Mark Cox
Ofgem
9 Millbank
London
SW1P 3GE

3 The Square
Stockley Park
Uxbridge
Middlesex
UB11 1BN

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By e-mail only to: distributionpolicy@ofgem.gov.uk

Direct Dial: 0208 734 9371
Facsimile: 0208 734 9350

Dear Mark,

Regulation of Independent Electricity Distribution Network Operators, Initial Proposals Document

Introduction and general comments

British Gas Trading (British Gas) welcomes the opportunity to respond to Ofgem's initial consultation in respect of the regulation of Independent Electricity Distribution Network Operators (IDNOs).

British Gas has an interest in the outcome of this issue because of our presence in the electricity market, and is happy for this non-confidential response to be placed in the Ofgem library.

Ofgem proposals

Charging arrangements

British Gas agrees that a relative price control (RPC) framework for a set period of ten years is the appropriate charging regime for new IDNOs and existing distribution network operators (DNOs) providing services outside their traditional service area.

We accept that the existing arrangements (which were introduced to ensure that customers' interests were protected by applying a cap to IDNOs' charges and thus ensuring that IDNO charges cannot exceed those of the incumbent DNO) has the shortcoming of providing a ceiling on charges but no floor to which charges may fall. This exposes IDNOs to unnecessary risk of under recovery if the host DNO's charges fall more quickly than expected. A RPC approach, which provides a floor as well as a ceiling for IDNOs' charges, contains this risk and thereby provides a degree of certainty for investors.

We also agree that a ten year horizon will provide a sufficient period of certainty to investors to enter this market.

However, we reiterate our view that the most appropriate enduring form of regulation for these charges should be price controls set on the basis of the efficient level of costs of serving those customers and this would best be achieved through RPI-X regulation based on the IDNOs' costs. However, we recognise that it may not be possible to introduce this mechanism until such time as IDNOs are of a sufficient size to allow such an approach to be able to reasonably predict the relevant future efficient costs and hence revenues.

Financial ring fencing

The proposals in this area are generally welcome. It is not realistic for small independent companies to be expected to obtain an investment grade credit rating, since the costs of obtaining a this would be relatively excessive and the financial requirements to obtain such a rating would result in a grossly inefficient financial structure.

We therefore support Ofgem's alternative financial arrangements for small IDNOs, which propose that for those below 500,000 connected supply points there is the option of:

- a keep well agreement with the parent company of the licensee with an investment grade credit rating; or
- a keep well agreement with the parent company of the licensee and, if the parent company does not have an investment grade credit rating, cash in escrow or an on-demand bond issued from a third party with an investment grade credit rating of a value of no less than six months operating costs and six months asset replacement expenditure.

We also agree that for licensees with more than 500,000 connected supply points there is the option of:

- an investment grade credit rating; or
- a keep well agreement with an entity with an investment grade credit rating.

Further, whilst we agree with Ofgem's principle of providing customers on different networks the same level of protection, we believe that this may be best achieved by complementing financial ring-fencing arrangements with a case by case assessment of the financial strength of the IDNO. For example, irrespective of size, a key factor to the financial well-being of an IDNO relates to the issue of where debt is raised. If an IDNO raises its own debt as opposed to this being done at Group level, the opportunity for cross subsidy is higher and accordingly the need for ring-fencing is greater.

Commercial Issues

Suppliers currently only have one contractual arrangement with either the DNO or IDNO depending on whose network the customer is located i.e. IDNOs own the responsibility for the upstream DNO DUoS charge. This differs from gas where suppliers contract with both IGTs and Transco for use of each respective part of the distribution network. Whilst we acknowledge that a benefit of adopting the gas model in electricity would be to reduce IDNO upstream risk, this would have a significant impact on suppliers' costs and we would strongly urge Ofgem to carry out an impact assessment if it is minded to progress this work which should include the option of moving the gas model to the current electricity model.

With regard to boundary equipment, we believe that if there are technical or regulatory benefits in the provision of such equipment i.e. for charging transparency, safety, measuring losses or benchmarking, the responsibility for the provision of such equipment should not discriminate against IDNOs. One way to achieve this is to ensure that all costs associated with boundary equipment are borne by all supply points irrespective of whether or not they are DNO's own connections or IDNOs'. The spreading of these costs is not without precedent, for example the costs of introducing retail competition were spread across entire customer base as ultimately competition, in this case between DNOs and IDNOS, is to the benefit of all customers.

With regard to Guaranteed Standards of Performance, consistent with our views expressed in the DPCR04 process, we are of the view that it is appropriate to apply these to both DNOs and IDNOs.

If you have any questions please do not hesitate to contact me on the number given above.

Yours sincerely

Roddy Monroe
Regulatory Issues Manager, Strategy