

The background of the slide features a close-up, slightly blurred image of a gas meter and its associated electrical components, including a meter face with numbers and a gas valve. The image is set against a light blue gradient background.

Gas Distribution Price Control Review Introductory Seminar

11 January 2006

Seminar outline and purpose

Agenda item	Speaker
Introduction to GDPCR	Gas distribution team
Customer view	Carole Pitkeathley, energywatch
Company view	Julian Bagwell, Wales & West Utilities
Q&A session	Panel
Concluding remarks	Joanna Whittington, Ofgem

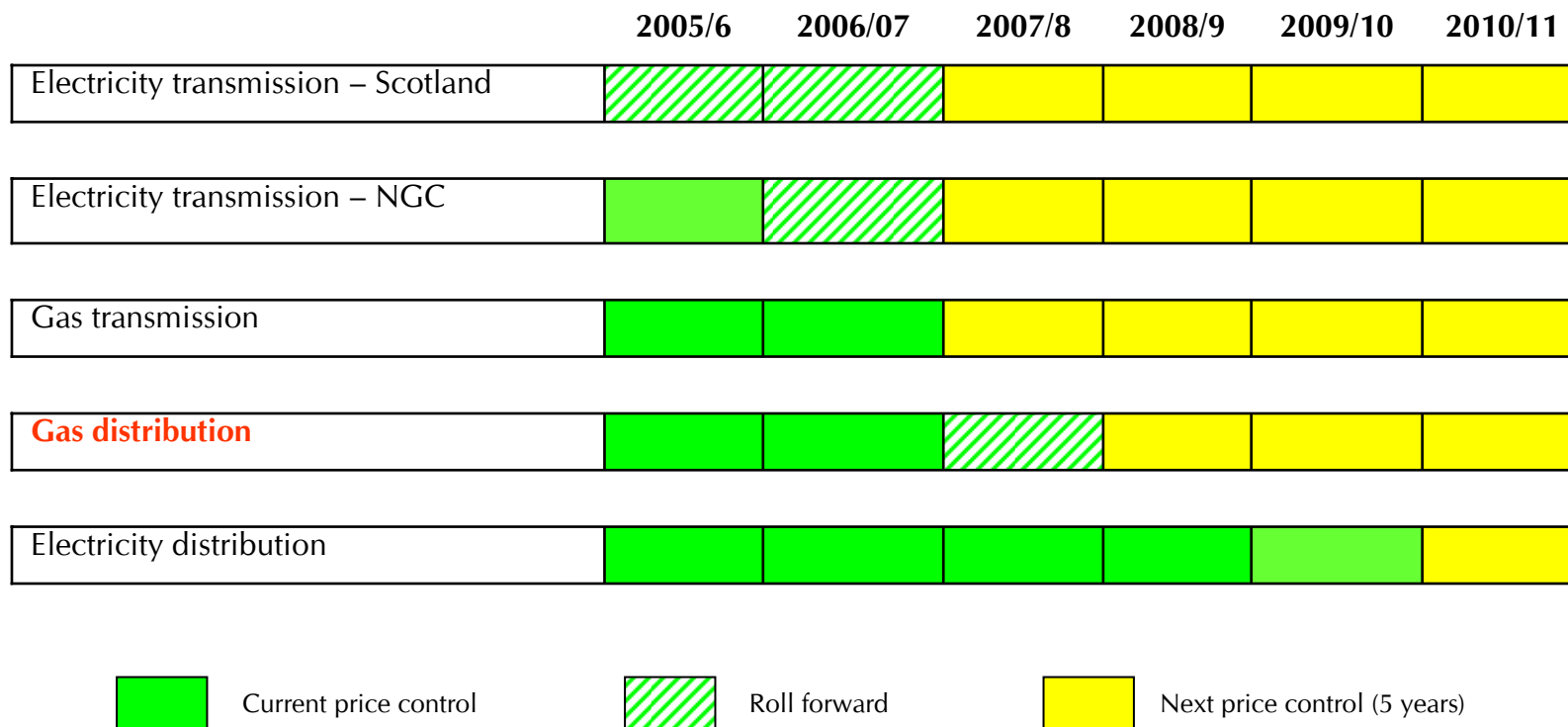
Purpose of seminar is to give interested parties the opportunity to provide comments and ask questions at an early stage in the review process

Ofgem's approach to setting price controls

- RPI-X and incentive regulation
 - effectiveness of incentives over time
 - dealing with uncertainty
- Assessing costs
 - making comparisons where possible
- Financial issues
 - including cost of capital, depreciation, consideration of financeability

Regulation should be transparent, predictable, consistent and sufficiently flexible to cope with uncertainties and changing circumstances

Ofgem's price control reviews



The background of the slide is a light blue gradient. On the left side, there is a vertical strip of images: a close-up of a white power plug, a person sitting at a desk working on a laptop, and a close-up of a power strip with several outlets. The text "Introduction to GDPCR" is centered in a white rounded rectangle with an orange border.

