

Gas Distribution Price Control Review Initial Proposals Document (Ref 125/07)

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Advantica Response to Section 6, Question 3

Advantica would like to offer the following comments regarding Ofgem's question "Is it appropriate to implement an opex rolling incentive?" (Section 6, page 65).

Advantica's View

Whilst we agree that an opex rolling incentive would encourage gas distribution networks (GDNs) to continue making incremental efficiency savings, we believe the proposed scheme would fail to encourage GDNs to address significant long term challenges facing the industry. We strongly believe it is appropriate to establish incentives to encourage robust long term research & development (R&D) programmes, similar to that of the Electricity Distribution and Transmission sectors.

Context

The U.S. Department of Energy provides the following relevant description of R&D / R&D expenditure:

In its most generic form, R&D expenditure is intended to create knowledge that benefits society. The results of research are inherently uncertain. The knowledge obtained may only reveal technical or economic dead ends to be avoided in the future. Thus, only a portion of R&D is likely to achieve results in the form of cost savings or other consumer benefits. Furthermore, to the extent that there are attributable results, they are likely to be measurable only years after the funded research effort is initiated.

R&D is classed as follows:

1. *Basic Research: Includes research projects designed to pursue the advancement of scientific knowledge and the understanding of phenomena rather than specific applications.*
2. *Applied Research:*
 - A. *Research To Develop New Technologies – Involves attempts to discover new scientific knowledge that can have commercial application. Although the end objective of the research is known, the research task is difficult and uncertain.*
 - B. *Research To Improve Existing Technologies –Emphasize the use of scientific knowledge to design and test new processes that may have substantial technical and cost uncertainties.[1]*

Opex Rolling Incentive & IFI Schemes

During the days of BG Technology, the UK Gas Industry had a robust R&D programme. Comparative regulation has compelled GDNs to seek opportunities to reduce operating costs. R&D expenditure has been an obvious target because of the inherent uncertainty and delayed benefit. We believe this would continue to be the case under the proposed scheme. The opex rolling incentive would encourage GDNs to undertake R&D only where the potential to achieve cost savings is high and the risk of failure is low. It is our view that it would result in very little, if any, basic research or research into the development of new technologies. The effect on the UK gas industry would be limited potential benefit to consumers in relation to cost savings, safety, customer service and environmental impact.

An IFI approach would be one means of improving the existing environment enabling the industry to finance the necessary resource to allow proper engagement in collaboration and undertake long term basic and applied research. Consideration should be given in the design of any IFI scheme to recognise that R&D is risky, with failure an inherent part of the process. We look to our customers in non-regulated industries, such as the oil majors (Shell, BP, BG), where we can cite examples of companies' long term commitments to R&D programmes. These companies accept that expenditure will necessarily occur long before cost savings or other benefits (e.g. reduced societal risk or environmental impacts) are recognized. We believe that comparative regulation severely limits the drivers that exist in non-regulated markets to invest in innovation. It is our view that an IFI approach is a tested means of encouraging innovation.



Furthermore, to solve the UK gas industry's sustainability, safety and environmental challenges e.g. maintaining and replacing risers, replacing large diameter cast iron mains, avoiding terrorist-related security threats, minimising excavation, etc., the industry must commit to substantial R&D programmes. In our view, these challenges will not be adequately addressed through a rolling opex incentive approach. We strongly believe that Ofgem should support and encourage robust innovation programmes, in addition to short term efficiency savings, for the benefit of consumers.

1. Federal Financial Interventions and Subsidies in Energy Markets 1999: Primary Energy, SR/OIAF/1999-03, September 1999, Energy Information Administration, Office of Integrated Analysis and Forecasting, U.S. Department of Energy, Washington, DC 20585, pages 25-26.

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