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Ref: AW/DM/014

3 February 2006

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Dear Joanna

GDPCR – Initial consultation

I have pleasure in attaching Northern Gas Network's (NGN's) response to the initial GDPCR consultation. For ease of reading, the document is structured in line with the questions asked within the consultation.

NGN will be working with Ofgem throughout the review to ensure that customers receive benefits, not only through efficiencies but also via improvements in safety and levels of service. However, at the same time the risk to GDNs needs to be managed and the review must ensure that GDNs can finance their functions, maintain credit ratings and provide reasonable returns to their investors.

NGN recognises the time constraints surrounding the one year control and concurs with Ofgem that a high level approach to the one year review, with the focus on resolving issues and policy in the one year review that are required for the five year review, will be the most appropriate solution.

NGN supports Ofgem's stance on the conduct of the review and welcomes this opportunity to present its comments on the specific issues raised.

Please note that this response can be treated as non-confidential. If you have any questions on the issues raised then please don't hesitate to contact us.

Yours sincerely

Alex Wiseman

Alex Wiseman
Regulation Director

Issues for early decision

1. Related projects

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

NGN welcomes the recognition of the link to related projects and the importance of understanding interactions between them. In particular it is essential that there is consistency between GDPCR and both NTS offtake reform and interruptions reform. Both these reforms have the potential to significantly impact forecast investment on the DN network. Whilst this should not be an issue for the one year review it is important a clear and costed framework is in place before our five year investment plan is agreed.

Other projects that should be taken into account include the changes being considered for connections and Ofgem's Social and Environmental Agenda.

2. Objectives and Framework

What should Ofgem consider to be the outputs of a GDN? What GDN services are valued by consumers?

A key output of a GDN is a safe and reliable network. Consequently, the approach of GDNs to both public and employee safety is paramount, hence lost time injuries and the number and scale of public safety incidents are important measures.

In addition to its statutory responsibilities, a GDN should seek to establish itself as a valued and valuable corporate citizen within its geographical area. This will be achieved through a range of community and corporate socially responsible activities and the approach of GDNs to Corporate Social Responsibility (CSR) should be considered. NGN is currently formulating its own CSR programme.

The quarterly Customer Satisfaction survey under the Regulatory Instructions & Guidance (RIGs) provides important data on customer satisfaction and will be a good measure of how GDNs are delivering quality service to customers.

Additionally, NGN is formulating other types of key statistics to publish on its website and in corporate publications relating to customer complaints, gas interruptions per length of infrastructure and by numbers of consumers, communications from the GDN prior to and during interruptions, the quality of the work undertaken and the professionalism of the workforce. NGN has established internal Key Performance Indicators against these measures as one way of determining the level of customer satisfaction within the network and NGN is keen to work with Ofgem and energywatch to develop meaningful customer satisfaction indices.

What aspects of GDN activities give rise to concerns?

Customers are concerned about having a safe, uninterrupted supply of gas. In the event of an interruption, customers would like prompt handling of the incident coupled with timely and accurate information about the incident and its resolution. NGN will be looking to improve the service it provides to customers in these areas.

Are the review objectives appropriate?

NGN supports the review objectives laid out by Ofgem in the consultation within the context of ensuring that the industry is safe and, as far as possible, can provide security of supply for end users. The policy decisions made during the PCR, as well as providing an appropriate balance between customers and shareholders should provide opportunities to minimise regulatory risk.

3. xoserve

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

The current funding arrangements were developed as a viable solution that expedited the sale of the DNs. Fundamental reform of these arrangements would be a challenge to achieve within the timetable of this review. However, there is one issue that NGN believes should be addressed during the PCR. xoserve has no control over some of its costs which are shipper imposed:

- via UNC modifications approved by Ofgem;
- through not achieving performance standards; and
- through requests for information.

Furthermore, the shippers have no incentives to minimise these costs. Consequently a model of "user pays" for part of the xoserve funding makes sense. This should be achieved by base-lining xoserve costs and ring-fencing the costs and outputs attributed to GTs. Additional services should then be funded by the relevant user. This model would benefit customers as it would align costs more closely with benefits and minimise the imposition of additional costs. NGN will work with both Ofgem and xoserve to develop this approach into a viable model for the price review.

4. Process

Should Ofgem conduct its consultation process in a different way to that outlined in chapter 7?

