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Wednesday, 25th April 2007

Gas Distribution Price Control Review - Fourth Consultation

Dear Joanna

Central Networks is a regulated network business and comments as an interested party on issues that are relevant to all regulated network businesses. Our views on three high level principles addressed by the above consultation, which are relevant to all network businesses, are attached to this letter. In terms of the other questions raised by the consultation, we feel that generally the issues are either too company or industry-specific to form an opinion.

I trust that if you have any questions on our attached comments, then you will feel free to contact me.

Yours sincerely

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Gas Distribution Price Control Review – Fourth Consultation

How should the various elements of cost analysis be brought together to establish cost allowances?

Clearly, there are elements of industry and company specific detail here that it would be inappropriate for us to comment on. However, as a point of principle, we agree that Ofgem should avoid creating an artificial GDN with a level of costs that does not reflect the overall activities and interfaces of a real company. Additionally, we agree that a mechanistic approach is unlikely to be satisfactory, given that uncertainties and measurement error will always accompany any high-level benchmarking exercise. Regional factors should be considered on a case-by-case basis, and should not be ruled out. Finally, we would caution against the blanket assumption, which appears to be made, that all indirect activities may be more efficient in different geographic locations. Undoubtedly, this is dependent on the definition of indirect costs. However, as an example, design or planning activities may require a significant degree of field-based work, and relocation of the base location for these activities may not be efficient. Additionally, there will be an element of up-front expenditure associated with any move, which would need to be accounted for.

Is there a case for real price effects?

Central Networks' experience is that real prices (especially skilled labour and certain key commodities) are increasing and that real price effects should therefore be included in allowances. These effects (and the changes in specific costs versus the rest of the economy) may not be properly reflected in the use of a 'straight' RPI-measure when calculating TFP, as they may be offset by movements in other components of the 'basket of goods.'

Should Ofgem adapt its pension principles to address the forecast defined benefit pension contributions?

The pension principles adopted by Ofgem following the review of network monopoly price controls in 2002/03 have allowed regulated companies to manage their pension obligations. There are few specific details relating to the GDN defined benefit schemes contained in the consultation document, but both the future accrual contribution rate and the past accrual funding level can be affected by many factors. For example, the age profile of pension scheme members and the life expectancy assumptions made by trustees can have significant impact. If a scheme has a mature age profile with a large proportion of members close to retirement, and members are expected to live longer, then the costs of a defined benefit pension scheme will increase. The variability of contribution rates and funding levels across the GDN schemes could well reflect different investment strategies, age profiles and differing degrees of prudence in setting assumptions for the actuarial valuations. Ofgem states that the GDN's actuaries have made reasonable assumptions and that there is no stewardship issue. On this basis it would seem inappropriate to change pension principles. Our comments on the specific options are given below:

- In view of the different legitimate approaches to managing a defined benefit scheme and the resulting variability of contribution rates and funding levels (for the reasons described in the previous paragraph) it is difficult to see how a benchmark contribution rate (option 1) would be meaningful in setting pension allowances.

- Option 2 appears to link pension cost allowances to an assumed ownership or financial structure via the employer covenant. This assumed structure may be inappropriate for a particular company under any specific set of circumstances. It seems more appropriate therefore to ensure that pension costs can be related to the specific distribution business in its particular circumstances, rather than a hypothetical organisational structure.

- Defined benefit pension schemes are long term liabilities, paid for by consumers over the long term. Any ex-post review (i.e. option 3) would need a long term perspective. This mechanism for surplus recovery will add to the risks faced by investors.

Central Networks
April 2007