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Dear Bob,

**Transmission Price Control Review – Fifth Consultation, Updated Proposals
September 2006**

Thank you for the opportunity to comment on the fifth stage of your consultation on the Transmission Price Control for 2007- 2012.

Given below are the views expressed on behalf of the various companies of Centrica plc involved in the use of the Gas and Electricity Transmission networks, but excluding Centrica Storage Ltd.

This paper addresses a number of key elements, some of which are related to the principal issues raised in earlier papers in the sequence. These remain our primary concerns with Ofgem's TPCR proposals.

Cost of Capital

We are aware from our previous correspondence and our meetings with you that the Authority position on Cost of Capital will not be progressed from the indicated figure of 4.2% in the Initial Proposals until the Final Proposals paper is published in December. In the meantime, we welcome the additional work commissioned by you from Smithers & Co. Their most significant conclusion, in our view, concerns the level of systematic risk faced by Transmission System Operators, in relation to quoted companies as a whole. Smithers' view of the equity β is very much in line with (or even below) that of Ian Rowson, as prepared at the time of the Initial Proposals response. Their central estimate for NGG appears to be around 0.6, with a 95% probability that the true β lies in a range of 0.5-0.8.

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This provides further strong support for the case that Ofgem's initial view of the β (0.9 or even 1.0) is substantially too high.

As we have discussed, however, we have some concerns about other elements of the Smithers' conclusions, especially around the upper end of their range., which lead them to suggest a real, post-tax Cost of Capital in the range 3.7% - 4.6%, notwithstanding their commonsense conclusion as to β .

We have therefore asked Ian Rowson to undertake a further review of the Smithers work and will forward his views as we agreed, by 27 October. I am grateful to you for the extension of the deadline for submission of this information. We do appreciate that there is now a very tight timeline to the preparation of the Final Proposals document and we believe that this work will provide a helpful insight into this matter.

Capital Expenditure Programme

A further area of concern is the Capital Expenditure programme. Again as we have discussed before, it is difficult for Users and Consumers to gain a detailed understanding of the nature and extent of this substantial increase in spend. Undoubtedly, it will have a major impact upon the setting of the Price Control and the subsequent charges to customers. We appreciate that the Consultants reports have now been published on your website but have to confess that at first sight these are somewhat indigestible. At the TPCR seminar in July a number of issues were raised in relation to this programme, including whether it was realistic to undertake such a challenging programme. We still believe that it would be beneficial for industry participants to be involved in a workshop or seminar where the TSOs can deliver a clear exposition of their plans so that these issues can be explored in a constructive and timely manner, if possible, before the Final Proposals are drafted.

User Commitment

At this stage of the Consultation, there is reference to the matters of User Commitment although as mentioned these are now proceeding through the UNC process. You will be well aware of the concerns expressed by the majority of industry players that there appear to be extremely complex processes being adopted with very little identified benefit. With respect to provisions for Entry and Exit arrangements for the National Transmission System, we firmly believe that there is a need for further transparency to uncover the true capability of the network and ensure that the Transporter can be appropriately rewarded where enhancement and increment are justified. With the current asymmetry of information, Users cannot be confident that this is the case. We welcome the work being carried out to establish true potential by setting of realistic benchmarks and believe that Baselines that reflect actual capability for both Entry and Exit are appropriate. Given this situation, it is particularly important that a full and rigorous Impact Assessment is undertaken in advance of a determination on the Modification Proposals. This requires clear quantitative, rather than qualitative, analysis of the costs and benefits.

Transparency and Information Asymmetry

With respect to the above comments on the Capital Programme and User Commitments it is appropriate to highlight a further concern, which is more generic. We are acutely aware in making these representations that there is a significant information asymmetry, which restricts both the level of understanding which stakeholders can achieve and the contribution they can make to the review process. The setting of Price Controls is of vital importance in ensuring that the regulated party is funded at the correct level to carry out their required duties and licence obligations. Naturally, we welcome the opportunity to make a meaningful contribution to the process but in doing so, are frequently in the position of making assumptions in the absence of reliable information. We would welcome greater transparency of the factors that are under consideration in the process. This is particularly relevant in assessing existing system capability and the expectations that are placed upon it. This information is critical to all Users both in their use of the system and in ensuring that full potential can be realised prior to unnecessary or uneconomic investment in incremental capability.

