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## **Gas Distribution Price Control Review**

### **Third Consultation Document**

A response by Centrica

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## GENERAL OBSERVATIONS

GDPCR offers an important opportunity for Ofgem to improve transparency around the gas distribution networks. This is the first price control review following the separation and sale of parts of the network to new owners. Centrica believes that this is an opportunity that should not be missed. In particular we urge:

- The systematic use of comparative regulation using benchmarking analysis to identify relative efficiency of different businesses
- Publication of disaggregated activity and cost information on each of the separately owned businesses with annual published updates to minimise ex post surprises for users, such as the overspends experienced at the end of the 2002-7 control.
- Adoption as part of GDPCR and subsequent reviews of a process akin to ‘constructive engagement’ in the airports sector. Constructive engagement seeks, through dialogue between infrastructure owners and users, to identify areas of agreement in such important areas as volume forecasts, capex requirements, quality of service priorities etc. We believe that adoption of such a process in the gas distribution sector will improve transparency and help identify priorities for service improvement and should not be limited to consultations around xoserve.

We welcome the stated intention of Ofgem to undertake a thorough review of the proposed repex and capex programmes. The GDNs have proposed very large expenditures over the next 5 year control period for both capex and repex. We note that there is no corresponding large increase in volumes of gas transported.

It is essential that shippers as well as Ofgem understand how these large expenditure programmes are justified and, where justified, their potential timing. The GDNs business case for these expenditures should be presented to, and discussed with shippers as early as possible. Constructive engagement would be a good framework within which such presentations and discussions could take place. Following such discussions Ofgem should seek the views of shippers.

We note that the GDNs have proposed significant rises in opex over 2008-13, amounting to a real increase of 9% between 2005-06 and 2012-13. Ofgem will clearly review the planned opex spend to ensure efficiency improvements are appropriate. We note that in this review the opex efficiency improvements should reflect the additional benefits to consumers anticipated at the time of GDN sales. We expect to see a step improvement in efficiency in this first price control review period following separation. We support the report from the Committee of Public Accounts, which stated that efficiency savings of 3% per annum should be considered as the starting point.

We welcome the intention of Ofgem to review fully the allowed weighted average cost of capital (WACC). We note that Ofgem has requested relevant information on cost of capital from the GDNs for this review, and the sharing of this information will be an important component of regulatory transparency. We plan to submit detailed analysis to Ofgem about the appropriate allowed WACC.

Following separation of the GDNs the question of differential regional price caps will have to be considered more fully. We plan to submit our views on the issues for shippers and competition in gas supply as part of our responses to the GDPCR process.

In addition to the publication of the activity and cost information referred to above, we believe that as part of this review, due regard should be given to the more general information requirements of shippers, suppliers and consumers over the price control period – both during the review process itself and after the new price control has been agreed.

In order to offer a choice of contract durations and a high quality service to customers, suppliers need to be able to predict the future path of prices with reasonable confidence. To support this, the limited reporting currently available should be expanded to include regular estimates of expected K factors, and updating of expected allowed revenues as the year progresses.

The consultation raises questions about revenue smoothing as well as over and under recovery mechanisms. Centrica welcomes this consideration, and urges that the effect of profiling on other industry participants as well as the GDNs should be taken into account.

In respect of the industry dialogue on xoserve and the UK Link replacement, Centrica has welcomed and supported the more consultative approach fostered by Ofgem. We have participated actively in the discussions and hope that the progress made and concerns raised by participants will be recognised and valued by Ofgem.

## QUESTIONS AS RAISED BY THE DOCUMENT

In this section, we address the questions as listed in the appendix to the consultation document.

### *CHAPTER 2 – High Level Framework of the price controls*

**Question 1:** Do you agree with our initial view on which services could be given excluded treatment? Are there any additional services that we have not considered?

Generally, we are in agreement with Ofgem’s view on which services could be given excluded treatment (please see the answer to question 2 below).

We are, however, concerned by the GDN proposal that an allowance should be provided which includes the full cost of emergency services absent metering income. We do not believe that this would be acceptable unless it were also possible to improve the incentives on the GDNs to secure infill work for the emergency workforce.

One possibility for such an approach could be to give the GDNs a target such that a defined percentage of time when they are not engaged in emergency work has to be occupied by chargeable work. If they are not able to meet this target, then allowed revenue should be reduced, but the obligations to provide the service remain in full. Income generated by the non-emergency work could then be partially used to offset the costs of the emergency service and partly retained by the DN under a sharing mechanism.

In addition, there appears to be an implication that GDNs are facing this difficulty as a result of DN Sales, namely a reduction in economies of scale and scope. If this is the case, then we believe it would be inconsistent for an additional allowance to be made, as Ofgem has previously indicated that customers should not bear the costs of losses of economies as a result of DN Sales.

In respect of item 3 in table 2.1, “Charges for gas illegally taken”, the unrecoverable theft investigation costs that a supplier is allowed to claim from the transporter under the Reasonable Endeavours Scheme do not seem to be mentioned. We assume that these would be treated as cost pass through items.

**Question 2:** Should domestic one-off connections be treated as excluded services or ordinary price controlled services?

Centrica believes that domestic one-off connections should continue to be treated as an excluded service. However, it will be appropriate to ensure that the charges levied under such a service are both reasonable and cost reflective.

**Question 3:** Have we correctly identified the range of items that could be treated as pass through items? Should these items be treated as pass through items?

We agree that the treatment of rateable values should be replicated from the TPCR; however, in order to ensure that the approach is fully effective, we believe it would be helpful to define what is meant by the companies having “engaged efficiently” with the VOA and SAA, and provide transparency around this outcome. We are also able to support the treatment of SoLR claims as pass through items.

