
Gas Distribution Price Control Review

Updated Proposals Document

A response by Centrica

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SECTION 1: KEY ISSUES

In responding to this Updated Proposals document, Centrica recognises the efforts made by Ofgem to provide a fair price control for the GDNs. We detail our views on the Gas Distribution Price Control Review (GDPCR) to date, and in particular, our concerns in respect of the final stages of the process.

Overall, we consider that the Updated Proposals are already generous to the GDNs, and that no further allowances should be provided.

There remains a considerable degree of uncertainty about the final proposals, the indicative cost of capital is still not known and Ofgem has signalled further potential increases in allowances, for example on capex. We believe it is unacceptable for such key elements only to be communicated at a point where no further consultation is planned.

Cost of Capital & Risk:

Centrica has engaged CEPA to provide technical support on GDPCR. CEPA has prepared a further paper on relative risk and the cost of equity. Whilst the views in the paper are those of CEPA, they are strongly supported by Centrica.

CEPA has carried out a detailed review of the evidence and analysis presented on relative risk by both Ofgem and Oxera, and has extended aspects of this analysis to include certain key parameters previously omitted. CEPA conclude that the evidence does not substantiate distribution as being more risky than transmission and hence that a cost of equity in excess of 6.5%-7.0% cannot be justified.

CEPA has also considered the recent cost of capital determinations by the Competition Commission. The Competition Commission estimates that the cost of equity of the equity market portfolio is 5%-7%. As it is implausible that the market's view of the risk of GDN exposure is greater than the risk of the equity portfolio as a whole, it follows that the highest plausible cost of equity for GDNs is 7%.

Our previous responses, and CEPA submissions, have demonstrated that the cost of debt should be significantly below 3.55%. The current market volatility has not affected the long term averages and ten year trailing averages, and the updated proposals highlight that spot rates have remained below the level used in the modelling assumption. Centrica believes that CEPA's earlier range for the cost of debt (with a point estimate of 3.0%) remains valid.

Finally, whilst we consider the gearing assumption of 62.5% to be conservative, we would not oppose it as part of a balanced package of proposals.

The previous approach to cost of capital has been set in the context of a price control with a significant volume driver and based on revenue collection reflecting a strong element of commodity charging. In our view, the removal of the volume driver from the price control and the proposal to change the capacity/commodity split on distribution transportation charges, fundamentally change the balance of risk faced by the GDNs. It would be remiss of Ofgem not to reflect this change of risk profile within the cost of capital going forward.

In the document, Ofgem has continued to use a modelling assumption of 4.84% for the vanilla WACC. Centrica considers that this is the upper limit of the appropriate cost of capital to be allowed for the next five years for the GDNs.

DN Sales Benefits:

Centrica has repeatedly pressed for DN Sales benefits to flow through the price controls, so we are encouraged by the application of benchmarking to the GDNs opex forecasts. However, the change in approach between the initial and updated proposals, of moving the target from the frontier to the upper quartile, relaxes the allowances for the GDNs at the expense of consumers.

Although we realise that GDNs would naturally oppose the application of full, bottom up benchmarking on the grounds that this would create a "virtual" DN as target; however, in our view

this should be welcomed. GDNs are funded by customers, and their target should be “best in class” in each area. To relax the target in this way can only mean additional costs to customers with questionable benefits over the five year period.

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.

Pensions:

Centrica has provided information to Ofgem clearly demonstrating our concerns that the GDNs have not acted as vigorously as normal commercial entities would have to do to minimise pension costs. We believe that this has led to customers bearing excessive GDN pensions costs, and the absence of immediate action by Ofgem will allow this regrettable situation to continue.

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 review should include the basis on which GDNs are permitted to pass through pensions costs to customers, and incorporate an independent, detailed examination of the benefits offered and funding, to ensure that customers are not asked unfairly to fund schemes which are more generous than the norm.

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 do not believe sufficient justification has been provided for the levels of investment in capex (given the relatively flat expectations for demand). Equally, there is insufficient evidence for the efficiency and economy of the planned repex investments.

In this area, our primary concern remains the unreliability of the peak demand forecasts, evidenced by the differences between NTS and xoserve forecasts and expressed GDN concerns. These discrepancies are sufficient to cast doubt on the reliability of the capex and repex figures in the updated proposals. We note that further work continues in some areas, leaving a risk of further increases in the Final proposals; this is not acceptable, especially in view of the increases already granted.

