

---

## **Gas Distribution Price Control Review**

### **One Year Control Initial Proposals**

A response by Centrica

---

Author: A. Russell  
Version Number: 1.0  
Status: Final issued  
Date Issued: 01 November 2006

## INTRODUCTION

Centrica welcomes the opportunity to respond to this consultation document and is content that this non-confidential response should be placed on the Ofgem website and in the Ofgem library.

The Gas Distribution Price Control Review (GDPCR) is very important to Centrica and other shippers and suppliers. However, unlike most other large domestic suppliers, Centrica does not hold any interest in distribution assets (either gas or electricity). Accordingly, at a group level, Centrica is more exposed to any adverse financial consequences of the GDPCR.

In addition, the GDPCR will have a material impact on consumers who will ultimately have to bear the cost of the proposed increase. In the context of retail pricing, that increase will be an important factor to be weighed against any sustained decrease in wholesale gas costs.

We are able to support Ofgem's approach on some of the key issues, but in other areas we have serious concerns about the proposals.

In our previous responses, we identified a key risk, namely that a piecemeal approach to the one year control would result in an asymmetric distribution of costs and benefits between customers and transporters. Unfortunately, we believe that the effect of these proposals is to do precisely that. The initial proposals, taken in the round, will provide significant benefits to the transporters with no commensurate compensation to customers. As such, we are unable to support the proposed one year GDPCR package as it stands.

The initial proposals are overly generous to the transporters in a number of areas, as detailed further below. Indeed, our view is that the figures cited in the initial proposals understate the magnitude of the increase in particular allowances, for matters such as pensions. Moreover, the presentation of those proposals (e.g. as an increase of £9 per customer) also under-represents the actual increase in allowed revenue. We have included our calculations in the table below, which converts from constant 2005/6 prices into nominal terms (money-of-the-day).

Description	Allowed revenue £m	Increase %
<b>From Initial Proposals for 2007/8</b>		
2006/07 price control revenue (2005/6 prices)	2,087	
<b>Inflation to 06/07 @ 2.5% for 1 year ie what was collected</b>	<b>2,139</b>	
2007/08 indicative price control revenue (2005/6 prices)	2,289	9.7%
<b>Inflation to 07/08 @ 2.5% for each of 2 years</b>	<b>2,405</b>	<b>12.4%</b>
<b>Actual change in 2007/8 prices</b>	<b>265</b>	
<b>Assuming 21 million customers, this equates to</b>	<b>£13 per customer</b>	
<b>In the last yr of the current control, actual chgs were higher than forecast</b>		
GDN Forecast 2006/7, £1.9bn usually quoted (2005/6 prices)*	1,895	
<b>GDN Forecast 2006/7, £1.9bn usually quoted (2006/7 prices)</b>	<b>1,942</b>	
2006/07 price control revenue (2005/6 prices)	2,087	
<b>Inflation to 06/07 @ 2.5% for 1 year ie what was collected</b>	<b>2,139</b>	
Actual change in 2006/7 prices	197	10.1%
<b>Assuming 21 million customers, this equates to</b>	<b>£9 per customer</b>	
<b>Assuming 21 million customers, over 2 years this =</b>	<b>£22 per customer</b>	
* as per the previous GDPCR document		

Thus the total cost increase versus the allowed revenue for 2006/7, in nominal terms, is as much as £22 for the average customer.

Since the last full gas price control review for the period 2002-7, the gas distribution sector has undergone significant change. In particular, the sector has seen separation of the price controls and the subsequent sale of four distribution networks. Both these changes were justified on the basis that they would yield material benefits for consumers. A total price increase to customers of almost 24% in money of the day terms is inconsistent with that commitment to benefit consumers.

Given the major change in the structure of gas distribution, which is now more akin to the electricity sector in terms of structural ownership, we believe that it is essential that Ofgem recognises understandable concerns with respect to the interests of non distribution affiliated suppliers.

