
Gas Distribution Price Control Review

Second Consultation Document

A Response by Centrica

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GENERAL COMMENTS

Centrica is pleased to respond to this consultation document; the comments contained in this response are made on behalf of the Centrica companies excluding Centrica Storage Ltd. We are content that this non-confidential response should be placed on the Ofgem website and in the Ofgem library.

We note that Ofgem intends to put in place a cost reporting framework to maximise its ability to ensure efficiency savings are passed back to customers post the DN Sales process. Although we remain concerned that a large part of the demonstrated savings may not be fully reflected until 2013, under Ofgem's proposals, we believe that it should still be possible to pass significant expected savings back to customers from the DN Sales within the forthcoming (2008-13) price control period. We hope that Ofgem will endeavour to ensure this is the case and that all such savings are monitored and quantified transparently.

We would urge Ofgem to build upon the work done for TPCR where possible, particularly in the area of Cost of Capital. Whilst we appreciate that Ofgem has not yet proposed a cost of capital and associated parameters for GDPCR, however, Centrica remains strongly of the opinion that in the upcoming control, the equity beta employed should be significantly less than one, and the equity risk premium should also be materially reduced from current values. We believe that the existing Rate of Return would be excessive given the changes that have taken place in the markets since the last price control was agreed, and that the new post tax WACC should be significantly less than the current equivalent value.

We also noted with concern the substantial overspend on total allowances for capital and non-mains expenditure over the present price control period. Whilst appreciating Ofgem's view that an important part of the GDPCR work is to determine the extent to which GDNs will be permitted to recover overspent costs, £841m (in 2005/6 prices) is clearly a significant sum – equivalent to something in the order of 10% per year on allowed revenues - and should lead to serious questions being asked. In our view, either the information supplied to Ofgem during the last Gas Price Control Review was erroneous, or the calculations/assumptions that generated the allowances were flawed. In either case, given an assumption that the GDNs will be permitted to recover at least a proportion of this sum, it is appropriate that explanations for the mismatch be placed in the public domain as a matter of some urgency as they clearly bear upon the interim one year control as well as the main PCR for 2008-13.

This massive over-spend significantly reinforces one of our previously expressed concerns, about the risk of a "one sided" approach to the interim one year control. In particular, accelerated mains replacement and other repex made on an unexpectedly large scale during the 2002-7 period are likely to result in significantly lower opex for maintenance/repair in 2007/8 and beyond. An interim control based on fully adjusted capex but with unchanged opex assumptions is therefore likely to be unduly favourable to the DNOs.

We welcome Ofgem's statement that the driver for the 2008 control will be what consumers want GDNs to deliver, and we believe that the research generating these conclusions should also be placed in the public domain.

We also support Ofgem's view that it will be necessary to manage GDPCR in the context of other processes such as TPCR and Ofgem initiatives such as Offtake Reform, Interruption and competition in connections.

QUESTIONS AS RAISED BY THE DOCUMENT

In this section, we address the questions as listed in the appendix to the document.

CHAPTER: One - Introduction

There are no specific questions in this chapter.

CHAPTER: Two – High level framework of the price controls

One year control issues

Question 1: Should Ofgem retain the form, structure and scope of the current price control during the one year control?

Centrica supports Ofgem's opinion that changes to the underlying framework should be avoided where possible. As we stated in our previous GDPCR response, we believe that either all key elements of the control should be thoroughly reviewed (opex, capex and repex), or a simple rollover should be applied for all three aspects. We continue to be concerned that a selective review may lead to windfall benefits for the companies, for example by adjusting for higher repex but not for consequent opex savings. As set out above, this concern has been significantly reinforced by the extent of the repex overspend during 2002-7. Moreover, the recent initial TPCR proposals provide a strong indication that the cost of capital embedded in the current GDPC now appears excessive. In the same vein, it would be unduly favourable towards the companies to make a full capex/repex adjustment whilst retaining a cost of capital that is now recognised to be too high. We are not persuaded that changes to the shrinkage arrangements should be made for the one year control, please see our comments under chapter 4. Overall, we consider that a simple rollover, or something close to it, is likely to be both pragmatic (in view of the limited time available and the demands of the main GDPCR) and even-handed.

Main control issues

Question 2: Should Ofgem introduce a new revenue driver other than the volume driver and, if so, what variable should it be linked to?

We understand why GDNs would wish to change the proportion of revenues associated with the volume driver, as a higher proportion of costs being recovered against fixed charges would be expected to result in more stable cashflows for the transporters. However, this needs to be balanced against signals to consumers in respect of energy consumption. Whilst we appreciate that the transporters do not bill customers directly, and that transportation charges are levied based on the charging methodology rather than the actual control, a change to the split of charges between fixed and variable would be expected to feed through into customer charges.

