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FINAL PROPOSALS FOR FIVE-YEAR GAS DISTRIBUTION PRICE CONTROLS ARE PUBLISHED

- **More than £5 billion investment in the networks, £3.6 billion of which will pay for replacing ageing gas mains**
- **Gas distribution networks (GDNs) must operate more efficiently in an environment of increasing cost pressures**
- **New incentives for GDNs to cut greenhouse gas emissions and to encourage sustainable development**

Sir John Mogg, Chairman of Ofgem's governing authority, has today (Monday) unveiled final proposals for new price controls setting out maximum revenue allowances for the gas distribution networks (GDNs) for the period 2008-13.

The price controls will allow the GDNs to spend on average over £1 billion a year on investment in the networks. This is 36 per cent more than they spent in the previous price control. The main area of investment will be the mains replacement programme, which is required by the Health & Safety Executive and is targeted at the replacement of ageing iron mains to create a safer network for all customers.

The GDNs currently face pressures in a number of areas where costs are increasing faster than the rate of inflation. But Ofgem has demanded that the GDNs step up their productivity to cut the resulting level of operating expenditure by 2.5 per cent a year.

Ofgem Chief Executive, Alistair Buchanan, said: "Our proposals are a fair deal for the GDNs and for customers, who will benefit from these investment increases. We have for the first time been able to reduce the GDNs' expenditure forecasts by comparing the performance of separately owned GDNs.

"This has allowed us to get a better deal for customers by challenging the companies to deliver investment and operate the networks more efficiently. At the next review we will have five more years of evidence of how the GDNs can improve efficiency and would expect to see even more significant benefits for customers at that stage. We have authorised £80 million for training and apprentices so the GDNs can maintain a high level of skilled staff to carry out their operations."

Ofgem has put forward a package of incentives for sustainable development of the networks. Changes will be made to cut the upfront charges that customers in fuel poor communities face if they want connections to the networks. Encouraging network extensions can help to alleviate fuel poverty and bring environmental benefits. For example, replacing fuel oil with mains gas for heating cuts household emissions.

The GDNs will now have a much stronger incentive to reduce the impact the networks have on the environment as they will be exposed to the Government's shadow price of carbon. This puts a monetary value on the decrease or increase in emissions from the networks, such as methane – a powerful greenhouse gas.

The GDNs will also have incentives to raise awareness of the dangers of carbon monoxide poisoning and gas safety. The companies can invest £60 million on research and innovation targeted at projects which promote sustainability. Similar incentives are in place for energy transmission companies between 2007 and 2012, and for the electricity distribution companies.

Under Ofgem's proposals household gas bills will increase by approximately £2 a year in real terms. The GDNs have until 7 January to respond to the final proposals. If accepted by the companies the finalised controls will take effect from 1 April 2008 and run to 31 March 2013.

All figures are in 2005-2006 prices.

Notes to Editors:

1. In June 2005 National Grid Gas completed the sale of four of its eight GDNs. The Scotland and South of England networks were sold to Scotia Gas Networks. The Wales and West network was sold to Wales & West Utilities and the North of England network was sold to Northern Gas Networks.

The table below shows Ofgem's final proposals for expenditure allowances and how they compare to companies' forecasts for spending between 2008 and 2013, spending under the previous five-year price control and allowances for the one-year price control (2007-2008). The proposals reflect Ofgem's assessment of each GDN's actual spending in 2006-2007.

£m 2005-06 prices	2002-07	2007-08	Average annual amounts 2008-13		
	Average actual spending	One year control allowances	GDN forecast	Final proposals	Difference between GDN forecast and final proposals
Operating expenditure	656.5	652.5	723.6	663.8	-8%
Capital expenditure	260.7	358.4	396.2	345.2	-13%
Replacement expenditure	491.9	588.0	787.5	722.0	-8%

The figures in the table take into account the information quality incentive which discourages the companies from bidding for higher capital expenditure allowances than they actually require. Under the incentive companies that put forward sensible projections will receive bigger rewards for outperforming the allowances than those who have bid for higher allowances

2. To address safety concerns all gas distribution companies are required to carry out a **mains replacement** programme which has been approved by the Health and Safety Executive. This programme, introduced in 2002, requires that all iron gas mains within 30 metres of homes and premises must be replaced over a 30-year period. The GDNs face rising costs for delivering this programme due to several factors including increasing labour costs.

3. Ofgem sets the allowed rate of return the companies can recoup when they invest in their networks - this is the cost of capital. Ofgem's final proposals are for a cost of capital of 4.94 per cent. This is a weighted average cost of capital (with a pre-tax debt and a post-tax equity component). The cost of capital for the GDNs is less than the 5.05 per cent for the 2007-2012 energy transmission price control and the 5.55 per cent for the 2005-2010 electricity distribution price control. The main driver for this reduction is the continuing evidence of relatively low interest rates.

4. Through the price controls Ofgem has strengthened the obligations on the GDNs to offer good customer service. For example, the existing targets for handling calls about gas leaks and attending them will be specified in licence conditions. This will enable Ofgem to take more

appropriate enforcement action against GDNs if they do not perform as required. Other examples include a reduction from ten days to five days of the time allowed to complete reinstatement after a GDN has finished work on a connection or repaired a pipe.

5. Ofgem is the Office of the Gas and Electricity Markets, which supports the Gas and Electricity Markets Authority, the regulator of the gas and electricity industries in Great Britain. The Authority's functions are set out mainly in the Gas Act 1986, the Electricity Act 1989, the Competition Act 1998 and the Utilities Act 2000. In this note, the functions of the Authority under all the relevant Acts are, for simplicity, described as the functions of Ofgem.

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