We support the scrutiny and challenge to the proposals by Ofgem and its consultants, but believe there should be greater transparency of this work at an earlier stage in the process.

As noted previously, Centrica has experienced difficulty in responding effectively in respect of capex and repex due to the lack of information supplied in the consultation documents. We acknowledge that Ofgem has placed its consultant reports into the public domain, this is welcome. However, the quantity of the reports was such that in the time available, they were of limited value.

Treatment of Non Operational Capex and Repex:

We welcome Ofgem’s proposals not to amend the treatment of non operational capex or repex in the GDNs’ favour. However, we do not support the expensing of 50% of repex as we believe this transfers a significant burden of cost to today’s consumers. We believe that the previous treatment expensing 50% was essentially a financing adjustment, and there is no rationale for carrying this forward.

In a new price control, we consider 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, therefore repex should be 100% capitalised.

We estimate that the continuation of the existing approach will bring costs of over £300m per year forward into the next price control and onto current customer bills. Capitalisation would spread this cost over the lifetime of the assets (45 years). We do not believe that placing a financing adjustment of this magnitude on to customers is justified.

Industry issues:

In addition 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.

UK Link is a vital system to the industry and its replacement must be given the priority it deserves. In our view, the plans to replace the UK Link system should be addressed in these updated proposals. We would welcome confirmation from Ofgem that it agrees a new system expected to last until 2020 and beyond needs to significantly improve on the original system built in the early 1990s.

We are encouraged by Ofgem's plans to introduce User Pays arrangements and see these as a vehicle for securing and funding reform additional to a like for like replacement. However we are concerned that there is potential for the User Pays arrangements to be reduced to the point that their value and inherent flexibility is lost.

If this proves to be the case, and hence such "additional" UK Link reform cannot be funded by User Pays, then we would like Ofgem to confirm they will take additional measures in a timely manner.

SECTION 2: CEPA PAPER

CONFIDENTIAL

RELATIVE RISK AND THE COST OF EQUITY

OFGEM: GDPCR 2008 - 13

SUPPLIED AS PDF DOCUMENT

SECTION 3: QUESTIONS AS RAISED BY THE DOCUMENT

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

CHAPTER: Three – Operating Expenditure Analysis

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

We do not agree with the relaxation to upper quartile from the frontier, as we believe it places additional cost on customers without commensurate benefits. As the GDNs are regulated monopolies, they should be aiming for best in class across the piece, not a less challenging target. As a result we believe that the allowances derived are over generous and do not agree with the principle of applying an uplift. We refer to our previous responses in this area.

In terms of the efficiency rankings supplied in table 3.5, we consider that the results are sufficiently similar to support the use of bottom up approach, which we believe would result in lower costs to customers.

Question 2: Do you agree with our approach to the additional operating cost items included in these proposals covering the areas where our work was incomplete at initial proposals?

The approach seems reasonable in most cases, but it will be important to ensure that such late additions are challenged with equal rigour. However, we consider that the acknowledgement by Ofgem of impacts in regional effects and labour costs results in a further reduction of GDN risk and that this must feed through into other aspects of the price control. If this is not the case, the piecemeal relaxation of opex allowances has a direct impact on customer costs and allows the GDNs to benefit at customers' expense.

CHAPTER: Four – Capital and Replacement Expenditure Analysis

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

Capex

Demand forecasts

Ofgem have acknowledged our point regarding the insufficiency of analysis carried out by PB Power on peak demand forecasts. However we still do not believe that, given the significance of both annual and peak demand forecasts to a price control, sufficient attention has been paid by PB Power to the demand forecasting process, other than to note inconsistencies in NTS and xoserve figures and to take account of the "uncertainties" in developing their capex forecasts.

There are initial indications from a GDN that the demand forecasting process is unsatisfactory. WWU have raised concerns that the forecasts they receive from NTS and xoserve are different. All GDNs originally chose to use the xoserve forecasts for deriving capex forecasts and OCS requests. WWU completed its BPO on the basis of last year's xoserve forecasts. However WWU observed that revised forecasts for this year from xoserve resulted in an 8% drop in the forecast for SW LDZ. They used the NTS forecasts for their OCS requests, which are higher than the xoserve figures. It is noted that Ofgem believe that this overstates demand.

