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Gas Distribution Price Control Review – Second Consultation Document July 2006

Dear Joanna,

We welcome the opportunity to comment on Ofgem's Second Consultation on the Distribution Price Control Review Initial Proposals consultation. This response reflects the views of RWE npower and the UK based business of RWE Trading GmbH.

General Comments

This second consultation document sets out Ofgem's overall approach to addressing a number of key issues, together with a number of options. Some of these options give Ofgem a significant oversight role, such as in approving investment and we would be concerned at excessive micro-management of the Gas Distribution Network's (GDN) businesses. We do, however, fully support initiatives that ensure that the direct and indirect costs of GDN sales are ring-fenced and agree that the establishment of a reporting framework to collect comparator information is an important priority.

One-year control

We support taking a minimum-change approach for the treatment of the one-year control. The form, structure and scope of the current control should be retained, and our preference would be that the existing shrinkage arrangements in the price control should not be reopened. More fundamentally, reopening the price control may adversely affect the interaction between mains replacement and shrinkage and this is inappropriate for the one-year control. If Ofgem believes that there is a case for reforming shrinkage then Option 1b creates greater incentives on the GDNs to procure shrinkage gas competitively. We see no reason to change the basis of shrinkage measurement at this time.

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We broadly agree with proposals for carrying out the ex-post assessment of historical efficiency and for setting the capital and replacement expenditure allowances for 2007/08. For the operating expenditure allowance, we still believe that Option 1 remains appropriate. This option addresses potential concerns that atypical expenditure patterns over the 2004 - 2006 period would be rolled forward.

Finally, we would welcome greater clarity on Ofgem's proposals to update incentive mechanisms for 2007/08, although we have generally supported the application of rolling incentives. In particular we would like to understand further why Ofgem believe there is a need to introduce incentives for the one year control in line with the new arrangements for the purchase of NTS offtake capacity and what form these might take.

Five-year control

Form, structure and scope

We agree that it is appropriate to review the 35% volume revenue driver although this needs to be done in conjunction with a review of the structure of gas distribution charges. It is possible that changing this revenue driver could be a simple and more transparent way of achieving greater cost reflectivity in transportation charges than adjusting the current capacity/commodity.

Although we accept that there may be some services remunerated outside the scope of the main price control, we would be concerned if services such as the SOMSA were treated as being excluded or pass through and the network operators were able to earn excessive revenue. Ofgem also need to ensure that intra-business services are correctly dealt with, particularly for those network owners that can avail of shared services.

As the consultation on one-off gas connections not yet been published, it is difficult to comment whether this should be a revenue driver or form part of the main price control revenue. The proposal to establish a set of principles setting out how given activities should be treated is welcomed as it will add clarity for all parties.

Shrinkage arrangements developed for the one-year control should be applied in the main control and measurement of shrinkage should remain as is. Throughout the period of the main price control we would support consideration and development of proposals to fundamentally reform the gas settlements/reconciliation process, such that more radical changes to shrinkage and shrinkage measurement could be seriously considered from 2013 onwards.

We see no strong case to move away from the RPI as the reference index. The RPI is well understood and well established and an alternative may not necessarily be more reflective of actual costs over the price control period.

Price controls that adjust automatically rather than being set in the expectation that they will be reopened offer greater stability, which benefits the asset owners, users and customers. However, if the Traffic Management Act was a re-opener for DNPCR it seems appropriate for it to be a re-opener in GDPCR, rather than trying to build assumptions into the price control that might be inaccurate.

Cost assessment

At the time of DN sales, the main area of potential benefits to customers was expected to be delivered through comparative regulation, based upon better information on the efficient level of operating expenditure for a GDN. For the 2008 - 2013 price control Ofgem has proposed a wide-ranging analysis using a number of techniques. The outputs from these analyses will act as

a surrogate for the comparator data as there will be insufficient comparator data for this price control. This is a reasonable approach and although we urge Ofgem to capture the sale benefits as early as possible, we accept that the bulk of the expected benefits will accrue in subsequent price control periods.

Turning to the assessment of capital and replacement expenditure allowances, we agree with Ofgem's general approach and await further details once the BPQ returns have been received. Clearly, an additional unknown faced by the GDNs is that until the commercial arrangements for securing NTS offtake capacity and reforms to GDN interruption have been finalised, they will have difficulty in providing accurate capital expenditure forecasts that reflect the trade-off between local investment, interruption and securing NTS offtake capacity.