We believe it is necessary to demonstrate, with great rigour, that all ring fencing (and related) conditions in the gas distribution licences are fully observed, ensuring that no inappropriate cross subsidy exists from the distribution businesses into the supply businesses. In common with electricity, we believe that the price control review process is an appropriate time to challenge the application within the distribution businesses to ensure that no unfair competitive advantage accrues to distribution related businesses at the expense of non-affiliated suppliers.

Accordingly, there is no basis for providing any further accommodation or concession to the GDNs in the final proposals. Any such concessions would place an even greater cost burden on suppliers and shippers and, ultimately, on end consumers. Indeed, wherever possible, Ofgem should pursue further reductions in the areas of operating efficiencies, treatment of overspends and pensions, as well as reconsidering the cost of capital.

Centrica has a number of concerns about specific features of Ofgem's initial proposals. Those concerns are set out in Sections 1 and 2 below. Section 1 sets out Centrica's position regarding a number of key issues, namely cost of capital, the proposed treatment of the overspends from the previous price control period, the proposed increase in allowed revenue and procedural issues. Section 2 sets out Centrica's response to the specific questions posed by Ofgem in the consultation document.

## SECTION 1: CENTRICA'S POSITION ON KEY ISSUES

### 1. Cost of Capital

We have already set out our view that Ofgem should either take a simple roll forward approach to the one year control or undertake a full review. We have opposed and continue to oppose a "partial" review on the ground that customers would be more likely to be unfairly disadvantaged by such an approach.

If Ofgem ultimately decides not to take the simple roll forward approach (as these initial proposals appear to indicate), our view is that Ofgem must also review and reduce the cost of capital. Such a review is essential in order to ensure that an equitable position for customers is maintained. If one takes the view that other cost assumptions underlying the 2006/7 allowed revenue are outdated and inappropriate as a basis for setting the 2007/8 control, then it is only logical to recognise that a cost of capital figure derived more than 5 years ago is also outdated and inappropriate for this purpose.

The initial proposals for the one year control assume a cost of capital of 4.38% on a post-tax real basis. This figure was established for the 2002-7 control and is well above the figure warranted by current market conditions. Ofgem has already proposed an indicative figure of 4.2% post tax real cost of capital in the TPCR. Our view is that even this figure substantially over-states the true cost of capital, since it is based on an equity  $\beta$  significantly higher than that considered appropriate by Ofgem's own advisers, Smithers and Co. The Smithers report, dated 1/9/2006 has a central estimate of around 0.6 for National Grid and concludes that the  $\beta$  lies in a 0.5-0.8 range with 95% probability. Accordingly, as matters stand, the cost of capital for the one year control should be adjusted downwards from the 4.38 % figure currently assumed. To maintain that outdated cost of capital would overcompensate the GDNs at the expense of shippers and, ultimately, consumers.

Further comments regarding the cost of capital for the one year control are set out in Section 2 below, in the answers to specific consultation questions. We would also ask Ofgem to have regard to our comments and submissions on cost of capital under the TPCR, which set out in more detail the strong evidence that even the 4.2% figure is substantially too high.

### 2. Overspends

The GDNs have overspent their previous capex and repex allowances by approximately £843m. The scale of these overspends is extremely significant and goes well beyond a level which could be incurred in a non-monopoly enterprise without a material adverse effect on financial performance.

It is a clearly a cause for concern for customers when regulated service providers such as the GDNs exceed their allowances by 65% over a five year period and then assume that full and immediate recovery will simply be allowed. Such conduct is unacceptable if it exposes customers to unforeseen increases in distribution charges. We therefore broadly support the approach that Ofgem has taken on this issue, namely to allow the transporters no more than 1% of the allowed revenue (we estimate c. £21m in 2005/6 money) in respect of the overspends issue in 2007/8 – but note that the proposed treatment is still likely to lead to a real increase of about 5% in annual gas distribution charges, once all the lagged effects have worked their way through in a number of years' time. The effect of this on customers' bills should not be ignored.