Incentive Arrangements

The further area of specific interest is that of Incentive arrangements that will apply to the Transmission Companies. This is the subject of a separate consultation and more detailed comments will be submitted via this channel.

General Approach

Prior to addressing the specific questions posed in the consultation I would like to take the opportunity to re-iterate our general attitude to Price Controls. Although there may be a perception that it is in the interest of Users to keep the Allowed Revenue to a minimum in order to reduce costs, this is not an objective in itself. Naturally, we would not condone any unnecessary expenditure but we are committed to the Transmission Companies being appropriately funded to develop and operate their systems in an efficient and economic manner. To do otherwise would undermine our own operation in giving rise to uncertain and unpredictable consequences which in themselves may generate high costs if the system is not sized appropriately or managed effectively. We are also looking for greater transparency, which would allow Centrica and other key stakeholders to assess whether or not this is the case.

Specific Questions

In addressing the specific questions posed, I will follow the order of the consultation document.

CHAPTER: 1

There are no questions in this chapter.

CHAPTER: 2

There are no questions in this chapter.

CHAPTER: 3

There are no questions set out in this chapter. Questions relating to the substance of the updated proposals are set out in later chapters.

CHAPTER: 4

There are no questions set out in this chapter. Questions relating to the substance of the updated proposals are set out in later chapters.

CHAPTER: 5

There are no questions set out in this chapter. Questions relating to the substance of the updated proposals are set out in later chapters.

CHAPTER: 6

There are no questions set out in this chapter. Questions relating to the substance of the updated proposals are set out in later chapters.

CHAPTER: 7

Question 7.1: Do you agree with our proposed incentives for efficient capital expenditure, including a 25 per cent incentive rate?

We generally concur that the proposals for incentives for efficient capital expenditure. The adoption of a 25% rate does appear to more accurately represent the nature of the asset. This would ensure a more consistent incentive throughout the control, rather than the unintended enhancement in the latter period as would be the case with RPI-X model.

Question 7.2: What do you think about our proposals to address significant capex under spend? In particular:

- (1) What action should we take if this happens?
- (2) At what level should we trigger this response?
- (3) Should this response apply to load related and non load related capex?

Any under-spends of Capital Expenditure may arise from a number of causes. It is important to determine the source of the under-spend, as this will influence the manner in which it should be addressed. The key areas are whether this has been through efficiency or otherwise. To do so would rely upon setting of realistic long-term output measures. We can recognise the potential for a different approach to non-load related expenditure as this is more closely related to the Transmission Company's own assessment. Load Related expenditure should be, and to some extent is, more open to scrutiny.

Question 7.3: Do you agree with our proposed approach for dealing with uncertain costs including future input price changes, specific cost uncertainties, and wider regulatory developments?

In any longer term process there will inevitably be uncertainty. Many of these will not be related to a standard index such as RPI. We share your concerns about the application of an ex-ante allowance with such a range of uncertainty. Although it may serve to increase the unpredictability of the Price Control, it does seem pragmatic to include some mechanism to review the effects after the event where these may be extreme. It is worthy

of note that this would relieve the Transmission Company of a further source of risk and exposure.

Question 7.4: What do you think regarding the proposed regulatory treatment of NGG's use of affiliated LNG?

There is a potential conflict in the current arrangement for services procured from NG LNG Storage. The requirement for Operating Margins and Transmission Support is correctly included within the control. The way in which it is procured should be transparent and open to competitive services. We are not aware that NG NTS have explored the procurement of this service from other providers. It would be inappropriate for the NGG Price Control to fund investment in NG LNG, which might then be in a position of competitive advantage. Therefore we support your view that this investment should not be funded in this way. It may be a consequence to permit an increase in the regulated price but this must be in an open and transparent manner in order to discover the true cost of the service and enable this to be open to other providers.

CHAPTER: 8

Question 8.1: Do you agree with the conclusions of the Smithers & Co cost of capital study, in particular the real cost of debt and equity?

As mentioned in our introductory paragraphs, we welcome the additional view that has been provided by your consultants. We strongly support their view of network company risk (the equity β) being set too high. However, their view of the risk-free rate does not appear to us to be well-supported and some of the other individual factors applied in their analysis (at least at the upper end of their indicated cost of capital range) appear ill-founded and thus over-generous. In order to provide a further independent view on these conclusions, we have asked Ian Rowson of IMR Solutions to review the Smithers report and conclusions. At the time of writing I have a draft report from Ian and we will make the final version available to you by the end of the week.

Question 8.2: Do you agree with our proposed revised treatment of pensions costs?

In general terms we support your approach to the treatment of Pensions. We Agree that the Early Retirement Deficiency Contributions (ERDCs) should be borne by the shareholders and not be funded by the Price Control. Although there is perhaps a "special case" in respect of the Centrica element for that period which relates to the obligations to non-active members retained by Lattice as a regulated business, from the information available this is a marginal effect and would not seem to support the claim for different treatment.

Question 8.3: Do you agree with our proposed approach to the provision of new equity?

We agree that it is desirable to avoid creating any artificial disincentive, within the price control, towards the raising of new equity. The difficulty in setting an appropriate allowance is not so much with the costs of issuance – where we believe the network companies should be incentivised to do so efficiently - but with predicting the number of occasions

and the scale on which equity should be issued. On balance, we tend to agree that something along the lines of the second approach would be most appropriate – i.e. set a base level of allowance based on a conservative set of assumptions and then permit the companies to seek ex post adjustments where appropriate. However, the scope for such adjustments should in our view focus on the scale of equity issuance and not on the unit cost of those arrangements.

CHAPTER 9:

Question 9.1: Do you agree with our proposal that it is appropriate for NGET to have a different form of revenue driver from SPTL and SHETL?

Question 9.2: Do you agree with our proposed mechanism to deal with baseline and revenue driver sample risk?

Question 9.3: Do you agree with our proposed split of revenue recovery between pre-connection and completion?

Question 9.4: What are your views on the appropriate method of providing connections to the Scottish Islands?

Question 9.5: What additional output measures do you think Ofgem should capture when considering system performance?

Question 9.6: Do you agree with our view that an Innovation Funding Incentive is appropriate?

As contained in our previous response, we do not support the inclusion of an Innovation Incentive. The regulated body has obligations for efficiency and economy. If innovation has a value it will become apparent through these efficiencies and economies. We do not believe there is any requirement beyond this.

CHAPTER: 10

Question 10.1: Do you agree with our proposals for the treatment of entry and offtake capacity release obligations, and capacity substitution?

The setting of baselines for both Entry and Offtake capacity is key to this process. As included within previous responses, our major concern is to set the baselines in such a way as to accurately reflect the true system capability. We appreciate that this is not a precise science and these measures of system capability will vary with the way in which the system is configured. From recent discussions with NGG over issues relating to capacity utilisation it is evident that the current baselines do not represent capability. It is essential to provide greater transparency to this issue in order that the wider industry has a reliable basis upon which to understand the provision on existing and incremental capacity.

Notwithstanding the issues of baselines, we have always been of the view that the withholding of 20% of System Entry Capacity in the long-term process distorts the view of

the product being offered. It also inhibits the development of any secondary trading of this product.

We are supporters of the development of arrangements for transfer of capacity and believe that there is potential to develop more radical solutions than have been proposed by NGG in their Modification Proposal 0118. Again the arrangements for this are dependent upon reliable baselines and a realistic assessment of the true potential to transfer capability from one point on the system to another.

