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Your Ref: Ofgem doc 169a/06

Dear Joanna

Gas Distribution Price Control Review: One Year Control Initial Proposals

energywatch welcomes the opportunity to respond to the issues raised in the initial proposals. This response is non-confidential and we are happy for it to be published on the Ofgem website.

Executive summary

- When Ofgem approved the gas network sales in January 2005, it announced total savings to trickle down to consumers of £225 million over 18 years. The current proposals may increase costs on the bills of 20 million gas consumers by £20 to £22. Around £400 million of extra costs borne by consumers
- We do not believe that recent rises in expenditure by gas distribution networks (DNs) have been efficiently and economically incurred to allow pass through to consumers
- We expected the sale of gas DN's to provide immediate efficiency benefits which have not been realised and shared with consumers
- We believe the actual rise in consumers' bills will be higher than Ofgem states
- Gas DN's will realise the benefits of the sale of networks while consumers are asked to wait until the enduring price control or longer
- Ofgem has not properly justified the basis for the proposed approach to calculation of the opex allowance
- Ofgem's approach to the shrinkage allowance does not provide the right incentive
- Ofgem should treat gas DN's as low risk and set a cost of capital as appropriate

Whilst we support the principle of an interim review we do have significant concerns about the proposals made within the review. We are particularly disappointed with the proposal to further increase consumer bills. Any rise in costs to consumers over which they have no direct control, and whose risks they are in no position to manage, is a matter of concern. This concern is even greater at a time when all consumers, particularly vulnerable consumers, have been subjected to significant rises in energy prices.

The emphasis of the review should be on keeping costs low, producing cost efficiencies through the use of improved practices and greater responsiveness to customer needs. The rise in spending by gas DNs during the current price control period highlights a significant proportion of expenditure which may not have been incurred either economically or efficiently, or perhaps that the asset values of the gas DNs have been historically understated.

General comments

We agree that the application of an interim price control, rolling forward the current price control by a year, is a sensible approach in synchronising the various price controls and sharing the workload required for this and the introduction of an enduring five-year control from 1 April 2008. We recognise Ofgem's efforts in trying to recognise the needs of consumers and in particular the consumer focused work that is being carried out in relation to standards for the enduring price control.

However we are extremely concerned with the proposals for the interim control, in particular the proposal to further increase consumer bills. Any rise in costs to consumers over which they have no direct control, and whose risks they are in no position to manage, is a matter of concern. This concern is even greater at a time when all consumers, particularly vulnerable consumers, have been subjected to significant rises in energy prices. Ofgem knows that the outlook for wholesale gas prices through the coming winter and beyond remains uncertain.

Consumers rely on gas distribution networks (DNs), as the regulated operators, to deliver safe, secure and reliable supplies and manage the risks of operating the networks in an efficient and economic manner. The emphasis should be on keeping costs low, producing cost efficiencies through the use of improved practices and greater responsiveness to customer needs. Consumers, quite rightly, have an expectation that they will have a significant share in the benefits of efficient operation.

The rise in spending by gas DNs during the current price control period outlined in the proposals highlights a significant proportion of expenditure which may not have been incurred either economically or efficiently, or perhaps that the asset values of the gas DNs have been historically understated. We are particularly concerned that this rise in spending has occurred against the background of the sale of four gas DNs by National Grid in June 2005. The sale took place at a premium and we would have reasonably expected the new owners to take effective action to reduce costs, not

increase them, and pass those efficiency savings to consumers. Instead of the sales creating real benefits for consumers in terms of immediate efficiency savings, it appears that expenditure has become inflated and that consumers will bear an increasing share of this overspend. The main beneficiaries of the sale have been National Grid, as the vendor of the DN businesses, and the shareholders of the new owners. We believe that consumers who have little control over these spending rises should be affected in only a very limited way.