The position of the GDNs is not (as they claim) assisted by the 16<sup>th</sup> March 2004 open letter from Andrew Walker of Ofgem. The GDNs have relied on that letter in support of their claims for

additional full recovery. In our view, this letter in fact supports Ofgem's position, as it makes clear that overspends will only be granted full recovery in certain limited circumstances - for example, where such overspends are clearly required in respect of security of supply or a new government requirement not anticipated in the PCR. Accordingly, the letter clearly sets forth the high standard against which the overspends should be assessed.

We welcome Ofgem's confirmation in the document that detailed analysis in this area has been undertaken, and the subsequent proposals that a proportion of these costs should be borne by shareholders. We would strongly urge that Ofgem should not relax this stance in any way between now and the final proposals. We would also suggest that the full analysis by Ofgem's consultants should be placed into the public domain.

### 3. Proposed Increase in Allowed Revenue

We believe that the scale of the proposed increase in allowed revenue for 2007/8 is a matter for serious concern when the industry is under great pressure to reduce costs to customers.

We have supplied a copy of our calculations in our introductory section above. We note that Ofgem calculates a real increase of 9.7% in allowed revenue, which we estimate is equivalent to 12.4% in nominal terms, as compared with 2006/7 (nominal). However, we believe that it is also important to recognise that the 2006/7 starting point has moved relative to previous industry expectations. The previous allowed revenue was estimated to be around £1.9bn (in 2005/6 prices) for the year 2006/7, whereas the starting point for 2007/8 is now given as £2.087bn.

Hence, the total increase is from £1,942m (in current 2006/7 prices) to just over £2.4bn (in 2007/8 prices, using 2.5% inflation). This increase is actually nearer to a figure of 24% in money of the day terms. A proportion of this increase may already be reflected in customer bills, as a consequence of transportation charges actually incurred and charged in 2006/7. Nonetheless, customers will be exposed to an increase of far more than the stated £9 on the average bill as a result of these proposals. The total increase in money-of-the-day (some of which may already have been passed through in 2006/7) is around £22 per customer.

We note in this regard that the Initial Proposals document does not provide a sufficient explanation for the expected rise of about 10% in actual 2006/7 charges (£2.087bn) versus the original 2006/7 allowances (£1.942bn). We presume that this increase reflects a mix of revenue drivers and increases in non-controllable opex. It is disturbing to have so little transparency around a feature of the GDPCR that will have such a significant impact on Centrica and its customers. Our position is, first, that additional clarification should be provided on the causes of this 10% increase, and, second, that the causes for that increase should be challenged with a view to achieving a reduction.

We believe that as the GDPCR is of such importance to consumers as well as suppliers that it would be beneficial in future for Ofgem to state key changes, such as this, in money of the day as well as real terms to improve the clarity of the proposals to all readers.

### 4 Pensions

We are extremely concerned by the effect of the pensions proposals. Based on the document, we estimate that the effect of the 4.70% of allowed revenue is to provide the GDNs with an additional allowance of the order of £100m in one year. Given that we believe the original allowance would have been around £23m, the year on year increase to be paid for by consumers is unacceptable.

As stated in our responses to previous GDPCR documents and DPCR4, we do not support Ofgem's proposed approach on pensions; we believe that it reduces risk on the GDNs at the expense of consumers without rewarding consumers for taking on that risk.

In addition, commercial companies are constantly driven to review the sustainability of legacy pension arrangements and make adjustments where necessary; in principle, therefore, we do not consider that network companies should be accorded more protection than is generally faced by their customers.

## 5. Information transparency

Our view is that the one year PCR has highlighted the need, going forward, for greater transparency regarding the process and the underlying data used to determine the allowances.

First, suppliers need more timely disclosure of information regarding the PCR in order that they can forecast future transportation costs in a timely and accurate manner. The failure to provide sufficient information on a timely basis unnecessarily complicates financial planning and retail pricing. This issue is critically important in a market where an increasing number of customers are seeking structured products in order to manage price risk.

