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24 July 2006

Dear Bob,

Transmission Price Control Review – Fourth Consultation, Initial Proposals June 2006

Thank you for the opportunity to comment on the fourth stage of your consultation on the Transmission Price Control for 2007- 2012.

Given below are the views expressed on behalf of the various companies of Centrica plc involved in the use of the Gas and Electricity Transmission networks, but excluding Centrica Storage Ltd.

In our earlier responses, we have set out a number of high level principles and objectives, which we believe, should form the basis of the Price Control Review. Although for the sake of brevity these are not re-stated here, we continue to believe that these should be evident in the background of our previous comments within this review process.

General points

We note that this Initial Proposals paper is primarily concerned with financial aspects of the Price Control. However, we would like to make a number of general comments on the developments observed since the third consultation earlier this year.

We welcome the recognition and retention of the principle of establishing baselines for Entry Points on the Gas Transmission system. We believe that this is an essential element in setting a reference point of existing system capability and without this it is difficult, if not impossible, to determine out-performance or the need for incremental investment.

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We continue to support the principle of User Commitment, as this is an important mechanism in exposing the appropriate parties to the risks involved with development of the network. However, we continue to have concerns about the complexity of the solutions currently under discussion for Gas Exit and Electricity Transmission Access. We believe that there is potential for solutions based upon “minimal necessary change” which addresses most, if not all, concerns about current arrangements.

With regard to the Capital Expenditure programme, we note that the Initial Proposals paper intends a reduction of those original projections provided by the Transmission Companies. Whilst there are naturally concerns about the magnitude of the capital programme, we find it very difficult to form a view as to the extent of load related and replacement expenditure as presented as the information is not transparent. We would welcome greater clarity of this part of the process and believe that an industry workshop or seminar would be of benefit where greater attention could be given to both the scale and timing of the necessary works.

Although this point is also covered in more detail elsewhere, we believe that it is important that the Review recognises the generally low risk associated with the operation of Transmission Networks. We believe that it is important to reflect this in the financial assessments and ensure that the evaluation applied is against comparable investments and not restricted solely to Utility companies.

Specific Questions

In the sections that follow I have, as far as possible, structured the response to address each of the questions posed in the “views invited” section of each chapter. These are included in italic at the beginning of each section. I hope that this is useful in evaluating the response and assimilating the comments to the relevant chapters.

CHAPTER: 1 - Introduction

There are no questions in this chapter.

CHAPTER: 2 – Overview of Initial Proposals

There are no questions in this chapter.

CHAPTER: 3 - NGET

There are no questions set out in this chapter. Questions relating to the substance of the initial proposals are set out in later chapters.

CHAPTER: 4 - SHETL

There are no questions set out in this chapter. Questions relating to the substance of the initial proposals are set out in later chapters.

CHAPTER: 5 - SPET

There are no questions set out in this chapter. Questions relating to the substance of the initial proposals are set out in later chapters.

CHAPTER: 6 - NGG

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Question 6.1: Do you think our proposed approach to the costs incurred in the current price control period in respect of increasing capacity at St Fergus is appropriate?

Whilst the main text in Ofgem's document does not make it clear, we have to assume that the St Fergus disallowance of expenditure in question relates to capacity in addition to the baseline, where such an increase in capacity was not indicated by user information and where such investment was not subsequently required by users. Such circumstances would appear to indicate inefficient expenditure and it would therefore be entirely appropriate for Ofgem to disallow such expenditure in full. Regulatory intentions of disallowing inefficiently incurred expenditure have to be credible to maintain the necessary incentives on companies investing efficiently. Disallowing the St Fergus expenditure, in these circumstances, would send such an appropriate signal and would also have the effect to ensuring that the regime appropriately maintained its broad symmetry with respect to the treatment of efficient and inefficient expenditure.

Although the LTSEC process has not identified any clear signal for investment at St Fergus (by meeting the IECR criteria) there were a number of winter quarters that have been oversubscribed at the SO baseline level in the shorter term. If this investment was necessary in order to enable delivery of baseline it may be regarded as efficient but this does raise the question of the basis of the RAV, and therefore the return allowed, if this baseline capacity was not available.

