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Gas Distribution Price Control Review

Initial Proposals Document

A response by Centrica

Author: A. Russell
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INTRODUCTION

Centrica's response to the Gas Distribution Price Control Review: Initial Proposals Document contains three main parts.

The first section focuses on key issues, setting out our main concerns on a number of areas relating to the consultation document and the price control process more generally.

The second section addresses those questions specifically raised by the consultation document and related issues.

SECTION 1: KEY ISSUES

In responding to this Initial Proposals document, Centrica raises a number of significant concerns we have with the Gas Distribution Price Control Review (GDPCR) to date, as well as making further comments on the new and positive approach we proposed to the cost of debt in our response to the Fourth Consultation Document.

Cost of Capital:
In response to the 4th consultation document, Centrica commissioned CEPA to research market evidence on the key elements of the cost of capital. The paper concluded that the cost of debt under the Transmission Price Control Review (TPCR) was probably overstated and that a significant reduction is appropriate. We hold firmly to the views set out in this paper and welcome Ofgem's further consultation on financeability issues and the cost of capital.

Whilst we agree with many elements of Ofgem's approach including the direction of change on the cost of debt, we do not believe that Ofgem have yet taken sufficient account of the evidence presented by CEPA. Hence we consider that Ofgem's proposals, if adopted, risk continuing to grant windfall gains to the GDN's through an unnecessarily high WACC.

We suggested that in addition to a significantly reduced cost of debt, Ofgem should consider introducing a trigger mechanism to allow the cost of debt to be adjusted within the price control should the cost of debt change for an extended period. This could be simple and transparent, protecting the GDNs at the same time as allowing customers to share in the benefits of any actual reduction in the cost of debt. However, Ofgem suggest that CEPA proposed a cost of debt of 3.0% with a trigger mechanism; in fact, the proposal was a cost of debt of 3.0% without a trigger mechanism. CEPA noted that the implementation of a trigger mechanism would permit a further reduction in the cost of debt in the low end of the range of 2.5-3.25%.

We continue to believe that the market evidence, even in the absence of an adjustment mechanism, would allow Ofgem to set a revised Vanilla WACC of between 4.3 and 4.5% against the current Vanilla WACC of 5.25%. We have calculated that this would bring a benefit to customers of around £90-110m (per annum) in real terms.

We have noted with interest, analyst reports on National Grid which note clearly that the post tax real WACC of 4.4% (equivalent to 5.05% Vanilla WACC) permitted under TPCR is well above the group's WACC. The same analyst goes on to observe that on the assumption this rate of 4.4% continued for the next two regulatory periods, the economic value created would be equivalent to a 16.8% premium to RAB. In our view, analysts factoring in such assumptions to their valuations, supports our contention that a Vanilla WACC higher than 4.5% would be unduly generous.

In addition, we continue to be concerned at the significant difference of views between regulators (Ofgem and the CAA), on an appropriate risk free rate for implementation on the same timescales, when the market evidence clearly aligns towards the view taken by the CAA, which appears to be around 0.5% lower than that used by Ofgem in TPCR.

Capital & Replacement Expenditure:
The bids on capex and repex put forward by the GDNs represent a substantial increase on the one year control, and we are not convinced that sufficient justification has been put forward for the levels of investment in capex (given the relatively flat expectations for demand) and equally, there is insufficient evidence for the efficiency and economy of the planned repex investments. We support the scrutiny and challenge to the proposals being exerted by Ofgem and its consultants, and believe greater transparency on this work should be given at an earlier stage in the process.

As we noted previously, Centrica has experienced difficulty in responding effectively to the document in respect of capex and repex due to the lack of information supplied in the consultation document. We do acknowledge that Ofgem has now placed its consultant reports into the public domain, however, they were published only last week and the volume of material is such (given the repetition of large amounts of text) that careful study in the time available was simply not possible.

Ofgem's consultants have challenged robustly in a number of areas, but as far as we are able to assess, Ofgem has only accepted of the order of 70% of their recommendations. We are concerned that this rejection of c. 30% of the consultants' recommendations may mean customers are asked to pay more than is strictly necessary.

We continue to believe that the asymmetry of information between GDNs and respondents is not acceptable and damages the effectiveness of the consultation process. We are aware that GDNs will be permitted to resubmit their capex and repex bids over the summer and hence that Ofgem's consultants will need to scrutinise the bids again.

We believe that to assist respondents to the September update document, the key tables should be republished in summary form in advance of the formal consultation to allow respondents to prepare. We would find it very helpful if a summary could be provided in August. In addition, we request that the revised consultant reports should be published with the September document and at least six weeks allowed for response submission.

Treatment of Non Operational Capex and Repex:

We welcome Ofgem's revised views on the probable treatment of non operational capex, we believe this should continue to be treated as capex and hence support the approach.

As we have mentioned previously, we do not support the current 50:50 treatment of repex. The logical economic and accounting treatment for repex is 100% capitalised as it is capital expenditure. We believe that the previous treatment expensing 50% was essentially a financing adjustment. In a new price control, we believe strongly that the starting point should be the normal commercial position, and that the burden of proof should be on reasons to diverge from this normal position, hence the starting point should be 100% capitalised.

We estimate that the continuation of expensing repex will bring costs of over £300m per year forward into the next price control and onto current customer bills. Instead, these costs should be spread over the life of the assets in the normal way minimising the immediate impact on the customer. As such, customers will not have to pay 50% of the annual repex cost in that particular year but rather gradually pay this cost over the lifetime of the assets (45 years). When also considering the time value of money of this immediate repex expenditure, the ultimate impact on customers will be even greater than the £300m per year mentioned. In conclusion here, placing a financing adjustment of this magnitude onto customers is in no way justified.

Pensions:

Centrica continues to have such significant concerns on the treatment of GDN pensions that we believe the approach set out in this and the previous consultation documents merits further review.

We have commissioned our actuaries, Watson Wyatt prepare a paper (appended to this document as Appendix 1) reviewing the information provided. Additional detail of the Watson Wyatt paper and Centrica's concerns are included under chapter 3. However, in summary Watson Wyatt consider that Ofgem's proposed approach is inconsistent with the stated principle that customers should pay the "efficient cost of providing a competitive package of pay and other benefits including pensions". The result of this is that costs to customers are

significantly higher than they might otherwise be, due to lack of pressure on GDNs to control/reduce benefits and contributions.

In addition to these concerns, we believe that the lack of information in this area is also a major problem. Watson Wyatt have not been able to carry out, on our behalf, a detailed assessment of these issues due to the lack of detailed information available to respondents. We do acknowledge the report placed in the public domain by SGN, but we believe that this information is insufficient and at too aggregated a level to allow us to carry out the kind of detailed review we would wish to and to properly assess the likely impact of the proposals on customers bills.

In our view, we believe these issues are sufficiently serious that Ofgem should re-open, as a matter of urgency, this whole area of the price control, the basis on which GDNs are permitted to pass through costs to customers and carry out a detailed examination of the benefits offered and funding in comparison to comparable schemes to ensure that customers are not asked unfairly to fund such generous schemes.

DN Sales Benefits:

Centrica has repeatedly pressed for DN Sales benefits to flow through the price controls at an early stage, so we are very encouraged by the application of benchmarking to the GDNs opex forecasts. However, we do have some concerns in respect of the uplift applied between the results of the bottom up benchmarking and the top down benchmarking.

