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26<sup>th</sup> January 2007

## Gas Distribution Price Control Review - Third Consultation Document

Dear Joanna,

RWE npower welcomes the opportunity to comment on Ofgem's Third Consultation on the Gas Distribution Price Control Review (GDPCR) and does so on behalf of all its licensed gas supply and shipping businesses.

We also welcome Ofgem's decision to hold a seminar on the policy issues contained in this consultation and applaud their attempts to try and make the consultation process as open and inclusive as possible. We hope such seminars will be repeated during the remainder of the review process as and when appropriate.

We have structured our response around the chapters of the consultation where we have comments to make. In some cases we have made general comments concerning the issues raised in that chapter. However, where we have more specific comments about issues we have included these in response to the specific questions raised.

### Chapter Two

*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?*

We broadly agree with Ofgem's initial view of the services that should be treated as excluded. However, it could be argued that because post emergency metering services are inexorably linked to gas distribution networks (GDN) provision of emergency services, this service should also be included within gas distribution price control. Despite GDNs not being bound by licence to provide post emergency metering services, the reality is that for the foreseeable future they are the only party able to provide such services efficiently. Provision of this service by other commercial meter asset managers (MAMs) will be more costly and delivered in a less timely and efficient manner, which will be to the detriment of customers.

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We do not believe that GDN cost allowances for provision of emergency services should be set absent any metering income as GDN fieldworkers (employed directly or through subsidiary companies) provide, and will continue to provide throughout the next price control period, the vast majority of the meter operator workload in the gas metering market. This is likely to persist regardless of whether one takes an optimistic or pessimistic view of the development of gas metering competition.

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

This will depend on the extent to which competition is likely to develop in the provision of domestic one-off gas connections over the forthcoming price control period. On the basis that the barriers to competition in provision of domestic one-off gas connections (such as streetworks legislation and the 10m rule) still persist, and are unlikely to be speedily or easily removed, we believe there is a case for including this service within gas distribution price control, subject to a revenue driver linked to the volume of connections.

*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 licence fees and network rates should continue to be treated as pass through items and that the incentive mechanism relating to network rates that now applies in transmission and electricity distribution price controls should be similarly applied to GDNs as well.

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

We agree that RPI should continue to be the index used within gas distribution price control to adjust allowed revenue.

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

We agree that re-openers have the potential to dampen GDNs incentives to manage costs and forecast accurately and should therefore, in general, be avoided. However, experience from the current price control shows that GDN capex, opex and repex spend can significantly exceed price control forecasts without re-openers being included. Ofgem need to remain vigilant in assessing whether such expenditure has been efficiently incurred.

We agree that the Traffic Management Act and Transport Act (Scotland) should be subject to re-openers to the extent that GDNs have not already assumed increased expenditure that may result from this legislation in their opex forecasts. We also believe that costs associated with any material change in the functionality of UK Link registration, billing and settlement systems should be subject to a re-opener in the event the user pays approach to xoserve funding can not be developed throughout the price control period.

*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?*

Introducing a two-tier correction mechanism for over and under recovery may have some merit, but the need for it is linked with other issues such as reducing the exposure of GDN charges to throughput.

Based on past experience of over and under recoveries we are not yet convinced that setting the second higher tier at +/-2% is appropriate, and maybe this should be increased. Also, we are not convinced of

the need for a higher second tier for under-recovery but if it is applied, the lower and higher tiers for under recovery need not necessarily be symmetrical with the lower and higher tiers for over recovery.

*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?*

We are not convinced of the need for revenue profiling at this stage, although if it reduces volatility of prices it may be worthy of further consideration. Nor is it clear how profiling would tie in with the proposed incentive schemes and the current or future over/under recovery correct mechanisms.

Whilst we tend, in principle, to support measures that reduce volatility in gas distribution charges predictability is equally, if not more, important to us, as the prices we charge the majority of our retail customers are influenced by our budgetary forecast of gas transportation costs over the year.