Introduction to GDPCR

Summary of presentation

- Objectives & process
- One year control
- Main control
- Way forward

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Objectives

Ofgem's principal duty is to protect the interests of consumers, wherever appropriate by promoting effective competition

- In carrying out this duty, we must:
 - have regard to the need to secure that all reasonable demands for gas and electricity are met
 - have regard to the need to secure that licence holders are able to finance their activities
 - promote efficiency and economy on the part of licence holders and
 - fulfill our safety, social and environmental obligations.

GDPCR deliverables

- GDPCR will
 - extend the existing gas distribution price control for one year
 - reset the gas distribution price control for the next price control period
 - introduce a cost reporting framework
- GDPCR needs to reflect the broader context of the industry

GDPCR deliverables

■ In addition...

Introduce a framework for maximising the customer benefits available from comparative competition

- cost reporting
- measurement of quality of service outputs

Focus on GDNs better meeting the needs of customers from both a management & regulatory perspective

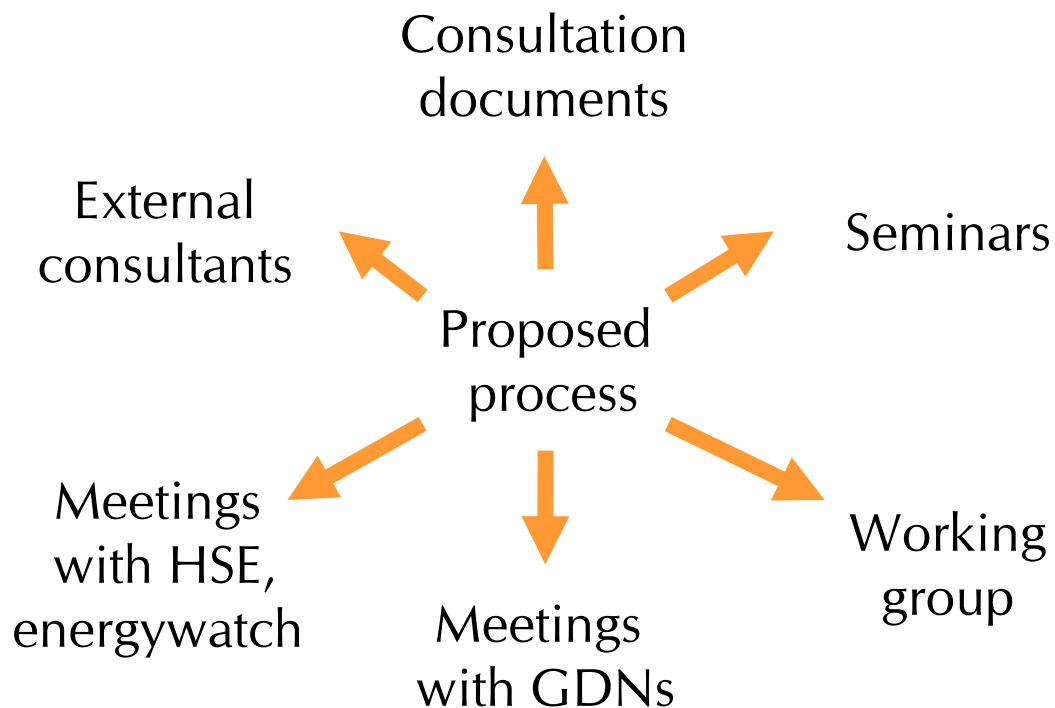
- passing back efficiency savings
- possible changes to the funding of xoserve

Develop long term solutions for issues which have emerged during this price control period

