British Gas
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26th September 2014

James Goldsack
Ofgem
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Dear James,

**Consultation on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators**

Thank you for the opportunity to respond to the consultation regarding the treatment of real price effects (RPEs) for RIIO-ED1 slow-track electricity distribution network operators (DNOs). This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

- **The current treatment of RPEs in energy networks price controls has resulted in customers unnecessarily funding a significant amount of revenue for customers and requires replacing.**
- **We prefer an appropriate indexation mechanism instead of ex-ante allowances to reduce risk for both customers and networks.**
- **On balance, we believe Option B (two year lagged RPE true up) is the most appropriate of the options presented. A possible variant of this option is presented in the CEPA paper accompanying this response.**
- **We suggest a full assessment of the knock-on effects of related components of the price control framework (such as the Information Quality Incentive) is published at the earliest opportunity.**

We welcome your acknowledgement of the dis-benefits to customers due to the current treatment of real price effects (RPEs) within energy networks price controls, including:

- Windfall gains for network operators (NWOs) because RPEs have consistently been over-estimated when fixed ex-ante allowances were awarded. We highlighted this has resulted in a premium of about £35 being levied on each customer since 2008 in our written evidence to the ongoing parliamentary Energy and Climate Change Committee inquiry into Network Costs[1].

- Increased difficulty in arriving at a reasonable forecast of RPEs because of the increase of the length of price controls to eight years and uncertainty about any changes to the structural relationship between the Retail Price Index (RPI) and RPEs, as outlined in the consultation document[2].

We briefly highlight related points of interest below and explain our preference for our indexation mechanism of choice in responses to the consultation questions.

**Impact on the cost of capital:**
We agree indexation is likely to reduce DNOs' overall risk exposure as highlighted in the consultation[3] because DNOs are guaranteed compensation for expenditure efficiently incurred. As a reduction in risk should normally require a proportionate decrease in (the constituent components of) the cost of capital, the assertion that RPE indexation will have no impact requires further explanation. We seek confirmation that this will be evaluated and any anticipated reduction will be incorporated into the RIIO-ED1 final proposals.

**Concerns about DNOs' RPEs forecasting:**
In the consultation, it is stated that labour costs have historically been considered more predictable and controllable than other cost components[4]. It is also acknowledged that labour costs have a dominant effect on the composite REP index[5]. Our analysis of data presented in the *RIIO-ED1 Draft Determinations*[6] supports that statement - labour costs account for about 67% of the overall impact on RPEs for a notional DNO.

Historical data published by the Office for National Statistics (ONS) and short-term forecasts produced by HM Treasury (HMT) both demonstrate the sustained deficit in wage growth relative to that of the Retail Price Index (RPI), as illustrated in figure 12.1 (General labour indices) in the *RIIO-ED1 Draft Determinations*[7]. Nevertheless, DNOs estimated RPEs will increase their total expenditure (totex) by about £772 million while Ofgem estimated that RPEs will reduce the baseline totex requirements by £78 million[8]. We are unclear why the dominant impact of labour costs on RPEs appears to have been overlooked by the DNOs given the ONS and HMT data used generate figure

[1] British Gas (2014), 'Written evidence submitted by British Gas (NTC0030)', page 8. See: http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/energy-and-climate-change-committee/network-costs/written/8309.pdf.
[2] Ofgem (2014), 'RIIO-ED1: Draft determinations for the slow-track electricity distribution companies Business plan expenditure assessment', chapter 12. See: https://www.ofgem.gov.uk/ofgem-publications/89068/riio-ed1draftdeterminationexpenditureassessment.pdf.
[3] Page 7 of the consultation document.
[4] Page 12 of the consultation document.
[5] Page 12 of the consultation document.
[6] Data presented in tables 12.2 and 12.3 of the 'Draft determinations for the slow-track electricity distribution companies Business plan expenditure assessment'
[7] This figure can be found on page 115 of the 'Draft determinations for the slow-track electricity distribution companies Business plan expenditure assessment'.
[8] The data can be found in table 12.5 (Value of DNO and our RPE forecasts over RIIO-ED1) on page 122 of the 'Draft determinations for the slow-track electricity distribution companies Business plan expenditure assessment'.

12.1 (referred to above) are publicly available. Review of the short term HMT forecasts published during the period encompassing a few months before fast-track submissions to a few months before slow-track submissions (reproduced in Table 1 below) would have suggested weaknesses in the DNOs' forecasts.

**Table 1: HMT forecasts**[9]

| Publication month | Average Earnings Growth (%) | RPI Growth (%) | | | | | |
|---|---|---|---|---|---|---|---|
| | | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| May 2013 | 2.3 | 3.3 | 2.9 | 3.2 | 3.4 | 3.6 | n/a |
| June 2013 | 2.3 | | | | | | |
| July 2013 | 2.32 | | | | | | |
| August 2013 | 2.5 | 3.1 | 2.9 | 2.9 | 3 | 3.4 | n/a |
| September 2013 | 2.4 | | | | | | |
| October 2013 | 2.3 | | | | | | |
| November 2013 | 2.4 | 3.1 | 3.1 | 3 | 3.2 | 3.5 | n/a |
| December 2013 | 2.4 | | | | | | |
| January 2014 | 2.2 | | | | | | |
| February 2014 | 2.2 | n/a | 2.8 | 3 | 3.2 | 3.3 | 3.3 |

**Independent review:**
We commissioned Cambridge Economic Policy Associates (CEPA) to independently review the issues raised in the consultation. Their report is attached as an annex to this submission. Their main findings are:

- The current RPEs forecasting methodology is not robust enough.
- The current methodology should not be abandoned without a replacement.
- An impact assessment should be conducted before any changes to the regulatory framework are made.
- Possible alternatives to the current approach include ex-ante allowances with deadbands, RPEs indexation similar to the RPI indexation and ex-ante allowances with true ups with deadbands (an adapted version of Option B described in the consultation).

While we prefer Option B as stated above, out of the options presented, we currently do not have a strong preference on the use of deadbands but believe this may merit further examination.

We hope you find our comments helpful. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements

[9] Source: HM Treasury Forecasts for the UK economy. See: https://www.gov.uk/government/collections/data-forecasts.

**Question 1: Do you think these criteria are appropriate and sufficient? If not, please explain why and justify any alternative assessment criteria.**

The criteria presented in the consultation appear appropriate. However, we suggest that issues relating to the development and implementation of indexation are also considered such as any constraints arising out of the RIIO-ED1 or other regulatory timetables. The next stage is to define measures for each criterion and assess each option accordingly.

**Question 2: Which of the RPE approaches (including the current approach of a fixed ex ante allowance, or any not explicitly discussed in this consultation) do you favour and why? Please justify with reference to the criteria.**

We favour Option B (two-year lagged true up) because:

- True ups will be based on price index data observed within the relevant regulatory year.
- Annual reconciliation theoretically minimises the amounts to be reconciled compared to reconciliations at set windows or at and the end of the RIIO-ED1 price control. By extension, network charging volatility is theoretically minimised.
- The risk of inter-generational charge distortions between current and future customers appears to be minimised.
- True ups can be accommodated within the Annual Iteration Process
- The lag is consistent with other mechanisms within the price control framework.

The CEPA paper accompanying this consultation suggests a variant to Option B (CEPA's Option 3) which is also worthy of further consideration.

**Question 3: If we use indexation with a deadband, at what value should the thresholds be set?**

We acknowledge that the RPE indexation approach is a means of managing this particular risk for both DNOs and customers, given the current difficulty in fully defining and quantifying its nature. The use of deadbands would limit the degree to which this risk is reduced, the extent of which depends on the threshold. We are uncertain whether either party would benefit if the outturn RPE index does not trigger a true-up, due to a deadband, would outweigh the increased exposure to risk.

**Question 4: If we use indexation, do you think the proposed indices are appropriate? If not please justify alternatives.**

We do not offer an opinion on the suitability of the proposed indices. However, we agree with the list of criteria used to identify which price indices can be used to construct any potential RPE index[10]. We suggest the following additions to that list:

- It must be produced and can be accessed in a timely manner in order to support the assessment of RPEs that should form an input into the Annual Iteration Process.

[10] Page 11 of the consultation document.

- It must sufficiently resilient to DNOs' expenditure decisions in order to avoid circularity. (This factor is noted by the health regulator when assessing labour costs within the National Health Service[11].)

**Question 5: Do you think that using a single mechanism covering all cost types is more appropriate than multiple mechanisms? If you think multiple mechanisms would be appropriate please justify which one you think should apply to each cost type.**

We agree with the use of a single mechanism that mirrors the 'totex' approach to expenditure assessment, for the reasons stated in the consultation.

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[11] Monitor (2013), 'A guide to the Market Forces Factor', page 14. See: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/300859/A_guide_to_the_Market_Forces_Factor.pdf.