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13 July 2007

Dear Joanna

**Gas Distribution Price Control Review: Initial Proposals Document**

We are pleased to respond to Ofgem's May 2007 consultation paper. I can confirm that this response can be placed on Ofgem's website. Our main points are summarised below and our detailed comments are included in the attachment to this letter.

Our main concern relates to the estimation of the cost of capital and the apparent regulatory 'opportunity' provided by historically low bond yields. It is essential for investor confidence that Ofgem bears in mind that regulated infrastructure licensees are long-term businesses which involve very substantial capital expenditure programmes, with cost recovery through regulated revenues over decades. Ofgem should take an equally long-term view of funding and base its cost of capital assessments on robust long term data which excludes the impact of short-term distortions.

We also believe that Ofgem's current methodologies for determining both operating (opex) and capital (capex) expenditure allowances are flawed. In principle, Ofgem's approach of uprating the output of the disaggregated opex benchmarking to take into account the results from the top down opex analysis is sensible. However, we can see no rationale to support the current approach of uprating the output of the disaggregated opex analysis only to the level of the frontier company in the top down analysis rather than to the upper quartile. In DPCR4 Ofgem moved away from using the frontier as a benchmark owing to the risk of its being used to set future operating costs at an unsustainable level. We supported this approach and believe that the output of the disaggregated opex analysis must be uprated to the upper quartile level of the top down analysis.

On capex, we believe that the proposed Information Quality Incentive needs further calibration as it is currently overly harsh. Under the current proposal, for every 1% that the company's forecast differs from that of Ofgem, the company is allowed only an additional 0.25%. This implies that the Ofgem forecast is near perfect. We do not believe this is credible and suggest that an appropriate level would be at least 0.75%.

If you have any queries on our response, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Linford'.

**Denis Linford**  
Director of Regulation

## **Attachment**

### **EDF Energy's detailed comments on GDPCR Initial Proposals Document**

#### **Form, structure and scope of price control review**

##### **Revenue Drivers**

We believe that Ofgem should further develop the idea of including a connections driver.

In electricity, DNOs are exposed to around half of the variable indirect costs of providing connections and of providing non-contestable services to the competitive connections market. Such costs are only partly added to the RAV (around 50%), with the remainder being treated as opex (for which the marginal funding rate is zero). A connections driver is one possible approach to resolving this issue.

##### **Connections Margins**

We strongly support Ofgem's proposal to allow the companies to retain a margin on customer-funded connections work provided in circumstances where competition has developed.

However, we do not believe that the extent of actual competition is a relevant consideration – it is the existence of a contestable market that is important. Indeed, all other things being equal, it is difficult to see how competition could develop where the incumbent is compelled through regulation to charge for its services at no more than cost incurred. This would seem to represent a significant barrier to entry.

Ofgem should therefore adopt a policy of allowing margins on connections in order to provide a level playing field and to encourage competitor entry. We believe that this would be entirely consistent with Ofgem's principal statutory duty to protect customers' interests through competition (where appropriate) and with the Competition Act.

#### **Operating expenditure analysis**

##### **Application of Benchmarking**

We note that the proposed approach utilises disaggregated opex benchmarking as the main analysis and then uprates the result to reflect the outcome of the top down opex analysis. In principle, we support this approach, as it helps to address the issue that at a disaggregated level there may be cost boundary issues between companies. We note that the disaggregated analysis uses an upper quartile benchmark. However, when these results are uprated to reflect the outcome of the top down analysis, they are uprated only to the level of the frontier company, not to the upper quartile. This approach seems to be without any logical foundation and should be changed.

In DPCR4, Ofgem rightly moved away from using the frontier as a benchmark owing to the risk of its setting future operating costs at an unsustainable level. We supported this approach and believe that the output of the disaggregated opex analysis must be uprated to the upper quartile level of the top down analysis.

