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Joanna Whittington
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Dear Joanna,

Re: Gas Distribution Price Control Review: Initial Consultation

Thank you for the opportunity to comment on the above initial consultation (hereafter "IC").

Overall we believe that Ofgem has identified most of the areas that need to be in scope for the Gas Distribution Price Control Review (GDPCR).

We do nevertheless have a fundamental concern with Ofgem's expectation (IC paragraph 2.15) that "the benefits of comparative competition will become evident during the course of the next price control period and be passed to customers from the start of the subsequent control period". This implies that neither shippers nor customers would see a significant benefit from the gas DN sales until 2013. Centrica continues to believe is it vital to ensure that the benefits ascribed to the DN Sales process are passed through to customers as early as possible. This has the benefit of maximising value, and matching the timing of benefits more closely with profile of additional costs to the industry and (indirectly) to customers.

In addition, given that the costs of separating the price controls were explicitly excluded from the DN Sales Impact Assessment, we believe that it will be important to ensure that the benefits associated with price control separation are separately identified and taken into account as well as those benefits attributed to DN Sales *per se*. This will help to ensure that maximum benefits are passed through to customers.

Duration of the Price Controls

Centrica believes that it would be possible to bring forward the benefits of DN Sales to customers by adjusting the duration of the next two controls.

The key consideration is the choice of base year that would be used to set the next round of price controls after the one which will run from 2007. We agree with Ofgem that this base year candidate must be one in which significant comparative efficiency savings from the DN Sales may be expected. However, it is also important that this base year should not be unduly delayed relative to the first achievement of such savings. Given the nature of some of the new GDN investors and the strong drive to see an early return on their investment, which includes private equity, it is probable that an earlier base year could be used than 2010/2011, which is what Ofgem's proposals imply. We would normally expect significant savings to show up within three years of acquisition – and possibly within two.

We would like to propose that instead of introducing a one year extension to the current control, Ofgem should implement two shorter controls and carry out a full review process for both. As an example, the first control could run from 1st April 2007 to 31st March 2010, and the second from 1st April 2010 to 31st March 2013. This would involve a significantly earlier base year (of 2007/2008) for the second of the two controls. This should naturally be subject to further consultation and debate.

From 1st April 2010, a new price control would thus be put in place, allowing identified savings to start being passed through to customers three full years earlier than under Ofgem's current IC proposals. Finally, from 1st April 2013, we suggest reversion to the standard 5 year price control cycle.

Given the significance of the changes the industry has undergone during this price control, Centrica is of the opinion that two shorter controls offer a better balance of cost and risk, for both customers and GDNs, than the current proposals, as well as better supporting the timing of transitional arrangements.

Whilst we strongly believe that two shorter controls will produce a more robust outcome than the Ofgem proposals, we have commented below based on the one and five year price control periods set out in the IC.

One year review to extend the existing GDPCR to 31st March 2008

We are concerned that the proposals to review only Capex and Cost of Capital in detail for the one year control could lead to an asymmetry in which potential benefits to the Gas Distribution Networks (GDNs) may not be balanced by potential benefits to customers. The primary reasons for our concern are as follows:

- On Capex, GDNs are currently believed to be under-performing (i.e. over-spending vis-à-vis previous capex assumptions) which might be expected to lead to additional funds being granted for one year.
- With respect to Opex, Ofgem proposes in the document to take a very simplistic approach. As GDNs are thought to be outperforming in this area, this is likely to lead to them retaining the cash from this existing out-performance for another year.
- Increased Capex (in more modern technology, IT enhancements etc) will frequently allow companies to achieve commensurate Opex savings, from which the benefits will not be captured in the "rollover" year. We are therefore concerned that the proposed approach will be unbalanced in favour of the GDNs.

Thus Centrica is not persuaded that permitting the five year retention from Opex out-performance to be extended for another year will act as an incentive to improved performance; it is much more likely to constitute an unwarranted windfall.