CHAPTER: 7 – price Control Cost Assessment and general Policy issues

Question 7.1: Do you agree with our proposed treatment of non-operational capex and 'quasi capex'?

Centrica agrees with Ofgem that it is not appropriate to include non-operational Capex in the normal TO RAV, given the depreciation policy. We note the other two options suggested of either creating a short-life RAV or treating non-operational Capex as Opex. We believe that there may be a third possibility that would be to link the policy in respect of the expenditure to the duration of the price control. This would suggest that where the appropriate depreciation period is less than 5 years (i.e. the duration of a normal control rather than the actual dates of a control) then the expenditure should be treated as Opex. Where the depreciation period is in excess of five years, then a short-life RAV approach should be employed.

Splitting the approach in this way should make the short-life RAV requirements more manageable, at the same time confining the Opex approach to those expenditures, which could reasonably be expected to be "used up" within the Opex period. We tend to agree with Ofgem's proposal of treating this as Opex. Whilst ideally all expenditure should be have its own time period related to the genuine useful life of the expenditure, in line with accounting treatment, creating additional regulatory categories of costs creates additional complexity and potentially perversities which are not easy to overcome or monitor. Hence unless there is an overwhelming case for a new category, the existing best fits should be used.

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In respect of the type of expenditure described as quasi Capex, we agree with Ofgem that this should be treated as Capex. We welcome Ofgem's reassurance that this approach will be monitored over time to ensure consistent application, we believe this monitoring should also reduce the risk of double counting the benefit.

Question 7.2: Do you agree with our proposed approach to future input price changes and indexation? Is our assumption of a 1.5% annual efficiency saving for opex realistic and appropriate?

In our view, it is important to provide the transmission companies with a stretch target. We are concerned that if one of the companies has, itself, suggested 1.5% annual efficiency savings for Opex as an appropriate target, then this is unlikely to be a stretch target for that company at least, and probably others.

With this in mind, we are of the view that this may be viewed as a relatively soft target and result in disproportionate benefit to the company in some cases. In respect of the proposed approach to future input price changes and indexation, we would prefer to see some examples in order to judge the likely magnitude. If an ex-ante allowance is forecast and paid within the Capex and Opex allowances, we would be concerned that an erroneous forecast would have the potential to lead to significant over or underfunding for the companies, resulting in customer dis-benefits in the short and longer term. Overall, we are inclined to take the view that when the underlying commodity is significantly unstable, then a degree of index linking may be beneficial as it may help reduce costs and support customer and investor confidence.

Question 7.3: Is our assumption on efficient connection design for wind generation, and the associated reduction to some of the company cost forecasts, appropriate?

Question 7.4: Do you think that we need to allow explicitly for the possibility of reopening the price controls for specified single events where the timing and level of costs is uncertain and driven by third party decisions? If so, what might such events be and why?

In setting a 5-year price control there is inherently a balance of risk between the regulated entities and the rest of the market. However, once set, there is a degree of certainty (for both sides) for the period as to revenues and charges etc. To allow re-openers, effectively shifts that balance in favour of the regulated entity as it implies greater certainty for them than the market. As such we are against the principle of re-openers.

If re-openers are required (eg. IAE) then the hurdles and criteria should be set high, and the publication of data surrounding TSO performance against the Price Control must improve significantly to allow the market to understand what is happening and also to be able to propose changes to the allowed revenues.

Where it is clear at the start of the control that investment will be required during the control, but there is insufficient detail available at this stage to formulate an accurate allowance, then it would seem reasonable to include an explicit revenue driver for that item which is triggered upon expenditure. This principle could be consistently applied.

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Where at the time of setting the control a likely requirement for significant investment has not been identified, then the price control should not be subject to a re-opener. Where expenditure is genuinely unforeseeable and unavoidable or required due to legislative or statutory change, then presumably the company could apply for an Income Adjusting Event. This in turn should be subject to testing criteria and robust scrutiny as to efficiency.

