

Centrica's Response to Ofgem's Methodology and Initial Results paper

Summary of key points

1. Electricity distribution charges are our largest area of cost after commodity costs, with our annual bill being around £700 million (over £3 billion over DPCR4). We do not own any distribution networks and therefore provide an unconflicted view, focused on ensuring that the rewards the networks earn properly reflect the risks they take and the performance they deliver.
2. Overall, we are encouraged by the work Ofgem has undertaken since December, including the development of methods for benchmarking DNO capex and opex forecasts (which reveal substantial differences between the DNOs), as well as further developments to improve the predictability of network charges. However, we believe significant further work is needed in a number of areas that are of critical importance for customers.
3. We are concerned by the unprecedented increases in capex and opex that have been proposed by DNOs. These increases lack sufficient justification in most instances, and are based on unrealistic views of the future macroeconomic outlook. The forecast asset replacement costs of £3.8billion in DPCR5 in particular seem excessive.
4. Nevertheless, we are encouraged that Ofgem is closely analysing the DNO forecasts, and it is important that Ofgem uses the results of the benchmarking analysis to make substantial reductions in expenditure plans for those DNOs shown to be inefficient. It is clear that Ofgem's analysis of opex bids highlights significant scope for savings. We calculate that these could deliver over £1billion in savings to customers over DPCR5¹.
5. We are encouraged by Ofgem's proposal to investigate the use of "logging up" for re-openers and other measures to address risk in DPCR5, which increase the predictability of charges. We believe the pass-through of risks to customers should be limited to where the management of these risks by the DNOs would otherwise incur a substantial risk premium.
6. A new process is needed for reopeners to make charges more visible and predictable. Other risks not covered by specific pass-through

¹Setting the efficiency of the DNOs to be equal to at least that of the fourth best performing DNO would save £1,024million. DNOs have forecast a total increase in opex of £1.044million from DPCR4 levels.

mechanisms should be captured by a single general re-opener (that treats risks on a net basis, and is symmetric in that it can be activated by suppliers as well as DNOs).

7. We urge Ofgem to maintain a focus on delivering a settlement that is an appropriate balance between risk, reward and performance. This means ensuring incentive targets, such as for IQI and losses, are stretching, and that only DNOs that genuinely outperform should earn returns greater than the cost of capital. We do not believe the IQI incentive should be extended to opex until it has been shown to be sufficiently robust.
8. We are concerned that there appears to have been little progress on the important issue of pensions. The ORR's treatment of pension costs as an operating cost, and Ofcom's policy of providing a zero allowance for pension deficit repair provide examples of other UK regulators taking active steps to protect customers.
9. Finally, we realise cost of capital will be an important focus for Initial Proposals. Current financial market conditions mean a new approach is needed for cost of capital. We urge Ofgem to introduce a trigger mechanism for an indexed cost of new debt to mitigate the risk of unstable financial markets on DNOs and allow removal of "headroom" in setting an overall level of WACC.

Introduction

10. We set out our more detailed comments in the following sections:
 - Cost outlook to 2015;
 - Managing uncertainty;
 - Balancing risk, reward and performance of the networks; and
 - Output measures.
11. We conclude by presenting our views on two areas in which we are hoping Ofgem will have made significant progress in time for Initial Proposals; the treatment of pension costs, and cost of capital.

Cost outlook to 2015

12. The scale of the increase in charges implied by DNO capex forecasts is unprecedented. Since the capex/opex numbers themselves would, according to Ofgem, imply a 12% increase in charges, it is reasonable to assume the total of DNO bids is in the region of 15-25%. It is essential that Ofgem scrutinises carefully whether all of the business plans submitted by DNOs represent value for money for customers.