NGN fully supports Ofgem's stance on its conduct of the review. The procedures established during the electricity DNO review such as early engagement of consultants worked well. We welcome the opportunity to engage in dialogue during the process with Ofgem and to meet with the Authority. NGN will work with Ofgem via the GDPCR working group to help develop appropriate policies and strategies.

5. Use of Impact Assessments

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

Impact assessments (IAs) are beneficial in that they help to ensure that policy decisions are in the best interests of stakeholders. The approach outlined in the consultation seems sensible whereby there is no IA on the overall price review, but Ofgem publishes specific IAs on new policy initiatives, for example service quality incentives or full exit reform.

6. Timetable

Is the timetable appropriate?

The timetable proposed for the five year review appears sound. For the one year review, the timetable is appropriate if the one year review is a high level review, otherwise the timetable will be challenging to achieve. Seven weeks between issue of BPQ and response may be insufficient if there is a requirement to submit detailed operating cost forecasts for 2007/08 (or beyond) or detailed capex and repex plans through to 2013.

Are there any issues that the timetable does not sufficiently take into account?

The timetable should clarify the interaction between the PCR and exit and interruption reform. It is important that these reforms are taken into account at the appropriate stages within the price review and workload planning would be helpful if these could be shown. Furthermore, these reforms should be treated as much a part of the GDPCR as of the TPCR with full consultation of GDNs.

Issues for initial views

1. Principles for the conduct of the review

Are the proposed principles appropriate?

NGN fully supports Ofgem's stance on the conduct of the review, in particular protection of customers, providing companies with the revenue required to deliver agreed outputs and meet statutory and licence obligations, and providing incentives on companies to provide appropriate outputs including safety, capacity and quality of service. It will, however, be important to achieve the right balance during the review process between these potentially conflicting objectives.

It is important that Ofgem's policies and decisions are transparent and consistent across DNs. To that end, we support Ofgem's proposal to publish a full, populated financial model and suggest that development of the financial model should be as early as possible in the review process to allow ample time for consideration and development of the methodology for setting allowed costs.

The treatment of shared assets was raised for the first time in Andrew Walker's letter of October 2004, after the sale price had been agreed with National Grid on the basis of previously published RAVs. NGN still has no clarity as to exactly what these shared assets are. As the letter points out, RAVs are an indicator of financial rather than operational capital and thus a change to a physical asset does not necessarily trigger a change in RAV. A RAV adjustment would be a transfer of value from IDNs to NGG and thus does not seem appropriate. Overall, customers will not be impacted if there is an adjustment so there is no benefit for customers in adjusting RAVs between IDNs and NGG.

We welcome the introduction of incentives to drive company behaviour and to ensure that customer service is maintained and improved. However, any incentive should be symmetrical and have an expected outcome of zero to ensure returns consistent with the allowed cost of capital. Additional quality requirements to conform to any targets need to be funded within the PCR. We would welcome consideration of the development of incentives related to environmental impact, corporate social responsibility and safety.

2. <u>One year control – capex and repex</u>

What is the appropriate scope of the work on capex and repex for the one year control?

There are now only seven months left until the initial proposals for the one year control are published, and the overlap with the main review will also make that review challenging. Consequently, the one year control should be kept as simple as possible, unless it is resolving issues that will arise in the full PCR and hence reduce the workload in 2007. However, the one year control should be trying to influence appropriate and consistent behaviour, for example through incentives, across all six years of the price review period.

We agree that the RAV should be rolled forwards to take account of actual capex and services repex from 1st April 2002, but the RAVs of the IDNs should not be adjusted for overspends or underspends between January 2001 and March 2002. This is because:

- NGN has no visibility of overspend or underspend during this period – we are waiting for NGG to provide us with this information.
- The network was purchased on the basis of an Ofgem published, sculpted RAV.
- The issue of a potential correction of RAV for issues before April 2002 was not raised during sale and is not mentioned in the Andrew Walker letter of March 2004.
- Unravelling the data for these months is likely to be time consuming and will potentially detract from other fundamental policy issues.

In paragraph 4.15, Ofgem raises the issue of the treatment of non-operating capex. Given the short-term nature (say 10 years) of much of this expenditure, which is mostly IT, consideration should be given to treating this as opex as in DPCR4 for the purposes of the price control rather than depreciating the assets over the current 45 year period.

What techniques should Ofgem use to assess capex and repex?