Question 7.5: What do you think of our proposed options for setting incentives for efficient capital expenditure?

We agree that for load related Capex, clearly drawn and properly targeted revenue drivers, together with a tough efficiency test for any over-expenditure should produce a robust incentive on the companies to invest efficiently.

We also agree that formulating an equivalent incentive in respect of non-load related capex is more difficult, requiring consideration of different issues. Whilst there appear to have been benefits in applying the differential approach to Capex incentives at DPCR4 as companies were not aware of the use of such a mechanism when they submitted their own forecasts; it is not clear that the routine use of such a mechanism would have the same results, as an expectation of such an outcome would be likely to change the behaviour of companies in the submission of their forecasts. Perhaps if such an approach were held in reserve for the foreseeable future it would have the effect of incentivising companies to submit more realistic forecasts.

However, we continue to be concerned that significant increases in non-load related expenditure, in effect expenditure to maintain the existing assets, is being countenanced without the required levels of regulatory transparency and justification. We believe that in such circumstances, there is a risk that assets might be prematurely replaced. Even after taking account of any differential incentive approach, significantly reducing the effective incentive for out-performance in this area, alongside a much more rigorous assessment of inefficient expenditure. This may be the best response in light of this significant uncertainty; at least until a credible way of establishing the right amount of load related Capex is available.

Notwithstanding the above, we would support a rolling incentive structure, allowing retention of benefits for a defined period, providing these benefits accrue as a result of improved efficiency rather than as a result of one off gains. We also believe that such incentives should be symmetrical, offering both an upside and a downside.

CHAPTER: 8 – Financial Issues

Our views on a number of the financial aspects of the Initial Proposals paper are contained in the main within a joint response that has been submitted on behalf of a number of shippers. A copy is attached for reference. This document contains strong evidence in two specific areas which we believe need to be reflected in setting the appropriate Cost of Capital. We also refer to the previous report recently produced by Ian Rowson, following a study commissioned by the Gas Forum and presented to Ofgem and the industry.

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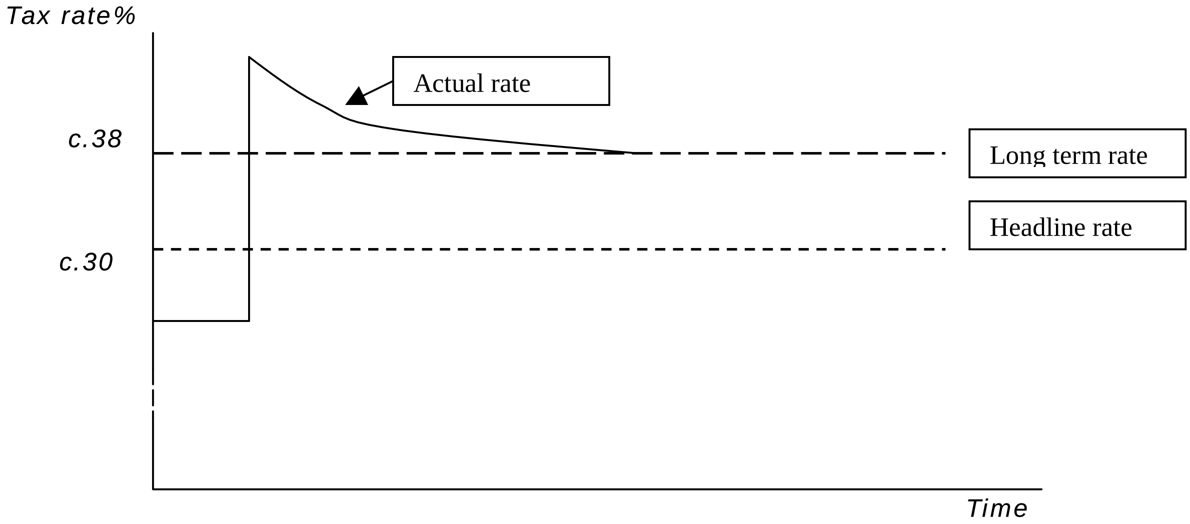
Question 8.1: Should the licensees' revenue allowances for tax payments be set to avoid any need for ex post adjustments?