##### **Regional Labour Rates**

We support Ofgem's inclusion of regional cost adjustments in its analysis. We cannot comment on the appropriateness of the overall level of the adjustments, as we have not seen the detailed analysis underpinning them.

## **Real Price Effects and Ongoing Efficiency**

We support Ofgem's inclusion of adjustments for sector-specific inflation above RPI.

However, we have strong concerns with regard to Ofgem's assumption of an annual 2.5% efficiency saving, which appears to be arbitrary. More importantly, we also believe that the assertion of future efficiencies will have a detrimental effect on management incentives.

We understand that, for shareholders, a marginal one pound (£) gain has the same incentive power as a marginal one pound loss avoided, and that such logic seems to allow regulators to capture efficiency savings before they have happened, without damaging incentives. However, such an approach ignores the fact that the shareholders can only provide positive incentives (i.e. rewards) to the managers of the business to make the relevant savings, and therefore believe that Ofgem's approach appears to run counter to the objectives of RPI-X incentive regulation.

## **Rolling Opex Incentives**

We remain of the opinion that a rolling opex incentive should be introduced only where it can be demonstrated that the reporting of costs is robust.

## **Funding for Skills and Training**

The age profile of employees is just as much a product of historical cycles as the replacement of ageing physical assets. It therefore seems entirely appropriate for Ofgem to consider the issue within price control reviews.

Clearly, companies will face short-term costs in recruiting staff, and this should be part of regular operating cost allowances. However, responsible companies will also incur longer-term costs, for example, in improving sector attractiveness (working with schools and youth apprenticeships), working with Government (mapping foreign qualifications onto UK equivalents to facilitate the importation of skills), and developing training centres.

We believe that the regulatory issues associated with long-term investment in skills have similarities with those already addressed by Ofgem in respect of research and development activities – in particular, the lack of incentives to incur additional operating costs within the incentive framework. We therefore propose that Ofgem develops an Innovation Funding Incentive (IFI)-type scheme where the companies are given an allowance on a 'use it or lose it' basis. Such an approach would also ensure that those companies who invested in training were not disadvantaged in the cost benchmarking analysis compared with those companies who did not.

## **Pensions**

We believe that Ofgem should adhere to the principles and policies it established during DPCR4. However, we agree that it would be prudent for Ofgem to consult expert opinion on the treatment of any future stranded pension surplus.

## **Capital and replacement expenditure analysis**

### **Capital Expenditure and Associated Incentives**

As with the opex analysis, we believe that it is appropriate to make adjustments for both regional costs and real price effects.

We are also particularly concerned with the calibration of the IQI scheme. Taking the values from Ofgem's worked example, we calculate that if a company's forecast differs from Ofgem's by 25%, then:

- Its incentive rate is reduced to 27% from a maximum of 40%;
- It is penalised to the extent of 0.78% of the value of Ofgem's forecast; and
- It is only allowed an extra 6.25% capital expenditure on top of Ofgem's forecast, i.e. 18.75% less than its forecast.

The example states that if the company genuinely expects to spend 25% more than Ofgem's forecast (i.e. its forecast was correct), then, under the IQI, this is what it should do because it would only be penalised 5.94% of Ofgem's forecast. It must be remembered that Ofgem's forecast is also a judgement and hence prone to error. However, the calibration of the scheme assumes that the Ofgem forecast is nearly perfect. This is clearly inappropriate.

If a company forecasts more capital expenditure than the regulator, then, for every 1% of the difference Ofgem proposes to allow only 0.25%. We believe that this level should be raised to at least 0.75% to reflect the fact that, given relative knowledge of what is required, Ofgem's forecast is less likely to be correct than the company's.

## **Outputs**

### **Balanced Scorecard**

We support the introduction of a balanced scorecard-type approach for GDNs. Such an approach is useful as it gives a more rounded view of the overall performance of the company.