Forecasts for capex and repex should not be set based on historical requirements as these were determined centrally by Transco. New owners will be introducing innovations and the forward projections should be based on the outputs that have to be delivered in 2007/08. NGN will work with Ofgem and its consultants to demonstrate the validity of our projections for both outputs and unit costs, though there needs to be recognition of the significant cost pressures within the business such as rising construction prices and material costs.

For the review of historic spend it should be noted that some of the historical information does not exist within the new network companies particularly details of centrally allocated capex, and so we are reliant on NGG providing accurate data for us to submit to Ofgem.

Comparative analysis will be of little value in the assessment of the efficiency of historic capex because all GDNs were in single ownership and there were regular internal reorganisations. The assessment should focus on the efficiency of procurement processes.

To ensure consistency across networks, it is essential that Ofgem provides key assumptions for example the likely availability and cost of storage from the NTS. We will clarify the assumptions that are required during the Ofgem working groups.

The process for repex should be that the HSE set outputs and that Ofgem then assess the cost of delivering those outputs.

3. <u>One year control – opex</u>

What is the appropriate scope of the work on opex for the one year control? What approach should Ofgem use to set 2007/08 opex allowance?

NGN is broadly indifferent between rolling forward the opex allowances or rebasing using actual opex. However, as discussed above, our preference is for a high level review to ensure that sufficient resource in both Ofgem and the DNs can be targeted at the full PCR. Rebasing on actual opex would require significant analysis of operating costs. Additionally, there has been and is continuing to be significant cost pressure on DNs, notably additional legislative requirements (such as the Traffic Management Act, pensions and environmental), construction prices, gas prices, insurance premiums, skill shortages etc. Furthermore, the proposed ARCA arrangements and enduring exit reform will also potentially impose additional costs and/or risks onto GDNs. As a consequence the historic level of costs should not be seen as a guide to future costs.

NGN is currently projecting to underperform its opex allowance in 2006/07 because of these additional cost pressures. Nevertheless, consistent with the need we recognise for a high level review, the simple approach of rolling forwards the opex allowance should be adopted. Given the cost pressures on the networks there should be a flat roll forward with no "efficiency" reduction (efficiency being achieved by cost challenges and initiatives within the business to offset these cost pressures).

If <u>actual</u> opex is rolled forward then there will need to be a full consideration of the issues discussed above that are driving costs higher when setting the allowance. In particular, there will need to be a detailed assessment of issues such as shrinkage, pensions, Traffic Management Act costs and construction prices.

What approach should Ofgem adopt for shrinkage for 2007/08?

Gas prices have increased significantly in the past year and the gas price appears to be getting more volatile, increasing the risk for GDNs.

NGN's preference is for Ofgem to review shrinkage costs in 2007/08 and to set an allowance for 07/08 that matches the expected cost. This could be done straightforwardly by using forward gas prices. This will enable GDNs to manage the risk of shrinkage purchases.

However, a more sophisticated mechanism is needed for the full review. We would welcome the opportunity to engage with Ofgem to develop an appropriate mechanism that passes through gas prices whilst retaining the incentive on DNs to reduce volumes (and also an incentive for <u>efficient</u> purchasing).

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

The one year review may be an opportunity to resolve recovery of historic pension issues and hence ease the pressure on the full PCR. However, NGN accepts that time constraints may mean deferral of consideration of pensions to the full review although this may mean revisiting the RAV roll forward up to March 2005 in the full review to make any adjustment for pensions.

4. <u>One year control – incentives</u>

Should rolling incentives be applied for capex, repex and opex for the one year control?

NGN fully supports rolling incentive mechanisms to provide consistent incentives on management to achieve savings throughout a price control period and remove the present imbalance that results in low incentives to reduce costs towards the end of the period.

Five year rolling incentives for capex work well and provide substantive benefits for customers as they benefit by approximately 70% of the NPV of the benefits. Arguably, the five year period should be extended to ensure that benefits are more equally split between customers and DNs. A five year rolling opex incentive would be appropriate to mirror the capex arrangements and to remove the incentive on DNs to make opex savings only early in the review with little incentive to reduce opex at the end of the review period. Customers would be expected to benefit from the stronger incentive throughout the review period to reduce costs.

It would be helpful to agree enduring incentive mechanisms for capex, repex and opex as part of the one year review with the principles then applied both for the one year and for the full PCR. (Although this increases the one year workload, it shifts work back from the five year PCR.)