In respect of the NTS charge for pension deficit costs, we support the approach of applying the amount transferred from the NTS control as a pass through item in GDPCR. However, we still firmly believe that there are unresolved issues around the level and treatment of pensions costs under both TPCR and GDPCR. Given that these are classed as part of “controllable opex”, we would strongly welcome a more rigorous efficiency assessment, e.g. via appropriate external benchmarking.

In addition, whilst Shrinkage is not specifically identified as a pass through item, in the light of the treatment under the one year control and the significance of shrinkage costs in the context of overall revenues, we believe that the treatment of shrinkage merits further careful consideration. The review needs to include both the treatment of price risk element and the future incentives on volume reduction which need to be applied to the GDNs. Please refer also to our comments under chapter 7.

**Question 4:** Is there any reason why we should change our position on cost indices?

Centrica supports the continuing use of RPI as the relevant cost index for price controls. At present, we do not believe that there is sufficient evidence to the contrary, but we will continue to consider this area, for example in the light of the Total Factor Productivity study results.

**Question 5:** Is there any reason why we should change our position on re-openers?

In general, we support Ofgem's view on the use of re-openers, believing that where practical, certainty is to be preferred. We also agree that it is reasonable to include a re-opener in respect of the Traffic Management Act if no greater clarity is available by the time GDPCR is finalised please see our comments below under chapter 3, Assessing Costs.

However, we also believe that there may be other areas where consideration needs to be given to a re-opener, the main one being in respect of industry development.

We understand from the industry dialogue discussions on xoserve and the UK Link replacement that Ofgem would prefer to fund a like-for-like replacement of UK Link. Further, we believe that the intention is to require further investment in change to be funded via a user pays mechanism, with no allowance for mandatory change. We are not able to support this as a viable way forward. Whilst we can support user sponsored industry change being paid for via a user pays mechanism, we do not support mandatory, regulatory or third party change being funded in the same way. We believe that these types of change should be centrally funded via transportation charges. In the absence of funding being provided up front for such change, then we believe that a re-opener facility is essential, where these costs are material.

**Question 6:** Should we introduce a two-tier correction mechanism for over and under recovery of allowed revenue, consistent with the arrangements that apply in electricity distribution?

We believe that this would be a reasonable way forward, incentivising accuracy in revenue recovery. In principle, we also support a degree of graduation in the incentives to minimise the annual corrections made however, we agree that the added benefits of this approach may be outweighed by the costs. Hence, before such a decision is made, we believe it would be appropriate to analyse the relative costs and benefits.

**Question 7:** Should we calculate the GDNs' allowed revenues in a way that creates a smooth revenue profile over the course of the price control period?

Smoothing revenue profiles has the potential to create additional risks around price stability due to the potential interaction with price controls – these risks will need to be carefully considered as part of Ofgem’s review.

Centrica supports incentivising the GDNs to minimise over and under-recoveries. However, as a supplier, it is equally important that we can make a reasonable estimate of the future path of prices. Many customers prefer certainty in their bills (as evidenced by the growth of multi-annual fixed price propositions) and in order for suppliers to provide such choices, visibility of future charges is required.

In particular, it is necessary for suppliers to have full transparency of the GDNs’ progress in collecting allowed revenue; visibility of how the allowed revenue changes throughout the control period as a result of volume drivers; and clear information on any over or underspends in capex/repex which may be developing.

Overall, Centrica believes that transparency and predictability are even more important than stability of charges. However, in order for the information provided to have full value, it needs to be provided at an early stage – given, for example, the significant lead times on many retail pricing decisions.

We also believe that the price control cycle itself creates difficulties in this area in the changeover years. For example, customers contract for one or more years at any point in the year. Where suppliers do not have information on the likely path of future revenues until around 3 months before those revenues come into effect, this changes the risk profile and hence the prices customers may need to be charged as suppliers attempt to predict what may happen.

In respect of the profiling employed under the last control, whilst we appreciate the view that customers may be neutral to the costs over time, this also contributed significantly to the increases required under the one year GDPCR. In view of this, we believe that the expected effect of profiling should also be transparent throughout the price control period.

It is also important to consider what NPV neutral actually means in respect of revenue profiling. In the document, profiling adjustments are noted to be NPV neutral, but this is only likely to be the case for the GDNs. If other players in the industry (such as shippers, suppliers and customers) have a higher cost of capital (or time preference rate) than the GDNs’ WACC, then they will not be neutral to the re-profiling of revenues. With this in mind, before a decision on profiling is made, we believe that an assessment should be made of these effects on such other parties.

Moreover, from an economic efficiency point of view, it is desirable to ensure that consumer market decisions (e.g. around fuel choices in new/renewed boilers or in new buildings) are not made against network charges which reflect a relatively short-term upward “blip” around the long term cost trend.

### *CHAPTER 3 - Assessing Costs*

Centrica has found it difficult to comment in detail on this section, as the information provided is limited. We appreciate that additional detail on costs will be supplied in the fourth consultation document. In Appendix 1, we have supplied a list of the kind of information we would appreciate being included in the fourth consultation as we believe it will assist the quality of responses to the document.

**Question 1:** Is our proposed approach to setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?

We recognise and support Ofgem's approach of carrying out a detailed review of the information and forecasts provided by the GDNs, as well as building on the work done for the one year control. We also refer to our comments under General Observations (above) on publication of information and Constructive Engagement.