At this stage we do not feel able to express a strong view on whether drivers associated with load growth or number of connections would improve the cost reflectivity of the charging arrangements. However, there is generally a significant costs element (overheads and other administrative costs) for which there is no obvious cost driver and it is not clear to us that the cost driver mix has changed significantly since the last GDPCR. Material changes to the established cost driver mix therefore need a clear and objective justification; we look forward to commenting in due course on the proposals, which Ofgem brings forward in June 2007. In particular, if Ofgem is in an appropriate position, we believe that it would be helpful to conduct a mini consultation on issues such as this once Ofgem has more information available to it in advance of the initial proposals document.

Question 3: What revenue and/or costs should be treated as excluded/de minimis/pass through? What principles should be used to classify revenues and/or costs as excluded/de minimis/pass through?

We believe it is helpful to review the principles behind excluded and de-minimis services at this point in the GDPCR process. One of our concerns, particularly in respect of excluded services, is the extent to which it is possible to properly allocate costs where the costs are apparently indivisible from the costs of carrying out regulated activities. We believe that one of the key principles in determining whether a service may be an excluded service should be whether the costs of provision are accurately attributable. Where such costs cannot be separated, we would question whether it is appropriate to allow the companies to earn both regulated and unregulated revenue from the same “asset”. In our view it is paramount that that revenues from regulated activities should not be used to allow the companies to earn additional unregulated income as this could amount to a cross subsidy.

Overall, we believe that the questions proposed by Ofgem are reasonable as tests for excluded services, with the addition of the points above. A further helpful question would be the justification of the request for treatment as an excluded service.

Question 4: Should Ofgem link some or all of allowed revenues to a price index other than RPI?

Based on the information presented within the document, we are inclined to support Ofgem's initial view that revenues should continue to be linked to RPI in preference to a construction output price index or similar. In our view there are already sufficient mechanisms within the Price Control to address any significant issues which may arise.

Question 5: Should Ofgem specify certain issues that could be the subject of a reopener and, if so, which issues?

We agree with Ofgem that a generic reopener mechanism dilutes incentives to manage costs and forecast accurately; however, we are sympathetic to the issue of major costs, which cannot be quantified prior to the setting of the control. The mechanisms already present (including Income Adjusting Events (IAEs)) provide a degree of insulation from major shocks, and we believe it might be possible to extend these provisions slightly. The merit of the IAE approach in particular is the associated requirement to “prove the case” for the additional funds, rather than a more automatic approach.

We consider that the approach described in 2.24, with further discussion to come in the third consultation document, seems appropriate. We would, however, request that if specific re-openers are to be provided, that these should be listed in advance, and that a robust mechanism should be included to ensure that the costs associated with the named activity are accurately quantified and reported to avoid scope creep.

CHAPTER: Three – High level framework of the price controls

One year control issues

Question 1: Is our approach to carrying out ex-post assessments of historical efficiency appropriate?

As a general observation at this point, we note that the increases in capex, repex and opex during 2002-7 appear to be correlated with the DN Sales process in respect of timing, with a very large part of the total overspend (vs. allowances) forecast to arise in the last two years of the period, after the DN Sales were agreed. Whilst this correlation may be no more than coincidence, we believe that it would be helpful for Ofgem to inquire further into the issue, and clarify the position to the stakeholder community. It is apparent from the opex figures that a significant part of the last two years' overspend is attributable to major increases in the financial cost of shrinkage (driven in turn by sharp increases in wholesale gas prices), but this is by no means a complete explanation.

We also note that the last two years' expenditure figures are forecasts rather than actuals, which highlights a need to ensure that these forecasts are soundly based.

To summarise, it will be important to determine what is driving the forecast opex overspends in 2005/6 and 2006/7 and assess the extent to which these reflect exceptional or temporary factors rather than sustained historical efficiency trends.

Given that aggregate capex overspends have taken place (or are forecast to arise) in all five years of the current GDPC period, with aggregate repex overspends vs. allowances in all except the first year, it will also be important to ensure that all the additional expenditure has been efficiently incurred.

We therefore agree with Ofgem that an appropriate understanding is needed of the discrepancies on both capex and repex, particularly whether there is any misalignment of allowances or allocation of costs, and believe that this is the correct approach.

