Promoting choice and value for all gas and electricity customers

Gas Distribution Price Control Review
One year control final proposals

Document Type: Decision Document

Ref: 205/06

Date of Publication: 4 December 2006

Target Audience: Consumers and their representatives, gas distribution networks (GDNs) and any other interested parties.

Overview:

The current price controls, which specify the maximum revenue that each GDN can recover from its customers, expire on 31 March 2007. The Gas Distribution Price Control Review (GDPCR) will reset the revenue allowances that apply to the GDNs for one year from April 2007 and for the next price control period 2008-2013. This document sets out our final proposals for the one year control to apply for 2007-08.

Our final proposals give rise to an increase of 11.5 per cent in gas distribution revenue. This compares with an increase of 9.7 per cent as set out in our initial proposals in September. The main changes that we have made since then are to take into account better or more up to date information on historical and future costs. In some cases these changes have been offsetting.

Contact name and details: Joanna Whittington, Director - Gas Distribution

Tel: 020 7901 7046

Email: GDPCR@ofgem.gov.uk

Team: Gas Distribution

Office of Gas and Electricity Markets, Ofgem, 9 Millbank, London SW1P 3GE

www.ofgem.gov.uk

Context

The price control that currently applies to the gas distribution networks (GDNs) expires on 31 March 2007. In 2004, we decided to extend the current control by one year in order to allow gas distribution to be considered separately from transmission.

The gas distribution price control review (GDPCR) will reset the revenue allowances that apply to the GDNs for one year from April 2007 and for the next full price control period from 2008 to 2013. This document sets out our final proposals for the one year control to apply for 2007-08.

We consider that the work associated with extending the price control should be proportionate to a one year interim arrangement and so, where appropriate, assumptions underlying the present price control have been extended or updated in a straightforward way to cover 2007-08. Most policy issues associated with GDPCR are being considered as part of the main (five year) price control review. Our latest thinking on the main review was set out in the GDPCR third consultation document, published in November 2006.

Associated Documents

- GDPCR One Year Control Final Proposals Supplementary Appendices, December 2006
- GDPCR One Year Control Initial Proposals and Supplementary Appendices, September 2006 (Ref. Nos. 169a/06 and 169b/06): http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/16829_169a.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasdistpriccon and http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/16830_169b.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasdistpriccon
- GDPCR Initial Consultation, December 2005 (Ref. No. 259/05): http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/13055_259_05.pdf
- GDPCR Second Consultation and Supplementary Appendices, July 2006 (Ref. Nos. 123a/06 and 123b/06): http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/15829_GDPCR_2CD_FINAL19July.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasdistpriccon and http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/15759_GDPCR_2CD_supplementary_appendices_FINAL.pdf?wtfrom=/ofgem/work/index.jsp&section=/areasofwork/gasdistpriccon
- GDPCR Third Consultation Document and Supplementary Appendices, November 2006 (Ref. Nos. 203/06 and 203/06a): http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/17777_203_06.pdf?wtfrom=/ofgem/index.jsp and http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/17778_203_06a.pdf?wtfrom=/ofgem/index.jsp

Table of Contents

Summary **1**
1. Introduction **3**
Purpose of this document 3
Background to the one year control 3
Objectives of the one year control 4
2. Operating expenditure **5**
2007-08 opex allowances (excluding shrinkage and pensions) 5
Shrinkage 8
Pensions 10
3. Capital and replacement expenditure **12**
Methodology for the efficiency assessment and the RAV roll forward 12
Assessment of capex and non-mains repex for April 2002 to March 2007 16
Assessment of capex and repex for January 2001 to March 2002 23
Conclusions on treatment of historical capex and repex 24
2007-08 forecast capital and replacement expenditure 26
4. Financial issues **30**
Cost of capital 30
Tax 31
Financeability 32
5. Conclusion **35**
Overall impact of proposals 35
Implications for gas distribution charges 36
Way forward 37
Appendices **38**
Appendix 1 Consultation questions **39**
Responses to Chapter 2 - Operating expenditure 41
Responses to Chapter 3 - Capital and replacement expenditure 45
Responses to Chapter 4 - Financial issues including overall impact of initial proposals 47
Responses to Chapter 5 - Timetable & process 50
Appendix 2 The Authority's powers and duties **52**
Appendix 3 Glossary **54**
Appendix 4 Feedback Questionnaire **57**

Summary

The price control that currently applies to the gas distribution networks (GDNs) comes to an end on 31 March 2007. We published our initial proposals for extending the control by one year in September. Our final proposals will allow GDNs to recover £2,328 million (in 2005-06 prices) from customers in 2007-08. This represents a real increase in allowed revenue of 11.5 per cent compared to the 9.7 per cent increase we proposed in September. For the average domestic consumer, the effect on their gas bill is around £10. The actual increase will depend on a number of other factors, which are discussed in Chapter 5 and Appendix 11.

We have considered the responses we received to our initial proposals from - among others - GDNs, shippers and consumer representatives. We have also held a number of meetings with the GDNs and others. The GDNs have had the opportunity to present to a subcommittee of the Gas and Electricity Markets Authority (GEMA).

Since initial proposals, we have made a number of changes to take account of:

- actual audited accounting information which was not available when we published our initial proposals in September,
- new information and arguments brought forward by the GDNs to support the original data that they provided for our consideration in April,
- revised actuarial reports assessing pension costs for two of the GDNs which were not available in advance of initial proposals, and
- the latest information on gas prices and forecast throughput for 2007-08 which indicates that the cost of shrinkage gas to be borne by customers is lower than we expected at initial proposals.

We have not made any substantive changes to the main policies underpinning our initial proposals. In particular, we are proposing to:

- use the same method for setting an operating expenditure allowance using actual operating expenditure for 2004-05 and 2005-06, together with an efficiency adjustment of 2.5 per cent,
- remove from GDNs the risk of gas price changes and throughput risk but retain an incentive on GDNs to reduce the volume of gas lost through their pipes (i.e. shrinkage gas),
- allow for GDNs to recover the latest estimate of the cost of their ongoing pension contributions, together with pensions costs incurred during the current price control for which they did not receive an allowance, and additional contributions to repair their pension deficits over a ten year period,
- apply the same method for dealing with the £864 million (in 2005-06 prices) of additional investment that GDNs have made compared with their capital and non-mains replacement allowances. The effect of this policy taking into account the changes described above has been to expose companies to, on average, 37 per cent of the additional expenditure compared to 38 per cent in initial proposals,
- set capex and repex allowances for 2007-08 at £946.4 million in 2005-06 prices compared to £925.9 million in initial proposals which is approximately 62 per cent higher than allowances for 2006-07,

- leave the cost of capital unchanged at a post tax real rate of 4.38 per cent and a ‘vanilla’ cost of capital of 5.25 per cent equivalent to the pretax real rate of 6.25 per cent used at the last review, and
- introduce a company specific tax allowance consistent with the approach that Ofgem has used in all price controls since adopting this policy in 2003. We will make an ex post adjustment to the tax allowance for 2007-08 using the cost of debt set as part of the main control.

The net impact of these policies, which have been consistently applied across all eight GDNs, is set out in the table below.

Table 1 Final proposals - 2007-08 allowed revenue by GDN

		2007-08 allowed revenue (£m, 2005-06 prices)	**Year on year change, % (P0)**
NGG	East England	427.2	12.4
	London	245.1	9.9
	North West	285.5	10.6
	West Midlands	217.8	11.0
NGN	North England	273.5	8.7
SGN	Scotland	194.3	12.9
	South England	432.4	13.0
WWU	Wales & West	252.0	12.9
Total		2,327.7	11.5

Respondents to our initial proposals have argued that our proposals are inconsistent with our principal objective and general duties, on the one hand, because we were overly generous to the GDNs in allowing a rise in allowances of on average of 9.7 per cent and, on the other hand, because their impact would be a serious deterioration in the financial position of GDNs. It remains our view that financeability is properly assessed over the medium term and we intend to do this next year as part of the review to set the five year control. We will also engage with credit rating agencies and market participants on the most appropriate way to assess this. That said, we are satisfied that our final proposals provide the appropriate level of revenue and incentives to fulfil our principal objective, while having regard to the need to secure that GDNs are able to finance their activities.

We have asked the GDNs to let us know by 8 January 2007 whether they are minded to accept our proposals. If they do, we will undertake a further statutory licence consultation early next year. If any company decides not to accept the proposals, we expect to refer the matter to the Competition Commission.

1. Introduction

Chapter Summary

This chapter sets out the purpose of the document and describes the background to and objectives of the GDPCR one year control.

Purpose of this document

1.1. The price control that currently applies to the gas distribution networks (GDNs) comes to an end on 31 March 2007. The gas distribution price control review (GDPCR) will reset the revenue allowances that apply to the GDNs for one year from April 2007 and for the next price control period 2008-2013. This document sets out our final proposals for the one year control to apply for 2007-08.

1.2. Most policy issues associated with GDPCR are being considered as part of the main (five year) price control review. During the one year control, in addition to resetting the price control for one year, we have sought to address issues from the present control which, without resolution, would extend uncertainty for GDNs unnecessarily. These include:

- the treatment of the GDNs' historical capital and replacement expenditure during the current price control period, and
- the treatment of shrinkage gas costs.

1.3. GDNs have the opportunity to decide whether to accept the proposals set out in this document. If they decide to accept the proposals, we will undertake a statutory licence consultation early next year, leading to the implementation of the one year control on 1 April 2007. If any company decides not to accept the proposals, we expect to refer the matter to the Competition Commission.

Background to the one year control

1.4. In March 2004, following consultation during the Developing Network Monopoly Price Controls consultation[1], we issued an open letter that set out our intention to extend the current gas distribution price control by one year to 31 March 2008.[2] This was intended to provide a more balanced workload for companies and Ofgem and to allow gas distribution and transmission issues to be considered separately. The one year control also creates an opportunity for us to review an additional year's data when setting the main price control.

1.5. The open letter noted that the work associated with extending the price control would need to be proportionate to a one year interim arrangement, and so, where

[1] Ofgem 54/03, Developing network monopoly price controls. Initial conclusions, June 2003
[2] Ofgem open letter, Gas Distribution Price Controls, 16 March 2004.

appropriate, assumptions underlying the present price control would be extended or updated in a straightforward way to cover 2007-08.

1.6. We published consultation documents that considered both the one year control and the main control in December 2005 and July 2006. In September 2006 we published our initial proposals for the one year control. Our final proposals have been developed taking into account views expressed in the responses to our initial proposals[3], further work carried out by ourselves and our consultants, and views expressed in discussions with the GDNs.

Objectives of the one year control

1.7. While we consider that a full review would neither be appropriate nor proportionate for a one year control - in particular for those elements of the control which will be revisited as part of the main control - our proposals must be consistent with the Authority's principal objective and general duties to:

- protect the interests of consumers, and
- ensure that the companies can finance their activities.

1.8. The Authority's powers and duties are set out in Appendix 2.

[3] A summary of responses to the initial proposals document is set out in Appendix 1.

2. Operating expenditure

Chapter Summary

This chapter sets out our decision on how to set the GDNs' operating expenditure (opex) allowances for 2007-08 and the specific allowances for opex, shrinkage and pension costs.

2007-08 opex allowances (excluding shrinkage and pensions)

Position set out in initial proposals

2.1. The initial and second consultation documents set out two possible options for a simple approach to setting the opex allowances for 2007-08 excluding shrinkage and pension costs:

- Option 1 - carrying forward the opex allowance for 2006-07, possibly with a 2.5 per cent reduction for efficiency improvements, or
- Option 2 - rolling forward actual levels of opex with possible adjustments for efficiency.

2.2. Our initial proposal was to base the allowances for 2007-08 on actual costs rather than 2006-07 allowances. We proposed using an average of 2004-05 and 2005-06 costs to reduce the impact of atypical costs in either year, and to reduce this average by 2.5 per cent to take account of efficiency improvements which we would expect the GDNs to have achieved.

Respondents' views

2.3. Respondents raised a number of concerns with Ofgem's proposed approach to setting the 2007-08 allowances for controllable opex (excluding shrinkage and pensions costs). Several respondents considered that it was inappropriate to base the 2007-08 allowances on actual costs as this may reward inefficient companies and penalise those that have reduced costs. These respondents argued that the allowances for 2007-08 should be based on a roll forward of 2006-07 allowances.

2.4. One GDN[4] considered that 2004-05 was an unusual year and suggested using an average of 2005-06 actual costs and 2006-07 forecast costs to set opex allowances. Two GDNs expressed concern over the 2.5 per cent efficiency factor as they considered that this takes no account of other cost pressures GDNs face, or the cost and time needed to deliver efficiency savings.

[4] When summarising respondents' views, we have referred to each GDN company as a (single) GDN, even if the company owns more than one GDN.

2.5. Other respondents were concerned that a more detailed assessment of operating cost allowances had not been carried out and that an average of 2004-05 and 2005-06 operating costs might not be sustainable.

2.6. Further issues raised by respondents are set out in Appendix 1, together with Ofgem's response.

Ofgem's decision

2.7. We have considered the responses to initial proposals and carried out further analysis of alternative options for setting the 2007-08 allowances. Our final decision is to base the allowances for 2007-08 opex, excluding shrinkage and pensions costs, on an average of 2004-05 and 2005-06 actual costs minus a 2.5 per cent efficiency adjustment for the reasons discussed below.

2.8. As discussed in the initial proposals document, there are a number of advantages and disadvantages for each approach to setting the 2007-08 opex allowances. The main disadvantage of carrying forward the existing allowances for each GDN is that they were not set as individual allowances as part of the last price control review. The last review set an opex allowance for the whole of gas distribution which was then apportioned between the GDNs as part of the work on separating price controls in 2003. The apportionment was made using the allocations in NGG's transaction model in 2000. Rolling forward allowances would perpetuate any inaccuracies or distortions in the allocations such as an atypical split of costs in 2000.