We are supportive of the detailed review proposed, especially the reviews of policies, procedures and forecast costs. We believe that the bottom-up benchmarking and the expert review of costs will support Ofgem's efforts in this area. Furthermore, whilst supporting the top-down benchmarking and total factor productivity (TPF) analysis being carried out for opex the same techniques should be applied to other categories of cost, e.g. capex and pension arrangements.

We look forward to reviewing the outcome of this work as part of the March consultation document.

However, in addition to the above, from our review of the document and appendices, we believe that there are a number of areas which raise significant questions. It is Centrica's view that sufficient detailed information should be shared with the community either before or with the cost document to fully address the concerns we detail below.

## **CAPEX**

### **a) LTS/Storage Investment**

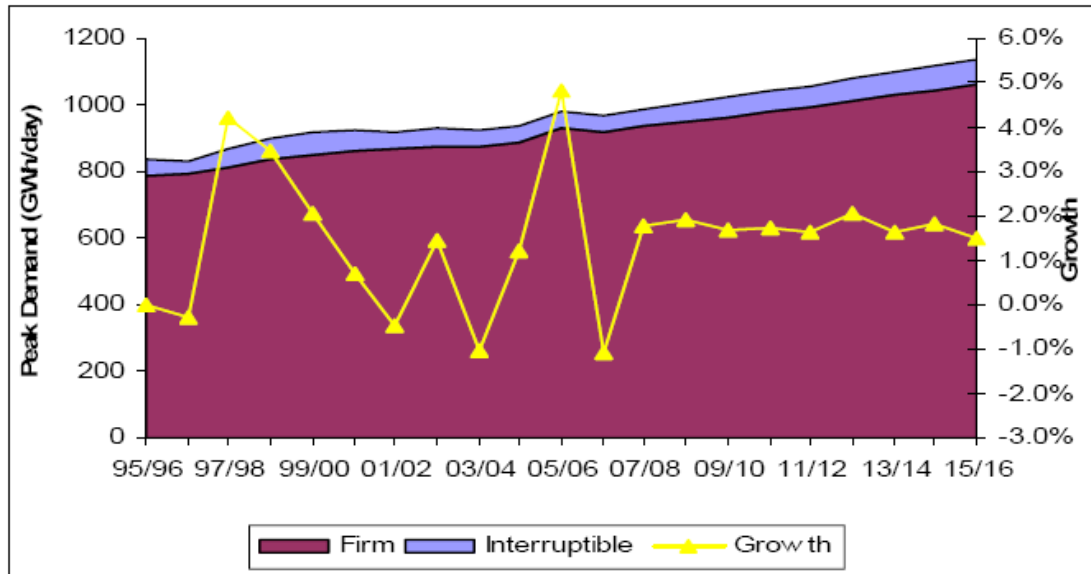
We note that there appear to be step changes in 2007/8 and 2009/10 as well as sustained high levels of capex. Whilst we appreciate that under TPCR, the NTS expects to invest heavily for supply reasons associated with new sources of gas supply we do not understand why such step changes should be required at the DN level given the limited level of projected growth.

We believe that clarification should be provided by each relevant GDN of the drivers behind the substantial capex increases compared to the actual capital expenditure for the last control period. In the absence of substantial demand growth, there must be other drivers for the investment. From the Ten Year Statement (2006), total GDN load growth between 2005/6 and 2008/9 is only 0.6%, but the forecast capex spend rises by substantially more than this.

In addition, at a GDN level, there seem to be some GDNs where the differences are more extreme than others. For example, the South of England has spent £15m on capex in the last two years but forecasts a spend of £250m in the next six years. In our view, this proposed increase merits publication of a detailed breakdown by project of the drivers behind the investment.

As well as full visibility of the underlying data from the GDNs, we would welcome Ofgem's view on any comparisons done between the NG NTS and various GDNs' views of forecast demand growth.

A review of the average peak demand growth from the 2006 Long Term Development Plan between 2005/6 and 2015/6 shows only 1.7% p.a. (compared to a national average from the NG NTS 10YS of 1.9%) with a profile as per graph below. This does not seem to support the large capex forecast and appears to provide further proof that demand growth cannot be the only driving factor.



Given the discrepancies noted above, Centrica believes it is important to confirm what assumptions the companies may have made in completing their forecasts. For example, have they included assumptions about the implications of NTS exit reform?

**b) Reinforcement/Governors**

We note from the document that significant investment is indicated in this area as well, but the document lacks the detail which would enable us to judge what the key drivers may be.

Again, there appear to be significant regional effects. For example, the South of England shows £140m of expenditure despite only modest levels of peak growth forecast (1.7%), and this represents 30% of total capex. By contrast, the East of England has similar levels of growth, but only 8% of total capex in this category.

As respondents, we are unable to assess such significant differences, or judge whether they are reasonable, without disclosure of additional BPQ data to respondents. We would like to request that Ofgem share this data with the community as part of the next document.

**c) Non-operational capex**

Again, the GDNS are forecasting significantly higher spends in this area, but we are not clear how such increases are justified. In addition, Ofgem is considering the possible treatment of non operational capex and whether this should, in fact, be treated as opex.

The sums involved are significant, and vary widely geographically and in time, as is evident in appendix 12. On this basis, we would be very concerned, were such sums to be transferred into opex without a great deal more justification for the level of spend being supplied by the GDNs. If, for example, such spend can be justified by a reduction in another area, we would wish the GDNs to supply details of the spend, the complementary saving, and how that saving will be reported. Where large increases in spend are proposed, we assume that the GDNs will have carried out supporting analysis, which could helpfully be shared with respondents.

