Our Ref PD/41.0
Your Ref 259/05

Joanna Whittington
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EDF ENERGY

Date 3 February 2006

Dear Joanna,

Gas Distribution Price Control Review – Initial consultation

EDF Energy plc is a major UK energy company active in a number of aspects of the UK electricity and gas markets. Among these we are responsible for the operation of power distribution networks, the operation of power stations and the sale to end users of electricity and gas. We are grateful for the opportunity to respond to this consultation and our detailed comments on the proposals are contained in the attachment to this letter.

The UK energy industry is entering a period of significant change. The recently published Energy Policy Review consultation recognises that investment in replacing the aging energy infrastructure is a key component of the UK reaching its broader energy goals. Consequently, it is vital that the future regulatory framework recognises this and in particular the long term nature of investments in energy infrastructure. We particularly welcome the proposed work on the cost of capital, as this work will have a profound effect on the future financing of the required investment

In our view, Ofgem must take particular care in assessing the cost efficiency of Gas Distribution Networks. Due to the small number of comparators available, we believe that over reliance on a single approach will increase the risk of the regulator setting companies unachievable cost targets. This would clearly be inappropriate. In our opinion, it is vital that a range of techniques, including both top down and bottom up analysis, are used to assess both capital and operating cost efficiency. We are pleased that Ofgem recognises this risk and is proposing to utilise a wide range of cost assessment techniques. We support this approach.

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I trust you will find these comments helpful. If you have any queries please do not hesitate to contact me.

Yours sincerely,

Denis Linford
Director of Regulation

Attachment

EDF Energy's detailed comments on the Gas Distribution Price Control Review consultation

1. Principles for the conduct of the review

In general, we agree with the high level principles set out for the Gas Distribution Price Control Review (GDPCR). In particular, we support the proposal to continue to include non operational capital expenditure in the RAV. The treatment at the electricity Distribution Price Control Review (DPCR) was a compromise necessitated by concerns over the differential treatment of such costs across companies. If this is not the case in gas distribution then the costs should be added to the RAV, as they deliver benefits to customers over a number of years.

We believe that further clarification is required on the treatment of capex overspends. We agree that only efficient expenditure should be included in the RAV and that companies should demonstrate why any over or underspend is efficient. However, if Ofgem excludes certain expenditure from the RAV it must set out why it has judged it inefficient. Ofgem's stated position is to include expenditure within the RAV only from the date when it was incurred, if it delivers significant customer benefits. We are unsure what is meant by significant customer benefits and believe that Ofgem should set out clearly how it will assess if such benefits have been delivered. Not to do so will increase regulatory uncertainty.

2. Setting the one year control

We agree that focusing on capital expenditure (capex) for the one year control is appropriate. The DPCR demonstrated that significant time is required for the Regulator and its consultants to understand the industry's historical capital expenditure and the drivers underpinning future expenditure requirements.

We also support a simple approach to the treatment of operating expenditure and would recommend that Ofgem roll forward the current price control assumptions. We acknowledge that such an approach would allow companies to keep the benefit of any operating cost savings for an additional year. However, we believe the impact of such a change on customers is small. Currently, if a company made an efficiency saving in the first year of the control it would keep, on a NPV basis, approximately 26% of the value of that saving. By extending the control by one year the company would keep 30% of the value of that saving. It should be borne in mind that the benefits of these efficiency savings will eventually be passed to customers and by extending the control by one year, and hence strengthening the incentive, companies may deliver more savings than would originally have been the case.

3. Setting the main control

3.1. Structure of the price control

In principle, we support:

- The continuation of RPI-X price regulation.
- A five year duration for the price control.

- The use of revenue drivers to adjust the price control for unanticipated events; and
- The pass through of costs which are outside the control of gas distributors.

We believe that the structure of the price control can be improved by the introduction of rolling retention periods for both operating and capital expenditure. This is discussed further below.

3.2. Dealing with uncertainty

We agree that, where possible, it is better to introduce automatic mechanisms to adjust revenues for unanticipated events rather than reopen the price control. However, we believe that there would be benefit in introducing a specific change of law reopener provision. Changes in legislation are difficult to predict but generally have the most significant impact on a company's operations and hence have the greatest likelihood of requiring the price control to be reopened. The distribution companies presented a proposed licence condition to address this issue during the last DPCR. We would encourage Ofgem to give fresh consideration to it.

3.3. Costs and Outputs

We support Ofgem's intended approach to utilising a range of techniques, including top down and bottom up approaches, to assess both capital and operating expenditure. The use of bottom up analysis, e.g. functional and/or activity analysis, is particularly important given the limited number of comparators available for top down benchmarking. At this stage in the process it is difficult to determine the most appropriate methodology for combining the outputs of the various approaches. We would suggest that Ofgem publish the results of the various analyses, on an anonymised basis, so that interested parties can see the range of outcomes. This would allow a more informed view on how the results should be interpreted and, if appropriate, combined.

