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Dear Rachel

**Electricity Distribution Price Control Review 'DPCR5' Consultation Document
159/08**

1. This is our response to the above consultation. It is not confidential and we are happy for this to be posted on the Ofgem website and in the Ofgem library. This letter summarises our main thoughts and is supported by a number of papers which we have commissioned from CEPA and which we outline in this letter.
2. As you are aware, unlike the majority of the other large domestic suppliers, we do not hold any distribution interests in the UK or elsewhere. This means we can provide a unique, unconflicted perspective on this price control. Our bill for electricity distribution charges is about £600 million p.a. (in excess of £3 billion over the current price control period 'DPCR4'). We therefore pay, on behalf of our customers, a substantial portion of the revenues that the DNOs earn in total.
3. British Gas takes substantial price risk on distribution costs when we enter into fixed contracts with domestic and non-domestic customers. So, particularly for these customers, but also for our portfolio as a whole, we need to be able to aggressively manage and forecast all our costs. In this sense we treat distribution costs no differently to any other costs we face. The commercial exposures we face in managing and forecasting these costs should be fully factored into Ofgem's approach to this review, particularly given that however good our forecasting, the distribution costs that we face are beyond our control (there are no effective hedges available at reasonable cost), once the price control is set. Indeed, we believe these considerations entitle us to as great a say in this process as the organisations whose operations are funded as a result.

The Cost Outlook to 2015

4. Ofgem's consultation seeks views on the whole range of policy issues raised by this price control and we provide comment on many areas in this response. However, our overriding feeling is deep concern about the level of cost increase that is implied by the Distribution Network Owner (DNO) numbers with which Ofgem has been presented. We understand that the energy sector as a whole faces a huge investment requirement over the next 10-15 years and we are ourselves investing significantly to meet the

challenges of carbon reduction and security of supply. However, while we are happy to consider any propositions that offer value for customers, whether that be carbon reduction, lower costs or other benefits, we have yet to see the business case that justifies the DNOs' plans.

5. We are extremely concerned to see the very substantial indicative cost increases set out in the policy paper – an 82% increase in network investment, and a 13% increase in network operating costs. Ofgem also refer to certain potential increases to come, notably pension deficit repair costs. Given the stock market turbulence of the last year, the cost to customers of continuing to provide extremely generous defined benefit pensions to DNO employees is likely to increase significantly, unless Ofgem takes steps to ensure these schemes operate at least in line with those enjoyed by employees in the defined benefit schemes that remain in competitive markets in the private sector. But even assuming Ofgem action does lead to some risk transfer and efficiency savings for customers on pensions, that category also, like opex and capex, looks likely to be a source of double digit increases. So the news on cost is all extremely negative for customers struggling as it is to pay their energy bills.
6. As far as we can work out from the limited information available to us, if network charges were set on the basis of the numbers provided by the DNOs, real network charges could increase by 20%-30% under DPCR5. As the largest energy supplier in the country, we are under huge pressure to reduce our charges to customers and to do what we can to alleviate rising fuel poverty. This price control therefore has significant implications for British Gas and its customers. We have become used to network and environmental costs increasing by more than the rate of inflation in recent years, contributing to the rising trend in energy bills. But this price control threatens to launch network costs into a whole new trajectory, implying the need for retail prices to rise significantly even if commodity costs are flat year-on-year.
7. We give one specific illustration of the impact on British Gas below. Many of our customers value fixed price products and we now have 25% of our household customers on these kinds of deals. These sorts of choices that customers have are one of the benefits of a competitive supply market. Many of the deals stretch into 2012. This is two years into the period from when the prices set by this control will apply. British Gas has therefore already had to take a view on what electricity distribution charges we will face from 2010.
8. Given the wide range of potential distribution charge outcomes implied by this price control, we have had to factor in the risks of different outcomes, risks which we need to reflect in our prices to customers. It is therefore essential that DNOs and the DPCR5 process as a whole help British Gas and other suppliers manage the risk of this sort of exposure, through as much transparency as early as possible in the range of possible price outcomes.
9. In the light of these cost implications, it would therefore be helpful to see a more visible public debate, led by the DNOs, explaining the need for these increases. While the document contains some insights, the explanation is thin. There may well be a need for substantial reinforcement of the network or for expansion to facilitate carbon reduction and renewable connections, but if so, the case needs to be properly made. And this case needs to be communicated to all customers and stakeholders, including government, and not just Ofgem. The track record of the DNOs suggests there is inevitably an

element of overbidding in their plans (as shown by their underspend against more modest capex budgets in DPCR4) and we expect Ofgem to identify significant scope to reduce DNO planned budgets, without necessarily dramatically impacting the outputs they produce.