Second, the current approach to the PCR perpetuates a serious information asymmetry between the GDNs and Ofgem on the one hand, and shippers, suppliers and consumers on the other hand. That asymmetry needs to be addressed and corrected going forward. Those who end up paying the GDN charges should have access to the data they need in order to effectively review and challenge the PCR proposals. In particular, Centrica's view is that the correction of this asymmetry should start with disclosure of the fully completed Business Plan Questionnaires (BPQs).

We are, however, very encouraged by the new approach to xoserve costs and the replacement of UK Link put forward by Ofgem. We believe that allowing the community the opportunity to provide input to the GDPCR in this way is a real improvement. It is an initiative which we strongly support. We would welcome the extension of a similar approach to other aspects of the five year control, and would be willing to work with Ofgem and the community in that regard.

## SECTION 2: CENTRICA'S RESPONSE TO QUESTIONS RAISED IN THE DOCUMENT

### *CHAPTER: One - Introduction*

There are no specific questions in this chapter.

### *CHAPTER: Two – Operating Expenditure*

**Question 1:** *Is Ofgem's approach for determining an opex allowance for 2007-08 appropriate? Are the resulting allowances appropriate?*

We recognise that a small reduction (in real terms) in controllable opex for efficiency improvements has been proposed as well as averaging to reduce the effect of atypical years.

However, we estimate that the proposed 2007/8 allowance for controllable opex still represents a small year on year increase in nominal terms relative to 2006/7, rather than a reduction (based on the figures quoted in the second and third consultation documents and using 2.5% inflation).

We find this a matter for serious concern. Not only are efficiencies from the DN Sales not filtering through, but proposed/allowed opex is actually indicated to rise. We would suggest that a significantly greater efficiency reduction would be appropriate on the basis that the purchasing companies clearly expect to obtain efficiency savings over and above those that National Grid Gas was targeting in the period before the sales.

Looking forward to the five year control, Ofgem should in our view take full account of the impact which sharply higher capex/opex spend is likely to have on future levels of opex (e.g. as regards repairs and maintenance).

**Question 2:** *Is Ofgem's proposed approach to setting pensions allowance for 2007-08 appropriate?*

As stated in our responses to previous GDPCR documents and DPCR4, we do not support the approach proposed in respect of pensions. Commercial companies are constantly driven to review the sustainability of legacy pension arrangements and make adjustments where necessary; in principle, therefore, we do not consider that network companies should be accorded more protection than is generally faced by their customers (shippers/suppliers) and their customers' customers. The key points from our previous responses are summarised below:

- The more generous pension allowances make up a significant proportion of the increased revenues to distribution companies. The initial proposals are particularly unwelcome and do not appear to appropriately balance the needs of customers and networks/GDNs.
- In the TPCR, we have been very concerned about the proposals relating to Early Retirement Deficiency Costs (ERDCs), as we believe that these can lead to the companies receiving a dual allowance, due to the different treatment of redundancy and pensions costs. Whilst not evident from the document, we are concerned that the pass through element from the NTS may include ERDCs, and would welcome clarification of whether or not this is the case.

- We were very disappointed by Ofgem’s decision to allow for 70% of unfunded ERDCs under DPCR4, as we consider it is reasonable to expect companies to absorb the risk of these. We believe that the companies will already have benefited from opex and/or capex incentive payments. Such costs and benefits should be taken into account when the case for early retirement is considered. So whilst we were initially pleased that Ofgem did not propose to replicate these arrangements under TPCR, we are concerned by the reversal of this policy (as happened under DPCR4). Although this is mainly a matter for the TPCR, it is important to GDPCR due to the potential pass through effects to the GDNs and their customers.
- In addition, we believe that there is cause for concern in respect of the principle of effective pass through of the generality of pension costs. Ofgem has previously granted an allowance for the pass through of an efficient level of pension costs, but it is not clear to us whether a formal efficiency assessment has been carried out (including a benchmarking exercise among GDNs and vis-à-vis other comparable UK plc’s) and what the results of any such an assessment were.
- Finally, as we have previously stated, we also believe that such issues as pensions should only be considered as part of the five year control and hence we would not support “pass through” at this stage, even if we did not object to the principle. We continue to believe that the one year control should be carried out on the basis of a very simple roll forward.

