



Industry & Regulation

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Martin Crouch
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By e-mail: distributionpolicy@ofgem.gov.uk
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Dear Martin,

Re: DPCR5 – looking ahead

Thank you for the opportunity to respond to the above open letter. This response is on behalf of the Centrica group of companies excluding Centrica Storage Ltd.

We have addressed the consultation questions specifically, but we have also made some observations on the price control process more generally. In Centrica's view there are a number of issues with the existing price control process which we believe need to be addressed as a matter of urgency prior to embarking on DPCR5.

Information transparency

The biggest single issue creating difficulties under the price control process is information asymmetry. Industry participants/interested parties are placed at a profound disadvantage in the process as a result of the limited information supplied.

Whilst Centrica acknowledges the efforts made by Ofgem to release additional information as part of GDPCR and, to a lesser extent, as part of the annual report process implemented post DPCR4, the information in the public domain remains inadequate. Suppliers do not have enough information to be able to challenge the Network Operators' (NO) assertions of their requirements, or, for that matter, enough information to fully evaluate the proposals and the likely effect on their businesses.

The fact that this situation has persisted throughout so many price control processes is a matter for concern and must not be allowed to continue; we believe this should be addressed from the start of DPCR5.

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Other approaches to the price control process

Centrica believes that there are other approaches to a price control process which may offer improvements to both suppliers and NOs. We would encourage Ofgem to consider options such as Constructive Engagement, which has been used in this country in the Airports' Q5 review, as well as options such as the Negotiated Settlements process used in Alberta.

We are not suggesting either process is a panacea, particularly given the difficulties associated with vertical integration, but we believe that both could offer significant contributions towards an enduring solution in the energy sector. In our view, and from the research we have done, the use of a constructive engagement type process has the potential to reduce information asymmetries, improving all parties understanding of requirements and to achieve a degree of consensus not seen as a result of the current PCR processes. We are aware that some may regard constructive engagement or negotiated settlement as potentially more adversarial/litigious given the approach used in parts of North America. In our view, such approaches are likely to improve co-operation and could be less adversarial than the current process with its tendency to push parties towards entrenched positions.

Timing

Timing is very important in the process and the effects of poor/compressed timing on suppliers are underestimated.

In our view, publication of final proposals in the December before implementation of a 5 year price control is much too late. The short notice complicates suppliers' annual budgeting and planning processes, contributing to potential volatility in customer prices, and adding costs by increasing the levels of risk suppliers are required to manage. Suppliers cannot place reliance on Initial or Updated proposals for planning purposes given the significant adverse (to customers) changes frequently experienced between the different sets of proposals; they can only rely on the final proposals. This has been recognised in Ofgem statements to the effect that only the final proposals can be relied upon.

In our view, the proposals need to be finalised (and accepted by the companies) at least six months earlier than is currently the case; this will allow earlier notification of pricing changes and reduce supplier risk.

Ability to Appeal

Centrica believes that given the price controls govern such a large proportion of suppliers' costs, it is inequitable that suppliers are unable to appeal the outcome of a PCR process in the same way that modifications under industry codes can be appealed.

We consider that it is unfortunate that price control outcomes would only be subject to review by the Competition Commission where the proposals are rejected by the companies as too tough. In our view, checks and balances are required to ensure that the proposals are not too generous, and hence risk disadvantaging customers.

1) Have Ofgem captured the key strategic issues?

We agree that Ofgem has captured the key strategic issues and that overall the regulatory framework needs to facilitate sustainable development and necessary investment, to promote secure supplies and customer service and to ensure that the networks and network operators change to meet the needs of a dynamic and developing industry.

It will be important to ensure the correct balance of incentives to ensure that efficient industry change is supported.

Other issues to be considered in this section include the green agenda and customers' shifting requirements in response to green/energy efficiency issues.

We acknowledge that some capex and repex investment is driven by legislative imperatives, in our view it is important that even where this is the case, it is still proven that customers have received value for money and the investment has been made as efficiently as possible.

We also agree that it will be vital to achieve the correct balance between opex and capex incentives. In addition, where the companies have been permitted to make significant capex/repex investment, it is important to demonstrate clearly to customers that this has resulted in opex reductions, as well as proven efficiency savings.

As part of the GDPCR process, Centrica has raised concerns that when, as regulated monopolies, NOs have received an over generous allowed rate of return, this has led to the creation of super returns for shareholders, to the detriment of customers. We believe strongly that Ofgem needs to exert more pressure on NOs to keep distribution costs under all key drivers down for the benefit of customers rather than shareholder profits.

In the area of information transparency, we do not feel that Ofgem has adequately captured the strategic nature of this issue. It is vital to end the information asymmetry between DNOs, regulators and respondents, both during the PCR process and then during the subsequent PCR period. Addressing this asymmetry will improve the price control process as well as assisting suppliers to manage the risks they face and helping suppliers take a reasonable view on the likely future path of distribution charges.

