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Friday, 23 November 2007

John McNamara
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By E-mail: john.mcnamara@ofgem.gov.uk

Dear John,

Re: DNPC03 - LDZ System Charges, Capacity Commodity Split and Interruptible Discounts – Draft Impact Assessment

This response is on behalf of Centrica plc excluding Centrica Storage Ltd. This letter is non confidential and may be placed on the Ofgem website and in the Ofgem library.

We have previously explained our views on this proposal in our responses to the Pricing Discussion Paper, Pricing Proposal and Information Request. Neither our views, nor the basis for them have changed.

Centrica remains highly concerned with the proposals contained within DNPC03. Aside from the potential for negative distributional impacts upon domestic customers we do not believe that Ofgem have addressed the key issues of risk transfer, impacts upon sustainability and transitional requirements. Until these issues have been addressed, we do not believe there is a robust basis on which to implement the proposed 95:5 split.

Risk Transfer

The proposed change will significantly reduce the risk faced by GDNs, transferring it to suppliers (and ultimately customers). Where higher levels of fixed transportation charges are imposed on energy suppliers, then over time, it is likely that those suppliers will seek to recover their costs through amendments to the way in which customers are charged, these charges would likely reflect the suppliers' view of the increased risks they face. If the GDN revenues are not also adjusted to reflect their lower level of risk, the total costs to customers would be expected to increase. To reduce GDN risk, and yet to allow GDNs to continue to claim the revenue associated with the previous level of risk, would result in unjustified benefits to the GDNs.

It is clear from the Draft IA that Ofgem's current inclination is to permit the proposal. We continue to disagree but, if this transfer of risk is allowed, the associated benefit to the GDNs must, at the very least, be quantified and reflected in the price control, via a significantly reduced cost of capital.

Sustainability

This proposal moves transportation charges to an almost fixed basis. This must be seen as part of a wider pattern of moves to shift transportation charges away from consumption related to effectively consumption independent. Whilst Ofgem has largely assessed this change on the basis of small "distributional" impacts for average customers, it is important to recognise the wider context. In terms of the increasing trends towards warmer winters and shifting risk from the GDNs to suppliers, as noted above, suppliers are likely to need to consider their tariffs.

Whilst it is possible to agree that this change alone may not have a dramatic impact on sustainability issues, as part of this wider pattern, then it would clearly reduce incentives on customers to cut consumption and have a detrimental impact on payback periods for energy efficiency products. This in turn will reduce the case for customer investment in energy efficiency measures and decrease the incentives on customers to fit these products.

In addition to the above points, we believe that focussing mostly on the impact on average customers is likely to understate the effects. Lower consuming customers, who may well have taken action to improve energy efficiency and change their behaviours, are more adversely impacted, whilst consumers who use more (or who have made less effort to reduce their consumption), benefit by more than the average. We do not believe this is equitable or sends appropriate signals in terms of energy efficiency.

Quality of Analysis and Available Information

The Draft IA places reliance on cost benefit analysis, but unfortunately it does not carry out a full quantitative analysis. For example, on page 2, it states that *"Implementation costs associated with IT system upgrades are minimal and will easily be outweighed by more efficient use of and investment in network assets, although it is impossible to be precise about the magnitude of these benefits. Increased competition is another major benefit of the proposal but here again quantification is difficult."*

Whilst we continue to dispute the point on network assets, believing that this has not been proved; on the basis that neither of these "beneficial" effects is quantified, Centrica does not believe that it is appropriate to make statements such as "easily outweighed". In addition, we do not understand how redistributing costs in this way can be expected to increase competition.

We continue to consider that the GDNs did not provide sufficient information in a timely manner to allow Suppliers to properly evaluate the effects of the proposals. In our response to the Ofgem Information request, we set out the details we would expect but note that to date, these have not been provided by GDNs.[1]

[1] Extract from Centrica Response to Ofgem Information request on DNPC03 Impact Assessment:

Transitional Requirements

The proposals reflect a wholesale shift in the way that allowed revenues are recovered, and have very significant impacts on the distribution of risks and cashflows. These have not been fully tested.

In addition, the proposals may adversely change the balance of existing long term/ fixed price contracts, that were written in good faith based upon present day charging structures.

If the new charging arrangements are to be implemented, we would like to see a phased introduction, which will lead to the following benefits:

- Allow suppliers to fully evaluate and respond to the impacts of this change to the charging methodologies, based on complete and accurate information.
- Reduce the likelihood of suppliers needing to include additional risk premia
- Reduce the impact of the proposals upon existing fixed term contracts, and in doing so give greater confidence to those suppliers aiming to create innovative new products.

We would propose an initial move towards, for example, a 70:30 capacity:commodity basis from October 2008, with a move to 95:5 in October 2009.

In summary, the proposed arrangements should not be implemented until the significant issues set out above have been fully resolved.

Kind regards,

Yours sincerely,

By e-mail

Alison Russell
Senior Regulation Manager, Upstream Energy

"We would expect to see two sets of charges based on whether the proposed change is implemented in April/October 2008, or April/October 2010. GDNs should also provide supporting information to demonstrate the effect on their allowed revenue and cashflows and the annual/cumulative distributional effects between customer groups, by GDN, over the next price control period. All this information should have been provided with the consultation document, not piecemeal during, or indeed after, the consultation."

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