Transparency on Overall Returns

10. If we are entering a world where network costs are increasing way beyond the experience of the last 10-15 years, then the overall returns that networks receive, funded by customers, need to be much more transparent than they have been to date. Customers need to know their money is well spent and that they are receiving value for money.
11. We are pleased that Ofgem recognises this and that it is introducing the measure of Regulatory Return on Equity. This sort of approach brings transparency about the additional return on equity that DNOs are making during the current price control, over and above their allowed cost of capital. We are concerned that specific incentive mechanisms set as part of this and other price controls by Ofgem have given regulated companies an opportunity to earn significant additional returns, often without evidence of value for money for customers (e.g., evidence that networks have delivered more than they otherwise would have done).
12. We recommend Ofgem publish this measure on an annual basis to stakeholders to understand how DNO's actual performance compares with the price control settlement and to improve transparency and confidence in regulation.

Dealing with Uncertainty in DPCR5

13. Ofgem have highlighted that uncertainty is a major issue for DPCR5, implying that it will be difficult to fix budgets and provide reasonable stability in network charges. From our viewpoint, the important question to consider is – who is best placed to manage that uncertainty and risk? Unfortunately, DNOs have demonstrated a lack of interest in helping suppliers to mitigate the charging risks that we face. However, in many cases, it is clear that DNOs are better placed than suppliers to manage risk, due to their network knowledge and expertise. As a result, risk premiums incurred by DNOs for absorbing risks should be expected to be smaller than those which would be levied by suppliers.
14. We are therefore concerned about Ofgem's proposals to introduce a number of detailed mitigation instruments to address individual risks and uncertainties. We believe these will significantly increase complexity and, potentially, volatility. Mitigating risks for DNOs does not make uncertainty disappear, it simply passes the risk to suppliers and customers, potentially leading to inefficient outcomes and an inappropriate risk allocation.
15. In other regulated industries, for example water, a stronger case can be made that the end customers are better placed to bear risk and volatility (compared to the regulated utility). The situation is different in a competitive energy market, where British Gas is one of many suppliers competing on price and service to customers. In our industry, predictability and visibility of network charges are essential to ensure we operate on a level playing field with the other suppliers, especially as most of our major competitors have network

interests. The higher the absolute level and the potential variance around future network charges, the more supply competition is distorted by the need for suppliers to make estimates about these uncontrollable costs that they face.

16. Furthermore, it is not clear to us that the degree of uncertainty is significantly greater than at previous reviews, except for the cost of finance. By breaking down costs and risks into small component parts, and introducing measures to deal with each one individually, the overall position can be obscured. We believe the risk should be considered holistically and where mitigation options are offered, there needs to be a clear understanding with DNOs about the effect of this mitigation on the overall returns due to them.

17. In light of the above considerations, we propose that:

- only a small number of specific risks should have their own risk mitigation – primarily the cost of debt, the number of connections, uncontrollable costs, corporation tax costs (we note with some dismay the tax windfall to DNOs in the last two years of DPCR4 was circa £50m per annum) and possibly units distributed;
- all other risks should be captured through a more explicit general re-opener which should have clear guidelines about use; and
- any specific risk instrument should incorporate logging-up so as to shift price volatility to the next price determination.

The WACC in DPCR5

18. Recent events in the financial markets have led to an abrupt change in the stability that has been evident for the last decade. In our view the likely direction and stability of financial markets for the coming control period is particularly uncertain. This means that Ofgem's traditional approach of focusing on long term trailing averages and 'aiming up' is unlikely to give the 'right' result for the allowed WACC. Ofgem appears hopeful that stability will return to the financial markets by July 2009, allowing it to rely on its traditional approach, while possible this seems highly optimistic to us.