Although the adoption of a post tax cost of capital is in line with the approach in other controls, it does appear that making the change at this time does result in a significant and unjustified benefit accruing to the Transmission Companies.

This is related to the fact that the companies have previously, in effect, been able to defer a proportion of tax payable, reducing their tax bill within the relevant price control period. At the same time, the companies received allowances predicated on the tax bill being paid in full at the headline rate. The end result of these two factors has been to the companies' benefit to date.

In future, as a consequence of changes in the tax arrangements, there will be a short-term increase in tax above the long term sustainable rate, but this short term increase is likely to be no more that the previous deferment. However, we recognise that the long-term applicable rate is higher than the headline rate, currently assumed to be 30%. See graph below. For the avoidance of doubt, this is not intended to suggest any impropriety on the part of the companies, simply to recognise the effect of the mechanisms, which have been in place.



To move from the existing approach to a post tax cost of capital approach in which the companies receive an allowance against a forecast tax bill, without any form of transitional recognition of the previous regime, would lead to a double benefit for the companies. It would be necessary to correct this benefit by making an appropriate adjustment to the allowances set. We see a clear parallel with the proposed treatment of pensions, where it is proposed that previous over/under-funding be accommodated within the setting of the overall control.

Question 8.2: Are there any other measures which could be taken to reduce perceptions of Regulatory risk and what level of risk do these regulated utilities carry relative to other plc's?

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Whilst we understand Ofgem's proposed approach of taking a longer term view of the appropriate return rather than relying solely on a snapshot of "latest" market data, we believe that a more balanced approach would look at data over short and longer term horizons. We do not believe that Ofgem's analysis adequately takes account of more recent, shorter term, information.

Firstly, we believe that it is appropriate to adopt an equity β value of materially less than 1.0. This recognises the fact that the operation and development of a Transmission Network carries with it significantly lower risk than is considered average for a company. We recognise that within the appendix to the Initial Proposals paper a figure of 0.9. was included. We welcome this break from the automatic adoption of an equity β of 1.0 and believe that there is a strong case for a lower value.

It is clear from a review of analyst reports on National Grid over time, that many analysts view an equity β of as low as 0.55 as an appropriate measure of the natural riskiness of National Grid. For example, in October 2005, a study applied an equity β of 0.71 for Electricity Transmission and 0.59 for Gas Transmission, generating a pre tax real WACC of 4.6 and 4.7% respectively.

Whilst we would agree that moving to a β of the order of 0.55 all the transmission businesses is unlikely to be appropriate at this stage, we do believe that an equity β of the order of 0.75 would be more suitable and should be factored in to Ofgem's calculation of revenue allowances. We also note that in the Netherlands, where a similar approach is taken to the UK, the DTe settled on a range for the equity β of 0.58-0.80, which clearly bears comparison with our suggested levels.

In respect of the gearing levels to be used in the calculations, we are of the view that Ofgem should base their calculations on an efficient level of gearing rather than using the companies' actual level of gearing as a starting point. It is then up to the companies on the approach they choose to take, providing they comply fully with all relevant licence conditions on financing. However, we see no reason why it would not be possible for a transmission company to significantly increase their level of gearing over 60% whilst comfortably maintaining the investment grade credit rating required. As Ofgem has noted, there is already evidence of this is respect of the independent gas distribution companies.

On the Debt Risk Premium and the Risk Free Rate, we are broadly in accordance with the initial proposals, which suggest a real pre-tax cost of debt of 3.4%.

Our views diverge from the initial proposals in respect of the cost of equity used. We note that under DPCR4, Ofgem elected not to rely on observed spot market data for the real risk free rate, and also assumed an equity β of 1.0 on the basis that observed market data was statistically unreliable in the early part of the decade due to the collapse of the telecoms and IT boom. The result of this was that Ofgem implemented a cost of capital at the high end of the possible outcomes.