2.9. There has also been a number of structural changes since 2000, but prior to GDN sales, that have affected the overall level and allocation of costs. These cannot be attributed to new owners operating more efficiently. For instance, North England LDZ and Yorkshire LDZ merged their operations in 2003 (before other LDZ mergers) to form Northern GDN, reducing costs in the process. Rolling forward allowances would give NGN an allowance based on the cost of two separate LDZs.

2.10. The main disadvantage of basing allowances for 2007-08 on actual levels of opex is that the most recent data available (2004-05 and 2005-06) may be atypical due to the impact of GDN sales. NGG may have reduced expenditure in 2004-05 for the GDNs it intended to sell relative to the GDNs it intended to retain. By contrast, the new GDNs are likely to have incurred additional costs in 2005-06 to establish their GDNs as standalone businesses. This issue has been addressed by averaging 2004-05 and 2005-06 costs.

2.11. We accept that a more robust approach to setting opex allowances would have been the top down and bottom up assessment that we are undertaking for the main review. However, we rejected this work as it would have been disproportionate for a one year control. We do not accept the view that this approach rewards inefficiency. If we had told the GDNs that this was the approach that we planned to use before the end of the 2005-06 financial year, then gaming might have been a risk. In practice, however, GDNs did not know that we would adopt this approach and therefore their incentives for efficiency were not affected.

2.12. We reviewed what would happen if we incorporated into our analysis the forecasts which GDNs supplied for 2006-07. This approach could potentially be appropriate because it may have taken time for the independent GDNs to address the under spending in 2004-05 and this would be reflected in their latest forecasts. In practice, however, this approach leads to significantly larger increases in the opex allowances for NGG's retained GDNs relative to the independent GDNs.

2.13. Since initial proposals we have updated our analysis to reflect GDNs' actual opex for 2005-06 as reported in their Business Plan Questionnaire submissions for the main review. We have also corrected some errors in the conversion of pension costs from a profit and loss account to a cash basis, and included £2.3 million of additional costs for the Scotland GDN to cover Glenmavis storage costs associated with Scottish independent networks.[5] This results in an overall increase in allowances of £17.8 million as set out in Table 2.1 below.

2.14. Using updated actuals for 2005-06 significantly reduces the differences in the relative impact of the two approaches for setting opex allowances between the retained GDNs and the independent GDNs.

Table 2.1 Final proposals opex allowances for 2007-08 (excluding shrinkage and pensions) (£m, 2005-06 prices)

		Initial proposals	Revised proposals	Change from initial proposals
NGG	East England	96.5	98.1	1.6
	London	62.3	63.4	1.1
	North West	70.5	71.8	1.3
	West Midlands	53.4	53.7	0.3
NGN	North England	67.7	69.4	1.7
SGN	Scotland	52.9	58.2	5.3
	South England	89.6	94.6	5.0
WWU	Wales & West	70.6	72.1	1.5
Total		563.4	581.2	17.8

2.15. Consistent with our initial proposals, the allowances shown in Table 2.1 have been adjusted downwards by 2.5 per cent from the average of 2004-05 and 2005-06 costs to reflect the efficiency savings that we expect GDNs to be able to achieve during the period up to and including 2007-08. We consider that this expectation is reasonable given the cost assumptions applied during the current control, and the GDNs' own forecasts of their 2007-08 opex requirements. The effect of removing the 2.5 per cent efficiency adjustment would be to reduce pressure on GDNs to continue to achieve efficiency savings.

[5] The Glenmavis storage costs were not reflected in Scotland's historical actual operating costs or their allowances. It was agreed that these costs would be paid by NGG until the next price control at which point they would form part of the normal price review process.

Shrinkage

Position set out in initial proposals

2.16. In our initial proposals document, we proposed the establishment of a separate shrinkage incentive mechanism. We proposed creating an incentive for GDNs to manage shrinkage volumes by exposing them to volume risk under their control (i.e. excluding changes in shrinkage volumes related to total throughput which would be passed through to consumers). We proposed to address price risk by basing allowances on a pre-defined index of market prices.

2.17. Under this approach, a shrinkage allowance would be calculated annually at the end of the year based on actual throughput, an allowed shrinkage factor as a percentage of total throughput and the index of market prices. We suggested using an index of the year-ahead quarterly forward price, flow weighted to take into account higher throughput in the winter months.

Respondents' views

2.18. The GDNs broadly supported our proposed approach for setting the shrinkage mechanism for the one year control but asked for a number of refinements.

2.19. Several GDNs have argued that a market index for any given period will underestimate the true cost of purchasing shrinkage gas as market indices are time weighted whereas actual costs are volume weighted. This is because GDNs need to purchase additional gas when costs are higher and sell gas when costs are lower.

2.20. They also argued that there are additional costs associated with within period variations. For example, if a GDN has bought gas to meet forecast shrinkage volumes on a day-ahead basis, within day it will have to trade to meet additional volumes required when winter weather is colder than expected and prices increase substantially or sell gas if the weather is hotter than average and prices are lower. The GDNs argue that this should be addressed through an uplift on the market index.

2.21. One GDN continued to argue that additional funding should be provided for underperformance during the current control period with regard to shrinkage.

2.22. Other respondents had mixed views. Some respondents believed that the proposed approach was appropriate. Others suggested that more work was needed to justify a move from the current arrangements and were concerned that it might lead to weaker incentives to reduce shrinkage volumes.

Ofgem's decision

2.23. We have decided to adopt a shrinkage mechanism based on the mechanism set out in initial proposals, but subject to certain refinements. A shrinkage allowance will be calculated at the end of the year based on actual throughput, pre-defined shrinkage factors and monthly index prices based on three-month ahead forward prices adjusted by a 3.5 per cent uplift to take into account the impact of volume-weighted intra-month fluctuations, and within-day trades.[6] For the one-year control we have based the 3.5 per cent adjustment on the most recent information regarding differences between monthly index prices and actual purchase costs. As the main review covers a longer period we will consider additional information on medium-term trends in monthly index prices and actual purchase costs.

2.24. We will base the reference price on the offer price specified in the price indices published by Heren, but allow the option for the GDNs to request approval from the Authority to specify another published price report service.[7]

2.25. Under the revised shrinkage arrangements, GDNs' actual shrinkage allowances will not be known until the end of the year. The only elements of the calculation that will be known in advance are the allowed shrinkage factors, which are set out in Appendix 7.[8] In order to understand the likely impact of our proposals for shrinkage on the GDNs' price control package, we have estimated shrinkage allowances based on monthly forecast prices, monthly throughput data and shrinkage factors. The assumed monthly allowance is summed across the year to give an annual allowance on an LDZ basis. On this basis, we estimate that GDNs' 2007-08 shrinkage allowances will be £88 million.[9] This is lower than the £92 million we assumed in setting initial proposals.

2.26. We consider that this mechanism provides strong incentives for GDNs to reduce the element of shrinkage that is within their control - i.e. to reduce shrinkage as a proportion of total throughput through the mains replacement programme and pressure management. It also provides strong incentives for GDNs to procure shrinkage gas efficiently. We will review the appropriate levels of shrinkage to be applied in the main control allowances, and will set explicit allowed shrinkage factors for each year.

2.27. It is not appropriate for GDNs to recover shrinkage overspends incurred during the current control period from customers in the next period. We have set out our position on this issue in previous documents.[10] We have not changed our position.

[6] For example, the forward price for April 2007 will be the average close of business forward offer price of gas for delivery in April 2007 averaged across all working days in January 2007. This will then be uplifted by 3.5 per cent to derive the April reference price.
[7] See Special Condition E2B, 8(7) Distribution Network Shrinkage Incentive Revenue.
[8] See Special Condition E2B, 8(7) Distribution Network Shrinkage Incentive Revenue.
[9] Estimated shrinkage allowances by GDN are set out in Appendix 8.
[10] See, for instance, Gas Distribution Price Control Review, Second Consultation Document, Ref 123a/06 para 4.12.

Pensions

Position set out in initial proposals

2.28. Our initial proposals applied our established Pensions Principles to the GDNs' pension costs. The principles are intended to ensure that cash allowances for pensions match actual cash costs, on an NPV-neutral basis. This resulted in allowances of £122.1 million in respect of pensions within the one year proposals.

2.29. In addition, we stated that the final levels might vary from the initial levels as a result of revised actuarial reports from the GDNs, and the output of the current TPCR review relating to the costs of repairing the deficit of former employees.

Respondents' views

2.30. The GDNs and some non-GDN respondents broadly supported our proposed approach for setting the pension allowance for the one year control. Two GDNs indicated that the indicative allowances were lower than their latest view of forecast cash pension costs, and provided revised actuarial reviews to support these claims.

2.31. Some non-GDN respondents stated that GDNs should meet increased pension deficits from their profits, or reduce benefits to reflect the increased costs. Some respondents pointed out that the approach to pensions was indicative of a lower-risk regime, which should be reflected in a lower cost of capital.

Ofgem's decision

2.32. We have decided to adopt the approach to pension costs proposed in the initial proposals document. This includes updating the numbers for revised actual and forecast cash pension costs during the current price control, increasing the allowances for SGN and WWU to reflect recent actuarial reviews.

2.33. There are material risks associated with funding defined benefit pension schemes that are outside GDNs' control, including variations in actuarial assumptions. Ofgem has an established policy, as applied in initial proposals, that these costs are recoverable through transportation income, subject to meeting certain conditions. We consider that it is appropriate to apply this policy consistently to the GDNs.

2.34. The revised pension allowances are given in Table 2.3 below.

Table 2.3 Final proposals - pensions allowances (£m, 2005-06 prices)

	GDN	Initial proposals	Final proposals	Change from initial proposals
NGG	East England	22.3	21.2	-1.1
	London	15.7	14.9	-0.8
	North West	16.1	15.4	-0.7
	West Midlands	11.8	11.3	-0.5
NGN	North England	16.1	16.5	0.4
SGN	Scotland	10.3	14.2	3.9
	South England	17.3	26.4	9.1
WWU	Wales & West	12.4	20.6	8.2
Total		122.1	140.5	18.4

2.35. Appendix 9 provides more detail of the explicit pension allowances for operating costs, capital expenditure and replacement expenditure, and guidance on how the principles will be applied within the main review.

3. Capital and replacement expenditure

Chapter Summary

This chapter sets out Ofgem's decision on how to update the regulatory asset values (RAVs) and establish the opening RAVs for the one year control period (known as the "RAV roll forward"). It also sets out our efficiency assessment of GDNs' historical and forecast capital expenditure (capex) and replacement expenditure (repex), and the implications for the RAV roll forward. This includes our final assessment of:

- ➔ historical and forecast capex and non-mains repex for April 2002 to March 2007 for each GDN,
- ➔ historical capex and repex for January 2001 to March 2002 at a UK distribution level, and
- ➔ the assessment of the appropriate capex and repex requirements for 2007-08.

Methodology for the efficiency assessment and the RAV roll forward

Position set out in initial proposals

3.1. The GDNs forecast that they will overspend their total allowances for capital and non-mains replacement expenditure in the current price control period by approximately 66 per cent or £864 million (in 2005-06 prices).[11] The size of the overspends, together with the lack of a clear framework to deal with them, have made it necessary for us to carry out a detailed review of historical expenditure and form a view on the extent to which GDNs will be able to recover these costs from customers.

3.2. We consulted on and adopted a methodology for the regulatory treatment of historical capex and repex in initial proposals which is based on the principles set out in the March 2004 open letter[12].

3.3. To apply the principles, we have assessed the efficiency of workload and expenditure given the outputs that were delivered. This included an assessment of the efficiency of unit and total costs, whether any work in excess of that implied by the price control allowances could have been deferred, and whether it could have been forecast at the last review or resulted from a major change of circumstance outside the GDNs' control. We then determined the treatment of expenditure by considering whether it was within or above the price control allowance. Table 3.1 summarises our proposed treatment of different types of spend.

[11] Our initial proposals cited this figure as £843 million (65 per cent). The increase is due to a reclassification of opex spend associated with Quarterback into capex. See paragraphs 3.33 and 3.48 for more details.
[12] Ofgem open letter, Gas Distribution Price Controls, 16 March 2004.

Table 3.1 Guide to treatment of spend for RAV categories

RAV pots	Treatment of spend
Pot 1	Inefficient above allowance – no recovery by the GDN
Pot 2a	Inefficient within allowance – recovery of allowed capital charges for 5 years then no further recovery by the GDN
Pot 2b	Efficient spend above allowance – the GDN is exposed to capital charges for 5 years
Pot 3a	Efficient spend within allowance – full recovery of spend
Pot 3b	Reopener for additional workload due to a change of circumstance – full recovery up to the allowed unit cost

3.4. We proposed to apply a reopener (i.e. Pot 3b) in two main areas:

- additional connections workload due to the GDNs retaining market share which was not anticipated at the last price review, and
- additional service replacement work as, in setting allowances in 2002, Ofgem made significant reductions to the GDNs' original workload forecasts. Exposing the GDNS to the full volume risk in this case would expose them to risks outside their control as this extra work was linked to the revised HSE requirement to replace mains.

3.5. In addition, we identified that there was some expenditure which may have been efficiently incurred but which should not be included in the RAV and recovered from customers as a whole. This category included GDN sales costs and under-recoveries of connection charges (which should have been paid for by the connecting customer) and related party margins on net connections costs.

3.6. We applied a high hurdle before allocating spend as either inefficient or being eligible for a reopener, which has led to the majority of the overspend falling within Pot 2. Our initial proposals would have resulted in shareholders funding almost 40 per cent of the overspend (and by implication consumers funding the remaining 60 per cent).

Respondents' views

3.7. Both GDNs and other respondents have raised a range of concerns on our approach to assessing the efficiency of historical expenditure and updating the RAVs.

Views of GDNs

3.8. Two GDNs broadly agreed with our methodology for the treatment of inefficient expenditure but disagreed with how the assessment had been carried out in practice and the detailed areas of inefficiency that have been identified. The other two GDNs considered that both the principles and application of the methodology are inappropriate. The detailed comments are discussed further in paragraphs 3.28-3.35 below.