2) What changes should be considered to the role and responsibilities/obligations of DNOs?

Centrica would not support any changes to the roles and responsibilities of DNOs that might, for example, result in the rebundling of services, however, we would strongly support changes that would strengthen the split between DNO businesses and any associated supply businesses.

We would also be concerned should Ofgem be considering increasing the scope of the DNO role to include activities that might be better facilitated through a competitive business rather than via a regulated monopoly, hence we would suggest that Ofgem should consult on changes of this nature.

Centrica does not oppose, for example, encouraging consideration of the DNOs' carbon footprint, but in our view it is important to ensure that customers do not reward DNOs via regulated revenue for undertaking normal "corporate responsibility" activities which should be funded by shareholders. If proposals in respect of the carbon footprint or other social responsibility issues are brought forward, we would expect it to be clearly demonstrated that costs of such programmes were met from profits rather than additional funding allowances paid for by customers.

3) How can Ofgem build on or make the best of the range of developments and initiatives set out.

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Centrica believes that wherever such programmes are created and produce assets, then those assets should be funded over their useful life, and not, for example, by allowances inappropriately paid up front.

Where a range of initiatives are set up, we consider that it will be essential for full requirements to be stipulated up front, setting out what will be delivered and how, over what period and how any required investment will be funded. In advance, Ofgem should also set up a clear reporting framework such that reports are published demonstrating clearly what has been achieved, the cost of the achievement, any further expenditure required and what savings/customer benefits are expected, together with an assessment of the value of those benefits, for example, a capex investment resulting in reduced opex going forward.

Where significant capex spend is required in order to support an initiative, we would welcome an impact assessment being published in advance, for consultation, allowing customers and interested parties to assess whether they believe the proposals will be of benefit and hence that they are willing to “fund” the expenditure.

4) How can Ofgem simplify and refocus the incentive package to address future requirements?

Essentially, we believe that wherever incentives are proposed they should be challenged against the following criteria:

- Is the proposal/remedy proportionate to the issue?
- Is the proposal cost reflective?
- Is the proposal simple and transparent?
- Can the results be quantified and the outcomes properly measured?
- Is there a simpler solution that could achieve all/most of the same result?
- Is the proposal supported by those who will fund it?

In addition, Centrica would wish to see DNO responsiveness to supplier issues/views improved.

5) Do you (respondent) agree with the suggested process and timetable set out, both for work in 2007 and for the review? What should Ofgem do differently?

Centrica considers that the suggested process includes some positive points, but that is also raises some interesting questions.

In terms of the points raised in the document, we are happy to support solicitation of end customer views, but to gain the most value from such consultation, it will be important to keep the customer consultations in particular, sharp and focused.

We support the longer consultation periods intended, but have concerns at the reduction in opportunities to formally influence the process. The “workshops” must be working groups formally charged with developing the proposals in specific areas and the DNOs obliged to recognise the output. Key to moving towards a more open and engaged process will be the timeliness and openness of information.

We would be willing to support a potential reduction in formal consultation, but only where other provision was made to ensure participants can increase their effective engagement in the process. We believe that DNOs must be compelled to engage actively and constructively with stakeholders both sharing information and consulting on plans to ensure they are meeting

customer/supplier requirements in the proposals they put forward to Ofgem as part of the process.

However, as Ofgem does not intend to start the DPCR5 process until 2008, we believe that there is an excellent opportunity to consider from first principles, how improvements can be made. One option would be to consider whether an alternative model (as mentioned previously) could be applied to part of the PCR process, rather than assuming the baseline is the now "standard" process.

In respect of the constructive engagement process used in the Q5 review in airports, we believe that whilst its application would be more complex in energy given the prevalence of vertical integration, we shouldn't prove impossible to secure reasonable levels of engagement with properly constituted groups in a number of areas.

We welcomed the intent behind the Industry Dialogue initiated by Ofgem in respect of xoserve & the user pays model under GDPCR, which was a "constructive engagement" type process. However, we believe that the process as applied had some major flaws which damaged the process and reduced the value available. From feedback received in respect of the process's application in the Q5 review, there were a number of fundamentals which were missing in the Ofgem application:

- 1) Not enough time was allowed for ground rules/confidence building
- 2) The timing for the discussions was too compressed
- 3) The group's discussions were fettered by regulatory steers early in the process.

We believe that these matters could be addressed in time for such a process to provide valuable input to DPCR5. In Centrica's view, failure to consider such alternatives from energy and other industries would be a missed opportunity which would result in a poorer outcome for all parties.

We hope these comments have been helpful, and we would be happy to discuss any points in more detail if you would find this helpful.

Yours sincerely,

By e-mail

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