In respect of the regulatory assessment of the efficiency of additional expenditure (as described in figure 3.5 and the relevant appendix), and its subsequent treatment, overall we believe that this is an appropriate approach. There is, however, one issue which it would be useful to clarify, given that total 2002-7 capex has generally been above the relevant allowances. If a part of that expenditure were judged inefficient, we presume that this portion would be considered, in so far as possible, as falling above the allowance (and the efficient portion considered, as far as possible, as falling within the allowance). This seems to be the implication of Ofgem's approach, but it does not appear to be explicit.

We agree that where an efficient overspend has resulted from additional workload due to new legislation, a reopener should be considered, but before any reopener is granted, the overspend should be tested as to whether all aspects were not reasonably foreseeable.

Question 2: Is our proposed regulatory treatment of our conclusions on efficiency appropriate, transparent and practical?

See question 1 above.

Question 3: Is our initial view on how to set capital and replacement expenditure allowances for 2007-08 appropriate?

We do not believe that sufficient information is available to comment at this stage, and will look forward to commenting on the initial proposals. At present we continue to adhere to our view that a consistent approach across the three main categories of allowance is key, i.e. either all three areas should be fully reviewed, or all should be subject to a simple rollover. We do not support a piecemeal approach, which might be one-sided and lead to windfall gains for the companies, as explained in our response to question 1 of Chapter 2.

Question 4: Which of our options is most appropriate for setting the operating expenditure allowance for 2007-08?

Subject to our previous comments above, and those set out in our response to the first consultation document with respect to consistency of approach on capex, repex and opex, we are of the view that the tighter of the two approaches should be employed, to ensure that incentives to control costs are not relaxed in the short term. Given our general preference for a simple “rollover” approach to the one year control, we would favour the first option based on 2006/7 opex allowances with efficiency adjustments where appropriate.

Please see our comments under chapter 4 in respect of shrinkage. Given, in particular, the impact of wholesale gas prices on its financial value, we would certainly support the case for “specific treatment” of shrinkage as suggested in paragraph 3.38 of the consultation document.

Main control issues

Question 5: Is our proposed approach for setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?

Whilst the information provided is necessarily limited at this point, overall we support the approach described to setting the capex and repex allowances. Adopting our preferred simple “roll forward” approach to the key allowances for the one year control would free up time and resources to concentrate on the main control. These resources potentially could be used to commence work on the reporting framework, to enable data collection to begin at an earlier date, addressing the data collection gap identified in 3.60 and identifying/quantifying customer benefits from the DN Sales process

Question 6: Is our proposed approach for setting operating expenditure allowances for 2008-09 to 2012-13 appropriate?

In respect of opex, we are encouraged by Ofgem’s remarks in 3.45 indicating that Ofgem will start to use comparative analysis to assess the GDNs costs. We would encourage Ofgem to pursue this approach robustly, with a view to driving out benefits from DN Sales for customers as soon as possible. Whilst we accept that Ofgem will have limited data available at this stage, we continue to believe that by 2008, it should be possible to see clear and unambiguous savings for customers based (inter alia) on goals already indicated by at least some of the new DN owners.

We also believe that it is sensible to benchmark against other industries wherever practical in the drive for frontier performance.

Overall, we support the approach outlined by Ofgem in the document, and Ofgem’s ongoing commitment to ensuring that customers do not meet the companies’ costs of sale.

Question 7: How should we deal with the uncertainty surrounding the level of costs associated with the Traffic Management Act?

We support the approach described in respect of the TMA, namely specifying an allowance if possible and, if not, making provision for a specific re-opener. As before, we believe that any such re-opener should be tightly defined and robustly challenged, requiring the companies to provide proof of additional funding required to ensure costs to customers are minimised.

Question 8: What are your views on our principles for assessing GTMS replacement costs, SOMSA exit and ongoing system operation costs?

We strongly support Ofgem's approach in respect of loss of economies of scale. As Ofgem has stated throughout the DN Sales process, it would not be appropriate that such costs be met by customers. Equally, where economies of scale exist, it is clearly appropriate that customers should benefit at the first opportunity.

Given the previous allowances made in respect of IT, which we believe included allowances for the replacement of significant systems at Transco, we agree with Ofgem that it will be essential to ensure that consumers do not pay twice for the same systems. We also support the approach that costs will be tested to ensure they are not supporting SOMSA exit, as these costs should be to the account of the network companies rather than customers.

We further agree that any costs of establishing separate control centres are an element in the lost economies of scale, and as such should not be subject to allowances.

In respect of the ongoing opex costs, we agree in principle that the costs incurred by GDNs for system operation are, in effect, unchanged whilst system operation continues to be carried out by NGG. Hence limiting the total allowance to that permitted for NGG in the years preceding the DN sales would provide some degree of protection for customers. However, we do not believe that this delivers any incentive for improvement. In our view, the incentive to reduce such costs needs to continue, and hence a reducing allowance would be more appropriate.

Overall we support Ofgem's proposed approach in respect of GTMS and SOMSA exit costs.

CHAPTER: Four – Outputs and Incentives

One year control issues

Question 1: Is Ofgem's initial view on how to update the mains replacement incentive mechanism for 2007-08 appropriate?

We are not persuaded that a detailed review of the mains replacement incentive mechanism is justified for the one year control, believing that a simple roll forward approach of the existing incentive would be sufficient. However, if it is believed that a more detailed review is required, then an assessment of the efficiency of the work carried out is logical and necessary. It will also be important to ensure that pressure is kept on costs, even allowing for real price effects.

Question 2: Is Ofgem's initial view on rolling incentives during the one year control appropriate?

In respect of the roiling incentives, we believe that it will be important to maintain pressure on costs, especially given the partial approach to review proposed by Ofgem. With this in mind, and as set out in our response to question 4 of chapter 3, we believe the tighter of the two approaches should be applied. We do not believe that there is sufficient information available at present to fully assess this and look forward to commenting further in our response to the next document.

Question 3: How should Ofgem determine shrinkage allowances? Should Ofgem adopt one of the options presented in this chapter or a different option?

As a general point in respect of shrinkage, we believe it is important to be clear that the reduction mentioned in 4.7 is a reduction in assessed shrinkage, not actual shrinkage, and hence the reduction is as a result of the application of a methodology not measured quantities.

The existing shrinkage incentive is significantly undermined in its effectiveness because of the scope of the volume of gas that is incentivised. As Ofgem notes, the current shrinkage incentive is applied to leakage, own use gas and a proportion of theft rather than total gas losses (difference between measured inputs and gas off-taken by customers). As shrinkage is very difficult to measure, the volumes are assessed by the GDNs. Consequently, the incentive on GDNs is to reduce the volume assessments rather than necessarily reduce actual shrinkage costs.

Shippers have great difficulty in challenging the GDN assessments. Such informational asymmetry is greater than that which occurs during a price control assessment and it is not eliminated at successive reviews, as is the case with typical price control assessments. Consequently, shippers do not have confidence in the accuracy of the assessments.

Whilst there are problems with all the assessments, the GDN theft assessments are particularly problematic. These use the numbers of declared cases of theft in the shipper versus GDN areas as a proportion of a largely arbitrary total volume of theft. We do not believe that the resulting figures are wholly reliable. The effect of this methodology, which it appears necessary to use within the existing scope of the shrinkage incentive, is to undermine both the GDN and shipper/supplier incentives to reduce theft.

As Ofgem itself noted “Dynamics between theft and LDZ shrinkage considered to create a perverse incentive on GDNs to detect upstream theft” (Reconciliation by Difference, Initial Thoughts, Distribution Workstream, August 2006).

Any errors or omissions from the shrinkage calculations and all non-shrinkage volumes are paid for directly by domestic shippers, hence there are no effective incentives on other industry participants to reduce these costs.

One alternative to the existing arrangements would be to expand the scope of the incentive to include all losses, as is currently the case in electricity. This would reduce the reliance on assessments. However, smaller supply points would either need to be measured via the removal of Reconciliation by Difference or they could be estimated by scaling up the existing directly measured demand profiling sample of sites. Our preference would be for the latter, this should not preclude the necessary cost benefit analysis on whether Meter Point Reconciliation should be further considered as an option going forward.

We believe that the expanded scope of the shrinkage incentive should be considered for the start of the main control. This would allow further consideration of the implications of such an incentive.

Subject to our comments above about the scope of the shrinkage incentive, we do not believe that the shrinkage arrangements should be addressed as part of the one year control, but should be considered as part of the review for the main control. We agree with Ofgem that the arrangements should not be adjusted retrospectively.

We believe that great care is needed in deciding whether to relieve GDNs of all price risk in respect of shrinkage, as this exposes suppliers and customers fully to such costs. The existing methodology for shrinkage assessment facilitates the network operators, as Shrinkage Provider, buying forward, therefore some of the price risk can be avoided. Whilst the wholesale markets have been volatile, GDNs do have the ability to influence shrinkage volumes, which (with some exceptions, such as theft) suppliers and customers do not. We believe that an approach, which shares an element of risk in proportion to participants' ability to influence the outcome, is most appropriate.

Of the options proposed we believe that Option 1a may prove appropriate for the main control, subject to additional consideration being given to the index used. An incentive would clearly be required, but the key would be to ensure that any caps and collars (if indeed any are set) do not act to unduly weaken the incentive scheme.