19. We therefore recommend that Ofgem should immediately commence specific consultation on alternative approaches. In particular, we suggest that Ofgem should:

- immediately develop and facilitate the development of options for a trigger mechanism on the cost of new debt;
- take more explicit account of the notional efficient DNO's financing structure, and to then consider the costs of existing debt and new debt separately; and
- take account of market evidence on the cost of equity, especially the relative stability of utility share prices.

20. This approach will remove much of the historic 'headroom' above the actual WACC and protect DNOs from significant movements in the cost of new debt. We intend to build on our initial thoughts about the approach to setting the WACC by submitting a paper before Ofgem's Initial Proposals with a proposed level for the WACC.

Incentives under DPCR4

21. The need for more transparency with respect to overall returns is acute in the light of the experience of this current price control. CEPA's analysis (commissioned by British Gas), which is similar in direction to Ofgem's, raises very significant questions about whether customers are getting value for money from the DNOs. In particular:
 - the value of rewards against the incentives for the first three years of DPCR4 are in excess of £600m; and
 - there is substantial evidence that customers have achieved limited or zero benefit for those rewards that they have paid out (notably on the losses incentives and on Information Quality Incentive (IQI))
22. Considering the understandable pressure for suppliers to minimise their bills to customers, it is alarming that in the monopoly parts of the supply chain, customers have not been adequately protected in recent years.
23. It is therefore imperative that Ofgem considers very carefully its approach to setting incentives for DPCR5 to ensure they deliver real value for customers. Ofgem should start from the presumption that incentive schemes should have an expected value of zero on average across all DNOs. The best performing DNOs would thus earn positive additional returns and an uplift on their cost of capital, while below average performers would earn negative returns under incentives – this is analogous to what happens in competitive markets.

The Distribution Losses Incentive

24. While an average zero net present value approach may have implicitly been Ofgem's approach to date, in practice incentives have been set that lead to significant positive rewards for DNOs as a group. The current losses incentive is a particular example where DNOs were able to earn positive rewards in many cases even when losses increased compared to the previous year.
25. The DPCR4 losses incentive has failed, principally due to poor design. We do, however, recommend that Ofgem continues to set the losses target on an output basis, as that provides the best way of seeking to achieve value for money for customers, and accountability for DNO performance.
26. The way the output-based target is set will be very important for determining the likely value for money. Ofgem should aim to set the target with a view to a zero average expected return across all DNOs, so only those performing above average would receive rewards from the incentive.
27. Ofgem's proposal of setting the target using the average performance of DNOs over the last five years could still result in substantial windfall gains for DNOs, even if actual losses did not fall substantially from current levels. If the target for the current price control had been set on a five year historical average basis DNOs would have gained £187m in the first three years of the current price control compared to the £322m they have gained – clearly an improvement for consumers but still a high price to pay. We therefore recommend a target set using a two year historical average – this would have led to only £31m of rewards for DNOs in the first three years of the existing

price control. This approach also largely avoids rewarding DNOs even when losses increase.

Capital Expenditure

28. Ofgem should scrutinise very carefully the huge proposed increases in capex and opex for the DNOs during the next price control period. It should learn the lessons from the current price controls where a number of DNOs appear to have asked for substantially more capex than they required. This gives Ofgem every right to be extremely challenging about precisely why customers need to provide these funds.
29. If it is for replacement capital expenditure, we need to have evidence that security standards will deteriorate without the investment. If it is driven by government energy policy, distributed energy and carbon reduction, we need to understand how DNO expenditure will help meet wider policy or market objectives in this area. British Gas recognises the importance of the government's 2020 targets and we are investing heavily to meet them both in generation projects upstream and in making customers' homes more energy efficient. We are also active in explaining to government the benefits of smart metering, which will also have roll-out costs. So we understand that investment involves cost. But as monopolies regulated in the public interest, DNOs should recognise a special responsibility to explain and justify their plans.
30. The IQI mechanism has so far delivered limited value for money for customers. It may have slightly reduced "over bidding" by some DNOs at the last price control, but comparisons of DNOs forecasts for capex and actual capex suggest that very conservative forecasts continue to be made by a number of DNOs. This makes the £222m in DNO gains from IQI in its first three years of operation look like a very hefty price for the limited benefits customers have received as a result.
31. While it would be premature to discontinue the use of IQI after only one price control period, and we support the intent behind it, its parameters need to be substantially changed to deliver better value for money for customers. In particular, the incentives need to be rebalanced to focus much more on incentives for better quality and more accurate forecasts from DNOs.
32. The development of robust output measures offers the longer term prospect of much better accountability for DNO capex, so customers can be confident they are receiving value for money. In the shorter term Ofgem needs to be careful to strike a reasonable balance between some financial incentives on DNOs to develop robust output measures and not providing excessive rewards for something that well run DNOs should be doing anyway.

