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Joanna Whittington
Director, Gas Distribution
Office of Gas and Electricity Markets
9 Millbank
London
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3 February 2006

Dear Joanna

Gas distribution price control review – Initial Consultation – December 2005

I am writing in response to the publication of the above document on 1 December 2005 on behalf of Wales & West Utilities Limited.

Please see our full response attached in the format of Appendix 2 of the document. For the avoidance of doubt I confirm that our response can be published.

Yours sincerely

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GAS DISTRIBUTION PRICE CONTROL REVIEW
INITIAL CONSULTATION – DECEMBER 2005

RESPONSE FROM WALES & WEST UTILITIES LIMITED

TABLE A2.2 VIEWS SOUGHT – ISSUES FOR EARLY DECISION

1. Related Projects (para 2.24)

- **Are there any projects, other than those listed in paragraph 2.24, that Ofgem should take into account in the context of GDPCR?**

The following areas will need to be taken into account:-

1. Exit Reform

Exit reform will impact in a number of areas and it is vitally important that the industry is clear on the benefits that Exit reform will bring. Full introduction in 2010 is particularly difficult, falling as it does in the middle of the price control period. More immediately clarification is needed on the costs of NTS providing storage as we will have to assess the trade-off between purchase of such storage and provision of it ourselves through pipeline and other investments. The outcome of this trade-off will have a significant impact on the projected Capex forecasts we are required to submit at the beginning of April. Clarity on the assumptions to be used in this area is required particularly when considered in conjunction with any possible Information Quality Incentive.

Whilst it is the subject of a separate consultation exercise the issues of exit capacity, IExCR and the use of five year ARCAs are also relevant here. Furthermore, were exit incentives to apply, we accept that their impact will need to be seen in conjunction with any differences between outturn and the assumptions on NTS storage costs that will underpin the relevant element of our capital forecasts.

2. Connections

We understand a Consultation paper on the provision of the first ten metres of new connections together with the connection, without direct charge to the connectee, is due shortly from Ofgem. Retention of the 10 metre allowance helps to address the fuel poverty agenda through enabling connections at least cost to the direct connectee. Any change to the existing arrangements would impact materially on the likely customer contribution and take up rates which would in turn affect our projected net Capex forecasts we are required to submit at the beginning of April. Clarity on the assumption to be used for these forecasts is required particularly when considered in conjunction with any possible Information Quality Incentive.

When considering connections in the context of a price control review it is important that the obligations placed on WWU are recognised. These include for example being the provider of last resort and the achievement of statutory standards of performance. These are serious obligations and WWU has acted accordingly to embed them into its management processes and to improve performance in this important area. It is essential that the efficient costs incurred in meeting these obligations are properly captured in our future allowances.

3. Social and environmental policy

The GDPCR will need to take account of the Government's views on social and environmental policy including any initiatives on Fuel Poverty. The WDA is very active in this area.

4. Energy Review

Whilst the Energy review is not expected to impact significantly on distribution networks it will important for the industry and Ofgem to input its views and take into account any output from the review. At this stage we therefore reserve our position and any initiatives arising from the review will be to be factored into our submissions.

2. Objectives and framework (para 3.3 – 3.7)

- **For the purposes of setting GDPCR, what should Ofgem consider to be the outputs of a GDN?**
- **What services offered by GDNs are valued by consumers?**
- **What aspects of GDNs' activities give rise to concerns?**
- **Are the objectives for the review proposed by Ofgem appropriate?**

A primary output of a GDN is to ensure a safe, reliable and secure system of gas transportation that is customer responsive and measured by appropriate outputs that are consistent with the incentivisation qualities of the regulatory regime. We look forward to working with Ofgem, energywatch, customers and other stakeholders in developing possible new outputs. In that regard, we think that the draft BPQs that have recently been circulated are a sensible first step in this process.

We should also take the opportunity to review the existing Guaranteed and Overall Standards of Performance. For example the requirement under OS3 to provide progress reports on restoration times is extremely difficult to monitor and adds very little value to the process of supply restoration.