It appears that the gas DNs are to benefit immediately from the proposed settlement in the price control, while consumers are expected to wait for the benefit of efficiency savings to filter down in the enduring price control period. Ofgem even suggested in the second consultation on the enduring control that it may take two such control periods to bring about the level of savings which it regarded as a major benefit for consumers of the sale of the DNs. In our view, Ofgem should clarify whether and what assurances the new owners had provided about their ability to run more efficient networks as part of the sale process. It seems that the new owners saw the potential benefit of immediate increased revenue streams from their purchases but have not as yet been able to deliver lower costs to consumers which we see as a product of promoting more effective competition through the sale.

We are concerned that Ofgem's projected cost to the average domestic consumer of the proposed settlement is understated. Ofgem has indicated a cost of around £9/year. Ofgem is aware that the distribution element of the consumer's bill is only at 15% because of the impact of high wholesale gas prices, already a significant burden on consumers. Ofgem does not highlight the effects of inflation over two years on the proposed increase (the £9/year figure has been derived in 2005/06 prices). When taking into account the impact of these rises in allowed revenues, the cost to consumers will be higher in nominal terms. Furthermore, with the recovery of actual costs in the current price control as an additional item, the cost to consumers will increase further. We believe that the cost to consumers may be considerably more than that indicated by Ofgem, which indicates poor value from the sale of gas DNs and the efficiency of their operations since the sale.

Ofgem must provide answers to questions around the costs of operating gas DNs which have been raised by the proposed settlement. The sale of the gas DNs focused on promoting competition and ensuring proper interfaces are in place between gas transmission and distribution networks. The costs of operation were not a main area of focus and the significant overspending on network provision seems to have been overlooked until now, when the results have largely been accepted without more rigorous scrutiny. There are real concerns for consumers that the enduring price control will not focus on efficient and economic network provision. The gas DNs must provide much more detailed information about their operations and how they intend to lower costs through the application of benchmarked best practice and adequate control of expenditure. The gas DNs are not entitled to blank cheques, as they are regulated businesses and Ofgem has a key role in drawing out the cost impact of operation when related issues such as gas quality are also on the horizon.

Opex allowances

Actual or forecast expenditure has, or is expected to, rise significantly in the last three years of the current price control (2004/05 to 2006/07). We stated in our previous response on the second consultation on the price control review that expenditure needs to be justified on the basis of efficiency. Taking an average of actual costs for 2004/05 and 2005/06 and applying a small downward efficiency adjustment for the roll forward allowance for 2007/08 is a simple approach but ignores two things.

It fails to recognise whether the average of the operating expenditure incurred in those two years provides a suitable basis for estimating future costs, and it fails to assess in any detail how efficiently gas DNs could have incurred expenditure in a more typical scenario. Averaging is a proxy measure at best and the small efficiency adjustment has not been objectively justified. However, the price impact on consumers of the proposed allowance is immediate.

We appreciate that the timetable for rolling forward the price control to 2007/08 has placed a constraint on Ofgem in more detailed assessment of the efficiency of past spending. However, consumers have a right to expect a more rigorous examination of past expenditure. This more robust approach must be adopted prior to the setting of the enduring control from 1 April 2008 and more exacting efficiency targets will need to be applied in price control allowances going forward.

We note that there are potentially more costs to be included in the enduring price control relating to the implementation of the Traffic Management Act 2004. We consider that a reasonable share of these costs should be met by the gas DNs and should not be passed to consumers. Any re-opening of the price control should reflect this concern prior to determining any further provision in allowances.

Shrinkage

We are concerned that the gas DNs are not being provided with appropriate incentives to minimise the loss of gas from the system effectively through the proposed changes to the shrinkage allowance. Ofgem takes the view that the rise in gas prices “could result in a disproportionate effect on the profitability of GDNs”. We do not believe this is the purpose of the shrinkage allowance.

Ofgem’s proposals provide the gas DNs with the ability to recover an amount which is reflected in market prices. As Ofgem is well aware, fluctuations in forward gas prices over time can be significant and, if lower than the proposed level of 57p/therm during the interim price control period, could lead to over-recovery of costs from consumers which would be unacceptable if suppliers are not passing through lower wholesale gas costs to consumers in their retail prices. Furthermore, the gas DNs are able, as Ofgem recognises, to take some action to hedge against changes in gas prices, an option not available to the vast majority of consumers.

