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Dear Rachel

Consultation on strategy for the next gas distribution price control – RIIO-GD1 Overview Paper

Thank you for the opportunity to comment on Ofgem's open letter regarding the strategy for the gas distribution price control. I can confirm that this response is not confidential and can be published on the Ofgem website.

The key points of our response are as follows:

- We agree that Ofgem has correctly identified the key outputs for RIIO-GD1; however we have concerns with some of the specific output measures being suggested.
- Any output measure should be technology neutral in nature and not favour any particular energy source.
- It should be recognised that there are numerous customers of gas distribution infrastructure, including end consumers. It is important that the interests of generators, shippers, suppliers and end consumers are considered when developing output measures.
- We support the social obligation outputs that Ofgem are suggesting, and believe that further benefits can be realised in this area by the Gas Distribution Networks (GDNs) maintaining a register of priority customers which will be essential on change of supplier.
- Funding arrangements for xoserve should be considered. One option might be to be split its funding out from RIIO-T1 and a separate price control, allowance and recovery mechanism set

The RIIO-GD1 framework has significant implications for our business as it has a direct impact on the costs that our customers face. It is recognised that RIIO-GD1 is being progressed when the long term outlook for gas demand is unclear as the UK looks to move to a low carbon economy in the future. From our perspective key to this is the decarbonisation of domestic heating which will require the electricification of domestic

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heating on the longer term. We are therefore closely tracing these developments to ensure that they complement each other.

Environmental Outputs

We believe that any output measure placed on the network owners should be technology neutral. The role of Government is to set the policy objectives for the UK, including which technologies are directly supported and those which are not. It is the role of Ofgem to ensure that these policy objectives are implemented and the role of the network owners to provide the required infrastructure to support the energy sources which need to connect to it. Any technology specific incentives run the risk that they interfere with Government policy, or create a further cross subsidy that increases costs to consumers with limited benefits. We therefore do not support any output measure which would incentivise the connection of biomethane above any other gas source.

Social Obligations

We fully support the proposals raised by Ofgem on ensuring that there is an ongoing role for networks in supporting the alleviation of fuel poverty , but reviewing the most effective way to achieve this in different circumstances. While extending the networks to fuel poor communities might be the most appropriate solution, the introduction of FITs and the imminent introduction of the RHI may present other lower costs solutions than extending the gas network. Overall, we believe that a more flexible approach can ensure fuel poor communities have access to cheaper energy and heating, while helping towards the governments CO2 reduction targets.

In supporting vulnerable customers, and specifically those registered on suppliers' Priority Services Register (PSR), we believe that there is currently an issue with the fact that we advise the DN of their vulnerable status but there is no facility for either the DN or the previous supplier to inform the new supplier. This creates a risk that these customers are not supported effectively. We believe that there would be a benefit in requiring the GDNs to maintain this register so that this information could be provided at change of supply and also to enable the GDNs to update this register and the relevant supplier when they become aware of a priority customer through their day to day activities.

Competitive Tendering

One of the new tools available to Ofgem under the RIIO framework is the ability for them to require the network owners to conduct a tender when it is not clear of their procurement arrangements are fit for purpose. We believe that this tool might be extended to all procurement activities including the provision of IT services. This in itself should encourage the network owners to ensure that their procurement arrangements are robust and ensure that the costs to consumers are minimised. We believe that the first candidate for competitive tendering might be the services and systems provided by xoserve.

I hope you find these comments useful, however please contact my colleague Stefan Leedham (**Stefan.leedham@edfenergy.com**, 020 3126 2312) if you wish to discuss this response further.

Yours sincerely

Rob Rome
Head of Transmission and Trading Arrangements
Corporate Policy and Regulation

Attachment

Consultation on strategy for the next gas distribution price control – RIIO-GD1 Overview Paper

EDF Energy response to your questions

CHAPTER: One

Question 1: Do you have any comments on the proposed process and timetable for the review?
Overall the proposed process and timetable appear reasonable.

CHAPTER: Two

Question 1: Do you agree that we have identified the key challenges facing the gas sector, and our approach to accommodating these challenges within the price review?
We believe that, as also identified by Ofgem, the key challenge facing the gas sector over this price control period is the uncertainty of future demand for gas. We recognise that with this uncertainty there is a significant risk that the incorrect level of funding is allowed, potentially creating issues for future customers. We believe that to a degree some of this uncertainty could be addressed through the business plans submitted by the GDNs, however overall we believe that ultimately this area can only be addressed through the development of uncertainty mechanisms. We discuss this in more detail later.