We previously highlighted the differential between xoserve and NTS forecasts at the aggregate level. What was of great concern to us is that at the GDN or LDZ level these variances could be much wider but cancel out in aggregate. PB Power has only provided evidence of the differentials for WWU. For all other GDN's there does not appear to be any comparison of the two sets of

forecasts at either GDN or LDZ level and no indication as to which set of forecasts has been used by each GDN.

Given the differences are substantial; Ofgem should provide further evidence of the assumptions used to calculate peak demand. To assess the viability of the peak forecasts we request that Ofgem provide comparisons, at the GDN and LDZ level, of the differences between NTS and xoserve forecasts, and confirm which forecasts have been used by each GDN, prior to publishing Final Proposals.

Regarding the investments associated with scenario 2b, if additional investment is allowed in the final proposals the specific elements that make up this investment must be made clear and every element of new allowed investment should be identified and justified individually. Ofgem should also confirm that they have eliminated any double counting by the GDNs. As changes to the capex figures following the completion of the OCS have been signalled, early indication of any material changes to load related forecast capex would be appreciated.

Capex Drivers

Wide ranges of proposed capex per unit of demand growth across the GDN's persist despite some reductions made by Ofgem and GDN's, in addition, forecast average investment compared to historical averages is still substantially higher in some GDNs, despite the efforts of Ofgem to defer projects. In our view, confirmation is required, as stated in our previous response:

- that GDNs are not factoring in investment to avoid issues associated with exit reform and UNC modification 90; and
- that decisions made by GDNs for a specific course of action e.g. between pipe investment and gas holders are actually the most cost efficient solution for customers rather than the least risk solution for the GDN

Our comment on the need for more information on capex drivers was included in the updated proposals and the PB Power reports go some way to providing greater transparency in this respect. However it is still not clear where PB Power have specifically identified discretionary investment. We still have concerns with non-operational capex, which makes up 30% of the total proposed allowance.

We re-iterate our previous comments that there does not appear to be the same level of rigour applied to the analysis as other aspects of capex, particularly with respect to IS capex. Certain opex efficiency trade-offs are mentioned briefly but there is no evidence to suggest that this comment has analysis to support it, which Ofgem acknowledges, other than that NGG believe that reduced capex leads to increased opex. In the absence of robust analysis to support this in our view Ofgem should not make any additional allowance to reflect this assertion. In any case, we believe it would be appropriate to consider developing some analysis to assess the impact of reduced capex on opex levels during this price control period.

Capex Categories

LTS and Storage

Some substantial differences between the capex figures contained in the initial proposals and these proposals are reported by Ofgem. Examples are that NGG total capex forecast is up by £68m primarily in LTS capex and mainly due to increased contractor charges on one pipeline (£53m). The PB Power analysis suggests that they are not convinced that the proposed pipeline is the most economical solution for the network concerned. We do not expect Ofgem to micro-manage the GDN's, but an appropriate incentive on GDNs is needed to ensure that the most economic solution is used.

Ofgem appear to have taken some direct action by deferring several projects.

- They have deferred £40m of storage capex for NW DN to post 2012/13
- WWU forecasting a big increase in capex (£35m) largely driven by storage projects to cover demand forecast increases (£27m). Ofgem have taken a different view on this and have in fact deferred £59.5m of capex

It is noted that SGN's LTS capex forecast has reduced by £52m, but in fact the Ofgem proposal is still essentially the same. It is also stated that one project has been deferred by Ofgem and that some projects that SGN have included should be deferred but that this will be reviewed again for the final proposals. We note that certain GDN's have indicated a significant level of LP holder storage reductions. We wish to understand if upward pressure on opex is foreseen as a result of deferring LTS storage projects, and we would like sight of any analysis that has been done on the opex/capex trade-offs with respect to holder decommissioning.

Given the observation we have made on demand forecasts, one GDN's open statement that they have doubts about the validity of the xoserve forecasts, and Ofgem's statement that the NTS forecasts overstate demand (at least in SW LDZ); we do not believe that the peak demand forecasts used by GDNs are valid and therefore the LTS and Storage capex forecasts are also not valid.

We are therefore very concerned that when the final proposals are published there could be substantial changes in the capex proposals, driven by last minute assessments of projects and step changes on peak demand forecasts. This exposes suppliers and customers to additional uncertainty. No such changes should be permitted without robust challenge and appropriate consultation.

Other Operational and Non-operational

There is still very limited information here to support the substantial levels of expenditure. We also note some large swings in forecasts as a result of advancing or deferring IS projects. In our view the lack of firm views from Ofgem and its consultants on the relationship between this capex and opex levels is a matter for concern. This needs to be addressed in advance of final proposals.

