

Centrica's Response to Ofgem's Electricity Distribution Price Control Review Initial Proposals

Summary

1. Network charges are an increasingly important area of cost for British Gas, with our customers paying over £700million per year in electricity distribution charges alone (representing around 15% of domestic customer electricity bills). The increases in network charges set out in the Initial Proposals also come at a time of continued concern about the prices customers face. British Gas is committed to ensuring that our customers get the best value for money from the services we provide. As a consequence, while we recognise the need for investment in the distribution networks, we place a high importance on ensuring that network charges do not increase in DPCR5 any more than is necessary.
2. In addition, we are unique in the UK energy market in being the only major supplier not to have any network interests in GB or Europe. This means that we are the only supplier able to provide a genuinely unconflicted view on the Initial Proposals.
3. The DPCR5 Initial Proposals come at a time of great uncertainty for network charges. In April 2010, customers will face price changes resulting from both the new price control settlement, as well as changes proposed by the networks in introducing a common charging methodology. Based on these proposals, the price control changes alone – representing an increase in allowed revenues of nearly £3.5billion over five years – will lead to an average increase in charges of 12% for customers in April 2010. In some locations this increase will be as high as 23%¹.
4. The scale of these increases is unprecedented, and come at a particularly difficult time for many of our customers. These large proposed increases also compare unfavourably to other comparable sectors. For example, in water it is proposed that consumers will see average household water and sewerage bills *reduced* by around four per cent over the same period (despite the water networks having similarly large requirements for capital expenditure over the next five years).
5. A further concern is the extent of uncertainty surrounding the proposed charges. Unpredictable and volatile charges place a costly strain on customers and suppliers alike. We therefore hope that proposals to

¹ This increase is expected in SP Manweb's region in April 2010

limit the impact of any reopeners during DPCR5 on customers' charges (through "logging up" proposals) will be developed further in the coming months and introduced as part of Final Proposals.

6. As key decisions remain to be taken on the issues of cost of capital and treatment of pensions, it is difficult to assess whether the Initial Proposals represent a good deal for customers.
7. One of the most important decisions to be made in DPCR5 is the choice of cost of capital for the DNOs. As you are aware from our previous responses, we believe that the approach that represents best value for customers is one in which DNOs would be allowed a cost of debt that is indexed rather than determined in December for the next 5 years (combined with a simple "trigger" mechanism). This would avoid the need to adopt a "headroom" approach to setting cost of capital, from which networks have historically received generous returns.
8. However, as it seems likely that the existing approach to setting cost of capital will be retained for DPCR5, we have commissioned a study from CEPA that sets out a fair range for the vanilla WACC (and supporting parameters) for the distribution networks. CEPA concludes that the appropriate range for the vanilla WACC in DPCR5 is from 4.6% to 4.9%. This is based upon a rigorous assessment of recent relevant regulatory decisions and market evidence. The complete report is appended to this paper.
9. A further decision that will have an important bearing on whether DPCR5 as a whole represents value for money for customers will be the treatment of pension costs. We have submitted a separate response on this issue, so do not cover this area in any detail here. However, it is important to reiterate that we do not believe that retaining the current "pass-through" approach to managing pension costs is a tenable model for DPCR5. We believe customers will benefit significantly from placing clear financial incentives on energy network owners to manage pension costs (through setting ex ante allowances). This will make energy more consistent with precedents set in other regulated industries. This approach must be implemented by setting challenging targets for pension costs, based on relevant comparators in the private sector.
10. We are encouraged by some elements of the proposals. In particular, the focus on use of RORE as an overarching method of setting the control, and the stated importance of ensuring that incentives deliver better value for money for customers than in DPCR4. Some elements of the benchmarking proposals for operating and capital expenditure are also valuable – if only in revealing the degree of difference in performance between companies, and therefore the scope for more

stretching targets that can deliver value for customers. It therefore seems to be a missed opportunity to only require DNOs to be required to meet average levels of opex efficiency, rather than at least upper quartile levels, which would seem to be more consistent with delivering value for customers, and which would be an appropriate response to the large differences in performance between the companies.

