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30th March 2012

Dear James,

Initial Assessment of RIIO-GD1 business plans

1. Thank you for the opportunity to respond to Ofgem's latest consultation, the initial assessment of RIIO-GD1 business plans, document 20/12. 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. Our response builds on our initial GDN business plans letter of 20th January 2012 and we have structured our comments as follows:
   - This letter gives our views on the assessment of GDNs' business plans.
   - Annex 1 CEPA paper covering the cost of capital.

   Our response looks at the generic issues with the business plans and we intend to write to each GDN separately with constructive feedback over the coming weeks to further help with their resubmission.

3. We reiterate our surprise 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. Centrica hopes that the next iteration of business plans will better reflect our expectation that consumers will see real decreases in gas distribution charges.

4. We agree with Ofgem's decision not to fast-track any of GDN's business plans. RIIO-GD1 is an opportunity to deliver real value for money for customers and we believe this can be best achieved with industry scrutiny and discussion. Such scrutiny and discussion would be severely impaired by fast tracking of one or more of the GDN submissions.

5. The GDNs' business plans and the stakeholder engagement that has accompanied the process has been a significant improvement over previous price controls. However, we do not feel the plans generally contained sufficient information for us to be confident they achieve the best result for customers, and specifically were overly generous to the GDNs in terms of Real Price Effects (RPEs) and Cost of Capital.

General Comments

6. In general, spending plans were justified in qualitative terms through narrative description, supported on occasions by the results of quantitative analysis. We understand that GDNs need to make their plans accessible to as many stakeholders as possible, but feel more detail is required relating to modelling undertaken for stakeholders to make in-depth assessments. We note that Ofgem has requested cost benefit analysis (CBA) for Capex and Repex and feel this is a further step forward in understanding more thoroughly the business plans. We hope that the CBA will be shared with stakeholders, in enough detail to understand the decisions the GDNs have made.

7. There is insufficient evidence of benchmarking by the GDNs in their business plans. It is not easy for a stakeholder to compare the relative efficiencies of GDNs from the information provided. Therefore we will rely on Ofgem to carry out considerable benchmarking analysis to ensure consumers share in the productivity gains and efficiency improvements that GDNs can reasonably be expected to deliver.

8. We have had difficulty in producing comparative analysis as the GDNs used redaction and inconsistent terminology and categorisation in their plans. We request that the redaction of information from stakeholders is kept to a minimum in the resubmissions due in April. We do understand that some data is commercially sensitive but believe substantially more information could be made available.

9. It is also important to note that our customers are interested in how their prices are likely to change in nominal terms. We would never describe any of our price changes in real terms, on the grounds of transparency and simplicity. To help stakeholders, the overall effect on customer bills over the length of GD1 should be outlined (using sensible inflation assumptions).

Real Price Effects

10. We do not believe there is a case for allowing positive RPEs in GD1.

11. The real price allowances given in GDPCR1 have proven to be over-generous, particularly for wage growth. For the current GDN price control, Ofgem set average RPIs of 1.5% for labour, 2.5% for contractors and 3% for materials. However, the evidence from the first three years of the price control indicates that RPEs for labour have been set well above what the GDNs would have required relative to the rest-of-the-economy. The rest-of-the-economy has been experiencing negative real wage growth (-3.7% in 2010/11). We also note that considerable positive allowances were granted at DPCR5 which also appear very generous, with negative allowances appearing more appropriate.

12. As GDNs have been receiving allowances for wage and contractor increases well above the rest-of-the-economy their average wage growth from the beginning of GDPCR to the beginning of RIIO-GD1 would be much higher than the rest-of-the-economy. We estimate that if GDNs' wages were held constant from the beginning of GD1 (i.e. 0% RPE) it would take the rest-of-the-economy average wage, growing at 2% per annum from 2010/11, until 2019/20 to achieve the same growth as GDNs were allowed during the current price control.

13. For companies in a competitive environment, particularly in the current economic climate, there is pressure to reduce costs in *nominal* terms (hence even greater reductions in real terms), therefore the GDNs should be challenged to reduce controllable costs and outperform inflation.

Cost of Capital

14. One of the most important decisions to be taken is the allowance for the GDNs' Cost of Capital. We have commissioned Cambridge Economic Policy Associates (CEPA) to produce an initial note on estimating the Cost of Capital for GD1, which we hope to build upon as the process continues.

15. We view the introduction of Cost of Debt indexation as a hugely positive step-forward and do not wish to see the value for customers eroded. Ofgem has calculated that network companies have been able to issue debt at a cost of around 58 bps below the index. We concur with Ofgem's view that the selected index has historically provided sufficient headroom. The fast-tracked T1 proposals do not incorporate any uplifts, and in the absence of clear evidence that the index would provide an insufficient allowance we would expect the same to apply in GD1.

16. The CEPA note illustrates that there is significant scope for Cost of Equity to be lower than that proposed by the GDNs. CAPM based evidence and regulators' determinations, as well as long term studies of equity markets, generally imply that the market cost of equity should be below 7.0%. Intuitively and based on quantitative evidence a lower figure would be appropriate for gas distribution.

17. CEPA say the cost of equity is a range between 6.0% - 6.6%; the lower half of Ofgem's range. We would suggest there is strong evidence to say the lower end of this range is appropriate. Networks need to make very strong arguments to justify a cost of equity above the midpoint of Ofgem range; otherwise there is a real risk of consumers being severely disadvantaged from the outcome of GD1.

18. To some extent the GDNs take the GDPCR allowance as a starting point, and attempt to assess relative risk. While this may provide useful insights, we do not believe this is a suitable overall approach. It is important to ensure that up-to-date evidence on each of the cost of equity parameters is fully reflected. Furthermore, GDNs have not provided compelling evidence that RIIO-GD1 is more risky.

Stakeholder Feedback

19. Throughout the stakeholder engagement process, we have repeatedly stated that we see managing charging volatility, predictability and transparency as key issues for GD1. However only one GDN made a proposal in their business plan to manage this. We believe that our issues are key for a number of other stakeholders also, as shown by UNC Modification Proposal 0368[1]. It would be helpful if the GDNs could propose methodology changes to improve predictability of charges and we are fully prepared to support Ofgem's volatility / transparency working groups.

[1] Smoothing of Distribution Charge Variation- http://www.gasgovernance.co.uk/0368

20. British Gas has attended a variety of GDN stakeholder events and has met bilaterally with each GDN to discuss and better understand their business plans. We intend to continue our discussions and further analyse each iteration of the business plans and Ofgem's assessments. We will also feedback individually to each GDN on their business plans as they have requested. Our broad suggestions for improving the business plans due in April, including our requests above are:

    - Wholesale review of the redactions and omissions from the November 2011 business plans.
    - Publish the data or spreadsheet models referenced in the qualitative evidence.
    - Clearly explain the price movements, reconciling 2012/13 revenues to 2013/14 including benefits from DN sales, revised policy from HSE review and the impact from financing assumptions.
    - Compare the mains replacement expenditure using the 30:30 programme versus the plans following the HSE review.
    - Make all data is available in spreadsheet format, clearly referenced to the tables in the business plans.
    - Express price movements in 'money of the day', clearly indicating the assumptions for inflation.
    - Agree and use the same terminology for capital and operating expenditure and keep the 'Other' category to a minimum. At the very least we would like the capital expenditure on governors, reinforcement, connections, gas holder removal, network security and the LTS as separate categories, with the expenditure value and related units.

21. It is not at all obvious from the business plans what price change would occur in April 2013 if these plans were accepted, and this is a key interest to a number of stakeholders. We request in the updated business plans that the GDNs explicitly state what allowed revenue percentage change they expect in April 2013 compared to current prices, and publish the mod 186 reports accordingly (with further years). We also need the figures with and without the IFRS tax impact and the same again from the impact of RPEs.

22. Requests for changes to the IQI parameters and incentive mechanisms more generally 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 and value for money for customers to assess the impact of any proposed changes. Data on the GDNs' past performance against incentives, including both financial outturns and outputs, will help stakeholders understand whether the proposed incentive arrangements are appropriate and gauge the full extent of the RIIO package. We request this is published before the initial proposals are due in July.

23. Without a full understanding of the incentives package, stakeholders will not be able to evaluate the package for RIIO-GD1. We urge Ofgem to improve the transparency of the incentive regime and ensure only well performing GDNs achieve incentive payments, so consumers truly benefit from RIIO.

24. In summary, we support the decision not to fast track any GDN and the full process that will follow. We believe the full scrutiny process will deliver better justified spending plans, specifically more realistic expectations of RPEs and Cost of Capital.

25. We hope you find the comments useful and would be happy to discuss further if helpful.

Yours sincerely,

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