3. Xoserve (para 6.87 – 6.92)

- **Are the current funding arrangements for xoserve satisfactory?**
- **If not, should change be limited to refinements on the status quo or more substantial reform?**

At the time of the DN sales it was recognised by all parties that the xoserve arrangements were a quick fix. It is now time to review those arrangements as the present ones are unsustainable. There are a number of options. At the extreme xoserve could be sold off to a provider of similar core services and the provision of services tendered. This approach would facilitate the transition to a user pays model. Alternatively the role of xoserve could be broadened to become a more sustainable service provider and therefore some principles underlying such a role would need to apply.

Xoserve should be an organisation focussed on delivery of the core essentials where users pay only for the services they require and use. Whilst we therefore believe that it is relevant for the review to look at funding arrangements, we also believe that charging arrangements should come within its scope.

Under the present arrangements GDNs pay xoserve for services and in turn will be allowed to pass through the efficient costs of those services to shippers. Therefore not all users of the service pay directly for the services they use. Over 50% of services and costs are not controllable by the GDNs. This exposes GDNs to a number of risks. The costs of xoserve may rise leaving a shortfall of allowed revenues particularly with possible significant IT expenditure in the near future. We would expect to see capex of this nature included in the GDN RAV. With a shareholding of only 10% it is debatable to what extent WWU will be able to influence xoserve Board decisions.

The second risk is where users of the service may seek improvements or additions to those services. Any additional service provided within the price control period will be required to be funded by GDNs and may or may not be subsequently allowed for in future price controls.

There are a number of possible solutions to address the concerns. We believe that a clear user pays structure of charges should be implemented. In this way users will be incentivised to only seek those changes that are essential and to implement the least cost solution. In addition or separately we believe there is strong merit in exploring a price control option for xoserve. This would not necessarily require a separate Licence; for example, Elexon provides services under NG's Licence. A separate price control would ensure xoserve is fully incentivised to control its costs.

Furthermore, if a separate price control is implemented, it would seem logical at the same time to reconsider funding arrangements. If not, then cost overruns would again fall on existing shareholders, even though such overruns had arisen from actions outside shareholder control.

<u>4. Process (para 7.2 – 7.4)</u>

- **Should Ofgem conduct its consultation process in a different way to the process outlined in Chapter 7?**

We support an open and iterative process and the variety of forms of communication as set out on pages 62 and 63. The process Ofgem followed in DPCR4 is generally regarded a success in this regard. We support transparent decision making and justifications on the validity of base assumptions used to make proposals. There should be clear traceability between our submission and the allowances proposed by Ofgem as part of the future price control. This should cover all aspects of the control, opex, capex and repex and allow a full and robust reconciliation back to the BPQs and wherever possible an explanation of the justification for the differences.

5. Use of Impact Assessments (para 7.5 – 7.8)

- **How should Ofgem incorporate Impact Assessments into the price control process?**

We support the use of IAs on specific issues. These are considered to be more useful and meaningful than a generic all encompassing Price Control IA and we agree with Ofgem that such an IA would serve only to delay matters with little or no improvement in justification of its proposals.

6. Timetable (para 7.9 – 7.11)

- **Is the timetable shown on page 2 appropriate?**
- **Are there any issues that the draft timetable does not sufficiently take into account?**

We believe the timetable is broadly appropriate but it is particularly challenging over the next six months. We agree it is important and correct to address the historic expenditure but are concerned at the resource implications of meeting the April 7th deadline to return BPQs issued in February particularly given our reliance upon the NG data for pre 2006 information.

A key issue is the interaction with Exit Reform in 2010, as noted earlier.

TABLE A2.3 VIEWS SOUGHT – ISSUES FOR INITIAL VIEWS

1. Principles for the conduct of the review (Chapter 4)

- **Are the proposed principles for the conduct of the review appropriate?**

The principles set out in Chapter 4 seem entirely appropriate. A number of other matters were also covered in Chapter 4, and our comments on them are as follows:

Shared assets – we note Ofgem's views that this could be treated in two ways, either through an Opex allowance with a commensurate reduction in RAV or to allow the values to remain in RAV which has the benefits of providing certainty and reducing the workload. Our view is that at the time of the DN sales the business was valued with an assumption that these shared assets were in the RAV. Therefore the simplest way forward that will reduce workload and maintain certainty is to leave the arrangements as they now stand with the value within RAV. Such an approach should have no impact on customers, as the costs involved would not change.