Question 4: Should Ofgem carry out any further work on incentives as part of the one year control review, other than that set out in paragraphs 4.1 to 4.23?

As per our previous comments on incentives, we do not believe additional work is required in respect of incentives for the one year control.

Main control issues

Question 5: Should the interruptions and NTS offtake incentives on the GDNs be part of the overall RPI-X price control or separate incentives with caps, collars and sharing factors? How should the price risk for each of these incentives be addressed?

There are a number of interactions between the Price Controls and the incentive arrangements for both Transmission and Distribution. These will form a key driver in informing DN Investment in their own network as an alternative to buying in the service from the NTS. The manner in which Networks are exposed to the risk of holding unused capacity and flexibility will drive their efficient purchases and/or investment decisions. The ability of a DN to take advantage of the diversity of load factors of its connectees in securing services from the NTS will be more visible if were subject to an incentive arrangement rather than subsumed within the overall control.

Question 6: Is it appropriate to adopt rolling incentives and an information quality incentive mechanism for capital expenditure for gas distribution? If so, what should be the features of the incentives?

We are supportive of the adoption of a regime which requires Distribution Networks providing information on the capabilities, utilisation and development of the network. It is implicit that this information should be reliable and therefore of good quality. We are not convinced that this should rely upon an incentive regime.

Question 7: Should the mains replacement incentive mechanism be carried forward in its current form, adjusted for particular factors such as service pipes, or abandoned in favour of a more generic incentive?

Whilst recognising that further analysis is required, overall we are inclined to believe at this stage that maintenance of the existing incentive would be advisable, with minor adjustments, such as the addition of a new band for larger diameter services. In the absence of strong evidence, we would not support a complete change to the incentives on a long term programme such as mains replacement, as the regulatory uncertainty implied between controls is likely to weaken the application of future incentives.

As per our previous comments, we do agree that the operation of this and related incentives does require analysis in the light of the variances from allowances during the latter part of the current 2002-7 control.

Question 8: Is it appropriate to adopt rolling incentives for operating expenditure for gas distribution?

We agree that RPI-x regulation should produce a strong incentive on GDNs to reduce costs and maintain pressure on costs. However, this is only the case where x is greater than zero. There have been suggestions under the TPCR that whilst RPI is still an appropriate linkage, that $x=2$ may have served its purpose and that $x=0$ may be the way forward. We are not convinced that all economies have been achieved, and would be concerned at reliance on RPI-x alone as an effective incentive structure, were x in fact set equal to 0. However, we appreciate that the key is to set the right number based on likely efficiency improvements. In our view, this should be based on an efficiency study, and we would note that the last study conducted for Ofgem by CEPA as part of the electricity DPCR came up with an X of greater than 2.

If allowances are set robustly, using benchmarking and a careful assessment of GDN forecasts, we see no reason why RPI-x should not continue to be successful, and hence our initial view would be that a further opex roller is not necessary. However, the GDPCR process is at a very early stage, and our view may well change once further, more detailed information becomes available.

We also note the inconsistency of the GDN proposals described in 4.47, and agree with Ofgem that any application of an opex roller (if used) would need to be symmetrical. We recognize the difficulty in applying the roller in practice. The timing of price control reviews combined with the use of base year, mid price control, data in effect already gives companies five full years of out performance opportunities. Until such issues can be addressed a mechanistic application of the opex roller would not appear to be in customers best interests.

Question 9: How can the quality of service arrangements be improved? In particular what are your views on the high level options proposed by Ofgem for the quality of service and outputs arrangements for 2008-2013?

In respect of water ingress in particular, Centrica is not persuaded of the need for GDNs to hold insurance in this area. Where ingress is the result of the actions of a third party, then presumably the proper source for the recovery of the GDN costs and compensation payments would be a claim against the offending third party if necessary via the courts in a civil action. This approach would reduce the effect on the GDN to a cashflow timing issue.

Alternative approaches to the insurance issue would be for the GDNs to self insure, or to opt for a large excess. It would seem sensible to remove the cap on payments to customers to avoid inequitable treatment. However, removal of the cap would be likely to increase insurance premiums, and hence all options to reduce such premiums need to be considered. In addition to the above, we believe it will be important that such insurance premiums are appropriately evidenced and challenged.

Finally, we believe it would be appropriate to explore whether stronger incentives in the area of quality of pipeline records would be beneficial in reducing water ingress incidents and hence compensation costs in the long run. In order to do this, we believe it would be helpful for GDNs to analyse and publish whether there is any correlation between water ingress and faulty pipeline records.