Repex

We remain of the view that a lot more information needs to be made available to enable constructive responses. As we previously suggested, it would be helpful, particularly given the large costs associated with repex, for Ofgem, the GDNs and the HSE to provide a detailed presentation in this and future PCRs. Of particular interest is the issue of completing priority replacements versus an efficient mains replacement strategy.

Repex allowances have been increased by 5.7% compared to a 1.6% reduction in the GDNs forecast. We understand this increase to be as a result of a meeting between Ofgem and the HSE whereby it is now assumed that the additional workload originally forecast by the GDNs has to be carried out. We can only re-iterate here our request to understand more thoroughly the process whereby increased replacement workload is agreed.

A proposed allowance for riser replacement is included of £85m but further work is to be done. This is another area which will not be resolved until the final proposals, reducing suppliers' ability to assess the impact of change and increasing risk. Finally, the GDN's assessment of the impact on costs of the waste management regulation changes should be published at the earliest opportunity to reduce uncertainty in the final figures.

Capex and Repex Incentives

As we have indicated we are not in a position to judge whether the level of forecast capex is appropriate and hence are unable to judge if the level of incentive is appropriate. Until the demand forecasting uncertainty is controlled we remain unable to comment specifically on the level of incentive.

We re-iterate our concerns from our previous response 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 request Ofgem to specifically comment on whether the incentive regime as designed could have as a consequence a rise in PREs and leakage.

We have previously supported the principle of an IQI and capex roller and this has not changed, but it is important to ensure that incentives are balanced and that customers receive value for money for the additional funding given.

CHAPTER: Five – Quality of Service Arrangements

Question 1: Do you agree with our updated proposals for the quality of service arrangements?

We are disappointed that Ofgem proposes to migrate a number of overall standards to guaranteed standards of performance. We do not object to the migration in principle, instead, our concern is the lack of visibility of performance with guaranteed standards when compared to overall standards.

If this change is to be made, Ofgem should ensure that a robust reporting mechanism is put in place, not just to reflect current reporting, but to improve upon it. These reports should be automatically made available to the industry for scrutiny in a timely manner.

In respect of 5.28, we support the introduction of the complaints standard as we believe customers need this to ensure they receive a minimum standard of service in this non-competitive market. Our view of a substantive response is one where a customer receives a full response to the issues raised by them or, where a full response is not possible; a timescale is provided in which they can expect a full response.

CHAPTER: Six - Incentives

Question 1: Do you agree with our view that an opex rolling incentive is not appropriate?

Overall yes, as we agree it would be difficult to manage and properly challenging targets as a result of detailed benchmarking work should be sufficient. We are less supportive if the relaxation proposed to the upper quartile rather than the frontier company is applied.

Question 2: Is our approach to capping the expenditure under the mains and services incentive appropriate?

Centrica does not object to this approach.

Question 3: Is our approach to allocating domestic purge and relight costs to services costs appropriate?

Centrica does not object to this approach. Based on our understanding, the costs are present, this simply relates to how they are allocated.

Question 4: Do you agree with our approach to the capacity outputs incentive? What are the issues raised by incentivising or not NTS flex capacity?

We broadly agree with Ofgem's proposal to set incentives for the use of flat capacity such that a natural balance should be struck between GDNs managing their networks on peak demand days by booking NTS flat capacity, and contracting with customers, via shippers, for interruptible services. We believe the proposal outlined will go some way towards achieving this. We will be better informed when we see the values of flat capacity bookings that Ofgem intends to publish, and look forward to responding further on that basis.

In respect of NTS flex capacity, as Ofgem recognises there is significant uncertainty around the future NTS exit regime following the Competition Commission decision. In responding to this question, it would have been helpful to have a greater understanding of Ofgem's intentions with regard to enduring Exit reform; however the timescales are such that we have to respond to this consultation in advance of any such clarity.

Notwithstanding Ofgem's view about the availability of NTS flex capacity, we are concerned that moves towards a competitive flex regime will lead to artificial scarcity, with every user seeking to cover their peak flex requirements rather than taking into account diversity of use. At this stage, therefore, with NTS flex not being constrained, we would suggest that an incentive in flex use is not necessary. Alternatively, were flex to be offered as a constrained product, GDNs should most definitely be incentivised to ensure efficient use. In the interim, we strongly advocate an unconstrained flex product, but with robust monitoring of NTS linepack.

In addition, we note the significant adjustments to the GDN capex proposals i.e. deferral of investment into future periods. In our view, the fact that Ofgem supports such deferrals, endorses our view that there is no need for a constrained flex product in the near future.

Question 5: Should the volume targets for the flat capacity incentive vary with changes in the calorific value (CV) of gas?

We consider that the changes in gas CV which are likely to be seen over the period of this price control are likely to be of relatively low materiality such that very little difference will be made to the actual volumes of gas that GDNs are required to transport. In order to justify an incentive, we would propose that evidence should be collected and published for consultation and debate.

Question 6: Is it appropriate to allow a price control re-opener (subject to certain criteria) for any capex spend that may be required following the interruption auctions?

In general, Centrica does not favour re-openers due to the uncertainty, but if this one is permitted, it must be only with the proviso that the most stringent criteria must be applied and monitored. In addition, the process should include a consultation with all interested parties to assist in the review and challenge process.

Question 7: Is it appropriate to have an adjustment mechanism for the treatment of emergency services costs arising from the loss of metering? If so do you agree with our approach and methodology for the parameters?

We can see the justification for this, but it will be necessary to test the parameters and trigger points very hard to ensure that unnecessary or automatic allowances are not provided to any GDN. The adjustment mechanism must be applied on a case by case basis and fully justified in each case. As part of the justification process, the applicant GDN must provide clear evidence that it has made all reasonable attempts to find alternative sources of revenue.

CHAPTER: Seven – Sustainable development

Question 1: Is it appropriate to roll forward the existing shrinkage incentive and if so do you consider the leakage volumes appropriate?

We broadly support the rolling forward of the existing shrinkage incentive. On shrinkage rates per se we broadly agree with Ofgem's proposals, but would be concerned if actual leakage rates as set via the annual shrinkage review differed widely from this, given the scrutiny already placed on shrinkage rates via the GDPCR process.

More generally, as per previous responses we believe there is merit in further exploring the extension of the shrinkage to include transportation charges associated with all losses, such that the present transportation element of RbD could ultimately be incorporated into the allowed revenues/incentives schemes associated with leakage. This coupled with our existing industry proposals to extend RbD to I&C shippers would provide a fuller coverage of incentives across all industry participants.

Question 2: Is the gas reference price formula appropriate?

Centrica agrees that using the day ahead price without an uplift is a more appropriate approach to the gas reference price than current three month ahead price with a 3.5% uplift.

Question 3: Should Ofgem establish a new incentive to target harmful environmental emissions?

We generally support the introduction of a new incentive to target harmful environmental emissions. However we do see the need for robust reporting of actual emissions and would request that Ofgem ensure this reporting is made visible to the industry in a timely manner.

Question 4: Do you support the design of the environmental incentive and its parameters?

We generally support the design of the environmental incentive and its parameters.

Question 5: Are the strength and baselines for the incentive appropriate?

We agree that an incentive of £28.50/MWh (2005-06 prices) is reasonable given the “Shadow Price of Carbon”. We believe that this should be reviewed annually in the light of carbon price changes.

Question 6: Are the cap and collar arrangements appropriate?

We support the introduction of a cap and collar arrangement as this will protect both GDNs and suppliers

Question 7: Is it appropriate to introduce a mechanism to address periodicity of investment?

In general, we believe it is reasonable to address periodicity of investment, providing this can be done economically and efficiently with customer benefit being clearly demonstrated. However, the precise nature of the proposed mechanism is not clear from the chapter.

Question 8: Are the leakage model and governance arrangements appropriate?

We note that Ofgem have worked with the GDNs over the summer but are disappointed that suppliers were not invited to participate in this work.

We would urge Ofgem to ensure that the industry is fully consulted before any changes to the model or baselines are agreed during the price control period.

CHAPTER: Eight – Other issues

Whilst no specific questions are raised in this section, we continue to have major concerns in respect of UK Link and the associated funding requirements.

UK Link is the single most important gas industry system. Its replacement offers many opportunities to improve upon present day industry arrangements, by removing complexity, speeding up customer transfer processes and increasing the accuracy of energy settlement processes. Moreover the roll-out of smart metering will, we believe, have a significant impact on the way that the industry operates. Developments in smart metering must be given due attention in such system replacement.

In our view, the plans to replace the UK Link system should be addressed in these updated proposals. We would welcome confirmation from Ofgem that it agrees a new system expected to last until 2020 and beyond needs to significantly improve on the original system built in the early 1990s.

We are encouraged by Ofgem’s plans to introduce User Pays arrangements and see these as a vehicle for securing and funding reform additional to a like for like replacement. However we are concerned that there is potential for the User Pays arrangements to be reduced to the point that their value and inherent flexibility is lost.

If this proves to be the case, and hence such “additional” UK Link reform cannot be funded by User Pays, then we would like Ofgem to confirm they will take additional measures in a timely manner.

CHAPTER: Nine – Financial Issues

Question 1: Does our risk analysis support a range for the cost of equity of 7.0-7.5per cent?

Centrica continues to consider that the evidence supports a range for the cost of equity for GDNs of 6.5-7.0%. We see no reason to set the allowed cost of equity higher than 7.0%. The most recent, independent and authoritative estimate of the economy wide parameters of the cost of capital was that of the Competition Commission. Their estimate for the cost of equity for the market portfolio was 5-7%. It is clearly implausible to suggest that the financial markets view investment in GDNs as more risky than the market as a whole. Therefore 7% is a maximum value for the cost of equity for GDNs.

Centrica commissioned CEPA to review the analysis of relative transmission-distribution risk undertaken by Ofgem and OXERA. Their conclusions (provided separately) are that there is no robust evidence of any difference in systematic risk across these industries. The Ofgem bottom up analysis does not appear robust, and cost differences are not a valid measure of non-diversifiable risk. Furthermore, it would be paradoxical if Ofgem were to reward inefficiencies through a higher cost of capital.

When the OXERA analysis is repeated allowing for differences in the regulatory regimes in different countries their conclusions are no longer supported.

Centrica believes that significant weight should be placed on market evidence when determining the cost of equity. There is extensive evidence from recent market transactions across a range of regulated industries that indicates that the required return on equity is materially lower than 7%. This evidence is in the form of market valuations of equity cash flows that are at a significant premium to the RABs of the assets. We agree that direct read-across from water to GDNs would be inappropriate. Nevertheless, we believe that Ofgem is bound to take account of the magnitude of MAR premia across a range of industries, taking account of plausible differential industry risks, when determining the value of the cost of equity for GDNs. That evidence clearly supports the Centrica view that the highest supportable value for the cost of equity of GDNs is 7%.

Question 2: Is it appropriate to continue to maintain a consistent approach to cost of debt to that taken in TPCR?

Centrica supports CEPA's recommendation that Ofgem should adopt triggers on the cost of debt (a form of debt indexation); although we appreciate that, at this late stage of the process, it will not be practical for Ofgem to do so for this review. Ofgem is therefore likely to continue to place weight on a combination of trailing averages, long term averages and current rates for the cost of debt. The judgment to be made by Ofgem is the magnitude of the 'headroom' above the short term average cost of debt that should be built into the allowed cost of debt for the next review period. A cost of debt of 3.55% would give excessive headroom to GDNs and is not justified by a combination of trailing averages, current rates and reasonable expectations of the cost of debt for 2008 – 2013, as demonstrated in CEPA's April 2007 paper 'The allowed cost of capital' and its August 2007 paper 'Further analysis of GDN cost of debt'.

We agree that Ofgem should allow for the financing fees incurred by an efficiently financed business. The Competition Commission concluded that an allowance of 15bp was appropriate for BAA. A cost of debt of 3.55% allows significant headroom after allowing for these costs.

Question 3: In the light of both the results of our risk analysis and the levels of actual gearing observed in the sector, is there a compelling reason to change our notional gearing assumption from 62.5per cent?

Centrica has previously noted that a notional gearing of 62.5% is conservative, but is not unreasonable in the light of GDNs increasing gearing levels whilst maintaining comfortable investment-grade credit ratings. Centrica has seen no new evidence to change this assessment.

Question 4: Is our approach to determining the GDNs' tax allowances appropriate?

Centrica continues to support the approach adopted by Ofgem in TPCR in determining GDN tax allowances.

Question 5: Should we make a financeability adjustment in cases where a GDN fails to meet our target ratios because of its own actions, such as penalties incurred under incentive schemes?

There is no justification for making financeability adjustments in cases where a GDN fails to meet Ofgem's target ratios because of its own actions. Indeed, to do so would impose on customers these costs of failure by this regulated company.