British Gas
1st Floor, Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY

James Grayburn
Head of RIIO-GD1
Ofgem
9 Millbank
LONDON
SW1P 3GE

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Dear James,

RIIO-GD1 second business plans

1. Thank you for the opportunity to respond to Ofgem's latest consultation, RIIO-GD1 second business plans, document 71/12. 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 other RIIO letters and we have structured our comments as follows:
    - This letter gives our views on the second GDNs' business plans.
    - Appendix 1 covers the consultation questions
    - Appendix 2 considers Real Price Effects.
    - Annex 1: CEPA paper covering the cost of equity.

Overall- GDNs are requesting significant *increases* in revenues when all major drivers indicate reduced prices.

3. We reiterate our surprise to see most 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. The GDNs have failed to make a compelling argument why increases are credible.

4. We believe that the incremental movements between RIIO-GD1 and the current control should generally be reductions for operating expenditure, capital expenditure and, potentially, replacement expenditure. How this translates into revenue, and so prices, also depends on the financial arrangements. Given the significance of the downward pressure price pressure from the move to 100% capitalisation it is difficult to conceive how this all can reasonably translate into price increases.

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5. However, we estimate that customers would pay over £2bn[1] more for Gas Distribution over the course of RIIO:GD1, *before* inflation, under the plans submitted by the GDNs, even when compared only to expected prices for the last year of the current control. This does not appear credible for steady-state networks without the need for major new capital investment. It is also important to note that our customers are interested in how their prices are likely to change in nominal terms. We do not explain any price changes in real terms, on the grounds of transparency and simplicity. Allowing for inflation, customers are likely to be paying around £7bn[2] more for Gas Distribution under current plans over the course of RIIO:GD1.

Expenditure proposals- The huge variation in expenditure level per customer leads us to believe that substantial savings can be realised through effective benchmarking.

6. Across the business plans there is a massive range in the average total expenditure per customer and also in all categories of expenditure. The range of total expenditure per customer across RIIO-GD1 varies by 37% between the lower and highest GDN. Even removing the 2 lowest average expenditure GDNs and the 2 highest, as 'outliers', leaves a range of 14% between the remaining networks. Whilst we recognise there will be a number of regional factors, it appears likely to us that substantial savings should be possible.

7. It is not easy for a stakeholder to compare the relative efficiencies of GDNs at a more detailed level. Therefore we will rely on Ofgem to carry out benchmarking analysis to ensure consumers share in the productivity gains and efficiency improvements that GDNs can reasonably be expected to deliver.

8. In terms of operating expenditure, it is generally claimed that the benefits of DN Sales have already been delivered by the GDNs. This should still result in a reduction in terms of allowances for operating expenditure, and so prices, as the allowances for GDPCR1 did not assume early delivery of benefits. GDNs have, quite rightly, enjoyed the benefits of early delivery and now this must be shared with customers.

9. There appears to be agreement that the need for capital expenditure is more limited within RIIO-GD1, as load growth is not expected, and so we would expect reduced expenditure to be a driver for reduced prices. This appears to be generally, but not always, the case. For replacement expenditure, it is clear that spending should be reduced in comparison to the original 30:30 programme. How this translates to a comparison against current spending levels and allowances is less obvious however, although it would be disappointing if costs were to be increasing significantly. It is difficult for a stakeholder to meaningfully assess capital and replacement expenditure programmes and so we rely on Ofgem in this area.

Information Quality Incentive- A transparent review of IQI, including the impact to date, is required as part of the RIIO:GD1 process.

10. The IQI is in part designed to encourage realistic bidding or 'truth telling', but we are concerned that there has been no review by Ofgem of performance under the IQI in GDPCR or the early years of DPCR5. Performance to date will give important insight into actual bidding behaviour under the IQI. In particular, it needs to be established whether bids have

[1] Comparing 2012/13 revenues (in 2009/10) from UNC Modification 186 reports to RIIO:GD1 revenues
[2] Uses Treasury forecasts where available and 2% inflation thereafter

become more 'truthful'. The success of the IQI will rely on the independent baseline being set correctly by Ofgem and, it may be viewed that submissions could influence that baseline, and so the incentive to 'truth tell' is reduced.

11. We also understand that incentive rates are likely to be strengthened significantly. It remains to be established that this is necessary or will benefit consumers, especially as it is companies that are pushing for higher incentive rates. We strongly request that Ofgem leads a transparent review of the IQI and the range of options for its detailed reform and design under RIIO. Due to timescales, it is likely this would now need to form part of Initial Proposals. We would be prepared to contribute to this review once data and details have been shared by Ofgem.