We agree that it would be appropriate to extend coverage of the scheme to customers on IGT networks, assuming the costs are appropriately allocated. We would also take the view that the minimum appropriate compensation should be paid, rather than incentivising GDNs to minimise the compensation paid out.

Question 10: What are the advantages and disadvantages of the different approaches to setting capacity outputs and providing appropriate incentives for efficient behavior by the GDNs in the next price control?

The essential element, in our view, in setting capacity outputs is to determine the realistic capability of the existing network. It is only once this “baseline” has been established can a consistent approach be followed to recognise and reward out-performance.

Question 11: Are there any other areas where outputs or output based incentives for GDNs should be developed including safety and the accuracy of gas pipeline records? If so, what should they be?

The only other area worthy of consideration is the Firm Load Shedding process in that the results of effective contacts in previous safety exercises have been concerning. Hence, an enhanced process with regular monitoring would need funding.

Question 12: Does any aspect of the operation of a GDN require more investment in technical innovation than occurs at present?

In general terms the incentive to innovate should be sufficiently rewarded from the efficiencies demonstrated from such innovation. Therefore, we are of the view that a specific incentive upon innovation is required.

Question 13: Should Ofgem consider any other form of incentive mechanism in the context of GDPCR?

In the context of the very recent announcement in respect of the Farningham offtake meter error, we believe there may be scope to ensure that future similar incidences are limited in terms of number and impact. Possible mechanisms could be through an incentive mechanism, a liabilities cap or a limitation on the duration of back claims by the billing party (as exists for Suppliers in respect of the Domestic Supply Billing Code).

Whilst Farningham has only recently come to the attention of the User community (although we understand that NGG has been aware of the issue for many months), there have been incidents in the past of a similar nature. We are concerned that given the history of large offtake metering errors, that such meters seem to be audited as infrequently as once in ten years. In these circumstances, we are of the view that the resulting unequal distribution of risk between the GDNs and the Users is unacceptable.

In addition to the above, we believe that it would be beneficial to improve transparency and reporting around Unaccounted for Gas under the next control. Whilst NGG and the GDNs provide some limited information at an aggregate level in the Billing Operations Forum, we believe that greater clarity would be helpful, and might provide earlier visibility of issues such as Farningham.

CHAPTER: Five – Financial Issues

One year control issues

Question 1: Is Ofgem's approach of calculating a post-tax cost of capital and an ex ante tax allowance appropriate?

Although the adoption of a post tax cost of capital is in line with the approach in other recent controls, Ofgem should consider the effects of the existing regime.

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.

Whilst we recognise that forecast tax liabilities are likely to be below the headline rate and the proposed approach would only allow for this lower rate of tax, the new approach should ideally take account of the historical tax liabilities at below the headline rate for a transitional period.

One possible option might be to correct for this historic benefit by making an appropriate adjustment to the allowances set. We see a clear parallel with the proposed treatment of pensions under TPCR, where it is proposed that previous over/under-funding be accommodated within the setting of the new control. We note that Ofgem is carrying out additional work in the area of pensions for GDPCR, and this comment is not intended to prejudge the outcome of that work. We will comment again in due course.

These same points were raised in response to the equivalent proposals under the TPCR document issued in June.

An additional point for consideration is that raised in 5.6. Whilst we agree that it may be appropriate to consider ex-post adjustments in areas which are beyond the control of the GDNs, we do not agree that this principle should include adjustments in respect of gearing levels and/or interest costs which differ from the notional level assumed in setting the price control. In our view, Ofgem should assume an efficient level of gearing and interest costs when setting the control. If the companies adopt an approach which is different from this, then we believe that is a choice made by the company (presumably for sound commercial reasons and in full awareness of their licence obligations), and special treatment should not be given.

Question 2: What, if any, financial indicators should be used to assess financeability (also relevant for the main control)?

Ofgem has correctly identified that financeability issues are much less acute in the one year control and as such, we do not see any need for specific financial indicators to be used for the one year control.

Main control issues

Question 3: Should Ofgem use its traditional approach to calculate the cost of capital or should other approaches be considered?

We are inclined to agree with Ofgem's initial view that CAPM remains an appropriate model for use in calculating the cost of capital. We believe that this is a well tested model which has been used consistently, and whilst not simple, it does have the merit of being well understood. In the circumstances, we believe that to diverge from this model without strong evidence to the contrary would be to increase the perception of regulatory risk.

As noted elsewhere, we consider that the risk faced by the GDNs is considerably less than the equity market average, and hence that the equity beta should be significantly less than 1. In the TPCR document, Ofgem noted the conservative approach taken in respect of DPCR4 and we believe that, given the continuation low interest rates and stability in other market fundamentals since DPCR4 was completed, Ofgem should take a more robust approach to the cost of capital in the GDPCR.

