Developing network monopoly price controls
Update Document

A Response by British Gas Trading

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1. Introduction

British Gas welcomes the opportunity to respond to Ofgem's update document on developing network price controls. As British Gas stated in its response to the initial consultation, we have a vested interest in ensuring that the development of price controls provides the incentives to ensure long term system security and the delivery of a good level of service to consumers.

We fully support Ofgem's aspiration to improve the framework of price controls and to increase the consistency between network industries. As part of these activities we are particularly interested in the work Ofgem is progressing in relation to the next distribution price control and in particular the efforts to reduce regulatory uncertainty and provide the incentives to encourage DNOs to pursue efficient and economic actions.

To that end we welcome the publication of the two workstreams documents by Frontier Economics entitled 'Regulatory Mechanisms for Dealing with Uncertainty' and 'Balancing Incentives' and we have included our initial thoughts on these publications under the relative headings.

Recognising the fact that we provided Ofgem with detailed comments to the initial consultation and that these have generally been taken into account we have limited our response to high level comments.

2. Financial Issues

We believe that DNOs now face a period of uncertainty particularly regarding the likely pattern and extent of distributed generation and that every effort is needed to minimise the impact that this uncertainty will have on the cost of capital.

With regard to gearing we believe it is essential that DNOs maintain the financial flexibility to respond effectively and efficiently to the challenges uncertainty creates. We acknowledge that, as with other network monopolies, there has been a tendency for DNOs towards higher levels of gearing. We believe that, although this may lead to a reduced 'embedded' cost of capital in the short run, higher gearing carries risks which may impact negatively on the marginal cost of capital, especially associated with the raising of new debt. We believe that, whilst companies have the right to choose individual risk profiles, the gearing level used in the derivation of the cost of capital should not unduly encourage companies to follow such structures. We therefore recommend that Ofgem bases gearing levels on a ratio which is consistent with current economic theory and believe that the figure of 50% employed by Ofwat is appropriate. We also believe that the cost of capital should be based on maintain investment grade credit ratings and that the debt risk premium necessary to provide this must not be impacted upon negatively by over leveraged structures.

With regard to taxation, whilst we agree that companies must be given the incentives to manage their tax liabilities efficiently, as companies' financial structures diverge we have concerns that a pre tax cost of capital will encourage companies to move toward a higher leveraged structure irrespective of their preferred equity / debt structure. We do not believe that this will necessarily prove beneficial in the long run. Therefore, of the two options we prefer the use of a post tax cost of capital with an adjustment to revenue to take into account tax liabilities as this will remove any perverse incentive and tend to reduce the final cost of capital.

With regard to the fixed costs of debt we agree that an efficiently managed company should hold a balanced debit portfolio which is capable of accommodating changes in financing costs and therefore do not see the case for a generic adjustment to the cost of capital. We do, however, accept that there may well be exceptional cases, and Ofgem should retain the discretion to make individual allowances.

With regard to the way the RAV should be updated for capex efficiencies, we believe that Ofgem should look to the process that has been developed by Ofwat. Under that regime, companies are allowed to earn a return on their RAVs which are fixed for a defined period on a rolling basis. Any out performance adjustments to RAV would only be made after the retention period had elapsed. We consider that a retention period of 5 years, as used by Ofwat, is appropriate.

3. Frontier reports

We now include our initial comments on the Frontier reports 'Regulatory Mechanisms for Dealing with Uncertainty' and 'Balancing Incentives' commissioned by Ofgem and published in March 2003.

Our overall comment is that the reports are fairly theoretical and leave open questions regarding the practical application of the developed principles by Ofgem. We believe that the reports should ideally provide a policy framework based on sound academic arguments and include practical recommendations including the ranking which needs to be applied to the different criteria given that a number of them may point to opposing policy implications.

We do not believe that the reports offer an adequate solution to the issue of regulatory uncertainty for companies in important areas such as output regulation and distributed generation where binary decisions are not easily made.

We agree with Frontier's assertion that uncertainty plays a central role in economic regulation and that a dilemma exists between risk and incentives. The greater the uncertainty, the greater the risk, and the greater the reward investors will seek to participate. As uncertainty increases, there is a tendency for companies to reduce innovation and move towards a 'cost pass-through' regime. In such an environment, the design of incentive mechanisms which are needed to encourage innovation and lead companies to pursue efficient and economic solutions will be challenging and will only be eased by better information.

We believe that the next price control period for DNOs is likely to pose such a challenge to Ofgem, and the success or failure of this review will largely depend upon the incentive framework that is employed to manage this. We believe that much of the uncertainty faced by DNOs with respect to distributed generation is likely to be of the 'unpredictable' variety.

We agree with the insurance framework mapped out on page 4 and believe that the decision to employ a cost pass through or incentive based regime will depend on the degree of uncertainty and the managers' aversion to risk.

The diversification arguments, especially how this impacts on the cost of capital, requires clarification. We are uncertain as to the extent risk can be hedged against when investors in some DNOs may not be in a position to hold shares in others, as much of the equity is non tradable as it is held by various parent organisations, including some in the public sector.

We also believe that the asymmetry of information can result in a non diversifiable risk which will impact on the debt premia and this appears to have been overlooked.

We agree with the different possible approaches to distributed generation contained within the report but would have liked to see some analysis of which approach to adopt under what circumstances. This omission leaves Ofgem with a difficult value judgement to make without providing companies with any clear ideas as to what the best approach might be.

We note that the main options proposed by Frontier are:

(i) incentives for cost efficiency through benchmarking;

(ii) having a volume revenue driver or auditing volumes built; and

(iii) cost pass-through.

We believe that the first option has limitations associated with the absence of meaningful data and that the cost drivers will need to be revealed before any meaningful yardstick competition can be carried out. We have explained our concerns related to the effectiveness of such regimes in our recent responses to Ofgem proposals to separate the Transco price control between the local distribution zones and suggest that Ofgem refer to those comments before embarking on comparative analysis. Therefore any regime will need to over compensate, rather than under compensate, if DNOs are to be provided the incentives to participate in this activity. We also note that the problems associated with data gathering are compounded by the uneven spread of distributed generation technologies across Great Britain.

The second option provides the incentive for companies to connect generation whose actual costs are below the benchmark set by Ofgem and that this benchmark can be set for each technology allowing the promotion of certain technologies.

The third option carries the least amount of risk for the DNO and may be viewed as the most appropriate if the risk of non delivery is considered significant. Cost pass-through may not be necessary for all aspects of DNOs' activities and should be limited to those associated with the risk of non delivery. Our understanding of the logging up process in the water industry is that it can lead to a high degree of regulatory risk and to long delays by DNOs in responding to connection requests.

We believe that in developing the incentive regime for the forthcoming DNO review that all three approaches will have a part to play and look forward to further details on how Ofgem intends to employ these mechanisms.

4. Conclusions

With regard to Ofgem's update document we are pleased that many of our thoughts have been included and we are satisfied that the general principles and approach to these are in the right direction.

We agree with Ofgem that DNOs now face a greater degree of uncertainty primarily as a result of the distributed generation that is expected to be connected to the electricity networks in the future and we consider that the two reports provide a useful contribution to this debate.