Langage – the arrangements as set out in the Consultation paper are appropriate. However for the avoidance of doubt if in the unlikely event we have to do any marginal investment or pay NTS for any investment in Langage we would expect this to be recognised and allowed into our RAV.

IT Investment - this delivers benefits over a number of years. Expenditure varies significantly year on year and in this respect displays characteristics similar to LTS projects. Whilst recognising that IT is likely to have a shorter set life than distribution system infrastructure, the asset base and RAV consists of many components with varied asset lives that go to make up one depreciation umbrella. It is therefore entirely appropriate to include efficient IT capex expenditure in the RAV.

2. Setting the one year control - capital and replacement expenditure (para 5.10 – 5.14)

- **What is the appropriate scope of the work on capital and replacement expenditure for the one year control?**

We support the detailed review of historic capex and repex expenditure to set the RAV to 2005. In particular it is correct to consider the difference between the forecast allowance and actual expenditure.

In respect of the RAV we agree with dealing with setting RAV as part of the extension year PCR. This will require a detailed examination of historic capex from the beginning of 2001 as the Transco price control proposals for the period 2002 to 2007 were set in 2001 on the basis of forecast or allowed Capex in 2001, as the actual outturn was not available at that time. However we are concerned with the differentiation between Types 2 and 3. WWU's view of the Ofgem letter of March 2004 is that Type 2 Capex would be allowed into the RAV from April 2007 irrespective of when the expenditure was incurred in accordance with the generally accepted arrangements in previous Price Controls. Type 3 expenditure would be remunerated from the date of investment. In practice we are unclear as to the tests and criteria that will be applied to establish the difference between these two classifications. All capital expenditure is driven by the need to meet our obligations to maintain a safe and efficient network. Therefore we feel that there is considerable scope for discussion over what would be very minor differences in definition that could have significant cashflow effects, and that a better approach would be to have only two pots, disallowed as Type 1 or allowed as Type 3.

- **What techniques should Ofgem seek to use in assessing capital and replacement expenditure?**

Whilst this analysis will inform the review of forecast expenditure, given the new ownership arrangements more weight should be attached to GDN's forecasts rather than historical outturns. There are two reasons for this:

- As an individual gas network we have little scope to operate an overall capex management process. Prior to the GDN sales one company had responsibility for eight GDNs and within the overall Capex price control allowances there was scope to sculpt the allowances over the eight GDNs to make optimum use of the allowances. As a new stand alone business those opportunities do not exist.

- As an individual gas network our capital plan has to be developed separately from the plan for the NTS, but has to integrate with it. Whilst there is information available in documents such as the Ten Year Statement, the processes are different to those that applied previously, when they were internalised within one business.

These considerations mean that we feel more weight should be attached to forecast rather than historic expenditure, as we as new owners will have to take a different, very focussed and disciplined approach to capex planning. We will demonstrate how this is applied within WWU as part of the review process.

In assessing capex we propose a dialogue with Ofgem and its consultants with a view to establishing as many common assumptions as possible. Without common assumptions BPQ forecasts are likely to differ between GDNs creating difficulties in comparative techniques. It is important these principles are clear and agreed up front, otherwise it will be very difficult to have a substantial debate on the proposed expenditure.

3. Setting the one year control – operating expenditure (para 5.17 – 5.26)

- **What is the appropriate scope of work on operating costs for the one year control?**
- **What approach should Ofgem use to set the operating costs allowance for 2007-8?**

Given the limited amount of time in which the review needs to be carried out and that the extension is only for one year, WWU supports a simple approach to setting revenues for the extension year through a roll forward of the Opex allowances with adjustments proposed for the following two topic areas:-

- **What approach should Ofgem adopt for shrinkage for 2007-08?**

Gas prices have risen very substantially since the shrinkage allowances were set in 2001. The wholesale price of gas is not within the control of a GDN and network companies should not be expected to take risks in the trading market. When the Transco price controls were set an allowance was provided for shrinkage based on the best evidence available at the time, predicated on the assumption that such allowances would be sufficient to cover the efficient costs. Therefore no allowance was made in the Cost of Capital for the trading risk that has become apparent recently.