**d) GTMS and SOMSA exit costs**

Centrica is aware of and supports Ofgem’s views on the treatment of SOMSA exit costs, and, therefore potential elements of GTMS replacement.

However, we would appreciate as part of the next consultation further information in this area, for example:-

- Are GDNs adopting an approach that delivers the most efficient solution, by keeping an open mind to the possibility of joint development between GDNs?
- Are common service costs incurred by the GDN owner in this area equitably allocated between the gas network business and other businesses owned by the GDN that use the same services?

### **REPEX**

Centrica is aware that there have been detailed and ongoing discussions with HSE on replacement activity as part of the mains replacement programme and without further information, is not in a position to question the projected workload.

However, we are concerned by the cost projections, from the document; it appears that the biggest cost driver in this area is increasing contractor costs. We would welcome detailed information on what proportion of the increase is due to this for each GDN. We also believe that it would be appropriate for the GDNs to share with respondents the actions they have taken to minimise these costs - for example, exploring the use of alternative labour pools, if necessary with additional training. We would welcome Ofgem's views on the potential for new labour from the expanding EU.

**Question 2:** Is our proposed approach to setting opex allowances for 2008-09 to 2012-13 appropriate?

We welcome Ofgem's proposals to use top-down benchmarking of total controllable operating costs across GDNs and to benchmark unit costs across GDNs. In addition we welcome the bottom-up activity based analysis, external benchmarking and expert review of costs. We believe that at the beginning of this new price control period, it will be especially important to ensure that the changes associated with DN sales are not used by the GDNs to justify a more relaxed approach to allowances and efficiency factors in the coming price control period.

In the wake of DN Sales we continue to believe it is important to ensure that consumers benefit from the sales process at the earliest opportunity. We agree with the National Audit Office (NAO) and the Committee of Public Accounts (CPA) that such benefits should start accruing before 2013. In addition, we note the point highlighted by the CPA that the NAO believed savings in excess of £800m were available in the absence of DN Sales, and the further comment that efficiency savings of at least 3% per annum should be expected.

Whilst we appreciate that there are limitations in the comparative data accessible to Ofgem at this stage, we would not support delays in requiring savings for consumers based on the fact that the new management has only been in place since 2005/6. The new owners will have purchased the GDNs based on their view of benefits achievable, including by new approaches to the management of these businesses. It was also clear that a new price control would be in place from 2008; hence it was clear that benefits to consumers should be expected promptly.

As noted earlier, we believe that benchmarking and TPF should be applied to additional categories of costs, including pensions. This would allow the setting of an efficient level of total opex costs and help to mitigate against the significant weakening of incentives inherent in the effective pass-through of pension costs. Moreover, this should also reduce any perverse incentives on GDNs to trade off reductions in general opex and capex for increases in pension costs.

As noted elsewhere in this response, we are supportive of a re-opener in respect of the Traffic Management Act. We believe that overall this will reduce costs to customers by more than providing a non-specific allowance. However, the issue is not new and some of the new owners already have multi-utility experience, hence we believe that they should be able to make a reasonable estimate of the costs.

Instead of a full re-opener, we propose a halfway house in which a very tight allowance is given based on estimated costs. In addition, a re-opener facility may be applied for if the GDNs can prove their efficient costs have exceeded the allowance. This will place the burden of proof on the GDNs to evidence that they have acted efficiently before additional funds are released.

In respect of the claims that additional funds are required to make good the loss of metering contracts and (presumably) the Post Emergency Metering Services contracts, we understand that a number of GDNs have had discussions with suppliers in this area in recent months. We believe it is important that the results of any such negotiations should be taken fully into account when setting opex allowances to ensure there is no double counting.

Finally, it appears that the GDNs also anticipate contractor costs having a significant impact on opex costs. As under the question above, we suggest GDNs should share the work that they have done to explore lower cost alternatives.

**Question 3:** Is our proposed approach to updating the GDNs' RAV to 1 April 2008 appropriate?

Overall we support the approach suggested to updating the RAV, including updating in the September document. We believe that during GDPCR the treatment of repex and whether and to what extent it is capitalised in the RAV will need to be reconsidered. We plan to submit detailed evidence on this point as part of this review process.

In addition to the points noted above, we are supportive of the robust approach taken by Ofgem in the document in respect of the costs of a GTMS replacement, in particular the exclusion of any inflation of these costs to assist SOMSA exit.

## *CHAPTER 4 – Outputs*

**Question 1:** Do you support the proposed changes to the quality of service outputs?

Centrica is of the view that option 2 as suggested in the document would be a sensible and appropriate way forward.

However, we believe that it is also necessary to ensure a balance of cost and benefit. Hence, prior to full implementation, we believe it would be sensible to fully quantify the costs and benefits, so that these may be accurately measured and tracked going forward.

In addition to the proposals contained within the document, as a specific improvement, we would wish to see tighter standards and measurement of outputs around “cut offs” and restorations to supply under the Gas Safety Management Regulations. At present, we believe that the GDNs' standards in this area are inadequate, and that large backlogs have accumulated in some areas. We consider this to be unsatisfactory. It increases the risk that sites may be “live” without end users logged in the systems, which in turn leads to increases in theft.

Centrica also believes it is important to consider the outputs regime as a whole. For example, significantly increased investment in mains replacement and associated services, together with better appliance technology, should lead not only to a reduction in leakage, but also to a reduction in the number and duration of emergency visits. It will be important to consider this type of improvement as part of this review, ensuring that the companies are not provided with allowances at the same level as previously when this should no longer be necessary.