Ofgem has applied a percentage uplift of 5.6%. This is a significant sum and in our view provides a major relaxation in the targets the GDNs face. We understand the GDN concern that bottom up benchmarking may lead to a “virtual” DN as target; however, in our view this is to be welcomed. GDNs are funded by and for customers, and hence it is not unreasonable for them to be targeted at “best in class” in each area. To relax the target in this way can only mean additional costs to customers over the five year period, and we cannot see where the offsetting benefit to customers may lie.

In addition to these specific points, we refer back to our previous responses to GDPCR and also our responses during the DN Sales process in which we continually stressed our concern that the benefits of DN Sales must flow through to customers at the earliest opportunity, and further, that these benefits must be monitored and demonstrated to be delivered given the basis on which DN Sales was permitted to proceed.

Constructive Engagement:

Centrica continues to advocate an approach to the price control process closer to that of Constructive Engagement employed by the CAA during the ongoing Q5 review. We have welcomed Ofgem’s efforts in this direction, including the industry dialogue on xoserve and the useful costs workshop held as a roundtable discussion with the GDNs in April. We would appreciate Ofgem arranging a similar discussion as soon as the information from the updated proposals can be made available. However, we would like to request that the discussion allow a longer period for in depth questioning of the GDNs on issues once interested parties have had the opportunity to thoroughly review the information.

Centrica believes that the current asymmetry of information is fundamentally damaging to the price control review process, and hence that a constructive engagement type model would be invaluable in setting price controls in energy in future. In our view, users should be actively involved in a dialogue around key capital plans and services to be provided, and we believe that this involvement would lead to a materially better outcome in future for all parties.

Clearly whilst Constructive Engagement will not lead to an agreed outcome in all cases, it will at least produce an informed basis for a decision.

Finally, we hope that Ofgem will use the experience of the CAA and issues from GDPCR to expand on the Constructive Engagement approach in DPCR5.

Information Transparency:

During the Price Control Review process

We welcome the publication of additional information and the financial models and Ofgem's efforts to provide indicative estimates of the effect of the proposals on customers. However, we believe there is still some difficulty for customers in understanding the numbers provided, and we believe it might be helpful for a small group of interested parties to meet and discuss how best to present the information so that the ramifications are fully understood. This is particularly important when annual averages are used as this has the effect of dampening year on year effects. We would be happy to work with such a group.

In GDPCR, the companies have been permitted to resubmit their data over the summer; this will allow the inclusion of an extra year's data post DN Sales. However, we also note that GDNs will be permitted to resubmit their capex/repex bids in the light of the proposals around the capex roller and the IQI (Information Quality Incentive). In our view, this process has added significantly to the uncertainty faced by suppliers during the process, further re-emphasising the information asymmetry. It will also require additional work by Ofgem and their consultants, presumably adding significantly to the costs of the process, which will also be borne by customers.

We believe that respondents need sufficient time to absorb the effects of this "rebidding" process on the proposals, and that September is extremely late in the process for such major changes. We therefore request that the GDN information and Ofgem's analysis be shared (including the consultant analysis) as soon as possible to allow respondents to carry out their own analysis and make a thorough evaluation of the updated proposals in advance of submitting responses.

Within Price Control Period transparency

As we have previously highlighted, Centrica believes there is a need for additional transparency of information both during and after the price control process. We look forward to participating in the cost reporting consultation, which we hope will reflect shippers' and suppliers' need for detailed information as well as regulatory reporting.

We believe it is essential that GDN reporting of key elements during the price control period is improved. This is to allow suppliers to estimate the future path of prices for budgeting purposes, and to ensure that any future overspends (such as the £840m in the last control) are signalled well in advance to the industry.

In order to support this process, Centrica has brought forward a Review Group proposal to facilitate detailed debate and modification proposals in this area.

We believe that greater transparency of information around price control revenues and transportation charges will support competition and greater customer choice.

Industry issues:

In additional to the technical and economic aspects described above, Centrica believes strongly that this GDPCR must set the right foundations for improving the present industry arrangements, to allow the industry to move forwards into a more efficient future.

Specifically the GDPCR must enable the improvement of industry systems, rather than simply replacing them, catering for advances such as smart metering and meter point reconciliation to name but two. In addition improved incentives and clearer obligations on the GDNS are required to drive down the excessive levels of industry imbalance created and perpetuated by RbD.

SECTION 2: QUESTIONS AS RAISED BY THE DOCUMENT

In this section, we address the questions as listed in the appendix to the consultation document.

CHAPTER 2: Form, Structure and Scope of Price Control

Question 1: Do you think that a wider deadband on the revenue recovery correction mechanism is appropriate in gas distribution?

We support the use of a modest deadband on revenue recovery correction, and further that the deadband should be symmetrical. We also support improved incentives on the GDNs to recover their revenue accurately. However, we do not support a wider deadband for gas than for electricity; indeed, if the volume driver were to be implemented (even though we do not support this) we would expect to see the deadband narrowed further.

CHAPTER 3: Operating Expenditure Analysis

As a general observation, both under this section and that relating to Capex and Repex, we note that pending the E.On appeal, any assessment of costs related to Exit Reform has been excluded.

Whilst we understand why this has been the case, we are very concerned that if significant proposals in this area are brought forward in September, this will leave only a very short period of time for interested parties to respond. With this in mind, we would encourage Ofgem to publish a summary of the likely changes in the September Update paper in August to allow respondents to consider their high level views in advance of the consultation being published.

In addition, if the new NTS Exit arrangements result in the DNs needing to book flexibility, we believe that the knock on effects should be carefully considered. For example, a view can be taken that DN requirements for NTS Flexibility effectively support the DNs' requirements for diurnal swing. This could, therefore, be considered as an alternative to investing in building diurnal storage. Centrica believes that it will be important to ensure that there are no perverse incentives created on DNs to do one rather than the other, solely on the basis that the costs from one option could be more easily passed to shippers that costs from the other.

Pensions

Whilst the document does not specifically raise questions on pensions, Centrica continues to have such significant concerns on the treatment of GDN pensions that we believe the approach set out in the previous consultation documents merits further review.

We have commissioned our actuaries, Watson Wyatt to review the material provided in the consultation documents to date and the report prepared by SGN's actuaries. The paper prepared by Watson Wyatt is appended to this document as Appendix 1.

The paper raises questions in several areas:

1) Level of benefits
   a) The level of benefits and associated cost is high
   b) The GDNs have little incentive to pursue (unpopular) changes to the levels of benefits provided when they can simply pass costs to customers
   c) The level of member contributions is low
   d) Scope to reduce costs in future

2) Investment profile and the risk/return strategy selected

3) Assumptions & approach used for funding the GDN schemes, which in Watson Wyatt's view may be significantly more prudent than for the average scheme.

In summary, Watson Wyatt consider that Ofgem's proposed approach is inconsistent with the stated principle that customers should pay the "efficient cost of providing a competitive package of pay and other benefits including pensions". The result of this is that costs to customers are significantly higher than they might otherwise be, due to lack of pressure on GDNs to control/reduce benefits and contributions.

Watson Wyatt also doubts that under the current regulatory regime, any surplus would arise to be passed back to customers, as an improvement in funding level would be likely to encourage the Trustees to further increase the degree of caution in their approach.