11. The relatively generous treatment of DNOs in opex benchmarking is also difficult to understand in the context of other decisions which seem to give DNOs the benefit of the doubt. For example, allowing DNOs significant real price increases for opex and allowing DNOs to receive the median level of capex unit costs (as opposed to levels achieved by upper quartile performers) does not seem consistent with giving DNOs a clear message that continued inefficiencies in network service delivery will not be tolerated.
12. British Gas is committed to the development of a sustainable energy sector, and as such we are supportive of the Low Carbon Network fund in principle. We believe that the proposed amount of funding allocated to the fund is sufficient. We agree that networks need to undertake some innovation on network assets to deliver a low carbon economy (e.g. on smart grids), and because of this we support the propose fund in principle. However, to deliver value for customers, we believe the innovation delivered by networks should be clearly delineated from that which is undertaken by suppliers (e.g. smart meters).
13. Overall, we believe DPCR5 will only represent a fair deal for customers if the relatively generous treatment of DNOs on some key policy areas in Initial Proposals is properly reflected in Ofgem's final proposals for cost of capital, pensions, and in the overall calibration of the settlement.

Introduction

14. We set out our more detailed comments in the following sections:
 - Cost of capital;
 - Pensions;
 - Proposed allowed revenues;
 - Uncertainty in DPCR5;
 - Incentives; and
 - Funding for low carbon initiatives.

Cost of capital

15. Ofgem's final decision on the allowed level of WACC is extremely material to customers. The range of vanilla WACC set out in the Initial Proposals (of 3.5% to 5.6%) represents a potential range of cost to customers of around £2billion over DPCR5.
16. Setting the WACC is particularly complex for DPCR5, given the dislocation in financial markets following the onset of the credit crunch in 2007 and the increased uncertainty over the likely cost of funding for new investments in DPCR5. It was in response to this uncertainty – and the lack of practical risk mitigation tools available to the DNOs in this area – that led us to propose the use of a trigger mechanism on cost of new debt. We still believe that the concept of a trigger around a defined cost of debt band represents the best value approach for customers, and a low risk solution for the DNOs.
17. Fundamentally, we do not agree that a trigger mechanism would be complex to introduce. The key elements of setting such a mechanism would involve selecting an appropriate index for new debt and setting caps / collars for the rate, together with logging-up. In principle, such policy decisions are no more complex than the calibration of a standard incentive – and arguably significantly less complex than the more elaborate IQI mechanism which we note has been extended in scope in DPCR5.
18. However, while we believe this is a missed opportunity for DPCR5, we recognise that Ofgem intends to develop this concept further through the RPI-X@20 review. We will be happy to continue to provide input on this issue through that process.
19. Given Ofgem's intent to continue with the existing long-term average approach to setting the cost of capital, we believe it is important that DNOs do not receive an unduly generous "headroom" of cost of capital in Final Proposals. To help inform the debate over the appropriate level of WACC under the historical average approach, we have commissioned a paper from CEPA. This paper is careful to separate the cost of embedded debt (much of which will have been incurred at historically low rates) from new debt, and we believe that Ofgem should explicitly follow such an approach. The CEPA report concludes that an appropriate value for the Vanilla WACC, based primarily on market evidence, is a range of 4.6% - 4.9%. We believe market evidence indicates a point estimate towards the lower end of this range.
20. Some of the key reasons driving this headline range are:
 - the weighted average cost of embedded and new debt should lie in the range 3.3% to 3.6%, given that risk-free rates are extremely low

and are expected to stay low, and debt premia now appear to be settling down for investment grade utilities;

- the cost of equity should lie in the range 6.5 – 7.1% given that risk free rates have fallen, there is no clear evidence that the equity risk premium has increased above 5% at the top end, and that there is substantial evidence that the equity beta is no more than one; and
- a range of 60% to 62.5% is recommended for gearing, and there is no evidence that Ofgem should reduce notional gearing from its most recent decision in GDPCR of 62.5%.

Pensions

21. Given the materiality of pension costs to the DNOs, it is clear that the policy adopted by Ofgem in this area will be of critical importance to setting DPCR5 Final Proposals.

22. While our detailed points are included in our separate submission on the pensions consultation, we note the following key points relevant to DPCR5 in the context of Initial Proposals:

- we welcome the acknowledgment that current pension cost treatment is equivalent to a pass through of cost to customers. Given this, we do not believe the current pensions policy places the correct incentives on networks to mitigate these costs;
- we agree that it is important to determine the treatment of pensions costs in the context of the wider control – and recognise the need to fully reflect the pensions treatment in the overall calibration of RORE;
- however, we have found no evidence of a clear link between regulatory treatment of pension costs and allowed cost of capital (and there is little evidence that customers have benefited historically from a lower cost of capital as a result of customers bearing all the exposure associated with pension costs).

23. Overall, we believe the model that would deliver the most benefit to customers would be one in which pension costs are treated as any other category of operating costs (similar to the framework currently in place for the treatment of Network Rail's pension costs). Setting an overall allowance for employee remuneration would allow the network companies the freedom to apportion funds between wages and pensions as they choose after discussions with employee representatives. In turn, this would be likely to deliver the greatest efficiency gains – and ultimately benefits to customers.

Proposed allowed revenues

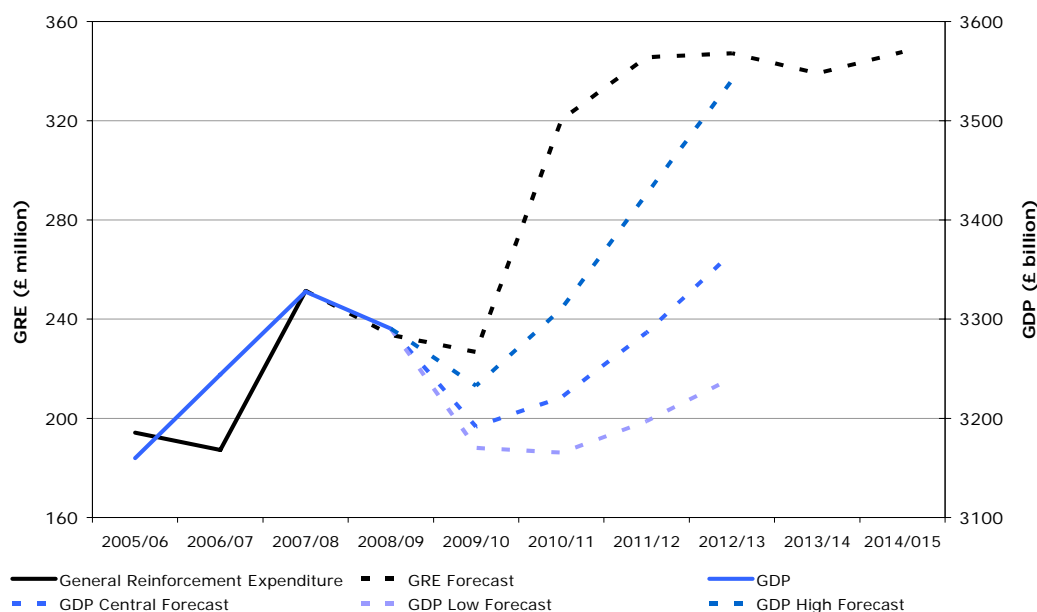
24. It is apparent from the Initial Proposals that Ofgem and its consultants have analysed the capex and opex submissions of the DNOs in more detail than in any previous control. This is welcome – given no other party has access to the DNO data or business strategy documents to enable them to make this assessment. As such we have focused our review of the proposals on a top-down assessment of whether the allowances seem sensible and consistent.
25. Overall, we believe the proposals fail to give the DNOs a clear signal that inefficiencies in network operation will not be tolerated. After 20 years of RPI-X regulation, we believe this is a serious shortcoming of the proposals. We set out our views in more detail in the remainder of this section.

Volume of capex

26. In our response to Initial Results we raised a number of concerns over the level of capex requested by the networks. Our main comment at the time was that no case had properly been made that such an increase was warranted, particularly in light of asset life data which suggested no obvious need for a replacement programme significantly above that implied by “straight line” depreciation assumptions. We continue to hold this view, and find it disappointing that further discussion of actual asset lives of network assets as a driver of capex allowances was not provided in the Initial Proposals.
27. We also note that the networks have been allowed over £1.3 billion for general reinforcement expenditure in DPCR5 (an increase of over £200 million over DPCR4). General reinforcement expenditure should correspond to the expected growth of electricity demand. Given the weak prospects for demand growth over DPCR5, we do not understand why such a large allowance has been suggested in Initial Proposals.
28. We understand networks are suggesting that a number of local “hotspots” in demand are responsible for this proposed increase in the need for reinforcement. However, in the face of weakening macroeconomic demand, it is difficult to understand why local effects could have anything other than a marginal effect on reinforcement expenditure. Such effects would certainly not be expected to lead to costs to customers of over £1.3 billion over DPCR5. This raises a real concern that companies are being given substantial sums of money for projects that should have been undertaken in previous price control reviews, but were not (which if this is the case would be unacceptable).
29. To illustrate this point, we have undertaken some simple analysis to illustrate how inconsistent the reinforcement expenditure proposals of

the networks are with views on macroeconomic growth forecasts. In Figure 1, we show a simple plot of general reinforcement expenditure and the current range of HM Treasury forecasts for GDP.

Figure 1: Plot of general Reinforcement Expenditure and GDP²



30. Over the period 1992/3-2007/8, on average for the 14 DNOs, total electricity demand has shared a correlation of 0.93 with the level of GDP. This explains the relatively close mapping of general reinforcement expenditure to GDP in the first section of Figure 1. However, in DPCR5, it is clear that the range of reinforcement expenditure is well in excess of a level that would be implied by even the most optimistic of HM Treasury forecasts.

31. We would be happy to share details of this analysis with Ofgem if that would be helpful. However, we continue to believe that reinforcement expenditure is an area where the proposals of the electricity networks seem excessive. No evidence has been presented in Initial Proposals that suggests that this is not the case.

Volume of opex

32. The benchmarking analysis undertaken on DNO opex has uncovered some extremely large differences in levels of DNO efficiency. It is clear that – even after 20 years of RPI-X regulation – some DNOs are twice as efficient as the worst performers³. Disparities in efficiency such as this would not persist in a properly functioning competitive market, and

² Sources: Ofgem, HM Treasury and CEPA analysis

³ For example, analysis shows that for Network Operational Costs, CN West is more than twice as costly as SSE Hydro, with CN West scoring 135% compared to SSE Hydro's 59%.

shows that historically opex benchmarking has not been sufficiently stretching for the DNOs.

33. While we are encouraged by the thoroughness of the benchmarking exercise undertaken by Ofgem, we are disappointed that Ofgem has not taken the opportunity to require all DNOs to meet a reasonable level of efficiency – such as upper quartile levels – as opposed to only requiring average levels of efficiency are achieved. This policy does not provide a clear enough message that opex inefficiencies will not be tolerated, nor does it represent fair value for customers.
34. We calculate that the cost to customers of the proposed approach over a more standard upper quartile approach is over £300million over DPCR5. To put this into context, the “merger tax” which an existing DNO would be required to pay were it to purchase another DNO group would only be £32million (in 2001/02 prices).
35. We find it difficult to understand why the data submitted by the DNOs should be of such poor quality to mean that the DNOs cannot be required to achieve a minimum of an upper quartile level of performance. If data quality is such a problem, then the responsibility for this should lie with DNOs. Customers should not be required to foot the bill for poor quality DNO data.

Real price effects

36. We strongly support the policy adopted by Ofgem with regard to real price effects in the context of DNO capex allowances. We agree that there is no evidence of the likelihood of real price increases as the networks have suggested. Indeed analysis we have undertaken in levels of real wages supports this view, and shows that wages in the utility sector tend to track significantly lower than other sectors, aside from a short period last year.
37. We believe it is appropriate that the burden of proof should be on the DNOs to provide evidence that significantly positive real price effect assumptions should be made over DPCR5. We would also be happy to share our analysis on wages in the utility sector with you if this would be helpful.
38. We are therefore surprised that in the context of opex, Ofgem proposes to allow *positive* real price effects in the proposals. We do not believe that any compelling evidence has been presented by the DNOs to suggest that positive real price effects will affect opex costs during DPCR5.
39. We consider the stance adopted between capex and opex real price effects is inconsistent, and overly generous to the networks. We

believe that opex real price effects should also be set to zero for the duration of the control.

40. Analysis set out in the consultation document suggests that two DNOs have prepared poorly for DPCR5 workforce renewal costs⁴. Clearly all businesses incur costs of turnover and training. However if a company fails to prepare for a “cliff edge” of staff retiring in a competitive market then it will suffer through lower profits. We therefore believe the DNOs should only be allowed workforce renewal costs that represent a business as usual amount for training and recruitment (plus a scaled amount to recruit for increased capex).

Capex unit costs

41. Finally, we welcome the detailed analysis that Ofgem and its consultants have undertaken of capex unit cost submissions made by the networks in recent months. It is apparent that the range of unit cost submissions made by the DNOs is surprisingly wide. However, we do not believe that the wide range of unit costs submitted by the DNOs warrants a policy of only requiring DNOs to achieve a level of unit costs in DPCR5 at “median” level.
42. We see no compelling reasons why unit costs should not be set at the upper quartile level for all networks. The wide range of cost submissions, in our view, makes it more important that networks have a strong incentive to limit costs to an efficient level. We do not believe that the median cost level is a sufficiently stretching target for the networks to drive efficient cost cutting in this important area.
43. In contrast, we note that Ofwat (the only other UK regulator with such a range of comparators as those open to Ofgem in DPCR5), assumes a 60% catch-up of efficiency gaps.
44. We estimate that, were Ofgem to require all DNOs to achieve unit cost levels consistent with the upper quartile performer, this would be worth £250million to customers over DPCR5.

⁴ Both CE NEDL and CE YEDL incurred workforce renewal costs well below average in DPCR4, and seemingly this has resulted in a large increase in these costs in DPCR5.

Uncertainty in DPCR5

45. The predictability of network charges is a major concern for our business. As set out above, the DPCR5 proposals come at a time of great uncertainty over the level of charges that the DNOs will be levying from April 2010. From this date, the changes resulting from both DPCR5 and the new common distribution charging methodology will impact customers' bills. Our estimates suggest that, while the impact of these increases varies by customer segment and locations, some domestic customers may be facing increases in distribution use of system charges of up to 36%⁵.
46. Given this context, we consider that measures that improve the predictability of charges over DPCR5 are particularly valuable. Whilst ensuring predictability is more important than managing volatility, we also believe that it is important to mitigate front loading of double digit percentage increases in April 2010 as far as possible, given the material impact on customers particularly in the current difficult economic climate.
47. The remainder of this section covers two key considerations:
- Reopeners and logging-up; and
 - Charge profiling

Reopeners and logging-up

48. We see there has been no further discussion in Initial Proposals of the use of "logging up" for re-openers and other measures to address risk in DPCR5, originally introduced in the Initial Results consultation. However, we understand that work is still progressing on this concept, and that further details on how this could be included in Final Proposals and are likely to be included in the October update document.
49. As you are aware, we have previously set out in detail how the uncertainty resulting from reopeners represents a real cost to customers, through the application of risk premia by suppliers.

⁵EdF SPN region, profile class 1 customers.

50. We would be happy to meet with Ofgem ahead of Final Proposals to consider alternative ways in which logging-up could work in a simple and transparent way during DPCR5. While we favour the pure “logging up” model (in which all “reopeners” in DPCR5 are logged and only impact charges during DPCR6 on an NPV neutral basis), we recognise that other models could also bring significant benefits to customers, and would be preferable to the status quo.
51. For example, we would be interested in considering further a model in which mid-control reopeners are restricted to a single “window” in DPCR5 (therefore avoiding the potential for multiple reopeners during the control period). This may be an appropriate compromise between the need for certainty, and financeability concerns of the networks.
52. We do welcome the clarity with which the Initial Proposals set out the charging implications of a selection of events that may arise over DPCR5. We find it particularly helpful to see the inclusion of the impact on RORE of these events.
53. However, while the Initial Proposals set out in some detail the mechanics of incentives, there is little regarding how the revenues from the incentives will feed through into charges. It is extremely important that Ofgem provides certainty about this for all incentives ahead of Final Proposals.

Charge profiling

54. The Initial Proposals describe the charging increases implied by DPCR5 as being a 5.3% average over 2010 to 2015. However, the charges as currently modelled significantly front load these increases, with a 12% movement in April 2010. Furthermore, we note that there is significant regional disparity across networks in this regard. For example, we note that SP Manweb is proposing an increase in charges of 23% in April 2010 (with an average over the entire period of 9%).
55. So long as the profile of charges proposed by each network is NPV neutral, we believe our customers will be financially unaffected by the choice of charging profile over the five year period. However, Ofgem needs to recognise the impact that the proposed network charge increases will have on customers from April 2010. In the current climate, large price increases represent a major burden for our customers – particularly the most vulnerable, and those in fuel poverty. We therefore ask Ofgem to limit such increases as far as is possible.
56. The large proposed increases also compare unfavourably to other comparable sectors. For example, in water (where price controls are also currently being set for 2010 – 2015), it is proposed that consumers will see average household water and sewerage bills *reduced* by

around four per cent by 2015. This is despite requiring the networks to complete an investment programme of nearly £21billion over that period⁶.

57. We also ask Ofgem to confirm that the front-loading of charges proposed by the networks is justified by a genuine expectation that DNOs will be incurring significantly more expenditure in the earlier part of the control than in the latter. We note that in DPCR4, capex has lagged significantly behind planned levels. It is therefore critical that Ofgem has checked that DNOs have credible plans to spend the levels of capex which they have requested. No such assurances are provided in the Initial Proposals as they currently stand.
58. Irrespective of the profile of charges, it is paramount that the charge increases that arise from the combined impact of DPCR5 and CDCM are predictable. Unpredictable network charges place a major burden on suppliers, exposing them to risks that they cannot hedge. We therefore need clarity at as early a stage as possible regarding the extent and profiling of charging increases, through to 2015.
59. To the extent that Ofgem can release such information ahead of Final Proposals, we would ask for confirmation of the proposed profiling approach together with indicative financial impact as soon as possible.

Incentives

60. The Initial Proposals on incentives are of key importance to customers, given that Ofgem's RORE analysis has clearly shown that the overly generous losses incentive in DPCR4 has resulted in excessively large returns on regulatory equity. Given this, we welcome the commitment in the Initial Proposals to consider expected incentive outturn in the overall calibration of the control.
61. We are encouraged that a review of the non-IQI incentives proposed by Ofgem suggests that (based on DPCR4 outturn levels) the DNOs will need to perform materially better than they have done in the past in order to earn positive incentive payments in DPCR5. However, we find it harder to assess whether the proposals relating to the IQI incentive represent a fair deal for customers.
62. As set out in our response to the Initial Results consultation, we maintain that extending the IQI to include opex at a time when we are still assessing how this incentive has operated for capex in DPCR4 represents a significant risk to customers. This complexity has

⁶ http://www.ofwat.gov.uk/pricereview/pr09phase3/prs_pn0309_pr09dd.pdf

increased through the introduction of “fast” and “slow” pots for paying money to DNOs.

63. As we move towards Final Proposals, we therefore expect Ofgem to ensure that the parameters of the IQI can be expected to be sufficiently challenging targets over the duration of DPCR5 to represent an effective incentive on DNOs to deliver significant efficiency improvements in the delivery of capex and opex. We also expect this to be reflected transparently in the overall calibration of the control through the use of RORE.
64. We understand the reasons for equalising incentives for opex and capex under the proposed “totex” approach. While we support this in principle, it will be important to ensure that Ofgem continues to gather information separately for each cost category to enable disaggregated benchmarking ahead of DPCR6. Without this there is a risk of a continued problem with data unreliability which has seemingly limited the scope for robust benchmarking for DPCR5.

Funding for low carbon initiatives

65. Finally, we welcome the focus Ofgem has placed on the need for the DNOs to develop their networks to be consistent with a low carbon economy. We agree that networks need to undertake some innovation on network assets to deliver a low carbon economy (e.g. on smart grids), and because of this we support the proposed fund in principle. However, to deliver value for customers, we believe the innovation delivered by networks should be clearly delineated from that which is undertaken by suppliers (e.g. smart meters).
66. We believe the £500m allocated to the scheme is sufficiently material to ensure the networks will fully participate in the fund. Given the value of the fund is so large, we believe that it is important to ensure that LCN funding is focused on delivering changes that will be most beneficial to customers in the long-term, taking account of changes being introduced across the entire energy supply chain.
67. We believe, in the first instance, the LCN fund would be a useful vehicle for allowing the DNOs to ensure that their network assets, systems and commercial processes are appropriate to maximising network benefits from the supplier-led roll-out of smart meters. To maximise the learnings that can be derived from such trials, we would also welcome the opportunity to work with DNOs in the running of such trials.
68. It may also be worth Ofgem considering whether LCN funding should be available to all market players (including ESCOs, universities,

research organisation and suppliers). Ofgem should specify the areas of innovation in which it would like to see the fund deliver (i.e. innovation that improves the operation and performance of the physical network. However, we do not believe there is a need to specify in advance who needs to be part of any consortium of bidders – even if it is likely in practice that one or more DNOs will be part of most bids in electricity distribution.

69. More generally, we believe the fund can benefit customers in understanding the implications for networks of other significant changes – such as the growth of distributed generation, and microgen (e.g. how DNOs will manage local geographic network management issues relating to the wider uptake of these technologies). Care will need to be taken that in assigning funding, projects are not sponsored that could otherwise be undertaken by competitive businesses (as this could otherwise lead to the “crowding-out” of market driven innovation).
70. As Ofgem recognise in its RPI working paper on innovation, there are good reasons why networks are not as effective as competitive companies at delivering successful innovation. Crowding-out would therefore represent a significant loss to customers.
71. To maximise the expected long-term benefit to customers of LCN funded projects, we suggest that bids for funding are assessed in rigorous detail ahead of funding being granted. We note that there are numerous precedents for clarity in the governance of funding awards, which are relevant to the LCN fund. These include the DTI Technology Programme and the Water Efficiency Award (WEA). The WEA in particular is a useful comparator scheme, as this is an ex post award scheme, which rewards projects on the basis of a set of clear assessment criteria, evaluated by an external panel. In addition, the award is divided in sub-categories, from which is easier to assess the criteria and requirements to obtain the reward. We would be happy to discuss these precedents with Ofgem if that would be helpful.