GDPCR Responses
Ofgem
9 Millbank
London
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25 April 2007

Dear Sir

Gas Distribution Price Control Review: fourth consultation document

We are pleased to respond to Ofgem's March 2007 consultation paper. I can confirm that this response can be placed on Ofgem's website. Our answers to Ofgem's specific questions, where we have views, are set out in the attachment to this letter.

There are two aspects of the proposed approach to determining operating costs allowances where we have particular concerns. They are:

- The assertion of future efficiency gains based on total factor productivity (TFP) analysis; and
- The approach to glidepaths

With respect to the TFP analysis we cannot comment on the veracity of the proposed range, as we have not yet seen the consultant's supporting report. However, we believe that the principle of asserting future efficiency gains is inappropriate. The basis of incentive regulation is that the regulator puts in place a framework that results in the company revealing the efficient level of costs and the regulator subsequently passing these efficiencies onto customers.

We believe that a glidepath should be assumed. Requiring full gap closure by the start of the next period assumes that the benchmarking is perfect and that the GDNs can deliver the required efficiency savings for no or little cost. Given that Ofgem's preferred approach to establishing the cost benchmark is a judgement based approach this illustrates that the benchmarking is not perfect. In our opinion, a pragmatic solution would be to require companies, with costs above the benchmark, to fully close the gap by the end of the following period.

With respect to the introduction of NTS Exit reform, we believe that a robust incentive based on data submitted under the BPQ needs to be created, to ensure risks and rewards between GDN's and Shippers are accurately and realistically balanced. Due to the insufficient information available ahead of the auctions in 2008 this may mean a reopener needs to be introduced and incentives re-set on an ex-post basis.

If you have any further queries please do not hesitate to contact me.

Yours faithfully

Denis Linford
Director of Regulation

Attachment 1: Detailed comments on GDPCR Fourth consultation document

Do you agree with our adjustments for related party margins?

The proposed policy to allow the GDNs to keep a proportion of the margin they charge on competitive connections is sensible. In fact, if the GDNs were not allowed to charge a margin this may distort the competitive market. The reasons for this are twofold. Firstly, if the GDNs decide not to compete in the market, due to their inability to charge a margin and hence make a profit, this will reduce competition and customer choice. Secondly, if the GDNs decide to compete in the market, possibly to realise economies of scale advantages, their inability to charge a margin may result in them inadvertently having an unfair advantage over their competitors. Neither of these outcomes would be in customers' interests.

Do you think we should change our treatment of non operational capex?

We believe that the non operational capex should be treated as capex. In our experience the majority of non operational capex expenditure tends to be related to the installation or upgrading of major IT systems, which tends to be variable both year to year and across companies. For example, as detailed in the Electricity Distribution Cost Review the expenditure on non operational capex, by the electricity distribution companies, varied from £0m to £11m in 2005/06. Additionally, if this variability is not normalised for it may affect the accuracy of the top down comparative efficiency benchmarking. This in turn may lead to inappropriate conclusions with respect to the GDNs' relative efficiency, which would be inappropriate.

How should we bring together the various consultants' analysis to establish an efficient cost benchmark and cost allowances? In light of our approach to setting a benchmark, what approach should we take to glidepaths?

At this stage in the development of price control regulation for GDNs the most sensible approach is to reach a judgement based on all the evidence. Favouring either the top down or disaggregated benchmarking approach at this stage would be unwise due to the data and methodological issues identified in Ofgem's analysis. However, we do recognise that the judgement based approach does present Ofgem with significant latitude and hence we would expect the rationale for its decisions to be set out in detail.

We are particularly concerned with Ofgem's application of Europe Economics total factor productivity analysis. We cannot comment on the veracity of the proposed range, as we have not yet seen the consultant's supporting report. However, we believe that the principle of asserting future efficiency gains is inappropriate. The basis of incentive regulation is that the regulator puts in place a framework that results in the company revealing the efficient level of costs and the regulator subsequently passing these efficiencies onto customers.

We believe that a glidepath should be assumed. Requiring full gap closure by the start of the next period assumes that the benchmarking is perfect and that the GDNs can deliver the required efficiency savings for no or little cost. Given that Ofgem's preferred approach to establishing the cost benchmark is a judgement based approach this illustrates that the benchmarking is not perfect. In our opinion, a pragmatic solution would be to require companies, with costs above the benchmark, to fully close the gap by the end of the following period.

Is there a case for making adjustments to allowances for real price effects, specifically direct labour, contractor labour or materials?

We believe that there is a case for making adjustments to allowances for real price effects. There is growing evidence that the RPI indicator does not fully reflect the cost pressures that infrastructure companies are experiencing in these areas. If real price effects are not allowed, and these effects are realised, then there is a high likelihood that companies will overspend their allowances. Under the proposed capital efficiency mechanism companies will bear a proportion of any overspend. Therefore, if real price effects are not allowed then the companies will effectively be penalised for regulatory “error” which would be inappropriate.

Is there a case for making adjustments to allowances for regional costs and if so what approach should be adopted?

There is a strong case for regional factor adjustments. If such adjustments are not made then those companies who operate in high cost areas will be inappropriately deemed inefficient. We favour the PB Power approach of adjusting every GDN’s direct labour and contractor costs to the national average. The rationale for adopting this approach is that only adjusting costs for those GDNs where costs are higher than the average could result in them being deemed inefficient if a GDN with costs lower than the average sets the performance benchmark.

We agree that regional adjustments should only be applied to those activities where incurring the additional costs is unavoidable. However, the blanket assumption that all indirect costs are not subject to regional costs may be overly simplistic. We believe that each indirect activity should be analysed to understand whether it is truly location insensitive.

Should we adopt our pension principles to address the forecast defined benefit pension contributions, which are both extremely high and vary widely across GDNs (despite funding similar packages?

We do not believe the level of the forecast contributions, or their variability, are robust reasons for Ofgem to change its pension principles.

We also do not believe that the particular financing structure adopted by a licensee should have any bearing on Ofgem’s pension principles so long as the licensee remains compliant with its obligations (e.g. to maintain an investment grade credit rating). We accept that where such structures are perceived by the relevant trustees to be higher risk, they may seek accelerated deficit repair (and thus accelerated revenue from customers). However, it should not be ignored that customers benefit from innovation in financing (e.g. through higher assumed gearing levels in the WACC).

Ofgem’s approach to pension costs should be symmetrical such that any surpluses are taken into account in setting price control allowances. As for deficits, the revenue implications of surpluses would need to be taken into account over time to avoid a potential see-sawing affect on revenues.

Is it appropriate to retain the current volume driver?

Whilst Ofgem's analysis appears to suggest that it is not appropriate to retain the current volume driver as only 5-10% of GDN costs vary with throughput, we would require further information on this. In particular we note that whilst Ofgem's analysis suggests 5-10% of GDN costs vary with throughput, the GDNs have recently published a pricing discussion paper that suggests only 5% of costs vary with throughput. We would therefore require further information as to exactly why these two figures differ, although only marginally.

Is it appropriate to implement any of the revenue drivers?

We recognise that DN costs are not that variable and that the current 65/35% split is outdated and problematic when estimating and fixing DN charges. The DN's desire to move to a 95/5% capacity/commodity split should make charges more stable but the implication of such a change in the regulatory framework should be appropriately evaluated.

We do not believe that it is appropriate to incorporate any of the other revenue drivers identified by Ofgem into the GDPCR; however we do believe that it would be beneficial to incorporate a revenue driver to encourage the efficient utilisation and procurement of flexible capacity under the new NTS exit regime. Given that under this regime both GDNs and Shippers will be competing for the same flexibility capacity, we believe that it is important that a revenue driver is incorporated that links GDN costs with Shipper costs. We believe that this will ensure that regulated monopolies do not gain an unfair advantage, especially when it is hard to predict what the cost of this regime.

Are our proposals for the treatment of offtake reform related costs and mains replacement costs under the IQI appropriate?

The significant uncertainties that are associated with the costs of offtake reform mean that we are not convinced an Information Quality Incentive (IQI) is the correct form of incentive to adopt. In particular we note that due to the uncertainties any "target costs" developed by consultations risk being overly generous or inadequate. GDN forecast costs may have no resemblance to consultant forecast costs. As previously stated we believe that the only way to overcome these risks, and ensure Shippers and GDNs are treated equitably is to link the price that Shippers pay for flexibility with the revenue driver. This could only be done using an ex-post adjustment mechanism on the basis of a reopener after the first set of auctions are run next Summer but would ensure flexibility is purchased at an efficient price.

Is it appropriate to strengthen capex rolling incentives?

In principle, the application of the Information Quality Incentive is appropriate. However, the robustness of the scheme is dependent on the quality of the consultants' capex analysis. It would be inappropriate for companies to be penalised if the consultants disagree with their capex forecasts due to a lack of understanding of the basis of the company forecasts. We would expect the consultants to share the detail of their modelling with the companies to ensure that such misunderstandings do not occur.

Do you agree with our proposed plan of work to determine the cost of capital? Are there other key areas of analysis that we should be carrying out?

We support Ofgem's proposed approach. In particular, we agree that Ofgem should take a long term view regarding the risk free rate using long run market information and recognising any embedded debt costs.