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Ms Joanna Whittington
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Tuesday, 29th August 2006

Dear Ms Whittington,

Gas Distribution Price Control Review Second Consultation

The Second Consultation paper for the Gas Distribution Price Control invites interested parties to respond to the issues raised. The E.ON UK response to a number of the issues raised is attached. A key point is that we believe the GDPCR should address the causes of volatility in gas transportation prices as this has an adverse effect on retail businesses and consumers.

If you need any additional information on the points we have made, please feel free to contact me.

Yours sincerely

Brian Seabourne
Manager, Regulation and Government Affairs

Gas Distribution Price Control Review Second Consultation

Comments from E.ON UK

Retail Impact of Gas Distribution Charging Volatility

A core aim of the GDPCR should be to avoid volatility in gas transportation costs due to the adverse impact this has on retail businesses and gas consumers. Stable, predictable transportation charges assist suppliers by enabling them to set prices for customers more accurately.

Gas distribution charges account for approximately 16% of the total cost for an average gas customer in Great Britain. Recently we have seen considerable variations in regional distribution charges. National Grid Gas for example recently announced price changes for October 2006 that varied from a reduction in the London area of 12% to an increase in the North West of 19%. They are currently predicting that charges may alter in 2007 by between -32% and +24%.

This level of volatility will require suppliers to add significant risk premiums into their tariff and contract prices for gas consumers. Considering the effect that recent increases in wholesale prices have already had on prices for customers any additional costs should be avoided.

The use of price indices other than RPI

We are experiencing high volatility of global commodity and energy prices. The cost of activities carried out by utility companies is more dependent on particular commodities and services than the general basket of items that are used to calculate RPI. It may well be that a price index other than RPI is a better proxy for the cost rises seen by network infrastructure companies and should be used to index allowances.

Assessment of historic spend

At a time of increasing capital expenditure it is not unreasonable to expect increased scrutiny from the regulator. It is important that the examination is conducted fairly in accordance with clearly understood and well defined conditions. From the proposals in the second consultation paper, it seems that there may be some confusion over how the original allowances were set and therefore how any spend can now be properly assessed. Consequently, it may be that such a mechanism should be forward looking with the current review providing more clarity in the allowances set for the next control period.

The treatment of expenditure should be balanced and transparent. It is unclear from the proposals document whether expenditure will be assessed against the allowances in aggregate or by project, or how specific projects will be allocated to each pot. The treatment of pot 2 (efficient overspend/underspend or inefficient spend within allowance) is symmetrical and appears to be equivalent to the rolling capex allowance in electricity distribution. The criterion for pot 1 (wasteful and unnecessary spend) and pot 3 (efficient spend) are not easily distinguished from pot 2. Undoubtedly this retrospective assessment of capex projects introduces a new element to price controls and also raises questions about the level of detail required in forecast capex work programmes. It is important to reflect in these proposals that apart from extreme circumstances all investment is of benefit to customers, albeit that the timing of the benefit can be open to question, and therefore the debate should be about the degree of cost to be disallowed rather than total exclusion. We ask that further clarification on these points is provided in the next consultation document.

Chapter 6 – Other Issues

Question 1: Are the three options for the funding of xoserve appropriate? Should we consider different options?

We believe that the option of moving the obligation to provide the services currently provided by xoserve from gas transporters to shippers should also be considered as part of an Impact Assessment. This option would be considerably more difficult to achieve but would have long term advantages for the industry.

The overwhelming majority of services that xoserve provide are in support of shipping and retailing functions rather than gas transportation activities. Therefore these parties should have the greatest vested interest in striking the correct balance between service levels and cost.

The current structure for the provision of these services by gas transporters has worked well to ensure that competition in the downstream market developed successfully. This market is now mature enough to progress and take more ownership for the central services that support it.

Ofgem’s preferred option of creating a core service where users pay for additional services goes some way to address the current issues. It may indeed be seen as the first step in the eventual change of funding for these services. However it also adds considerable risk that the future service provision will end up costing the industry as a whole considerably more than at present with only a minor gain in service improvement.

To ensure that Ofgem’s preferred option 3 does not result in considerable additional costs for industry participants then the following requirements will be needed:

1. Service provision costs by xoserve will need to be made transparent to shippers.
2. The ownership of xoserve will need to be changed to ensure that gas transporters are excluded.

Question 2: Should Ofgem consider the outcome of an industry dialogue as part of its assessment of the funding required to replace UK-Link?

It is not clear how an informed industry dialogue on the future replacement of UK Link can take place outside of the GDPCR review. It is therefore essential that Ofgem facilitate the dialogue concerning the funding requirements for the replacement of UK Link.

Developments are already underway in the industry such as Modification Review Group 88 to support the implementation of Smart Metering that will have considerable implications for the future of UK Link and these would form useful supporting information for the Impact Assessment.

Question 3: Which, if any, of the 5 options for facilitating network extensions should Ofgem consider in more detail?

We believe that implementation of an incentive scheme, Option 3, should for this price control period at least be explored as a mechanism for promoting GDNs to extend their current networks.

This would allow the GDNs to differentiate their service provision and therefore may allow competition to encourage more enhanced activity compared to the other options.

This is an important issue in alleviating fuel poverty in rural areas and the answer may involve more of a co-operative approach between IGT and GDN. GDN could be incentivised to extend the medium or lower pressure elements of their networks and IGT encouraged to complete the final infrastructure development to individual properties. This may allow the existing business models of IGT and GDN to be utilised in the best interests of rural consumers.

E.ON UK
August 2006