E.ON UK plc
Westwood Way
Westwood Business Park
Coventry
West Midlands
United Kingdom
CV4 8LG

www.eon-uk.com

Joanna Whittington
Director – Gas Distribution
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Friday, 13 July 2007

<u>Gas Distribution Price Control Review – Initial Proposals Document</u>

Dear Joanna,

E.ON UK is responding to this consultation as a company which is active in gas shipping and supply, in addition to owning Central Networks the UK's second largest power distribution company.

Our comments therefore refer to general regulatory principles which would be applicable to our regulated business, as well as to some aspects of the proposals are of more relevance to our gas supply and shipping activities. In the latter case, we have also helped contribute to the Gas Forum's response to these proposals and are supportive of the comments they have made.

Assessment of Efficient Opex

Central Networks' commentary on the fourth consultation paper commented on the risk of creating a virtual company that does not reflect the overall activities and interfaces of a real company. We appreciate the challenges faced, given the amount of data and number of comparators available to Ofgem, and acknowledge that Ofgem have adjusted cost allowances upward to take account of the fact that it is likely to be impractical (para. 1.4, appendix 7) for a single company to achieve upper quartile performance in every activity.

However, the reasons for adopting different benchmark measures in the top down (frontier) and bottom up (upper quartile) approaches are not clear. At DR4 Ofgem acknowledged that use of a single outlier to determine the frontier was not 'prudent' (paragraph 7.18, final proposals document). Given that in this case there is arguably less data available to Ofgem than at DR4 – and so greater uncertainty regarding the reliability of the top down regression - normalising by the frontier company would seem to be inconsistent with the DR4 approach.

Instead, it would seem more consistent and reasonable to take account of the increased likelihood of error in the top down regression by normalising the results from the activity analysis by the top down upper quartile benchmark. This would ensure that the allowance implied for the upper quartile company in the top down analysis was equal to that implied by the disaggregated approach.

We note that in paragraph 1.43 of appendix 7 Ofgem state that "a privatisation effect may be small so many years after privatisation" and further note that electricity DNOs have been exposed to the effects of comparative competition for a significantly longer period than gas DNs.

We have previously expressed support for rolling opex incentives and believe that they help maintain a constant strength of incentive and deal with some of the artificial drivers created by fixed-period reviews. We continue to support a rolling opex approach in principle and believe that improvements in data quality and adoption of a high-level principle based on ensuring whole life costs are efficient (i.e. opex and capex are appropriately balanced when making investment decisions) will alleviate concerns that Ofgem has previously expressed.

Nevertheless, we do not believe that introducing a rolling incentive is an appropriate alternative to specific funding of investment in skills or R&D (paragraph 6.27) principally since the pay back times expected could be significantly longer than that of the rolling period. We therefore welcome moves by Ofgem to increase certainty by extending the IFI mechanism into the DR5 period and introduce it in Transmission. It may also be appropriate to introduce it to Gas Distribution. We have commented further on skills below

Finally, we are pleased to see that Ofgem are considering the impact of real price effects and are further considering the choice of comparative index for productivity for the September update. We would however point out that our experience to date has revealed far higher cost increases that Ofgem are proposing here e.g. price of copper has risen by 50% over the past two years.

Specific allowances

We were surprised to learn that GDN's Emergency Service personnel do not currently always carry and use carbon monoxide measuring equipment when they attend emergency investigations. We would support them doing so and for the Gas Distribution Networks (GDN) to receive an appropriate allowance for this.

It would seem appropriate that this change should be supported by amending aspects of relevant safety procedures and/or legislation at the same time to mandate the carrying of such equipment during emergency investigations to ensure that it is used.

Financing

EdF and Central Networks have submitted a NERA study to the Competition Commission's inquiry into the CAA's proposals on the risk free rate which also provides an alternative method to derive this data taking into account recent distorting factors. E.g. the impact of changes in pension legislation. We would welcome opportunities to discuss this with Ofgem.

We continue to believe that in the longer term, equity finance remains important in order to provide strong incentives on management continually to improve. Consequently, the approach to gearing should be consistent with ensuring that sufficient levels of equity continue to be invested in networks.

