British Gas
Looking after your world

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Dear James,

RIIO-GD1: Gas Distribution Networks' (GDNs) business plans

1. Thank you for the opportunity to respond to Ofgem's latest consultation, RIIO-GD1 business plans, document 170/11. As a large integrated energy company in Great Britain that does not own any network interests, Centrica is in an ideal position to provide an unconflicted perspective on the business plans and offer our thoughts on the Gas Distribution Networks (GDNs) giving consumers' value for money.

2. This is a non-confidential response on behalf of the Centrica Group excluding Centrica Storage. We have structured our comments as follows:
   - The covering letter summarises our views on the GDNs' business plans.
   - Appendix 1 gives our more detailed initial views.
   - Appendix 2 answers Ofgem's consultation questions.

   We expect our views will develop over the coming months as we further analyse the GDNs' documents and seek bilateral meetings with each company.

3. Network charges are an increasingly important area of cost for British Gas, with our customers paying over £1 billion per year in gas distribution charges alone. 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.

4. RIIO-GD1 offers the gas industry an opportunity to deliver real value for money for our customers. There is a danger, however, the value could be lost if a full and transparent debate on the key issues underpinning the GDNs' business plans is not held. Overall, there is insufficient information for **any** of the plans to be considered well-justified. This means, when taken in conjunction with the compressed timescales, following the HSE review of the Mains Replacement Programme, it is difficult to see how it would be in the interests of consumers for any of the GDNs' business plans to be fast-tracked.

5. We are very surprised to see the GDNs asking, on average, for revenue increases above inflation. We believe that the main drivers of GDN revenues are downwards and would expect this to be reflected in reduced prices. All of the following should be reducing GDN revenues across GD1:

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- Network reinforcement costs should be minimal with no growth in average demand or peak expected
- Mains Replacement costs should be reducing following the HSE review
- The efficiency gains promised after DN Sales should be fully captured during GD1
- The move to 100% capitalisation of Mains Replacement costs, although we note that Ofgem has already made a significant concession by introducing a front-end loaded depreciation profile for all assets.[1]

6. Whilst all the GDNs address these issues to a certain degree, it is not credible that this can translate into significant price increases. A number of GDNs have referred to a 1p per day increase when assessing the impact of their plans on customer bills. We believe this is a significant amount, translating to annual increases of 3-4% above inflation and would mean increases in the order of 25% across the Price Control period.

7. The quality and content of the business plans has been mixed. Difficulty has arisen from use of redaction and inconsistent terminology and categorisation making it challenging to analyse and compare GDN plans. It is not at all obvious from these plans what price change would occur in April 2013 if these plans were accepted, which would be of key interest to a number of stakeholders. This was a key ask for us in all stakeholder meetings with GDNs.

8. Throughout the stakeholder engagement process, we have repeatedly stated that we see managing charging volatility as a key issue for GD1. We believe that this is an issue for a number of other stakeholders also, as shown by UNC Modification Proposal 0368[2]. We are disappointed; therefore, that only one GDN has reflected this stakeholder feedback with proposals within their business plan.

9. Requests for changes to the IQI and incentive mechanisms seem unclear at best. Ofgem will need to lead the debate on incentives, reviewing performance in GDPCR, engaging with stakeholders and understanding the detailed mechanics to assess the impact of any proposed changes. Ofgem will also need to show a clear link to the allowed cost of equity. Furthermore, requests for substantial one-directional RPEs have not been justified in the context of market conditions and outlook.

10. The GDN financing proposals seem extremely generous, when we compare to our own analysis of key financial market variables. Cost of equity, for example, exceeds Ofgem's own range by up to 0.3 percentage points and the TPCR4 rollover decision by up to 0.5 percentage points. We also note that the GDN proposals are inconsistent in their view – which suggests that rigorous analysis in this area should drive significant gains for consumers. We believe the capital requirements during GD1 are relatively modest for mature and stable distribution businesses. Hence financeability adjustments should not be placing additional costs on customers through the GD1 period and we do not believe the transitional arrangements proposed have been justified.

11. In summary, we do not believe that the GDNs have provided sufficient justification that their plans provide value for money for customers. We believe that none of the plans are capable of being fast-tracked and a far better result will be achieved through a full and rigorous assessment process.

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[1] Ofgem: RIIO-GD1 Overview Paper – Decision, pg 44.
[2] Smoothing of Distribution Charge Variation- http://www.gasgovernance.co.uk/0368

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements
British Gas
[Via email]

Appendix 1

Overall quality of the plans

1. The publication of the business plans are a significant step forward in the price control process and gives some insight into the GDNs' businesses, however they are neither concise nor give the information required to fully analyse their plans with sufficient confidence. The lack of detailed figures for their expenditure and expected allowed revenue, with comparison to the current price control period, makes analysis difficult.

2. More specifically Wales and West Utilities have chosen to redact all the detailed financial section, with the result that it is not possible for stakeholders to engage fully with its proposals. Given Ofgem's commitment that proposals should be as transparent as possible fast tracking does not appear to be an option.

3. The business plans are difficult to decipher, particularly where graphs and pie charts have been used to convey expenditure plans, when tables of numbers would have been far more beneficial. The business plans are also extremely large and onerous to read and comprehend, whilst the format and differing terminology makes comparisons between networks very difficult.

4. Centrica suggests a common format for all GDNs in the future with certain sections available for their differing structures and nuances. We also request that future business plan submissions include an Excel spreadsheet to help stakeholders efficiently and effectively analyse all expenditure, allowed revenue, financing and incentive plans.

Expenditure Plans

Real Price Effects

5. Real Price Effects (RPEs) in and of themselves are not problematic. Relative costs do change over time, and it may be appropriate to make provisions for this. However, it is also important to note that the term is neutral; RPEs can denote relative increases or decreases. The business plans, however, appear imbalanced and generally propose increases. A well-justified plan would have to present clear arguments in support of this.

6. The potential magnitude of the proposed RPEs is large. National Grid's RPEs, for example, represent an allowance of £589m over the price control period, partly as a result of rapid escalation from £21m per year in 2013/14 to £125m in 2020/21. By contrast, the forecasts provided for other companies by Oxford Economics have a much flatter profile.

7. Wages represent the majority of the costs covered by RPEs. In the case of National Grid, out of £589m, £309m comes from increased wage costs. It may be useful to set these additional cost forecasts in the context of the current economic climate. Northern argues that average wage RPEs from 1973-83 and 1983-93 (around 2% per year) are particularly relevant, and that industry costs are currently at a cyclical low. They dismiss figures from 1993-2008 and 2000-10 that are 60-70 bps lower.

8. The GDNs may have used the Oxford Economics January 2011 report[3] as a basis of their RPE forecasts, the GDNs' interpretation has impacted these assumptions and there does not appear to be consistency of approach. Indeed, in the Oxford Economics report there is a section specifically for WWU. Centrica believes that the RPEs look high, based on outdated assumptions, as the economy has changed significantly over the past year and that the GDNs need to be more realistic in their forecasts.

Traffic Management Act

9. As the street works or Traffic Management Act (TMA) costs are unknown for most networks, Centrica believes that these costs should be logged up and reviewed at the 4 year interval within RIIO, with a reasonable allowance given and explicitly understood within their allowed revenue from April 2013. An allowance should be set using efficient costs as seen in the recent determination for London and Southern Networks, excluding penalty payments. All the GDNs mention street works within their business plans with limited suggestions for minimising the cost, managing the process more efficiently or sharing knowledge between the networks.

10. The costs associated with the TMA or street works is largely unknown to the GDNs' stakeholders and could have a significant effect on the distribution charges. Centrica expects that the GDNs are only compensated for efficiently incurred costs and would welcome clear and updated information from each GDN region, via the mod 186 process to allow transparency of potential changes.

11. Within the business plans there is no mention of how the GDNs will share knowledge and efficient procedures regarding TMA. Shared information is essential to the GDNs keeping down costs and not incurring penalty charges from the local councils. As the GDNs have shared agencies, xoserve, Joint Office and ENA working with them, perhaps their help could be leveraged in sharing knowledge and collaborating on processes.

Metering Emergency Services

12. All stakeholders greatly value the emergency service the GDNs fulfil and believe the targets set attain the correct level of service for consumers. Centrica is concerned with the lack of flexibility the GDNs have used in considering how best to utilise their engineering employees once the metering service is overtaken by the Smart meter rollout.

13. The lack of metering work should not cause the GDN's significant cost implications if they plan and organise their workforces correctly. Centrica is disappointed that the GDNs' expect consumers to fully fund the change to their business model.

Reinforcement Costs

14. Although Centrica expects that gas will be required for several decades as Great Britain progresses towards the 2020 and 2050 environment targets, for flexibility of electricity generation and convenience for consumers, however significant investment is no longer required. The GDNs need to ensure decisions on assets and capacity investment will

[3] Oxford Economics Input Cost Forecast report January 2011
http://www.sgn.co.uk/ScotiaGas/uploadedFiles/About_us/Stakeholder_info/Business_plan/Oxford%20Economics%20Input%20cost%20forecasts%20Jul%2011.pdf

respond to decreasing usage rather than building for the longer term, thereby minimising the effect of asset stranding.

15. Significant capacity investment is not required. The recent 1 in 30 cold winter proved that the gas distribution networks are already built to cope with very high demand. Taken along with half GDNs forecasting peak demand to remain flat, whilst the other half expects the peak demand to decrease. In British Gas' experience, the underlying cause of reduced demand (including peak) arises from more households being properly insulated, and increasingly efficient boilers (from scrappage schemes etc.), and not economic factors as the GDNs quote. Therefore, Centrica expects that peak demand will continue to decrease over the GD1 period and not increase, or flatten off, if the economy recovers.

16. Centrica is not in a position to understand whether an asset is unsafe as it reaches the end of its design life, but we would expect an efficient GDN to assess whether it is more cost effective to maintain such as asset rather than just replace. From the business plans it is difficult to know if the GDNs have made this assessment, as the majority of asset health data was redacted.

Mains Replacement

17. We welcome that National Grid has forecasted a saving to end consumers of £0.5bn over the GD1 period, from using an improved risk based assessment for the Mains Replacement Programme. However, it is not clear from the plans what savings the other GDNs have been or should be able to provide for consumers.

DN Sales savings

18. The DN sales in 2005 was expected to bring savings to end consumers of between £80m to £225m[i], however it is not clear from the business plans where those savings have been captured and whether they will continue. We urge Ofgem to consolidate the savings and report back to the industry on whether these benefits have or can be realised and the progress to date.

Financial Arrangements

Cost of Equity

19. The range requested for Cost of Equity (7.2%-7.5%) is at, or even beyond, the top of the range proposed by Ofgem's March document. This is largely justified by an argument that the RIIO framework has brought increased risk, and also the current economic and financial environment.

20. The argument that RIIO is riskier than current arrangements is contrary to the view that has come from Ofgem and we are not convinced by the evidence put forward within these business plan submissions. We would also note that the networks take a very different view on this. Whereas National Grid attribute an uplift of 2.7% to Cost of Equity, Scotia state

1.2% and the other networks make no explicit reference. This supports that there is not a strong rationale for this argument.

21. The assumption that risk is especially high for the upcoming period due to macroeconomic factors is questionable, and has been rejected by other regulators. This area clearly needs extensive further analysis and debate.

Cost of Debt

22. All the business plans argue to some extent for a headroom allowance above the proposed cost of debt index. The arguments put forward for this include:
    - issuance and carry costs;
    - inflation mismatch; and
    - risk of adverse changes to the index.

23. We believe that issuance and carry costs were dealt with by Ofgem in its March decision, noting that historically network companies have been able to issue debt at coupons 58 bps below the market cost of debt on the day.

24. At this stage, we do not believe a compelling case has been made for any other adjustments. As for the cost of equity the networks take different views, with Northern suggesting an uplift of 85 bps over the benchmark index and WWU suggesting 35 bps. Again, this area clearly needs extensive further analysis and debate.

25. We note that Scotia and Northern argue for an increase to Cost of Debt and also ask for an increase to Cost of Equity to allow for Cost of Debt risk. Any changes to Cost of Debt would certainly need to be reflected in the Cost of Equity.

Financeability

26. Each plan incorporates some form of transition arrangement but without full consideration of alternatives. There is a lack of overall clarity and coherence to these requests, and moreover it is not clear that they are required. This appears to have been the conclusion of Ofgem in its March 2011 decision document – which furthermore incorporated a significant concession by allowing front-end loaded depreciation for all assets.

IQI and incentives

27. Regarding the IQI, each plan includes measures (including additional incentive categories and higher sharing factors) to widen the RORE spread. If positive net payouts are envisaged the implications are significant. If GDNs failure to deliver to consumers their incentives should not still give a 'bonus'. If the expectation is that these will be positive, this should be reflected in a lower Cost of Equity allowance. We also note that at this stage there is insufficient clarity regarding the calibration and implementation of the IQI. We do not think it would be appropriate to set the cost of capital for any company without further clarity on this point.

28. In Northern Gas Networks' business plan they request a Frontier reward of £10m-£15m per annum, equivalent to an additional c.1.5% return on equity. An ad-hoc, asymmetric reward such as this would go beyond the allowances under previous price controls, effectively resulting in overcompensation of investors.

Wider Industry Issues

29. Centrica feels that the stakeholder engagement has broadly been successful, with the GDNs inviting key stakeholders to presentations, asking for survey responses and publishing data universally on their websites. However the structure of the stakeholder engagement was led by the GDNs with limited scope for stakeholders to offer views not associated to the lead of the GDNs'.

30. At stakeholder events it has been muted that the GDNs could raise the awareness of carbon monoxide, however GDNs have limited access to consumers' homes and businesses, and carbon monoxide awareness should be a whole industry initiative, particularly involving all Gas Safe engineers.

31. Centrica wishes to reiterate from our response to the RIIO strategy consultation, in February 2011, the areas where the GDNs need to focus and output measures / incentives that are considered vital.

32. LDZ offtake meters are part of network reliability, where robust, transparent arrangements and incentives are required to ensure any errors are prevented from occurring, identified early, notified and rectified promptly. Centrica feels that the following output metrics are required:
    - The actual volume of gas and associated cost;
    - The length of time taken to identify and fix the error;
    - The length of time taken to notify industry parties and
    - The reason for the error.

    Centrica believes that any incentive should be asymmetric with GDNs paying a penalty for LDZ offtake errors over a certain size or number. Measuring and controlling the amount of gas entering a network is a core activity of the GDNs and consumers should not pay twice for this to be achieved.

33. Centrica believes that the GDNs need an incentive linking gas shrinkage, upstream theft and unregistered sites, including reporting back on the information passed to them by suppliers. Theft of gas is a significant health and safety risk, not just to the perpetrator but also to their neighbours, passers by and possibly staff and customers.

34. Linked to theft is the identification of unregistered sites. Currently all unaccounted for gas (UAG) is picked up by the shippers, in the main RbD shippers, giving no incentive to the GDNs to resolve it. The shrinkage incentives could be linked to unaccounted for gas flowing into the reconciliation process.

Appendix 2

Overall quality of the plans
• Do you consider that the plans are comprehensive and well-justified?

Centrica does not believe the plans to be comprehensive or well justified. The business plans are considerable in size and limited in figures, one GDN only gives stakeholders average figures over the 8 years and many others presenting data in graphic form when tables of numbers would have been more useful. The detail stakeholders require is redacted in many GDNs' business plans causing Centrica to believe they are not well justified.

- *Do they provide a clear understanding of what the company will deliver over the price control period?*

Whilst the business plans are a step forward in understanding the GDNs' business and future plans, the changes in terminology ensures understanding of their plans are difficult. Centrica is having difficulty fully understanding what asset integrity means and whether there is a safety risk to consumers as assets get to the end of their design lives or whether efficient maintenance would ensure the assets continue well into GD2.

• Do the plans include all relevant information necessary for you to understand the impact of those plans on your interests?

The impact on consumers bills and whether the consumer is receiving value for money is not always apparent, especially as only one GDN offered a comparison to 2012/13 costs (all at 2009/10 prices). Centrica believes that DN sales, changes in the replacement programme and reduced levels of pipeline reinforcement points to below inflation increases, not 3%+ price rises in real terms.

Reflecting what customers value/ stakeholder engagement
• Have the views you provided to the network companies been reflected in their plans?

No, we have repeatedly raised charging volatility as a key issue to be addressed through GD1. Only Scotia has made proposals to directly address this.

• Do you consider that the plans reflect the interests of both existing and future consumers?

The distribution network has a role to play over the next 30 – 50 years; however current consumers seem to be paying more for the network under the various transitional arrangements proposed.

Expenditure proposals
• Do you consider that the companies have clearly identified and justified their operating and capital expenditure requirements to deliver the required outputs?

We believe there are a number of areas where sufficient evidence to justify expenditure plans has not been presented. These include:
- Demonstrating the expected efficiency savings following DN sales
- Demonstrating the impact of the HSE review of the Mains Replacement Programme
- Providing clarity over the nature and extent of capacity 'integrity' spending
- Further analysis of Real Price Effects

Financial proposals

• Do you have any views on the package of finance measures proposed by the companies?

We are not convinced of the need for transitional arrangements and believe the overall packages look generous compared to other regulatory settlements.

Uncertainty and risk

• Do you consider that the plans present a comprehensive consideration of the sources of uncertainty they face, including uncertainty in relation to the future role of gas networks in a low carbon energy sector?

We are satisfied that the GDNs have identified the main areas of uncertainty. Given the range of uncertainty measures generally promoted, we would naturally expect a lower Cost of Equity to reflect this.

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[i] Figures quoted are NPV basis, 2004 prices. The majority of these benefits were anticipated by Ofgem to flow through to customers by the time of the second price control – see *Potential sale of gas distribution network businesses: Final Regulatory Impact Assessment*
http://www.ofgem.gov.uk/Networks/GasDistr/otherwork/Documents1/8895-25504a.pdf