13. Centrica supports investment necessary to deliver good quality networks that are fit for purpose for the future, but we are concerned that the DNOs have submitted plans which over-estimate the required expenditure, and without indicating clearly what benefits customers will receive.
14. While there is much welcome analysis in Ofgem's document, we remain unclear as to the key drivers of many of the proposed expenditure increases. With customers being largely satisfied with network performance, it is unclear what improvements are to be delivered by the asset replacement expenditure or what future deterioration in service is being prevented. The proposed expenditure increases for general reinforcement and real price effects both seem questionable given current macroeconomic conditions and initiatives to increase energy efficiency. We would strongly encourage Ofgem to consider whether for many of the key inputs for DNOs, including steel and copper, the forecasts from DNOs reasonably reflect the macroeconomic situation.
15. We discuss in more detail below individual aspects of the expenditure, but we would strongly encourage Ofgem to challenge vigorously the proposed expenditure by the DNOs, and to take a tough line in its Initial Proposals. We also ask Ofgem to bear in mind that analysis for Ofgem's RPI-X@20 project shows that DNOs are the only group of companies (who are subject to Ofgem price controls) that have underspent capex allowances at every control since 1990, despite benefiting from higher charges corresponding to their allowances². This suggests DNOs have often overbid capex requirements, and that the initial bids made in the February forecasts should be viewed with caution. We therefore welcome the indication in Ofgem's consultation that evidence of past performance will be a factor in determining the revenue allowances.

Network investment

16. We find it very hard to understand why the DNOs are proposing collectively a 44% increase in load related expenditure for DPCR5 compared to DPCR4 outturn levels.³ Given the accepted link between electricity demand and indicators of macroeconomic performance such as GDP⁴, the proposed increase suggests either that DNOs have taken

² Performance of the Energy Networks under RPI-X, Ofgem, February 2009

³ As the DPCR4 outturn value includes forecasts for the final two years of the control period, we also note that this forecast may be optimistic if it does not fully factor in the impact of the macroeconomic downturn.

⁴ See the report by CEPA published by Ofgem showing strong correlations between the level of GDP growth and electricity demand.

a very optimistic view of future macroeconomic performance or that forecast expenditure is inefficient⁵.

17. It is difficult from the information available for us to review robustly the appropriateness of the load related expenditure projections. However, the indications Ofgem provides of DNO's forecasts for future demand levels suggests that DNOs take wildly varying views of demand in coming years (with some forecasting major falls between 2008/09 and 2010/11, and others forecasting increases over the same period). While some regional variation in demand forecasts could be expected, the extent of these variations suggests that there are fundamental differences in DNOs' views of the underlying drivers of demand in coming years.
18. We suggest that the load-related element of the capex allowance for the DNOs is therefore set on the basis of demand forecasts that are independently verified, and prepared on the basis of consistent assumptions. In particular, we would ask Ofgem to consider whether DNO forecasts for load related expenditure are consistent with expected demand reductions from energy efficiency schemes and the introduction of smart metering. As a minimum, we would expect Ofgem to review the historical performance of DNOs in forecasting demand at price control reviews, and place greater reliance on those DNOs with a proven track record of good quality forecasting.
19. The DNOs are also proposing a 33% increase in asset replacement expenditure – an increase of nearly £1billion over DPCR4 outturn levels to a total of £3.8billion. We are clearly supportive of DNOs being sufficiently funded to maintain good quality networks. However, the submissions we have seen provide little or no justification for this large proposed increase. Taking a simple “straight line” approach to depreciation of the RAB, we would expect an asset replacement need of around £1.6billion over DPCR5 for all DNOs (even when using a relatively conservative average asset life of 50 years)⁶. We recognise that the required profile of investment over time may not be smooth. However we have seen no evidence to suggest this justifies a level of asset replacement that is more than double the level we might have expected.

⁵ Analysts agree that in 2009 the UK economy is experiencing its most severe recession since the 1930s. The median market forecast as of May is for a 2.9% contraction in GDP this year. This would be the largest decline in GDP on record (ONS figures on its website go back to 1955) and would dwarf the recessions of the early nineties (1.3% decline in GDP during 1991) and early eighties (a 2.1% decline in 1980).

⁶Regulatory accounts assume network assets have lives of between 40 and 60 years.

20. This is particularly the case in light of data presented in the May document which suggests that the lives of assets in over 66% of DNO asset categories have actually *increased* compared to DPCR4 (at an average increase of over 5 years)⁷. Ofgem should therefore be sceptical of allowing substantial increases in asset replacement expenditure until there are clear output measures that show what benefits in improved or maintained network quality the expenditure will deliver.
21. Finally, even in the event Ofgem finds the large increases in capex proposed by the DNOs to be justified, we question whether DNOs have the capability to deliver the increased expenditure they are proposing. In DPCR4, for example, the DNOs have been extremely slow to scale-up expenditure. We note in particular that Ofgem has calculated actual DPCR4 outturn capex for all DNOs is £4.8billion which is over 25% below the £6.5billion they have been allowed⁸.
22. We share the concerns set out in Ofgem's RPI-X@20 documentation that DNOs have historically treated capex allowances as budgets within which their spending must be confined⁹. It is therefore important that customers should not be required to pay upfront for expenditure allowances the DNOs are unable (or unwilling) to deliver. We therefore urge Ofgem to view the large increases in capex forecast by the DNOs with caution, and use the track record of particular DNOs when assessing claims they would achieve such a large ramp-up in expenditure.