The repex incentive was initially set as an asymmetric incentive because of the uncertainty of the actual costs that would result. However, there are now several years' data on repex costs and, despite cost pressures, NGN has been performing close to the allowed matrix levels. Consequently, it is appropriate that the incentive going forwards should be symmetric. Additionally, the costs incurred vary in line with construction prices and not RPI and thus the matrix should be indexed to a construction price index. This would reduce the risk for both customers and GDNs of a misalignment between future allowances and costs.

The repex services allowance is significantly overspent in the current period as it appears that the number of services requiring replacement was underestimated. A services matrix, similar to the repex mains matrix, could be considered to avoid any significant differences between allowances and actuals arising this time due to misestimates of the number of services to replace.

5. <u>One year control – financial issues</u>

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

The time available for the one year review suggests that a simple approach is required to the setting of cost of capital and hence precedents from previous reviews should be used rather than a full bottom-up approach.

The (pre-tax) costs of capital precedents are 7.3% for water, 6.9% for electricity DNOs and 6.25% for transmission and for Transco last time.

There are a number of reasons why gas distribution can be considered riskier than other utilities, some of which are listed below:

- There are no price reopeners in gas distribution whereas there are in water.
- The Northern Ireland regulator set a higher cost of capital for distribution than for transmission because of its higher risk.
- Safety issues are greater within gas, require a separate H&SE safety case and have the potential to significantly impact reputation.
- The licence is revokable at 10 years' notice compared to 25 years for water and electricity.
- The repex programme is a larger, riskier programme than any electricity equivalents.
- Security of supply is of fundamental importance, and insufficient supply has more serious financial and reputational consequences than in electricity.

Furthermore, risks are increasing due to exit and interruption reform and the proposed ARCA arrangements.

Given the need for a simple approach, the electricity DNO review provides a recent, compromise precedent and NGN's recommendation is that consequently the cost of capital should be set at the post-tax equivalent of 6.9%. This should not be seen, though, as our proposal for an appropriate cost of capital for the full review.

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

NGN supports Ofgem's stance on moving to a post-tax approach for setting the cost of capital and providing a separate tax allowance.

Consideration of the tax allowance should be similar to the approach used to provide opex allowances. That is companies should have an incentive to outperform allowances and customers can then benefit from any tax saving measures at future reviews.

Furthermore, a full ex-post adjustment is impractical as it can take several years before a final tax charge is known. This methodology would not encourage tax efficiency by GDNs.

Hence NGN supports an ex-ante approach to tax. NGN recognises Ofgem concerns about gearing up and would accept the need for an ex-post adjustment for any substantive change in gearing.

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

The businesses of the newly acquired networks have been in existence for just eight months. They were bought on the basis of their financeability within the existing regulatory regime. If the one year review is high level with little change to the assumptions then the approach to financeability and financial issues can be high level. However, if there are significant changes in the regulatory environment and assumptions then there will be a need for more substantive financeability analysis and financial modelling.

6. Structure of the price control

Should Ofgem consider setting GDPCR for a period other than 5 years?

NGN supports the retention of a five year price control period. The five year period provides consistency across different energy utilities and enables an evolution of regulatory thinking. A shorter period would increase workloads for both Ofgem and GDNs, may divert management attention from running the business and may be insufficient time for management to make step changes in the business that will ultimately benefit customers. A longer period may result in increased regulatory risk as revenues are broadly fixed but changing industry dynamics or costs outside GDN control may significantly affect costs and profitability.

Should the current volume-based revenue driver be modified? Should Ofgem introduce any other form of revenue driver?

The existing 35% exposure to changes in volume presents a significant risk to GDNs which is not reflected in the allowed cost of capital. Both milder weather and reduced demand due to high gas prices have led to actual demand consistently undershooting forecasted demand. The variable costs are relatively low, perhaps of the order of 5% - Transco's analysis in 1999 indicated that variable costs were in the range of 1% to 30% depending on allocation of indirect costs. Thus NGN believes that the volume-based driver should be reduced to 5-10% variable.

A further issue to take into consideration is the variability of charges. Currently the structure of charges results in a variable element of 65% of revenue. Our preference would be to also reduce the variability of charges to bring these into line with the volume driver of revenue. This would benefit customers by reducing over and under recoveries and hence reducing price volatility. This is in line with Ofgem's preference in its structure of charges consultation.

The high weighting given to small users in the composite demand calculation reduces the exposure to the more variable large and very large users and we are comfortable with the existing weighting.

Is the pass through mechanism that applies under the current price control review still appropriate? Should any other costs be subject to pass through?