The scale of the additional allowances proposed, as they appear to more than treble the funding based on the document, concerns us greatly. We have estimated the effect from the information provided in the document, and we believe that the proposals increase the allowances from around £20-25m by a figure in the order of £100m. It is not clear to us how and why the GDNs’ pensions deficits should have mushroomed to this extent, especially against a background in which recently improved stock market performance is generally thought to be bringing the level of deficits back down.

We also believe that, in the five year control, it will be important to ensure that any claimed deficits in respect of pensions are audited to ensure that they have not arisen as a result of poor management by the companies. Any such issues should clearly be to the account of shareholders and not customers.

If these proposals are allowed to proceed, either as part of the one year or the five year control, we firmly believe that the consequent reduced risk to the companies needs to be reflected, at the same time, in a reduced cost of capital. We do not believe that it is acceptable to reduce the companies’ risk in this way, whilst allowing them to continue to earn an unjustifiably high rate of return. This point further supports our comments on the cost of capital already raised in this response.

### **Shrinkage related questions (Reference: Appendix 9)**

**Question 3:** *Is Ofgem’s assessment of the costs and benefits associated with the three options for setting shrinkage allowances, as set out in the impact assessment, reasonable?*

We continue to believe that, in the absence of a move to a total losses approach, removal of all shrinkage price risk from the GDNs is inappropriate, as (a) the shippers/customers who will bear this cost have no opportunity to influence the leakage volumes, which make up most of shrinkage, and (b) it is not proposed to reduce the cost of capital, to compensate for passing additional commodity price risk onto customers.

As a result of the revised approach, risk would be transferred from the GDNs to customers, and hence there would be a consequential cost impact at the supply level via revenues recovered. We believe that the Impact Assessment (IA) should quantify this impact as part of the cost

benefit analysis prior to implementation of revised shrinkage proposals, to confirm whether there is actually a net benefit to customers. We would expect that when gas prices are high/volatile, the result of the risk transfer would be to have an offsetting effect to the benefits identified in respect of the reduction in the cost of capital.

In paragraph 1.36 in the IA, we note Ofgem's view that the strength of the incentives (to purchase gas efficiently) on GDNs does not vary between the "do nothing" option and option 1a. Centrica is not confident that this is correct, as we believe that the incentives on the GDN may be stronger under a fixed allowance.

To summarise, we believe that the IA is incomplete in the following respects

- a) The IA does not quantify the costs to customers which would be expected to result from a transfer of risk to customers via transportation charges. Hence, in table A9.2, whilst a figure is given for benefits, the cost element is lacking.
- b) In table A9.4, the impacts of options 1a and 1b are assessed relative to the "do nothing" option in terms of ticks and crosses. We do not believe that this method has sufficient rigour when used as a basis to transfer risk to customers. Instead, we believe that the impacts should be properly quantified. If a precise figure cannot be determined, then we believe a range would be acceptable initially (followed by an update) to avoid spurious accuracy.

**Question 4:** *Do you support Ofgem's proposed approach to setting shrinkage allowances (i.e. Option 1a)?*

We do not support changing the shrinkage allowance for the one year control; the main reason for this is the transfer of risk from GDNs to customers, via transportation charges, with no commensurate change in reward.

Ofgem identifies in the IA that they believe reducing this risk for GDNs should equate to a reduction in the cost of capital of the order of 0.04%. (This in itself appears to be a very low figure, equivalent to a £6-7m reduction in annual gas distribution charges, when customers are being faced with a £50m increase in the 2007/8 cost of shrinkage.) In our view, if this risk were to be removed from customers from 2007, then a realistic compensating adjustment to the cost of capital should be made in the same control. However, we would like to clarify that we believe that, in the absence of a simple rollover approach to the one year GDPCR, a reduction in the cost of capital is needed in any case, not only as a result of the shrinkage proposals. Simply stated, we believe that the overall reduction in the cost of capital should be much greater than this single figure of 0.04% suggests.