Operational activities

23. We welcome the chance to review the results of Ofgem's initial benchmarking analysis at this early stage in DPCR5. We find this analysis striking in that it clearly shows a wide range of performance between the DNOs in terms of their operating expenditure.
24. Despite the view often expressed that the scope for efficiency savings has been exhausted through twenty years of price regulation, it is clear from this analysis that there remains significant scope for some companies to improve their operating efficiency.

⁷ Analysis of "difference between DNO forecast and DNO actual lives" data in Appendix 7 of the May document indicates that assets in 66.8% of DNO asset categories have shown an increase in asset life over that forecast for DPCR4 (at an average increase of 5.4 years). For the remaining 33.2% of asset categories, asset lives have fallen by an average of 4.7 years.

⁸ DNOs were allowed a total of £5.734billion for network investment in DPCR4 (£6.738billion in 2007/08 prices). DPCR4 outturn data presented by Ofgem in the May document was £4.761billion (also in 2007/08 prices), calculated using actual expenditure for the first three years of the control and forecast data for the remaining two years.

⁹ Regulating Energy Networks for the Future: RPI-X@20, History of Energy Network Regulation, Ofgem, February 2009, page 44.

25. Although we recognise that Ofgem's analysis is at a relatively early stage, we have used the initial results presented in the May document to estimate the significance of the opex efficiency savings that may be available in DPCR5. Our analysis suggests that, under certain assumptions, the efficiency savings available to customers if applied to the total opex forecasts of the DNOs¹⁰ may be in excess of £1billion (or 12% of total opex)¹¹. We estimate that these savings alone may reduce customer bills by around £4 per annum, representing almost a quarter of the total increase in cost forecast by DNOs in DPCR5.
26. The large difference between the most and least efficient companies also further underlines that there remains a significant range of performance across the networks. As such, we think it right that the poorest performing companies should not automatically be able to earn their cost of capital. Instead, cost of capital should be calibrated such that it is only earned by an average performer.
27. Ofgem reports that DNOs are seeking £261m of network workforce renewal costs for DPCR5, compared to a forecast of £87m for DPCR4. Ofgem reports that workforce renewal costs cover both replacing existing workers and increasing staff to deliver the forecast higher expenditure. While we recognise that any reasonably well run business will incur some staff replacement and training costs, we find it hard to believe that the DNOs could not have anticipated – and addressed – the impact of an ageing workforce at an earlier stage. Any commercial business in a competitive market would either have taken steps to change the profile of its workforce or would seek to find savings in other costs to remain competitive. We therefore do not think it is appropriate for customers to pay for any additional expenditure incurred by the DNOs resulting from their failure to plan their future staffing requirements efficiently.
28. Aside from workforce renewal effects, it seems a significant proportion of forecast opex costs in DPCR5 (over £0.5billion) results from DNO assumed levels of real input price inflation. From the data presented by Ofgem, it seems DNO assumptions of the level of input price inflation are significantly higher than those prepared by the independent analysis commissioned by Ofgem¹². We welcome

¹⁰We recognise that the benchmarking did not apply to total opex, but we believe it is a fair assumption that a similar scope for efficiency gains exists across all opex categories.

¹¹This analysis assumes all DNOs are required to be at least as efficient as the fourth best performing DNO (i.e. WPD S West in Ofgem's analysis). Reducing costs of the 10 remaining DNOs to this level of performance would lead to a saving of £1,024million. Note if all DNOs were only required to meet an efficiency level of 100% (i.e. equal to Ofgem's modelled cost level), then this would still result in cost savings of £379million.

¹²Average opex input price inflation forecasts from the December 2008 First Economics paper are 1.53% over 2009/10 – 2014/15. The average real price effects estimated by CEPA are

Ofgem's intention to review this evidence in detail, and urge Ofgem to apply more realistic price inflation assumptions in Initial Proposals.

29. Finally, we note that DNOs state that a major driver of their increased staffing costs is the large proposed increase in capex. We would therefore expect Ofgem to reduce DNO proposals for staffing costs to reflect any reductions Ofgem makes to DNOs proposals for capex.

Managing uncertainty

30. Ofgem reiterates that managing risk is an important theme for DPCR5, and that uncertainty should be managed by those parties that are best placed to influence outcomes. We agree with this view, and continue to believe that customers will tend to gain the best value outcome from this review if networks retain those risks that they are most able to control, and which they can reasonably be expected to manage at lowest cost. As such, DNOs tend to be better placed than suppliers in managing most network-related risks, given their experience and knowledge of network operation.
31. We therefore welcome a number of Ofgem's latest views, particularly the decision to reduce the number of complex risk instruments being considered, and the intent to apply risk mitigation to only a small number of very specific risks.
32. Pass-through of risk to customers should only be allowed if:
- DNOs would otherwise charge a high risk premium for retaining that risk; and
 - the way in which the pass-through is implemented is very transparent (allowing suppliers to be able to understand the charging implications of specific outcomes).
33. This approach will minimise the extent to which the supply market is distorted by the need for suppliers to take a view on their future network costs based on uncertain information what those costs will be.
34. We support the use of a general type of reopener mechanism as a complement to a small number of risk measures. However, the trigger for such a reopener must be set at a sufficiently high level to encourage networks to take full ownership of the risks they face. Such a reopener should also take account of the offsetting nature of many of the risks facing DNOs, with reopeners applying to the *net* outturn of risks facing them across the price control as a whole. This is a fairer way of

significantly below this level in both the "optimistic" and "prolonged crisis" scenarios (at 0.9% and 0.6% respectively), although are marginally higher in the "deflation trap" scenario in which GDP is assumed to contract for three successive years.

mitigating risk than a mechanism in which DNOs are able to “cherry pick” reopeners for adverse events, while allowing DNOs to enjoy the windfall gains of those risks that outturn in their favour¹³.

35. We can understand why number of connections, uncontrollable costs and corporation tax costs would be selected as specific risks to be passed-through to customers. However, unlike these other risks, DNOs appear to be much better-placed than customers to take a view on their required level of general reinforcement costs. Ofgem and DNOs therefore need to explain why any form of pass-through in this area is appropriate, as we think DNOs are better-placed to manage this risk.
36. We do believe that a trigger mechanism is warranted for the cost of new debt. We are disappointed to see no update on policy in this area in this document, and set out our latest views on this issue later in this response.
37. Finally, we welcome Ofgem’s recognition that volatility and predictability of allowed revenues is a very important issue for suppliers and customers. We strongly support Ofgem’s proposal that the use of logging up helps to minimise volatility and increase predictability in network charges, and agree that such a policy would be very helpful in reducing the impact on suppliers and customers of any revenue adjustments that may arise during DPCR5.

Balancing risk, reward and performance of the networks

38. Ensuring that an appropriate balance is struck between the risk allocated to DNOs, the rewards they receive and the performance they are expected to deliver should remain a priority for DPCR5. As you are aware from our previous response, we have concerns that price controls have systematically over-rewarded DNOs in the past, with Ofgem’s own data forecasting that all DNOs except one will outperform the current price control settlement. This is despite performance of the networks often failing to justify these returns¹⁴.
39. Achieving this balance means recognising that, should the level of risk we ask DNOs to take be reduced in part of the price control, then we would expect a similar reduction in the level of rewards that the DNOs can expect to earn. For this reason we welcome Ofgem’s statement that in developing Initial Proposals, an appropriate balance will be

¹³A suitable model for such a mechanism could be that used in the postal sector, where Royal Mail is allowed to seek a re-opening of the price control if it satisfies certain requirements regarding the significance of additional costs it is facing and its overall financial position.

¹⁴For example, in a period when distribution losses have increased, ten of the DNOs have a contribution to out-performance from the losses incentive.

struck between the level of risk mitigation provided to networks, and the allowed return on capital built into the settlement

40. Incentives are another area where it is particularly important to ensure that a fair balance is achieved between risk and reward. One clear way that this can be achieved is for Ofgem to ensure that, in return for an appropriate cost of capital, DNOs should only receive – on average – an expected value of zero from incentive schemes across all DNOs. This means that the best performing DNOs would be able to earn positive returns (and therefore an increase in overall returns), while below average performers would earn reduced returns. Although we have made this point in previous responses, Ofgem has not yet confirmed that this is way in which incentives and cost of capital will be calibrated, and the approach to IQI proposed in the consultation appears unlikely to lead to this outcome. We hope that this will be addressed in Initial Proposals.¹⁵
41. One specific area where we would urge Ofgem to apply this principle is the Information Quality Incentive (IQI). Although the current IQI mechanism delivered some limited reductions in “over bidding” by some DNOs in DPCR4, DNOs have made gains of £222m from this incentive in the first three years of the control. Without any clear evidence that these gains will be fully offset by high levels of DNO capex in the remaining two years of the control, this suggests the parameters of the existing incentive need to be adjusted significantly for DPCR5.
42. While we support the concept of IQI, we believe that that the parameters of the incentive need to be substantially changed to deliver better value for money for customers. We are therefore concerned that Ofgem is proposing to use the parameters from the GDPCR (which are only slightly tighter than for EDPCR) without any further adjustments to limit the problem of over-bidding by DNOs. The incentive needs to be rebalanced to focus much more on incentives for better quality and more accurate forecasts from DNOs. On the basis of the current proposals, we expect that the DNOs will continue to bid conservatively as the best response to the incentives offered by Ofgem.
43. We recognise the benefits in principle of equalising incentives across both capex and opex, although Ofgem has provided little practical evidence of examples where DNOs have engaged in inefficient behaviour as a result of the differential incentives. However, we do not

¹⁵We have previously accepted that there may be circumstances in which an incentive could be set with a positive expected value, but were Ofgem to adopt this approach we consider that it should state this explicitly, and explain how it has taken this into account when setting the cost of capital.

think that extending the IQI to include opex while concerns remain over the effective operation of the IQI incentive will represent a good deal for customers. We urge Ofgem to delay the extension of IQI to opex until it is clear that concerns over DNO over-bidding have been properly addressed.

Output measures

44. Robust output measures are likely to lead to major long-term benefits to customers. By rewarding networks on the basis of the outputs they deliver, the DNOs should focus more directly on the aspects of service delivery that customers truly value. An output based regime will also make networks more accountable for the costs they incur, meaning customers can be more certain that they are getting value for money.
45. We are therefore supportive of the progress Ofgem has made since December in developing measures of DNO outputs. It is clear that the output measures are at an early stage of development, therefore it is not appropriate to link these to significant levels of funding in DPCR5. However, we are encouraged that DNOs are committed to developing robust output measures on a consistent basis, with an ultimate aim of benchmarking the output-based performance of DNOs.
46. For the monitoring of output measures in DPCR5 to be a meaningful exercise, we would encourage Ofgem to develop stretching targets for the output measures that are developed. Even in the absence of a link between funding and the achievement of output-based targets, this will help networks to focus more effectively on network performance. Meaningful targets will also be key to building confidence in the robustness of output measures – critical to expanding the role of such measures in future controls.

Looking ahead to Initial Proposals

47. We are disappointed that Ofgem, while reporting on progress on a range of policy issues, does not offer any further indication of its latest thinking on two issues that are of key importance to customers given their materiality; pensions and the cost of capital.
48. This is particularly the case regarding pensions, in which the current policy of allowing a pass-through of efficiently incurred costs is amongst the most generous of any regulated industry.
49. In developing Initial Proposals, we therefore urge Ofgem to consider the precedents being set by other regulators, where the use of ex ante incentives on the pension costs of regulated companies is increasingly common. In particular, we note that ORR's treatment of pension costs

as an operating cost provides a strong incentive to limit cost increases. We also note that both Ofcom and Ofwat have limited allowances for pension deficit repair (with Ofcom allowing no pension deficit repair and Ofwat allowing 50%). Adopting Ofcom's policy deficit repair alone would have created customer benefit of over £700million over DPCR4¹⁶.

50. Regarding cost of capital, we are encouraged to see that Ofgem is still considering the use of indexation to mitigate the risk of unstable financial markets on DNOs. Combined with suitable triggers, we believe this approach will represent a better deal for customers than the traditional 'headroom' approach (in which WACC is set above actual levels to protect DNOs from significant movements in the cost of new debt). This is particularly the case given the continued uncertainty over the direction and stability of financial markets for the coming control period.

¹⁶November 2004 Final Proposals for DPCR4 show total deficit funding for DNOs per annum of £122.7m (equivalent to £144m per annum in 2007/08 prices). This estimate could also be viewed as being conservative, in that it takes no account of the recent falls in equity markets.