energywatch
your gas and electricity watchdog

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Dear Joanna

Gas Distribution Price Control Review Fourth Consultation Document

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

Consumers expect the delivery of safe, secure and reliable gas supplies by distribution network operators (gas DNs) in the most efficient and economic manner. The gas DNs are under licence obligations to ensure this happens. To meet those expectations, they must demonstrate that they are currently spending the allowances which they are allowed under the price control in the most effective manner. For future price controls, specifically the five-year enduring control to apply from 1 April 2008, the gas DNs must also make not just reasonable estimates of current and future capital, operating and replacement expenditure associated with the networks, but also show a willingness to be benchmarked against best practice for comparable activities to ensure that achievable cost efficiencies can be realised.

We participated in Ofgem's recent workshop held in conjunction with this consultation. This was a useful exercise in terms of hearing the gas DNs present their views on future expenditure and how they perceive the relationship between spending and the levels of allowed revenue they are seeking under the next price control. It also allowed network users and consumer representatives to challenge some of the assumptions made by the gas DNs. We believe that workshops like this provide both an informative and effective forum for broader discussion of the issues and would request that Ofgem hold similar sessions in future as a matter of course as part of each price control review.

There are a number of points which we picked up from the workshop and which are relevant to our views on the cost issues arising from this price control review.

Cost efficiency issues

We believe that, since ownership of four of the gas DNs passed from National Grid in June 2005, there is now scope for analysing and benchmarking common activities across the new and existing companies to determine the most efficient way to pay for infrastructure improvements. Effective benchmarking ought also to be undertaken for activities where there are comparable external service providers. There is scope for further refinement of the cost analysis as Ofgem progresses the price control review to a conclusion through this year.

We do not accept that the new owners were entirely ‘bedding in’ in 2005/06, making the cost data for that financial year less useful for benchmarking purposes. As part of the purchase process, some high level assumptions would have been made about potential areas for cost savings. Otherwise the price paid would have been at a significant premium to the real value of the gas DNs which were sold. Furthermore, there is now cost data available for 2006/07 and on an ongoing basis through the BPQ process to allow Ofgem to undertake some historical benchmarking.

Consumers expect Ofgem to identify ways in which the companies can achieve cost efficiencies in the 2008-13 price control period and pass these through to them. It is not enough to argue that real cost efficiencies may need to be postponed to later price controls. An important consideration by Ofgem in approving the gas DN sales would have involved the recognition that new ownership would bring improvements to the way that the gas DNs are run and that cost efficiencies would be an outcome of more efficient operation.

Ofgem is well aware that, to provide regulatory certainty, this price control review represents the first significant opportunity to analyse and build in cost efficiencies after the DN sales. Re-opening the price control to identify cost efficiencies in the interim is not an option and would create regulatory uncertainty which is not beneficial to either the gas DNs or for consumers. Therefore, Ofgem must meet consumers’ expectations in this regard.

We note the comments of the gas DNs that there are inflationary pressures around the provision of their services which encourage the dilution of the RPI-X price control formula because of regional price differentials and because service costs in general are rising faster than RPI. We believe that these arguments are not borne out and that RPI-X remains the most effective formula against which to assess and implement cost efficiencies. An analysis which seeks to disaggregate the costs of the provision of network services in a particular way to demonstrate that these costs are rising faster compared to general RPI is not a reasonable approach. Many users and consumers also face a variety of costs which, in aggregate, constitute the general rise in prices reflected in RPI. Network operators are therefore not a special case and their allowed revenues do not need to reflect special treatment of some costs, whether based on regional or national effects other than on a very exceptional, objectively proven, basis.

We accept that there may be some uncertainties around future costs arising from legislation such as the Traffic Management Act and industry change such as offtake and interruption regime reform. We do not however, in general, favour price re-openers once revenue allowances have been set but we recognise that there is a potential for higher costs and that these may need to be accommodated. However, we would urge Ofgem, when the impact of these changes becomes clearer, to undertake rigorous analysis and assess the real effects in terms of any re-opening of the 2008-13 price control.

Unless there can be clear justification for additional expenditure which does not fit in with existing efficient spending commitments by the gas DNs, no further revenue should be allowed. In addition, there must be substantive justification for any different treatment of the various companies regarding these changes. Otherwise, we would suggest that a common approach to efficient implementation of the changes is adopted to keep costs to end consumers low.

We noted that there were diverse opinions expressed at the workshop about the key cost drivers upon which future allowed revenues could be determined. The main drivers identified were length of the physical network, customer numbers and volume throughput. However, there was a clear gas DN-specific bias to these comments based on which factor(s) most affects each gas DN. We suspect that all these factors play a part in driving DN costs and that an appropriate weighting should be applied to each as part of effective benchmarking of costs.

We do not exclude the possibility that there are some DN-specific cost drivers which could be used to determine allowed revenues but these should be considered on an exceptional basis. A large number of costs will be driven by characteristics which are common to all gas DNs and a like-for-like assessment of costs should be undertaken to determine the appropriate efficient level. We do not accept the argument that gas DNs will achieve efficiency savings over 2008-13 by spending less than they could have done. Some efficiency savings can be achieved within benchmarked target spending levels which will be refined as the review continues.

The gas DNs need to provide assurance to consumers that future expenditure will have a real impact on shrinkage factors and that losses and leakages will be minimised. It should be part of the gas DNs' remit to target their capital and replacement programmes on efficient reduction of leakages and on the 'sweating' of new assets based on realistic assumptions about the life of those assets, using new technology to limit costs as necessary. Additional expenditure can only be justified if real cost efficiencies emerge over the long term.

We are keen to see incentives in place which allow the gas DNs to realise cost savings but which strike an appropriate balance between risk and reward. This approach ensures that consumers do not pay for over-incentivisation where a DN reaches its target savings quicker than expected or is incentivised for activities which are part of its ordinary course of business. Any phased application of incentives over the life of the price control must be mindful of achieving a suitable balance.

Cost reporting

We welcome Ofgem's introduction of a licence condition to put in place a cost reporting framework which will allow ongoing reporting and analysis of costs in between price controls. We will comment in more detail on the substance of the framework when the initial proposals consultation is issued in July. The framework must create adequate transparency and effective and robust reporting processes that help to smooth the path for cost analysis at subsequent price control reviews.

Customer service

We noted the aspirations expressed by the gas DNs at the workshop to improve their levels of customer service. We believe, based on the issues raised by consumers with us, that there are qualitative and quantitative improvements which the gas DNs should be pursuing. The latter should be reflected in the price control.

On a qualitative basis, even though there is more competition in some segments of the gas connections market compared to electricity connections in terms of the number of providers, consumers continue to have specific difficulties with providers. These include a lack of transparency on the face of quotations, a failure to break down charges and explain these to consumers, and also a lack of information about where to obtain alternative quotes. Consumers need to see real qualitative improvement in the 'soft' aspects of customer service provided by gas DNs and all connections providers – the level and effectiveness of communication with them and the need to make the consumer feel valued and listened to when they contact a provider for information. In-house provision of gas connections by some of the gas DNs places a greater responsibility, and opportunity, on them to make improvements. While coordination of connection provision is comparatively better than for electricity, all providers must seek to continually improve in an open and effective competitive market. Ofgem should monitor progress and act if there are failings.

On a quantitative basis, we would expect that real improvements in customer service will feed through in lower costs as gas DNs and others get better at providing the service. Those cost savings must be passed through to consumers directly where possible in lower connection costs, and also through the price control where general operational efficiencies are attained through a more streamlined approach. We believe that the gas DNs must make real progress in this area, as one of the outcomes of the DN sales must be to establish more effective competition between the gas DNs and continual improvement in delivery of services.

Other comments

It is critical to the effectiveness of the price control review process to have clarity and transparency in the data provided by the gas DNs in the BPQs. Ofgem must ensure that disparities are eliminated altogether and that there is consistent treatment of similar items, particularly in reconciling submissions to regulatory accounts. Differences which cannot be explained through appropriate and accepted accounting treatment ought to be disallowed in calculating the cost base. This will enhance confidence in the efficacy of the resulting allowed revenues.

Pension costs allowed under the price control will be influenced by how the gas DNs intend to fund their pension contributions in future. We believe that if shareholders of the gas DNs choose to create a pensions structure, based on actuarial or other expert advice, that suggests that higher actual pension contributions are required which makes pension provision riskier, shareholders must fund the additional contributions required and not consumers. The pension costs borne by consumers must be based on the ex ante assumptions underlying the pension allowance and not reflective of changes to the assumptions.

Going forward, we will continue to keep these issues under review as and when they are raised, always considering the possible impact on consumers. We look forward to commenting further once the initial proposals are published at the end of May 2007.

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

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs