energywatch
your gas and electricity watchdog

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Dear Joanna

Gas Distribution Price Control Review 2008-13: Third Consultation Document

energywatch welcomes the opportunity to respond to the issues raised by this consultation. This response is non-confidential and we are happy for it to be published on the Ofgem website.

Executive Summary

- Gas distribution networks (GDNs) must deliver safe, secure and reliable networks efficiently and at economic cost.
- RPI-X remains the most appropriate form for the price control.
- Costs must be clearly differentiated and derived in a simple, transparent and easily understood manner, with limited use of re-openers.
- Consumers need to see immediate efficiency benefits, based on, and enhanced by, robust and regular reporting of costs.
- Streamlining standards will benefit consumers and GDNs, but the level of protection – licence condition or guaranteed standard – must be appropriate.
- Improving quality of service to consumers means sufficient notice of interruptions, extension of the customer satisfaction survey to provide feedback, with costs offset by efficiency, and prompt action when consumer detriment occurs.
- Incentives must fit the drive towards greater operational efficiency and not reward GDNs for doing their job.
- GDNs are low risk and their cost of capital must reflect this.
- Efficient network extensions will benefit off-gas communities.
- Xoserve services should be split between core and 'user pays'.

General comments

Consumers expect all distribution businesses to operate efficiently and economically to provide safe, secure and reliable networks. This is particularly true of gas distribution networks (GDNs), four of which were sold to other operators by National Grid Gas (NGG) in May 2005. This price control review provides a significant opportunity to realise real savings for consumers through the effective regulation of these networks. Consumers rely on GDNs to manage the risks associated with the networks and trust them to manage on an efficient and effective basis. Only those costs which are efficiently incurred by the GDNs ought to be recovered by them.

We agree that the continued use of RPI-X regulation provides an appropriate framework for setting the price controls for monopoly network businesses. It ensures that efficiency savings are measured in relation to the rise in general prices and encourages GDNs to outperform their targets, passing savings through to consumers. We agree that there are other approaches which Ofgem could apply which may be inherently more complex, for instance the use of a multitude of price indices for material costs. However, those approaches would deny consumers the ability to gauge on a comparative and simple basis the benefits and savings which could be passed through to them.

Scope of the price control

We recognise that the price control could cover a wide range of costs incurred by the GDNs. However, a clear distinction needs to be drawn between core regulated services, the costs of which can be recovered through price control revenue allowances, and other separately identifiable one-off or value added services, which should still be provided efficiently if the costs are to be recovered but which ought to be borne by those creating the cost. We would welcome clarification from Ofgem on the difference between core and excluded services so that all consumers pay only for those services clearly attributable to them.

We agree that revenue drivers should appropriately reflect (and in relative proportion) how costs are incurred, whether by volume or customer numbers. However, the revenue drivers must not be unnecessarily complex. Distribution costs should be derived in a simple, transparent and easily understood manner. We note Ofgem's desire to give further consideration to the costs of domestic one-off connections and emergency services to determine how these are defined and treated. We believe that any appropriate treatment must ensure that those costs are incurred efficiently to keep the costs low for affected consumers.

As a general rule we do not support the use of price control re-openers except in very specific circumstances where it is obvious that unforeseen costs have arisen which ought appropriately to be passed through to consumers. The price control must be based on an agreed set of core services and the revenue allowances should reflect this benchmark. We note the concerns of the GDNs that future legislative action may give rise to additional costs but we counsel Ofgem against accepting the case for re-openers unless the costs are truly exceptional. Even then, we would expect the impact on consumers to be measured on the basis that those costs are incurred as efficiently as possible.

