



**CHEMICAL INDUSTRIES**  
ASSOCIATION

29 August 2006

GDPCR Responses  
Ofgem  
9 Millbank  
London SW1P 3GE

Kings Buildings  
Smith Square  
London SW1P 3JJ

Telephone: 020 7834 3399  
Fax: 020 7834 4469

Direct phone: 020 7963 6718

Direct fax: 020 7834 8587

e-mail: [brayh@cia.org.uk](mailto:brayh@cia.org.uk)

[www.cia.org.uk](http://www.cia.org.uk)

**Gas Distribution Price Control: Second Consultation Document**

Dear Joanna,

The CIA welcomes the opportunity to comment on the Gas Distribution Price Control. We note that the Gas Distribution Networks (GDNs) have spent considerably more than was anticipated in the last price control review. We have concerns that our members will be exposed to increase costs due to pensions and shrinkage and ask Ofgem to also look closely at these areas and other areas of significant overspend, for example, connections and replacement work. We are concerned that our members will not see any benefits from the Gas Distribution Network sales and ask Ofgem to ensure that they scrutinise the information received.

Kind regards,

Helen Bray

**CHAPTER: Two**

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

CIA agrees that it seems sensible to avoid making changes to the underlying regulatory framework.

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

As the GDNs have mentioned a volume driver is weather dependent and this may not always be the best way forward. We look forward to reviewing Ofgem's initial view in June 2007.

**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 note that Ofgem will be reviewing all existing and proposed excluded services and pass through costs to consider their future treatment, and will propose a set of principles for determining how a given activity should be treated. We have no further comments to add at this time.

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

We agree with Ofgem that it is more appropriate to link allowed revenues to RPI rather than the construction price index, but in the future Ofgem should look at other indices.

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

The CIA believes that it is difficult because if you can't always predict all the issues that could be associated with a possible reopener. We believe that the current processes in place are adequate and that a generic mechanism for dealing with uncertainty dampens GDNs' incentives to manage costs and forecast accurately.



CIA members are committed to Responsible Care

## **CHAPTER 3: 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?**

Ofgem's approach seems to be appropriate in that they are concentrating their resources on understanding the areas where there have been significant overspend such as connections and replacement work.

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

It is a complex area and we welcome the fact that Ofgem wish to make it more transparent. We agree with Ofgem's regulatory treatment of expenditure which in effect introduces a capex roller through Pot 2.

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

The methodology appears to be appropriate but we await further information in Ofgem's initial proposals for capex and repex allowances in September.

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

The CIA is not sure which is the best option for setting opex allowance for 2007/08 and await Ofgem's initial view on opex allowances in the one year control initial proposals document.

### **Main control issues**

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

We note that there will only be one year of data and so Ofgem cannot be solely reliant on this source of information. We welcome the fact that Ofgem will be carrying out more detailed work such as assessments of planning processes and bottom-up modeling of allowances.

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

We welcome the fact that Ofgem will be able to use comparative analysis for the main price control to assess GDNs' costs including top-down benchmarking and unit costs.

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

The CIA agrees that it is preferable to specify fixed allowances once the magnitude of costs becomes known so that distributors are incentivised to reduce costs.

#### **Question 8: What are your view's on our principles for assessing GTMS replacement costs, SOMSA exit and ongoing system operation costs?**

We agree that the costs of establishing separate control centres could be considered to be a loss of economies of scale, and would not wish consumers to pay for the purchase of land, buildings or operational costs. We agree that the total allowance for system operation costs across all GDNs should not be allowed to exceed the costs incurred by NGG in the year preceding the sale for the same activity.

## **CHAPTER 4**

### **One year control issues**

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

It seems sensible to ensure that there are no perverse incentives and that main replacement is appropriately incentivised.

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

The CIA believes that it is appropriate for the one year control.

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

The costs of shrinkage gas form part of the main operating expenditure allowance, which gives GDNs a strong incentive to reduce costs by reducing shrinkage volumes. CIA believes that GDNs should be able to hedge their

price risk, and we agree with Ofgem that there should not be a reopening of the existing price control arrangements. The GDNs purchased their networks as on the basis that prices risk would lie with the GDNs until March 2007. Any changes to this will result in increased costs to consumers who are already being hit by high and volatile gas prices.

