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By E-mail to : Una Shortall at ergeg-unbundling@ergeg.org

Dear Una,

Re: Guidelines for Good Practice on Regulatory Accounts Unbundling.

Centrica welcomes preparation of these guidelines from ERGEG and is pleased to provide comments on this crucial area. It is essential to the operation of a fair and competitive market that there are specific safeguards in place to guard against the possibility or incentive for integrated companies to cross subsidise. The result of such cross subsidy is likely to discriminate in favour of a network's affiliated downstream activity and produce excessive network tariffs, that operate against the interests of new entrants and other network users.

We would note the experience in Great Britain, where new entrants to the domestic electricity supply market were significantly hampered by cross subsidies within the former monopoly integrated supply and distribution companies, until these cross subsidies were addressed in 1999. Misallocation of costs in such areas as advertising and marketing, customer service, billing, metering and corporate overheads amounted to some €15 per customer per annum.

A more recent example of significant cross subsidy was illustrated by the French regulator's September 2005 consultation on distribution network tariffs. At the time of the consultation, 50% of integrated gas utilities' customer management costs were recovered through distribution network tariffs. The consultation suggested that this proportion could be reduced to 20%. Experience in Great Britain indicated that network companies should fund as little as 15% of those costs.

These guidelines therefore form an important step towards the goal of a competitive market. We look to the effective implementation of these guidelines by national regulatory authorities to ensure the risk of these market distortions is eliminated.

We also commend the timing of this consultation. The early consultation should allow any system implications flowing from implementation of the guidelines to be resolved in good time.

Generally, we welcome the proposed form of the guidelines as drafted. We have a number of specific comments on the proposed guidelines, which are set out below. However, we would first stress the urgent need also to agree guidelines on functional unbundling (organisation

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and decision making) to enable guidelines on this area too to be in place for full market opening next year.

Need for Guidelines on Independence of Organisation and Decision Making

We note that these account guidelines are intended as a first set of unbundling guidelines, and that those on informational and management unbundling 'will be elaborated after more experience is gathered on the actual implementation of the relevant requirements'. While welcoming the current initiative, we are concerned that there appears from this comment to be no prospect of these other guidelines appearing imminently; there is for example no indication from the current ERGEG work programme that these further guidelines are likely later this year.

Centrica is fully committed to the development of the internal energy market in Europe, and already participates in a number of national energy markets where the regulatory regime is conducive to new entry. As the deadline date of 1st July 2007 approaches, it seems to us essential that all the requisite building blocks are in place. This means not just the extension of eligibility to all consumers, but also the existence of a market, regulatory and operational framework in which competition can develop. We do not deny the magnitude of this task, which includes finalising suitable network access rules, terms and services, the development and testing of effective customer switching systems, and appropriate safeguards for consumers. But for new entry to be likely and sustainable, it is also vital that wider issues around the position of integrated companies are addressed, not just that of accounting unbundling.

Hitherto, the focus of many national regulators has been on legal unbundling. Among the countries where we have an interest, this is certainly true in the case of Belgium, Spain, and the process that is already underway in Germany. Yet Article 13.1 of the Gas Directive says that 'where the distribution system operator is part of a vertically integrated undertaking, it shall be independent at least in terms of its legal form, organisation and decision making from other activities not related to distribution' [emphasis added].

While NRAs have made progress on legal unbundling, we are much less confident about the transposition of the organisation and decision making requirements of the Directive. Last year's progress report by DG TREN and the Draft Explanatory Note to the 2005 Gas Transmission Regulations both refer to the overall objective of unbundling, which is 'a configuration of the interests of a network operator that is very similar if not identical to that of a network operator also separated from any supply interests by ownership, i.e. the network would not be owned anymore by any vertically integrated company with supply interests'.

We also note the comment in DG COMP's draft preliminary report: 'The provisions of the second electricity and gas Directives on unbundling need to be fully implemented, not just in their letter but also in their spirit. If real progress in this respect does not develop and a true level playing field result, further measures such as full structural unbundling (i.e. separation on the supply and retail business from monopoly infrastructures) should be considered.'

