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Dear Joanna

Gas Distribution Price Control Review – One Year Control Initial Proposals

I would like to comment briefly on some aspects of your proposals for a one-year control for gas distributors, concentrating on issues covered in your last consultation and other matters where parallels can be drawn with electricity distribution price controls.

Chapter 2 – Operating expenditure

We can understand the difficulties in determining future opex needs without a robust means of assessing past efficiencies. Neither option 1 nor option 2 is without disadvantages. During DPCR4 Ofgem faced similar problems in response to comments on the proposed approach to opex modelling. The eventual outcome took account of more than one methodology in determining appropriate levels of opex. Allowances were based on the higher of two possible approaches, and one of those was an average of the results from more than one methodology. These techniques would seem equally relevant for you now and would avoid undue reliance on a single approach that has obvious inadequacies.

We support the extended use of the pension cost recovery principles developed during DPCR4, and agree that these should be incorporated in the one year control for gas distribution. At some stage it will be important to discuss how the future trade off between scheme risk and potential returns should be handled, so that companies can understand clearly what is meant by pass-through of future costs. We are aware that this has been a significant topic of discussion between PostComm and the Post Office, and that similar clarity in the energy sector will be helpful to all parties.

As I mentioned in my August letter we do not feel qualified to comment on the detail of your proposals on the treatment of shrinkage costs, but we welcome the recognition that network companies should not bear the full consequences of movements in wholesale energy costs. From this perspective it would not be appropriate to use frontier performance as a proxy for efficient behaviour. Use of index (option 1a) or average GDN costs (option 1b) would both be preferable to taking the lowest costs for any GDN as the benchmark.

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Chapter 3 – Capital and replacement expenditure

In our previous correspondence we noted that the intrusive nature of your review of capex and repex was a necessary response to particular circumstances. This is still our view, but we are concerned that this novel approach will be seen to set regulatory precedents. The justification for disallowing capex must therefore be robust, if it is not to distort the incentives on companies to invest to meet customers' needs. We note the unease expressed by GDNs on the detail of your approach and hope that you will be able to reassure them before the final RAV for 2005/6 and 2006/7 are settled.

Chapter 4 – Financial issues

We note that for the one year review you have chosen not to consider in detail the future cost of capital. This is consistent with the approach taken in the short term extension of transmission price controls in recent years. This also adds weight to the view that the cost of capital needs to be seen in a long term context and should not necessarily be varied in response to short term market variations. This is particularly important in a sector where a range of new purchasers have recently been encouraged by regulatory action to support the sale of separate regional networks. In achieving a balance between the interests of consumers and shareholders, the longer term benefits associated with investor confidence in the regulatory regime should be emphasised.

However there appears to be a worrying inconsistency in your approach to the modelling of tax allowances and the subsequent assessment of financeability. You seem to have calculated tax allowances using a model which includes interest costs derived from the cost of debt within the assumed WACC. However, this is not followed by a financeability test on the same basis. Consequently a company can be left with inadequate resources to meet all its costs, including interest consistent with the proposed WACC. In these circumstances we would expect to see some other adjustment to allow a company to finance its functions. As it is now the regulatory norm for cost of capital to be expressed in a post tax form, it is important for all network companies that a consistent and rational approach is adopted.

I hope that you find these comments helpful. Please call me if you would like to discuss any of the matters raised.

Yours sincerely

Mike Boxall
Electricity Regulation Director