3.9. A number of GDNs have suggested that there was insufficient clarity about the treatment of overspends at the time the last price control was set and that our proposed approach was inconsistent with their expectations following the March 2004 open letter. They argued that the letter created an expectation that efficient overspends would be fully funded as they provided "significant customer benefits". Several GDNs emphasised that the additional expenditure was incurred while meeting customer needs in accordance with their statutory and licence obligations.

3.10. The GDNs suggested that it was inappropriate to assess additional connections and repex services workloads eligible for Pot 3b treatment at the allowed unit cost. They argued that this placed too much weight on detailed forecast unit costs which were only accepted as part of the overall price control package and before Ofgem decided to implement a rolling capex incentive.

3.11. Several GDNs argued that requiring approximately 40 per cent of the overspend to be funded by the companies is disproportionate as the additional investments provided benefits to customers. They argued that disallowing 31 per cent of the net present value (NPV) of efficient overspends (Pot 2b) is an excessive penalty for inaccurate forecasting. Some GDNs proposed an alternative treatment for expenditure classified as Pot 2, which is to allow return and depreciation with effect from 1 April 2007 rather than five years after being incurred.

3.12. One GDN expressed the view that Ofgem has not sufficiently consulted on the treatment of historical capital and replacement expenditure.

3.13. Finally, NGN considered it inequitable for a larger proportion of their overspend to be disallowed when they have overspent their allowance by a lower percentage than any other GDN.

Views of other respondents

3.14. There were mixed views on the treatment of inefficient expenditure. Some respondents supported Ofgem's approach to reviewing and challenging historical expenditure. Others expressed concern at the level of disallowance and considered it important that the justification was robust. One respondent suggested that reopeners be limited to those areas signalled in advance with clear volume drivers. Consumer groups suggested that companies should absorb at least half of the risk and costs associated with the capex and repex overspends.

Ofgem's decision

3.15. We have considered the responses to the initial proposals and have decided to apply the methodology set out in initial proposals for the reasons set out below.

3.16. We agree that in principle it is desirable for there to be a clear framework set out in advance for the treatment of costs. Ofgem's March 2004 open letter, which set out our latest thinking on the principles that should be applied for the treatment of historical capex, left some scope for different interpretations on how the approach would be applied in practice. The letter made clear made clear that we would consult further as part of the gas distribution price control review. This is particularly important given the level of overspend incurred by the GDNs. It is not in consumers' interests to include this amount in the RAV without detailed scrutiny.

3.17. We have consulted on the treatment of historical capital and replacement expenditure in each of the three preceding consultation documents on the one year control. We have also taken into account some of the concerns raised to us by GDNs through working group meetings, four rounds of meetings with Ofgem staff and at their meeting with the GDPCR Authority committee.

3.18. The approach has been developed in the context of general principles of RPI-X regulation, the work on Developing Network Monopoly Price Controls, subsequent work as part of the electricity distribution price control review and our principal objective and statutory duties.

3.19. It is appropriate to assess the treatment of expenditure based on allowed workloads and unit costs specified at the last review and by the work to separate gas distribution price controls. Network businesses are generally expected to manage their costs within their price control allowance and are exposed to both price and volume risk. This provides strong incentives for GDNs to manage their expenditure.

3.20. We consider that applying a capex rolling incentive with GDNs exposed to both depreciation and rate of return on any overspends for 5 years is appropriate. It is consistent with our approach to rolling incentives set out as part of the work on Developing Network Monopoly Price Controls. The application of this incentive results in 31 per of the NPV of efficient overspend being disallowed. The strength of this incentive is towards the bottom end of the strength of the rolling incentives applied as part of DPCR.[13]

3.21. We do not support the alternative treatment of Pot 2 expenditure suggested by some GDNs (see paragraph 3.11) because it would significantly weaken incentives for GDNs to manage their expenditure within allowances. GDNs would be exposed to 13 per cent of the costs associated with efficient overspend, rather than 31 per cent under our proposals. The alternative treatment is also inconsistent with the March 2004 open letter.

3.22. The intention has always been for a reopener (Pot 3b) to apply in very limited circumstances such as where additional workload has arisen from new circumstances or legislative changes outside the GDNs' control and not taken into account at the last review. In such cases, we consider it appropriate to give the associated spend the same treatment as if the additional work had been anticipated and an allowance made at the last review. In this case, GDNs would continue to be exposed to the price risk on the additional work.

[13] Electricity Distribution Price Control Review, Final Proposals, November 2004, Ref 265/04

3.23. We recognise that a greater proportion of NGN's overspend has been disallowed than for other GDNs. A consistent process has been applied to all GDNs. NGN's higher proportion of disallowed spend is due to a smaller proportion of their overspend having arisen as a result of additional services repex volumes (where we have applied a reopener), and the disallowance for GDN sales costs relating to their new IS systems.

Assessment of capex and non-mains repex for April 2002 to March 2007

Position set out in initial proposals

3.24. In our initial proposals, we proposed the following treatment of the overspend:

- £50.0 million would be treated as wasteful and unnecessary (Pot 1) spend over the allowance for which there would be no recovery of costs by the GDNs,
- £634.2 million would be treated as efficient overspend (Pot 2). Under the principles of the rolling incentive, the GDNs would be exposed to the capital charges (i.e. rate of return and depreciation) for a period of five years,
- £86.3 million would be treated as a reopener (Pot 3b) and the GDNs would receive full recovery of the capital charges,
- £35.0 million would be attributed to under-recovery of connections income from customers in the competitive section of the connections market for which we proposed there would be no recovery of costs by GDNs,
- £20.1 million of the overspend consisted of related party margins on net connection costs which would be disallowed from the RAV consistent with the approach applied for DPCR4, and
- £17.7 million would be attributed to GDN sales costs which are not recoverable.

3.25. Of the allowed spend of £1.3 billion we proposed that:

- £1.29 billion would be attributed to efficient allowed expenditure for which the GDNs would receive full recovery of allowed capital charges, and
- the remainder of £14 million would be attributed to inefficiencies within the allowance for which the GDNs would have full recovery of capital charges for five years and then no further recovery (Pot 2a).

Respondents' views

3.26. The GDNs raised a range of detailed comments on Ofgem's efficiency assessment and application of the methodology to update the RAVs.

3.27. Several GDNs expressed concern over asymmetry in our ex post efficiency review, suggesting that our consultants were selective in focussing on projects that were over budget.

3.28. A number of GDNs argued that our proposal to disallow a proportion of connections, mains reinforcement, governor and services repex costs on the basis of a lack of management information is inappropriate. They indicated that an absence of management information does not necessarily indicate that there are inefficiencies.

3.29. Several GDNs objected to our proposals to disallow certain costs associated with the EPC contracts because the GDNs failed to subject the contracts to a competitive tender process. They suggested that, given the environment of rising costs, it was reasonable to expect the outcome of a tender process to be more expensive than rolling over existing contracts.

3.30. Several GDNs argued that it was inappropriate to disallow the component of the connections overspend that had arisen from under-recoveries in connections costs from customers due to time lag effects. They indicated that the costs associated with time lags are inevitable as there are significant lead times before work is carried out. They suggested that carrying out more regular reviews of rates going into quotations would lead to additional costs and possible inconsistencies in quotations. Similarly, increasing the frequency of reviewing contractors' rates would lead to upward cost pressures. GDNs also suggested that following a number of connections determinations and the Enforcement Order they were required to charge on the basis of costs at the time of quotation rather than forecast costs.

3.31. The GDNs also argued that Ofgem's analysis assumed that a larger proportion of the non-domestic connections market is competitive than is actually the case with the effect that initial proposals would have disallowed an unduly high proportion of spend.

3.32. Some GDNs have argued that related party margins associated with net connections costs on work carried out by Fulcrum should be allowed into the RAV. They argued that disallowing margins on connections costs would mean that these costs were effectively treated as a cost pass-through with no incentive to carry out the work or undertake it efficiently. Some GDNs also argued that disallowance of margins would create a perverse incentive to use third-party contractors. One GDN suggested that only a proportion of the related party margins for Fulcrum Connections should be disallowed. Finally, some GDNs suggested that Ofgem had double counted by disallowing costs associated with both related party margins and under-recovery of connections costs.

3.33. As part of the current price control, GDNs as whole were allowed £68m (2000 prices) to replace their Private Mobile Radio (PMR) network. The purpose of the PMR network was to provide resilient communications between emergency field users, office systems, and office-based staff. NGG decided to adopt an alternative system, Quarterback (QB), to send information to and from the field. NGG has argued that the software development costs associated with the QB system should be allowed as capex for RAV purposes as this was a direct substitute for PMR.

3.34. The GDNs argued that a wider range of areas of overspend could not have reasonably been anticipated at the last review and that Ofgem should widen the scope of the reopeners.

3.35. In addition, a number of points were raised that were specific to individual GDNs. These are discussed further in paragraph 3.49 and Appendix 1.

Ofgem's decision

Overall treatment of expenditure

3.36. Table 3.2 (page 20) sets out our final treatment of historical capex and non-mains repex for each GDN and how this compares to our initial proposals. Table 3.3 (page 21) then identifies the main changes compared to initial proposals which are discussed in further detail below.

Inefficiencies

3.37. We do not consider that our ex post efficiency review process gives rise to asymmetry. We note that those GDNs who raised it as an issue did not produce any evidence of asymmetry.

3.38. We have retained the efficiency adjustments associated with a lack of management information set out in initial proposals. There is strong evidence to support the view that there have been inefficiencies in these areas. There was generally a lack of routine detailed information to monitor the productivity of individual teams within the GDNs or connections contractors. We recognise that it is difficult to quantify the scale of the impact due to the poor quality of information that was provided by NGG. As it is important that the price control process does not allow GDNs to benefit as a result of submitting poor quality data, we have estimated the efficiency savings that could have been made.

3.39. We have applied the inefficiency adjustments relating to EPC contracts set out in initial proposals. There is strong evidence of a lack of stability in GDNs' contracting strategy with regards to replacement expenditure, mains reinforcement and governor capex. Prior to 2002, there were target cost contracts in place with profit sharing between NGG and its contractors. In principle, this should have led to efficiency savings being passed back to the company but frequent rate reviews undermined these incentives. In 2002, the EPC contracts were renegotiated bilaterally with existing contractors and there was a move to fixed rates indexed at RPI and RPI-X. This meant that there was minimal incentive to pass productivity improvements back to the GDNs. In practice, there were also further renegotiations in contractors' charges which meant that rates for service replacement work rose much faster than RPI.

3.40. We have corrected an error in the calculation of connections inefficiencies for the GDNs. This has resulted in an £8.3 million reduction in inefficient overspend (Pot

1) and an equivalent increase in efficient overspend (Pot 2b) for GDNs as a whole as shown in Table 3.3.

Reopeners

3.41. We have decided to limit the reopeners to those set out in initial proposals. The additional spend incurred by GDNs on LTS projects, mains reinforcement and governors could have been identified at the last review. Although demand forecasts were updated on an annual basis, the network validation process was not completed until after the review. Carrying out the network validation process in time to inform the BPQ forecasts would have made it possible for these costs to be taken account of in the last review.

Other capex not included in the RAV

3.42. We consider that GDNs could have taken additional steps to manage under-recoveries in connections costs in the competitive segment of the connections market, such as using forward-looking charges to take account of increases in contractors' costs. This is standard practice in most competitive markets. We are satisfied that the GDNs have demonstrated that a smaller proportion (35 per cent) of the non-domestic connections market is competitive. We have reduced the under-recovery adjustments accordingly. This has resulted in a £3.9 million reduction in disallowances and an equivalent increase in efficient overspend (Pot 2b) for GDNs as a whole.

3.43. Our disallowance of net capex associated with under-recovery of connections charges relates to the competitive segments of the connections market, such as connections to new housing and large value non-domestic connections where customers have a choice of alternative connections providers. We have applied no under-recovery disallowance in the monopoly elements of the market such as one-off connections to existing housing and smaller value non-domestic connections. As such, our proposals do not mean that GDNs need to increase their charges in these areas where competition has not developed.