CHAPTER: Three

Question 1: Do you have any comments of the overall approach to stakeholder engagement?
Overall the approach to stakeholder engagement has been mixed by company. National Grid has been very proactive with stakeholder engagement, organising stakeholder questionnaires and events. However, it is likely to be prove challenging for many participants to manage all consultations and events and to keep track of what is being progressed. We believe that in the future a more co-ordinated approach to stakeholder engagement may prove beneficial to all interested parties.

Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?
As previously mentioned, a more co-ordinated approach to stakeholder engagement amongst network companies may prove beneficial to all interested parties.

CHAPTER: Four

Question 1: Do you consider the proposed outputs and associated incentives, along with the other elements of the proposals, will ensure companies deliver value-for-money for consumers and play their role in delivering a sustainable energy sector?

We have some significant concerns with some of the outputs and associated incentive mechanisms that Ofgem are proposing. Primarily we do not support the introduction of an environmental incentive or output measure targeted at biomethane. As previously noted we believe it is the role of Government to identify and develop the funding arrangements required to bring forward technologies that they believe will have a societal benefits through measures such as the Renewable Heat Incentive (RHI). We believe that further interference from the GDNs through their output and incentive measures might have unintended consequences and could create an additional cross subsidy from consumers. Ultimately, this will result in higher costs to consumers than they would otherwise have been exposed to.

Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate?

As noted in the previous question we believe that some of the outputs and incentives require fundamental reform.

Question 3: Do you have any views on the proposed outputs or incentive mechanisms?

Yes

- Environmental Impact: We do not support any incentive that is targeted at a particular technology type or energy source. We believe that the role of Government is to set the policy which identifies which technologies and energy sources that should be developed by the market. The role of network companies is to connect these energy sources in the most cost effective manner and in doing so should not seek to differentiate between technology or energy source. The risk otherwise is that further cross subsidies are created which might increase costs to consumers and potentially interfere with Government objectives.

  Any incentive on direct network emissions should be in addition to those that the companies have already corporately committed to. In particular we note that almost all energy companies have corporate sustainability commitments, which have been endorsed by their shareholders and investors. These commitments have already been funded by shareholders and so any incentive mechanism should only target environmental impacts in addition. This will ensure that costs to consumers are minimised.

- Customer Satisfaction: as previously noted we believe that a customer satisfaction matrix should be developed that incorporates all of the customers of the gas distribution networks. We also support Ofgem's proposal to undertake a separate review of xoserve. From our perspective xoserve provides key services that are central to our business, we have therefore been disappointed from discussions in UNC review group 0334 that National Grid does not believe that xoserve provide a service to Shippers. One option might be that xoserve be subject to a separate price control allowance, and outputs to ensure that they have control over their own budget. This could also be combined with a reform of the Governance arrangements so that xoserve's board is not dominated by Gas Transporters. Ultimately however we believe that there is a benefit in conducting a competitive tender to ensure that the services provided by xoserve are delivered in the most cost effective manner whilst ensuring that the requirements of Shippers and consumers are met.

- Reliability and availability: We believe that a key output measure under the reliability incentive should focus on the NTS to LDZ meters. We note that this has become a significant issue and focus for gas Shippers who have seen significant errors occurring on these meters in 2010. In particular we note that two errors were discovered that amounted to a re-allocation of £60m of energy in 2010 alone. However, according to National Grid's figures it appears that there is still 4.5TWh of gas that is being misallocated as a result of metering errors at the NTS to LDZ interface. At the same time we note that there have not been any significant metering errors for customers directly connected to the NTS. We believe that this is because the meter owners for directly connected customers are also financially exposed to these. Ann output measure could be developed so that the GDNs are exposed to financial costs when a large meter error is discovered. An improvement in this area would also benefit consumers as the risk premium attributed to these errors by Shippers would be reduced, if the NTS to LDZ meters were felt to be reliable.

CHAPTER: Five

Question 1: Is our proposed approach to cost assessment appropriate?
In general Ofgem's proposed approach appears reasonable.

Question 2: Do you have any views on our proposed process for proportionate treatment?
In general we believe that Ofgem's proposed process for proportionate treatment appears reasonable. However, all business plans should be subject to scrutiny to ensure that what appears to be a good business plan is based on solid assumptions and modelling. In particular, we note that a business plan, or any model, is only as good as the inputs and assumptions into the model. Ofgem should therefore look to ensure that assumptions that are common to all network owners are consistent, e.g. expected economic growth rates.

Where differences occur there should be further analysis to identify whether the differences are justified.

Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Should any additional criteria be added?
The criteria identified by Ofgem appear appropriate. There may be a value in having the business plans assessed by a third party to ensure that they appear reasonable and appropriate.

Question 4: Do you have any views on the proposed role for competition in third party delivery?
This should help to provide an incentive on the network companies to ensure that they have the most efficient and effective procurement strategies. We also note that this principle could be applied to all services, including provision of IT systems and services.

CHAPTER: Six

Question 1: Do you have any views on the uncertainty mechanisms identified?
We are concerned that the uncertainty mechanisms identified might only be targeted when network companies' costs are higher than expected or allowed. We believe that this should be widened to cover instances when costs are unexpectedly lower, or when there is a significant upside to that which was expected when the final formula is set. We note that in gas the most significant issue in the last price control was in fact significant revenue being triggered for National Grid for a project that never materialised and costs were not incurred for. It is therefore important to ensure that the uncertainty mechanism covers both upside and downside to ensure that customers do not pay more than is required.

Question 2: Are there any additional uncertainty mechanisms required that we have not identified?
None identified.

Question 3: Are there any mechanisms that we have included that are not necessary and, if so, why?
At this stage we are unconvinced that a revenue driver for National Grid gas on incremental capacity uncertainty is required. In particular, we note that in the recent National Planning Statements, consulted on by Government they dismissed the idea of constraining infrastructure developments to particular areas or corridors. This was mainly driven by the fact that gas supplies are already constrained by geographic requirements and so new gas storage facilities are only likely to develop in existing fields or in salt caverns; whilst LNG importation is likely to be constrained to deep water harbours. We are

therefore unconvinced that there is any significant uncertainty regarding the geographic locations of future energy supplies at this stage.

CHAPTER: Seven

Question 1: Do you have any views on the role of innovation in RIIO-TI?
We agree with Ofgem that the scope for innovation is less in transmission than in distribution, and less in gas than electricity. The proposed funding and arrangements therefore appear appropriate.

Question 2: Do you have any views on the time limited innovation stimulus?
This appears sensible.

CHAPTER: Eight

Question 1: Do you consider that the package of financial measures identified will enable required network expenditure to be effectively financed?
As a package we believe that the financial measures will enable the required network expenditure to be effectively financed. We note that to fund investments there are three sources of cash for network companies, namely, debt, allowed revenue and new equity release. We believe that the package of financial measures should ensure that they network owners are able to access all these sources.

Question 2: Do you have any views on our proposed approach to depreciation?
At this stage we do not have sufficient information to demonstrate that it is appropriate to move from straight line depreciation to a front loaded depreciation curve. We note that changing the depreciation rates of network companies has a significant impact on their cashflows. We therefore believe further information is required to demonstrate that the use of front loaded depreciation is appropriate and that equity does not represent an alternative cash source.

Question 3: Do you have any views on our preferred approach to implement any transition arrangements over one price control period where possible?
The proposed approach appears reasonable.

Question 4: Do you have any views on our preferred approach to remunerating the cost of debt?
We support Ofgem's intention to index the cost of debt to investment grade bonds. We note that in the past the cost of debt has been set at a point in time depending on historical perceptions. However, as the debt markets are fluid this has resulted in network owners being winners (when cost of debt reduces) or losers (when it increases). These movements are outside of the networks controls and so we believe that indexing to the

markets will remove this risk. In addition, we this might remove any premium which may have been applied to cover the risk of market movements.

Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent?
At a high level this appears appropriate, although we would question what Beta has been assumed for network owner equity? We note that in the past Ofgem has used a Beta of 1.0, although in the DPCR5 they moved to a Beta of 0.9 to reflect that network companies are lower risk than the market average. Research conducted by Ofcom suggested that the equity beta of energy utilities was between 0.64 for National Grid and 0.12 for Scottish and Southern Energy with Scottish Power having an equity beta of 0.44[1]. Given that these ratios will also cover the riskier sides of these businesses, then it is clear that an equity beta of 0.9 is comparatively high. Ofgem should consider calculating the cost of capital and equity based on an equity beta of 0.7 or less; it may be possible to employ independent experts to determine an appropriate equity beta for the network owners.

Question 6: Do you have any views on other elements of our financial proposals?
We have no further comments.

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[1] See Ofcom presentation available at:
http://xfi.exeter.ac.uk/conferences/costofcapital/papers/stephen_gibson_exeter_conference_beta_lecture.pdf