- treatment of overspend and incentives
- shrinkage

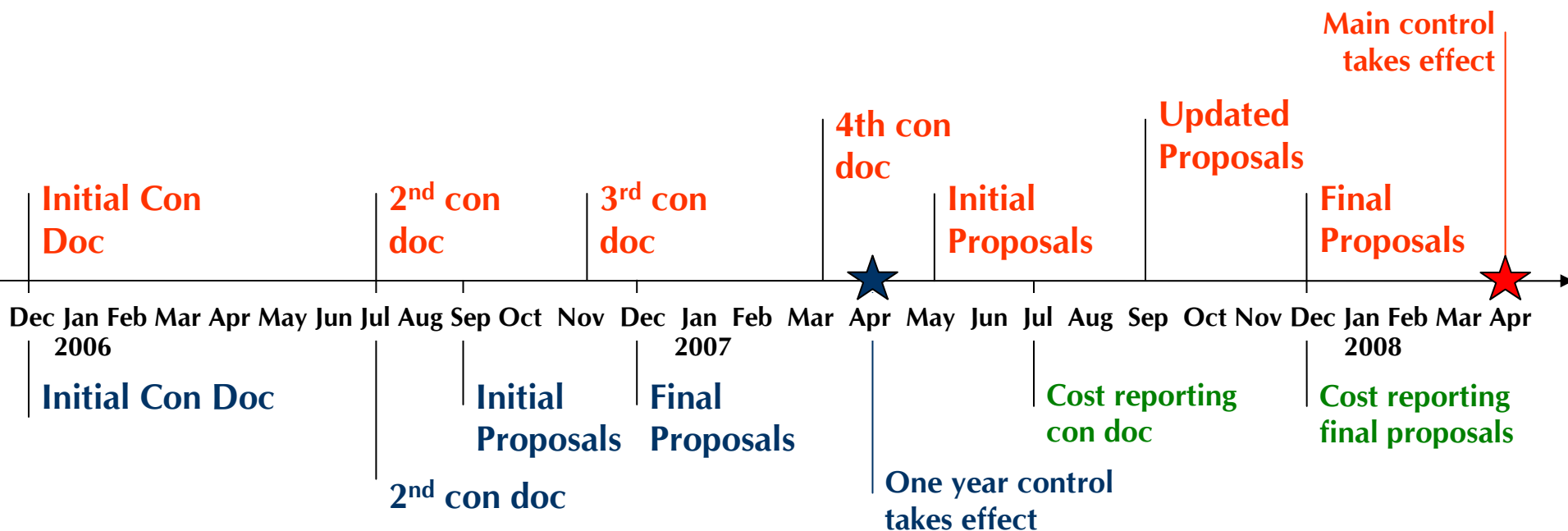
Proposed process

- Open and iterative process
- Build on Ofgem's experience of previous controls including DPCR4



Is the proposed process appropriate?

Proposed GDPCR timetable

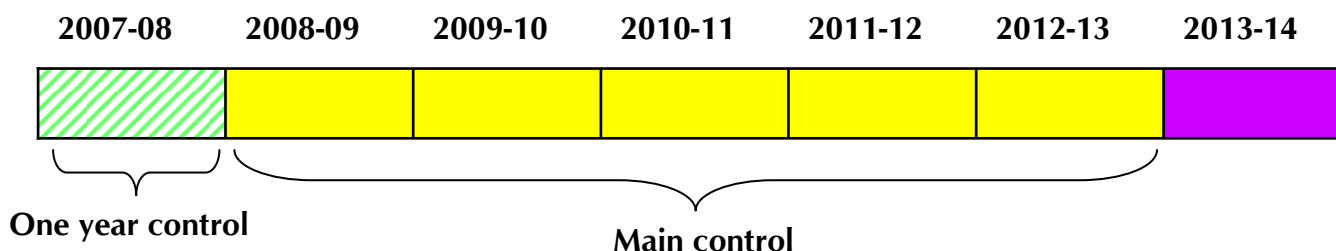


Is the proposed timetable appropriate?

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Scope of the one year control



- Work associated with one year control to be proportionate to a one year interim arrangement
 - spectrum of approaches between simple roll forward & full review
- Balance of work between one year control and main review

What issues should be addressed as part of the one year control review?

How should Ofgem assess costs as part of the one year control review?

Focus of the one year control

- GDNs currently overspending on capex relative to price control allowances
- Ofgem proposes that the one year control
 - assess historic capex in order to roll forward the RAVs
 - sets allowances for 07/08
- In March 2004 open letter, Ofgem indicated that capex incurred between April 2003 and March 2007 will be classified as one of:

Wasteful & unnecessary expenditure

Not included in RAV

Efficient expenditure in excess of allowance

Included in RAV after 5 years

Efficient expenditure within allowances and overspend that provides significant customer benefits

Included in RAV when incurred

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Main control key issues

- Costs
- Outputs
- Incentives
- Financial issues.