With the above in mind, Centrica does not support the current proposals in respect of pensions, we believe that a much tougher regime should be implemented, and we detail our additional points below:

- We consider that as the schemes are more generous than many occupational schemes, consumers are subsidising the supplier schemes to their own detriment

- The benefits from pension schemes are paid for from two sources: contributions and likely investment income. If GDNs are investing on a conservative basis this pushes the contributions up – they will get the benefit of investment security without the pain of higher contributions. Other UK schemes have to balance the interests of the employer and the trustees and contribution rates are not set by the actuary – they are set by the scheme trustees after taking account of the views of the employer and the Pensions Regulator has made it clear that trustees need to be reasonable.

- There is no incentive for the GDNs to manage their pension contributions or seek to limit these.

- We believe that a regular opinion of by a third party independent actuary would be important in providing comfort to those paying the bills and help create cost reduction incentives on the GDNs

- In respect of paragraph 3.84, we are not sure that it is true to state that the costs are likely to balance out over time. As respondents, we are unable to identify why the costs are so high now, hence we are not persuaded that this will not continue to be the case, particularly if the scheme trustees were to adopt a practice of moving towards a more conservative investment basis.

We agree that a review of the treatment of potential future surplus is appropriate; however we consider that the review should be wider ranging than simply treatment of surplus, to incorporate the areas we have detailed above. We further believe that the review workstream should include supplier and customer representatives. We would be happy to work with and support such a review

Question 1: Do you agree with our approach for setting opex allowances and the proposed allowances we have derived using that approach?

Whilst not the only issue associated with the setting of opex allowances, we do support the proposed Ofgem approach of removing margins in respect of connections costs where such costs are recovered from the generality of customers.

Overall we agree with the broad approach taken towards benchmarking but would appreciate more information from Ofgem about how:

- The choices regarding benchmarking techniques have impacted upon the final cost allowances, including presenting the detailed results of the sensitivity analysis that has been carried out.
- The overall efficiency targets for the individual GDNs have been constructed at a higher level, including the reasons for the differences between them, such as the separate frontier shift and catch up components.

We consider that the final average figure for the opex efficiency savings seems conservative. It would be useful if Ofgem could justify this figure in the context of other studies and previous allowances and explain further to what extent the lack of glidepaths is compensated for in the DNs' favour and hence the additional cost to customers. For example, Deloitte carried out partial factor productivity analysis of opex for transportation activities for UK gas companies between 1996 and 2000 that indicated these businesses achieved real annual cost savings of 5.0 per cent[1]. In addition, CEPA carried out similar analysis for distribution activities of a European gas company, which that indicacted they had achieved real unit operating opex savings of around 10 per cent per annum.

We agree that benchmarking can be a useful source of information but note that it is more difficult to apply to investment activities than more short-term spending. Further, whilst the sole use of the disaggregated approach may lead to lower allowances, it is important to ensure that these allowances do efficiently and economically support the businesses.

General Points

There are some specific IS savings identified by PB Power (in work management for example) that have been discounted by Ofgem as being part of the efficiency savings already provided for. We would be interested to see what capex if any was associated with these savings.

Emergencies

Ofgem have accepted reductions in external public reported escapes (PREs) proposed by PB Power as a result of replacement activity, but GDNs disagree. In our view it is reasonable to assume that PRE's should reduce, and the evidence presented by PB Power across the GDNs clearly indicates this to be the case. We would also like to have seen a small downward trend in no-trace reports, but appreciate that there would be difficulty in assessing exactly what the impact could be, unless there is evidence based on historical trends to suggest that no-trace PREs have reduced as the length of non-PE main has decreased. With regard to the effect of ageing on the number of PREs we would not expect this to be material, however if this was to be considered appropriate we would like to see clear evidence to justify any increase in PREs due to this factor.

We acknowledge that the amount of meter work carried out by the same staff affects efficiency for emergency work and makes the final outcome uncertain, but Ofgem have said they will create incentives to reduce increased waiting time if meter workload declines. We look forward to seeing the further work being done on this aspect by Ofgem. Unfortunately we are unable to validate the assumptions made regarding the loss of meter work as Appendix 3 from each report has been removed, but would appreciate some indication of the way that the specific increases in costs have been allocated to each GDN.

We fully support any activity to reduce the level of PREs and anything that supports a reduction in the risk of a serious incident. PB Power have highlighted however that the Supplementary Incentive Mechanism introduced in the last price control for mains replacement could lead to higher costs in other areas including PRE's. We note the Ofgem proposals for revised incentives but it is not immediately apparent that the impact on external PREs and leakage has been specifically addressed. We request Ofgem to confirm that the new incentive mechanisms do ensure that that GDNs are encouraged to seek the optimal solution for mains

[1] *Deloitte 2006, Results of work carried out by Deloitte in support of Ofgem's Transmission Price Control Review 2007-2012, Draft Report, April, p.142.*

replacement and reinforcement, whilst keeping external PREs and leakage on a downward trend.

It is stated that Ofgem are still looking at the possibility of regional variations (rural versus urban) but we would expect that this should take account of not just situations where the different areas could have legitimate reasons to increase costs, but also areas where there are legitimate reasons for lower costs.

Repairs

It is noted that the majority of the costs associated with this activity are associated with mains and service condition repairs and that an across the board reduction of 3% for all GDNs has been applied based on a reducing non-PE network. We are interested to understand the basis for this common adjustment.

We would also like to raise the following questions regarding the service population.

- What percentage of services are non-PE at the beginning and end of the control period?
- Most service replacement is domestic and amounts to a total of 1m service relays over the control period. Has reconciliation been carried out to establish consistency between the amount of repair work, service replacement activity and declining population of non-PE services?

Maintenance

We note that there are quite wide ranging adjustments made against the GDN submissions in percentage terms reflecting the fact that some GDNs have much higher unit costs for maintenance than others and are expected to make the greatest improvements. However when it comes to holder maintenance the number of holders forecast to be in use seems to be accepted with what appears to be a quite cursory justification for the numbers. The typical comment “The further loss of X holders is we believe broadly consistent with Capex projections and the loss of X mcm of low pressure storage”. When looking into different cases of holder demolition across the GDNs it is apparent that PB Power do not appear, from the analysis presented, to have challenged a decision to invest in storage with what appears to be a minor reduction in opex.

We would like to illustrate this with some examples.

East of England are forecasting a loss of 8 holders equivalent to 0.43 mcm of holder storage, which at the lowest cost shown in the capex report (£9m/mcm) for this GDN gives a total investment cost of £3.9m. It is quite difficult to assess from the data provided what the effective reduction in annual opex would be from the data provided, but if we assume as stated in the report that maintenance and repair costs per holder per annum are £14,262, painting costs are equivalent to £15,400 and the cost of working at height regulations a one off cost of £30,000 per holder. This gives a total cost saving by demolishing 8 holders of £240,000 per annum plus a one-off saving of £30,000. At an 8% discount rate over 20 years this would suggest a net present cost of approximately £1.5m. What may alter the position for the GDN is the realisation of profit from the land sale, but the report does not go into this in any detail other than to say that demolition costs should be covered by land sale revenue.

The equivalent calculation for Southern shows a NPC of around £4.5m although there is one project that could bring this down to £0.5m, but this project is effectively linked with another project that has a cost per mcm of storage that is three times this project and hence the £4.5m is based on the combined projects.

We would like to know if the above analysis was carried out by PB Power and also what would be the treatment in this analysis of profits from land sale.

Question 2: Do you agree with the proposals to uplift allowances derived from disaggregated benchmarking so that they are consistent with the power of a top down approach?