We strongly hold the view that a transportation company should not be subject to wholesale gas price risk that is inconsistent with the low cost of capital associated with network infrastructures. This year our shrinkage costs have more than tripled from the allowance set at the 2002 price control. Therefore it is imperative that we discuss and agree mechanisms whereby a GDN is incentivised to manage system losses efficiently but which removes the risk on gas purchase prices. It is important that these mechanisms for incentivisation are clearly understood by all parties.

Whilst we accept that we may be time constrained in respect of implementing a new scheme for the extension year, given the magnitude of the present increases in shrinkage costs we believe that an additional allowance should be provided for the extension year that reflects actual gas purchase costs in that year.

Turning to the present price control period, whilst we appreciate that in respect of costs generally there will always be swings and roundabouts over a five year control period, given the magnitude of the differential between the allowances and actual outturn we believe this is a wholly exceptional circumstance. Therefore we believe Ofgem should give serious consideration to providing retrospective allowances for 2005/06 and 2006/7 in this specific exceptional instance.

- **Should Ofgem apply the principles relating to pensions costs to GDNs as part of the one year control or the main review?**

Pensions should follow the principles agreed in DPCR4 and in accordance with keeping a simple approach, allowances based on those principles for the extension year and then separately for the full five years of the main review should be permitted. These arrangements should include full recognition of the costs of the new Pension Protection Levy.

4. Setting the one year control – incentives (para 5.28 – 5.29)

- **Should rolling incentives be applied for capital, replacement and operating expenditure for the one year control?**

At the time of the DN purchases there was clear regulatory guidance that the opex roller would be applied from 2003. This assumption was used to underpin the valuation of the WWU GDN.

In 2003, Ofgem's final proposals on Developing Monopoly Price Controls stated that in principle rolling Opex incentives would be implemented for Gas, applicable from the Transco PC 2002. On the basis this principle is implemented then it will apply for the extension year. We would wish to see the commitment to introduce an Opex roller from 2003 actioned and implemented in full. In the recent electricity DPCR4, DNOs were provided with 5 year rolling Opex allowances based on clear evidence that Ofgem had given a commitment to introduce such a rolling mechanism in the Developing Monopoly Price Controls paper. We accept however that the rolling allowance was subsequently only applied for 2003/4, as Ofgem later in the DPCR4 process in 2004 stated that such a rolling mechanism would not be implemented after all. Therefore at the very least it is appropriate that savings achieved in 2003/4 should be retained for the full five years consistent with the treatment of the electricity DNOs.

We would also ask Ofgem to consider an efficiency retention mechanism to incentivise the new GDN owners to set new opex performance frontiers in the run up to the new price control.

5. Setting the one year control – financial issues (para 5.31 – 5.38)

- **What issues need to be considered when providing a cost of capital allowance for the one year control?**

In the limited time available for the setting of the PCs for the extension year and given Ofgem's review of the Cost of Capital in 2006 that will inform the main review, it would seem appropriate to roll forward the current arrangements into the one year extension.

In respect of the main PCR the present cost of capital was set in 2001 and reflects the perceived low risk of the business at that time. Since then there have been a number of external shocks and increased risks to the business. Examples including the tripling of gas purchase prices and the huge impact this has had on shrinkage purchase costs, exit reform, interruption reform, ARCAs and the impact of the Larkhall explosion and the even greater focus on safety issues. All these are exclusive to gas transporters and are not an issue for other price controlled utilities. We are also exposed to increased volatility in volumes and the current weighted average cost of capital does not reflect the increased risk to allowed revenues.

Whilst the water industry do not face the issues as described above they are also protected against cost shocks through in-built mechanisms within their price controls. There are logging up and reopener mechanisms within water. For example notified items or relevant change of circumstances have a 10% of turnover in 10 years threshold. It would therefore seem entirely appropriate to introduce similar arrangements within the gas licence, particularly to deal with external shocks that were not anticipated when the control was set.