To argue that the authorised activities of the gas DNs would be made more difficult to finance without the proposed shrinkage allowance appears to fail to stand up to

scrutiny and needs to be properly justified by Ofgem. This is a further disappointing example of how consumers are expected to pay upfront on costs while the benefits of efficiency will take longer to pass through to them.

Capex and repex allowances

We agree that Ofgem should have undertaken independent analysis of capital and replacement expenditure and a number of instances of inefficient expenditure have been highlighted which Ofgem intends to exclude from the interim price allowance. While we believe that independent verification of such capital expenditure is appropriate and draws out areas where the gas DNs could have done more to keep costs to consumers low, we would urge Ofgem to ensure that a rigorous approach is developed and applied for the enduring price control. The gas DNs should not expect to be rewarded for poor management and planning or unnecessary complexity in projects which add to costs.

Most importantly, the gas DNs should not be allowed to 'game' the price controls by a process of deliberate under or overspending over the period of an enduring price control to maximise the financial benefit at the cost of inefficient operation. We will pay particularly close attention to this issue in the future and whether there is sufficient detailed information being provided by the gas DNs which allows the setting of allowances resulting in real efficiency savings to consumers. As already stated, we expected at least some of those savings to filter through in this interim control period.

We are concerned that a significant amount of connections work remains with the gas DNs in circumstances where Ofgem is considering how effective competition in connections actually is. We are separately addressing the competition issue in our response to Ofgem's competition in connections review. However, we would note that effective competition should reduce overall costs to consumers, the opposite of what is occurring in the interim price control, where consumers could be exposed to under recovered costs for the retention of some connections work by gas DNs.

Pensions

We note the significant jump in pension costs which are proposed in the interim price control. Generally those costs ought to be allowed where there has been a clear shortfall and there needs to be a 'catch up'. However, we would advise that the level of additional allowances are carefully scrutinised and that there should be appropriate adjustments to the allowances if the actuarial reports for the new gas DNs indicate a lower level of recovery is required. Where the gas DNs can absorb a proportion of these costs, they should do so.

Cost of capital

We are concerned that Ofgem should treat gas DNs in a similar way to other regulated networks businesses by applying a lower weighted average cost of capital both pre- and post-tax. Gas DNs are relatively low-risk businesses and should be generally stable regardless of the new situation where there is a diverse ownership

of the network companies. In that respect, they are not entitled to a return at a higher level than other similar companies. We agree that the gas DNs should return the benefit that they have received from tax allowance over the current price control, but that, as noted in our comments elsewhere, there is no intention on Ofgem's part to offset this loss through increased allowances elsewhere.

Summary

We are clear that the failure to focus on costs when some of the gas DNs were sold has resulted in a significant benefit to the new owners without any impetus on them to produce efficiency savings to the benefit of consumers. This is not acceptable and we intend to be fully engaged in the enduring price control review to ensure that consumers see real benefits of efficient and economic operation of gas DNs as early as possible. Consumers expect effective competition to translate into an appropriate share in benefits of efficiency, not higher bills. We would urge Ofgem and the gas DNs to take effective action in the enduring price control to realise the supposed benefits of greater competition following on from the sale of the gas DNs.

Consumers also expect effective performance from gas DNs which is meaningful, measurable and provides compensation when things go wrong. We support Ofgem's approach to finding a meaningful set of standards which provide consumers with the opportunity to hold gas DNs to account and create a relevant and useful set of comparators to aid the regulatory process. We believe that the interim price control period is an ideal time to develop these standards in the run-up to the start of the enduring price control period.

Going forward, we will continue to keep under review the development of these proposals as and when they are raised, always considering the possible impact on consumers.

We would appreciate being kept informed of the progress of the consultation and any related issues to enable us to comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs