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OFGEM PUBLISHES INITIAL PROPOSALS FOR GAS DISTRIBUTION PRICE CONTROLS

- **Proposals call for significant reductions in operating expenditure from current level**
- **Increased allowances for investment and replacement of old iron gas mains**
- **Obligations to offer good customer service will be strengthened**
- **New approach to charges and incentives to extend gas network to fuel poor communities**

Energy regulator Ofgem has today (Tuesday) published its initial proposals for the price controls which will apply to the gas distribution networks (GDNs) between 2008 and 2013.

In 2005 National Grid sold four of the gas distribution networks to new owners. These initial proposals make full use of the new information now available to Ofgem through comparison of four independently owned GDNs. They also take account of the challenges the GDNs face including the significant ongoing programme of mains replacement, and the outputs they must deliver.

Ofgem is proposing a reduction in the GDNs' operating expenditure of 3.3 per cent a year from forecast actual levels in 2006-07. Ofgem recognises that this is a challenging target.

Ofgem also recognises that fulfilling the Health and Safety Executive's requirements on mains replacement and meeting steady growth in gas demand will result in higher capital and replacement expenditure. These proposals contain increases in capital and replacement expenditure of 26 per cent and 32 per cent respectively compared with expenditure in the previous price control period (2002-2007). In total, allowances for capital and replacement expenditure are approximately £1 billion per year for the four companies. Ofgem has challenged the companies' expenditure forecasts to ensure customers get good value. The net effect of the proposals is a small rise in gas distribution charges, which would increase an average domestic customer's bill by less than £1 per year in real terms.*

Ofgem Chief Executive, Alistair Buchanan, said: "Today is one of a number of milestones along the way to our final proposals this December. We will listen carefully to the feedback we receive. We do intend to set challenging price controls to give the companies incentives to operate more efficiently. This will generate savings for customers which will be passed on in successive price controls.

"Our initial proposals set out how existing customer service obligations can be improved and we have also offered incentives to the companies to extend parts of the gas network to connect up fuel poor communities."

The obligations on the GDNs to offer good customer service will be strengthened. 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 in the event of a failure to meet the specified performance level. Other examples include reducing the time allowed to complete reinstatement after a GDN has finished work on a connection or repaired a pipe from ten days to five days.

Extending the gas network can in some circumstances help to alleviate fuel poverty and have environmental benefits. Ofgem is recommending changes which will reduce upfront connection charges to these communities. In addition, we propose to implement an incentive scheme that will encourage GDNs to help these communities, for example, by coordinating various sources of government funding for central heating systems or insulation.

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Notes to editors

*Gas distribution charges make up around one fifth of a domestic customer's bill. Ofgem estimates that the effect of the initial proposals will be an increase in a domestic customer's bill of less than £1 per year in real terms, (i.e. excluding for example changes due to inflation).

1. In June 2005 National Grid Gas completed the sale of four of its eight gas distribution networks. The Scotland and south east of England networks were sold to Scotia Gas Networks. The Wales and south west network was sold to Wales & West Utilities and the network in the north east was sold to Northern Gas Networks.

2. The table below shows Ofgem's initial proposals for expenditure allowances (prior to the application of the information quality incentive*) and how they compare to companies' forecasts:

£m in 2005-06 prices	Average annual actual 2002 to 2007	2007-08 Allowances	Average annual GDN forecast over 2008-13	Average annual Ofgem allowance over 2008-13	Difference GDN forecast to allowance
Operating expenditure	662.4	652.5	722.1	598.0	-17%
Capital expenditure	260.5	358.4	393.1	328.2	-17%
Replacement expenditure	493.9	588.0	797.5	654.0	-18%

*The information quality incentive is designed to address concerns that companies have an incentive to bid for higher capital expenditure allowances than they actually require. Companies that put forward sensible projections will receive bigger rewards for outperforming these allowances in future than those who have bid for higher allowances.

3. All gas distribution companies carry out a mains replacement programme which has been approved by the Health and Safety Executive to address safety concerns. This programme was introduced in 2002 and means 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.

4 Ofgem sets the allowed rate of return the companies can recoup when they invest in their networks - this is the cost of capital. The detailed analysis on cost of capital is yet to be done and the decision on the final figure will not be taken until final proposals. For the purposes of initial proposals Ofgem has used a weighted average cost of capital (pre tax debt, post tax equity) of 4.84 percent.

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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