To this extent annual publication of retrospective cost and RAV information (as now published under electricity distribution price control) is helpful, and we await with interest to see what further detailed information will be disclosed in the next annual report due later this month. We would also welcome the opportunity to participate in discussions on the gas distribution cost reporting framework, which we understand Ofgem intend to conduct later in the review timetable.

As well as gaining a better understanding of actual costs that have been incurred throughout the price control we also hope that as a consequence of this GDPCR further information could be made available about forecast allowed revenue throughout a price control year. Whilst information provided under modification proposal 698 is helpful, it does not project revenue forward. Suppliers therefore have to predict this based on incomplete information.

Aligning the gas distribution pricing year (Oct - Sep) with the price control year (Apr - Mar) may have merit in the longer term as it will allow a full 12 months of recovery. However, it will also lead to assumptions having to be made about the extent of any under/over recovery from the previous year when setting prices for the next year, as winter will not be over by the time final prices have to be published. Again, if other steps have been taken to reduce the variability of charges to throughput (such as the recently announced change in LDZ domestic customer charges and any future changes to the capacity/commodity split) the need for re-alignment is reduced. We suggest that GDNs do further analysis of these issues and issue a charging consultation to further debate before any decision is taken on alignment.

If a convincing case can be made for re-alignment it might be possible to do this with effect from Apr 2009 by setting charges in Oct 2007 based on 18 months of recovery. This could mitigate against some of the very large GDN price increases that might otherwise be expected in Oct 2007. If necessary prices could be re-assessed in Oct 08 if a significant over/under recovery was building up, or to take account of any significant change between GDPCR initial and final proposals.

### **Chapter Three**

We have no basis for assessing whether the significant rises GDNs are seeking in capex, opex and repex over the next price control are justified, but trust that Ofgem's use of the techniques described in the consultation will sufficiently be robust to ensure allowed revenues are based only on necessary and efficient cost forecasts.

We are pleased that Ofgem have restated their intention to ensure that any capex or opex incurred by a GDN as a result of a loss of economies of scale arising from GDN sales would not be included in their

assessment of allowed revenue, despite suggestions from some GDNs that Ofgem should relax this approach providing such expenditure was efficiently incurred.

## Chapter Four

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

Ofgem's proposals to rationalise and simplify the current GDN guaranteed and overall standards of performance seem to be broadly sensible and reflective of feedback received from customer surveys. In the event these changes go ahead, we would support applying them equally to independent gas transporters so that customers can receive equivalent levels of service and compensation for service failure, regardless of whose network they are connected to.

Whilst on the face of it may appear logical to replace the overall standard relating to complaints with a guaranteed standard, this would be inconsistent with electricity distribution price control and may cause confusion to customers. As GDN performance against this overall standard is generally well above target, there may be a case for expanding the customer satisfaction survey to assess GDNs performance in responding to complaints in future.

With regard to the guaranteed standards relating to connections, we have long been of the view that these standards are overly complicated and generous to transporters and therefore we support their simplification. We would refer you to previous comments we have made on this subject<sup>1</sup> and hope that these can be taken into account when considering what changes are required.

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

We fully support incorporating third party damage and water ingress arrangements into the supply restoration guaranteed standard of performance for both domestic and non-domestic customers.

GDNs have limited direct control over their exposure to third party damage and water ingress and as such limiting their liabilities in the event such instances occur may be necessary. However, we suspect that instances of third party damage and water ingress are closely correlated with the inaccuracy of pipeline records, which are, or should be, within the control of GDNs.

A mechanism that limits a GDN's exposure up to a percentage of their turnover, with a percentage of any excess costs being treated as a pass through item, seems pragmatic. This being the case it is questionable whether an event cap is also necessary.

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

Inaccuracy of pipeline records is likely to be major a contributor to instances of third party damage and water ingress and to delays that are experienced in quoting, planning and delivering gas connection services. Anything that can be done to improve the accuracy of pipeline information is therefore welcomed.