Sustainable Development

We recognise the benefits that expanding the gas network could have for alleviating fuel poverty and reducing carbon emissions. The suggested proposals would appear to be a logical way to achieve these aims and using the Government's Index of Multiple Deprivation would be seem appropriate even though it does not give an exact measure of fuel poverty.

Care must be taken when introducing the scheme to ensure that existing gas customers are not too onerously affected by cross subsidisation and that competition in the gas connections market is not distorted.

Skills

We are extremely concerned with the narrow position Ofgem has taken in respect of skills. All of the utilities are facing increasing investment as well as an ageing workforce and, contrary to Ofgem's views, we do not believe sufficient incentives exist within the current price control frameworks to deliver the resources necessary. By not considering this issue fully we are concerned that the current framework will continue to deny investment in our future resources, thus pushing the risk onto consumers who will ultimately pay higher prices as a result of this future constraint. This issue has been further recognised in the Energy White Paper: "[r]ecruitment and training are key to developing a new workforce but there is the additional challenge of transferring knowledge and experience from the older generation." We would argue that the current position taken by Ofgem within the price control framework does nothing to address this concern.

There has been significant collaborative work undertaken across the gas and electricity businesses, co-ordinated through EU Skills and we would welcome further discussion with Ofgem in finding a more appropriate funding mechanism to what is a short term cost but with pay back considerably longer than the 5 year price control.

Xoserve

Proposed approach to the funding of xoserve

We are not entirely convinced that the proposed funding mechanism for xoserve will offer the greatest cost efficiencies. We would have preferred the funding of xoserve to move entirely to a model where it was derived directly from shippers and not via transportation income. We believe that this would offer the greatest opportunity for the delivery of an efficient and responsive service that would meet the needs of the participants in the competitive retail gas market.

We appreciate that the proposed 'user pays' option is a step towards this model and therefore support it over maintaining the existing funding structure. We believe that it is an effort to try to bridge the difference between the existing financing for xoserve and a more radical and better model described above that could be introduced in the future.

We are concerned however that the limited service lines that have been identified for a 'user pays' model may make it overly complex to administer. They may also be too limited in scope and value to engender the change of attitude that is needed within xoserve to realise its full benefit for the competitive retail gas market and for consumers.

Benefits arising to xoserve from redundancy created from the replacement of

UK link

Assessing the benefits that may be available from xoserve's system replacement is difficult at this stage. It would be appropriate to incentivise xoserve to develop a flexible system that would manage change in the future at a low a cost as possible.

The current funding structure of xoserve will incentivise the replacement of the existing systems in as lower a cost manner as is possible without scope to cater for future developments. If this is allowed to proceed during the lifespan of the replacement system the full advantage of any changes in the industry may not be realised for either the participants in the retail market or gas customers. Significant change is expected in the market during the lifespan of the new xoserve system including the potential replacement of the existing gas meters with more advanced smart metering. Incentivising xoserve to replace their system in a manner which would not hamper the development of smart meters should be a priority.

Facilitating governance arrangements for user-pays

We do not believe that the current ownership structure of xoserve helps it deliver services in an efficient and flexible manner. By maintaining ownership the GDN's encourage xoserve to focus solely on the cost efficiencies and not on the flexibility or the levels of service delivered. The management of the GDN's are not best placed to capitalise upon the potential opportunities that xoserve could present. The agency function is a knowledge based information service company and it would be more appropriate for it to be controlled by a company specialising in this form of activity.

We would support modification to the gas transporters licence to help facilitate governance arrangements for a user pays model.

Adequacy of the governance of xoserve

The current governance arrangements of xoserve are not sufficiently robust to protect the interests of gas shippers and suppliers if a 'user pays' model is adopted. The services delivered by xoserve would benefit from revised governance and the GDN's should be incentivised and obligated to introduce this in a timely manner.

Yours sincerely

Dan Meredith

Regulation and Government Affairs
Strategy & Energy Policy
office: **02476 183115**
mobex: **777-2563**
mobile: **07876 445181**
daniel.meredith@eon-uk.com