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Gas Distribution Price Control Review – One Year Control Initial Proposals

Dear Joanna,

RWE npower welcomes the opportunity to respond to the above consultation and does so on behalf of all its licensed gas supply businesses.

In our previous responses we supported a minimum-change approach for the treatment of the one-year control and that the form, structure and scope of the current control should be retained. We therefore agree with Ofgem's approach of focussing its efforts on the four key areas which impact and endure throughout the next five year control.

We have limited our comments below to the issues of shrinkage, opex and the treatment of historical capex/repex as we do not feel best placed to comment on the other issues referred to in the consultation.

Shrinkage

Our preference would be that the existing shrinkage arrangements in the price control should not be reopened for the one year control. However, to the extent that Ofgem have decided this is appropriate and that the one year arrangements will apply throughout the next five control period, we favour the Option 1b approach as we believe this creates greater incentives on the GDNs to procure shrinkage gas competitively compared to Option 1a.

We agree that GDNs should be incentivised to manage that element of volume risk they are able to control (i.e. non throughput related).

It is not entirely clear to us how option 1a would work based on the description given in Appendix 9. We assume that under this option an ex post calculation will be made of shrinkage costs based on the shrinkage factor, actual throughput over the previous year and a reference price based on volume weighted actual gas prices over that time. If the reference price is based on an index of forward prices (as stated in Appendix 9), presumably set at the beginning of the previous year, GDNs would still be exposed to

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price risk as the price they pay for shrinkage gas over the year will not necessarily be reflective of the forward price used at the time the reference price is set. This is not dissimilar to the risk they face under the current arrangements (albeit the price would be set using more recent market information) and it would be possible for GDNs to hedge this price risk if they so chose.

Option 1b, if calculated ex post based on the same shrinkage factors and actual throughput figures as Option 1a but using the lowest average cost of actual shrinkage gas purchased by the four GDNs as a reference price, would force GDNs to assess whether their procurement strategy is as effective as that used by other GDNs. This could lead to an increased use of traded products and derivatives by GDNs to improve efficiency.

Opex

Whilst we previously supported rolling forward 2006-07 allowances we are in agreement with Ofgem's approach to use an average of 2004-05 and 2005-06 actual costs as the basis for opex allowances in 2007-08. We also believe it is appropriate to reduce these costs by 2.5% to reflect anticipated efficiency improvements.

Capex and Repex

We are concerned by the extent to which GDNs have exceeded their capex and repex allowances in the latter years of this price control and about the impact this will have on the gas distribution charges paid by customers.

With this in mind it is imperative that Ofgem undertake rigorous analysis of the efficiency of such investment and whether it should be included in GDNs regulatory asset base going forward.

It is difficult for us to comment on whether expenditure relating to particular projects is efficient, should be subject to a re-opener or should be included in the RAV, as we do not have access to any of the BPQ data that has been submitted. However, we have previously supported Ofgem's methodology for assessing this and continue to do so.

We agree with Ofgem that GDNs should not be allowed to benefit under price control by submitting poor quality and confusing data and welcome steps Ofgem have taken to verify costs incurred independently.

Whilst we would accept that it is not appropriate for Ofgem to evaluate the efficiency of GDN expenditure on an ongoing basis throughout the price control, we are concerned that it may be harder to properly assess the efficiency of investment the further back in time it took place. This may be a contributing factor to the poor quality of information and why changes of such magnitude have arisen. As a shipper we have little real visibility of the extent to which costs are being incurred and investment is being made throughout the price control period. This means we are forced to accept such changes, and their knock on effect going forward in the event they are included in the GDN's RAV, largely on trust.

It is to be hoped that steps can be taken to increase the visibility of costs incurred by GDNs to suppliers as part of the next five year control and to introduce mechanisms to smooth large variations in charges resulting from such overspends. This will help reduce the volatility of charges that suppliers face and will avoid further surprises, both of which seem to us to have become more common over the last few years.

Ofgem have set a high hurdle for allocating spend to either Pot 1 or Pot 3b, which may be appropriate. However, the consequence is that by far the largest proportion of overspend falls within pot 2b and will therefore, ultimately be included in the RAV. We believe that Ofgem may need to review this hurdle prior

to publishing their final proposals, particularly where assumptions have had to be made based on poor data quality. This will reinforce the message to all monopoly network operators that Ofgem can be expected to take a robust stance when ensuring that they manage their costs within price control allowances, and that only exceptional circumstances should prevent them doing so.

In the absence of such an approach monopoly network providers are likely to be looked upon more favourably by investors as low risk stable return enterprises, and this should properly be reflected in their equity beta.

A significant proportion of GDNs overspend appears to have been as a result of Ofgem having taken an overly optimistic view of the development of competition in one-off gas connections. This is not the first time that Ofgem's optimistic view of how competition will develop in previously monopolistic markets has led to decisions having to be taken at a later date to correct the consequences of this not transpiring. Ofgem should learn from this and adopt a more cautious approach when considering such issues in future.

Should you wish to discuss our response in more detail please do not hesitate to contact me.

Yours sincerely,

Steve Rose
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