Table 3.2 Treatment of historical capex and non-mains repex

	NGG								NGN		SGN				WWU			
GDN	**East of England**		**London**		**North-West**		**West Midlands**		**North England**		**Scotland**		**South England**		**Wales West**		**Total**	
Comparison of actual and allowed spend	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change
Total Allowed Capex and Non-Mains Repex	197.4	0.0	105.2	0.0	129.4	0.0	120.7	0.0	182.0	0.0	145.7	6.3	260.8	0.0	170.6	0.0	1,311.7	6.3
Total Actual	353.4	5.0	185.3	2.5	236.0	3.1	170.7	2.2	245.2	3.2	263.5	2.6	392.1	4.7	329.7	3.9	2,175.9	27.2
Overspend	156.0	5.0	80.1	2.5	106.6	3.1	50.0	2.2	63.3	3.2	117.8	-3.7	131.3	4.7	159.1	3.9	864.2	20.9
% overspend against allowances	79%	3%	76%	2%	82%	2%	41%	2%	35%	2%	81%	-6%	50%	2%	93%	2%	66%	1%
Treatment of overspend																		
Related party margins disallowance	4.3	-0.2	1.6	-0.1	2.3	-0.1	1.7	-0.1	1.8	0.0	3.7	1.0	3.4	1.0	3.0	0.0	21.6	1.5
DN sales costs disallowance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.6	0.0	0.0	0.0	0.0	0.0	14.1	0.0	17.7	0.0
Under recovery of connections income disallowance	7.5	-0.8	1.9	-0.4	4.1	-0.4	3.3	-0.3	3.2	-0.4	4.7	-0.6	2.8	-0.6	3.7	-0.4	31.1	-3.9
Inefficient above allowance (Pot 1)	4.1	-1.6	2.6	-0.8	6.8	-0.1	1.8	-0.6	3.3	-1.7	4.1	-0.8	8.5	-1.1	4.9	-7.1	36.1	-13.9
Efficient overspend (Pot 2b)	114.5	7.6	72.6	3.8	92.3	3.7	32.9	3.1	44.5	5.4	101.2	-3.2	108.5	5.4	104.9	11.4	671.4	37.2
Reopener (Pot 3b)	25.7	0.0	1.4	0.0	1.2	0.0	10.4	0.0	6.8	0.0	4.1	0.0	8.1	0.0	28.6	0.0	86.3	0.0
Total overspend	156.0	5.0	80.1	2.5	106.6	3.1	50.0	2.2	63.3	3.2	117.8	-3.7	131.3	4.7	159.1	3.9	864.2	20.9
Treatment of allowed spend																		
Inefficient spend within the allowance (Pot 2a)	1.9	0.0	0.8	-0.2	0.0	-0.7	0.9	-0.1	1.4	-1.4	0.9	-0.1	1.6	-0.1	3.8	0.0	11.3	-2.7
Efficient allowed spend (Pot 3a)	195.5	0.0	104.4	0.2	129.3	0.7	119.8	0.1	180.5	1.4	144.8	6.4	259.2	0.1	166.8	0.0	1,300.4	9.0
Total allowance	197.4	0.0	105.2	0.0	129.4	0.0	120.7	0.0	182.0	0.0	145.7	6.3	260.8	0.0	170.6	0.0	1,311.7	6.3

Table 3.3 Impact of changes on the treatment of expenditure[14]

Historical RAV changes	**NGG**				**NGN**	**SGN**		**WWU**	
GDN	**East of England**	**London**	**North-West**	**West Midlands**	**North England**	**Scotland**	**South England**	**Wales West**	**Total**
Changes to disallowances									
Revised related party margins adjustments (movement from disallowance to Pot 2b)	-0.2	-0.1	-0.1	-0.1	0.0	1.0	1.0	0.0	1.5
Reduced connections under-recovery (movement from disallowance to Pot 2b)	-0.8	-0.4	-0.4	-0.3	-0.4	-0.6	-0.6	-0.4	-3.9
Total	**-1.0**	**-0.5**	**-0.5**	**-0.3**	**-0.4**	**0.4**	**0.3**	**-0.4**	**-2.4**
Changes to inefficient spend above allowance (Pot 1)									
Correction in connections inefficiency adjustment (movement from Pot 1 to Pot 2b)	-1.6	-1.0	-0.8	-0.7	-1.0	-1.0	-1.1	-1.2	-8.3
Impact of additional QB spend (some inefficiencies move from Pot 2a to Pot 1)	0.0	0.2	0.7	0.1	0.0	0.1	0.0	0.0	1.1
Other GDN specific changes (movement from Pot1 to Pot 2b)	0.0	0.0	0.0	0.0	-0.8	0.0	0.0	-5.9	-6.7
Total	**-1.6**	**-0.8**	**-0.1**	**-0.6**	**-1.7**	**-0.8**	**-1.1**	**-7.1**	**-13.9**
Changes to efficient overspend (Pot 2b)									
Revised related party margins adjustments (movement from disallowance to Pot 2b)	0.2	0.1	0.1	0.1	0.0	-1.0	-1.0	0.0	-1.5
Reduced connections under-recovery (movement from disallowance to Pot 2b)	0.8	0.4	0.4	0.3	0.4	0.6	0.6	0.4	3.9
Correction in connections inefficiency adjustment (movement from Pot 1 to Pot 2b)	1.6	1.0	0.8	0.7	1.0	1.0	1.1	1.2	8.3
Impact of additional QB spend with actual capex (extra spend in Pot 2b)	5.0	2.3	2.4	2.1	3.2	2.5	4.7	3.9	26.1
Other GDN specific changes (movement from Pot 1 to Pot 2b)	0.0	0.0	0.0	0.0	0.8	0.0	0.0	5.9	6.7
Other GDN specific changes (movement from Pot 2b to 3a)	0.0	0.0	0.0	0.0	0.0	-6.3	0.0	0.0	-6.3
Total	**7.6**	**3.8**	**3.7**	**3.1**	**5.4**	**-3.2**	**5.5**	**11.4**	**37.2**

[14] There are minor differences of £0.1 million between Tables 3.2 and 3.3 due to rounding. Further details of the changes to the treatment of allowed spend can be found in table A5.33 in Appendix 5

3.44. We have disallowed the full related party margins on net connections capex prior to 1 June 2005 for all the GDNs. We have disallowed margins for all of NGGs' net connection capex up to March 2007, with the exception of one-off domestic connections which were insourced from October 2005. We have disallowed margins on net connections capex for SGN's GDNs for 2006-07. Fulcrum is part of National Grid Group and over 25 per cent of its turnover was to the group in each year of the current price control period. Similarly, in 2006-07, SGN contracted their connections work to two companies within its group: SGN Connections; and, SGN Contracting. It would be inappropriate to allow related party margins on this capex as GDNs already receive a rate of return on the RAV.

3.45. The removal of the related party margins adjustment for NGG from October 2005 has reduced its connections disallowance by £0.5 million. The application of the related party margins adjustment to Scotia for 2006-07 has increased its connections disallowance by £2 million. The overall impact of these changes is a £1.5 million increase in the policy disallowances and an equivalent decrease in efficient overspend (Pot 2b).

3.46. We have only disallowed related party margins on net connections costs. As Ofgem sets an allowance for net connections costs GDNs have an incentive to carry out connections work efficiently to outperform their allowance and increase their return. GDNs would only be expected to use third party contractors to the extent that their total fees including margins are cheaper than doing the work in house or through a related party.

3.47. There is no double counting between the disallowances we have applied for related party margins and under-recoveries of connections costs. We have disallowed the under-recovery element of net connections capex first and then applied a percentage disallowance for related party margins to the remaining net capex.

Other capex included in the RAV

3.48. We have decided to allow 50 per cent of the software development costs associated with the QB system into the RAV as we accept that this system was a partial substitute for the allowed PMR replacement. QB facilitates communication and exchange of data with field staff. However, this is primarily a software solution reliant on other service providers through use of the GPRS mobile data network. This does not provide the same resilience benefits as were anticipated through the PMR replacement. This change has resulted in GDNs' actual capex for 2002 to 2007 increasing by £27.2 million, efficient overspend (Pot 2b) increasing by £26.1 million and efficient spend within the allowance (Pot 3a) increasing by £1.1 million.

Other issues relating to individual GDNs

3.49. We have considered each of the specific issues relating to individual GDNs and have decided to make a number of changes to initial proposals. Overall these changes have reduced inefficiencies above the allowance (Pot 1) by £6.7 million, and increased both the efficient overspend (Pot 2b) by £0.4 million and the efficient allowed spend (Pot 3a) by £7.7 million.

Assessment of capex and repex for January 2001 to March 2002

Position set out in initial proposals

3.50. Over the 15 month period from January 2001 to March 2002 NGG overspent the price control allowance by £49 million (5 per cent). Our assessment of capex and repex for January 2001 to March 2002 in initial proposals identified two key areas of inefficiency:

- £6.9 million related to the Ulysses and QB (Mars) projects, and
- £2.9 million related to problems with planning and contract management for the Horndean to Newalls Lane and Newbury reinforcement projects.

3.51. In addition we proposed to disallow £6.4 million of net connections capex due to under-recoveries in connection costs from customers in the competitive segment of the connection market. The remaining spend would be added to the opening RAVs of each GDN as at 1 April 2007, pro-rated to their April 2002 RAV values.

Respondents' views

3.52. There were mixed views on the on the assessment of the January 2001 to March 2002 expenditure. One GDN was concerned that Ofgem had extrapolated the conclusions of the efficiency review for 2002 to 2007 to the preceding 15 months and that this had the effect of extending the period to which the rolling capex incentive applies. Another GDN agreed in principle to the approach but said it was unreasonable for a proportion of the capex for this period to be treated in a way that they considered to be equivalent to Pot 2 treatment.

3.53. One GDN considered the efficiency adjustments to be reasonable, however they argued that due to the difficulty of external assessment of efficient spend and the potential for a substantial amount of overspends to be disallowed, the adjustments represent a significant increase in regulatory risk which should be reflected in the allowed cost of capital.

3.54. Finally, one GDN argued that £0.5 million of the £0.7 million disallowed for the Horndean to Newalls Lane reinforcement, and £0.9 million of the £2.2 million disallowed for the Newbury reinforcement related to unavoidable delays in obtaining planning consents, and should therefore be allowed into the RAV.

Ofgem's decision

3.55. Table 3.4 below sets out our final decision on the treatment of expenditure for the 15-month period and the change from initial proposals.

Table 3.4 Capex and repex, January 2001 to March 2002 £m, 2005-06 prices

	Final proposals	Change from initial proposals
Allowed expenditure	927.6	0.0
Actual expenditure	976.7	0.0
Overspend (underspend)	49.1	0.0
Inefficient expenditure	9.8	0.0
Connections income under-recovery	5.5	-0.9
Overspend allowed into RAV	33.8	-0.9

3.56. We have applied a consistent approach in reviewing the efficiency of January 2001 to March 2002 expenditure and spend for the current price control period. Where projects have cut across the two periods, we have reviewed the efficiency of expenditure for the project as a whole. The traditional approach has been applied to the RAV roll forward for this period meaning that efficient spend has been rolled into the RAV at the commencement of the next price control period, in this case 1 April 2007.

3.57. We have decided to apply the inefficiency adjustments set out in initial proposals. For Horndean to Newalls Lane insufficient lead time was allowed to mitigate all the planning issues. The decision on the diameter of the new pipe was not carried out in a timely manner and subsequently led to a two phase construction project which incurred greater costs. For Newbury reinforcement the risks associated with obtaining planning permission for Bucklebury PRS were not correctly assessed or mitigated. The overspend was due to construction works taking place in a designated “Area of Outstanding Natural Beauty” which was known about at the time of tender evaluation. As the PRS and AGI sections were not needed until the second phase of the project they could have been removed and let once the planning issues were resolved.

3.58. Similar issues of connection under-recoveries apply for the 15-month period as for the current price control period. We have reduced the under-recovery disallowance as we are satisfied that only 35 per cent of the non-domestic connections market is competitive as explained in paragraph 3.42. This has reduced the disallowance by £0.9 million and led to an equivalent increase in the amount to be allowed into the RAV.

Conclusions on treatment of historical capex and repex

3.59. The overall impact of our final decision on the efficiency assessment and the treatment of expenditure on the total GDN RAV is set out in Table 3.5. The opening

RAV for April 2002 used for the current price control allowances is adjusted to take into account a number of factors:

- £33.8 million efficient overspend for January 2001 to March 2002 (see above),
- £51.5 million of regulatory value in respect of datalogger activity that has been transferred from the metering RAV to the distribution RAV. The transfer is a result of Ofgem's determination that datalogger activity should form part of the distribution price control.[15] An adjustment was made to allowed revenue to account for additional return and depreciation as part of the work on the separation of price controls but no adjustment was made to the RAV,
- £9.7 million of meter governor regulatory value that was incorrectly included in the distribution RAV and has now been moved to the metering RAV[16], and
- £16.1 million of regulatory value relating to NTS offtakes has been transferred to the distribution RAV to reflect a transfer of responsibility for those assets in April 2002. We have also made a retrospective adjustment to revenue to reflect the additional assets similar in effect to a Pot 3 reopener.

3.60. The RAV is rolled forward year by year to take into account additions minus disposals and depreciation. Net additions include allowances for net capex and 50 per cent of the allowances for repex. They also include efficient capex or non-mains repex which has been treated as an overspend (Pot 2) or as a reopener (Pot 3).

3.61. While the RAV includes both the allowance and the efficient Pot 2 overspend for net capex and non-mains repex, the GDNs are exposed to the capital charges (including depreciation) in respect of the Pot 2 overspend for five years. These are subtracted from the resulting revenue allowance as an incentive adjustment. Similarly, if there is an underspend or inefficient spend within the allowance, it is removed from the RAV, but the GDN will retain the allowed capital charges for five years. This is added to revenue as an incentive adjustment.

Table 3.5 Total GDN RAV Roll forward (£m, 2005-06 prices)

	2002-03	2003-04	2004-05	2005-06	2006-07
Opening value bf per last price control	10,634.7				
Additions to pre-2002 assets	91.8				
Revised Opening value bf	10,726.5	10,845.7	10,845.7	10,815.5	10,799.1
Depreciation	-376.4	-380.7	-382.4	-383.5	-384.9
Net capex additions	507.0	379.4	351.5	371.6	380.4
Disposals	-11.4	1.2	0.8	-4.5	-3.5
Closing RAV (incl. Pot 3)	10,845.7	10,845.7	10,815.5	10,799.1	10,791.2
Pot 2 additions (cumulative)	63.4	151.4	247.6	444.5	660.1
Pot 2 depreciation (cumulative)	0.0	-1.4	-4.8	-10.3	-20.2
Total Closing RAV	**10,909.1**	**10,995.6**	**11,058.3**	**11,233.3**	**11,431.2**

[15] Transco price control and NTS SO incentives 2002-7. Explanatory notes to accompany the section 23 notice of proposed modifications to Transco's Gas Transporter Licence.
[16] Ofgem open letter on treatment of I&C and meter governors, 29 April 2005.

3.62. RAV roll forward figures for individual GDNs are set out in Appendix 5. There will be no further changes to the RAV figures up to 31 March 2005. We intend to update the analysis of expenditure for 2005-06 and 2006-07 to reflect actual cost information for those two years. We will carry out this work once updated cost information becomes available in June 2007 and use the results to update the RAVs. We will consult on the results of this work in the September 2007 update paper.

2007-08 forecast capital and replacement expenditure

Position set out in initial proposals

3.63. Our initial proposals set out total capex and repex allowances of £925.9 million for the GDNs based on benchmarking by using historical data and comparisons between the GDNs. These capex and repex allowances were 7 per cent lower than the companies asked for but 9 per cent higher than their forecasts of spend for 2006-07 as set out in their April BPQ submissions.