The principle that should be applied is that costs which are outside the control of the DN should be passed through. If not, then the business risk would increase and a higher cost of capital would be required.

Consequently, licence fee costs and rates should remain as pass through items. In addition, other costs that are outside the control of the DN that should also be passed through, in particular Traffic Management Act (TMA) costs in the event that they cannot be predicted with any degree of accuracy. As discussed earlier, the shrinkage allowance should be based on a mechanism that enables GDNs to recover the actual price of gas rather than using a gas price that is forecasted forwards for five years.

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

The correction mechanism works well and any under or over recovery at the end of the current price control period should be rolled forward.

It would be helpful to consider ways to deal with areas of uncertainty – as Ofgem makes clear, the Authority has a statutory duty to ensure that licence holders can finance their functions. For example, if an allowance was set for estimated TMA costs within the price control it would be legitimate for an ex-post adjustment to be made if outturn costs (beyond the control of GDNs) were materially different.

7. Scope of the price control

Is the scope of the current price control appropriate?

As discussed earlier (under issues for early consideration Q3), we believe an element of xoserve costs should be funded through charges to end users of the services so that the correct economic signals and behaviours can be established. To the extent that such costs are recovered through charges to end users they should be excluded from the scope of the distribution price control.

There is no discussion in the consultation of metering. As competition develops in metering, consideration should be given to reviewing metering policy and assessing whether the meter of last resort obligation is appropriate or cost effective – is it in the best interests of customers? Furthermore, Ofgem discusses smart metering in its proposed corporate strategy. In the event that options require investment by DNs then this should be taken account of during the price control.

Assuming no changes are made to the statutory obligations surrounding connections we see no rationale for any other changes to the scope of the price control at the present time.

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

As part of the sale arrangement a number of temporary consents were granted to NGN to permit some services provided by us to be treated as de-minimus activities. These temporary consents cover the provision of maintenance services to the NTS, provision of work force services to meter asset managers and the provision of emergency meter works to shippers and suppliers.

Each of these needs to be considered against the criteria for excluded services and the extent to which DNs are likely to be requested to continue providing such services on an enduring basis:

- **Maintenance services to the NTS**. This is a specialist service which is provided for the benefit of a third party (NTS) and not made available as a normal part of transportation activity. We understand that the NTS is likely to want us to continue to provide this service on an enduring basis though in principle it may be possible for the NTS to undertake this work. On this basis we believe it is appropriate for this be treated as an excluded service in the next price review period.

- **Provision of workforce services to Meter Asset Managers**. These services are provided for the benefit of a third party and not made available as a normal part of transportation activity. We envisage that we will continue to be asked to provide such services to Metering companies. This work makes efficient use of DN resources at times of low workloads and this benefits customers by reducing regulated costs. On this basis we believe it is appropriate for this be treated as an excluded service in the next price review period.

- **Provision of emergency meter works services**. These services are provided for the benefit of a third party and not made available as a normal part of transportation activity. As part of the development of metering competition some suppliers/shippers have moved metering work including some emergency work away from the DN. However, all the intelligence we receive from suppliers indicates that there will be an enduring requirement for the DN to provide emergency metering works. On this basis we believe it is appropriate for this be treated as an excluded service in the next price review period.

8. Sliding scale incentives

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

The sliding scale mechanism appeared to work well in electricity. However the scale of capex required is very much smaller in gas and the mechanism may be more sophisticated than required. We believe that Ofgem's proposed methodology using a variety of techniques will provide the appropriate level of challenge to demonstrate that NGN's capex submissions are robust.

9. SOMSAs

Should Ofgem respond to the new developments relating to SOMSAs and if so how?

The GDNs are working together to ensure a smooth and efficient exit from the SOMSA arrangements and a memorandum of understanding has now been agreed by each of the GDNs. NGN's preference is to exit SOMSA as soon as possible, however, as Ofgem is aware, the GTMS requires replacement and the most efficient process for exiting SOMSA is to first replace GTMS and then for each GDN to exit in sequence. The GDNs are trying to complete this as soon as possible, but the earliest that all IDNs can exit the SOMSA arrangements is October 2010 and this will result in the Authority's consent to relinquishment of operational control requiring an extension to October 2010.

The (efficiently incurred) costs of GTMS replacement should be fully allowed as part of the price control as GTMS, developed in the mid 1990's and running on archaic systems, is obsolete.