On Cost of Capital, the proposed move (from a pre-tax to post-tax approach) might also lead to an additional allowance for the GDNs if the effective tax rate they face is lower than the headline rate. However, we do see potential customer benefits in a comparative review of Cost of Capital at this stage, to the extent that the new GDNs (or their acquiring companies) may well be more highly geared than Ofgem has traditionally assumed in relation to NG's gas distribution business. Again, the important principle is to ensure that the one year "rollover" review is properly balanced.

The document also suggests that areas such as Shrinkage, Pensions, Outputs and Incentives may require additional attention. Centrica is concerned that reviewing only those areas where the GDNs may be under-performing would not be appropriate. Symmetry of incentives and proposals is important; hence either all relevant areas should be subject to detailed review, in a balanced manner, or else all should be rolled forward to maintain the balance of the initial 5 year period.

A possible option for a less detailed opex review would be to predict the outturn opex, net of any costs related to restructuring, and then apply an efficiency factor. This efficacy of this approach would depend on taking the same view across the piece and not giving special consideration to individual items where the GDNs may be under-performing and request upward review.

In summary, we do not believe that the current IC proposal would deliver a fair balance of cost and risk; it therefore carries a clear risk of disbenefit to customers. Centrica is of the view that either:

- All three main elements of the control should be reviewed in detail (Capex, Cost of Capital and Opex), or
- All three elements should be subject to a simple roll forward of existing allowances with the retention of existing levels of efficiency.

Five year review: Proposed period 1st April 2008 to 31st March 2013

Post DN Sales, Centrica believes it will be important to consider the relative positions of NGG and the other GDNs. In particular, we would encourage Ofgem to take into account the gearing of the GDNs (or the relevant financing/acquisition vehicles). We believe it is possible that the GDN levels of gearing could be higher than that of NGG. This in turn would suggest that a lower cost of capital assumption might prove appropriate for the GDPCR.

If the post tax cost of capital approach is adopted as suggested in the document, it will be necessary to assess the specific tax liabilities of each of the GDNs in order to ensure the most appropriate cost of capital is used, rather than assuming a standard 30% corporate rate.

We would also wish to highlight the fact that, if Ofgem focuses on forward looking rather than historical costs (IC paragraph 2.16), where appropriate informed by GDN forecasts, then some form of normalisation may be required to ensure that there is a degree of rigour and consistency around the forecasts provided.

In considering the potential treatment of capex overspends, we note the proposal that, where genuine customer benefit can be demonstrated, companies will be allowed depreciation and a return from the date of spend. Whilst Centrica is not opposed to this principle, we believe that it can only be applied effectively and fairly where the proposals can be demonstrated to be fully symmetrical to the efficiency (or otherwise) of expenditure. The principles and mechanisms for assessing any inefficient expenditure will need to be clear and transparent. We do have some concerns as to how the treatment of inefficient expenditure could be given effect, and hence that Ofgem's proposal might in practice lead to an asymmetry in the incentives favouring the GDNs.

The whole question of incentives is also an area of concern, but at this stage can only be addressed at a high level. In Centrica's view, incentives should ideally be equalised across capex and opex; however, this is might not always be possible. If incentives cannot be properly equalised, then robust measures and monitoring must be put in place to prevent reclassification of expenditure, for example between capex and opex so that companies cannot simply gain windfall profits through apparent opex efficiencies. This monitoring should be published at regular intervals to give confidence in the regime.

In addition to the areas mentioned above, we believe that it is time under this GDPCR to reassess the whole area of Shrinkage and Theft of Gas. Whilst it may appear that the existing price control arrangements would be sufficient to ensure that Shrinkage costs would be efficiently managed, in practice they are undermined by the shrinkage arrangements in the UNC. In particular, this arises because of the absence of any credible data on levels of theft, as well as the proportion of theft that relates to GDN rather than shipper responsibility. Centrica is actively participating in the ENA/ERA workgroups currently looking at theft, and we would encourage Ofgem to use the GDPCR to place robust incentives on the GDNs in this area. This is likely to require a radical change to the existing arrangements. In the absence of data on theft levels, it is likely that only a move to arrangements similar to those currently in place in electricity distribution whereby the GDNs would be incentivised with respect to all losses, including theft that is currently the responsibility of shippers, will provide an appropriate solution to the current problems.