Pensions

33. During Ofgem's recent Pension Principles review, we set out (with supporting evidence from Watson Wyatt) why there are good reasons to believe that network pension costs are not being managed efficiently. The gap between network and commercial company pension schemes is widening all the time as non-regulated companies continue to make progress in facing up to, and addressing, the complex issues involved in reducing pension cost exposures. Our conclusion was that, whilst a robust incentive scheme may take some

time to develop, it is essential not to miss the opportunity to make progress during the current price control review.

34. We are therefore disappointed to see that little progress has been made since the consultation was completed, and to note from your policy paper that the Pension Principles are seen to be generally working well. We see no evidence for this. Our view is that some proper disciplines must be put in place as soon as possible to make network owners more accountable for managing their pension costs effectively.
35. We note that you have recently requested questionnaires from the network owners to obtain detailed information on the status of their defined benefit pension schemes. We have supported this process by voluntarily providing questionnaires of our own defined benefit schemes for comparative purposes. If the information you have collected indicates that electricity distribution network owners are not managing their pension costs as efficiently as they would do if they faced the pressures of a competitive market, then we believe the case for action in this price control is compelling.

Stakeholder Engagement

36. We look forward to continue being an active contributor to this price control process. While we welcome in principle the development of the Expert Consumer Panel for this price control review, we are concerned that there is very limited visibility to us and other stakeholders about the approach and analysis being undertaken by this group. Indeed it is unclear to us what resources if any this group has to undertake analysis or gather evidence to challenge the views of DNOs or Ofgem. We note that we would like the opportunity that the DNOs and the Expert Consumer Panel are being given to meet with the Authority and its relevant sub-committee at various stages of the review. As you may be aware, we were given this opportunity during the gas distribution price control review. As the only large independent supplier without a network business, we believe the Authority will not be able to find any other independent perspective that is as well-informed and considered as ours.

Structure of our response

37. We have organised the rest of this response into a number of separate appendices that discuss specific issues raised by Ofgem's consultation. These are:
 - **Appendix 1: Returns Under Incentives** – this provides our perspective on the returns achieved by DNOs through the incentive mechanisms in DPCR4 and considers the appropriate expected value and distribution of returns under incentives for DPCR5.
 - **Appendix 2: Dealing with Uncertainty** – this sets out our view of the appropriate approach to dealing with the perceived potentially high degree of uncertainty around cost factors in DPCR5.
 - **Appendix 3: Approach to Setting the WACC** – sets out our view on dealing with uncertainty and sets out our preferred approach to setting the WACC in

the light of the dislocation in and continued uncertainty around the future direction of financial markets.

- **Appendix 4:** Distribution Losses Incentive – provides specific commentary on the distribution losses incentive, including the impact of different approaches to setting a target under an output-based approach.
- **Appendix 5:** Capex Incentives – this provides specific commentary on the IQI mechanism, and suggests specific adjustments to this mechanism for DPCR5.

The appendices have been prepared for us by CEPA.

We hope you agree that the papers we have submitted as part of this response are a constructive contribution to the process. Should you wish to discuss any of the points raised in more detail, please contact either Ann Donovan or myself.

Yours sincerely

Philip Davies
Director of Regulatory Affairs