### **Gas Riser Replacement**

We note that a number of GDNs are proposing a proactive programme for gas riser replacement but that the indicative costs of carrying out this work will be significant. We support the proposed further work in this area and would point out that the assumption of converting those buildings (where the gas replacement cost appears high) to electric forms of cooking and heating may require the upgrading of the associated electrical rising main and, in some cases, the local distribution network as well. Such work would also incur the additional costs associated with working on high rise buildings.

### **Quality of Service Arrangements**

We believe that Ofgem's proposals for changes to the outputs and quality of service arrangements should be beneficial to customers, as they will be compensated for instances when they are provided with a lower level of service. We support Ofgem's proposals and believe that they provide an appropriate level of protection for customers whilst ensuring that the compensation that customers receive reflects the value that they place on the service. We also support Ofgem's proposal to maintain General Standard 3 (the provision of alternative heating and cooking facilities) to priority customers and to extend it to include customers who request these facilities. We believe that this will ensure that those most in need of these facilities receive them, whilst also reflecting the GDNs' current practice in terms of these arrangements.

### **Accuracy of Pipeline Records**

We support Ofgem's proposals for improving the accuracy of pipeline records. The maintenance of accurate pipeline records is clearly a safety issue, and is a requirement for any parties wishing to connect or undertake work close to where they are located.

## Incentives

### Capacity Output Incentives

We remain concerned at the lack of progress being made in relation to the capacity output incentive. We note that market participants will only have one opportunity to comment on Ofgem's proposals in the GDPCR September update before the final decision on this incentive is reached. Given the complexity and potential impact on consumers, we believe that an adequate consultation process is required. We believe that it would be appropriate to produce additional consultation documents on this subject in addition to the September 2007 update.

## Sustainable development

### Network Extensions

We support proposals for network extensions regarding fuel poor communities provided that a level playing field for competitive connections work is maintained. We have already noted above that the connections market would benefit from the incumbents being permitted to earn and retain a margin on customer funded connections work.

### Carbon Footprint

We also believe that Ofgem should go further in this area and develop a set of measures which incentivise the companies to reduce their respective carbon footprints. Initially, to avoid an overly complex scheme, this should consist of the main measurable carbon (and carbon equivalent) impacts, for example:

- Methane emissions;
- Own consumption of gas and electricity;
- Fuel use; and
- Recycling of waste.

### Shrinkage arrangements

We support Ofgem's proposals with regard to gas shrinkage and the discretionary reward scheme.

EDF Energy welcomes Ofgem's undertaking to review the current shrinkage arrangements. We believe that the role originally envisaged for the Shrinkage Forum remains relevant, and combined with Ofgem's role in accepting or rejecting any proposed shrinkage factors we believe that this provides sufficient governance. We would note that this governance would be further improved were Ofgem to be active within the Shrinkage Forum to ensure full transparency in the role that this forum takes. We would however note that the role of the shrinkage forum has been weakened since the GDN sales, as it has not met regularly since this date and has not given sufficient time for the issues to be discussed fully. We therefore believe that a potential outcome would be to place an undertaking on all the transporters to ensure that this forum meets regularly and sufficient time is allocated to discuss the topics at hand. EDF Energy would also encourage Ofgem to use this opportunity to identify whether IGTs are being paid twice in relation to the shrinkage that occurs on their respective systems through both the GDPCR and the IGTs' charging arrangements.

## Other issues

### Funding of Xoserve

EDF Energy believes that further work needs to be undertaken to develop the proposed approach for the funding of xoserve, as recommended by the industry group that was tasked with investigating this, particularly with regard to the practicalities of implementing a user-pays approach (i.e. what is classified as core service and what is user pays).

### Benefits Arising to Xoserve from Redundancy Created from the Replacement of UK Link

We believe that factoring in any benefits derived from redundancy ex ante will create significant problems within the GDCPR as Ofgem will be trying to identify and account for any benefits that cannot be identified until they are actually recognised. We believe that there will be benefits for the industry and xoserve in allowing redundancy in the systems to cater for future unknown changes and developments and that the best way to accommodate these is to address these benefits ex post.