We believe that distribution charges can be kept relatively stable throughout the price control period and we would encourage an approach that ensures that price control mechanisms promote stable charges. We note that correction mechanisms can deter over and under recovery of charges and ensure there is no 'gaming' of the price control by the GDNs which may suit them commercially but which can cause charges to fluctuate. Incentives, revenue drivers and other mechanisms should be used to limit the extent to which variations occur in the charging mechanism. Effective and robust reporting of costs by the GDNs during the price control period should be implemented to further assist stability and predictability. Shippers and suppliers require certainty about their costs so that they can pass relevant savings back to consumers over time.

Assessing costs

We have two main concerns regarding how costs are determined for the enduring price control:

- new and replacement capex costs are being forecast to rise further, yet there is no indication that there should also be cost efficiencies arising from previous additional expenditure and how much of this should be passed back to consumers; and

- there are no effective mechanisms proposed for regular cost reporting between price control reviews which would help identify where savings can be made on an ongoing basis and assist in streamlining the price control process next time around.

Ofgem must address these concerns. The interim price control set for 2007/08 highlighted a number of areas where costs are to rise. However, there was no information about the work that the new owners are undertaking to identify cost savings. When National Grid sold four networks in May 2005, it is inconceivable that the prospective owners would not have carried out due diligence which would have highlighted areas where cost savings could be made. If that is the case, the new owners should have highlighted these to Ofgem, or Ofgem should have made the appropriate enquiries, when setting the interim price control. Instead, consumers are expected to pay significant additional costs at a time when energy prices are already creating consumer detriment. However, no immediate savings from the sales are being passed back to consumers.

We would resist the same approach being adopted for the enduring price control. The recent report of the Public Accounts Committee[1] regarding the GDN sales has highlighted how Ofgem has failed to deliver more immediate efficiency savings from

[1] The Committee's report can be found at: http://www.publications.parliament.uk/pa/cm200607/cmselect/cmpubacc/110/110.pdf.

the GDN sales to consumers and is taking a relaxed, rather than rigorous, approach to efficiency targets going forward.

We concur with the Committee's opinion that Ofgem must start from the premise that the GDNs, particularly, but not exclusively, those no longer owned by National Grid, have the ability to deliver savings as well as requesting additional expenditure. The purpose of the sales was to enhance competition and innovation. If these are the drivers of efficiency going forward, then there should be information available from the managements of the GDNs, all of which have experience of operating utilities, which point to ways in which expenditure can be offset by savings.
Consumers should not have to wait until after 2013 to see such savings.

Ofgem can and must seek to develop effective reporting mechanisms for this price control and beyond. Robust reporting means that the process of cost analysis does not end once allowances have been agreed with the GDNs. Instead, the GDNs should continue to report on their actual spend against targets set and the proposed cost reporting pack must reflect this. This will assist in two ways:

- by keeping the GDNs alive to their costs and ensuring they identify savings through innovation and competitive pressure; and

- allowing Ofgem to run a more streamlined process in the run-up to the next price control (2013-18).

We believe that Ofgem must adopt this approach to meet its primary statutory duty to consumers. Ofgem can apply the practice of other regulatory bodies and constructively engage with the GDNs to maximise the transparency and usefulness of data on an ongoing basis.

We do not accept that the availability of data is poor because the new owners of GDNs are still getting to grips with the businesses they have bought. In addition to information obtained prior to the sales, there will be a further two years of post-sales data available by May 2007, before Ofgem plans to publish its initial proposals. That data could certainly be analysed and incorporated into the final proposals which Ofgem will issue later this year.

We recognise that there will be additional costs given the level of activity that is expected on the distribution networks in coming years. However, the baseline expectation of consumers will be that costs are incurred efficiently, are kept as low as possible, and that competitive pressures and increasing innovation in network management can and will drive costs down over time. It is up to Ofgem to ensure that the GDNs deliver.