We agree in principle with the use of a top down approach as a sense check on the disaggregated benchmarking activity. However, we consider that where the two approaches generate such significantly different approaches, it is important to establish why this has been the case rather than simply adjusting the allowances upwards.

In our view, such an adjustment has the effect of relaxing the targets in the DN's favour, by relieving the requirement to aim for best in class as a target in each case.

Question 3: Do you agree that GDNs Emergency Service Personnel (ESPs) should be required to carry and use carbon monoxide measuring equipment during gas emergency investigations?

Centrica is concerned about the above proposals, as we believe that there are a number of issues that would need to be thoroughly addressed in order to move such proposals forward, hence at this stage, we do not feel able to support them. We have listed a number of points for consideration below

- The ESP's licence condition only allows for 30 minutes on site and flue gas analysis will therefore significantly extend this.
- In order to maintain current response times for controlled and uncontrolled escapes, the use of Flue Gas Analysers (FGAs) would potentially necessitate hundreds more operatives nationally to maintain standards of service to the public.
- The additional testing would require operatives to be trained, assessed and CORGI registered to work on appliances.
- Such testing also requires access to the flue, which isn't always possible. In addition, FGAs are not suitable for use on all appliances.
- Defective appliances may not be identified because of the wind direction, reverse flueing etc. in which case a false level of assurance could be given leading to the inappropriate 'continuing' use of appliances.
- To undertake a meaningful test the appliance must first be brought up to temperature, which can take up to 30 minutes. This will significantly extend the operative's time on site, if a robust test is to be undertaken, particularly if several appliances are to be tested.
- Individual appliances have different warm up durations, which in turn are affected by the presence of faults. An operative would therefore need to be trained and assessed in a wider range of appliances and fault conditions.
- When ESP operatives attend gas escapes/fumes they, in the vast majority of cases, enter an oxygen rich atmosphere due to the fact that customers reporting gas escapes/fumes are advised to turn off meter/emergency control valve, ventilate the premises by opening doors and windows, extinguish all sources of ignition and not to operate electrical switches. Hence, when they attend there is no carbon monoxide to test for.
- In the vast majority of CO investigations the cause cannot be replicated, hence a more detailed investigation process has to be adopted in order to reproduce the build up of CO levels.
- It is common for CO investigations to take in excess of a day and for the report production to take a further day; this is unlikely to be practical for the ESPs.
- Appliance technology varies from the very simple to the very complex Energy Efficiency appliances, further complicating the training requirements.
- If adopted we believe that the ESP's would be required to comply with paragraph 26.9 in the Gas Safety (Installation and Use) Regulations 1998. This paragraph essentially sets out that the Gas Safety Check must:
  For a gas appliance, include the examination of:
  (i) The effectiveness of any flue;
  (ii) The supply of combustion air;
  (iii) Its operating pressure or heat input or, where necessary, both; and
  (iv) Its operation so as to ensure its safe functioning.

- Given the extensive nature of these obligations, we believe it is possible that the system would be open to abuse by some customers seeking to have appliances thoroughly checked at no cost to themselves. In holding this view, we do note that vulnerable customers are protected in this area by the Gas Supply Licence.
- The time to execute, additional equipment, training and monitoring needs will carry significant additional costs which will, via transportation charges, be passed to all customers. We are not certain that this is the most cost efficient or effective way to address this issue.

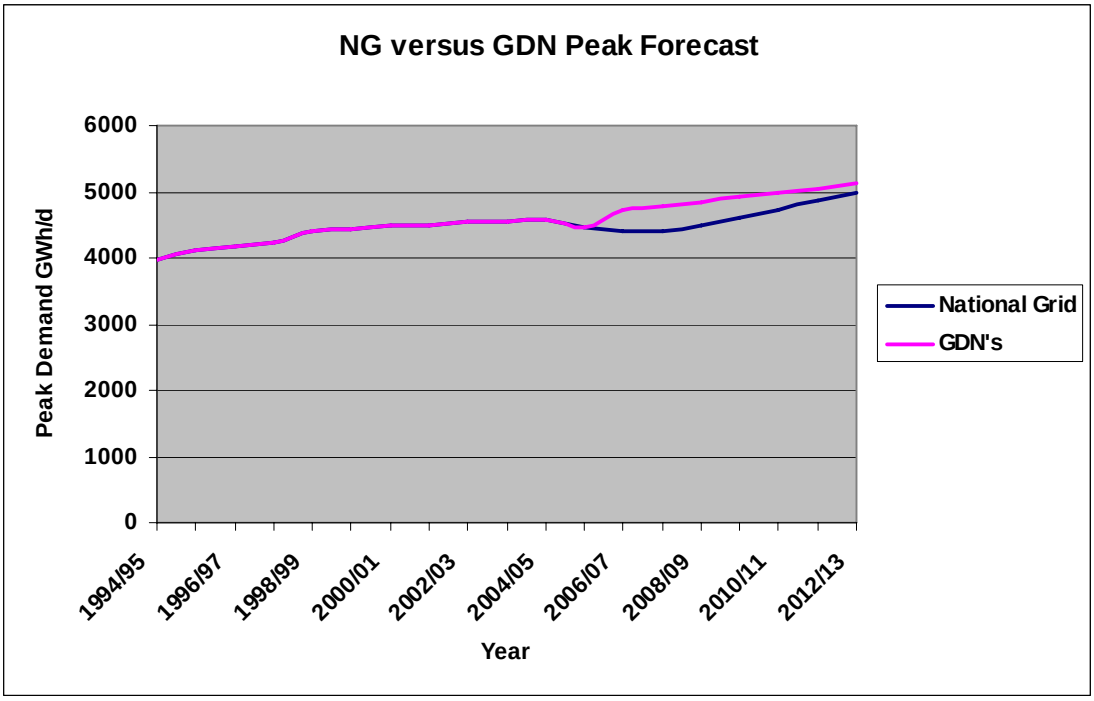
CHAPTER 4: Capital and Replacement Expenditure Analysis

Question 1: Do you agree with our approach for setting capex allowances and the proposed allowances we have derived using that approach?

Demand forecasts

It is clear from the PB Power reports on capex and repex that there has been insufficient analysis carried out on the peak demand forecasts that would provide any confidence that the capex figures developed from these forecasts have any validity. They have made comparisons between the GDN and NG NTS figures but have concluded that "Our work has not included an analysis of demand forecasts in sufficient depth to make a judgement on the most appropriate forecasts to use for capital expenditure planning. In this report we have carried out a cost analysis, assuming the GDN proposed demand forecasts." In effect PB Power appears from the reports to have accepted the figures provided by the GDNs on the basis that the only impact on the final capex relates to phasing of expenditure.

We have concerns with this approach. On examining the different forecasts there is a clear discrepancy in the starting point for the forecasts. The graph below shows the different forecasts from NG NTS and the GDNs for total GDN peak demand taken from their 2006 Ten Year Statement and 2006 Long Term Development Statements respectively. Historical data is only available from the NG NTS 2006 Ten Year Statement.