Whilst, as stated, we do not support changing the shrinkage allowances in the one year control, if a change is to be made, option 1a (a market based index price) would seem to be a reasonable approach.

However, in respect of the five year control, we would urge Ofgem to consider now more innovative approaches for shrinkage gas. As we have previously proposed, we strongly believe that a total losses approach would exert a far greater incentive on the GDNs and hence improve benefits to customers.

**Question 5:** *In the event that Ofgem adopts Option 1a for shrinkage, which market index (or indices) should GDNs' shrinkage allowances be linked to?*

In Centrica's view, if the move away from a simple, roll forward approach is made for 2007/8, then a SAP related price would be most suitable. We would suggest an average, on the day system price.

We believe that a SAP related price as above would be appropriate as there is a liquid within day market and SAP is a simple, reliable, objective and unambiguous price indicator. In addition, we believe SAP to have the merit of being well understood and familiar to the industry.

The choice of the index for the purposes of setting an allowance does not, of course, affect the range of procurement options open to the GDNs in respect of shrinkage gas.

**Question 6:** *In the event that Ofgem adopts Option 1b for shrinkage, should allowances be based on shrinkage costs incurred by the average GDN or lowest cost GDN?*

We believe that the document may be slightly ambiguous in this area, and we are not clear on the nature of the proposal, i.e., whether the intention is to use an up front estimate and then reconcile to the actual out-turn costs of the best performing GDN, or whether it is simply proposed to set an estimate based on the likely performance of the best performing GDN.

If it is the former, then we believe that this could be a strong incentive on GDNs to perform well; conversely, it might also create perverse incentives on the GDN's collectively in respect of performance.

If GDNs were to be relieved of all price risk at the expense of customers, then in Centrica's view it would be important that all other incentives in this area were as sharp as possible. With this in mind it would seem appropriate to base the allowance on the lowest cost GDN should this option be selected. There is thus a case for some performance benchmarking among GDNs. We have previously supported the use of upper quartile or second lowest performers as the benchmark, but in view of the transfer of risk in this area, we believe that a strong case for the more challenging approach exists.

However, as Ofgem has correctly identified in the document, careful monitoring would be needed to ensure that the effect of the benchmarking is not weakened as a result of the low number of genuine comparators.

**Question 7:** *Should Ofgem remove throughput-related shrinkage volume risk from GDNs?*

Centrica believes it would not be at all reasonable or appropriate to remove throughput related shrinkage volume risk from GDNs. Whilst the GDNs clearly have limited influence over consumer demand, removal of volume risk would further weaken incentives to reduce shrinkage and measure it accurately. We believe a reduction in incentives would be seriously detrimental, from both a consumer protection perspective and from an environmental standpoint, and as we have stated above, we do not believe it is reasonable to move risk from parties who can influence it to those who cannot.

In addition, as stated above in our response to question 4, we believe that in respect of the five year control, a more stringent, total losses approach would offer much greater benefits.

## **CHAPTER: Three – Capital and Replacement Expenditure**

**Question 1:** *Do you agree with our proposals regarding expenditure that we should treat as wasteful and unnecessary?*

Centrica continues to be extremely concerned with respect to the whole area of overspends and the GDNs' approach to the issue. During the PCR process, information is submitted to the regulator in the form of Business Plan Questionnaires (BPQs) to assist in the construction of an appropriate control.

Our understanding is that once this "package" has been consulted upon and accepted as a whole by the companies, this then, with the exception of any revenue drivers or incentive schemes that have been incorporated, forms the basis of the allowed revenue for the next five years. The control is not then reopened.

On 16<sup>th</sup> March 2004, Ofgem issued an open letter giving additional guidance, inter alia, on the likely treatment of any capital overspends at the next price control review. We believe that this letter set out clearly that, in general, there would be a symmetrical treatment of over and underspends. The letter went on to say that, in most cases, a licensee could expect to have to meet at least the return element of the financing costs on an overspend for a full five year period. In referencing those costs that might be considered for a re-opener, Ofgem gave examples of the "significant benefits to consumers" as being "essential for security of supply", or as a result of a new government requirement. This letter was available to companies at the time of DN sales, and would, presumably, have been taken fully into account in any due diligence work carried out.

However, the responses issued by GDNs seem to indicate an assumption that, even if they did overspend, they would be allowed to place the resulting assets into the RAB almost on a pro forma basis. One of the companies suggests that had they been aware of this proposed treatment, their behaviour might have been different; another speculates that had Transco known the importance proposed to be attached to capex volume forecasts and unit costs, it might have taken a different attitude to the tradeoffs inherent in any settlement.

We believe both of these views are a cause for concern. If the companies felt the guidance provided in the letter was insufficiently clear, they had the option of seeking additional guidance from Ofgem before committing to the expenditure; equally, it seems obvious to us that forecasts provided during a price control process are vitally important, and it is inconceivable that a regulated entity could view them in any other way.

We feel that this apparent difference in opinion, between companies and the regulator, is a serious matter. In our view, it suggests network company approaches to the GDPCR process which can only create concerns as to the quality of the information provided to Ofgem and hence the robustness of the resulting allowances. We believe that such quality concerns increase the risk of a poor outcome for customers, and potentially, a repeat of the overspends which have become apparent through this GDPCR process.

Given the above, we strongly support Ofgem's actions in thoroughly reviewing and challenging this expenditure. Where Ofgem evidences the expenditure as inefficient and/or unnecessary, it is clearly appropriate that this should be disallowed. Equally, we are reassured by Ofgem's identification and exclusion of costs associated with DN Sales. Ofgem has clearly stated that such costs should not flow to customers and we fully support this.

More generally, Centrica does not believe that it is acceptable for GDNs to be spending such huge sums in excess of the allowances, however efficient the GDNs may consider it, when they intend to request that shippers/customers fund this expenditure at relatively short notice. It is clearly inappropriate that GDNs alone should be making such decisions and assumptions, exposing customers to unapproved costs. If expenditure in excess of allowances is necessary, then companies should seek consultation and regulatory approval prior to committing to the outlay – which would also bring benefits to customers in terms of transparency and predictability.

**Question 2:** *Do you agree with our proposals regarding expenditure that we should treat as efficient overspend and, in particular, expenditure that should be subject to a reopener?*

Our comments above notwithstanding, we can accept that there will be some occasions where efficient overspend will occur and even that a re-opener may be justified. However, in the case of a re-opener, we are of the view that this should be limited to those areas signalled in advance, with clear volume drivers. We also believe that it would be beneficial for such re-openers to be linked to a transparent consultation process to allow those parties affected by the re-opener to consider the proposals and challenge as required.

We welcome Ofgem's recognition that it is appropriate for GDN shareholders to bear some of the cost of the companies' behaviour. However, we have not been able to fully reconcile the 40% of costs quoted as to be borne by shareholders with the document, and would welcome further clarification in this area.

Based on the information in the document, we believe that the principles underpinning the re-opener proposals may be reasonable. In respect of the split between inefficient and efficient, we do not feel qualified to fully assess the proposals due to lack of information. This is in itself indicative of the lack of transparency in the process, in that major shippers/customers of the GDNs are unable to express an informed view on such a key issue.

**Question 3:** *Do you agree with our proposed adjustments to the RAVs to reflect expenditure incurred between 1 January 2001 and 31 March 2002?*

As a mechanism to adjust for actual expenditure for the period, compared to the estimated expenditure for that period which was used at the start of the last price control (due to lack of actual data at that point), we believe the approach seems moderate and reasonable. We support the work that Ofgem has done to challenge and review the increase in expenditure over the 15 month period, noting the proposals to disallow 33% of the GDNs' request. As before, we would strongly urge that Ofgem maintain this firm approach in the matter of overspends by monopoly regulated companies.

