

Joanna Whittington
Director, Gas Distribution
Ofgem
9 Millbank
London
SW1P 3GE



23 October 2006

Dear Joanna

Gas Distribution Price Control: One Year Control Initial Proposals

EDF Energy welcomes the opportunity to respond to Ofgem's initial proposals for the one year extension to the gas distribution price control. I can confirm that this response can be published on Ofgem's website.

We are concerned with three particular areas of the proposals. They are:

- The assessment of historical capital efficiency
- The proposed cost of capital for the one year control; and
- The treatment of shrinkage costs

We note with concern that Ofgem are proposing to disallow approximately £38m of capex due to poor management practice, and in particular the lack of unit cost monitoring. We are concerned because, in taking this line, Ofgem appears to be asserting that since there was insufficient information to monitor productivity, inefficiency must have arisen. We do not regard this as an appropriate development since it suggests a 'guilty until proven innocent' approach has been adopted. For example, by extension, such an approach would suggest that efficient expenditure can be disallowed merely because a company has a different view from that of Ofgem or its consultants about the information required to monitor efficiency. The onus is on the regulator to demonstrate inefficiency rather than just hypothecate its existence.

We do not support the simple rolling forward of the cost of capital. We are concerned that a key justification for this approach is that the calculated value of 4.38% post tax is broadly in line with the transmission price control modelling value of 4.2%. We believe that this is inappropriate. Ofgem, in the Transmission Price Control Review (TPCR) updated proposals, indicated that this value was for modelling purposes and that a number of factors, including the investment focus of the review, financeability and consistency with past regulatory decisions would be considered in determining the final figure.

We believe that the issue of regulatory consistency is particularly relevant. In December 2004, Ofgem determined that 4.8% was an appropriate cost of capital for electricity distribution companies. The proposed level for the gas distributors implies a significant cut compared to the DPCR4 outcome. Such a conclusion will be seen as a precedent for the full distribution price control and, in our view, be

highly damaging to a sector where investors will be asked for many price control periods to come to fund the extension to and replacement of ageing infrastructures.

In addition, in the July consultation Ofgem stated that the gas distribution cost of capital would be informed by the TPCR but that they would also analyse whether there are differences in the risks to which the different companies they regulate are exposed to hence leading to a different cost of capital for those companies. There is no evidence that such analysis has been undertaken. Until such analysis is undertaken it is inappropriate to simply use the TPCR modelling value for cost of capital as a guide to determining the correct cost of capital for gas distributors.

With respect to the treatment of shrinkage costs, we believe that option 1a (base allowances on a pre-defined index of market prices) is the most appropriate option. However, the proposed approach could be further refined if instead of basing it on an index of flow weighted forward prices it was based on a index related target which is pegged against outturn prices on the day. Under such an approach the gas distributors can buy up to 12 months ahead of the day of delivery on any index (quarterly/monthly, Day ahead). We believe that this approach would reduce the volatility that the gas distributors are exposed to and also mitigate the risk of them inappropriately influencing gas prices on the day.

Option 1b (comparative GDN benchmarking) would only be attractive if each company was incentivised to minimise purchase prices since otherwise there would be no reason to expect efficient purchasing, even by the best performing company.

Incentives could be included in either option by allowing the GDN to retain the benefit of achieving prices below the index (1a) or below the benchmark (1b) – possibly with caps and collars. Such an approach would limit the purchase price risks that the GDN would be exposed to, but retain incentives for efficient purchasing. Similar arrangements have already worked well in electricity SO incentives.

I hope you will find our comments helpful.

Yours sincerely,

A handwritten signature in black ink, appearing to read "D. Linford".

Denis Linford
Director of Regulation