

GDPCR Responses
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE



29 August 2006

Dear Sir

Gas Distribution Price Control Review: Second consultation document

We are pleased to respond to Ofgem's July 2006 consultation paper. I can confirm that this response can be placed on Ofgem's website.

Our answers to Ofgem's specific questions, where we have views, are set out in the attachment to this letter.

Our key area of concern relates to the cost of capital for Gas Distribution Networks (GDNs). The current proposals will draw heavily on the work undertaken for the Transmission Price Control Review (TPCR). We have a number of fundamental concerns with the TPCR initial proposals in this area. In our view, the current estimate is insupportably low and is in need of further development. We therefore support the additional work which Ofgem has said it will carry out with the assistance of its consultants.

We would also be extremely concerned if Ofgem waited until the final proposals to publish its definitive view on the GDN cost of capital. We do not believe that such an approach is appropriate for something so fundamental to the UK's networks businesses: nor do we believe that it is consistent with the principles of better regulation (in particular, those relating to accountability, consistency and transparency).

We have asked NERA to examine and comment on Ofgem's view of the TPCR cost of capital. They have produced two papers, which we endorse. They are:

1. A Review of Ofgem's Initial Proposal for TPCR
2. DGM Cost of Equity Estimates for UK Transmission Companies

We believe that these papers are also relevant to the GDPCR and they are therefore attached to this submission for consideration.

If you have any further queries please do not hesitate to contact me.

Yours sincerely

Roger Barnard

Head of Regulatory Law

Attachment

High level framework of the price controls

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

Yes, subject to resolving the shrinkage issue

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

Across the range of infrastructure industries significant investment is planned for the next five years. This coupled with large one off projects e.g. the Olympics will increase cost pressures in the construction industry generally and in some circumstances have a disproportionate effect on a regional basis. The scale of these increases is unlikely to be reflected wholly within the RPI index. We believe there would be merit in Ofgem indexing certain elements of the GDN cost base by a more appropriate factor such as a construction output index. Such an approach would minimise the risk on both customers and the companies of Ofgem incorrectly forecasting the impacts of the relative price effects across a price control period.

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

Yes, we believe that issues such as the Traffic Management Act should be subject to a specific reopener.

High level framework of the price controls – one year control

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

In general, we believe that the proposed approach is appropriate, as Ofgem is proposing to use a range of techniques to assess efficiency rather than relying on a single approach. We would, however, expect the companies to have access to detailed information underpinning the range of analyses undertaken. This is vital so that the companies can engage effectively with both Ofgem and its consultants in areas where there is a difference of opinion.

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

The proposed model for the treatment of efficiency conclusions raises a number of issues. Firstly, while the proposed approach is clearly described, we are concerned that the GDNs have only seen its details now but that it will nevertheless be used to assess historic efficiency. It would have been more transparent if the rules had been determined at the start of the period rather than at the end.

Secondly, it is vital that companies are allowed sufficient time to review the decisions underpinning Ofgem's conclusion to place expenditure into one of the four relevant categories, and particularly any expenditure which Ofgem intends to disallow. We would expect Ofgem to make this information available to the companies, as soon as practicable, and believe that this will aid the transparency of the process.

We are also concerned that the proposed approach requires the company to bear the risk of Ofgem (or its consultants) under-forecasting unit costs. This would appear to be a particular issue with respect to overspends. In Ofgem's stylised example the efficient unit cost was originally deemed to be £200. However, the ex-post analysis determined that the efficient unit cost was £300. In the analysis the company would

be required to bear capital costs of this apparent overspend of £100 per unit even on work which was deemed to be efficient. This cannot be right.

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

Yes, at a high level. However, it is difficult to judge without understanding the detail of the consultant's processes.

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

We believe that Ofgem must be pragmatic and favour the rolling forward to current allowances, with a suitable efficiency assumption. We believe significant resource will be required to normalise the operating cost data to set allowances for the main control and that Ofgem should focus on this rather on trying to analyse whether 2004/05 and 2005/06 are atypical years.

High level framework of the price controls – main control

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

Yes, at a high level. However, it is difficult to judge without understanding the detail of the consultant's processes.

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

In general, we believe that the proposed approach is appropriate, as Ofgem is proposing to use a range of techniques to assess efficiency rather than relying on a single approach. We would, however, expect the companies to have access to detailed information underpinning the range of analyses undertaken. This is vital so that the companies can engage effectively with both Ofgem and its consultants in areas where there is a difference of opinion.

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

We support the proposed approach as detailed in para 3.48, i.e. if the costs can be quantified then these should be included within the allowance and if they cannot be quantified then a specific reopener condition should be included within the price control.

Outputs and incentives – 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?