We have already commented that, to the extent that the magnitude of costs associated with the Traffic Management Act are known, then our preference is that these are reflected in the price control allowance. If they are still unknown, then a price re-opener is appropriate. We are pleased that Ofgem has reaffirmed its commitment to the principle that costs associated with the DN sales are excluded from the price control.

Maintaining this rigorous approach is especially relevant in the area of systems costs and restating the principles will help the GDNs establish whether it preferable to develop their own area control capability or retain the SOMSA. Looking forward, we also need to ensure any DN system costs for managing NTS Flow Flexibility requirements as part of the enduring offtake regime are excluded from the price control.

Finally, we endorse Ofgem's establishing a detailed cost-reporting framework. It is important to address information asymmetry between Ofgem and the GDNs as well as to providing a mechanism to collect comparator information. We agree that a prescriptive approach should deliver more consistent responses and remove ambiguity, which will facilitate more informative comparisons between the GDNs.

Outputs and incentives

It is important that any refinements to the incentives do deliver incentives that are coordinated. If the incentives are poorly designed or incorrectly specified then the GDNs will have the potential opportunity to arbitrage between them, leading to sub-optimal decisions for customers. This is particularly relevant in relation to investment as, under the new price control, investment decisions will increasingly be based on a trade-off between investment in local capacity, contracting for interruption on the GDN and procuring NTS offtake capacity. As the NTS offtake arrangements and reforms of GDN interruption are still under development, it is difficult to assess their interaction, although there will probably be a requirement to introduce incentive schemes. The precise details of the schemes can only be finalised once the arrangements themselves have been defined fully.

We have supported the principle of using rolling incentives as a mechanism to address concerns about periodicity effects on capital expenditure under standard five-year price controls. They should be considered for the GDPCR, provided that their application does not cause distortions in relation to operating expenditure incentives. An Information Quality Incentive may have some merit but it may be too soon to expect the new GDN owners to have sufficient understanding to make an informed choice between the high-powered and low-powered incentive schemes.

We will await Ofgem's November document before we comment on the options for the mains replacement incentive scheme, but the retention of the 50:50 split between capital and operating expenditure seems appropriate.

Ofgem correctly identifies that the cost saving incentives delivered via RPI-X need to be in part counter-balanced by a range of quality of service outputs and incentives. We agree that there is a need to review these outputs and incentives and in particular to consider whether the exclusions from the current compensation arrangements remain appropriate. Of the options presented, Option 3 may have merits but could get very complicated and would need shipper input into defining performance measures.

We share Ofgem's concerns over inaccurate pipeline data and although we did not support introducing a Designated Registrar of Pipes agree that improved performance is needed, although how this could be incentivised is unclear. There may also be a case for introducing an incentive on the GDNs to train greater numbers of gas engineers and installers, although again it is immediately obvious how one could be implemented in practice.

One area of GDN operation that may benefit from more investment in technical innovation could be network isolation or voluntary self discontinuance bearing in mind the increased focus on security of gas supplies in future. Whether this is worthy of an Innovation Funding Incentive however, is not possible for us to determine.

Other issues

The creation of xoserve to act as a single interface between shippers and GDNs was a vital step in avoiding fragmentation of core shipper/supplier registration and billing systems at the time of DN sales. Although Ofgem is considering a range of funding options for xoserve we do not wish to see radical change in the operating or funding arrangements of xoserve during the term of the next main price control. We do not think the principle of user pays should be applied to all or part of xoserve funding, and we favour retaining the existing funding arrangements. However, we do believe there are improvements that could be made to the agency role and to UK Link governance arrangements, which would ensure shippers/suppliers have more direct input into the work undertaken by the agency and any system developments carried out on registration and billing systems.

Whilst we welcome the proposal that Ofgem consider the outcome of an industry dialogue as part of its assessment of the funding required to replace UK-Link, we are disappointed that some of the proposals we suggested in our previous response seem to have been discounted. We are also concerned that there already seems to be an assumption that users will have to pay directly towards any UK-Link re-write involving existing services which are considered as non core. We also still believe that there is merit in extending the agency role to cover registration (and possibly billing) of IGT customers and would like to understand how this could be funded.

We hope these views are helpful and if you wish to discuss them further please contact Steve Rose on 01793 892068 or myself on 01793 893983.

Yours sincerely,

Charles Ruffell
Economic Regulation