Outputs

We believe that it is appropriate to re-assess whether the existing quality of service outputs are delivering the desired benefits for consumers. A 'do nothing' approach is unsatisfactory. Our view is that an effective regime of standards should produce the following outcomes:

- for the GDNs, the adoption of standards with wide application beyond a sub-set of consumers which are easy to record, clearly understood, and provide meaningful data, capable of comparison, which allows them to make quantitative and qualitative improvement to the service which is delivered to consumers while maintaining incentives on them to increase efficiency; and

- for consumers, standards which address the practical issues raised by them with the GDNs, and which contribute to progressive increases in customer satisfaction by ensuring that action is taken promptly and effectively.

We agree with Ofgem's preference for Option 2 of rationalising and updating outputs. We have a number of specific comments on Ofgem's proposals:

- We favour the removal of overall standards and their replacement with licence conditions or guaranteed standards as appropriate. When determining whether a licence condition or Guaranteed Standard of Performance (GS) is more appropriate, Ofgem must consider the level of protection required by individual consumers. Whilst a failure of a GS would result in redress for an individual consumer it is unlikely that Ofgem would seek to enforce a breach where only one consumer was affected. Licence conditions must prompt action from the GDNs where deficiencies in performance occur and Ofgem must be prepared to take relevant enforcement action to ensure compliance. Where it is likely that a single licence breach would not result in a consumer receiving redress then Ofgem must opt for a GS.

- We believe that there are good reasons based on safety requirements that necessitate the retention of OS1 in a strengthened licence condition regarding the provision of manned telephone services for reporting gas escapes and emergencies.

- We agree that OS2 (notification of planned interruptions) would be more effective for consumers as a GS. Ofgem's customer research and energywatch's database of complaints and enquiries highlight the desire of consumers for as much notice as possible of a planned interruption. Consumers need to prepare for such events, so advance notice, coupled perhaps with a reminder, is essential to them particularly during colder weather.

- We accept that it may be difficult for GDNs to record and report accurately against OS3 but believe it is essential that all consumers, particularly vulnerable consumers, are aware of elongated periods of (unplanned) interruption. It may well be the case that GDNs believe they are outperforming the current standard but it is vital that they seek a more accurate measure. Extending the customer survey to cover all affected consumers in all but the most extreme cases would ensure that GDNs are truly aware of whether or not consumers received the necessary notifications. Equally, GDNs must be tasked with resolving any issues that arise from these surveys and we look to Ofgem to monitor and measure the effectiveness of performance against issues raised in the customer survey.

- Failure to respond to individual consumer complaints (OS4) can create real problems for some consumers, particularly for those who have suffered loss as a result of the action or inaction of a GDN. We believe it is right and proper that this element of customer service should be covered by a GS.

- energywatch agrees that there are issues with the enforcement of a failure of the existing OS5 (attending emergencies) standard. This is a vital area of service to consumers and, although performance in this area has generally been very good, we should not be complacent. Incorporating this element into the licence and attaching a service level to it should make it easier for Ofgem to take relevant action in the event of a failure. Given the importance of this issue in relation to safety we would expect Ofgem to be able to react quickly to any identified areas of detriment as a result of GDN failure in this regard.

- energywatch has some sympathy with the GDNs' argument that they find it difficult to report against GS3, and with their belief that they presently provide a service which exceeds the current arrangements. Further, we understand that the majority of consumers are visited at the outset of an interruption so will have the opportunity to ask for alternative heating and cooking facilities. However, we cannot support Ofgem's intention to remove the GS in favour of including this provision in the licence. GDNs may well be performing to a good standard in this area but we are concerned about the impact a failure may have on consumers (particularly the vulnerable) of the lost opportunity to provide redress if individual breaches are not investigated by the GDN, and of the ability of Ofgem to enforce individual breaches. We would urge GDNs to review current PSR information with a view to improving its quality and accuracy (in much the same way as DNOs have done), and would urge Ofgem to retain this provision as a GS and extend the definition from "priority customers" to "all customers in need". We note that Ofgem is considering introducing the concept of a discretionary reward and feel that improving the quality of PSR data and working to identify consumers in need could be one element of this new area of work. This GS is intended to ensure that the most vulnerable are not put at risk in times of emergency and Ofgem and the industry must do all it can to ensure that this intention is not compromised.