In recent years, DNs have sought, and been granted, reductions in the Shrinkage provision. Currently, the incentives on the GDNs to properly address issues of Shrinkage (and Theft) are weak. Instead, the drivers are to minimise the proportion of costs borne by the GDNs, which is not the same thing as overall cost minimisation. What is required is a set of clear, consistent and robust incentives in this area, developed in conjunction with the industry and supported by simple and transparent processes, which are regularly reviewed.

Views are also sought in the IC on the pass-through elements of the price control. As a principle, Centrica believes that the only pass-through costs which should be permitted are those where the companies genuinely have no control or influence over the costs. We would be keen to avoid simple pass-through of pensions costs, as occurred with the electricity distribution companies; instead, we believe a full review of pension treatment would be appropriate.

As we move further into the GDPCR process, it will naturally be essential to consider a number of detailed requirements of the GDNs going forward. Whilst these points are generally too detailed for early decision, we wish to highlight the issues below and see them given due consideration in the next consultation:

- Increased GDN responsibility for data quality, for example in the Supply Point Register

- Improving the quality of the deeming arrangements and key industry processes such as AQ Review. (This will improve the accuracy of transporter billing and hence collection of revenue)

- Stability of charging: stronger incentives on GDNs to ensure accuracy of revenue forcasting, revenue collection and stability of transportation charges.

- Consideration of IGT issues.

xoserve

Given the relatively small scale of the revenues associated with xoserve, Centrica is of the view that a separate price control is not required. We would also not support a change in ownership structure, and do not, at present, see any necessity to seek an alternative service provider. We would strongly encourage xoserve to continue service provision in the same way as they have started, and maintain standards at a high level.

Our preference is to adjust the current arrangements such that a greater degree of cost reflectivity is incorporated into the charging, such that charges truly reflect the costs of servicing each individual shipper. There is currently a risk that less efficient shippers impose additional costs on xoserve which are then recovered from the generality of network users, including those who are more efficient. xoserve must deliver value for money and hence we would support greater transparency of costs.

In addition, it is important that there are robust service standards around all xoserve's activities, before consideration is given to the application of a separate price control.

During the Price Control process we would encourage xoserve to bring forward proposals for improvements to processes and systems, such that these can be fully evaluated by Shippers and Suppliers. This will enable participants to decide if they wish to bear a proportion of the costs of such developments.

A final area of concern is in the area of unregulated revenue. Whilst Centrica supports xoserve being able to provide value added services, core services must not be undermined nor cross-subsidise those which are unregulated. Centrica is strongly of the opinion that, where xoserve wishes to earn unregulated revenue, it is essential to ensure either that it does not use regulated assets to provide unregulated services or, where it does, that a full market value is properly attributed to the regulated business.

Framework, Process and Impact Assessments

We broadly support the framework and process put forward. However, given the importance of the GDPCR to the industry, we would strongly encourage Ofgem not only to observe the guidelines from Project Paperless, but to adhere to the Cabinet Office Guidelines in respect of consultation periods allowed. This will allow respondents to fully consider and plan their responses, which will in turn lead to a more productive consultation process.

In respect of Impact Assessments (IAs), we are broadly supportive of the proposal to conduct IAs on important new initiatives, and on specific issues where it appears that an IA may be beneficial. To balance this, we consider it is important not to rule out the need for an overall IA, depending on how the proposals develop over the period of the review. It would be sensible to take stock at intervals during the process to ensure that a change of plan is not required.

Whichever course is chosen, Centrica continues to believe that the “no change” option should be evaluated, or, if this is not practical, the costs of the chosen base case must incorporate the costs of getting to that base case from the existing baseline.

Conclusion

In conclusion, Centrica supports many of the areas identified as being in scope for the review, and would wish to recommend further issues for consideration. By far the most important early decision, in our view, concerns the timing and duration of the price reviews – in order to secure for customers the earliest possible benefit from DN sales and comparative regulation of the GDNs. We would therefore request that Ofgem considers our proposals for alteration the duration of the next two price controls, and consults the wider industry in this area.

We trust these comments have been helpful and, if you would like to discuss any points in more detail, I should be more than happy to help.

Yours sincerely,

Alison Russell