Turning to the assessment of the cost of capital, it would be appropriate to look at a broad range of techniques including those that have more recently come to light, for example the Fama French model. If an appropriate treatment of shrinkage costs is not incorporated into our opex allowance, or as a pass through, it will be important to raise the current Cost of Capital to recognise the substantial risks associated with gas purchasing in the current volatile market. We believe it is also extremely important to retain consistency across sectors and therefore take the view that the allowance used in the recent electricity DPCR4 would be the minimum starting point in the consideration of the Cost of Capital given that GDNs have higher risks than DNOs.

- **What issues need to be considered when providing a tax allowance for the one year control?**

In the limited time available for the setting of the PCs for the extension year, we support the use of the current pre tax approach for the extension year.

- **What analysis should Ofgem perform in relation to financeability and financial modelling for the one year control?**

Given a pragmatic approach simple tests on normal financial criteria such as dividend cover should be sufficient. Financeability stress tests were undertaken at the time of the DN sales and we believe that these are appropriate measures that should continue to be used by Ofgem as appropriate.

<u>6. Structure of the price control (para 6.6 – 6.15)</u>

- **Should Ofgem consider setting GDPCR for a period other than five years?**

Five years is an appropriate duration. It is now an established practice in the UK across a number of Utilities and thus what the market expects. Different durations could have impacts on perceived risk and hence the cost of capital.

- **Should the current volume-based revenue driver be retained? Should it be modified?**

- **Should Ofgem introduce any other form of revenue driver?**

The volume driver is meant to provide some flexibility in allowed revenues if volumes are higher or lower than those assumed when the price controls were set. In this way the additional costs arising from higher volumes such as increased PREs or Capex reinforcement are remunerated until reset at the next price control. In recent years, however, the volume volatility has been exacerbated and in general volumes are lower than forecast in the previous BPQs. Given a substantial amount of a GDN's costs are fixed this volume volatility impacts on cash flows and price variations to end users through the K factor.

Balancing certainty of cash flow revenues against retaining some flexibility against unforeseen changes in volumes is not easy. However on balance it would seem appropriate to reduce or possibly even eliminate the volume driver given that recent historic data is not as reliable as it was previously in underpinning volume forecasts.

Such a move would reduce some price volatility to shippers. However a much greater impact in reducing volatility would be achieved by aligning the structure of charges with the revenue driver in the price control by increasing the capacity component of the charges.

- **Is the pass through mechanism that applies under the current price control review still appropriate?**

The pass through mechanism is an appropriate way to recognise those costs that are outside of the control of the GDN. Incentive mechanisms can only work where the body incentivised can actually respond to those incentives and take action.

- **Should any other costs be subject to the pass through mechanism?**

There are a number of other costs that are considered appropriate for pass through in addition to the existing pass through of Rates and Licence fees:

- As discussed earlier, the price risk associated with shrinkage gas is an entirely appropriate pass through item, if this allows a simpler mechanism for it to be adopted, although we accept that some sort of efficient purchasing requirement would also be necessary
- xoserve costs as small minority shareholders can not effectively exercise control. If xoserve is subject to a separate price control then logically these costs become a pass through item on the basis that costs are not price regulated twice,
- Wayleaves are not subject to our control and should be a pass through, again subject to some efficient purchase test or criterion,
- Traffic Management Act costs of lane rentals should be a pass through, as they cannot be avoided or reduced once relevant roadworks are required.

We believe the current risks faced by GDNs are simply not reflected in the current low cost of capital allowance. Unless there is a material increase in the WACC then it is appropriate to remove the risks referred to above by permitting them as pass through items.

Whilst probably not a pass through item, we have a significant concern over TMA fines. Due to the complexities of the work planning process, some level of fines is very likely for all statutory undertakers. We are particularly concerned that local authorities will see TMA fines as a new and important source of income, especially given existing pressures on their budgets, and will therefore seek rigid adherence to TMA requirements with no latitude for minor infringements. We believe that this is a very likely outcome given that local authorities are not subject to the same legislation, and that such an approach will have no impact on the planning and execution of their own highways work. We will want to discuss with Ofgem how to mitigate this risk in ways that do not provide any perverse incentives not to minimise the level of fines.