Respondents' views

3.64. Most GDNs broadly supported our approach for determining 2007-08 capex and repex allowances but expressed some issues with the detailed analysis. Two GDNs argued that our adjustments to their proposed ratios for mains installed to mains abandoned to 1:1.1 did not take full account of the inter-relationships between the mains replacement techniques that are used, the abandonment ratios, and the efficiency of unit costs. In particular, greater use of insertion will tend to lower the abandonment ratio but reduce unit costs. They suggested that their original ratios were appropriate.

3.65. One GDN indicated that our treatment of time-lag issues for the 2007-08 connections allowance was inconsistent with our treatment of historical spend.

3.66. WWU argued that our adjustments to their service workload are inappropriate. They suggested that this means that service workload does not rise proportionately with mains replacement work required by the HSE.

3.67. WWU also noted that we had proposed to disallow £3.1 million of their proposed IS spend on grounds that it was above the average GDN forecast spend. They argued that this was inappropriate as the additional costs were related to GTMS replacement and Ofgem had indicated that it would allow efficient GTMS costs in the July consultation document.

3.68. Some GDNs put forward significant revisions to their 2007-08 capex and repex plans as part of their October BPQ submissions for the main price control.

3.69. One respondent expressed concern at our proposal to increase capex and repex allowances by almost 60 per cent in 2007-08. This respondent suggested that Ofgem should adopt a simple roll forward of capex and repex allowances for the one year control.

Ofgem's decision

3.70. Ofgem's final decision for capex and repex allowances for 2007-08 is set out in Table 3.6 (page 29). This also shows the changes since initial proposals. The allowances are £946.4 million in total, 11 per cent higher than the GDNs forecast they will spend this year in their April BPQ submissions but 5 per less than the GDNs sought in their April BPQ submissions.

3.71. We have reviewed the work on benchmarking the ratio of mains abandoned to mains installed and recognise that the ratios set out in initial proposals were inappropriate for NGG and WWU given their mix of replacement techniques and unit costs. The ratio for WWU has been revised to 1:1.05, the ratios for North London, West Midlands and East of England GDNs have been revised to 1:1 and the ratio for North West GDN has been revised to 1:1.02. This has resulted in a £1.5 million increase in WWU's mains repex allowance and a £15.4 million increase in NGG's mains repex allowance.

3.72. We have reviewed our calculations of the 2007-08 connections allowances. The approach that we have applied to time-lag issues is consistent with the treatment of historical spend. We have only applied an adjustment to customer contributions for the competitive element of the connections market. We have corrected a minor error in the calculation of the 2007-08 connections allowances which has increased allowances by £0.4 million.

3.73. We have corrected an error in the calculation of WWU's service repex allowance which has increased their allowance by £0.1 million. We have not changed our proposals for WWU's service workload. They are consistent with the historical ratio of service replacement volumes to mains replacement volumes including work related to the HSE requirements, condition based replacement and diversions.

3.74. We have included £3.1 million of WWU's costs relating to GTMS replacement which had previously been disallowed. The disallowance in initial proposals resulted from WWU's GTMS costs being categorised differently than the other GDNs' costs.

3.75. We have not adjusted our proposals for the revised work plans put forward by some GDNs. Additional information since April implies that costs will have gone up in some areas and down in others. We are concerned that companies have mainly put forward those areas where costs have increased. We consider that it is appropriate to base final proposals for the one year control on the April BPQ submissions.

3.76. The one exception to this will be in the event that a GDN has signed an Advance Reservation of Capacity Agreement (ARCA) with a future customer. If an ARCA is signed before February 2007, which commits a GDN to expenditure in 2007-

08, we will make an allowance for the additional expenditure net of any customer contributions. If one is signed later than February 2007, and expenditure is then incurred in 2007-08, we will make an ex post adjustment to the 2007-08 allowance. We are only aware of one GDN that is in this position. More generally, we will want to consider the most appropriate approach for dealing with this type of expenditure as part of the main review, recognising that it has historically been a relatively small part of the GDNs' capex plans when compared to transmission.

3.77. Given the detailed information on GDNs' costs that we have considered as part of our review of historical capex and repex, we consider that it would be inconsistent with our statutory duties to base 2007-08 capex and repex allowances on a simple roll forward of 2006-07 allowances.

3.78. More detailed information on how the allowances are built up for each GDN from volume and unit cost information is set out in Appendix 6. This includes the final mains replacement incentive matrices for each of the GDNs. Consistent with the current price control we have applied a cap to the allowances that GDNs are able to receive under the mains replacement incentive mechanism. Each GDN's mains replacement incentive allowance has been capped at their total matrix costs, as set out in Appendix 6, plus 15 per cent[17]. This will allow GDNs some flexibility on the diameter mix that will be replaced each year under the HSE approved 30:30 programme, but avoids the possibility of disproportionate costs being passed through to customers if there was a major rebalancing of workload between the diameter bands.

[17] For NGG this means that its total price control allowance under the mains replacement incentive mechanism will be capped at the sum of the total matrix costs for each of its four GDNs as set out in Appendix 6 plus 15 per cent. For other GDNs the total price control allowance under the incentive mechanism will be capped at that GDN's total matrix cost plus 15 per cent.

Table 3.6 Final capex and repex allowances for 2007-08 by GDN (£m, 2005-06 prices)

	NGG								NGN		SGN				WWU		Total	
GDN	**East of England**		**North London**		**North West**		**West Midlands**		**North England**		**Scotland**		**Southern**		**Wales and West**			
	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change	Final proposal	change
Ofgem forecast																		
LTS and storage capex	9.6	0.0	27.6	0.0	5.8	0.0	3.1	0.0	2.2	0.0	24.0	0.0	34.2	0.0	9.0	0.0	115.6	0.0
Mains reinforcement and governors	4.7	0.0	3.8	0.0	3.9	0.0	2.4	0.0	6.2	0.0	9.6	0.0	18.3	0.0	6.2	0.0	55.1	0.0
Connections	6.8	0.1	1.9	0.0	3.3	0.0	2.2	0.0	8.6	0.1	12.5	0.1	13.1	0.1	6.3	0.1	54.7	0.4
Other capex	19.7	0.0	10.9	0.0	14.1	0.0	10.1	0.0	20.5	0.0	15.7	0.0	24.0	0.0	18.1	3.1	133.1	3.1
Mains repex	64.9	5.9	25.3	2.3	54.9	4.0	35.2	3.2	41.6	0.0	31.6	0.0	64.4	0.0	32.0	1.5	349.9	16.9
Services Repex	41.2	0.0	20.9	0.0	28.7	0.0	21.5	0.0	22.7	0.0	21.9	0.0	57.6	0.0	21.9	0.1	236.4	0.1
Other repex	-2.3	0.0	-1.5	0.0	-1.3	0.0	-1.2	0.0	5.1	0.0	1.0	0.0	1.8	0.0	0.0	0.0	1.6	0.0
Total capex and repex	144.5	6.0	88.9	2.3	109.4	4.0	73.3	3.2	107.0	0.1	116.3	0.1	213.4	0.1	93.5	4.7	946.4	20.5

4. Financial issues

Chapter Summary

This chapter sets out Ofgem's decision on the cost of capital, tax, pensions and the revenue driver for the one year control. In particular, we have retained our view that it is appropriate to move to a post tax cost of capital as part of the one year control.

Cost of capital

Position set out in initial proposals

4.1. We proposed to roll forward the cost of capital (6.25 per cent pre tax) unchanged, other than in relation to the treatment of tax. In line with established Ofgem policy, we proposed to convert the cost of capital to a vanilla WACC of 5.25 per cent, and calculate a specific ex ante tax allowance for each GDN. If a GDN was facing a tax charge equivalent to 30 per cent of its return on equity, this would equate to a post tax cost of capital of 4.38 per cent.

Respondents' views

4.2. Three GDNs indicated in their responses to initial proposals that they do not agree with our proposed approach to calculating the cost of capital. In general, they consider that a rollover of the cost of capital should include a rollover of the pre tax figure, retaining the 30 per cent tax wedge assumption. They argue that the move to post tax leaves them with a return on capital that is insufficient to attract long-term investment. GDNs generally accept the adoption of a post tax approach from 2008 as part of the main control.

4.3. In contrast, one GDN said that they accept the move to post tax for the one year control, provided we make an appropriate allowance for tax and/or increased the vanilla WACC. Most other respondents either agreed with our approach or did not express an opinion. One non-GDN respondent said that we should reduce the cost of capital if we were going to increase allowances for pensions and shrinkage.

4.4. Further views put forward by respondents are set out in Appendix 1, together with Ofgem's response.

Ofgem's decision

4.5. We have not changed our view as set out in initial proposals. We do not consider that rolling forward the cost of capital, but calculating a specific tax allowance is inconsistent with the spirit of the one year control. The fact that this reduces allowances, other things being equal, is not a sufficient reason to diverge from standard Ofgem policy. Since this is a one year control, and we have explained that we will review the cost of capital for the main control, we are not sending any signal regarding long-term returns, so long-term investment decisions should not be unduly affected.

4.6. We do not consider that a reduction in the cost of capital, on the grounds that we have removed shrinkage risk, is appropriate in the context of a one year control. We do not propose to change the cost of capital until we have carefully considered the relevant issues.

Tax

Position set out in initial proposals

4.7. We calculated tax allowances based on information provided to us by the GDNs (primarily in respect of capital allowances). We assumed notional gearing of 62.5 per cent and real cost of debt of 4.65 per cent, as per the cost of capital calculation in the current price control. We did not give negative tax allowances to those GDNs that had tax losses according to our calculations, but we noted that we would carry such losses forward and set them off against future tax allowances when the timing differences that led to the losses reversed.

Respondents' views

4.8. Only one GDN put forward a substantive response regarding the way we calculated the tax allowance (as opposed to the implementation of an ex ante tax allowance). This GDN considered that we had not given them a sufficient allowance when compared to their forecast tax provision. Another GDN argued against an ex post adjustment for GDNs with higher gearing or interest cost than our notional assumptions.[18] A non-GDN respondent argued that if we moved to a post tax cost of capital, we should claw back the benefits enjoyed by the GDNs of the assumed 30 per cent tax wedge. Another respondent claimed that it would be inconsistent to take account of the fact that debt yields are lower in the rolled over cost of capital when we assessed financeability but suggested not to do so for the purposes of calculating tax.

Ofgem's decision

4.9. We continue to hold the view that our overall approach to the calculation of tax allowances is appropriate. The principle of using a company specific tax allowance is discussed above. NGN have provided us with further details of their forecast tax provision. Based on this information, we have reduced their allowed taxable losses, which will increase their future tax allowances when timing differences reverse. The tax allowance for 2007-08 will still be zero.

[18] Our proposals to claw back the benefits of excess gearing is restricted to the situation where both gearing and interest are higher.

4.10. We do not consider that it would be appropriate to attempt to claw back tax benefits from previous years as the pre tax policy was part of the overall package and in line with Ofgem's policy at the time. This is consistent with the approach we have adopted elsewhere. For example, we have not reopened the price control to allow GDNs to recover previous shrinkage losses.

4.11. We are aware that the ex ante tax allowances are based on a real interest tax shield of 4.65 per cent. This is higher than prevailing debt costs, and so, leaving aside differences in gearing, the GDNs will face a lower tax shield in practice. Since we are not conducting a review of the cost of capital for the one year control, there is no basis for selecting a different interest rate ex ante. Once we have determined the cost of capital for the main control, we will use that interest rate and gearing level to re-calculate the interest tax shield and resultant tax allowances for 2007-08. We will then carry out the standard ex post review, comparing this tax shield with the actual levels of interest and gearing in the GDNs. If both of these are higher than in our re-calculated model, we will adjust for the excess interest tax shield. GDNs will be allowed to recover the net amount of these two items on an NPV-neutral basis. Our indicative calculations using the TPCR cost of debt as a proxy (though this should not be taken as in indication that we will simply adopt this rate for the main control) suggest that overall the GDNs may recover around £14m (equivalent to a 0.7 per cent P0 increase).

4.12. We will also review all GDNs' submitted tax computations for 2005-06 to confirm the transfer value of the capital allowance pools acquired by the IDNs when they purchased their networks from NGG (NGG's computation should show a disposal of an equivalent amount). To the extent that these figures are different from those provided to us by the GDNs to date (and used in the calculation of the tax allowance) we will make an ex post adjustment.

4.13. Several of the GDNs have no tax allowances, and we are therefore carrying forward their regulatory tax losses, to be set against future liabilities. These are outlined in Appendix 10.

Financeability

Position set out in initial proposals

4.14. Financeability is most appropriately considered over the medium term and against the background of future capex requirements. As we are only setting allowances for one year, and we will be resetting the control the following year, we are not able to assess trends forward from 2007-08. Since our initial proposals would increase the GDNs' revenue allowances by more than their expected costs in 2007-08, we would expect the trend to be positive for typical financial indicators. All the GDNs currently have an investment grade credit rating.

Respondents' views

4.15. In general, the GDNs did not consider that we had given enough emphasis to financeability. They did not agree with the way we had modelled key ratios, and argued instead that one key ratio, the Post Maintenance Interest Cover Ratio (PMICR), would deteriorate, and was unacceptably low. Even if it did not deteriorate, some GDNs argued that PMICR might trigger a ratings downgrade because the agencies had assumed that Ofgem's settlement would be more generous. Alternatively, agencies might believe that there were long-term indicators of poor financeability in Ofgem's proposals of which account should be taken.

Ofgem's decision

4.16. Our final proposals result in a further increase in allowances for all the GDNs. Since increased allowances do not generate additional costs (except tax, however our model accounts for that), this improves the GDNs' financeability, even though such changes do not always show up as financeability improvements in our modelling because we conventionally assume that the GDNs actual costs will match allowances, i.e. we take account of potential outperformance.