	2006/7	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13
NG	4397	4414	4492	4602	4733	4861	4995

GDN	4716	4771	4848	4914	4993	5057	5145
%Diff	7.2	8.1	7.9	6.8	5.5	4.0	3.0

In the fourth consultation it was stated that further work would be done to assess the differences between the NG and GDN forecasts in the area of the phasing of demand growth, but the PB Power reports do not provide sufficient explanation as to why there is such a substantial difference at the start of the control period and even at the end the GDN figures are 3% higher than those of NG NTS, equivalent to 2 years growth (from the GDN figures). The only explanation is a difference of opinion between NG NTS and the GDNs on the impact of high prices on peak demand. NG NTS have indicated a reduction in peak, whereas the GDNs don't indicate this. We are particularly interested to know more detail of how GDNs derive their forecasts and if they use consistent or comparable methodologies as it would assist us greatly in understanding the validity of the GDN capex forecasts.

We have not been able to study each GDN in any detail with respect to the demand forecasts but have carried out an analysis based on data from their 2006 Long Term Development Statements which we assume should be consistent with their current submissions. We studied the load band splits for the 2006 and 2007 annual demand forecasts and have the following comparisons. Units are TWh.

2006	0-73 MWh	73-732 MWh	Total LDZ
NG	401.3	64.6	682.6
GDN	403.5	64.1	689.4
%Diff	+0.5	-0.7	+1.0

2007	0-73 MWh	73-732 MWh	Total LDZ
NG	396.3	65.9	675.5
GDN	402.1	65.6	686.6
%Diff	+1.5	-0.4	+1.6

It was not possible from the data available to break down some of the GDN numbers to match those from the NG NTS 2006 Ten Year Statement. However it is clear from this that there is very little difference in the key load categories that affect peak demand and have the greatest weather sensitivity. We therefore have to assume that there has been a substantial shift in the load factor assumptions for the weather sensitive loads. Could Ofgem therefore please provide further evidence of the assumptions used to calculate peak demand as it is not possible from the PB Power analysis to make any constructive response to the consultation with respect to demand led capex.

Capex Drivers

In order to assess the impact of different drivers on capex we would be very interested to see the breakdown of drivers for investment in the different categories of Operational and Non-operational capex (as provided in the BPQ) as this would assist in identifying any discretionary investment. The PB Power analysis focuses on cost analysis but does not specifically address the key drivers of activity in sufficient detail for judgement to be made on the capex forecasts. The demand forecasts are an example, but with two of the cost areas that make up nearly 40% of the total proposed allowance there is not the same level of rigour applied to the analysis, particularly with respect to IS capex. Certain opex efficiencies are mentioned briefly (for example in section 7.4.3.2 in the PB Power report on NGN) but there is no evidence to suggest that this comment has any analysis to support it. We would ask Ofgem to provide some information in support of the PB Power comments in this area.

There are wide ranges of capex per unit of demand growth across the GDN's and some GDN's are being allowed up to almost double the forecast average investment compared to historical averages. There are comments that investments are being made for a number of reasons, which in the case of Southern LTS and Storage investment includes resilience, security of supply and replacement of IP mains. There does not appear to be any analysis to support the

justification of investment for these purposes. For example what cost benefit analysis has been carried out to support additional resilience, does this comment for example suggest that the networks are being designed to provide greater than 1 in 20 peak day security. We also need to be reassured that GDNs are not factoring in investment to avoid issues associated with exit reform and that the decisions made by GDNs on a specific course of action e.g. between pipe investment and gas holders are actually the most cost efficient solutions for customers or just the least risk solutions for the GDN.

	2002 - 6	2007	2008 - 12
Forecast Peak Demand Growth	5.5%	1.2% GDN forecast	7.8% GDN forecast
Actual Peak Growth & Average Annual Investment	-2.4% £261m		
Forecast Average Annual Investment		£358m Ofgem allowance	£328m Ofgem initial

The table above shows our calculation of historic and forecast growth and capex for the three different periods of the last control period, the one year extension and the new period. We would just like to raise the question: Is it possible that investment for some of the growth that is being forecast by GDNs has already been made. Especially as the 5.5% growth forecast figure was taken from the NG NTS 2005 Ten Year Statement and GDNs were still forecasting demand growth in their 2005 Long Term Development Statements.

Capex Categories

LTS and Storage

We have one general observation on the target storage cost of £50m/mcm. This is derived from an analysis that looks at NTS storage costs. So any GDN that builds storage that is below this value is deemed to have built efficient storage. We would not disagree with this comparison on a like for like basis, but it may not necessarily be the most cost effective solution if a storage pipeline is being built to replace a decommissioned holder. We have only been able to carry out simple DCF calculations as shown above in the opex comments, but we would appreciate Ofgem's thoughts on the impact on customer costs of replacing holders with linepack.

We have a specific observation regarding the requirement for diurnal storage. Some of the GDNs have shown significant jumps in storage requirement in the early part of the control period, most notably in the Southern GDN. They have adopted a policy of ramping up their diurnal storage requirements significantly at substantial expense in capex. The justification is that they believe that they need to keep their reliance on NTS storage to the current levels, which due to the rapid rise in total storage required requires a reduced reliance on NTS storage as a percentage of the total. It has not been explained as to why there is such a large increase in the total storage requirement, relative to other GDNs. Is there a specific driver for this requirement other than demand growth that can be identified?

We note that further investigation will be carried out as part of the update into the possibility of profiling offtakes across the NTS to facilitate movement of storage between Southern and South East LDZs and look forward to the conclusions of this analysis.

Mains Reinforcement

We have one specific comment regarding mains reinforcement. Two network owners (SGN and WWU) have a policy of retaining a specific operating strategy which involves keeping maximum operating pressures at current levels. This incurs higher mains reinforcement costs for upsizing and also the potential for increased leakage and hence PREs. PB Power could find limited evidence of a cost benefit analysis being carried out for projects that delivered this strategy. It

is not clear from the comments in the PB Power report if this specific matter will be investigated further or if it will form part of the recommended further review of the total reinforcement workload. Could Ofgem please confirm if the pressure management strategy will be examined further?

Question 2: Do you agree with our approach for setting repex allowances and the proposed allowances we have derived using that approach?

The 4th consultation document presented a range of questions on the issue of mains replacement policies. There would have needed to be a lot more information made available for anyone to make a sensible response. However it would be very helpful, particularly given the large costs associated with repex, for Ofgem, the GDNs and the HSE to provide a detailed presentation on the subject to enable a more informed judgement to be made. Of particular interest is the issue of completing priority replacements versus an efficient mains replacement strategy, and the impact that NGG's approach in particular to replacement has on current costs compared to other GDN owners. We note that PB Power recommended specific reductions in workload on the basis that NGG were planning to replace mains at a rate that exceeded the requirement to meet the thirty year programme. Ofgem have stated that they have reinstated the full mains replacement workload that NGG have agreed with the HSE.

We would like to know why Ofgem have decided to do this and how much additional repex will be incurred and in which periods as a result of this decision?

50% of the proposed expenditure on riser costs is in one GDN. PB Power have recommended that this level of investment should not be necessary as the risers should be either replaced on failure or there should be a more detailed evaluation of the risers that should be replaced to take account of more factors like the consequences of failure. We look forward to Ofgem's further review on this subject, but are interested to know the reasoning for the inclusion of costs at this stage.

We would like to see at the earliest opportunity the GDN's assessment of the impact on costs of the waste management regulation changes.

Whilst we understand the main driver behind the replacement expenditure is the HSE requirement, we do not believe that this in any way reduces the obligations to be cost efficient and economic. In our view it behooves both Ofgem and the GDNs to apply even more robust challenge to costs under these circumstances to protect customers' interests.

CHAPTER 5: Outputs

Question 1: Do you support our proposals for changes to the outputs and quality of service arrangements?

