British Gas

Hannah Nixon
Ofgem
9 Millbank
London
SW1P 3GE

**Legal & Regulatory**
Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY
t: 01784 874 000
f: 01784 878 719

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Dear Hannah

**RPI-X@20 review: Further working papers and consultancy reports**

1. We welcome the opportunity to provide further input to the RPI-X@20 review, ahead of the publication of the Final Proposals consultation document. This response sets out our views on the two Ofgem working papers published recently (on financeability, and longer term price controls), and to the two Frontier Economics reports (on the future of benchmarking, and output measures).

2. This response is submitted on behalf of the Centrica group of companies excluding Centrica Storage, is not confidential, and we are happy for it to be placed on the Ofgem website.

**Summary**

3. Centrica is the largest integrated gas and electricity company in Great Britain that does not own any energy network interests. We are therefore uniquely placed to provide an unconflicted perspective on the RPI-X@20 review. We plan to respond in more detail to the Final Proposals consultation document over the summer. However, as the review now enters its final stages, we considered it important to set out our views on these latest reports, given their potentially major implications for customers.

*Value for money should remain a key focus for the regulatory regime*

4. We are supportive of the strawman proposals for financeability, and believe that the experience of other sectors (e.g. water) has shown that this model can work. However, in assessing these proposals, it is important that delivering value for money for customers remains a key consideration for the review. This is particularly the case in the financeability proposals, where the focus seems to be primarily on the requirements of networks, rather than fully recognising those of consumers.

5. If introduced in full, the financeability proposals have the potential to deliver significant benefits for customers. Given many of the principles set out in the working paper have already been introduced in other sectors, Ofgem will be falling behind the good practices of other regulators unless it moves to adopt the strawman model in full.

*Recent wins for customers should not be lost*

6. DPCR5 made a number of significant advances over previous controls. Improvements to benchmarking methodologies, for example, delivered clear and compelling views on comparative efficiencies of the networks. This also showed that, even after 20 years of strong incentive regulation, very material differences in efficiency remain between the networks.

7. Totex benchmarking, including of forward looking business plans, may deliver significant benefits to consumers, through the more consistent treatment of capex and opex. However, this should be a complement to, not a replacement for, historical cost benchmarking, at least until its robustness is demonstrated. Benchmarking undertaken in DPCR5 provided a richness of detail that would be lost if Ofgem relied on new approaches to totex benchmarking alone. This will be particularly important until a robust output-based regulatory framework is in place.

*Unconvinced that longer price control durations will benefit customers*

8. We are sceptical that the strawman set out in the longer price control working paper will deliver any benefits. In particular, the numerous reopeners, and an interim four-year review rare likely to lead to significantly more uncertain network charges than at present. Even the benefit to networks of extending price controls by an additional three year period is unclear. A better approach may be to identify parts of the control that can be "carved-out", and on which certainty can be provided on key factors (such as cost of capital) for a longer duration (e.g. 20 years). On this issue our views appear aligned with those of most of the networks.

9. If longer price controls are to be considered, then the thinking developed in DPCR5 to protect customers from uncertainty in network charges should not be discarded. Revenue changes resulting from reopeners should be "logged up" and applied to charges from the next price control (on an NPV neutral basis). Fixed numbers of windows for reopeners should also become a mandatory part of controls to increase charging certainty.

*Support better accountability for the networks*

10. Output-based regulation should remain the long–term objective for Ofgem. Clearly specified output measures deliver far clearer accountability for networks than the existing (largely input-focused) regime. However, it is important that Ofgem does not attach significant financial weight to an output-based regime until there is confidence that the selected measures are robust.

11. We would suggest that new approaches developed and introduced as a consequence of the review (such as output measures) should be introduced in parallel to existing measures. This will provide confidence that the new approach will deliver benefits to consumers before it is introduced. It will also mean that the benefits of existing approaches will not be lost.

12. In the remainder of this response, we set out our views on:

    - financeability;
    - longer term price controls;
    - benchmarking; and
    - output measures.

**Financeability**

13. The strawman in the Working Paper sets out a number of important advances that will deliver significant benefits. It will also bring the energy sector into line with approaches already introduced by other regulators, most recently Ofwat. From the Competition Commission's initial findings on the Bristol Water appeal it would appear that they are also supportive of this approach.

14. It is wholly appropriate for networks to be expected to meet short term financing requirements through raising new equity, rather than relying on accelerated charges being paid by consumers. This is more consistent with the operation of private sector companies in competitive markets, and is an approach that has already been introduced in the water sector.

15. The use of accelerated depreciation in past controls is not a solution to financeability issues, and is not a sustainable policy. Accelerated depreciation also unfairly penalises current consumers compared to future consumers. Instead, setting depreciation rates to reflect useful asset lives is the most appropriate way of treating present and future consumers fairly.

16. We would strongly disagree with any suggestion from the networks that the financeability proposals justify an increase in the cost of capital. The new approach does not imply any change to the NPV of cash flows (and Ofgem's duties regarding the financing of networks also remain unchanged). We would also note that Ofwat has broadly adopted the new approach Ofgem is considering, and has not seen a justification for increasing the cost of capital.

17. As a company that has undertaken a major rights issue in the last couple of years, we are aware that the issuing of new equity increases costs. However these are "one-off" in nature (being directly linked to the issue). It is therefore appropriate for an allowance for these direct costs to be included in the RAB. Shareholders, whether they take up the rights or not, are protected against the indirect costs of underpricing since they own the company. The only instance where this is not the case is when the issue leads to a greater than expected fall in the share price (which will only happen if the issue is poorly communicated to the market, and includes new information). That should not be a concern if the regulatory regime is well-explained and the need for additional equity is clearly signalled by the company.

18. The idea of indexing the cost of debt is a proposal we strongly support. By removing uncertainty over the level of cost of debt from the networks, there would no longer be a need to provide any "headroom" in the allowed rate. So long as changes in the index are logged-up and applied at the next price control on an NPV neutral basis (rather than being passed on mid-control), there will also be no increase in costs for customers resulting from increased uncertainty in network charges.

19. We realise that the speed with which Ofgem will be able to introduce these changes will vary by sector. For example, it may be difficult to move to a different and consistent policy for depreciation immediately. However, we encourage Ofgem to commit to adopting these principles in full over a reasonable period of time in all sectors (with the detail to be worked out at each price control review).

**Longer term price controls**

20. We do not believe that the strawman set out in the longer price control working paper would deliver benefits for consumers if introduced as currently specified. Reductions in uncertainty for networks can deliver benefits (e.g. in terms of reductions in the cost of financing). However, this must be balanced against the costs that increased uncertainty place on consumers. End-consumers place a high value on predictability of their charges, and in response to this Centrica offers fixed-price contracts to both domestic and non-domestic customers. Suppliers levy risk premia to mitigate the impact of unpredictable network charges, and where risk is inappropriately allocated this leads to inefficient outcomes for the end-consumer.

21. It is therefore important that any measures designed to improve certainty for networks (such as volume drivers, revenue drivers and pass-through items) are accompanied by ways of limiting the increase of uncertainty on end-consumers. "Logging up" is one way of achieving this, by reducing the need for mid-control reopeners and instead applying revenue changes on an NPV-neutral basis at the next control. The re-opener windows developed in DPCR5 also provide a practical mechanism that balances relatively regular adjustment of charges with certainty for suppliers and customers.

22. We are unconvinced that the scope of "small-scale" reviews four years into an eight year control will be as limited as the paper suggests. Previous attempts to introduce longer price controls (such as water in the 1990s) have failed because the interim review has become effectively a new full review.

23. We also have some concerns that the extension of the review by an additional three years will in reality deliver any tangible benefits to networks in terms of increased certainty. From the recent Ofgem-led working group on this issue, it seemed clear that in order to deliver investment certainty that would have a tangible impact on financing costs, then price controls would need to be set for periods closer to asset lives (i.e. 20-25 years).

24. A better approach may therefore be to focus on areas where longer term commitments can be credibly given (such as financing of large transmission assets, supported by user commitment or from an investment plan agreed ex ante with Ofgem and the industry). It may be that fixing a longer period for a new investment in specified assets may be workable, leaving the remaining capital and operating costs to be managed through the usual five year process. This might support a longer-term funding approach enabling networks to better match type of funding to type of investor, resulting in a reduced cost of capital.

25. This could also complement Ofgem's emerging thoughts about the possibility of having competitive tenders for some new large infrastructure projects in a similar way to the offshore transmission tenders. As well as revealing the efficient costs of such projects through market testing, this approach could also be used to "lock-in" certain aspects, such as the cost of capital, for a long period into the future.

26. The proposals to introduce a longer price control also come at time of great change for the regulatory framework. The introduction of richer business plans, the increased used of output measures, allowances for anticipatory investment and revised transmission access rules will have an uncertain impact. Retaining a five year control for GDPCR2 and TPCR5 would therefore be a more pragmatic approach, allowing time to ensure the many new measures being introduced are robust before locking in consumers for a full eight years. A movement to eight years in the context of such changes is also likely to make the interim review even more important, further reducing the benefits of a longer control.

27. These proposals also come at a time of unprecedented uncertainty over levels of demand, both on the gas and electricity networks. This makes the design of a robust longer price control period even more challenging, and suggests that a five year control remains appropriate at least in the short term.

28. A five year control should also be retained if the movement to eight years would mean any significant increase in the allowance for "headroom" in setting the cost of capital. This issue could be addressed by some form of indexation in the cost of capital (particularly in the cost of debt). We would therefore suggest that further analysis of how the cost of debt indexation could work in practice would be a prerequisite for any proposals to extend the duration of price controls.

**Benchmarking**

29. The increasing sophistication of benchmarking techniques over the last 20 years has delivered huge benefits. DPCR5 was a good example, where further refinements in benchmarking methodologies led to the clear conclusion that even after 20 years of RPI-X@20 regulation, major differences remained in the opex efficiency of the electricity networks. The Frontier report did not seem to fully recognise the significance of this conclusion.

30. We have no objection in principle to the development of totex benchmarking. However, including capex in benchmarking presents a number of significant challenges (as the Frontier report concedes). It is therefore important that, particularly while totex benchmarks and an output-based framework are still being developed, that more standard forms of benchmarking continue to be undertaken. The wide difference in opex efficiency between networks uncovered in DPCR5 suggests there is a continued and important role for benchmarking of historical costs. There is also a risk that some networks that have not performed well through rigorous historic cost benchmarking may see an opportunity to push for alternative, less rigorous, approaches.

31. We would therefore encourage Ofgem to begin to develop totex benchmarking approaches, including for forward looking business plans. However, this should be done in parallel with continued historical cost benchmarking, until it can be demonstrated that totex benchmarking is at least as robust. We believe that the relatively small resource costs of running both approaches in parallel is a small cost relative to the risk that totex benchmarking proves substantially less robust leading to higher bills for customers.

32. We would also dispute the Frontier assertion that the changes to the energy sector resulting from the transition to a low carbon economy mean that historical benchmarking is no longer fit for purpose. Although the energy sector is experiencing a radical transformation, this is more likely to happen incrementally over the next ten years, meaning historical analysis will remain a valuable indicator of comparative efficiency.

**Output measures**

33. We support many of the conclusions of the Frontier report on output measures. We favour the movement to an output-based regulatory regime in the long run, as this means networks will focus more clearly on delivering the services customers truly want. However, it is important not to underestimate the challenge that will need to be faced before a robust output-based regime can be introduced in practice.

34. In specifying output measures, we would suggest that Ofgem consults directly with end-customers on whether these are the right outcomes and outputs (as well as the relative weight they attach to different outcomes and outputs). This could help inform the financial incentives attached to the measures over time. The role of customers of the networks should be pivotal in specifying the output measures selected for the framework.

35. Finally, we would also strongly agree with the caution expressed in the report about linking substantial amounts of revenue to relatively small changes in output measures. Until output measures can be shown to be robust, then customers should not be exposed to unpredictable changes in allowed revenues resulting from incentives placed on such measures.

36. However, we would suggest that this caution should only be a short term issue. Once an enduring and robust output-based framework is in place, then full benefits for customers will only be realised if the majority of network revenues are set by this methodology. We would therefore suggest that as measures become established then the amount of money at stake should be increased.

37. I hope this short response is helpful. If you have any questions regarding this submission, or require any clarifications on the substance of our response, then please do contact me.

Yours sincerely,

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**Tim Dewhurst**
**Senior Manager, British Gas**