4.17. We were satisfied that our initial proposals were financeable for reasons set out in the initial proposals document.[19] As our final proposals increase GDNs' allowed revenue relative to initial proposals, we are also satisfied that our final proposals are financeable. While we note that the GDNs disagreed with our assessment of the financeability of the initial proposals, we consider that the additional allowances are sufficient to address some of their principal arguments about the minimum additional income they believed they needed to maintain financeability. We also note that their responses largely focussed on a single ratio for a single year, whereas ratings agencies use a range of quantitative and qualitative judgments in their assessment of creditworthiness, and look at medium to long-term projections in making these judgments. Our analysis indicates that other ratios appear to be, on balance, comparable with those which would have been achieved by a notional GDN within the current price control. We have concerns regarding over-reliance on PMICR for assessing financeability. We will comment further on such matters in the consultation process for the main control, where financeability testing will have greater prominence.

4.18. The values for the PMICR ratio using Ofgem's model are low by ratings agencies' benchmark standards. We recognise that the implied cost of debt in the current cost of capital is no longer indicative of prevailing trends in the debt market, and materially overstates the finance costs an efficient company might expect to pay. Calculating the ratio on this basis is not a realistic projection of likely company performance.

4.19. We would not expect the rating agencies to be able to take a long-term view of the GDNs' prospects from these proposals. There are significant issues to be addressed in the main control regarding capex, opex and repex allowances for 2008-

[19] GDPCR One Year Control Initial Proposals, September 2006, Ref No 169a/06, page 32.

13, including the incentive schemes that will apply, the continuation of the volume driver, the cost of capital, and a full financeability review.

4.20. Importantly, Ofgem's financeability duty does not mean that we have to guarantee financeability in all circumstances. We interpret it to mean that we have to be confident that our proposed revenue allowances, taken together with the cost assumptions on which they are based (including those implied by our cost of capital and gearing assumptions), should allow the GDN to maintain a comfortable investment grade credit rating if it is efficiently managed. In practice, the GDNs' ratings will be dependent not only on the final price control settlement but also on their own financial structure, as well as their performance against allowances. Particularly, in the case of some of the GDNs who have chosen to adopt very highly geared structures, an actual rating weaker than this would not be sufficient evidence that the price control settlement was inconsistent with our financing duties.

5. Conclusion

Chapter Summary

This chapter draws together our analysis set out in earlier chapters in order to outline the overall impact of Ofgem's decision. It also describes the process to finalise and implement the one year control.

Overall impact of proposals

5.1. The overall result of our proposals is a total revenue allowance of £2,327.7 million for 2007-08, representing an increase of £240.4 million or 11.5 per cent over 2006-07 allowances.[20] These figures are split by GDN in Table 5.1.

Table 5.1 Changes in allowances from 2006-07 to 2007-08 (£m, 2005-06 prices)

		2006-07	2007-08	% change
NGG	East of England	380.1	427.2	12.4
	North London	223.0	245.1	9.9
	North West	258.0	285.5	10.6
	West Midlands	196.3	217.8	11.0
NGN	North England	251.7	273.5	8.7
SGN	Scotland	172.1	194.3	12.9
	Southern	382.8	432.4	13.0
WWU	Wales and West	223.3	252.0	12.9
Total		2,087.3	2,327.7	11.5

5.2. The net increase in allowances (P0) can be explained by a number of factors. The principal ones are:

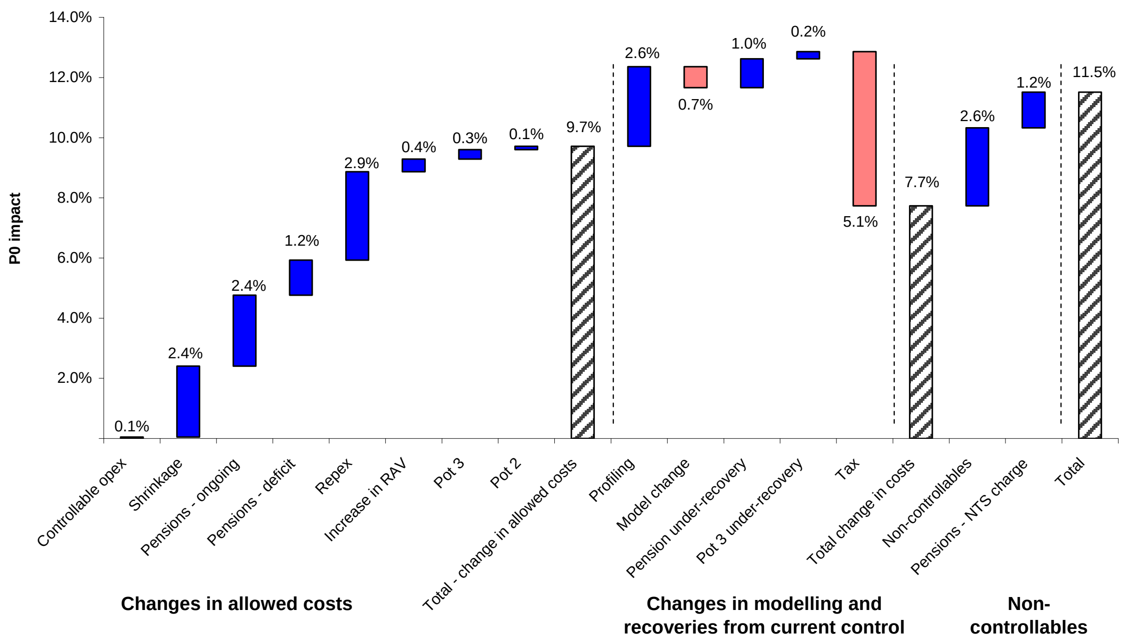
- an increase in replacement expenditure (see paragraph 3.70) – 2.9 per cent increase in P0,
- changes to the shrinkage arrangements (see paragraph 2.23) – 2.4 per cent increase,
- an increase in pensions allowances for ongoing contributions, special NTS charge and deficit payments (see paragraph 2.32) – 4.8 per cent increase,

[20] The final 11.5 per cent figure represents the real difference between 2006-07 allowances and proposed 2007-08 allowances. This measure is the best way of reflecting the price control settlement, however it is not exactly the same as the impact of our proposals on charges. For example, actual revenues recovered by GDNs in 2006-07 will already be higher than 2006-07 allowances due to the effect of the pass through mechanism. 2006-07 allowances are based on a forecast of non-controllable costs (business rates and licence fees) but GDNs are permitted to recover actual costs associated with these items - in particular, business rates were increased mid way through the current price control and charges to customers already reflect this. In addition, companies adjust their charges every year to take account of any under or over recovery from the previous year. As all figures are in constant prices, there will also be a further increase in allowances caused by inflation, which is expected to be around 2.5 per cent.

- the impact of profiling costs in the current price control using a constant 2 per cent reduction rather than forecast trends[21] - 2.6 per cent increase,
- the move from an implicit 30 per cent tax wedge under a pre tax cost of capital to a more realistic ex ante tax allowance (see paragraph 4.9) – 5.1 per cent decrease, and
- under-recoveries from the current control – 1.2 per cent increase.

5.3. In addition to the increases in 2007-08, there is an ongoing effect between 2008-09 and 2011-12 as Pot 2 capex becomes eligible for allowances. This will occur gradually and will amount to around 2 per cent additional allowances by the end of the period. We will also make tax adjustments as described in paragraph 4.11, which we estimate at an extra 0.7%. The impact of our final proposals is represented graphically in Figure 5.1.

Figure 5.1 Components of the increase in allowances



Implications for gas distribution charges

5.4. The price control allowances represent the maximum revenue that the GDNs can collect via gas transportation charges (primarily use of system charges and customer charges). Other revenue streams such as connections contributions, metering and meter reading are not affected.

5.5. There are difficulties in predicting the precise impact on charges to different types of customers of these proposals. These difficulties include:

[21] See paragraph 3.56 of GDPCR Second Consultation, July 2006 (Ref. No. 123a/06) for an explanation of the profiling effect.

- uncertainty over the timing of gas distribution price changes next year,
- potential changes to the structure of charges[22],
- the gains or losses that may be made by GDNs due to specific incentive schemes,
- the gas price index in 2007-08,
- changes in the level of business rates,
- the gradual unwinding of regional cost differentials,
- the application of a k factor as a result of under or over-recoveries, and
- the rate of inflation.

5.6. Additionally, shippers may not pass the full increase in charges on to customers immediately. We consider the best way to illustrate the likely effect on customers is the method used in presenting our initial proposals. For the sake of clarity, this is as follows:

- take the 11.5 per cent P0 increase outlined above, subtract the 2.6 per cent increase for non-controllable allowances,
- add the expected actual increase in non-controllables, based on estimates submitted by the GDNs,
- since the final proposals are expressed in 2005-06 prices, add estimated inflation at 2.5 per cent (consistent with the Monetary Policy Committee's stated targets), and
- apply this increase to average domestic customer charges for 2006-07 for each GDN.

5.7. For domestic customers, this represents an increase of around £10 per annum. This calculation is not dependent on the proportion of the total bill that relates to gas distribution charges, which varies with gas prices.

5.8. Following feedback from respondents we have also calculated the change from actual 2006-07 revenues to 2007-08. This is set out in Appendix 11.

Way forward

5.9. We have asked GDNs to respond to these final proposals by no later than 8 January 2007. In the event that GDNs accept the Authority's proposals, we will carry out a statutory licence consultation in February 2007 and implement the proposals on 1 April 2007. The proposed licence conditions are set out in Appendix 7. If any company decides not to accept the proposals, we expect to refer the matter to the Competition Commission.

[22] We are currently consulting on a number of possible changes to the structure of gas distribution charges. See Ofgem, Reform of interruption arrangements on gas distribution networks, October 2006, Ref 191/06, Chapter 5.

Appendices

Index

Appendix	Name of Appendix
1	Consultation questions
2	Authority's Powers and Duties
3	Glossary
4	Feedback Questionnaire

Supplementary appendices

Appendix	Name of appendix
5	Treatment of historical capital and replacement expenditure
6	2007-08 capital and replacement allowances
7	Proposed licence conditions
8	Results of financial model
9	Application of pensions principles
10	Regulatory tax losses
11	Indicative increase in charges

The supplementary appendices can be found in a separate appendices document.

Appendix 1 Consultation questions

1.1. The initial proposals document sought the views of respondents on the following questions:

CHAPTER: One

There are no specific questions in this Chapter.

CHAPTER: Two

Question 1: Is Ofgem's approach for determining an opex allowance for 2007-08 appropriate? Are the resulting allowances appropriate?
Question 2: Is Ofgem's proposed approach to setting pensions allowance for 2007-08 appropriate?

Shrinkage related questions
Question 3: Is Ofgem's assessment of the costs and benefits associated with the three options for setting shrinkage allowances, as set out in the impact assessment, reasonable?
Question 4: Do you support Ofgem's proposed approach to setting shrinkage allowances (i.e. Option 1a)?
Question 5: In the event that Ofgem adopts Option 1a for shrinkage, which market index (or indices) should GDNs' shrinkage allowances be linked to?
Question 6: In the event that Ofgem adopts Option 1b for shrinkage, should allowances be based on shrinkage costs incurred by the average GDN or lowest cost GDN?
Question 7: Should Ofgem remove throughput-related shrinkage volume risk from GDNs?

CHAPTER: Three

Question 1: Do you agree with our proposals regarding expenditure that we should treat as wasteful and unnecessary?
Question 2: Do you agree with our proposals regarding expenditure that we should treat as efficient overspend and, in particular, expenditure that should be subject to a reopener?
Question 3: Do you agree with our proposed adjustments to the RAVs to reflect expenditure incurred between 1 January 2001 and 31 March 2002?
Question 4: Is our proposed approach for determining capex and repex allowances for 2007-08 appropriate? Are the resulting allowances appropriate?
Question 5: Is our proposed update of the mains replacement incentive mechanism for 2007-08 appropriate?

CHAPTER: Four

Question 1: Do you agree with our proposed approach to calculating the cost of capital to apply for 2007-08?
Question 2: Do you agree with our proposed approach to the treatment of tax?
Question 3: Do our initial proposals, taken in aggregate, represent a reasonable outcome that both protects the interests of consumers and ensures that GDNs are able to finance their activities during 2007-08?

CHAPTER: Five

Question 1: Are the high level licence drafting changes proposed in Appendix 10 of the initial proposals document appropriate? Should we consider any other licence drafting changes?

1.2. We received 13 responses from the following organisations:

List	Name
1	Centrica
2	Chemical Industries Association
3	EDF Energy
4	Energywatch
5	Fuel Poverty Advisory Group
6	Public Utilities Access Forum
7	National Energy action
8	National Grid Gas
9	Northern Gas Networks
10	RWE npower
11	Scotia Gas Networks
12	United Utilities plc
13	Wales & West Utilities

1.3. Responses received by Ofgem which were not marked as being confidential have been published on the Gas Distribution Price Control area of work on Ofgem's website (www.ofgem.gov.uk). Copies of non-confidential responses are also available from Ofgem's library.

1.4. The remainder of this appendix summarises responses received from GDNs and other interested parties, together with our views. When summarising respondents' views, we have referred to each GDN company as a (single) GDN, even if the company owns more than one GDN.

Responses to Chapter 2 - Operating expenditure

1.5. Chapter 2 of the initial proposals document set out Ofgem's proposed approach to setting the GDNs' opex allowances for 2007-08, as well as the specific allowances for opex, shrinkage and pension costs.

Views of GDNs

2007-08 controllable opex allowances (excluding pensions and shrinkage)

1.6. Two GDNs considered the proposed approach to setting opex allowances (excluding shrinkage and pensions) inappropriate as it rewards inefficient companies and penalises those that have reduced costs. They both argued that opex allowances should be set based on rolling forward allowances. One GDN considered that 2004-05 was an unusual year and suggested using an average of 2005-06 actual costs and 2006-07 forecast costs to set opex allowances. Two GDNs expressed concern over the 2.5 per cent efficiency factor.

1.7. One GDN suggested that an opex rolling incentive should be applied to any outperformance in the current control, at the very least for 2003-04, in line with the period for which it was applied in DPCR4.