Real Price Effects (RPEs)- GDNs are in an extremely favourable position from RPEs in the current price control and there is no need for positive RPE allowances in RIIO:GD1

12. Companies have asked for significant allowances for RPEs within their revised business plans for RIIO-GD1. For labour especially, RPEs are positive, suggesting that companies expect to face above-inflation wage costs throughout GD1, with this amount compounding for each of the eight years. This follows from GDPCR, where allowed RPEs were significantly above actual private sector wage growth. The difference across the industry in GDPCR is estimated to have been in the order of £0.5bn. This gain to companies through an overly generous allowance could have gone to company workers or shareholders. If the former is true, real employee wages should be significantly above the rest of the economy at the start of RIIO-GD1. If the benefits fell to shareholders, there would have been an unanticipated gain to those shareholders, which is not the purpose of the RPE mechanism and should be reflected in the RIIO:GD1 settlement.

Financial Package- The GDNs have not made a case for additional transitional arrangements and none should be allowed. The overall financial packages suggested are too generous.

13. Ofgem has already offset the move to 100% capitalisation with changes to depreciation and there is no clear case made for any further transitional measures. To allow any additional measures would have a significant and unfair effect on the prices current customers will have to pay.

14. We attach a paper from CEPA on the cost of equity. It shows that using a CAPM-based approach, crossed check to a relative risk assessment and market evidence, an appropriate allowed cost of equity for GD1 is likely to be below 7% and that GD1, on balance, is no more risky than DPCR5, for which the cost of equity was set at 6.7%. CEPA's recommendation, before sight of Initial Proposals and thus fuller details on the regime, is that a range of 6-6.75% is appropriate.

15. 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]

Appendix 1- Consultation Questions

Overall quality of the plans

- Do you consider that the plans are comprehensive and well-justified? Do they provide a clear understanding of what the company will deliver over the price control period?

The published plans are voluminous in nature and reference significant amounts of data and underpinning modelling. A vast amount of analysis is required to assess whether the plans are efficient and effective which we expect Ofgem to undertake. We, as stakeholders, do not have access to the detailed information and data, such as Cost Benefit Analyses, required to be able to complete this analysis.

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

The provision of summary data in a standard format is a welcome development. We note, however, that only Wales and West included within this data-set comparable information from the current price control. This data is key to setting the context of expenditure plans and is also very useful in understanding the drivers behind price movements. Throughout the plans, it would be extremely instructive for stakeholders to see the equivalent values from the current price control for comparison purposes.

The business plans still do not express clearly and explicitly the suggested price changes in each year of the price control, and, although we recognise the GDNs have engaged with the industry towards interpreting the potential impact of these plans on gas distribution prices, not all GDNs have provided this information specifically.

Reflecting what customers value / stakeholder engagement

- Have the views you provided to the network companies been reflected in their plans?

The GDNs have all been keen to engage with us as stakeholders and have responded positively to any requests for additional understanding we have made. We have held instructive discussions with all GDNs.

We raised a number of issues in our response to the initial business plan submissions, both regarding the expenditure and revenue proposals and of a more practical nature. Whilst, we did not necessarily expect the GDNs to accept our arguments over the business plan submissions, such as regarding the appropriate cost of capital, we have yet to see a clear rebuttal either.

In terms of the practical feedback, progress has been made and we acknowledge the provision of summary data as a positive reaction to stakeholder feedback. There remains, however, a significant degree of redactions and omissions in the information available to stakeholders. We also note the GDNs have sought to engage over charging predictability, one of areas of concerns, although this has now been superseded by Ofgem’s consultation.

As mentioned above, whilst all GDNs have assisted the industry in interpreting the potential price impact of these proposals, not all have provided the actual proposed numbers. We believe the GDNs are better placed than stakeholders to provide this.

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

We believe that implementing 100% capitalisation is essential to ensure the correct sharing of costs between existing and future customers and to fairly reflect the interests of both. Thus we believe the transitional measures that are suggested cause an inter-generational issue with existing customers paying disproportionately. We do not believe that any additional transitional measures should be allowed or have been justified. Arguments are offered about the desirability of bringing cash forwards to avoid the possibility of sharp price increases due to a diminishing charging base. Whilst we understand and acknowledge the issue, we do not believe this is a relevant argument and is speculative.

Expenditure proposals

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

The companies have clearly identified their expenditure requirements. However, as noted above, the range of expenditure, on a total and on a per customer basis, leads us to believe that there is plenty of scope for savings.

For example, controllable operating expenditure varies by around 38% between the least and highest cost GDN, on a per customer basis. It is unlikely that all the differences between the GDNs will be due to network-specific issues and expect that effective benchmarking to have a favourable impact for customers.