Whilst Ofgem has not yet proposed ranges for key assumptions under GDPCR, in our view, the ranges considered should be at the lower end of the ranges for TPCR. Ofgem has commented that it is reluctant to consider assumptions at the lower end of these ranges, as these did not represent a sustainable long term return. Whilst we can appreciate that this concern may have a foundation in the extremely high capex bids submitted by the transmission companies, we are not aware that the GDNs face the same stresses. Clearly, they have requirements in respect of the long term mains replacement programme, but these requirements are significantly less at a per company level than the transmission requirements. With this in mind, we believe that a more robust approach can be taken to these assumptions under GDPCR.

As has been noted, with some of the GDNs in independent ownership, it is likely that they will have different approaches towards gearing and finance, which whilst remaining compliant with the ringfencing provisions in the licence, lead to more efficient capital structures. It would be wrong to continue in such a conservative approach under these circumstances and the benefits of a more efficient structure should be encouraged to flow to customers at the earliest opportunity, provided only that any risk of "excessive" gearing can be managed or avoided.

Question 4: How should Ofgem approach the issue of the level of gearing to be used in the calculation of the tax allowance? Should Ofgem ensure that consumers share in any benefits arising from companies having higher actual gearing than the regulatory assumption?

In section 5.15, we note that Ofgem intends to continue to make ex-post adjustments in respect of interest where the actual gearing and interest expense exceed the levels assumed when setting the cost of capital. As already stated, we do not believe this to be appropriate.

As we have explained above, and in our response to the TPCR document, we believe that Ofgem should use an assumption of an efficient level of gearing in calculating the tax allowance. The level chosen should be robust and challenge the companies. If the companies are then able to outperform the assumption then it would be reasonable for them to retain the benefit in the usual way, but Ofgem should then take the outperformance into account when setting the next price control, using this as a benchmark for the other companies to aspire to. In this way, customers and the companies will share in the benefit.

The key to this approach is to ensure that the initial target is sufficiently challenging, and we would encourage Ofgem to ensure that this is the case for all the companies.

In respect of the overall cost of capital, we are not persuaded that the risk profile of the distribution companies is materially different from the transmission companies, the similarities between their businesses being far greater than the differences. With this in mind, we hold to our view that the equity beta used to assess these companies should be significantly less than 1.

Question 5: Are there any arguments for changing the depreciation rates used in the price control?

At present we cannot see any reason why the depreciation approach currently used in the control should be changed.

Question 6: Is Ofgem's initial view on the treatment of pensions, and in particular the treatment of the GDNs' pension deficits, appropriate?

Whilst we are not expert in pensions administration, the approach seems reasonable. We agree that it would not be appropriate for NTS connected customers to bear pensions costs associated with the GDNs.

We note that 95% of the employees of the independent GDNs have transferred to the relevant schemes run by their employers. The document does not, however, state what has happened to the remaining 5% and how those employees' pensions are to be funded. We believe it would be appropriate to provide clarity in this area.

Question 7: Is Ofgem's proposal on the mechanism for recharging NTS pension costs appropriate?

We believe that the arrangements seem complex and would benefit from simplification, but that the outcome is probably reasonable. We also believe that it would be appropriate to ensure that the approach taken is consistent with that of other regulated entities.

Question 8: What should be the timing of allowances for under recoveries from the current price control and deficit repair costs?

We believe that care will need to be taken to ensure that consumers are not effectively charged twice. If an allowance has previously been granted, but not fully utilised and this has contributed to the deficit, then we believe that portion of the deficit should be for the account of the shareholders. Careful analysis will also be needed to ensure that, where relevant, such under-recoveries or deficits are correctly apportioned between the periods pre and post DN sales. Where under-recoveries/deficits can be proved to be valid and acceptable, then we would suggest that the recovery should take place over the period of the main control to ensure a smoothing effect.

Question 9: How will the changes to pensions law affect the price control?

We are unable to assist with specific comments here, but as under question 7, we believe that it would be appropriate to ensure that any changes made are consistent with the approach applied to other regulated entities.

CHAPTER: Six – Other issues

Question 1: Are the three options for the funding of xoserve appropriate? Should we consider different options?

We do not believe that a separate price control is necessary for xoserve, and in general have been pleased with the level of performance. We are of the view that the current model is acceptable with some minor adjustments, but that there could be clear benefits to a “core services and user pays” model. This is consistent with the principles established during the DN Sales process, that the licence obligations applied to the regulated party but that these obligations may be discharged by other parties, in some cases by means of agency undertakings.