**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?**

The CIA does not believe that any further work should be carried out 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?**

This area is very complex and the work being undertaken in gas distribution network interruption and the enduring offtake working group shows how much extra complexity the proposed market arrangements could represent going forward. CIA believe that the GDNs use network planning models to ensure they meet their 1 in 20 planning standard, and it would be up to the GDNs to decide the most efficient way to meet the standard. We are unsure at this time what would be the best way to ensure that GDNs invest appropriately in their networks, but we suggest they have the overall appropriate incentive from their 1 in 20 planning standard and would question whether complex incentives are required.

**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?**

CIA believes that it may be appropriate to adopt a rolling incentive with annual reviews to move away from perverse timing incentives with to discourage from over-forecasting. We note that with respect to the information quality incentive mechanisms for capital expenditure that Ofgem is waiting until the size of the gap between the GDNs' forecasts and Ofgem's views is published before taking a final decision on this.

**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?**

It seems sensible to ensure that there are no perverse incentives and that main replacement is appropriately incentivised.

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

CIA notes Ofgem statements that they will review the ways in which incentives might be applied in GDPCR when they have some detailed operating expenditure data for the main control in October 2006, and when a decision can be taken on how much Ofgem are able to use benchmarking analysis in setting allowances. When this information is available then CIA will be able to comment on whether it is appropriate or not to adopt rolling incentives for operating expenditure.

**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?**

We agree that a simpler and more integrated quality of service and outputs framework may be beneficial for Ofgem, GDNs and consumers in understanding performance. We are interested in exploring options 2 and 3 with our members and look forward to providing feedback. The biggest priority is to ensure that there are no disruptions to supply.

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

The CIA agree that it would be good to look at output as opposed to just spend, however, it could be difficult to set outputs in the appropriate manner and we welcome discussion on this issue in the future. However, we would want to avoid a situation where Ofgem is effectively managing the output from the GDNs as this could create extra workload.

**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?**

As stated in question 9, CIA biggest concern is interruption to supply.

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

CIA does not believe that this is an issue at the moment.

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

CIA does not believe we wish to consider any other form of incentive mechanism in the context of the GDPCR.

**CHAPTER 5: 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?**

CIA agrees that Ofgem's approach is correct and should incentivise GDNs to reduce their tax bills.

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

We believe 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.

**Main control issues**

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

It seems fair to use the traditional approach.

**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?**

The CIA believes that Ofgem should ensure that consumers share in any benefits arising from companies having higher actual gearing than the regulatory assumption, and we ask Ofgem to work with the GDNs regarding the actual level of gearing used.

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

The CIA believes that the approach to depreciation is simple and transparent, and consistent with the average asset lives of actual expenditure, and we agree with Ofgem that there is no requirement to review the way RAV is calculated at present.

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

CIA's members believe that it is inappropriate for the price control to allow for recovery of pension fund deficits in the manner described. In the private sector (and many of the customers of GDNs are private sector companies or employees of private sector companies) there is no automatic right to funds to repay deficits. Private companies may be forced to take cash out of profits and the same should apply to GDNs. In other words GDNs should not be given an allowance for any pension deficit but should use part of their declared profits to pay for deficits. Alternatively members of their pension funds will be forced to accept reduced benefits as happens from time to time in the private sector.

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

Please see our response to Question 6.

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

The CIA has no comments to make at this time.

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

The CIA has no comments to make at this time.

**CHAPTER 6: Other Issues**

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

We agree that industry dialogue should be promoted about xoserve's costs and the nature of the UK-link upgrade.

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

Yes, it is important that GTs and users reach an agreed position on the nature of the UK-link rewrite and understand which services are core and which should be subject to user pays.

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

The CIA has no comment to make regarding facilitating network extensions.

**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?**

CIA notes that Determinations issued by the Secretary of State, consumers connected to independent systems pay no more than the average GB charge, and we note that GDNs that have independent system are already partially funded for the costs associated with the independent systems. We await further information from Ofgem in the GDPCR consultation process.

**CHAPTER: Seven**

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

The issues list in paragraph 7.5, could include pensions as well.