If, as a result of this consultation, changes are made in relation to the provision of alternative heating and cooking facilities, it may also be appropriate to consider consequential changes to the supplier obligations. One example could be removal of the obligation on suppliers to pass Priority Services Register information to GDNs, as this information would be redundant.

**Question 2:** Do you support the proposed changes to third party damage and water ingress proposals?

Again, we are in agreement with Ofgem that option 2 would be the most appropriate way forward. In our view, non-domestic consumers should also be protected in respect of third party damage and water ingress the proposals seem a reasonable way of achieving this.

Limiting GTs' exposure to liabilities in these events (paragraph 4.57), and moving to arrangements similar to those for electricity DNOs seems sensible, as those arrangements underwent significant consultation and development and appear to be working well to date.

**Question 3:** Do you support our proposals for improving the accuracy of pipeline records?

We strongly support Ofgem's view that additional outputs and incentives are required in this area to improve the quality of data. We would, in fact, suggest that the review should further and consider the accuracy and completeness of the information held in Sites and Meters. This should include proper auditing and reconciliation between the physical world, Sites & Meters and the pipeline records.

**Question 4:** Is it appropriate to introduce network capacity output measures? If so what type of output measures are appropriate and what sort of rewards/ penalties should the GDNs be exposed to?

We support Ofgem's comments in the document that it will be important to ensure that the GDNs are not remunerated more than once for the provision of the same capacity. We believe that it will require careful monitoring in the early stages to ensure that the incentives are having the desired effects and that there are no unintended consequences. On this basis we agree that it would be appropriate to introduce network capacity output measures.

In simple terms, if there is a signal to provide additional capacity on the network, it will have a beneficial effect on capability of gas to enter the network, to exit the network, and to be held as linepack. With this in mind, although the investment will result in three separate benefits, only one reward should be received.

We also note and support the concern raised in 4.65, i.e. the risk that if a strong capex roller were to be applied, there would be a perverse incentive in respect of deferral of capex spend, to the potential detriment of the network. In addition to our views on Chapter 5, questions 2 & 3, a further mechanism to address this is considered below.

Based upon transparent reporting of Capex targets and spends over time, if a GDN has an apparent underspend against their reported target, without a full explanation of the delay, then a proportion of the underspend could be permanently forfeited and allowed revenue reduced by the same amount. This could flow back to customers automatically via K in the succeeding year. Even a small retention would provide a strong incentive to adhere to the agreed programme.

In addition to the above, we note 4.67, and comments on setting the output measures. We fully support the proposal to continue to rely on the Licence Conditions for networks to meet the 1 in 20 peak demand. However, we are concerned that in the event that the GDNs were to fail in this obligation, if the appropriate measure has not been carefully monitored and hence, the failure

becomes evident in good time, any opportunity to rectify may have been lost. The proposal in the document to adopt a more prescriptive measure appears attractive, but would be dependent on a transparent process for setting the physical levels to be achieved, and should be in addition to and not a replacement for the existing 1 in 20 peak demand standard.

## *CHAPTER 5 - Incentives*

**Question 1:** Have we identified all the issues for each of the incentives?

Centrica supports appropriate incentives, but has a concern about a potential proliferation of measures that could lead to difficulty in forecasting prices, administrative burden, lack of transparency and potentially perverse interactions between measures.

Centrica is in agreement that Ofgem has identified the key issues for each of the incentives mentioned. We also recognise the difficulties inherent in the informational asymmetry between Ofgem and the GDNs, as identified in the document. This asymmetry is even more pronounced in respect of general respondents to price control consultations. The lack of detailed information available to users severely restricts our ability to offer detailed and constructive input to large areas of the debate such as expenditure and the detailed effect of incentives.

We believe that it will be especially important to consider the incentives, as a whole, placed on the GDNs as a result of this control, and to map the potential interactions. Whilst we welcome clear, sharp incentives being placed on GDNs to produce desired behaviour, we are concerned that an overly complex of the incentive regime would lead to conflicts of incentives and perverse outcomes.

**Question 2:** Is it appropriate to better align capex and opex incentives?

In our view it would be preferable to align the strengths of the opex and capex incentives. However, the significant and persistent informational asymmetries with respect to capex require that care needs to be taken when increasing incentives in this area.

If incentives are unequal, then companies (as recognised in the document) will prefer an opex saving. This may lead to inefficient tradeoffs between different types of expenditure and/or re-badging of expenditure to profit from incentive differentials. Centrica would welcome proposals from Ofgem on how to address these potential trade-offs.

We agree that the proposed benchmarking activity would be expected to strengthen the opex incentives. However, this is only true in this control period if efficiencies identified from the benchmarking (and as a result of DN Sales) are applied within this control period rather than waiting for 2013. In addition, we believe that equivalent benchmarking of capex performance will further strengthen the incentives in that area.

**Question 3:** Do you agree with our initial view that a capex rolling incentive and information quality incentive should be implemented?

At a high level, we support the principle of a rolling incentive for capex, believing that over time this will produce the best result for customers and reduce the risk of uneven investment. However, such a change should be accompanied by a confidence in the ability to benchmark capex costs. On balance, we would also support the implementation of an information quality incentive to modify the capex roller. However, we would be keen that the effects of both the incentives are published at regular intervals throughout the control period, for example actual expenditure against allowances.

**Question 4:** Given the issues raised is there a case for an opex rolling incentive?

We appreciate the difficulties with the implementation of an opex roller, and hence agree this may not be the most appropriate way forward at this time, although we do note the potential for an opex roller to create additional incentives for efficiency savings. However, if a tough opex target is set, together with year on year efficiency factors and robust benchmarking, then we do not believe an opex roller would be necessary, although we will continue to consider the case for an opex rolling incentive in the light of progress with opex efficiency.