We note that for National Grid whilst expenditure plans for the RIIO-GD1 period have reduced by 2% since the original plan submission, forecast revenues for the period have *increased* by 7%. If a larger expenditure programme was financeable on significantly lower revenues then the reduced programme must be financeable on similar revenues as the original submission and the requested transitional measures are, at best, vastly overstated.

We do not believe positive allowances should be made for Real Price Effects. This is considered in Appendix 2.

Financial Proposals

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

We attach a paper from CEPA on the cost of equity. It shows that using a CAPM-based approach, crossed check to a relative risk assessment and market evidence, an appropriate allowed cost of equity for GD1 is likely below 7% and that GD1, on balance, is no more risky than DPCR5, for which the cost of equity was set at 6.7%. CEPA's recommended range, before sight of Initial Proposals and thus fuller details on the regime, is that a range of 6-6.75% is appropriate. Since the DPCR5 decision, risk-free rates have continued to fall to near zero levels, and even taking into account the potential impact of the unwinding of Quantitative Easing, an allowance of 2% on the risk-free rate would be an upper limit. Evidence on the Equity Risk Premium points to no more than 5%, supporting a 7% ceiling for a market return.

We also need to consider the relative risk of the gas distribution sector to the broader market. Evidence from asset betas show that, not surprisingly, the sector is less risky than the market. CEPA has provided a qualitative analysis of the relative risk of GD1 compared to GDPCR and other controls, which shows that:

(i) there is enhanced stability and predictability of revenues through long term regulatory commitments to returns and incentives;

(ii) capex and opex risks (and therefore exposure of profits to cyclical factors) are expected to be managed through an equalised totex incentive; and

(iii) reducing operational gearing, reflecting that the GDNs businesses are approaching a more steady-state.

This supports the case that relative risk has not increased.

This evidence is strongly supported by City analyst comment and the continued observed market appetite for UK regulated assets – the acquisition of controlling or minority stakes in water and energy assets has been made at significant premia to regulatory asset bases, which can only be justified by assumptions about continued outperformance on the allowed cost of capital, and the cost of equity in particular given the welcome introduction of debt indexation. Investors do not assume significant outperformance on incentives. It is thus difficult to see how GDN request for costs of equity of up to 7.5% are justified.

On gearing, the data shows that comparator companies are continuing to sustain investment grades at around the current level of notional gearing and so there is no case for a change in Ofgem's assumption from 62.5%. We also note that GDNs will not face significant levels of capex: RAB and as such there is no prima facia case to consider financeability adjustments, including the level of gearing granted to the fast-tracked transmission companies. We also note that Ofgem has already made a significant financeability concession to the GDNs through the treatment of depreciation.

Appendix 2- Real Price Effects

RPE proposals for RIIO-GD1

The reason for the existence of Real Price Effects (RPEs) allowances within price controls is to compensate for cost drivers that rise or fall by different amounts compared to RPI inflation and to provide more accurate cost forecasts. Companies have asked for significant allowances for RPEs within their revised business plans for RIIO-GD1. For labour especially, RPEs are positive, suggesting that companies expect to face above-inflation wage costs throughout GD1, with this amount compounding for each of the eight years.

This follows from GDPCR, where allowed RPEs were significantly above actual private sector wage growth. The difference across the industry in GDPCR is estimated to have been in the order of £0.5bn.

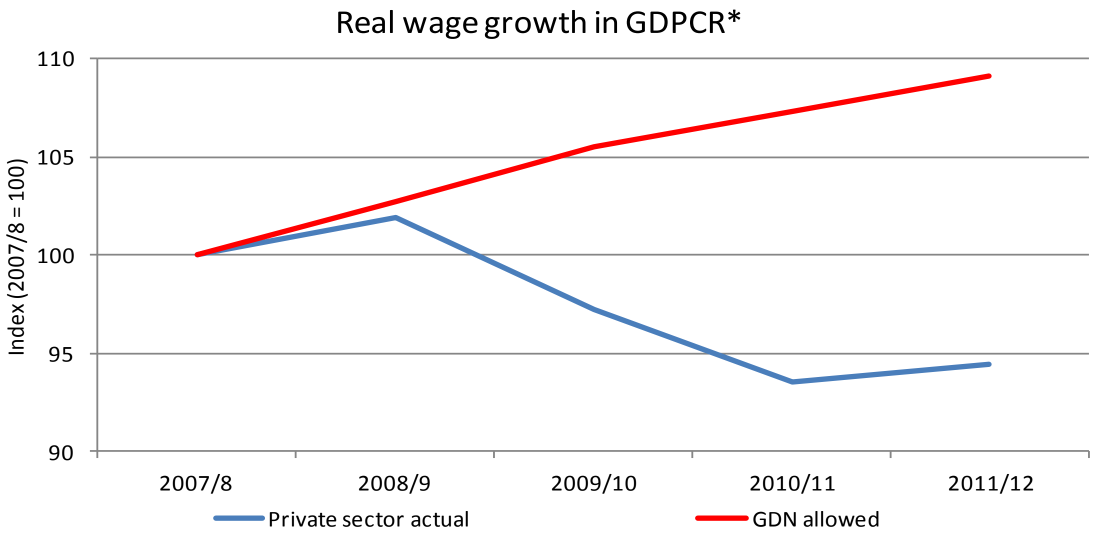
This gain to companies through an overly generous allowance could have gone in wage settlements or to shareholders. If the former is true, real employee wages should be significantly above the rest of the economy and therefore GDNs are starting GD1 at an advantageous position. If the benefits fell to shareholders, there would have been an unanticipated gain to those shareholders, which is not the purpose of the RPE mechanism.

Shareholders might of course argue that they equally took the risk of wage pressures increasing above the allowance (including RPEs), but the depth of the recession was unanticipated and as such the size of the gain should factor in to the GD1 allowances. More information from companies on the flow of this gain, i.e. whether to workers or shareholders, would help stakeholders to understand the case for the RPE requests.

RPE outturn in GDPCR

The economy has experienced negative real wage growth over the last three years (-3.7% for all professions in 2010/11). The current RPE allowances have been very generous to the GDNs – zero allowance would have been more reflective. According to the estimates made by CEPA, these allowances will result in GDNs receiving over £0.5bn more than required to reflect real wage growth in the wider economy in the current price control. This utilises a notional cost weighting of materials (15%), direct labour (35%) and contract labour (50%). The chart below shows the actual wage growth for the private sector against CEPA estimates of the RPE allowances.

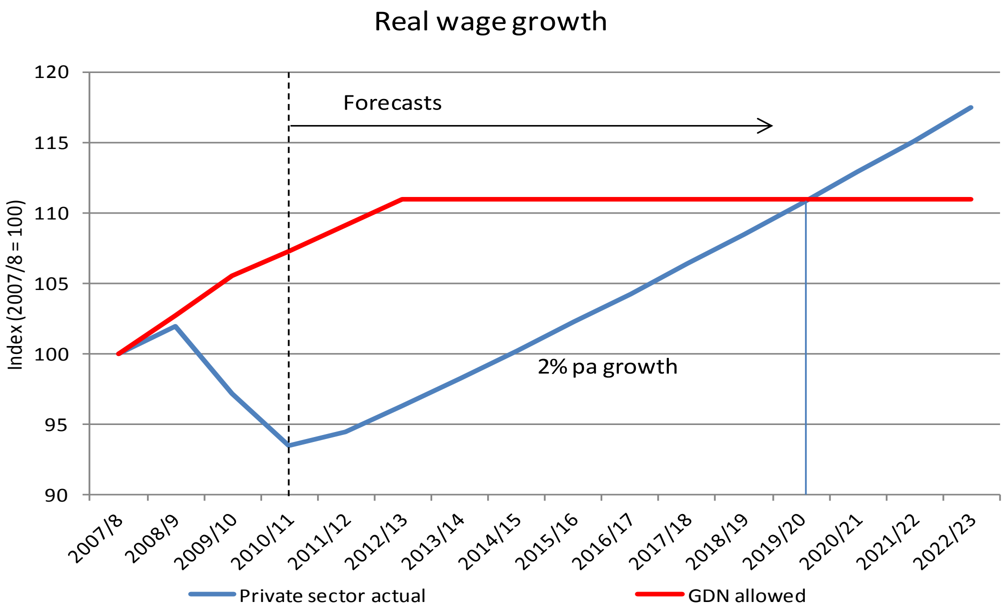
Figure 1: Allowances against actual in GDPCR.



Source: ONS, Ofgem, Business plans & CEPA analysis.

The economy is not forecast to return to long-term growth until 2015 depressing wage growth over this time. We do not believe that recovering this money would be appropriate, but think that it is important to consider this when setting the allowances for RIIO GD1. Even if allowance set at zero for GD1, it would take the rest of the economy until 2019/20 to catch-up to GDNs wage levels assuming a 2% p.a. real wage growth for rest of the economy. This is shown in Figure 2 below.

Figure 2: Catch-up of private sector wage growth against allowed GDN wage growth



Source: ONS, Ofgem, Business plans & CEPA analysis.

This assumes that real wage growth for the private sector outpaces the GDNs by 2% in real terms each year and catch up does not occur until near the very end of the price control period. In order to be cost-neutral for consumers, a negative RPE would have to be in place even with this 2% differential. If private sector wage growth continues to be depressed, this negative RPE allowance for the GDNs would of course have to be even greater in magnitude. This is especially important when the GDNs have asked for around £0.9bn gross RPEs for the next price control.