Pensions

1.8. All GDNs expressed support for our proposed approach to setting pensions allowances for 2007-08. However, one GDN stated that they prefer allowances to be spread over the three year period to the next actuarial valuation in order to re-set allowances, if required, in 2009 following finalisation of the next triennial actuarial valuation.

Shrinkage

1.9. Among the GDNs there was general support of our assessment of the costs and benefits associated with the three options for setting shrinkage allowances.

1.10. All of the GDNs broadly agreed with our proposed approach to setting shrinkage allowances (i.e. Option 1a). One GDN stated however they favour Option 2 for the main price control. This GDN further stated that an adjustment to any ex ante index (like the NTS scheme) will be required in order to capture the correlation between shrinkage volumes and the market price that leads to the volume weighted average price being consistently higher than the forward price. Another GDN said that although they generally support the proposed approach, it does not go far enough and still exposes GDNs to significant within-month price risk.

1.11. The GDNs most commonly suggested the Heren price indices to base Option 1a on if it is adopted for shrinkage allowances. Daily, monthly and quarterly price indices were all put forth by the GDNs. One GDN considered that the gas cost reference price as currently used for the NTS shrinkage incentive scheme based on the Heren price index should be used. Another GDN stated that there needs to be an additional allowance for the following: unhedgeable monthly variance; additional volumes above projections when winter weather is colder than expected and prices increase substantially; and, the cost of purchasing shrinkage gas.

1.12. All GDNs stated that they do not support Option 1b but if it is chosen then it should be based on average GDN cost. Finally all GDNs agreed that Ofgem should remove throughput-related shrinkage volume risk from them.

Views of other respondents

2007-08 controllable opex allowances (excluding pensions and shrinkage)

1.13. One respondent stated that the proposed allowances for controllable opex represent a small yearly increase in nominal terms relative to 2006-07 rather than a reduction, and suggested a significantly larger efficiency reduction. Another respondent said that the proposed approach to setting opex allowances fails to recognise whether the average of the opex incurred in 2004-05 and 2005-06 provides a sustainable basis for estimating future costs, and, fails to assess how efficiently GDNs could have incurred expenditure in a more typical scenario. Finally, one respondent considered that we should follow the approach adopted in DPCR4 when choosing between methodologies.

Pensions

1.14. Three respondents considered the proposed approach to setting pensions allowances for 2007-08 inappropriate. One respondent stated that pensions should only be considered as part of the five year control and the one year control should be carried out on the basis of a very simple roll forward. This respondent also said that if these proposals proceed, the consequent reduced risk to the companies needs to be reflected at the same time in a reduced cost of capital. Another respondent advised that there should be appropriate adjustments to the allowances if the actuarial reports for the new GDNs indicate a lower level of recovery is required. Finally, one respondent supported our approach of following the pension cost recovery principles developed during DPCR4.

Shrinkage

1.15. One respondent considered the impact assessment on shrinkage gas arrangements incomplete as it did not quantify the costs to customers which would be expected to result from a transfer of risk to customers via transportation charges. This respondent also said that a qualitative assessment on the impacts of Options 1a and 1b relative to do nothing is not sufficiently rigorous when used as a basis to transfer risk to customers. Another respondent said that the case for changing the shrinkage arrangements has not been properly made.

1.16. One respondent stated that it prefers to retain the existing shrinkage allowances, however if a change is to be made, then it considers Option 1a reasonable. Another respondent also favoured the existing shrinkage arrangements but preferred Option 1b over 1a. One respondent stated that Option 1a is the most appropriate but the proposed approach could be further refined, and that incentives could be included in either option by allowing the GDNs to retain the benefit of achieving prices below the index or below the benchmark. One respondent raised concerns that the GDNs are not being provided with appropriate incentives to minimise the loss of gas from the system effectively through the proposed changes to the shrinkage allowance. Finally, one respondent welcomed the recognition that network companies should not bear the full consequences of movements in wholesale energy costs.

1.17. If Option 1a is adopted for shrinkage, one respondent proposed that allowances should be based on a SAP related price. Another respondent stated that if the reference price is based on an index of forward prices, GDNs would still be exposed to price risk as the price they pay for shrinkage gas over the year will not necessarily be reflective of the forward price used at the time the reference price is set.

1.18. One respondent did not consider it appropriate for Ofgem to remove throughput-related shrinkage volume risk from GDNs as it would further weaken incentives to reduce and measure shrinkage accurately. This respondent also stated that it is not reasonable to move risk from parties who can influence it to those who cannot. One respondent said that GDNs should be incentivised to manage the element of volume risk they are able to control (i.e. non throughput related).

Ofgem's views

2007-08 controllable opex (excluding shrinkage and pensions)

1.19. Ofgem's reasons for preferring to set 2007-08 controllable opex based on an average of 2004-05 and 2005-06 actual costs (minus a 2.5 per cent efficiency adjustment) are set out in Chapter 2, paragraphs 2.7-2.15.

1.20. We have not applied an opex rolling incentive for 2003-04 as suggested by one GDN. One of the key reasons for applying it in DPCR4, despite the decision not to use an opex rolling incentive going forward, was that Ofgem had indicated that it would be applied in 2003. In the case of GDPCR, GDNs have been aware of our change in policy which arose as a result of problems that we encountered when we tried to implement the opex rolling incentive during DPCR4.[23] The only period for which there could have been ambiguity regarding the application of opex rolling incentives is 2003-04. Although the GDNs did outperform opex allowances in 2003-04, the subsequent rise in costs shows that any reduction in costs in that year were not sustained, thus failing to provide any long-term benefit to consumers, which is

[23] These issues were first highlighted in Ofgem open letter, Electricity Distribution Price Control - Equalisation of opex and capex incentives, 14 May 2004. Ofgem reiterated its concerns in the GDPCR Initial Consultation, December 2005, Ref No 259/05 and GDPCR Second Consultation Document, July 2006, Ref No 123a/06.

the rationale for applying an opex rolling incentive. One of the criteria used in DPCR4 for qualifying for an opex rolling incentive was that electricity distribution networks had to demonstrate outperformance by showing that their opex was lower than any previous year. There is no comparable data for GDNs as the separation of the price control only took place in 2003. Under these circumstances, we do not consider that an additional allowance for cost savings in a single year is appropriate.

Pensions

1.21. Recent changes to the commercial and legislative environment means than all companies (not just GDNs) faced increased costs associated with pension deficits. Given the scale of the risk associated with pensions costs, and the low level of risk attributable to regulated network utilities (which is reflected in the cost of capital), it is appropriate that GDNs receive funding to cover their efficient pensions costs. This policy has been in place since 2003 and was first approved as part of DPCR4.

1.22. It would be inconsistent with the general five year price control cycle for Ofgem to revise pension allowances on the basis suggested in paragraph 1.8 above. There is a mechanism within our pension principles for any changes in actuarially recommended funding rates to be reflected in future price control allowances, on an NPV-neutral basis, to the extent that those changes meet our best practice tests. This will apply whether future actuarial reviews suggest higher or lower contribution requirements.

Shrinkage

1.23. We consider that our decision to revise the price control treatment of shrinkage is consistent with our statutory duties to ensure that GDNs are able to finance their licensed activities.[24] Exposing GDNs to the full gas price risk and residual volume risk related to gas throughput could have a disproportionate effect on the profitability of the GDNs given our views on the appropriate cost of capital for such businesses. As we have developed the new shrinkage arrangements, we have considered various options and have paid particular attention to the associated costs and benefits.

1.24. We consider that Option 1a will best achieve our objectives because it ensures that GDNs are incentivised to reduce shrinkage volumes which they are able to control whilst not penalising them for factors they can not control i.e. the wholesale price of gas and throughput. The mechanism also ensures that only efficient purchasing costs are passed through to customers.

1.25. Since initial proposals, we have refined our proposals and have decided to base the forward prices on a monthly index adjusted by 3.5 per cent to take into account the impact of within month trades, which will need to be undertaken to meet the actual profile of shrinkage gas. Typically, this will involve GDNs buying additional gas when demand is high and prices are higher than the monthly index, and selling gas

[24] Further discussion of Ofgem's objectives and duties in the context of shrinkage is set out in Gas Distribution Price Control Review Second Consultation Document, Supplementary Appendices, 169b/06, July 2006, Appendix 9, paragraphs 1.1-1.2

when prices are lower. We consider that this approach creates the appropriate balance between fairness and complexity. The purpose of setting an index is to reflect an efficient level of gas prices rather than to determine GDNs' purchasing strategies. GDNs will be incentivised to forecast shrinkage volumes accurately to minimise short-term trading expenditure and to develop and implement their own purchasing strategy.

Responses to Chapter 3 - Capital and replacement expenditure

1.26. Chapter 3 discussed Ofgem's proposed methodology for updating the RAVs and establishing the opening RAVs for the one year control period (known as "RAV roll forward"). It set out our efficiency assessment of GDNs' historical and forecast capex and repex and the implications for the RAV roll forward.

1.27. Respondents' views on capital and replacement expenditure, together with our views, are set out in detail in Chapter 3. However certain issues relating to specific GDNs, or specific LTS projects, are discussed below.

Views of GDNs

1.28. NGN have provided further evidence that the West Hull LTS reinforcement project was efficient. Delays in the project arose due to the outbreak of foot and mouth disease in 2001. They argued that it would have been impractical for them to store the LTS pipes for the duration of the project delays, and it would have been more expensive to return the pipes to the manufacturer.

1.29. SGN have suggested that the Bathgate-Carfin overspend should be treated as a Pot 3 spend so that the costs are fully recovered. They argued that the overspend could not have been forecast at the last review. Further, a proportion of the project costs (£6.3 million) were previously allowed for as part of the NTS control. With the responsibility of these offtakes transferring to the GDNs, it would be reasonable for the allowance to be moved accordingly.

1.30. WWU have argued that they have provided sufficient evidence to demonstrate that the Gilwern to Hafodyrnys reinforcement project was efficient. They suggest that no person would reasonably have been able to forecast the delays in work and that these delays would not have impacted significantly on the costs.

1.31. WWU have also argued that Ofgem’s comparison of the costs of IS systems across NGN and WWU is skewed. In particular, they noted differences in the nature of the IS investment.

1.32. NGG has argued that there should be an adjustment to each of the GDNs' RAVs to reflect certain shared assets (IS property etc) which were allocated proportionally to each of the GDNs as part of the work on the separation of price controls but which were not sold as part of GDN sales. This would have the impact of £25 million being transferred out of the RAVs for the four sold GDNs and into the RAVs of NGG's four retained GDNs.

Ofgem's views

1.33. We are satisfied that the additional information from NGN shows the West Hull reinforcement project was efficient. This results in a reduction in inefficient spend of £2.2 million. There is a £0.8 million decrease in inefficient spend above the allowance (Pot 1) and an equivalent increase in efficient overspend (Pot 2b). There is also a £1.4 million decrease in inefficient spend within the allowance and an equivalent increase in efficient allowance spend (Pot 3a).

1.34. We accept that a proportion of the project costs (£6.3 million) for Bathgate to Carfin were previously allowed for as part of the NTS control. With the responsibility of these offtakes transferring to the GDNs, it is reasonable for the allowance to be moved accordingly. However, the remaining overspend on Bathgate to Carfin could have been identified at the last review. Although demand forecasts are updated on an annual basis, the network validation process was not completed until after the review. Overall this resulted in £6.3 million moving from efficient overspend (Pot 2b) to efficient allowed spend (Pot 3a).

1.35. We have not changed the inefficiencies associated with the Gilwern to Hafodyrnys reinforcement project. Even though the pipeline was on an existing route, public objections should have been identified during the planning stage avoiding delays and consequent increases in costs. The actual cost of the project was 45 per cent higher than original approval. The documents submitted clearly identified that the route was an area with particular environmental and archaeological sensitivities. However the tight timescales drawn up by the GDN did not enable these to be fully considered.

1.36. We consider that the additional information presented by WWU shows that the comparison we have made with NGN for their IS project not on a like-for-like basis. We have removed the inefficiency adjustment. This reduces their inefficient spend above the allowance (Pot 1) by £5.9 million and leads to an equivalent increase in efficient overspend (Pot 2b).

1.37. We have not adjusted the GDN RAVs for shared capex incurred prior to GDN sales. The investment in shared assets took place to support ongoing operations in all of the GDNs. As part of GDN sales, we made clear that diseconomies of scale relating to capital expenditure would not be allowed. It would be inappropriate to transfer the RAV value for the shared capex to NGG so that Grid's customers have to fund additional capex because of DN sales.

Responses to Chapter 4 - Financial issues including overall impact of initial proposals

1.38. Chapter 4 set out Ofgem's proposals on the cost of capital, tax and pensions for the one year control and it outlined the impact of all of the initial proposals.

Views of GDNs

Financial issues

1.39. In general, GDNs do not agree with our proposed approach to calculating the cost of capital or our proposed approach to treating tax. They argue that moving to a post tax cost of capital restores the GDNs' financial position to status quo and removes any benefit to them from the one year control.

1.40. GDNs have also argued that Ofgem has not fully considered the implications of moving to post tax cost of capital on financeability. Two GDNs said that the change will decrease their Post Maintenance Interest Cover Ratio (PMICR). All GDNs suggested that the move to post tax cost of capital will worsen their financial position, and some suggested that this may cause their credit ratings to be downgraded.

1.41. One GDN suggested that our proposals for the cost of capital were materially different to precedents set by other regulators and from Ofgem's own proposals in DPCR4. This GDN also suggested that an impact assessment should have been carried out in reaching our decision to move to a post tax cost of capital.

Overall impact of initial proposals

1.42. The GDNs all expressed the view that our initial proposals do not represent a reasonable outcome that both protects the interests of consumers and ensures that GDNs are able to finance their activities. Their main areas of concern are the move to post tax cost of capital and the associated reduction in allowed cost of capital, as well as the substantial disallowance of overspend.

Views of other respondents

Financial issues

1.43. Shipper and consumer representatives expressed concerns over our proposed approach to calculating the cost of capital. Two respondents argued that our proposals should also include a lower cost of capital. Other respondents expressed concern over the prospect that the GDPCR one year control could simply adopt TPCR's post tax modelling value.