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<sup>1</sup> RWE npower's response dated 10<sup>th</sup> January 2005 to Ofgem's consultation on "Improving the provision of gas connections services by gas transporters (270/04)"  
RWE npower's response dated 8<sup>th</sup> February 2005 to Ofgem's consultation on "Revised standards of performance arrangements for licensed gas distributors (04/05)"  
RWE npower's response dated 31<sup>st</sup> October 2006 to Ofgem's consultation on "Review of Competition in Gas and Electricity Connections (159/06)"

We previously expressed our views on this subject in our response to Ofgem's consultation letter on whether to establish a Designated Registrar of Pipes<sup>2</sup> and we agree that incentives in this area are complex and require careful definition.

On balance we believe that any incentive scheme is best based around an audit process. This is due to the potential difficulty in measuring accuracy of records and our expectation that GDNs will find it difficult to report on performance. The nature of any audit however, should be more wide-ranging than simply focussing on GDNs and information should be gathered from all relevant participants in the connections market, including ICPs and suppliers.

*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 do not believe it is necessary, or appropriate, for Ofgem to set network capacity output measures. Instead GDNs should be allowed to continue to develop their network to meet a 1 in 20 licence obligation.

## **Chapter Five**

Our previous response to Ofgem's second consultation document indicated that we support, in principle, the use of rolling incentives as mechanisms to address concerns about periodicity under standard five-year price controls providing they are well designed, not overly generous or penal and are correctly specified. We believe Ofgem are best placed to judge the merits, or otherwise, of applying capex, information quality, opex and repex incentive mechanisms in the next price control. Such judgements, and the design of any incentives, should draw from their experience of previous price controls and the current electricity distribution price control.

In the event incentive mechanisms are put in place, information should be made publicly available on GDNs performance against these incentives annually. This will allow suppliers to factor this into their assessments of how this will affect the future direction and scale of GDN price changes on an ongoing basis.

As regards a capacity output incentive, the extent to which this can be set and the complexity of such a scheme is largely dependant on Ofgem's decision on modification proposals 116 (and all its alternatives) and 090. Like every other gas shipper and supplier in the gas market, we do not believe there is a convincing case for disaggregating flat and flexibility NTS exit capacity at this stage. If Ofgem take a pragmatic approach and support this view, the simplicity and effectiveness of implementing a capacity output incentive will increase.

If however Ofgem take a dogmatic approach and implement modification 116 in its current form, any capacity output incentive scheme will be based on a best guess of how GDNs and shipper/suppliers will operate in a market they neither support or understand. This increases the probability that whatever incentive is set it is likely to be wrong, although whether it proves to be overly generous or penal is anybody's guess.

We believe there may be merit in introducing an accuracy of pipeline records incentive scheme based around a wide ranging audit process, but are not convinced of the need for an innovation funding incentive. As previously stated we also believe there may be merit in further incentivising GDNs to train greater numbers of gas engineers and installers bearing in mind the skills shortage in these areas.

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<sup>2</sup> RWE npower's response dated 7<sup>th</sup> October 2005 to Ofgem's consultation letter on "Designated Registrar of Pipes Licence Conditions/Accuracy of gas pipeline records(RBA/TR/A/CON/268)

Despite GDNs showing signs of increasing their recruitment of such staff an incentive could accelerate this process, which will be to the long-term benefit of customers.

## **Chapter Seven**

Network extensions could help to alleviate fuel poverty, to the extent that customers are able to afford or secure funding for the in house works costs that may be required to benefit from the extension. It is right therefore that Ofgem should give careful thought about how they might be encouraged.

The starting point for considering network extensions should be that the receipts from new customers cover the costs of extending the network. A modest cross-subsidy may be consistent with Ofgem's guidance from the Secretary of State and its broad duties, including sustainability. There may also be a case for allowing the extension costs to exceed the receipts from customers to the extent that the subsidy is directed at the fuel poor and can be demonstrated to be a more cost effective way of delivering government fuel poverty targets than alternatives.

Both of the incentive options under consideration are likely to result in some element of cross subsidy being made to fuel poor customers from general transportation charges. It is important for any incentive scheme to accurately quantify the extent of any cross subsidy, along with the social benefits that are expected to arise as a result of network extensions. We would expect these to be clearly laid out in Ofgem's final impact assessment.