Presently performance against overall standards is published by Ofgem, whilst performance against guaranteed standards is not. In our view, the transfer of proposals from overall to guaranteed standards means that in the absence of additional arrangements, suppliers will have less visibility of performance than they do at present. Ofgem can address this by publishing network owner performance against all performance standards including guaranteed standards. The improved reporting requirements should also be applied to all the retained existing standards operated by all the GDNs.

Overall, we believe that GSOP is perhaps the right approach, however, as an approach it leaves a concern that GDNs will focus on the easiest parts of the network to give them the best chance of achieving the required standards. For example, in communications, this might lead them to concentrate on the easier conurbations, whereas the sparser rural areas may fall into the 5% part of the 95% target. This supports the point above and we believe that the

reporting against GSOPs should be at a level of granularity which will allow this issue to be monitored.

Centrica considers that there is a need to increase accountability of network owners by increasing visibility of performance, and in particular, placing clearer obligations on network owners in those areas that can impact upon gas imbalance.

Increased performance visibility will increase the accountability of network owners, and help suppliers take more informed views regarding the service that is delivered by network owners.

Suppliers can add valuable critique and review to the reported performance levels themselves. We believe that this could be a useful validation /verification step, given the recent case of misreporting by Central Electric, which had not been identified until the company itself came forward.

We would like to see much clearer reporting obligations and greater transparency in a number of areas that have potential impacts on safety and gas imbalance. These include, but are not limited to;

- Detailed reporting of GDN Supply Point registers to provide the market with a holistic overview of the make-up of the Network – including all potential off-takes, isolated, demolished and shipperless supply-points.
- Gas safety regulation cut off performance and associated obligation improvements – including but not limited to the timeliness of physical isolations.
- Disconnections – how quickly disconnections are completed from request – including notification to supplier.
- Identification, investigation and relative performance of upstream theft detection.
- Off-take metering audit performance and resultant findings

Question 2: Do you support our proposals for improving the accuracy of pipeline records?

In respect of improving the accuracy of pipeline records, we agree with Ofgem that improvements are needed, and further support the approach set out in the document. However, Centrica continues to believe that the improvements need to be extended to include the accuracy and completeness of the supply point register. We have real concerns that many sites exist that are capable of or are indeed receiving gas, and are not properly recorded as such on industry systems. Aside from the impact on imbalance charges via the RbD mechanism, this poses a real risk to safety. In addition, such improvements will facilitate the extension of the networks to fuel poor communities in the most efficient and economical manner, maximising cost savings.

Network owners have resisted pressure from shippers for assurance work in this area. In the absence of voluntary commitment by the GDNs to make the necessary improvements in this area, we believe that formal obligations need to be placed on the network owners. We assert that a national reconciliation of the supply-point register with an independent source is urgently required. Going forwards we propose that these obligations should also include a requirement to routinely sample and visit sites that are on other industry systems such as gas pipeline / emergency meter works records; but which are not recorded on the supply point register. These obligations should be accompanied by clearly specified targets and independent auditing.

Question 3: Is Ofgem's proposed approach to setting allowances for the outputs and quality of service arrangements for 2008-13 appropriate?

Centrica is supportive of the general approach set out, it appears proportionate. However, given the additional costs likely to be incurred, this support is conditional on clear and transparent reporting to enable shippers to assess whether value for money has been

provided. The reporting should be put in place at implementation and provided with reasonable frequency and regularity, at least six monthly.

In addition, we have some specific issues in the area of connections. When small numbers of connections are required, usually less than 5 plots per site, provision tends to be by the last resort supplier, reflecting the fact that such connections are generally deemed uneconomic for competitive suppliers. In this scenario, we do not believe that service standards and performance levels are satisfactory. Even where the DNs are meeting required performance standards, we do not consider that the target is high enough, this is borne out by complaints from customers not within the "achieved" part of the standard.

A second area of concern is that the DNs are required to report their performance directly to Ofgem, but there is no requirement to report to customers, though we do receive some reporting through our normal business relationships. It is also important to recognise that whilst the DNs may be able to demonstrate delivery against SLAs, the impact of failure is borne by the customer and not visible to Ofgem.

We would wish to see reporting and standards in this area strengthened significantly and made more transparent to suppliers and customers.

CHAPTER 6: Incentives

Revenue drivers

The role of revenue drivers is an issue that goes beyond the immediate GDN in terms of its impact and consequently further consideration of the implications for retail price structures is required. In our view Ofgem's decision to remove the volume revenue driver is likely to have a negative impact on final consumers.

We do not support the removal of the volume based revenue driver, we believe it is appropriate that the DN revenues do vary with gas transported and we are concerned at the potential perverse incentives which may be created as a result of this approach. In the absence of such a volume driver, we consider that the disincentives on energy efficiency are potentially harmful to the environment.

Question 1: Are the proposals for the capex rolling incentive and IQI appropriate?

Whilst Centrica believes the principle of the incentive based system is helpful and we support it in conjunction with the capex roller, there are some specific issues that need to be clarified so that the long-term impact can be assessed. In particular, short-term benefits from the system may, in time, generate longer-term problems. In our view, scenario based modelling over a longer-time horizon than just the next price control period would be helpful. The shift to a five-year rolling incentive is appropriate.

Specific issues include:

- Whether the system will be symmetrical, with overspends being included in the RAV after five years?
- If the system is symmetrical, will the "three pot" assessment of overspends be used to determine whether they should be included (as was used with the massive overspends in the last five year control)?
- The robustness of the challenges to the new capex bids which the DNs are being permitted to make given the policy decision on the IQI?
- How was the base sharing level chosen and what evidence can be used to support the choice to ensure that DNs are not being over-rewarded?

Overall, while the proposed changes may be appropriate, we believe that the proposals offer an increase in the overall level of benefit retained by companies. As this will result in additional

cost to customers, we consider it is extremely important that a full impact analysis is made and the expected benefits to customers quantified and monitored to ensure delivery.

As we have indicated above we are not in a position to judge whether the level of forecast capex by PB Power and Ofgem is appropriate and hence unable to judge if the level of incentive is appropriate. We will be interested to see the reaction of GDNs to the incentive levels and the impact that this has on their capex (and repex) forecasts.

We still have some concern that the incentive mechanism may create less than optimal costs, particularly with respect to the impact on opex and leakage. We appreciate that any incentive mechanism cannot address all areas in one but the combination of mechanisms should aim to eliminate the possibility of sub-optimal costs whilst retaining some flexibility for GDNs to react to legitimate changing cost drivers. We also do not think that the incentive regime should have as a consequence a rise in PREs and leakage.

Question 2: Is it appropriate to implement an opex rolling incentive?

In principle we believe that the application of a rolling incentive on opex is sensible, especially if there is a move to a rolling capex incentive. However, in our view it is more important to ensure that the incentives on capex and opex are balanced to avoid perversities. Whilst Ofgem has identified some issues with incorporating a rolling opex system, we are also concerned that in the absence of an opex roller the incentive to shift costs between opex and capex will be increased since the IQI initially appears to offer greater benefits.

With the above in mind, we believe that it is essential to model the operation of the different combinations of incentives in detail, including taking account of other incentive schemes not directly applicable to capex and opex which may have indirect influence.