In particular, we note that xoserve's current system configuration is creating difficulty with the number of files submitted at particular times. We believe that it would have been prudent to cater for increased numbers of file submissions when the original systems were designed, in order to avoid unexpected changes in practice guidelines received from xoserve at short notice.

### Modifying SSC A15 to Facilitate Governance Arrangements for User-Pays

EDF Energy believes that the correct governance arrangements must be put in place to facilitate any user-pays arrangements, in particular to ensure that any user-pays services are not cross-subsidising the core services, and to ensure that any core services are not classified as user-pays.

### Enforcement of the range of services and outputs delivered by xoserve

While we are generally satisfied with the current service levels provided by xoserve, we do not believe that the current arrangements are adequate to ensure that these levels of service continue for both user pays and core service provision. As noted previously, it would appear that xoserve will be a monopoly provider for most of the user-pays services that it may provide, and so it is important to ensure that these services are priced cost reflectively, and that user recourse is available where the service is inadequate. We therefore believe that arrangements will need to be developed to ensure transparency in prices for any user-pays service, and clear and enforceable service levels.

## Financial issues

### Cost of Capital

We remain opposed to Ofgem's current practice of proposing a value of the cost of capital only at the end of the price control review process, since it provides no opportunity for consultation, critique and response. We believe that Ofgem should revisit its policy in the light of its better regulation duties.

We urge Ofgem to continue to take a long term view of the cost of capital consistent with the long term investment that the companies are expected to make in their networks.

Investors expect UK economic regulation to maintain its reputation for evolution rather than revolution. Both regulatory precedent and consistency are key considerations for regulated infrastructure industries. Significant changes in key regulatory assumptions are likely to damage investor confidence.

Investors also expect Ofgem to take account of the investment requirements of the energy sector (particularly in the context of diminishing opportunities for out-performance), recognising the societal impact of underinvestment in critical infrastructure. Ofgem needs to bear in mind the impact on investor perception of reduced dividend streams, and even the need for new equity injection.

It is clear that there are a number of recognised approaches for assessing the cost of capital, which are capable of producing a range of results. We encourage Ofgem to use a range of techniques in order to derive a balanced view e.g. Dividend Growth Model and the Fama-French approach, as a cross check to the CAPM in assessing the cost of capital.

### **Cost of debt**

We do not support any approach involving the indexation of debt costs.

We, like most companies, maintain a portfolio of debt built up over many years, with each borrowing decision being an efficient one in the context of the then current conditions. Such a portfolio is, within a particular price control period, relatively invariant to market movements, indeed it is more like the fixed five year allowances that regulators have provided for within price controls. An index mechanism which responded to shorter term movements would therefore, until a suitable tracking portfolio could be built up, simply introduce more risk, which would have the effect of increasing the cost of equity.

We also foresee significant design issues associated with any debt indexing scheme. For example, it is uncertain whether it would focus on the risk free rate or the overall cost of debt, whether the rates would be a blend of fixed and variable and with what mix, whether it would assume any proportion of index linked debt, what would be the mix of terms— viz. five year, ten year, twenty five year etc, whether there would be a time lag between market movements and any changes in price control allowances, and what credit quality would be assumed, etc.

Furthermore, we believe that answering these questions would inevitably lead to the creation of a scheme with perverse outcomes and this would not be in consumers' interests. Indeed, we believe that it would inevitably incentivise companies to create portfolios of debt which matched an arbitrary price control mechanism rather than one which reflected an optimally efficient debt structure.

Finally, we disagree with any approach which would mean that customers would effectively have to bear the burden of market volatility. What matters is that the companies are in a position to mitigate the impact of risk, even where the risk itself is beyond their control.

**EDF Energy**  
**13 July 2007**