- Streamlining the reporting of all GSs is welcome including improving the reporting processes attached to the connections GS. We are happy to support the changes proposed by Ofgem providing the impact on GDNs is not such that consumers suffer any detriment as a result. Connection issues are already a difficult area for many consumers and form the bulk of the complaints and enquiries received by energywatch. Any changes to the current processes must be seamless for consumers and must not divert GDNs' attention away from providing an efficient and effective service to them.

- We note Ofgem's intention to amend the scope of the customer satisfaction survey and agree that this would complement the measurement of existing standards. We also note that there may be increased costs associated with this. However, we believe that these can and should be offset against the savings made by reducing reporting obligations (i.e. removal of overall standards) and the streamlining of others. We also believe that any amendment to the scope of customer satisfaction surveys must also build in the net benefit to consumers that would result from the lessons learned and the process and efficiency changes that should inevitably result.

- With regard to improving the measurement of the standards of service, energywatch feels that it (and its successor) should play a role in this to ensure that the interests of consumers are represented across all areas of service.

- Equally, we are willing to assist Ofgem and the GDNs in developing appropriate balanced score cards which improve the robustness and comparative nature of data gathered under the streamlined standards. We believe that GDNs should drive forward efficiency through innovation and competition and comparative data will help to show how effective individual GDNs have been in this regard.

In terms of third party water ingress issues, we agree with Ofgem that consumers connected to IGT networks should be covered by compensation arrangements no matter that the risk of an incident is comparatively small. This would be significantly better than no compensation at all. Ofgem is well aware that energywatch has been concerned about the protection afforded to consumers connected to IGT networks over a range of issues, including the additional transportation costs these consumers are required to pay by their suppliers. We view extension of the compensatory arrangements as a means of ensuring equal treatment to all consumers. In addition, the use of a GS would allow domestic and non-domestic consumers to be placed on equivalent footing for compensation as well.

We understand the need to insure against major events and agree with Ofgem's proposal for an event cap for compensation as a realistic assessment of the number of consumers likely to be affected by a single interruption event. It is essential however that any benefit gained as a result is passed on to consumers.

In conclusion, we are pleased that Ofgem has taken seriously the concerns energywatch has raised in the past about the level of service provided to consumers and the impact that poor service can have on individual consumers. We have always maintained that generally the service provided was quite good but that there is always scope for improvement. Further, from our complaints and enquiry data, we have identified that when something goes wrong the results can often be severe. We agree that more effective standards are required to maintain focus by GDNs on what matters to consumers when interruptions, emergencies or similar situations arise. The more robust and relevant the data gathered, the more likely that GDNs will develop adequate and suitable preparatory measures to act more promptly and effectively. The improved data gathered will provide good comparators for Ofgem and will enable GDNs to see exactly where they rank in terms of the service they provide to consumers. In turn this should increase competition to improve and spread both innovation and best practice.

Scope of networks

We have two brief comments on this section:

- riser replacement – a more pro-active approach is required, taking into account whether vulnerable consumers are disproportionately impacted, the costs of replacement compared to alternative approaches of providing energy, and which is the most efficient solution; and

- private networks – we believe that equal treatment of consumers is critical and that those connected to private networks deserve exactly the same level of protection, particularly with regard to safety as other consumers. Whilst we are aware that as these networks are developed they do get adopted by GDNs, we believe that the industry should consider ways of improving the situation, not only because of the safety element but also because of the differences in the metering arrangements and the inability of this group of consumers to enjoy the benefits of competition.