We appreciate that the scale of the project will necessitate the use of consultants to undertake some of the assessment work. We would, however, encourage Ofgem to utilise its own internal staff to lead this work as far as is practicable. We believe that such an approach would ensure that the detailed knowledge gained from the review process was maintained within Ofgem. In our opinion this would help reduce the effort associated with an annual cost reporting process.

3.4. Shrinkage

With respect to shrinkage, we believe that Gas Distribution Networks (GDNs) should bear the volume risk but should not be required to bear the price risk associated with circumstances outside their control. We agree that GDNs should be incentivised to procure gas efficiently. An approach could be to apply a sliding scale mechanism to shrinkage costs.

In addition, given the recent large unanticipated gas price rises we believe that Ofgem should examine shrinkage costs, as part of the one year control extension.

3.5. Pensions

We support Ofgem's approach of building on the work carried out at the DPCR with respect to determining pension costs. However, it would be beneficial if Ofgem could set out how costs arising from the Pension Protection Fund will be dealt with, as there was insufficient information available at the DPCR for this issue to be addressed.

3.6. Outputs

We believe that GDNs should be incentivised to deliver outputs that customers value. However, in order to assess the latter Ofgem should undertake a customer survey to inform its views. This would be consistent with the approach adopted during the DPCR.

3.7. Rolling retention periods

We believe that rolling retention periods are an effective means of reducing the periodicity effects that can occur at the end of the price control periods. If it can be demonstrated that the capital and operating expenditure information is robust then it would seem appropriate to introduce rolling mechanisms for both capex and opex from April 2003. An issue that would have to be addressed is the length of the rolling period.

Historically, most regulatory regimes in the UK have used a five year rolling retention period. The introduction of a five year rolling incentive for operating expenditure would mean that a company would keep approximately 30%[1]of the value of that saving and consequently customers would keep 70%. As the 30% that companies would be allowed to retain must also cover the implementation costs associated with efficiency initiative there is a risk that in the future a number of viable initiatives might not be progressed, as they would not be cost effective for the company. This is not in customers' best interests. We believe that if a rolling incentive is introduced for opex the period should be extended to 7 years. This would allow the company to retain 38% of the value of any saving. Additionally, if a five year scheme was introduced for capex this would ensure that the incentive power of both schemes is balanced, as a five year rolling period for capex expenditure results in the company retaining 38%[2] of the value of that efficiency. The balancing of incentive power across capex and opex would ensure that the incentive schemes did not inadvertently distort company investment decisions. We also believe that the rolling mechanism should be symmetrical, i.e. apply equally to overspends and underspends. If this were not the case then there would be an asymmetric sharing of risk between customers and shareholders.

3.8. Information quality incentives

We are unconvinced that an information quality (or sliding scale) incentive will add significant value to the GDPCR process. The introduction of the capex sliding scale mechanism during the last electricity Distribution Price Control Review (DPCR) was to address issues associated with capex assessment. We did not see it as enduring mechanism. Ofgem's stated intention at outset of the DPCR process was that it wanted to utilise the company's capex forecasts wherever practicable. This should be its aim for the GDPCR. Instead of introducing a sliding scale incentive Ofgem should focus on gaining a better understanding of the Asset Risk Management processes utilised in the GDNs so that it understands and can have confidence in the GDNs

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[1] Assumes operating cost savings are recurring and a discount rate of 7%
[2] Assumes capex cost savings are one off and a discount rate of 7%

forecasts. This would align with the approach being taken in electricity distribution. In our opinion, a sliding scale incentive should be introduced only if this work is unsuccessful.

4. Financial Issues

4.1. Cost of Capital

We welcome Ofgem's work on the cost of capital and the opportunity to submit evidence with respect to the appropriate inputs and their estimation. We intend to provide such evidence.

We also believe that Ofgem should determine the final value for the cost of capital before the final proposals in December 2006. While we accept that leaving the decision as late as possible may facilitate the use of the most recent data, this benefit is outweighed by the regulatory uncertainty it creates. We believe that a suitable compromise would be to include a decision on the cost of capital in the September 2006 update.

4.2. Financeability

Our initial view is that it remains appropriate to determine the ability of a licensee to finance its regulated business by utilising key financial indicators to assess whether the company can maintain an investment grade credit rating. However, we agree that the Ofwat/Ofgem work on the financing of network companies will inform this area and we will review its findings to assess if they provide a better alternative.

4.3. Financial Modelling

We support the proposal to develop a financial model in conjunction with the GDNs and other interested parties. We agree that transparency of the price control would be improved by publishing the financial model. However, before publishing a fully populated financial model for each licencee we would expect Ofgem to have regard to its duty not to publish information which would prejudice the commercial interests of that company. If the information contained within the model is deemed to be commercially sensitive an alternative approach may to publish an aggregated industry model.

4.4. Xoserve funding arrangements

We support the continuation of the existing xoserve funding arrangements. However, we believe that there would be benefit in commencing dialogue between xoserve and other interested parties, particularly focusing on the quality of service provided by xoserve.

EDF Energy
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