Finally, we note Ofgem's view that the implementation of an opex roller may be possible in gas where it was not under electricity, as the DNs procedures are likely to be more consistent that the DNOs due to the recent sale. As was highlighted under DN Sales, unless divergence is prevented, then with separate ownership, DNs' procedures etc. will diverge with time. Hence, if a decision is made to implement an opex roller, we trust that Ofgem will include the appropriate licence conditions to ensure that the DNs maintain reporting procedures in such a way that the opex roller can continue to function without repeated rebasing and reconciliation.

CHAPTER 7: Sustainable Development

Gas Shrinkage Arrangements:

Centrica is supportive of Ofgem's proposals to review the Leakage Model to assess whether improvements can be made, and in this regard would propose that Ofgem consider including a requirement for a National Leakage Test to be carried out at reasonable intervals whilst the Mains Replacement Programme is ongoing. In our view, an interval of 5-10 years would be appropriate.

We note Ofgem's intention to work with the industry over the course of the summer on these issues and welcome the approach. However, given the limited planned meetings of the Shrinkage Forum, specific action will be required. Within this process we will be seeking enhancements to the (currently arbitrary) measurement and estimation of the shrinkage volumes and welcome the opportunity to formally consider and debate the governance structure, the potential metering of OUG, the inclusion of Shipperless supply-points and the exclusion of the "non-shrinkage" components from the leakage model. This would allow more accurately for the right party to control both the financial and environmental costs of Gas Distribution.

In respect of the existing Shrinkage incentive, we are encouraged that Ofgem does not propose to change this, but we continue to have concerns in respect of the GDNs being relieved of all Shrinkage Price risk. In particular, we do not agree that the need for an uplift has been fully demonstrated to the community. In our view, whilst we do not support the removal of all Shrinkage Price Risk from the GDNs, if such risk is to be removed, the application of a market related price should effect this, we do not understand why a further "market related" uplift is required.

We continue to believe that removal of shrinkage price risk will not incentivise economic and efficient purchasing of shrinkage gas by the GDNs, a volume incentive will only incentivise GDNs to manage volume, it will not incentivise GDNs to time their purchases of gas in the most efficient and economical way. We are also concerned that such a reduction in risk should be fully reflected in a reduced cost of capital.

Question 1: Do you agree with our assessment of the risks, costs and benefits attributable to the options for facilitating network extensions (Appendix 14)?

See question 2 below

Question 2: Do you agree with our initial proposal (i.e. Option 3 complemented by a discretionary reward scheme)?

Centrica agrees that the Initial Proposals to facilitate Network Extensions by amending the Economic Test, complemented by a Discretionary Reward Scheme is a reasonable way forward.

Question 3: Do you consider our proposed method to implement Option 6 appropriate (i.e. through GDNs' connection charging statements)?

Whilst we do not object to the proposal to implement the option 6 by setting out the details in the charging methodology statements, we do have some concerns about the detail of the proposals. We are supportive of the principle of extending the network to rural communities where it is reasonable and practical to do so. However, we do not believe that this should result in the extension of these networks "at any cost".

We appreciate that by linking the proposals explicitly to Fuel Poverty (which is based upon consumers spending 10%+ of income on fuel), this would set limits to the proposals, however, we believe that it will be very difficult for such prioritisation to take place without obtaining data from the Department for Work and Pensions. There are other issues as well to consider, for example, much of Kent does not have gas, so this would further complicate the prioritisation process. It will also be difficult to assess the specific benefit to Fuel Poor households, given that the extension of the network will benefit the community rather than the individual household. In addition, it will be important to ensure (as recognised in previous consultations), that any schemes are aligned to Energy Efficiency schemes such as Warm Front, which can, potentially, help with other facets of installing the gas supply.

Question 4: Do you consider the Government's Index of Multiple Deprivation to be an appropriate index to identify which fuel poor non-gas communities qualify for special treatment for gas network extensions? If not, what do you recommend?

Centrica agrees that the index described will assist in identifying the relevant communities. However, we would also strongly recommend that data is requested from the Department for Work and Pensions to assess those on eligible benefits and hence eligible for free energy efficiency measures to support the extension.

Question 5: Do you support our proposals for the introduction of a Discretionary Reward Scheme for GDNs and its format given the larger reward?

Centrica does not support the introduction of a Discretionary Reward Scheme for Corporate Social Responsibility (CSR). In our view, the GDNs are major regional monopoly organisations who should naturally carry out their own CSR activity without being additionally incentivised to deliver benefits to customers.

In addition to the points above, when schemes such as this are implemented, we are concerned that "winning" against the incentive becomes the focus rather than the delivery of schemes that will produce real benefits to customers.

CHAPTER 8: Other Issues

In addition to the questions in the document, we believe that the issue of Statutory Independent Undertakings is outstanding. Whilst we understand that this is not solely an issue for Ofgem, as the DBERR is also involved, we remain extremely concerned at the apparent lack of progress on this issue.

Question 1: Do you agree with our proposed approach to the funding of xoserve?

Centrica supports the proposed approach. In our view the introduction of a User Pays mechanism provides the potential for

- A conduit to deliver real, user driven, industry reform that is both efficient and effective. This would include major reforms such as meter point reconciliation, as well as more minor "housekeeping" changes.
- An ability for users to procure additional services/differing service levels according to their individual requirements
- A mechanism to share costs across industry participants

In our view, the major benefits of a User Pays model lie in the first two bullets, whereas we believe that the immediacy of possible changes to the allocation of current costs has inclined many participants to view cost as the primary issue in this case.

Question 2: How should we address any benefits arising to xoserve from redundancy created from the replacement of UK link?

The replacement of UK Link provides a unique opportunity to deliver improved industry arrangements. The initial scoping of the system will need to consider a number of strategic reform opportunities which have, to date, been deemed out of scope, as well as simple replacement.

In our view, it is too early to assess the levels of any benefits arising to xoserve which might result from any systems redundancy created from the UK Link Replacement. This is something that will need to be considered in detail as the project unfolds.

Question 3: Do you agree with our approach of modifying SSC A15 to facilitate governance arrangements for user-pays?

We agree that modification of SSC A15 is the appropriate mechanism to require the GDNs to facilitate governance arrangements for the discussion of User Pays. However, once agreed, we

would prefer that the actual governance and change mechanisms rest within the UNC to ensure that users are enabled to propose change at need.

In our view there are a number of areas which will need to be considered in further detail:

- The identification of appropriate User Pays service lines and levels
- The funding of future change and the mechanism for delivering this
- Assessment of risks (to industry participants) and issues
- Overall governance arrangements for a User Pays model need to be developed to ensure clarity

We would hope to see all these requirements fully reflected for the main governance of the User Pays model.

We also consider that it is important for User specific issues, that Users should be able to engage directly with xoserve on a commercial basis if they wish. However, we do accept that any such additional services or activity should not compromise their activities under the UNC.

Question 4: Do you think that the existing arrangements are adequate to ensure enforcement of the range of services and outputs delivered by xoserve in light of these proposals?

In respect of the current licence drafting and service provision, we acknowledge that since the implementation of DN sales the service provided by xoserve has generally been at an acceptable level. However, as we identified at the time of DN Sales when the new licence was implemented, we have continuing concerns that should xoserve fail to provide the service quality required, there is little or no recourse for Users.

We believe that as the forward looking governance arrangements are fully identified, then at the same time, appropriate recourse mechanisms for all parties should be agreed.

CHAPTER 9: Financial Issues

Question 1: What are your views on the factors relevant to our consideration of cost of capital?