1.44. In terms of Ofgem's proposed approach to the treatment of tax, one respondent stated that the review should attempt to reclaim the benefit of customers a proportion of the previous windfall experienced by the companies as a result of the previous pre tax approach. Another respondent stated that there appears to be some inconsistency in the approach to modelling tax allowances and the subsequent assessment of financeability, with the outcome that a company can be left with inadequate resources to meet all its costs including interest consistent with the proposed WACC.

Overall impact of initial proposals

1.45. A range of consumer representatives expressed their strong opposition to the price increases set out in our initial proposals. It was suggested that Ofgem has not provided sufficient evidence to justify the scale of the price rises. One respondent suggested that our initial proposals are asymmetric because we have focussed on the elements of the current control which are detrimental to GDNs, without any corresponding focus on the elements which are detrimental to consumers.

1.46. Some consumer groups drew a link between the GDPCR initial proposals and the GDN sales impact assessment, suggesting that our initial proposals are evidence that we will be unable to deliver the consumer benefits identified during GDN sales.

1.47. Finally, some respondents have suggested that we have presented our initial proposals in a way that understates the negative effect on consumers.

Ofgem's views

Financial issues

1.48. We continue to hold the view that a simple rollover of the existing cost of capital is appropriate. However, as this figure was set five years ago, it is appropriate to check that the existing cost of capital is still realistic given subsequent market movements. This was the context in which we referred to the TPCR modelling assumption. We might also have referred to the DPCR4 cost of capital of 4.8 per cent post tax (5.55 per cent vanilla WACC), and noted that the rolled-forward figure lay between these two figures, which had resulted from a more up-to-date assessment of the cost of capital. All of this indicates that the rolled-forward figure can be reasonably expected to be in an appropriate range. It neither indicates that we have determined this will be the correct rate going forward, nor does it indicate that we have benchmarked gas distribution against the other types of network that Ofgem regulates and drawn conclusions regarding their relative risk. These are the kind of considerations that will inform our decision for the main control. For the same reason, it does not follow that the TPCR cost of capital must be an appropriate rate to apply to gas distribution for the one year control, as some respondents have suggested.

1.49. We consider that it is appropriate to apply the general Ofgem principle of setting a specific ex ante tax allowance. The one year control gave us an opportunity to address some particularly pressing areas where costs had materially outstripped the allowances set five years ago, i.e. shrinkage and pensions. It would be inconsistent with our principal objective and general duties if we did not symmetrically look at an area where GDNs' allowances were somewhat greater than their actual costs. On the other hand, it would also be asymmetric to attempt to claw back prior year gains (as one respondent suggests) for reasons set out in paragraph 4.10.

1.50. We do not consider that our proposals in themselves create financeability concerns. Principally, this is because we are only setting a one year control, and in particular, we are not setting a precedent for several crucial elements of the main price control, such as the cost of capital. Additionally, our modelling of a range of key ratios using the GDNs' own projections for 2006-07 to the one year control shows that the ratios remain broadly stable and, in many cases, improve. The GDNs' focus on PMICR as a single determinant of financeability does not reflect the actual approach of credit ratings agencies, which use a range of different ratios to assess a company's creditworthiness.

1.51. We do not agree with the suggestion that our financeability assessment is dependent on using market debt levels rather than the cost of debt in the rolled-forward cost of capital, although we consider that this is a sensible approach, as to assume an unrealistically high interest cost risks customers paying for unnecessary financeability adjustments. In any case the argument that this is inconsistent with our calculation of the tax allowance is addressed by the ex post adjustment described in paragraph 4.11.

1.52. Our proposals for the cost of capital are broadly consistent with other Ofgem proposals.[25] Ofgem is not bound by the decisions of other regulators, who have differing circumstances to take into consideration.

1.53. It is unnecessary for us to carry out an impact assessment on the move from a pre tax to a post tax cost of capital for two reasons:

- Following consultation as part the initial consultation document, we stated our intention not to carry out a formal impact assessment for aspects of the price control where the approach and policy position is consistent with past price control reviews. In this case, there is no change in policy or the activities being carried on by the Authority, which would warrant an impact assessment. We adopted our policy of setting company specific tax allowances following the Developing Network Monopoly Price Controls consultation in 2003, and we have applied this approach consistently at every opportunity since then. The benefits of the policy, which were recognised at the time, are that companies obtain some protection against long-term increases in tax costs, but where they are able to make tax efficiency savings, these can be shared with consumers in subsequent price controls.

[25] The allowed cash return on RAV of 5.25 per cent is around the average of the 2004 DPCR4 and Scottish settlements (5.55 per cent), the 2005 National Grid Electricity Transmission extension settlement (5.06 per cent) and the TPCR settlement (5.05 per cent). It is clearly consistent with the previous 2001 Transco settlement and the 2000 National Grid Electricity Transmission settlement (5.17 per cent).

- Any impact assessment would only show that the benefits to consumers associated with using a post tax approach is £107 million in 2005-06 prices (equivalent to an additional 5.1 per cent increase in P0s across GDNs).[26] There is no offsetting cost to consumers associated with the use of a post tax approach, unless the application of the post tax approach means that the GDNs are unable to finance their licensed activities. As discussed in paragraphs 4.16-4.20, this is not the case. In these conditions, we do not consider that an impact assessment would add value to the regulatory process. We have not carried out an impact assessment, nor have we been asked to, on comparable issues where we are giving effect to policies which are consistent with previous controls, for example, pensions.

Responses to Chapter 5 - Timetable & process

1.54. Chapter 5 detailed our proposed process and timetable for completing the one year price control review.

Views of GDNs

1.55. The GDNs considered the high level licence drafting changes proposed in Appendix 10 of the initial proposals document appropriate. They made the following specific comments:

- in amending Special Condition E2B, Ofgem should change the dates within clause 11, "Disapplication of the Distribution Network transportation activity revenue restriction", to reflect the additional one year control.
- Ofgem should delete Part 1a and 2, which became redundant following the separation of the Transmission & Distribution GT licences,
- the revenue volume driver should be deleted for the one year review,
- the proposed licence drafting for shrinkage does not use a "pre-determined index of market prices". GDNs would not be able to hedge based on these proposals to remove gas price risk,
- under "Setting a price control allowance", confirmation is required on whether there will need to be any particular drafting to deal with the k factor,
- the "Exit Capacity Incentive" drafting should not be included as it is not a price control matter, and
- Ofgem should remove Standard Special Condition D5, "Licensee's procurement and use of system management services".

Views of other respondents

1.56. Only one other respondent expressed a view on the proposed licence drafting changes. This respondent considered that the changes reasonably reflect the proposals set out in the initial proposals document.

[26] This figure represents the additional amount that would be added to GDNs' allowances if Ofgem were to calculate the cost of capital using a pre tax approach and an assumed 30 per cent tax wedge as sought by most GDNs.

Ofgem's views

1.57. In light of the comments listed above, we propose to change the date in paragraph (5) (b) of clause 11, "Disapplication of the Distribution Network transportation activity revenue restriction", of Special Condition E2B, and remove the revenue driver for the one year control.

1.58. In response to the other points raised by GDNs:

- we do not propose to omit Parts 1a and 2 of Special Condition E2B as part of the one year control as this would entail renumbering the provisions of the condition,
- we do not consider that it is necessary to amend to the definition of DNK,
- we are not making any changes to the Exit Incentive as part of the one year control,
- we will consider any concerns regarding Standard Special Condition D5 in the context of the main control, and
- we have had dialogue with the GDNs to address their concerns regarding the index of gas prices used for the shrinkage incentive.

1.59. Our proposed licence drafting changes are published in Appendix 7.

Appendix 2 The Authority's powers and duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.[27]

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly[28].

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met,
- The need to secure that all reasonable demands for electricity are met,
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them[29], and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[30]

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

[27] Entitled "Gas Supply" and "Electricity Supply" respectively.
[28] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.
[29] Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.
[30] The Authority may have regard to other descriptions of consumers.

- Promote efficiency and economy on the part of those licensed[31] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems,
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity,
- Contribute to the achievement of sustainable development, and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[32] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[31] or persons authorised by exemptions to carry on any activity.
[32] Council Regulation (EC) 1/2003.

Appendix 3 Glossary

Advance Reservation of Capacity Agreement (ARCA)
A type of contract between a gas transporter and a party seeking a new connection to the network. ARCAs are used where the incremental capacity requested by the connectee is judged by the gas transporter to trigger additional investment.

Business Plan Questionnaire (BPQ)
Expenditure information requested by Ofgem from the GDNs to inform decisions about setting the price control.

Distribution Price Control Review 4 (DPCR4)
The price control review for the electricity distribution network operators which covers the five years from 1 April 2005 to 31 March 2010.

Engineering Period Contracts (EPCs)
Contracts drawn up by the asset owner and a service provider to provide a level of work at an agreed price for a certain length of time.

Fulcrum Connections
A business established by Transco plc to undertake all connections activities on behalf of the GDNs.

Gas Cost Reference Price (GCRP)
The gas price based on an indexed formula of forward prices which is used by the regulator to determine the revenue allowance to cover GDNs' shrinkage costs.

Gas Distribution Network (GDN)
GDNs transport gas from the NTS to final consumers and to connected system exit points. There are currently eight GDNs in Great Britain which comprise twelve LDZs.

Gas Distribution Price Control Review (GDPCR)
The review of the price control applying to gas distribution networks. The review will extend the existing price control for the year 2007-8 and reset the control for the period commencing 1 April 2008.

Gas Transporter (GT)
The holder of a Gas Transporter's licence in accordance with the provisions of the Gas Act 1986.

Health and Safety Executive (HSE)
The Health and Safety Commission is responsible for health and safety regulation in Great Britain. The Health and Safety Executive and local government are the enforcing authorities who work in support of the Commission.

Heren (Heren Energy)
Heren Energy is an independent publisher of information on the European gas and power markets. It produces reports covering, among other things, wholesale energy prices.

Independent Gas Transporter (IGT)
IGTs are GT licence holders that own and operate small local gas networks and levy distribution charges on shippers.

Local Distribution Zones (LDZs)
LDZs are low pressure pipeline systems which deliver gas to final users and Independent Gas Transporters. There are twelve LDZs which take gas from the high pressure transmission system for onward distribution at lower pressures.

Local Transmission System (LTS)
The pipeline system operating at >7barg that transports gas from NTS offtakes to distribution systems. Some large users may take their gas direct from the LTS.

National Grid Gas (NGG)
The GT licence holder for the North West, West Midlands, East England and London GDNs. NGG also hold the GT licence for the gas national transmission system (NTS). Prior to 10 October 2005, NGG was known as Transco.

National Transmission System (NTS)
NGG's high pressure gas transmission system. It consists of more than 6,400 km of pipe carrying gas at pressures of up to 85 bar (85 times normal atmospheric pressure).

Northern Gas Networks (NGN)
The GT licence holder for North England GDN.

Post-Maintenance Interest Cover Ratio (PMICR)
A ratio used by Moody's and Fitch for assessing credit quality, which measures the ability of GDNs to fund interest from operating cash flow, after adjusting for regulatory depreciation and the 50 per cent of replacement expenditure allowed as cash.

Quarterback Project or QB (Mars) Project
An information systems project, implemented by Transco plc, which involved the rolling out of a software application suite that managed the issue and return of work between the office and the field.

Regulatory Asset Value (RAV)
The value ascribed by Ofgem to the capital employed in the licensee's regulated distribution business (the 'regulated asset base'). The RAV is calculated by summing an estimate of the initial market value of each licensee's regulated asset base at privatisation and all subsequent allowed additions to it at historical cost, and deducting annual depreciation amounts calculated in accordance with established regulatory methods. These vary between classes of licensee. A deduction is also made in certain cases to reflect the value realised from the disposal of assets comprised in the regulatory asset base. The RAV is indexed to RPI in order to allow for the effects of inflation on the licensee's capital allowances for the regulatory depreciation and also for the return investors are estimated to require to provide the capital.

Service pipes (or services)
A pipe, other than a distribution main of a gas transporter which is used for the purpose of conveying gas from such main to any premises, and includes any part of such pipe.

Scotia Gas Networks (SGN)
The GT licence holder for Southern GDN and Scotland GDN.

Shrinkage
Shrinkage is gas lost from the distribution system due to leakage or theft and gas used for operational reasons. Shrinkage gas constitutes approximately 0.7 per cent of annual throughput and 90 per cent of this relates to leakage. GDNs are required to procure gas to cover shrinkage losses.

Traffic Management Act (TMA)
The Traffic Management Act is intended to provide better conditions for all road users through proactive management of the national and local road network[33].

Transco plc (see NGG Gas)
Transco plc changed its name to NGG Gas on 10 October 2005.

Transmission Price Control Review (TPCR)
The TPCR will establish the price controls for the transmission licensees which will take effect in April 2007 for a 5-year period. The review applies to the three electricity transmission licensees, NGET, Scottish Power Transmission Limited, Scottish Hydro-Electric Transmission Limited and to the licensed gas transporter responsible for the gas transmission system, NGG.

Ulysses project
A turnkey project approved in 1999 to undertake the complete replacement of Transco System Operation's systems' support suite. This included telemetry outstations, communications network, control systems and decision support tools.

Wales & West Utilities (WWU)
The GT licence holder for Wales & West GDN.

Water ingress
An incident where water enters gas pipes resulting in a loss of gas supply.

xoserve
A transporter agency which provides a single, uniform interface between the IT systems of relevant GTs and shippers. Xoserve is jointly owned by the GDNs and NTS.

[33] Department for Transport:
http://www.dft.gov.uk/stellent/groups/dft_roads/documents/divisionhomepage/032064.hcsp

Appendix 4 Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Does the report adequately reflect your views? If not, why not?
- Does the report offer a clear explanation as to why not all the views offered had been taken forward?
- Did the report offer a clear explanation and justification for the decision? If not, how could this information have been better presented?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk