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Dear Joanna

Gas Distribution Price Control Review: Update Proposals Document

We are pleased to respond to Ofgem's September 2007 consultation paper. Our detailed response is contained in the attachment to this letter.

Overall, we believe that Ofgem is making good progress with the review, but we have significant concerns with the opex benchmarking, where there is clearly scope for further improvements.

I confirm that this response can be placed on Ofgem's website.

Yours sincerely

Roger Barnard

Head of Regulatory Law

GAS DISTRIBUTION PRICE CONTROL REVIEW: UPDATE PROPOSALS DOCUMENT: DETAILED COMMENTS FROM EDF ENERGY

Correction mechanism

We agree that a deadband of 3% is appropriate to address concerns over volatility. We also agree that any approved changes to Gas Distribution Network (GDN) pricing methodologies which materially increase the weighting given to the capacity element would further reduce the impact of throughput volatility and would justify an appropriate tightening of the correction mechanism deadband.

Operating expenditure analysis

We welcome a number of changes in the opex benchmarking methodology. These include:

- Proposals to up-rate the output of the bottom up benchmarking to the upper quartile of the top down analysis. This removes an internal inconsistency within the previous analysis.
- Ofgem's intention to make adjustments for non labour related regional costs relating to the effects of both density and sparsity. Such an approach is required as the current top down benchmarking cannot easily take account of these important effects.
- An allowance for apprentice and general training costs.
- Additional expenditure to cover the increased costs of efficient waste management.

We are concerned about Ofgem's assertion that proximity to London has no impact on the local labour market. By implication this means that the labour costs in Reading are the same as those in Newcastle or Swansea. Publicly available earnings data from the Office of National Statistics clearly demonstrates that the regions closest to London tend to have higher than average earnings than those further from London. This fact is also recognised by Government in its calculation of the labour cost factors used in the Area Cost Adjustments – which are used in determining local government allowances – where the regions closest to London tend to have an adjustment factor of greater than 1, whereas those further from London tend to have a factor of one.

We agree with the GDNs that allowed revenue is an inappropriate scale variable for assessing indirect opex efficiency. We accept that Ofgem has mitigated a proportion of the risk by excluding third party benchmarks from the efficiency assessment for a number of the activities. However, it remains unclear to us why allowed revenue would be a driver of indirect costs, as it is typically dominated by RAV components e.g. return and depreciation. Consequently, we concur with the GDNs that total distribution costs would appear to be a better scale variable.

We also note that Ofgem has also maintained its view that the GDNs can achieve ongoing productivity improvements of 2.5% p.a. A key element is the assumption that the GDNs can improve their productivity 1.4% p.a. faster than the economy as a whole. This figure has been derived by analysing the productivity growth in sectors deemed to have similar characteristics to gas distribution. It is obvious that the choice of comparator sectors is highly influential on the outcome but it is unclear how Ofgem and their consultants have come to select certain sectors to include in the analysis. For example, it is not immediately obvious why "manufacture of chemicals, chemical products and man made fibres" is a more relevant comparator than say "manufacture of machinery and equipment not elsewhere classified". We believe it would aid transparency if Ofgem set out in more detail how these decisions have been arrived at.

Capital expenditure and replacement analysis

We remain of the view that the proposed Information Quality Incentive (IQI) 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 would again suggest that an appropriate level would be at least 0.75%.

Quality of service

We support Ofgem's proposals and believe that they provide an appropriate level of protection for customers while ensuring that the compensation they receive reflects the value placed on the service. However, it is important that improvements in service are appropriately funded.

We support Ofgem's proposal to maintain General Standard 3 (the provision of alternative heating and cooking facilities) to priority customers as it will ensure that those most in need of these facilities receive them. We further welcome the development of a best practice guideline document to ensure that these facilities are provided to customers who are not on the priority list, based on an assessment of needs.

Private and sub-deduct networks

Given the potential health and safety issues associated with private and sub-deduct networks, EDF Energy supports the principle that these networks should be adopted by the GDNs. We further recognise the risk to the GDNs that adoption of these networks represents and therefore we support Ofgem's intention to carry out a full technical survey to inform this decision.

Capacity outputs incentive and issues raised by choosing whether to incentivise NTS flex capacity

At this stage, the capacity outputs incentive appears reasonable. However, there are several issues that need to be addressed. In particular we note that Ofgem appears to be setting the NTS Flat capacity incentive on the assumption that all loads apart from Network Sensitive Loads (NSLs) are firm, with the incentive working through a profit maximisation approach. The volumetric target could have been developed based on current firm requirements, with the incentive working through a cost minimisation approach for the GDNs. We would further note that while it is desirable to have symmetrical caps, collars and sharing factors between the flat capacity incentive and the interruption incentive (we note that one is volumetric and the other appears to be price driven), it is also important to ensure that the caps, collars and sharing factors are set at an appropriate level so that the financial impact of the two incentives is the same.

EDF Energy also supports Ofgem's intention to conduct a separate consultation exercise on the interruption incentive, to ensure that it is set at an appropriate level.

Volume targets for the flat capacity/incentive changes in the calorific value (CV) of gas

It would appear inappropriate that the GDNs could be impacted by this incentive (both positively and negatively) due to the changing CV of gas, over which they have no control. We would further note that, with the UK's changing supply pattern, it is likely that there will be regional impacts associated with this. It would therefore appear appropriate to adjust the long term flat target to reflect the long term changes to CV in an area. However, how the long term CV characteristics are identified would appear problematic.

Price control re-opens for interruption auction related capex

EDF Energy actively participated in the UNC Modification Work Group that developed these proposals and the subsequent consultations. Throughout the process the industry has expressed a concern that the impact of implementing interruption reform would be a large capex requirement funded by customers as previously interruptible loads and Network Sensitive Loads (NSLs) sought to go firm. If it becomes apparent that the interruption reform has failed and a significant capex re-opener was required it would therefore appear appropriate to revoke the reform. In the longer term it would be beneficial to review the reform and identify where, and why, it has failed.

While we recognise the theory behind Ofgem's belief that those loads that are NSLs should be best placed to offer interruptible services at low cost, industry experience would suggest that the ability to offer interruptible services is dependent on the flexibility of the plant. The cost of being an NSL and offering interruptible services could therefore be significant, especially if the plant is not flexible and alternative fuel sources and Integrated Pollution Prevention and Control (IPPC) certificates are required. It should also be noted that in instances where the back up fuel source has a larger carbon footprint than gas, the potential Climate Change Agreement (CCA) and EU ETS impacts could represent an additional opportunity cost as part of any tender.

Emergency services costs adjustment mechanism arising from the loss of metering

While it is appropriate that the GDNs are funded to provide this emergency service, it is not clear why they are forecasting such a significant reduction in workload from Meter Asset Managers (MAMs). We recognise that MAMs would require standards of service, but note that this would be offset by the cost savings that the GDNs could offer. It would therefore be useful to identify how the cost of this service provision compares between GDNs and external service providers, and to understand from the MAMs why the service provision from the GDNs is no longer acceptable to them.

Flex capacity

EDF Energy recognises the difficulty of incentivising flex capacity, in that there is no scarcity of it at the moment and so there appears no need to artificially ration it. However, if it is not rationed, or if the flex bookings are not incentivised, then there is a risk that this will become a scarce product in the future, which could have a detrimental impact on securing supplies to domestic customers. This is especially the case if the GDNs become increasingly reliant on NTS Flex, which may be heavily impacted by changing UK supply patterns and profiles.

It would therefore appear appropriate to monitor the provision of flexibility within the UK both at GDN and NTS level, and identify whether the amount of flexibility within the UK is increasing or decreasing. This is important to ensure that the flexibility on the systems is maintained to meet peak day demand and ensure that the UK's security of supply position is not adversely impacted. Such monitoring would identify whether it was appropriate to develop an incentive to ensure that current provision of flexibility in the UK is maintained – which could take the form of an NTS flex booking incentive on the GDNs, or a combined incentive so that they could choose between maintaining their own flexibility or procuring it from the NTS. However, the first priority is to identify what is happening to the UK's flexibility provision.

Sustainable development capacity

We welcome Ofgem's proposal to introduce an environmental incentive scheme related to shrinkage. We see this as a first step in refocusing the incentives on GDNs to contribute positively to reducing their impact on the climate. We also believe that Ofgem should go further in this area and develop a set of measures which incentivises 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:

- Own consumption of gas and electricity
- Fuel use, and
- Recycling of waste

Rolling forward the existing shrinkage incentive and appropriate leakage volumes

The existing shrinkage incentive appears appropriate and ensures that GDNs are incentivised to reduce shrinkage. We further believe that a fixed volume for leakage and demand linked volumetric targets for own use gas and theft are also appropriate. However, EDF Energy remains concerned at the lack of metered data for the GDNs' own use gas. We believe that it is appropriate for these volumes to be measured so that it can be confirmed that the GDNs are operating their networks in an economic and efficient manner. This would further enable the development of incentives focused on the different elements of shrinkage.

Gas reference price formula

The choice of any price formula will inevitably be arbitrary, and retrospective analysis will always be able to identify "more appropriate" formulas. The choice of a day ahead reference price formula would therefore appear appropriate.

Appropriateness of the leakage model and governance arrangements

We believe that the role originally envisaged for the Shrinkage Forum remains relevant and that this, combined with Ofgem's role in accepting or rejecting any proposed shrinkage factors, should provide sufficient governance. We believe that these arrangements 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 allowed 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 that sufficient time is allocated to discuss the topics at hand.

Funding of xoserve

EDF Energy welcomes the workgroup that has been formed to progress this issue further. However, we remain concerned with the fact that there is insufficient detail as to how this model will be developed. In particular, we note that the initial review group only found five service lines that could potentially be classified as "user-pays", and even the appropriateness of these was questionable.

There were further discussions as to how industry change was funded. However, this topic was perceived to be exceptionally complex and likely to require significantly more development work to ensure that this did not create a barrier to users, or the industry, against proposing change. It would appear that there is a case for xoserve developing a user-pays approach for providing commercial services to individual shippers. However, this is a service that xoserve already provides, and it is unclear whether Ofgem is looking to encourage xoserve to extend the provision of these services, or whether it is looking for a fundamental reform of how change is delivered to the industry.