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Anna Rossington
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4th November 2013

Dear Anna,

Consultation on the timing of a decision on electricity distribution networks' revenue for 2015-16

1. Thank you for the opportunity to respond to Ofgem's consultation regarding electricity distribution networks' revenue for 2015-16. This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

2. Our preference is for **option (b)**, setting 2015/16 revenues at the Draft Determination stage in July 2014. We believe this option is of the most benefit to customers, eliminating the risk of short-notice price disturbance without the potential detrimental impacts of using DNO business plan submissions (option (c)).

3. Past experiences have shown that there can be significant movements between Initial and Final Proposals at a price control review. Whilst we acknowledge that under the new RIIO model Ofgem consider that there will be relatively less movement between Draft Determinations and Final Determinations, the recent experience of RIIO:GD1 does not support this. It is likely, therefore, there will be a significant perceived risk of movement between the Draft and Final Determinations which may affect customer pricing. Assuming that, as the RIIO process evolves, Draft Determinations do become more reliable, setting first-year revenues at the Draft Determination stage (option (b)) will eliminate the perceived risk of price disturbance without causing DNOs to recover revenues significantly different to the Final Determinations.

4. We do not support option (c), setting revenues at the levels contained in DNO business plans. We expect the Ofgem review process to remove costs from the DNO business plans and so option (c) would mean customers paying too much in the first-year of the price control. Not only is this timing undesirable in the current economic climate but it will also add costs to all customers overall. Option (c) also only provides improved certainty to a limited additional portion of customers when compared to our preferred option (b). We are also concerned that option (c) will set a precedent which would effectively allow networks to set their own revenues for the first year of a price control which would increase the risk associated with price controls prior to the publication of business plans.

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

Yours sincerely,

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

Consultation Questions

1. Please provide any relevant information to improve our analysis of the benefit of each option including (if available):
(i) information on the risk premium included in contracts offered to consumers; and
(ii) the expected reduction in the risk premium an additional 4 months (option (b)) and an additional 11 months (option (c)) would provide.
Please specify if you wish any data provided to remain confidential.

With regards to any reduction in risk premium, we would point out that the additional reduction in risk between option (b) and option (c) is likely to be restricted to a limited portion of customers. Given that supplier contracts are typically entered into in either April or October, the increase in certainty under option (c) compared to option (b) would be in relation to the second year only of a two year fixed contract entered in to in April 2014 i.e. there would be no change in certainty for:

- The first year of a two year fixed contract entered into in April 2014
- All fixed contracts of any length entered into in October 2014
- All fixed contracts longer than two years entered into in April 2014
- All pass-through contracts
- All one year fixed contracts

We do not believe that such limited additional certainty warrants the additional costs likely to be faced by all customers under option (c).

2. Do you have any views on the potential costs we have identified? Do you consider there to be other costs we have not identified?

We have identified two further potential costs which could particularly arise under option (c):

(1) We are concerned that option (c) would create a precedent which would effectively allow all networks (Electricity and Gas Distribution and Transmission) to set their own revenues for the first year of any future price control. Setting revenues before Ofgem has performed a robust cost efficiency assessment will significantly increase the risk associated with price controls. This will add risk to long term contracts which extend to future price control review periods which have been entered into prior to the publication of business plans.

(2) Whilst Ofgem consider that applying the WACC to any revenue deferred or brought forward will make network companies NPV neutral, we do not believe that applying the WACC will make consumers NPV neutral. We believe that consumers have a higher financing cost than networks and therefore any revenue brought forward, as would be likely under option (c), will result in consumers being a net loser even when the payback of such revenue is adjusted by the WACC.

3. What is your preferred treatment of deferred revenue? Please explain your reasoning.

We believe that the appropriate treatment is dependent on whether revenue is 'deferred' or whether it is 'brought forward'. Where revenue is deferred we favour option 3, however where revenue is brought forward we favour option 1.

Revenue deferred: **We favour option 3**.
Where networks have revenue deferred under either option (b) or, as unlikely as it should be, option (c), it is appropriate to apply the WACC to any amount deferred. We also consider that it is appropriate to put networks' finances right as soon as is reasonably practical. However since

networks will be NPV neutral in all instances, there is no cost, and potentially some market benefit, to having some regard to the impact on future year revenue volatility.

We therefore propose that the recovery of deferred revenue be subject to a threshold and we believe that by setting this threshold as a percentage of the 2015/16 base revenues, Ofgem would provide additional assurance about the potential levels of volatility in years post 2015/16.

Revenue brought forward: We favour option 1.
Where networks have had revenue brought forward – and we agree with Ofgem that this is likely to occur under option (c) – we believe that these revenues should be paid back to consumers as soon as possible.

We believe that consumers face a higher financing cost than networks and therefore in any instance where revenue has been brought forward, the consumer will be a net loser despite the application of the WACC. The consumer should therefore be put right as soon as possible, i.e. in 2016/17.

We believe our suggested approach of applying different options depending on whether revenue is deferred or brought forward should be applied at a licence area level regardless of whether option (b) or option (c) is implemented (if either). We note that this may result in applying option 1 to some licence areas and option 3 to others, but we believe that such an approach is appropriate and do not consider it to add to complexity.

4. If you prefer option 3 for deferring revenue, what do you consider an appropriate threshold? Please explain your reasoning.

We suggest a materiality threshold of 3% of 2015/16 base revenue per year. We believe this should allow networks to recover any deferred revenue reasonably promptly whilst also providing the market with a degree of assurance over the level of potential volatility in revenues subsequent to 2015/16.

For clarity, we repeat that we do not believe option 3 is appropriate for any licensee which has had revenue brought forward (as opposed to deferred) under any option for setting 2015/16 revenues.

5. Do you have any views on our initial assessment of each option?

We agree with Ofgem that option (c), which would set revenues at the level contained in the DNO business plans, is unlikely to benefit consumers. **We are therefore not supportive of option (c))**.

Based on previous prices controls, option (c) would be likely to result in consumers funding services earlier than they should. Whilst networks would be NPV neutral in such a scenario, we do not believe consumers would be NPV neutral since their applicable discount factor is likely to be higher than the networks' WACC. Option (c) will therefore add cost to consumers.

We are also concerned that option (c) would create a precedent which would effectively allow all networks to set their own revenues for the first year of any future price control. Setting revenues before Ofgem has performed a robust cost efficiency assessment will significantly increase the risk associated with price controls. This will add risk to long term contracts which extend to future price control review periods which have been entered into prior to the publication of business plans.

We would also note that given that supplier contracts are typically entered into in either April or October, the only increase in certainty under option (c) compared to option (b) would be in relation to the second year only of a two year fixed contract entered in to in April 2014 i.e. there would be no change in certainty for:

- The first year of a two year fixed contract entered into in April 2014
- All fixed contracts of any length entered into in October 2014
- All fixed contracts longer than two years entered into in April 2014
- All pass-through contracts
- All one year fixed contracts

We do not believe that such limited additional certainty warrants the additional costs likely to be faced by all customers under option (c).

Our preference is for option (b), setting 2015/16 revenues at the Draft Determination stage in July 2014. We believe this option is of the most benefit to customers, eliminating the risk of short-notice price disturbance without the potential detrimental impacts of using DNO business plan submissions (option (c)).

Whilst we acknowledge that under the new RIIO model Ofgem consider that there will be relatively less movement between Draft Determinations and Final Determinations, the recent experience of RIIO:GD1 does not support this. It is likely, therefore, there will be a significant perceived risk of movement between the Draft and Final Determinations which may affect customer pricing. Assuming that, as the RIIO process evolves, Draft Determinations do become more reliable, setting first-year revenues at the Draft Determination stage (option (b)) will eliminate the perceived risk of price disturbance without causing DNOs to recover revenues significantly different to the Final Determinations. We therefore consider that the benefits to customers of option (b) are greater than the potential costs of moving away from option (a).

6. Which option do you consider will drive the greatest benefit to consumers? Please support this view with analysis of the costs and benefits.

For the reasons stated above and summarised below, **we believe that option (b) will drive the greatest benefit to consumers**:

- Option (b) will remove the perceived risk that currently exists in relation to unexpected revenue movements between Draft and Final determinations.
- Assuming that, as the RIIO process evolves, Draft Determinations do become more reliable then we believe that the benefits to customers of removing this perceived risk are greater than the potential costs of moving away from option (a).
- Option (c) will add costs to customers and only delivers additional certainty vs. option (b) in relation to a limited portion of customers (the second year of two year fixed contracts entered into in April 2014).
- Option (c) would create a precedent for future price controls and business plan submissions which would effectively allow networks to choose their own revenue in the first year of a price control, adding risk to longer term contracts.

7. Do you have any views on the relative complexity of option (b) and (c)?

We consider both options could be implemented without any undue increase in complexity and we agree with Ofgem's assessment that neither is more complex than the other.