



EDF Energy | Response

Gas Distribution Price Control Review
Third Consultation Document

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EDF Energy's responses to specific questions raised

Chapter 2

Q1: 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?

In general the approach to excluded services appears reasonable, however it could be questioned why the charges for gas taken illegally are treated as an excluded service. Under the current arrangements the value of the stolen gas is covered through distribution charges, it would therefore appear appropriate that if Shippers pay for gas taken illegally, then they should also benefit from charges that are recovered in relation to this gas.

Q2: Should domestic one off connections be treated as excluded services or ordinary price control services?

Given that the volumes in this area can be unpredictable we believe the most sensible option would be to continue to treat it as an excluded service. The option of including this service within the price control linked with a new connections revenue driver is, in our view, overly complex.

Q3: 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?

It appears reasonable that the NTS charge for pension deficits and payment claims associated with last resort supply are treated as pass through items as the GDNs have little or no control, over these charges. It appears reasonable that charges recovered in relation to gas taken illegally should also be treated as a pass through item.

Q4: Is there any reason why we should change our position on cost indices?

Please see our response to questions 1 and 2 in Chapter 3.

As stated in our response to the second consultation document we believe that there is merit in incorporating a construction cost indices in the GDN cost base. We believe that this would minimise the risk on both customers and the companies of Ofgem incorrectly forecasting the impacts of the relative price effects across a price control period.

Q5: Is there any reason why we should change our position on re-openers?

No.

Q6: 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?

The principle of a two-tiered correction mechanism appears appropriate as it will incentivise GDNs to recover their allowed revenue, and promote stability.

Q7: Should we calculate the GDNs' allowed revenues in a way that creates a smooth revenue profile over the course of the price control period?

Provided the calculations are NPV neutral, allowed revenue should be calculated in a way that creates as far as possible a smooth revenue profile.

Chapter 3

Q1: Is our proposed approach to setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?

Q2: Is our proposed approach to setting Opex allowances for 2008-09 to 2012-13 appropriate?

Broadly, Ofgem's proposed approach is sensible. We welcome the fact that they propose to use multiple methods for assessing opex efficiency and setting capital expenditure allowances. However, we are concerned that Ofgem is proposing to use a Total Factor Productivity (TFP) study. Historically, Ofgem has used the output of this work to assert future efficiency savings. We believe that such an approach is contrary to the principles of RPI-X regulation. The basis of this form of regulation was to put in place an incentive framework which incentivised companies to reveal their efficient costs, which the regulator would then pass on to customers. Given that Ofgem has historically not allowed for costs of change then asserting efficiency savings is in effect disallowing these costs, as shareholders cannot share in the benefit associated with the delivery of these efficiencies.

A number of GDNs have highlighted that they are experiencing significant upward cost pressures in a number of areas e.g. wage costs. The increase in costs is likely to exceed RPI and hence this needs to be addressed in setting both the opex and capex allowances. In the recent TPCR, Ofgem have included the companies' assumptions on real wage growth in developing the allowances. In addition, they have made ex ante allowances for increased unit costs in a number of areas. Assuming that Ofgem finds robust information to support the GDN forecast cost increases the application of a similar approach, to that used at the TPCR, would be appropriate.

In addition, we note that the analysis is being carried out by a number of different consultants. We appreciate that the scale of the work and the timescales involved necessitate such an approach. However, we would expect the process to be carefully project managed to ensure that the data requests are co-ordinated to minimise the information provision burden on GDNs.

We would also expect Ofgem to publish detailed information from its capex consultants including both volumes and unit costs at an appropriate level. This is vital if companies are to judge their future exposure under the four pot model that Ofgem have used to assess the efficiency of historic capital spend.

Q3: Is our proposed approach to updating the GDN's RAV to 1 April 2008 appropriate?

Yes .

Chapter 4

Q1: Do you support the proposed changes to the quality of service outputs?

In general the proposed changes to the quality of service outputs appears reasonable, providing Transporters with clarity as to when a breach will be enforced. However it is concerning to see that it is proposed that the compensation arrangements for a

Guaranteed Standard 3 (GS3) breach are removed as it is unlikely that a failure will occur and that compensation will be paid. We believe that by removing the compensation payments, the incentive to avoid this type of breach is reduced, or even removed, and so it could be more likely that a breach will occur.

Q2: Do you support the proposed changes to third party damage and water ingress proposals?

The initial proposals appear reasonable, providing an incentive for GDNs to reconnect supplies following third party damage or water ingress, whilst not excessively exposing them to costs which are outside of their control. However we do question the appropriateness of altering the governance of non-domestic interruptions in light of the current UNC proposal. We believe that for I&C interruption arrangements the UNC provides adequate governance arrangements and so see no need to remove these arrangements from the UNC, although there may be scope to limit these arrangements to sites that are eligible for interruptible status, and so remove the SME sector from the UNC.

Q3: Do you support our proposals for improving the accuracy of pipeline records?

Given the implications of not being able to accurately identify where the pipelines are we believe that these proposals appear appropriate.

Q4: Is it appropriate to introduce network capacity output measures? If so what type of output measures are appropriate and what sort of reward/penalties should the GDNs be exposed to?

EDF Energy believes that the current arrangements for GDNs to meet their licence obligations to develop their networks to meet 1 in 20 peak demand conditions, combined with the numerous efficiency incentives, remains adequate. We believe that this provides GDNs with flexibility as to how they will meet their capacity requirements, and does not expose the industry to the risk that the investment requirements are set at an inaccurate level by Ofgem. We do however note, that central to this issue will be the incentives that Ofgem set in relation to NTS Exit bookings, interruption procurement and LTS investment, and their associated cost recovery. We would also note that the requirement for Ofgem to set correct incentives and cost recovery mechanisms clearly demonstrates how GDNs are materially different to other NTS offtakes who operate in a competitive market.

Chapter 5

Q1: Have we identified all the issues for each of the incentives?

In general we believe that the majority of issues has been identified, however there are two notable exceptions, the interaction of mains replacement incentive with the capacity output incentive, and the interaction of the capacity output incentive with the competitive market for the purchasing of NTS Exit flat and flexibility capacity, if it were to be introduced. It would appear that a GDN's activity under the mains replacement incentive could have a direct impact on the volume of interruption and NTS offtake capacity that it is required to book. It will therefore be necessary to ensure that the two incentives operate in such a way so as to ensure that there is no gaming between the two, and to insure that any efficiencies that are achievable through mains replacement work are recognised. It would also appear that were exit reform to be implemented so that GDNs were competing with other NTS Offtakes for flat and flexibility capacity, then the interaction of any incentive with this competitive market should also be identified. In particular it should be expected that any incentive for GDNs should mirror the incentives

that are in place for other NTS Offtake points operating in this market, and that any caps, collars and sharing factors are applied equally to both NTS Offtakes as well as GDNs.

Q2: Is it better to align Capex and Opex incentives?

We believe that if Ofgem introduce an information quality incentive it would be inappropriate to align capex and opex incentive rates. This is because under the information quality incentive it is possible for companies to have differing capex incentive rates. Hence, if the incentives are aligned companies may have differing opex incentive rates. This means that some companies will be able to reduce costs faster than other companies, as relatively more efficiency programmes would be NPV positive. This would seem to rule out comparative analysis as a tool for the next price control, as it would discriminate against those companies with lower incentive rates by inappropriately judging them less efficient, whereas in fact they will merely have been reacting appropriately to the incentives on offer.

Q3: Do you agree with our initial view that a Capex rolling incentive and information quality incentive should be implemented?

In principle, the implementation of both the rolling capex and information quality incentives is sensible. We would however question how we would be able to identify the cost saving this would have in terms of reduced workload for Ofgem. Moreover, we are concerned that the scheme has been portrayed as incentivising low capex bids rather than sustainable forecasts. The key element of the information quality incentive is the quality of the consultants' forecasts. The GDNs should be provided with sufficient detail to understand how the consultants' forecasts have been built up, particularly if there are significant differences between the company's and consultants' views.

Q4: Given the issues raised is there a case for an Opex rolling incentive?

We believe that a rolling incentive should only be introduced after the cost reporting framework has been implemented and Ofgem are convinced that companies are reporting accurately against the rules.

Q5: Do you agree with our proposals to retain the mains replacement incentive?

As previously noted we believe that there could be a strong interaction between the mains replacement incentive and the capacity output incentive. We believe further work is required to identify the interaction between these two incentives to ensure that they are adequately aligned.

Q6: 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 capacity product?

As noted in our responses to Uniform Network Code (UNC) Modifications 0090, 0116V, 0116A, 0116BV, 0116CVV and 0116VD a key issue with these reforms is that they interact with each other, with the volume of flexibility capacity required being directly linked to the volume of interruption that a GDN has procured, which in turn is directly linked to the volume of flat capacity that it requires. It would therefore appear that all three outputs should be given equal weighting in any incentive. We would further note that if the use of the existing NTS Exit flexibility capacity is the most efficient outcome, then there is no need to implement radical reform of this product.

Q7: Is it appropriate to assume that NTS and LTS flat capacity are complimentary products? Should we incentivise tradeoffs between flat capacity and interruptible capacity?

Whilst it is clear that NTS and LTS flat capacity are not substitutes, it is not clear that they are perfectly complimentary products. We would note that an increase in LTS flat capacity does not necessarily require an increase in NTS flat capacity, but that an increase in NTS flat capacity is likely to be accompanied by an increase in LTS flat capacity.

Q8: Should we incentivise accuracy of pipeline records? If so, how could accuracy be measured and audited?

Please see our response to Chapter 4 Question 3.

Q9: Is there a case for an innovation funding incentive?

Yes, we believe that there would be benefit in establishing an IFI scheme for GDNs. This would ensure that research and development capability is protected in the long term, as efficiency savings become progressively more onerous to achieve.

Chapter 6

Q1: Should we allow for an ex-post adjustment for changes in tax?

Yes, we believe it would be appropriate to adjust ex post for changes in tax.

Q2: Which key ratios should we use as financeability indicators?

We believe Ofgem should use financial indicators which allow it to assess if its proposals result in the company being able to maintain its credit rating “comfortably” within investment grade. We believe that the indicators, and associated ratios, utilised at the last DPCR, are appropriate and that Ofgem should continue to use them unless it has quantifiable evidence that any of them is no longer substantially correct.

Q3: How should we finance replacement expenditure, having regard to its impact on the overall financeability of the price control?

We believe that Ofgem’s previous approach of striking an appropriate balance between the interests of current and future customers remains appropriate in determining how much expenditure should be expensed and how much should be capitalised.

Q4: Should we change our depreciation rate for new assets in response to the changing mix of assets being capitalised?

We believe that information technology (IT) assets should be treated as capex and depreciated over their useful economic life. Accordingly, we believe that Ofgem should look at the practicality of introducing an IT RAV.

Chapter 7

Q1: Which of the two forms of the network extensions incentive should we adopt going forward?

EDF Energy does not have a view on this question

Q2: Do you agree with our assessment of the risks, costs and benefits attributable to the options for facilitating network extensions?

EDF Energy does not have a view on this question

Q3: Is our proposed methodology for quantifying the costs and benefits associated with the various options appropriate?

EDF Energy does not have a view on this question

Q4: Is it appropriate to set an incentive scheme which recognises the initiatives that some companies undertake with respect to their corporate social responsibilities?

Yes, we believe it is appropriate to incentivise best practice in areas which cannot be easily measured via traditional mechanistic schemes. An incentive of this type would be appropriate to recognise the effort Distribution companies have made in implementing social and local schemes to improve their relationship with their customers and communities in which they operate. Such an incentive would also serve as a bench mark between competing DNs to compare performance and initiatives implemented by different DNs and their relative success.

Q5: What other criteria should be included in a Corporate Social Responsibility incentive scheme for GDNs?

Ofgem's proposed criteria appear broadly sensible.

Chapter 8

Q1: Do you agree with our assessment of the risks, costs and benefits attributable to the two options for the funding of xoserve?

We welcome the inclusive work done to date on Xoserve and the UK Link replacement and the report published in December.

We generally support the move to the “user pays” model as it will be more cost reflective, however we require additional clarity as to what the core services would be under Option 2 and what the User Pays service would be. At this stage it is not clear exactly what xoserve would be funded for and so it is hard to identify what the actual risks, costs and benefits will be. There is also a question about the level of governance needed with Shippers having a vested and “hands-on” position to be able to review charging methodologies and not just the GTs/Xoserve which would make the model biased. We believe the costs of implementing such a model may incur some expenditure and therefore the final model or proposal should be subject to an Impact Assessment.

Q2: If we adopt a core service plus User pays approach, how should we define core services and user pays services?

We would expect the industry dialogue on xoserve's funding to identify which services were core and which should be user pays.

Q3: What costs/benefits would your organisation incur in the event that we adopt Option 2?

We require further clarity as to what services would be core and what would be user pays before being able to identify the costs/benefits to our organisation.

Costs

Additional costs would be incurred in order to validate the additional costs and invoices that will be received.

New agreement will be required to be in place between shippers and xoserve. Users will have to contract with xoserve for the provision of these services so some sort of “Contract Manager” role may well be required.

Benefit

Greater incentive on xoserve to tailor services to each shippers particular needs so could differentiate our product. Would ensure GTs and xoserve respond to market more effectively.

However, we would require visibility of the costs from xoserve

Q4: What questions do we need to ask GTs, xoserve and Shippers in order to accurately quantify the costs associated with Option 2?

What services are to be part of the core services?

Will cost be based on volume (traffic of flows) or portfolio size at a point in time?

How will the model compare to the electricity Elexon model?

Q5: 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)?

EDF Energy does not have a view on this question

EDF Energy
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