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Gas Distribution Price Control Review: Initial Consultation

Dear Joanna

This is the first gas distribution price control review following the decision of National Grid to sell a number of the licences. As a result the gas distribution networks will begin to be regulated in a way that more closely resembles the existing framework for electricity distribution. Throughout the review we intend to comment on issues that are common to both gas and electricity distribution.

Our response to the first consultation is separated into two sections. The first section comments on the lessons learned from the recent electricity distribution review. This is followed by our initial views on some of the policy areas discussed in the paper.

Lessons learned from DPCR 4
Ofgem's review of the DPCR 4 process set out a number of areas where improvements could be made to the price control review process.

The intention of the Gas review team to reach decisions on certain issues early on in the process is something that we would support. From our experience this helps to create certainty for investors, and also helps spread

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the workload both within companies and Ofgem. We would encourage Ofgem to make high level policy decisions early on in the review, thus allowing sufficient time to focus on the implementation issues for the remainder of the time. There was some evidence of this during DPCR 4, but we believe further improvements to the planning process can be made to enable more decisions to be taken at an earlier stage.

We support Ofgem's willingness to engage with external consultants at a sufficiently early stage in the review such that they become fully integrated from the start. In particular the capex consultants should from the outset be aware of the network issues facing the companies, which would improve the way future network requirements are debated and modelled for projecting future allowances. It is however important for Ofgem to own the process and improve their knowledge of these network businesses. This would improve the overall regulation of companies to the benefit of all stakeholders.

Ofgem's intentions to give companies the opportunity to put forward their views on policy issues to the Authority throughout the review in order to better inform the Authority's decisions is also welcomed. This was certainly a good development of the price control process during DPCR 4, as was the establishment of working groups to consider policy options. On the latter, we would encourage these to be established as early as possible during the process. This would permit sufficient time to be allocated to debate the issues fully, prior to Ofgem closing off options as the final determination approaches.

The remainder of our response focuses on some of the policy issues set out in this first consultation.

Pass through and dealing with uncertainty

Incentives can only be meaningful and effective where managers have at least some control over the costs incurred. There are areas where such control does not exist, for example licence fees and network rates. Where this is the case, we would argue that such costs be passed through to the customer.

Additional costs that were not originally factored into the process for setting allowances may be incurred, for example as a result of new primary legislation. To reduce the uncertainty that would be caused by such an outcome, we advocate a transparent mechanism similar to that introduced for electricity distributors at DPCR 4. This provides for a limited re-opener for specified items, which ensures that the incentive properties on management are maintained.

Approach to setting opex allowances
The decision by National Grid to sell off the gas distribution networks introduces a limited number of comparators. This could be used to help inform future decisions on opex allowances by benchmarking these companies.

Nevertheless, we have concerns with the current benchmarking approach in electricity distribution where there are only seven independent management teams, and question the robustness of the results from any single benchmarking technique employed. Therefore whilst we welcome the intention of Ofgem to use a "range of techniques" for setting the opex allowance, we caution against attaching significant weight to any one result.

The current management will have been in place for less than twelve months in any subsequent comparative assessment. In this environment, where there is considerable uncertainty regarding the potential savings available, more weight should be given to assessing the "credibility of forecasts". Moreover the incentive properties of a rolling mechanism should be implemented to pass benefits onto customers in the future.

As the industry converges and future efficiencies are limited, the approach to setting allowances should evolve. We argue that less emphasis should be given to detailed cost benchmarking, to be replaced with the need to consider the appropriate ongoing productivity assumption, consistent with that of the wider economy. This is consistent with the legitimate aspirations of "light touch" regulation.

Approach to setting capex allowances
The principle of a sliding scale mechanism to inform the setting of capital allowances is supported by Central Networks. Our experience of DPCR 4 is that the methodology allows companies some degree of flexibility in the way they manage risks on the network. However, as we argued in our response to the second Transmission price control review (January 2006), it should not dilute the requirement for Ofgem and the companies to understand and agree a proper level of capital investment that is appropriate for reinforcement and replacement of the network assets. We would be extremely concerned if there was not sufficient focus on the accuracy of future capex requirements because of the flexibility provided by the sliding scale mechanism.

Rolling incentives

Where opportunities to make savings are identified, they should be pursued by management, leading to lower long term prices to customers. The longer these savings are retained by shareholders, the more likely it is that efficiency initiatives will be introduced on economic grounds to the benefit of customers. The application of a rolling incentive regime for opex and capex will ensure that there is no discrimination between making efficiency savings in the first year of a price control compared with the fourth or fifth year of that price control. Moreover it would be supportive of efficiency saving programmes that generally incur significant upfront costs, but provide ongoing benefits to customers.

The establishment of a cost reporting project will also ensure that companies apply the same rules for allocating costs to the opex and capex "pots". The risks from having different incentive properties for opex and capex efficiencies will therefore be removed. Therefore in line with the recommendations of the Frontier Economics report on "Balancing incentives", we support the use of separate rolling incentives for opex and capex, both for the one year review, and also for the five year price control starting in April 2008.

Cost of capital

To consider the approach that should be taken for determining the cost of capital it is important to form a belief on the need to attract funds to deliver the investment programme.

As we commented in our response to the second Transmission price control review (January 2006), our overall philosophy is that a climate must be created that enables a business to decide on the appropriate mixture of debt and equity. To have this flexibility requires investors to be sufficiently attracted to inject equity into the business. This is beneficial for customers as a reliance on debt to finance an ever increasing investment requirement on network businesses over the coming decades (as recognised by the 2006 Energy Review) will increase the risk profile of these businesses and damage the incentive properties placed upon business managers.

A question that has to be answered is how new equity can be attracted into the sector. We believe that the financing community requires certainty in decision making, especially since investment decisions that are long lived overlap a number of price control periods. Furthermore there must be recognition that the demand for capital across the world is increasing, as infrastructure businesses (e.g. energy, telecoms, airports, water etc) are all operating in an upward phase of their respective investment cycles. The ability to attract funds to finance higher investment programmes needs to be factored into the process for determining the appropriate cost of capital. It also follows that consideration of global markets, and not just market data within the UK is required for setting the cost of capital.

Setting a gearing level that is consistent with ensuring there is a significant equity presence in the industry is also an important factor that should govern any decision made during the review. Financial ratios will also have an increasing level of importance during an upward phase in the investment cycle. This environment will inevitably place greater strain on the Balance Sheets of the licence entities concerned. Making sure that a price control is supportive of an investment grade credit rating is therefore fundamental to the cost of capital approach.

Tax

We supported Ofgem's approach to setting tax allowances during the recent distribution review and believe that a similar approach be applied to gas distributors. Both customers and shareholders benefit from incentives to minimise the tax burden facing these businesses, and as such believe ex-ante tax allowances should also be set.

Role of impact assessments

The use of impact assessments (IAs) during a price control process can be beneficial when considering various policy options for dealing with a particular issue. If used at the start of the process, it can objectively focus on the pros and cons of each option and help to ascertain whether there are sufficient benefits of going down one particular route as opposed to another compared with the costs of achieving it. Where they do not have merit is where they are applied after a policy decision has been made.

Our general response to the question raised by Ofgem in the paper is that option three (Ofgem publish appendices which set out the various policy options under consideration and their respective costs and benefits) would be a sensible approach going forward, subject to our above comments.

I trust that if you have comments from any points we have made in our attached paper, then you will feel free to contact me.

Yours sincerely

Jonathan Ashcroft
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