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We believe that passage of time has muted these effects and that continuing the same approach would lead to an overly generous outcome. Instead, we consider that a cost of equity at the lower end of the range (for example, the 6.25% used for NGC in December 2000) as well as a reduced β would now be appropriate.

As stated in our response to the Ofgem/Ofwat Financing Networks paper, we do not consider that there are significant issues around the ability of regulated energy transmission companies to attract suitable equity finance at reasonable cost. The fact that network businesses such as the gas DNs have changed ownership at a significant premium to the RAV suggests considerable appetite among the investment community. On the basis of today's regulatory regime, this indicates (with the benefit of hindsight) that past price control reviews could have been somewhat tighter than they were. In particular, we note that some analysts appear to support the premia, which have been paid, on the basis of the currently applicable regulatory regime.

In reviewing a number of analysts' reports, we believe there is an expectation of a similar, relatively relaxed approach in the future, which appears to have been factored into many assessments. This view is further supported by some of the speakers at the recent TPCR seminar, who indicated clear expectations that the proposals would be relaxed between the Initial and Final Proposals documents. In contrast, we would encourage Ofgem to take a significantly firmer approach in future on cost of capital issues.

We welcome Ofgem's remarks in 8.3 in respect of the conservative outcome of the approach taken on DPCR4, as well as at the TPCR seminar in which Ofgem made clear that they have not yet reached a decision on these aspects of the control. We would also agree that the transmission companies could be expected to face a similar level of risk as each other and hence that they should have the same cost of capital.

In appendix 9, the document makes reference (in section 1.19) to the companies' potential requirement for equity investment in the light of the capex proposals brought forward. In this section, Ofgem applies the assumption that this equity investment will occur in the absence of changes to the gearing level. As above, Centrica inclines to the view that allowances should rather be set using an assumption of an efficient gearing level. However, we welcome Ofgem's recognition that it does not need to provide additional financing along the lines recently provided to the water companies by Ofwat.

In our response to the Ofgem/Ofwat Financing Networks paper, we recognised the challenge inherent in the requirement to raise significant amounts of capital going forward to fund additional investment in long life assets, when such investment must be supported by revenues which are only certain over a 5 year time frame. We also noted our belief that the improvement in the quality and transparency of consultation over recent price control review periods can be expected to have helped reduce the regulatory risk premium, which in turn will assist the funding of the proposed investment programmes if they are approved.

In this consultation (App 9, 1.24), Ofgem expresses the initial view that a similar effect to the split cost of capital approach may be achieved by establishing an appropriate rate of return across the entire asset base. Whilst we would agree that this should be the case, we believe that the difficulties inherent in forecasting market movements would indicate that a form of index linking for all or part of the allowed rate of return merits further investigation. We appreciate that this is unlikely to be possible in respect of the existing transmission reviews, but would welcome Ofgem initiating such exploratory work in time for the next Price Control Reviews.

CHAPTER 9 – System Operator Costs
Questions
There are no questions in this chapter.

CHAPTER: 10 – Adjustment mechanisms and incentives: electricity
Question 10.1: Is our proposed two-part revenue driver design appropriate and proportionate to the issue it is seeking to address?

Overall, Centrica supports the use of clearly defined revenue drivers to ensure that the price control is flexible and fit for purpose going forward. The key in ensuring the efficacy of the drivers is clear specifications and triggers together with robust monitoring and challenge mechanisms in respect of the efficiency of the investment and any over-spending incurred.

In respect of the two part revenue driver design, it would seem sensible to consider two such different aspects as local connection and deep reinforcement separately. On the local connection incentive suggested, we believe that the incentive needs to operate on the timeliness of the work being carried out and should not solely be concerned with mapping revenues and costs. We look forward to commenting further at the final proposals stage.

Question 10.2: What are the costs and benefits of seeking to facilitate greater competition between providers of transmission services, in respect of the prospective transmission links to the Scottish Islands?

Question 10.3: Is our proposed approach to funding for innovation appropriate and necessary?

Questions 10.4: Is our proposal to extend the existing performance incentive scheme appropriate?

CHAPTER: 11 - Adjustment mechanisms and incentives: gas
Question 11.1: What do you think of our revised proposals for setting entry capacity release obligation baselines, and for the proposed mechanisms for enable such baselines to be re-allocated in some circumstances?

As mentioned in our opening comments, we welcome the inclusion of baselines set to reflect existing system capability. We do support the adoption of a maximum practical physical basis as we believe this is the closest to the true representation of actual system capability. Although the details of the mechanism, and importantly the setting of exchange rates, has yet to be finalised, we are supportive of the facility to re-allocate capacity

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between terminals to the extent that this is possible to maximise the capability of the system and avoid unnecessary physical reinforcement.

Question 11.2: Are our proposals for revenue drivers for entry and offtake appropriate and proportionate, given the issues they are seeking to address?

Question 11.3: Are our proposals for revenue drivers for entry and offtake appropriate and proportionate, given the issues they are seeking to address?

We have been concerned about the current arrangements for setting reserve or baseline prices by means of Unit Cost Allowances (UCAs). In the past these have been unpredictable and we believe that this is primarily due to the disconnect of the capability of the system at the time the UCA is set with that of the capability at the time of system use. We are of the view that a move to Revenue Drivers, based upon current system capability, should avoid this problem. We are also supportive of this approach in being applied consistently through the control period. We would also hope that this consistency of approach could be applied between price controls.

Questions 11.4: Is there a case for an innovation incentive for NGG NTS?

At the time of writing it is difficult to envisage an effective mechanism for incentivising innovation in gas transmission. There are more tangible applications of this type of mechanism in power. However, we believe that there is a sound principle here in enabling the Transporter to derive some benefit from improvements in the system achieved through technology and innovation.

CHAPTER: 12 – Environmental considerations

Question 12.1: Do you agree with our assessment of the main impacts of the transmission system? What are the most important impacts from the perspective of consumers?

Question 12.2: Should emissions of SF6 be subject to a separate incentive scheme, given that they are currently outside the scope of the European Emission Trading Scheme (EU-ETS)

Question12.3: Should there be additional measures to promote innovation in support of environmental benefits, either as part of the proposed incentive scheme for innovation for NGET, SPT and SHET or as a separate measure?

In summary

We are supportive of the application of baselines as a measure or reference point of existing system capability for both Entry and Exit capacity regimes. This facilitates the distinction between existing and incremental capability and the requirement for investments and returns accruing from that.

We are also supportive of the principle of User Commitment as a mechanism for demonstration of an enduring requirement for additional capability. However, we have concerns that the complexity associated with some of the processes being contemplated my outweigh any benefits and could in some circumstances deter or distort the signals for future investment. We are supportive of an approach that adopts simpler minimum necessary change to existing arrangements.

We are firmly of the opinion that the Transmission businesses are essentially a low risk operation and therefore the Cost of Capital allowed within the Price Control should be proportionate to this risk. The combination of this low level of risk with the advantage derived from moving to a post tax rate suggests to us that a Cost of Capital of at least 50 basis points below that cited in your Initial Proposals document would be fitting.

We share the concerns of many industry participants at the scale of the proposed capital expenditure programme but find it difficult to comment constructively on the proportion of this programme, which is required. We would welcome greater transparency of the process in order to understand both the scale of the works proposed and the scheduling of these projects through the Price Control Review and beyond.

I hope that these comments are useful and informative at this stage of the Price Control Review. You will be aware that we are actively engaged, both directly and by means of participation within the Gas Forum group, in supporting the work of this PCR. We would welcome the opportunity to discuss these issues with you directly, perhaps within the next stage of the process.

Please contact me if you require any further information.

Yours sincerely,

Mike Young
Commercial Manager

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