make sure that whilst the control evolves to meet the new demands of customers, it does so in a way that is transparent and relatively simple to understand for all key stakeholders.

DNO annual revenue breakdown	**Annual cost (£) per typical domestic customer**	**% of total costs**
Depreciation (less capitalised pensions)	18	29
Operating costs	17	28
WACC (cost of equity)	8	13
Tax allowance	6	10
WACC (cost of debt)	6	10
Pensions (expensed & capitalised)	4	6
Losses incentive	2	3
Other incentives & award schemes	1	1
Total	**62**	**100**

This sort of revenue breakdown illustrates the size of the impact that each major cost item has for those who pay the bills: suppliers and customers. Remunerating capital expenditure that has already taken place is the largest item at around 30% of the cost. The rationale for RPI-X regulation traditionally encouraging more efficiency in operating and capital expenditure is clear, with opex still accounting for over a quarter of DNO costs on top of the depreciation charge for the year. The costs of debt and equity account for another quarter of DNO costs.

The table also provides a reminder that in addition to the main areas that a price control typically covers areas such as losses and pensions are also very material, together accounting for nearly 10% of costs. It is in these more difficult areas of policy that progress needs to be made relatively early in the control if innovative solutions are to make it into the final DPCR5 package. For this reason we have a paper on each on these topics included in our submission.

Looking back at what has been delivered for customers from DPCR4 and GDPCR, we think that financial issues should be the source of improved value and reduced cost for customers in DPCR5. Use of the GDPCR parameters on the weighted average cost of capital would save £90 million per annum for customers, including £25 million per annum through moving to a notional efficient gearing of 62.5%.

Some DNOs will no doubt argue that the credit crunch increases the cost of capital that they require. CEPA's evidence in Appendix 1 suggests that this is not the case. The credit crunch does however raise the question of how the regulator can devise a regime that is a good deal for customers at a time of great uncertainty about the future cost of capital. CEPA's suggested cost of debt adjustment mechanism potentially solves this conundrum. DNOs would have some risk protection should the cost of debt increase, while customers would no longer need to pay the "insurance premium" associated with allowing the DNOs some "headroom" over the observed cost of capital at the time the price control is agreed with Ofgem. This would lead to significant annual savings for customers while also re-allocating risk more sensibly between DNOs and their customers at a time of global financial uncertainty.

In Appendix 2 we provide a fairly detailed critique of the recent spending of the DNOs on opex and capex and try to assess what this tells us about the effectiveness of the existing regulatory incentives. We believe some of the reasons identified by DNOs for failing to spend their capex allowances should rather be seen as failures by them to undertake more effective planning and procurement. At a minimum the experience of DPCR4 raises real questions about the ability of the DNOs to spend the

capex allowances they are requesting for DPCR5, even assuming they can make a case that the investment is warranted. And we have seen no evidence to date to suggest that increasing spending in DPCR5 is indeed required or justified. While there are not strong grounds for a radical overhaul of the regulatory regime as a whole, Ofgem should act on the conclusions of this evidence in setting allowances for DPCR5. This means more benchmarking to attempt to explain the drivers of different DNO performance. It also means reaching a regulatory settlement with each DNO that reflects how it has delivered against the bids it has made over DPCR4. Those whose bids have proved to be way beyond their actual delivery, or who have failed to supply consistent business plan data, should have a correspondingly higher threshold to get over to convince Ofgem and all stakeholders that their plans have merit.

Appendix 3 sets our views on distribution losses. This is a difficult area for Ofgem because the drivers of losses are often not well understood. Yet they are a major source of carbon emissions. The current incentive regime is not transparent and so the CEPA paper draws from a number of different sources to value its cost effectiveness. But the findings are compelling: customers appear to have significantly overpaid for the reductions in losses delivered in recent years. The new control needs to devise a new incentive mechanism that provides incentives for reduced losses at lower costs to customers in a more transparent way.

The experience with losses is instructive for other areas of the control where Ofgem is looking for new ways to encourage the DNOs to become more active players in delivering sustainable development. Centrica fully supports Ofgem pursuing this direction. But in seeking to encourage this transformation in DNO behaviour it must keep in mind that all new incentives need to strike a balance between pursuing the value of reduced carbon emissions and improved environmental performance, and the cost and complexity that such measures may involve. Furthermore, financial incentives may not always be the most effective means of changing company behaviour.

We look forward to being an active contributor to this price control process. We hope you agree that the papers we have submitted as part of this response are a constructive contribution to that process. Should you wish to discuss any of the points raised in more detail, please contact either Philip Davies or myself.

Yours sincerely

Adrian Morris
General Counsel, British Gas