Centrica Plc
Millstream
Maidenhead Rd
Windsor
Berkshire SL4 5GD
www.centrica.com

David Hunt
Senior Manager, Electricity Transmission Policy
Ofgem
9 Millbank
London
SW1P 3GE

Monday 26th April, 2010

Dear David,

Re: Transmission Price Control 4 – Scope of the "Adapted Rollover" (2012-2013)

Thank you for the opportunity to comment on the above consultation. This non confidential response is on behalf of the Centrica group of companies excluding Centrica Storage Ltd.

Centrica did not favour a one year rollover of the existing price control, due to our significant concerns which we set out in our previous response and do not restate here. However, given that a rollover is to be applied, we do support a proportionate approach.

This response is on two parts, comprising this letter and an annex in which we address the questions raised by Ofgem.

In terms of the general objectives put forward in the consultation document, we agree that these are reasonable, but believe that it would also be appropriate to include a further objective around the balance of risk and reward, for example, that there should be no change to the reward received by the network companies without a commensurate increase in risk (and vice versa). We are particularly concerned that by carrying out a partial review, Ofgem introduces the potential for customers to bear both additional risk and additional cost for minimal benefit.

However, we agree with Ofgem that where there is clear evidence to support a review in the interests of consumers then this should be carefully considered. On this basis we welcome Ofgem's proposal to consider the key elements of the cost of capital as part of this review and believe that this principle should be extended to ensure that the issue of entry baselines at Fleetwood is effectively addressed. This needs to be resolved as part of the adapted rollover and should not be allowed to continue for a further year to the detriment of users and consumers.

In carrying out the adapted rollover described, it will be important to ensure that the overall balance of the control is not disturbed to the point that perverse incentives result, while maintaining the strength of incentives on the transmission licensees to operate efficiently.

Moving towards the process and timescale, the indicative timings are helpful, but we believe it would be useful to see a version which also included the activities under the main controls for transmission and gas distribution to consider any pinch points.

We note for the adapted rollover, only one formal consultation is proposed, that being on the initial proposals. This being so we would encourage Ofgem to consider the use of supplementary consultations on those few areas where more significant "adaptation" is proposed, in particular financing and pensions.

In addition to the points above, we believe that information transparency is essential, both in terms of improving general understanding and to support high quality engagement from stakeholders. We have welcomed the efforts made by Ofgem and the network companies to improve information provision over the more recent price controls and believe that this has contributed significantly to stakeholders' ability to engage. Where major consultations on topics such as price controls have short response periods of only 4-6 weeks, it is important to ensure that the detailed information on which the consultation is based is available promptly, and preferably in advance of the consultation to allow time for modelling if required.

The recent Transmission Annual Report is helpful in providing a review of what the companies have achieved to date and hence indicating important areas to assess in the rollover. However, it only covers the period to 31/3/2009; we would encourage Ofgem to ensure that the next report covering the period to 31/3/10 is published much closer to the end of the period covered, perhaps by Sept 10. A provisional report on the period to 31/3/2011 in advance of the initial proposals consultation would also be valuable.

If you have any questions or comments relating to this response, please contact me on 01753 431270 or at alison.russell@centrica.com

Yours sincerely,

By e-mail

Alison Russell
Senior Regulation Manager, Upstream Energy

Annex 1 – Centrica response to Ofgem Questions

CHAPTER: Two
Question 1: Do you agree with the objectives for the one-year "adapted roll-over" set out in this chapter? Are there additional objectives that should be included?

Centrica is broadly in accord with the objectives stated, but believes that an additional objective should be included to reflect a requirement that there should be no increase in reward (to the network companies) without a demonstrable increase in risk or clear compensatory benefits to consumers.

In terms of changes to the price controls as part of the adapted rollover to reflect policy developments, we believe that this is only appropriate where such changes are essential as it would otherwise conflict with the objective of a proportionate approach.

CHAPTER: Three
Question 1: Do you agree with our intention to include TO and SO components in the one-year "adapted roll-over"?

Yes. Whilst we support using a similar approach to TO costs, perhaps parameters could be applied to changes in SO Internal costs such that if these costs change by more than +/- [5 or 10%] , then the proposals would be consulted upon. We are concerned that as a result of changes to the OFTO regime and Connect & Manage that there is the potential for material change in resource and administration requirements, such changes should be the subject of careful review and challenge.

Question 2: Do you agree with the three options we have identified regarding the treatment of capex? Do you agree with our 'minded to' position i.e. option 2?

We agree that option 2 is a proportionate approach. However, we believe that it will be important in the analysis and reporting provided to clearly demonstrate separation of the incremental investment incentives associated with TAR from any increased capex allowances.

Question 3: Do you agree with the four options we have identified regarding the treatment of opex? Do you agree with our 'minded to' position i.e. option 3?

Option 3 appears a reasonable approach; however we would appreciate greater clarity on how the proposed efficiency factor would be calculated to ensure that this would maintain appropriate pressures on the networks.

Question 4: Do you support our intention not to pursue new policy issues as part of the one-year "adapted roll-over"? In particular, do you agree with our position not to assess in the "adapted roll-over" those projects that were nominated under the Enhanced TO Incentives project?

Broadly we are in agreement with the approach of not pursuing new policy issues as part of the one year rollover. However, where there is clear evidence that issues need to be addressed in order to rectify an obvious inequity in the current regime, such as the issue with the Fleetwood baseline, then action should be taken to ensure that the detriment to consumers does not persist unnecessarily.

In particular, at this stage it will be important to ensure that the SO incentive issue is addressed even if the Asset RAV issue is not addressed until the main control.

An outstanding issue from TPCR4 is the matter of the creation of a new System Entry Point at Fleetwood. This investment was signalled in the LTSEC held in 2006, indicating entry capacity at that location from October 2010. The developer has been unable to secure planning consent and when credit cover was required against this capacity, from October 2009, defaulted on this provision. Under the previous TPCR, National Grid continues to receive incentive revenue from the sale of this capacity, although no investment has taken place. A proposal has been raised to require securitisation at the time of bidding which should go some way to preventing a recurrence in subsequent LTSEC processes. We understand that Ofgem are also considering amendment of the licence to ensure that incentive can only be gained when there has been tangible investment.

Question 5: Regarding revenue drivers, do you agree that no new regulatory incentives should be introduced and that the existing targets should be simply rolled forward with the exception of any adjustments to address areas where there has been significant misalignment between TPCR4 baselines and outturn values?

National Grid have reduced the provision of LNG Storage Facilities, specifically Dynevor Arms LNG is no longer operational. However, TPCR4 Rollover includes a Baseline Capacity at Dynevor Arms which has the effect of National Grid earning allowed revenue on capacity which is unusable. In our view it would be appropriate to adjust the baselines to reflect this in the adapted rollover.

Question 6: Do you agree with our 'minded to' position to extend the application of the existing network output measures methodology for the one-year "adapted rollover"?

Yes.

Question 7: Do you agree with our 'minded to' position to restrict licence amendments to those required to facilitate execution of the "adapted roll-over" and for any rationalisation process to take place as part of TPCR5?

Yes.

Question 8: Do you agree with our proposals regarding the engagement of stakeholders? Do you have any suggestions for additional ways which we should pursue to improve stakeholder engagement?

Subject to the comments made in our covering letter we are broadly comfortable with the proposed approach to stakeholder engagement.

Question 9: Do you have any further comments on the general scope of the one year "adapted roll-over"?

Our main concerns over and above those identified in the consultation document remain the timely provision of information to stakeholders other than the network companies (preferably in advance of the actual consultation) and the Fleetwood issue highlighted under question 4 above and in our covering letter.

However, in addition, we would welcome clarification of two points:

a) how requirements around smart grids will be addressed for the period 2012/2013; and
b) how costs of decommissioning facilities will be managed, for example Dynevor Arms and some of the tanks at Partington and Avonmouth, if these costs are not already catered for.

CHAPTER: Four

Question 1: Do you agree with our intention to use an enhanced version of the TPCR4 financial model following developments embodied in the GDPCR and DPCR5 models for the "adapted roll-over"?

We agree that it is sensible to develop an enhanced model but would recommend that it is run in parallel and variances in the results generated carefully considered before implementation. The GDPCR and DPCR5 price controls were complete packages and it will be important to ensure that the application of a partial rollover rather than a complete package does not result in perverse incentives. Implementing enhancements in advance of the balanced approach which would be expected as part of a full price control may result in a change in the focus of risk. A consistent approach is needed as far as possible.

Please also note our previous comments on timely information provision, we would welcome the model being made available at an early stage, even if later updates are then required.

Question 2: Do you agree with our intention to use RoRE analysis for the "adapted roll-over" to ensure the package as a whole is appropriate?

We are very supportive of the concept of monitoring and calibrating controls through the use of the Return on Regulatory Equity (RORE). DPCR5 has shown that RORE is a very useful tool for indicating whether network companies have received an appropriate balance of risk and reward (for a good level of performance). We see no reasons to suggest why RORE would be inappropriate for application to the transmission networks.

Question 3: Do you agree with the three options we have identified regarding the treatment of the cost of capital and our 'minded to' position i.e. option 2?

We agree with Ofgem that a review of the WACC is necessary and strongly support it. Given the extensive economic changes over the last few years and recent price control settlements, we do not believe it would be reasonable or in the interests of consumers to simply roll forward the existing vanilla WACC without re-assessment of the inputs. In our view, there have been fundamental changes which indicate that a review of the cost of capital should not be delayed until TPCR5.

It is clear that in general the overall cost of debt is lower, driven by an exceptionally low risk free rate and a continuing expectation that the risk free rate will remain low (and be only partially offset by an increase in risk premia). In addition, there are indications for a lower cost of equity, again, largely driven by reductions in the risk free rate.

We note that Ofgem would only carry out a more comprehensive review where the movement in inputs is sufficiently large. We would appreciate clarification in advance of further work as to what criteria Ofgem will use to assess "material change" in this context.

Question 4: Do you agree with the two options we have identified regarding the treatment of capitalisation & depreciation and our 'minded to' position for option 1?

On balance we would support this approach.

Question 5: Do you agree with the three options we have identified regarding the treatment of tax and our 'minded to' position i.e. option 2?

While in principle this appears to be a reasonable approach, it is clearly not appropriate to assess the options without an indication of what the actual gearing has been. If, as a result of their approach, the company has been generating excess returns, this should not simply roll forward for an additional year. If such excess returns are being generated it will be important to demonstrate this clearly along with the planned approach in the initial proposals.

Question 6: Do you agree with the three options we have identified regarding the treatment of Pensions? Do you agree with our 'minded to' position i.e. option 2?

We prefer the approach under option 2 to that in option 1, but given the amount of work carried out recently on the approach to pensions provision, we believe it should be possible to carry out the full review.

Question 7: Do you have any further comments regarding financial issues for the one-year "adapted roll-over"?

No additional points to raise.

CHAPTER: Five
Question 1: Do you have any comments regarding our indicative timetable?

As noted in our covering letter, we would like to see the timetable alongside the timetables for the main controls to identify any pinch points. We would also like to see publication of information to stakeholders at key points in the process included within the timetable.

Finally, given the single planned consultation we would encourage Ofgem to consider the use of more targeted consultations on particular areas in which major change is planned.