Since the issue of NGG's Modification Proposal (0116) on Enduring Arrangements for Offtake, a number of alternative proposals have now been lodged. Our own alternate Proposal (0116c) would facilitate arrangements for flat offtake capacity as per 0116 but excludes the development of arrangements to ration Flexibility on Offtake. There are a number of concerns which are more fully cited in our proposal but a fundamental issue is related to the setting of the National baseline for Flexibility. Due to the uncertainty of the availability of Flexibility in the long term it is necessary to set this baseline to an unreasonably low level that can be guaranteed 1-5 years forward. Setting of this figure at 22mcm grossly under estimates the potential capability of the system and would serve to constrain the product unnecessarily. Its intention appears to be to create an artificial shortage, which may be expected to cause consequential high costs, where there is low expectation of shortage in reality. This uncertainty of the quantity available in the distant future undermines the ability to offer the product for sale in the long-term.

Question 10.2: Do you agree with our proposed approach in relation to revenue drivers?

In respect of the provision of incremental capacity at Entry, and almost certainly soon at Exit, the User Commitment requirements to justify such investment have largely superseded a revenue driver. Therefore we concur with the view that these are no longer key elements.

The issue of "over-build" is also raised and the critical issue here is whether the provision is economic and efficient. In considering the sizing of the transmission pipeline there will inevitably be instances where a greater amount of capability can be provided at minimal additional cost. Marginal over-investment is far more benign than marginal under-investment. The judgement of whether this would be economic or efficient may not be apparent until much later. In such circumstances we would tend to support an ad-hoc approach as this should not be frequent. This is a particular area where transparency of information would greatly assist the process.

Question 10.3: What are your views of our proposals on buy back incentives, in particular, in relation to investment lead times and caps on exposure?

We again agree that it is appropriate to separate the two principal causes of the need for buy-backs, i.e. that which is within and that which is outside the control of the Transporter. Although we recognise that there are some difficulties in obtaining the necessary consents for major projects, we are concerned about this becoming a default value. Although it does

introduce a further process, it would be preferable to retain the default at 36 months, with provision to extend this when required as happened prior to the LTSEC process in September 2006. This enables the Transporter to indicate whether there is any restriction in providing the full (150%) level of increment prior to the allocation process being run. We cannot foresee a situation where there would not be sufficient lead time to allow this step in a significant engineering project of this nature.

Question 10.4: Is it appropriate to propose an incentive on NGG NTS to release additional incremental flexibility over and above the flexibility baseline?

As detailed above, we have grave reservations about the proposed process for flexibility release and rationing. NGG have clearly stated that it would not invest simply for Flexibility, therefore this could only be applied in the manner in which the system is configured. By definition, this is of necessity a short-term measure. However, we firmly support appropriate incentives in order to ensure that the maximum potential capability of the system is identified and made available to Users.

Question 10.5: Do you agree with our view that an Innovation Funding Incentive is appropriate?

As contained in our previous response and comment in 9.6 above, we do not support the inclusion of an Innovation Incentive. The regulated body has obligations for efficiency and economy. If innovation has a value it will become apparent through these efficiencies and economies. We do not believe there is any requirement beyond this.

Question 10.6: What are your views on our proposals for transitional offtake incentives?

The arrangements for transitional offtake incentives address a key principle in the manner in which this service can be provided. Whether transmission support can be provided only by physical gas (CLNG) held at a specific location or if it can be a contracted service. NGG has the obligation to provide this transmission support and the way in which it does so must be 100% reliable and to the satisfaction of the HSE, as detailed in their safety case. With regard to the gas price, we believe that the incentives applied should parallel those for any other procurement of this commodity. The quantities required can be determined in advance by NGG according to their general assessment of the system capability and there is no why this should not be secured in a forward market with prices no more volatile than any other contract.

CHAPTER: 11

Question 11.1: Do you agree that the licensees should be incentivised to reduce leakage of SF6? Do you agree the incentive should be set for 5 years?

Question 11.2: Do you agree with our proposal not to apply the DPCR approach to transmission undergrounding? Do you have views upon how we may best factor this in to our decisions?

I hope that these comments are useful and informative at this stage of the Price Control Review. You will be aware that we are actively engaged, both directly and by means of participation within the Gas Forum group, in supporting the work of this PCR.

Please contact me if you require any further information.

Yours sincerely,

Mike Young
Commercial Manager