**Question 4:** *Is our proposed approach for determining capex and repex allowances for 2007-08 appropriate? Are the resulting allowances appropriate?*

As we have previously argued, we believe that the minimalist approach should be taken to the one year control, i.e. a simple roll forward of capex, repex and opex. We do therefore have some concerns that Ofgem is proposing to increase the capex/repex allowances by almost 60% in 2007/8. We note that this is less than was sought by the GDNs, but this is still a massive increase year on year, which will feed through to customers' bills over time.

Notwithstanding the above, we are encouraged by the approach taken in respect of the average unit costs applied. In efficient companies we would expect unit costs for like activities to trend towards each other over time. We agree that those costs above average should clearly be adjusted to ensure that customers in those regions do not suffer disproportionately. This is also true of the approach taken to mains abandonment.

**Question 5:** *Is our proposed update of the mains replacement incentive mechanism for 2007-08 appropriate?*

We are concerned at the uncertainty implied by the update. Whilst we appreciate that NGG is in discussion with HSE over a revised mains replacement programme, and hence Ofgem cannot complete the analysis at this stage, this means that this could have a significant effect on the

allowed revenue for next year, and the first notification to the industry of this fact will be in December, for implementation on 1 April 2007.

As we noted above, suppliers need to forecast and budget in the same way as other companies, and leaving the resolution of such potentially significant uncertainties until such a late date in the process further complicates the forecasting process.

## *CHAPTER: Four – Financial Issues including overall impact of initial proposals*

**Question 1:** *Do you agree with our proposed approach to calculating the cost of capital to apply for 2007-08?*

Centrica is of the view that the cost of capital is overstated in the present market. Ofgem has given an indicative figure of 4.2% post tax real under TPCR. Whilst we consider that even this substantially over-states the true cost of capital, since it is based on an equity  $\beta$  significantly higher than that considered appropriate by Ofgem's own advisers, the one year control is clearly predicated on a cost of capital assumption of 4.38% post-tax real established in 2002, which Ofgem's initial TPCR proposals indicate is well above that warranted by current market conditions.

We have argued consistently that a simple rollover approach in all aspects of the control would be appropriate; equally, a reopener of all relevant aspects (if practicable in the time available) could also be considered fair and reasonable. Our concern has always been that a piecemeal approach would probably disadvantage customers and benefit the GDNs. We believe that this has indeed been the case. That being so, whilst we continue to prefer the simple approach, if the adjustments proposed by Ofgem in the initial proposals are implemented, then we believe that at the very least, the cost of capital should be reduced to 4.2%, which we estimate could offer a benefit to customers of the order of c. £25m.

We believe that this approach is reasonable, as the accommodations provided to the GDNs in the proposals reduce their risk sufficiently and leaving the cost of capital unchanged is completely inequitable.

**Question 2:** *Do you agree with our proposed approach to the treatment of tax?*

We have consistently argued that a simple, rollover approach to the one year GDPCR would be preferable to a selective review, and further, that if a simple approach is not adopted, then all relevant aspects of the price control should be subject to review.

On the basis of the more complex approach set out in the proposals, we believe that, among other things, it is only reasonable and right that the current inequitable treatment of tax should also be addressed. Indeed, in our view, the tax review is presently incomplete, and should look to reclaim to the benefit of customers, a proportion of the previous windfall experienced by the companies as a result of the previous pre tax approach.

**Question 3:** *Do our initial proposals, taken in aggregate, represent a reasonable outcome that both protects the interests of consumers and ensures that GDNs are able to finance their activities during 2007-08?*

As under our response to question Ch4, 1 above, we believe that the proposals, in aggregate, represent an unreasonable outcome for shippers, suppliers and their customers, particularly when the timing and scale of the increased costs are considered.

***CHAPTER: Five – Timetable and Process***

**Question 1:** *Are the high level licence drafting changes proposed in Appendix 10 appropriate? Should we consider any other licence drafting changes?*

We believe that the high level drafting changes reasonably reflect the proposals set out in the document.