This will ensure a sound foundation for the choice of one course of action over another in delivering government policy objectives and that the aggregate effect of piecemeal activities, all geared to a particular policy objective, remain compatible with the regulatory framework. Ofgem has effected a range of distinct policies aimed at furthering social or environmental goals. It is important to understand the collective effect of these on cross-subsidy between customers, both in the context of Ofgem's social remit and in relation to the broader democratic discussion of social policy.

Of the two incentive schemes under consideration option 6 seems preferable to option 5 based on the limited description of how these schemes would work, although we need to understand each option better before we are able to give our support to either or them.

We are not convinced of the merits of implementing a related discretionary rewards scheme or output based incentive scheme (option 3) in conjunction with these two options. Nor are we convinced of the need for a wider Corporate Social Responsibility incentive scheme as, in the current business climate, stakeholders expect the boards of directors of all large companies to pursue initiatives in this area, regardless of whether they operate in competitive or regulated monopoly markets.

## **Chapter Eight**

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

We believe that the costs of funding xoserve to provide a broadly equivalent level of service to that which they provide now should be relatively easy to quantify. Such costs should include the costs of making modest changes to existing systems and services in line with transporters and shippers incremental change requirements, along with costs for ensuring these systems run on up to date and supportable IT software and infrastructure to at least the current standards of performance.

We do not believe that the benefits of introducing a core services plus user pays funding model are sufficient at this stage (based on our assumption that most of the services xoserve provide shippers are likely to be treated as core services) to warrant this. Because new governance and contractual arrangements would need to be established under this funding model the net benefits may in fact be negative.

We are also concerned that adopting this funding model at this stage could result in xoserve arguing that every future change to a system or process, however minor, falls outside the scope of core services and therefore has to be funded separately by shippers. This would inevitably stifle innovation and the future efficiency of the systems that underpin GB's competitive wholesale and retail gas markets.

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

We would expect the industry workgroup that was formed to look at these issues to provide a definitive view on this and understand that, with the exception of a handful of incidental services, all current services will be deemed to be core services.

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

We see no obvious benefits arising to us at this stage from a core services plus user pays funding model. We would however, expect to incur reasonably significant costs for putting in place contractual arrangements with xoserve, developing and participating in governance arrangements and paying for provision of user pays services.

Our favoured approach at this stage would be for further consideration to be given to providing a specific sum of money within xoserve's budget to use in relation to shipper driven initiatives and work requests, or for xoserve staff to be principally assigned to work on behalf of shippers. It appears however, that Ofgem have discounted these potential options but we continue to believe they are worthy of further consideration.

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

We believe the workgroup has made an initial attempt to quantify the costs associated with the limited number of services that could be treated as non core should Option 2 be considered worthy of implementation at this stage.

Where we believe the funding principle of user pays may be relevant in relation to any significant functional re-write of UK-Link, for example to cater for future developments in Smart Metering and gas settlements. Obviously both the specification and costs associated with this are unknown and so it should not be taken account of in xoserve funding at this stage. However, to the extent it would not be appropriate to treat a functional re-write as a pass through item in future, funding based on the principle of user pays could be appropriate.

This said, we would stress that the governance arrangements of a user pays funding mechanism would need to be fully worked through and be robust enough before we would endorse this approach. Perhaps not surprisingly we understand the workgroup has struggled to make progress in this area.

We would also need to understand how xoserve would charge ongoing costs for each user pays transaction once the service is in place, and have a way of challenging these transaction costs if we

considered them to be unreasonable. Should xoserve fail to provide the service for any reason, an agreed mechanism would also be needed to recover liquidated damages.

*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 independents 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)?*

To the extent that continued cross subsidy of customers connected to independent non-mains gas connected systems is considered acceptable and appropriate, we believe the excess costs should be borne by all customers. This would however, introduce a further cross subsidy between transmission and distribution networks.

We hope our comments above will help to further inform your thinking on relevant GDPCR issues. Should you wish to discuss them in more detail please do not hesitate to contact me.

Yours sincerely,

Steve Rose  
Economic Regulation

Sent by e-mail and therefore not signed