We would be happy to work with the industry to assess how best such a model might be shaped. However, we do believe that depending on the extent of any changes proposed, it would be appropriate to consider whether an Impact Assessment would be beneficial.

Given the likely time to develop such proposals, and the potential benefit from carrying out an Impact Assessment, we believe that work in this area should be initiated at an early stage to allow adequate time for evaluation. We also believe that it would be beneficial to the industry to improve the transparency of xoserve’s costs.

Finally, in this area, we believe that a key concern is to ensure that the GDNs are not incentivised to block or object to industry change, but instead to support the industry going forward.

Question 2: Should Ofgem consider the outcome of an industry dialogue as part of its assessment of the funding required to replace UK-Link?

Prior to the agreement of an allowance for the replacement of UK Link, we believe it will be important to assess allowances previously made and the use to which such allowances were put. We believe that the approach suggested by Ofgem in respect to GTMS would be equally valid here.

We are encouraged by Ofgem’s recognition of previous concerns expressed by Users in relation to system changes and welcome the suggestion of such developments being subject to a far more collaborative process with wide industry involvement, including IGTs. We would be happy to work with Ofgem and the industry in moving such a dialogue forward.

We note the point on unduly high costs in paragraph 6.9 and agree that it would be important to ensure that consumers do not bear unnecessarily high costs. In the event that proposed costings seem disproportionately high, we believe that a transparent challenge mechanism would be appropriate to ensure best value is being offered.

Question 3: Which, if any, of the 5 options for facilitating network extensions should Ofgem consider in more detail?

We support the effort Ofgem is making to try and improve access to gas for infill communities, but we believe there may be difficulties with a number of the proposals.

We agree with the point made under option 1 that the issue may be better targeting and co-ordination of the funding already available. We are also inclined to the view that such funding

should not be part of the price control, but would be better addressed as part of a government initiative.

In our opinion, options 2 & 3 both carry significant cross subsidy issues. In addition, a modest incentive such as that proposed is unlikely to generate significant additional activity on the part of the GDNs, given the likely administrative effort required.

In respect of option 4, whilst initially this may seem appealing, we would have major concerns as to how this could be managed through supplier billing systems without significant system changes if these infill sites were established on the main systems. We have similar concerns in relation to option 5, as at this stage it is difficult to see how the GDNs would actually collect the revenue.

Question 4: Should Ofgem introduce a licence condition that requires NGG NTS to recover the excess costs associated with independent systems on behalf of GDNs?

As expressed during the DN Sales process, we have concerns in respect of the current operation of the independent systems. The current determination is set out in terms of the relevant consumers paying no more than the average GB charge. We believe that this is inappropriate and that the consumers should instead pay no more than the average charge in that DN. There is no reason why this regional average charging could not co-exist with a national recovery programme if that is the final option selected.

We note the questions raised in Chapter 6 regarding Independent Systems. BGT is concerned that the different issues that relate to those networks historically referred to as Scottish Independent Networks (SINs) and those as Independent Undertakings (IUs) should not be confused.

When Ofgem agreed to the sale by National Grid of a number of DN's these issues were not fully addressed. We therefore welcome the intention that an enduring solution to continue on those Agreements which are currently in place, and have been since the inception of the Network Code, continues, and that the principles as reconfirmed by the Secretary of State in 2005 as to protection for these customers and the expectation that Network Operators would directly bear a proportion of the costs associated with operating these networks and supplying the customers connected to them should be put in place. We would therefore welcome the opportunity to discuss this matter with Ofgem and the Secretary of State.

In respect of whether a licence condition should be introduced, we are ambivalent. It may not be appropriate for NGG or any licensed party to recover all monies. However, we agree that it would not be appropriate for a GDN to receive double funding in respect of these undertakings and therefore that the issue of the RAV sculpting at GDN price control separation will need careful consideration.

CHAPTER: Seven – Timetable and Process

Question 1: What issues to be addressed as part of GDPCR should be considered in an impact assessment?

We agree that it will not be necessary to carry out an IA for all aspects of GDPCR and that carrying out an IA for important new proposals would seem to be a reasonable compromise.

However, we do believe that it will be important to quantify and publish transparently the benefits due to customers generated under this control as a direct result of DN Sales. This will be an

important foundation for the next control period, and allow a proper accounting for the benefits of the DN Sales process at a point in the future.

In addition to the items for which Ofgem considers an IA may be necessary, we believe that depending on the outcome of the Industry dialogue on UK Link, an IA may be appropriate in respect of certain aspects of the UK Link replacement proposals.