A good example of this point is the so-called "thin netbeheer" model operated by many Dutch utilities. This typically involves an asset owning subsidiary which is (almost) an empty shell, with only a small handful of employees, while the network asset operations remain and are accounted for within the integrated utility holding. The published accounts of the "netbeer" company are thus no real guide to the finances of the network business. Whether or not this is compliant with the letter of the Directives, it is certainly contrary to their spirit. We note that the Dutch government – partly in response to such ineffective unbundling – is now committed

to legislating for full ownership unbundling and the necessary legislation has already passed the Tweede Kamer.

We therefore urge ERGEG and national regulatory authorities to take steps as a matter of urgency to ensure that the full implications of functional unbundling are recognised as soon as possible and that appropriate guidelines are agreed upon without delay, in good time for full market opening next year.

We are not sure what further experience ERGEG might be looking for to inform the development of the informational and management unbundling guidelines they envisage. In our view there is good experience in Great Britain and elsewhere (including those member states where markets are already fully open) on what good practice in such separation should consist of and what should be avoided.

In our view functional unbundling should address:

- equivalence at the product level: not just the access prices charged but arrangements that mimic as far as possible within the integrated entity the arms-length agreements, products and processes which third party suppliers have to use in order to compete;
- organisational changes - management structures, incentives, business processes and information flows;
- governance and regulatory measures to ensure compliance with the principles of separation and eventual detailed guidelines. These should include distribution service standards.

We believe that unbundling will be ineffective unless there is greater clarity very soon on these aspects in preparation for 1st July 2007, particularly as regards the unbundling of distribution companies (other than small undertakings). If the whole subject is not to be reviewed by the Commission or ERGEG until, say Autumn 2007, then there will be an extended period after full market opening during which incumbents are able to exploit the deficiencies in the regulatory regime, new entry is deterred and customers do not obtain the benefits of a competitive market.

Centrica would be very pleased to engage further with ERGEG on this matter, based on its own experience of internal functional unbundling and the insights of its operations in continental markets.

Detailed Comments on Guidelines for Good Practice on Regulatory Accounts Unbundling

External accounting – G1

The transactions mentioned appear sufficient to cover economic relations between network and affiliated companies.

Internal Accounting – G2

Transparency should be at the heart of regulation. There should be a presumption of publication unless the individual circumstances of the publication would materially and adversely affect the commercial interests of the relevant parties. In such circumstances, it might be appropriate to aggregate or withhold certain categories or items of information. However, sufficient information should still be placed in the public domain to allow interested third parties to be aware of the type, frequency and materiality of such economic relations.

Overhead cost – G5

The fair allocation of overhead cost is a significant challenge to regulators as there is typically no right or wrong answer. Consequently, this area may offer significant scope for cross subsidy, as was discovered in Britain in the example already quoted.

The calculation and use of standalone cost will help regulators as it can eliminate any possibility of cross subsidy. However, as standalone cost will be an option, other forms of cost allocation will be permitted. Where other forms of cost allocation are used it will be difficult to adequately assess whether or not cross subsidy exists. Consequently, regulators may find the calculation of incremental cost and fully attributed cost useful.

Shared services – G5

It is advantageous to tender for shared services as a properly defined tender awarded to a non-affiliated party will not only help to reveal an adequate price for the service but will also remove any perverse incentives flowing from agreements with affiliated companies.

However, great care should be taken with the price revealed by a tender won by an affiliate company. Companies may have perverse incentives to design a tender such that it maximises the likelihood of an affiliated company being successful. Such an outcome may, for example, be achieved by attaching a particularly onerous and unreasonable condition to the tender proposal such that all tender responses received from non-affiliates were uncompetitive.

Assets – G6

It is right to presume a regulatory policy that is indifferent to whether or not assets are owned or leased. That is, ownership (financing) of assets should not have any impact on capital cost. Such a policy will ensure that the company does not have any perverse incentives to choose one solution over another; rather the company will pursue the most efficient solution.

We see no financial reason why there should be any differences in the actual capital cost in the two different strategies. However, even if leasing did incur higher capital costs then, all other things being equal, such a strategy is not in customers' best interests.

Further to our earlier comments, transparency is key to effective regulation. This transparency should extend to the setting of levels of WACC. In the past regulatory decisions have often been opaque in this area.

We hope these comments have been helpful, and would be happy to discuss any points in more detail if this would be useful.

Yours sincerely,

By e-mail

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