Conceptually, option 2 may be the most suitable for determining shrinkage allowances. In our opinion, the significant risk associated with gas price volatility is incompatible with the low risk nature of a networks business. However, we would prefer a longer lead time for a change of this nature.

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?

We believe that the application of separate incentives with caps, collars and sharing factors would be the most appropriate form of incentive in relation to the interruption and NTS offtake incentives, to ensure the efficient and economic

procurement of GDN interruption and NTS offtake volumes. We believe that as the GDNs will be price takers in both of these schemes, it would be appropriate to apply a volume and price incentive to ensure adequate volumes of capacity are contracted for at least cost.

Outputs and incentives – main 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 believe that the application of a rolling incentive mechanism is appropriate, as it deals with the issue of periodicity. However, we do not believe that the introduction of a “strong” roller would remove the requirement for Ofgem to undertake an in depth assessment of the company’s historical capex. Such analysis will be required to place the capital expenditure into one of the proposed efficiency “pots” so that the inputs to the rolling mechanism can be determined.

The introduction of an information quality incentive is more problematic. As Ofgem recognises the key to such an incentive is the scale of the difference between Ofgem’s view of the required capex and the company’s. In order for the process not to become a lottery it is essential that Ofgem’s consultant’s process is both transparent and robust and that each company has access to the information relevant to it i.e. the assumptions used by the consultants in deriving their forecasts. The companies will only be able to make an appropriate and efficient choice if they understand how the consultant’s overall capex forecast has been derived.

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

Ofgem should only introduce a rolling incentive mechanism for opex when it can be demonstrated that operating expenditure is being reported on a truly consistent basis across all GDNs.

Financial issues – one year control

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

Yes, the move to using a post tax cost of capital and an ex ante tax allowance, across all regulated network companies, is appropriate. However, this does not mean that the actual cost of capital will be common across all network companies, as the individual circumstances of each industry sector may differ considerably.

We do, however, have significant concerns with the initial proposals on the appropriate cost of capital developed for the TPCR. We have included two reports by NERA reviewing the approach to calculating the cost of capital set out in the TPCR initial proposals. We support all the points raised in these papers and, in particular, there are a number of key areas that we would like to bring to your attention, as we believe that they are relevant to the GDPCR. They are:

- Risk Free Rate: It is vital to ensure that the time series data chosen is free from significant bias. In the TPCR initial proposals the choice of a ten year historical average of UK ILG (Index Linked Gilt) yields introduces bias into the data series due to the introduction of the Minimum Funding Requirement for pension schemes from 1997, and the more recent introduction of the Pension Protection Fund and FRS17 (which have further encouraged funds to hold gilts). For these reasons, the UK ILGs no longer serve as a robust measure for

estimating the risk-free rate. NERA has identified that Eurozone index-linked government bonds suggest a risk-free rate in the region of 2.5%.

- Beta estimate: Ofgem must set out its methodology for calculating its beta estimates.
- Equity Risk Premium (ERP): Ofgem must set out its methodology for deriving the ERP. Even though NERA concludes that an estimate of 5.2% is supportable, Ofgem should publish its analysis.

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

We believe Ofgem should use financial indicators which allow it to assess if its proposals result in the company being able to maintain its credit rating "comfortably" within investment grade. We believe that the indicators, and associated ratios, utilised at the last DPCR, are appropriate and that Ofgem should continue to use them unless it has quantifiable evidence that any of them is no longer substantially correct.

Financial issues – main control

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

We believe that Ofgem should calculate the cost of capital using both the Capital Asset Pricing Model (CAPM) and the Dividend Growth Model (DGM). We believe that this would be consistent with Ofgem's proposed approach for efficiency assessment, where it is not relying on a single methodology. The second paper from NERA details the principles for calculating a DGM estimate for the cost of capital.

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

We expect that changes to pension law will impose further statutory provisions on GDNs e.g. the Pension Protection Fund (PPF) levy. We agree that it is appropriate that these costs are funded through the price control and, where appropriate, passed directly through to customers.

Other issues

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

We believe that the "Do nothing except promote dialogue" option does not in fact represent an alternative to the "Do nothing" option as we understand that under both options transporters would continue to be responsible for the funding of Xoserve. In principle, we support the implementation of Option 3 – core services plus user pays – but would require further clarity as to what the "core services" are and what additional services Xoserve would offer.

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

We believe that it is essential that an industry dialogue should be facilitated when assessing the UK-Link re-write to ensure that a solution acceptable to the industry is implemented. There may also be some value in establishing whether the UK-Link re-write could be coordinated with the Elexon system replacement to capture economies of scale and provide a coordinated electricity and gas market interface.

EDF Energy
29 August 2006