Cost assessment

Given significant changes that have occurred since the previous review, obtaining high quality data is likely to be a key issue for GDPCR

To address this, Ofgem proposes to

- start review process early
- involve GDNs and others in formulation of data requests
- use 2006-07 data as a substantive update
- use a variety of cost analysis techniques
- put in place a framework that will maximise Ofgem's ability to identify and compare GDNs' costs during GDPCR2

Is there anything else we should do?

Operating expenditure

- Ofgem will be able to use comparative information for first time, however
 - independent businesses have only recently been established
 - fewer comparators than in electricity distribution
- Range of approaches to be used
 - top down benchmarking, bottom up modelling, activity based analysis, expert review of costs
- Interactions with TPCR
 - shared services, xoserve

What techniques should Ofgem use to determine opex allowances?

Operating expenditure - shrinkage

- Under current price control, GDNs receive a fixed allowance for shrinkage procurement
- Rising gas prices means that GDNs are overspending on shrinkage relative to price control allowances
- Necessary to review incentive mechanism for shrinkage
 - Volume risk, price risk

Should the price control treatment of shrinkage change? How could a shrinkage incentive mechanism operate?

Capital & replacement expenditure

- Building on work carried out as part of one year review, Ofgem proposes that main review
 - reviews capex and repex for 2005-06 and 2006-07
 - rolls forward RAVs for actuals until 1 April 2007
 - projects capex and repex for main control period
- This will involve assessment of
 - investment policies and procedures
 - forecast costs and forecasting processes
- As part of this, Ofgem proposes to
 - conduct a detailed assessment of a sample of projects
 - consider the results of bottom up modelling

What techniques should Ofgem use to review capex allowances?

Outputs

- GDPCR is the first review to consider gas distribution on its own
- Seeking to better define the outputs of a GDN
 - quality of service, capacity
- Improving measurement of outputs
 - eg number and duration of interruptions

What are the outputs of a GDN?

How should Ofgem measure the outputs of a GDN?

Cost reporting framework

- Ofgem will develop the cost reporting framework as part of GDPCR
 - inform future price controls by having comparable data and making it easier to roll forward the RAV
 - this will exacerbate the peak in workload, but will give rise to benefits during GDPCR2
- Tightly defined reporting requirements which build on BPQ process
 - how prescriptive, should they be published, ongoing monitoring?

What role do people see cost reporting playing as part of price regulation?

Incentive mechanisms

- Effectiveness of existing incentives
 - how well has mains replacement scheme worked in practice?
 - relationship with service replacement?
- Rolling retention periods
- Information quality incentives
 - should there be a similar mechanism to DPCR4?
- Other incentive schemes
 - DN interruptions incentive
 - NTS exit capacity booking incentive scheme

What incentives should Ofgem use as part of GDPCR?

Other issues

- Funding arrangements for xoserve
- Structure of the control and incentives
 - impact on variability of transportation charges
- Interactions with other projects

Is it appropriate to change xoserve's funding arrangements and if so how?

What other issues should Ofgem consider in the context of GDPCR?

Financial issues

- Main review financial issues mirror those that arise in the context of the one year review
 - cost of capital, treatment of tax
- Financeability and financial modelling
 - efficient company should be able to earn a return on RAV that is at least equal to the expected cost of capital
 - companies should be able to raise finance readily and on reasonable terms

Are there any reasons why GDNs should receive different financial treatment to other networks regulated by Ofgem?

Financial issues - pensions

- Ofgem proposes to build on work carried out during previous reviews
- Need to consider arrangements put in place as part of GDN sales
 - NGG's transmission business funds all network related non-active Lattice pension scheme members in existence at time of GDN sales
 - work on NGG's pensions deficit to be carried out as part of TPCR

Are there any reasons why GDNs' pensions costs should receive different treatment to those of other networks regulated by Ofgem?

How do the changes to pension law affect GDPCR?

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Next steps

- Responses to the initial consultation document due 3 February 2006
- Second consultation document scheduled to be issued in July 2006
- In the meantime, Ofgem will be focussing on
 - considering responses
 - preparing and receiving GDNs' Business Plan Questionnaires
 - developing proposals in relation to the one year control

Issues to be thinking about

What should be the objectives of GDPCR?

What are the outputs of a GDN?

What issues should be considered as part of the one year control?

Are the proposed process and timetable appropriate?

Is it appropriate to change xoserve's funding arrangements and if so how?

A large, central version of the ofgem logo is positioned in the middle of the slide. It features the word "ofgem" in white lowercase letters on a rounded orange background. The background of the slide is a faded, blue-tinted image of electrical components, including a three-pin plug and a meter.

Promoting choice and value for all
gas and electricity customers