Incentives

We have the following comments on incentives arrangements:

- incentives must be appropriate and encourage efficient investment, operation and output (reduced shrinkage levels). Rolling incentives would need to encourage the GDNs to continually assess and re-assess how they are managing their networks, whether particular investments have long-term benefits and reduce costs, and whether shrinkage is minimised or eliminated to be effective. We are not yet convinced that the GDNs need further specific incentives to do so;

- we do not agree with information quality incentives as a means of encouraging any network operator to improve performance. The suggestion is that data quality will be poor if incentives are not provided. We believe instead that continually improving forecasting is a requisite element of efficient and effective network management and requires no special treatment. If Ofgem does agree to such incentives, there must be appropriate downside risk for failure to perform;

- we do not agree with any form of incentive for keeping accurate gas pipeline records. GDNs must, as part of normal business, know which assets they are required to manage. If not, they would be unable to manage those assets efficiently and economically. Knowing where the assets are is an integral part of running the network and is a matter of safety, not only for those operating the network but also for those third parties coming into contact with it. We reject the notion that incentives will prompt GDNs to be better at keeping records. If an incentive is to be applied then a significant downside risk must accompany any failure to meet optimal standards;

- we do not see any requirement for an Innovation Funding Incentive (IFI) at this stage and would argue against it. There appears to be little demand at present from GDNs themselves for such a scheme yet innovation continues apace.

Cost of capital

We believe that gas networks are relatively low risk and should attract a cost of capital which reflects this position. As income is guaranteed through the price control, we are unclear why the cost of capital needs to be significantly different from other network operations. The GDNs recognise that additional or unforeseen risks may be revisited through re-openers (although we believe in very exceptional circumstances). Effective incentivisation must be reflected in return.

Sustainable development issues

We have the following comments on these issues:

- Shrinkage – the GDNs must seek to minimise the risks of leakage as this is part and parcel of an efficiently run network. This can be done through more effective forecasting which minimises the need to purchase or sell gas in short time periods which leaves GDNs open to price fluctuations. Improvements to infrastructure through the continual replacement of older pipes should also reduce the levels of shrinkage. We believe that careful consideration is required before developing any incentives to limit losses on the networks.

- Network extensions – we fully support the extension of networks to off-gas communities to allow them to share the benefits of a cheaper source of heating and cooking fuel and increase their access to competitive offerings. Clearly, extensions must be justified in efficient and economic terms, assessing all the benefits against costs. There is real scope for the benefits to be assessed in a rounded way, taking into account the support that can be provided to consumers from other schemes to facilitate 'in house works'. We agree that a discretionary rewards scheme, with tightly drawn criteria, may be a suitable way forward but such an approach should ensure that benefits to consumers are maximised and are not simply a way to reward GDNs for network management which could have been undertaken efficiently as a matter of good practice. A mixture of approaches should also not be ruled out. What may be most appropriate, in relation to the discretionary reward is to limit the category to the spreading of good practice in relation to network extension or working with consumers to help them understand the benefits associated with this, including an awareness of the range of government assistance available.

- Discretionary rewards - when considering whether discretionary rewards are appropriate, Ofgem must consider the work carried out by GDNs in areas of fuel poverty or deprivation and GDNs should be rewarded for schemes which help to reduce detriment to these groups of consumers.

- Consumer education – GDNs should be encouraged to engage effectively with the community, with education of consumers essential to ensure smooth running of operations before, during, and following, an incident. Too many consumers are unaware of the critical role played in their supply by GDNs. We would need to consider further whether further rewards are necessary to achieve this aim.

Xoserve services

We have had the opportunity to indirectly contribute to the current workgroup which is assessing the role and services provided to the industry by Xoserve. From the consumer perspective, the issue is one of better delivery of core services – energywatch's consumer advisers are not able to verify consumers' information onscreen without further confirmation by telephone.

We agree that there should be a clear distinction between core services for which all users pay, and separately funded 'user pays' services. However, we will await the conclusions of the workgroup before commenting further.

Going forward, we will continue to keep these issues under review as the price control review proceeds through its various phases, always considering the possible impact on consumers. We would appreciate being kept informed of the progress of the review and any related issues to enable us to comment as the need arises.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

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