**Question 5:** Do you agree with our proposals to retain the mains replacement incentive?

We agree that there is still significant uncertainty around the costs and workload associated with the mains replacement programme, and further that it is reasonable to include bandings for larger pipes as well and recognising service costs.

We also agree that riser replacement forms part of a separate workload and should not be included. However, in the light of large costs implied, and the previous lack of communication on this matter, we would like to understand better why this has only now arisen as an issue.

Given the magnitude of the likely costs (especially if the programme is moving on to larger diameter mains), we also believe that it is reasonable to provide more reporting throughout the control period about the levels of costs and hence the revenues targeted to be collected for this area. Ideally this reporting would provide a target in advance and progress against that target.

**Question 6:** Is flexibility capacity the key incentive to focus on for the capacity outputs? Should we assume that the use of existing NTS flex capacity is the most efficient flexibility capacity product?

Centrica is concerned at present that there is insufficient clarity over the long term NTS Exit regime to enable the setting of robust incentives in an enduring form. We believe that whatever incentives are set in the first instance will require review in the light of the operation of the regime to be implemented. With this in mind, we believe that any early incentive regime should take the simplest possible form we would even consider an incentive with zero value being simply used as a data gathering tool. Robust and enduring incentives could then be set at a later date.

For Flat Capacity, there is a natural trade off between levels of NTS Capacity secured and the GDNs' decision on levels of interruption secured and consequent investment required. However, for Flexibility Capacity, it is very much dependent upon the regime implemented. If a regime were implemented, with complete requirements to acquire flexibility in advance, this indicates limited quantities of flexibility and high levels of competition for a limited resource. This is likely to lead to high costs and incentives will need to be carefully applied to achieve the desired effect.

If, however, the zero or low cost, data gathering option is selected for Flex, the incentives applied have much less significance at this stage.

In the enduring regime, the GDNs should not be able to pass on the full cost of acquiring Flex to users, without some form of exposure to ensure efficient use. As an additional observation, the NTS is not the only source of efficient Flexibility open to the GDNs.

We also observe that there is a need for regulatory consistency in developing a stable regime for setting output measures. It is only with some level of predictability that GDNs and their

customers will be able to provide sound and reliable signals of the future use of the networks and this will underpin investment decisions.

**Question 7:** Is it appropriate to assume that NTS and LTS flat capacity are complementary products? Should we incentivise tradeoffs between flat capacity and interruptible capacity?

Centrica understands that the provision of LTS Capacity is dependent on or substitutable with NTS Capacity, i.e. not a complementary product. The GDNs will evaluate the requirement for LTS capacity and interruption based upon the quantity and cost of that available from NTS.

**Question 8:** Should we incentivise accuracy of pipeline records? If so how could accuracy be measured and audited?

Centrica believes that action is needed to improve the quality of pipeline records and other key data held by the transporters and connection companies. At present, we believe that the lack of an overall audit regime allows GTs, IGTs and connection companies to hand off queries and responsibility for data quality.

Whilst the area clearly requires significant additional work, our initial thoughts are that an end to end process review is required, resulting in a form of audit regime with which GTs, IGTs and connection companies all contribute. The proposed audit would need to include random visits across the country, taking account of such items as those listed below:

- a) Whether demolition notifications are promptly acted upon,
- b) Whether suppliers have been advised
- c) Whether data from emergency visits flows freely to xoserve
- d) Whether missing meters are promptly reported to suppliers

**Question 9:** Is there a case for an innovation funding incentive?

Whilst we have previously questioned both the need for and value for money of the IFI scheme, we support Ofgem's conclusions that such an incentive is not required here.

## *CHAPTER 6 – Financial Issues*

**Question 1:** Should we allow for an ex post adjustment for changes in tax treatment of certain kinds of expenditure, as outlined in paragraphs 6.3 and 6.4?

We agree with the Ofgem approach of allowing a post-tax WACC and the use of an ex ante tax allowance. We agree with the principle of an ex post adjustment to reflect unanticipated changes in the tax rules that are outside the control of the GDNs. Such adjustment should be symmetric i.e. upwards or downwards depending on the changes to the tax regime.

As regards the proposed ex post adjustment due to restatement of accounts, if changes have a cash cost implication and cannot be avoided and GDNs' management show evidence of efforts to minimise the impact, it is reasonable that an ex post adjustment to allowed revenue to fund taxation costs should be allowed.

Ofgem proposes to allow a re-opener only if companies are able to demonstrate that they have taken all reasonable steps to mitigate the cost. We support this approach.

In addition, if the GDNs apply for a re-opener, we believe that this process and the amount of any adjustment must be transparent and communicated to industry participants, together with the likely effect on transportation charges, both via K and in future years of the control.

**Question 2:** Which key ratios should we use as financeability indicators?

The issues around whether, and if so how, to adjust allowed revenue for financeability considerations were considered by Ofgem in 'Financing Networks: A Discussion Paper'. In responding to this question; we wish to be clear that Centrica does not accept that breach of specific financial ratios in the short term, with a given assumed financing strategy, necessarily implies that allowed revenues should be increased. In practice, situations of this nature are often best addressed via changes in financing structure. We will submit further evidence on financeability issues as part of this review.

When considering financeability issues, Ofgem will necessarily need to take account of the ratios that are most important to the ratings agencies. As you are aware, key ratios include:

- FFO invest cover
- Adjusted FFO invest cover
- FFO / debt
- Retained cash flow / debt
- Debt / RAV

All of these ratios should be modelled and evaluated in order to assess ex ante the possible impact of determinations on credit assessments of the GDNs. The assessments should use notional gearing and allowed cost of debt and a range of alternative financing strategies including use of index-linked debt

**Question 3:** How should we finance replacement expenditure, having regard to its impact on the overall financeability of the price control?

Please refer to our answer to question 4 below.

**Question 4:** Should we change our depreciation rate for new assets in response to the changing mix of assets being capitalised?

The logic of Ofgem's approach to setting the price control is that allowed revenue over the full life of the assets should fund the costs of providing the assets – if the owner is operating and investing efficiently. It follows that the depreciation rate for all the capital expenditure – whether classified as repex or new assets – should reflect the life of the relevant assets on which the expenditure is being incurred.

Therefore, in principle, Ofgem should manage the depreciation rate for new assets in response to the changing mix of assets being capitalised. In practice, significant changes in depreciation rates for new assets seem unlikely.

The question of how to finance repex expenditures is clearly very important. This expenditure is capital in nature and in principle should be capitalised, added to the RAV and funded through the depreciation provision over the life of the assets, in the same way as expenditure on new assets.

The expensing of a significant proportion of repex appears to have been allowed because of financeability considerations, in view of the heavy repex expenditure proposed by the GDNs. A repetition of this approach will result in much higher increases in distribution charges than would have arisen if repex were fully capitalised and depreciated.

Centrica is firmly of the view that the starting position for Ofgem should be that all repex expenditure is capitalised and depreciated. If financeability constraints prove to be strong

constraints then separate consideration should be given to how to address those constraints. As noted earlier, we will submit further submissions on repex and financeability as part of this review.

## *CHAPTER 7 – Sustainable Development*

We appreciate that in the main, the questions in this chapter do not relate to shrinkage, and that issues relating specifically to shrinkage will be raised later in the process. However, we continue to consider the issues around shrinkage internally, and in the light of the comments in paragraphs 7.2 & 7.3, we hope that the following will be helpful.

Whilst, on balance, we agree that GDNs should not be fully exposed to the shrinkage gas price risk, we will give further thought to the form of the shrinkage incentive implemented as part of the one year review to see if improvements can be made to that area. GDNs should continue to be fully exposed to the shrinkage volume risk as this is an area that is largely within their control and it would not be in customers' best interests for this incentive to be weakened - in particular, as other market participants are less able to control this risk. However, there are a number of issues associated with the scope of the existing price control arrangements as well as the way that they are implemented via the Uniform Network Code that need addressing. We have previously highlighted these to Ofgem.

Some of the implementation issues can be addressed via the existing Uniform Network Code industry governance arrangements. For example, the industry is considering British Gas Trading's UNC code modification proposal 0115 "Correct Apportionment of NDM Error". This modification seeks to address the current inequity of allocating all errors flowing from the GDN shrinkage assessments as well as other errors, omissions and systematic biases to the smaller supply point (SSP), mainly domestic, sector as a consequence of the industry Reconciliation by Difference Arrangements. To put this issue into context, the existing shrinkage factor is approximately 0.7% of throughput, whereas the over-deeming in the SSP sector is up to an additional 3% of that market. Consequently, domestic customers are in effect cross-subsidising larger non-domestic loads.

However, other issues require consideration by Ofgem as part of this price control review. In particular, whether the scope of the existing shrinkage incentive is sufficiently wide to ensure that the incentive is effective, or whether any deficiencies would be better addressed by more targeted obligations or incentives to reduce the SSP over deeming. Whilst in theory it may be possible to address these issues using the existing UNC governance procedures so long as the price control is changed to reflect any changes to GDN cost or risk, in practice such issues are so fundamental to the overall price control settlement that they should be addressed at a high level by Ofgem via this price control review. The industry governance could consider the detailed design of the regime and deliver the changes either in parallel or following Ofgem consideration.

We will provide further submissions on these issues as part of the review.

**Question 1:** Which of the two forms of the network extensions incentive scheme should we adopt going forward?

Centrica does not have strong views in this area, but believes that Ofgem's suggested way forward of an incentive scheme aligned with either option 5 or 6 would be a reasonable approach.

**Question 2:** Do you agree with our assessment of the risks, costs and benefits attributable to the options for facilitating network extensions (see Appendix 6)

No comments to make

**Question 3:** Is our proposed methodology for quantifying the costs and benefits associated with the various options appropriate (see Appendix 6)?

No comments to make

**Question 4:** Is it appropriate to set an incentive scheme which recognises the initiatives that some companies undertake with respect to their corporate social responsibilities?

Centrica is of the view that given Corporate Social Responsibility (CSR) activities would be expected to enhance the brand and reputation of the companies, this activity should be funded by shareholders rather than customers. For example, Centrica funds a range of CSR initiatives including a winter rebate for our most vulnerable customers in receipt of certain benefits. This provided a rebate of up to £90 per customer with c. 400,000 eligible customers, and was delivered in conjunction with our charity partners.

**Question 5:** What other criteria should be included in a Corporate Social Responsibility incentive scheme for GDNs?

In the light of our response to question 4 above, we would not be supportive of any additional criteria in this area.

## *CHAPTER 8 – Other Issues*

### **General**

Centrica continue to actively participate in the industry group, which was established to trigger, and focus industry dialogue on the five key areas, as detailed under section 8.3 of the consultation.

The group is currently in the process of preparing its final report, which will set out participants views on each of the areas identified, the report is due to be issued to Ofgem on 23<sup>rd</sup> February 2007.

Centrica is of the opinion that, at present, the industry group is not yet in a position to provide Ofgem with a definitive set of answers to all of the deliverables set. The group needs to continue to address the issues being discussed as quickly as possible, otherwise there is a risk that the response provided as part of the group's final report to Ofgem, may be not be of sufficient detail to satisfactorily answer the questions posed.

**Question 1:** Do you agree with our assessment of the risks, costs and benefits attributable to the two options for the funding of xoserve?

Centrica agree in principle with a move towards a user pays approach, in line with Option 2 as defined within the consultation document, providing the benefits of such an approach outweigh the costs and risks. However, we have not yet formed any firm conclusion on whether or how any user pays services should be implemented. There is currently insufficient detail and certainty as to how any user pays arrangements would be governed; how the associated charging

methodologies would be structured; and, most importantly, at what level unit charge costs would be set.

Further consideration needs to be given to the appropriateness and cost effectiveness of which, if any, current xoserve service lines could or should be established as a user pays service going forward, or whether user pays initiatives should, for the time being, be limited to future non-core services as they develop.

**Question 2:** If we adopt a core services plus user pays approach (Option 2), how should we define core services and user pays services?

Through its work to date, the industry group has identified five candidate service lines. However, work in this area is incomplete. Each of these candidate service lines requires further discussion and development, both externally at an industry level and internally within individual organisations. This is essential before parties can provide a clear and objective view on exactly which service lines, if any, could safely move to a user pays service and be subject to user pays arrangements.

By default, any service lines which are not specifically identified as user pays, must continue to be treated as core services.

**Question 3:** What costs/benefits would your organisation incur in the event that we adopt Option 2?

As above, Centrica along with other Shippers, currently find itself in a position where it cannot provide any definitive indicators for or against a user pays mechanism. At present, there is no definitive information available on how a user pays charging methodology would be structured, and, at what levels the individual service lines' unit charge costs would be set.

Once this information has been provided, Centrica will be in a position to undertake the appropriate cost benefit analysis of the potential user pays service and hence reach a definitive view.

**Question 4:** What questions do we need to ask GTs, xoserve and shippers in order to accurately quantify the costs associated with Option 2?

In order for industry participants to be in a position to undertake the work and analysis required, to accurately quantify the costs associated with Option 2, full details relating to the structure of the proposed user pays arrangements and costs, need to be provided.

Specific areas where Centrica believes further detail and ultimately agreement is required, to enable this process, include:

- the framework arrangements within the UNC
- the structure of charging methodologies
- the commercial contracts between parties
- the costs and charges
- change management considerations and funding.

The latter point, regarding change management consideration and funding, is a crucial element of understanding how future changes to the UNC and subsequently xoserve service lines, will be funded during the next price control period, compared with the existing arrangements.

**Question 5:** In the event that the Secretary of State requires GDNs to put in place further alternative arrangements relating to independent systems, should the excess costs associated with independent systems be:

- spread across all GB consumers via transmission charges, or
- borne by customers located in gas distribution areas where independent systems are located (primarily Scotland)?

Our understanding is that the current position is the Secretary of State requires support to Independent Systems on an enduring basis. If the basis for charging shippers and/or GDNs in relation to these arrangements needs to be amended, this will require formal authorisation from the Secretary of State.

Responding to your specific questions, we believe that a) the excess costs should be spread across all GB consumers via transmission charges, but b) that the basis of the transportation charges should reflect those of the Gas Distribution area in which they are located. Therefore, we believe that the current arrangements are unsatisfactory.

In respect of the Statutory Independent Undertakings, there are a number of contractual issues which still require resolution post DN Sales.

## **Appendix 1**

In order to facilitate detailed and constructive responses to the next consultation on costs, we have prepared a list of the information which we believe it would be helpful to have included in the next document.

We would be happy to discuss this list with Ofgem and the GDNs and consider alternatives to the information suggested.

We have broken the list up into the major cost categories, which we hope will be helpful, we believe that this will provide useful information to respondents. An alternative would simply be to publish the BPQ data.

### **Capex**

- A full list of all major capex projects (over £500,000) together with a description of the full justification for the project.
- If the project(s) above are growth related, then supply the supporting demand growth analysis related to the project. In each case, cost breakdowns by year and category e.g. contract/direct labour, materials etc. should be supplied with details of any contributions to be received.
- For mains and pipeline projects diameters and lengths laid to be provided.
- Any details of demand forecasts produced by the GDN below LDZ level (zonal) with associated zonal definition
- Breakdown of capex forecasts in more detail than those produced in the 3rd Consultation. Examples are the split between LTS and Storage, split between Reinforcement and Governors, non-operational breakdown by category. Suggest that breakdown goes down to categories of £100,000 or greater.
- For each category the total increase in asset to be provided e.g. length of main for each diameter installed, number of governor installations, additional storage etc.
- For each category details of capitalised overhead

### **Repex**

- For mains, please provide the breakdown of costs between policy and condition replacement with policy sub-divided by HSE Enforcement Policy/MP DI Improvement Order/Other policy
- For each category length of new mains installed and old mains abandoned
- For each category details of capitalised overheads and contributions received
- Details of any LTS expenditure - costs and justification
- Total cost of replacement services, number replaced, capitalised overheads and contributions received

### **Opex**

- Operating cost matrix as per BPQ table B1.
- Shared Service cost matrix as per BPQ table B2
- Labour cost matrix as per BPQ table B3.
- Anticipated uncertain costs of complying with legislation etc. as per BPQ table B5.1
- Shrinkage data as per BPQ table B6

### **Asset data**

- Data as per BPQ tables C10, C11, C12, C13 and C20.