- **Are any changes required to the correction mechanism that applies under the current price control?**

The correct mechanism remains appropriate. However as stated previously the structure of charges should be more aligned with the revenue driver though a more capacity based mechanism which would have the effect of reducing correction mechanism carry overs.
K should be rolled forward into both the extension year PC and the main PC as in all other revenue years.

7. Scope of the price control (para 6.16 – 6.22)

- **Is the scope of the current price control appropriate for GDPCR?**

The scope is appropriate with the addition of considering how GDNs can assist the fuel poverty issue through extensions to the Gas network. We intend to consider this in more detail and envisage seeking discussions with Ofgem and other interested parties such as energywatch and the Welsh Assembly once we have formulated a possible way forward.

In respect of the resources required to provide emergency provision it is currently only partially allowed for under the present price control. This position may not be sustainable following the advent of metering competition and the performance standards on suppliers placed on them under the Standards of Performance (SOP) Regulations 2005. Prior to the advent of metering competition, metering work was used as a buffer to fill in work between emergencies. Before the DN sales the relationships between ourselves and the meter asset manager (MAM) were not on a formalised contractual basis. Just ahead of the DN sales NG negotiated, signed and implemented new contracts so that following the network sales these SOPs are now backed off contractually through MAMs to WWU. If an emergency engineer is diverted to an emergency and breaks a metering appointment, WWU is now liable for a liquidated damage payment to the MAM. Therefore we have a fundamental mismatch between meeting SOPs under the metering contracts and performance standards relating to emergency service provision.

The logical conclusion of complete separation would be complete funding of the provision of emergency services without regard to meterwork income. We want to explore with Ofgem what are appropriate tasks for emergency staff other than front line response, what service standards apply to such tasks and how that impacts forecast future revenues that might affect the costs of emergency provision.

- **Which services provided by GDNs should be considered to be excluded services?**

The present list is appropriate with the addition that we would like recognition that metering is wholly outside of the Transportation PC and not part of de-minimus revenues as it is a permitted business.

8. Sliding scale incentives (para 6.59 – 6.64)

- **Should Ofgem adopt a sliding scale mechanism similar to that used in DPCR4 to encourage more realistic BPQ submissions?**

We support the use of the innovative sliding scale adjustment. However as stated earlier we would like discussions to establish common assumptions such as the impact of exit reform on storage and the appropriate length of asset lives.

9. SOMSAs (para 6.96 – 6.102)

- **Should Ofgem respond to the new developments in relation to SOMSAs and if so how?**

We are advised by NGT that the GTMS system introduced in the 1980s is nearing the end of its economical life and will only be supported until October 2009. Our initial view is that it will be more cost effective to build one replacement GTMS system with SOMSA exit built in and for these costs to be shared. However it is important that credible alternatives are fully explored and the assumptions tested. We support early dialogue with Ofgem before final decisions are taken and IT spend committed.

There may be merit in exploring linking this with the xoserve, emergency call centre and metering database management if linking such centrally provided facilities provides either better service standards or improved efficiencies.

10. ADDITIONAL COMMENTS

- **Cost Reporting Framework**

We support Ofgem's proposal to introduce a cost reporting framework

- **Replacement Expenditure (Repex) and Financeability**

The allowances for Repex need to reflect the individual needs of the network. WWU can not replicate the level of economies of scale that other companies such as NG can achieve through a much larger repex programme.

Within WWU there have been four incidents of escapes in the last fifteen months that have occurred in pipelines that were not due to be replaced until the end of the replacement programme. In other words the standard risk assessment processes that prioritise replacement work had not identified the pipes in question as having high priority. Therefore there is a possibility that the assets are deteriorating at a faster rate than envisaged at the commencement of the 30 year programme. Further assessment needs to be made regarding the overall length of the programme.

We note Ofgem's inclusion in the consultation paper of the issue of including within the matrix an additional diameter band in respect of large diameter bands. This would remove any possible perverse incentive to focus on smaller scale pipes. We would support a review of the matrix in this respect.

Turning to replacement services, where we replace services as a consequence of repex expenditure the issue of the treatment of such expenditure is not whether it sits within the matrix per se. Rather, it is the fact that at present such expenditure is not fully allowed for. In future it needs to be funded in the same way as any other capital project and the expenditure rolled into the RAV in a similar way.