Overview

Whilst we agree with many elements of Ofgem's approach including the direction of change on the cost of debt, we do not believe that Ofgem have yet taken sufficient account of the evidence presented by CEPA, included in our response to the 4th consultation document. Hence we consider that Ofgem's proposals, if adopted, risk continuing to grant windfall gains to the GDN's through an unnecessarily high WACC.

CEPA's analysis is supported (as above) by a recent analyst report[2]. The report looks at the analyst view of the likely MR Ratio for National Grid. Assuming an allowed WACC of 4.4% post tax real would give a 16.8% premium to RAB over the next two regulatory periods.

This analysis is based on a National Grid post tax real WACC of 3.1%, which would indicate a cost of debt and a cost of equity at (or indeed in the case of equity) significantly below, the lower end of the CEPA range of assumptions.

Gearing

As Ofgem have noted, there is market evidence which suggests that gearing levels in excess of 70% can be consistent with a solid investment grade rating. In addition, we agree with Ofgem that there is no clear justification to reduce the assumed gearing from 62.5%.

[2] Morgan Stanley, May 23, 2007

Cost of debt

CEPA's April 2007 report (appended to Centrica's response to the 4th consultation document) indicated that a cost of debt of 3.0% was clearly defensible. This was based on an assessment of short-term rates, long-run averages and market evidence – and therefore includes an allowance for mean reversion. CEPA's estimate of 3.0% for the cost of debt also assumed that Ofgem would not adopt a trigger mechanism for the coming control period. An assessment of the appropriate cost of debt based taking account of the use of triggers would point to a Cost of Debt in the low end of the range of 2.5% - 3.25%.

We agree with Ofgem that the market cost of debt is commoditised and as such there is no case for assuming a higher (or indeed lower) debt premium for a 'solid' investment grade rated gas distribution company as compared to an identically rated transmission company.

We also welcome Ofgem's view that there is 'unlikely to be any basis for considering a higher cost of debt than TPCR', but would urge Ofgem to provide an allowed cost of debt which avoids the risk of continuing to give windfall gains to GDNs (by putting too great an emphasis on relatively high, very long run (20th century) averages, for which the underlying data does not show stable means – see Smithers (2006)).

Cost of Equity

As noted in the work carried out by CEPA, Centrica believes that there is good evidence to suggest that an appropriate range for the cost of equity, taking account of current market conditions, is 6.5 – 7.0%. In addition, we believe that there is a good case for Ofgem using a point estimate of less than 7%, even allowing for some tightening of markets, for the allowed cost of equity.

We agree with Ofgem's proposal to consider the relative risk faced by the GDNs in the current regulatory regime as compared with other regulated utilities. We think that the relative risk analysis should include at least the following factors:

- Volume or market risk, i.e. the level of exposure of the regulated company to changes in levels of demand. Where possible, this draws on evidence on operational gearing in the business (i.e. the proportion of total costs in the business that vary with volume).

- Operating cost risk, i.e. the variability of the costs that the regulated utility faces in the operation of its business, and the extent to which the regulator allows these costs to be passed through to the customer/users.

- Capital expenditure risk, i.e. the riskiness of delivery of major capital expenditure projects and how capex over or underspends are treated within the regulatory regime.

- Regulatory risk, i.e. the consistency and predictability of the regulatory regime.

Our preliminary conclusion on the basis of initial analysis by CEPA is that the gas distribution regime is towards the lower end of the "riskiness" range for regulatory regimes and is not materially different to gas or electricity transmission.

Appendix 2 provides an updated Cost of Equity Section for CEPA's April 2007 report on The Allowed Cost of Capital. The update corrects a computational error in the calculation of the MR ratios. This update does not change the conclusions presented in CEPA's April 2007 report on The Allowed Cost of Capital'.

Tax allowance

We would like to understand more about Ofgem's proposals on ex-post tax adjustments. Ofgem proposes to 'reduce the tax allowance when both actual gearing and actual interest expense exceed the level assumed'. We would like to understand whether Ofgem therefore intends to adjust the tax allowance for increases in interest expense caused by interest rate changes? We believe that such a treatment would not give appropriate incentives to GDNs to manage in-period changes to interest expense.

Profiling
We note the fact that Ofgem is not, at this stage, applying any smoothing to revenue allowances in the financial model. We do have some concerns in this area in that if revenues are not smoothed then the effect is that at the beginning of each price control year, each of the DNs will experience a Po change plus RPI. In our view whilst the year on year variations are not large, when taken in conjunction with the unpredictability of transportation charges and revenue recovery, this may create a wider variation than is anticipated.

We appreciate (after the one year control) the degree of step change that may result from previous profiling at the start of the next control, and agree that this is a matter for concern. However, in our view, the difficulty is compounded by the lack of usable information provided by the DNs to assist shippers in forecasting the future path of transportation charges. Had more detailed information been made available, both Ofgem and Shippers would have had a much better view of the risk.

We therefore look forward to commenting in detail on the cost reporting framework consultation, and hope that Ofgem will also take into account Shippers' desire for additional information when drawing up the framework and frequency of reporting.

Question 2: Are the factors affecting financeability set out in paragraph 9.36 the responsibility of shareholders or the regulator to address and how should they be addressed?

Index-linked debt
We do not agree with Ofgem and the GDNs that it is inappropriate to assume a proportion of index-linked debt. In our view, there is clear evidence that borrowers can significantly reduce their cost of borrowing by accessing the index-linked market.

GDNs or their parent companies have made increasing use of these instruments, presumably as part of an efficient financing structure. The appropriate WACC and financial ratio analysis should therefore be considered based on the assessment of the cost of debt of an efficiently financed business which demonstrably involves, in current market conditions, a weighting for index-linked debt.

The CEPA analysis (as previously submitted) shows that an assumption of 30% index-linked debt would be an appropriate, even conservative assumption.

Timing of allowances
Ofgem should only consider allowing GDNs to expense any portion of repex, non-operational capex or capex if there is a demonstrable and sustained financeability constraint. Whether such constraints exist depends in part on the profiling of capex and in part on the borrowing strategy, where the use of indexed linked debt, in addition to offering cost advantages, helps smooth any mismatch between revenues and debt service.

Ofgem should indicate in its updated proposals how it believes such constraints arise and for what period it considers it appropriate to allow a GDN to expense items of a capital nature.

Outcomes
We agree with Ofgem that where outcomes are the result of GDN decisions (and therefore controllable by GDN management) there is no need for Ofgem to consider adjustments for financeability, indeed we would strongly oppose such adjustments.

This applies to both Scotland's relatively high 'pot 2' expenditure and the cash penalty under the IQI mechanism, experienced by Scotland and the Southern DN as well as to other items within GDN control.

However, we strongly disagree with Ofgem that it would be appropriate to consider NPV positive measures (or even NPV neutral measures) to address financeability constraints arising

from the RAV 'sculpting' in advance of GDN sales. The information on RAV 'sculpting' would have been well known to the entities acquiring the GDNs, and those entities should have arranged the finance of the GDN in question to fit that sculpted RAV profile.

To award a GDN a NPV positive measure for an item within the control of its shareholders and managers would be entirely inappropriate, sending an undesirable message regarding incentives to GDNs.

APPENDIX 1

Paper on pensions by Watson Wyatt, Actuaries

APPENDIX 2

Updated text for CEPA paper on Cost of Capital, section on Cost of Equity

Supplied as separate PDF file