

AW/DM/038

29 August 2006

Joanna Whittington
Ofgem
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Dear Joanna

Re: Gas Distribution Price Control July 2006 - Second Consultation Document


I have pleasure in providing NGN's response to the second GDPCR consultation. I would be happy to meet with you to discuss any of the content in more detail if that would be helpful.

The key points from our response are as follows:

- Operating costs for the one year control should be based on 06/07 allowances with a separate allowance for shrinkage costs. The alternative of using the cost information for 05/06 will reward inefficient companies or those that have inflated 05/06 costs. Furthermore, any proposal to reduce the allowance by an efficiency factor should recognise the significant cost pressures facing GDNs. .
- There has been no detailed analysis undertaken for cost of capital and relative risk of gas distribution and hence for the one year control cost of capital should be based on regulatory precedent. The most recent precedents are the 7.3% pre-tax for water and the 6.9% pre-tax for electricity DNOs.
- It should be noted that a switch to a post-tax methodology is likely to result in a substantial reduction in revenue for GDNs. The financial impact on the business should be reflected by adopting a more conservative approach to other aspects of the price review, in particular in setting the allowed post tax cost of capital.
- NGN favours the "strong capex roller" methodology proposed for the main review because it is simpler to operate and it will enable GDNs to manage their capex programmes as a whole rather than manage each element against discrete allowances.
- The 35% volume driver for revenue does not reflect cost variability and should be reduced to 5-10%, in line with the variable proportion of costs.

Please note that the response can be regarded as non-confidential.

Yours sincerely



Alex Wiseman
Regulation Director

Gas Distribution Price Control July 2006 Second Consultation Document

CHAPTER: Two

Question 1: Should Ofgem retain the form, structure and scope of the current price control during the one year control?

The current structure and scope of the price control works well and should largely be retained subject to the two points below:

- NGN agrees that the shrinkage arrangements should change (see answer to chapter four question 3).
- Competition is well established in metering and hence consideration should be given to reviewing metering policy and assessing whether the meter of last resort obligation is appropriate or cost effective. NGN has installed less than 2,000 meters since taking over the Northern Network in June 2005 and it cannot be in the best interests of customers to pay for such a small scale operation.

Question 2: Should Ofgem introduce a new revenue driver other than the volume driver and, if so, what variable should it be linked to?

Given the difficulty in predicting connections volumes as evidenced by the large discrepancies in the current review period between actual and allowed volumes, connections should perhaps also be a revenue driver in some form. It may also be appropriate to include, as Ofgem suggests, a load growth driver.

However, the current revenue volume driver does not reflect fixed versus variable costs and should be reduced from 35% to about 5-10% in line with the proportion of costs that are variable. It would be appropriate to reduce the variable element in charges from 65% at the same time which would benefit customers by reducing over and under recoveries and hence reducing price volatility. However, the sharp increases in gas prices and the Energy Review conclusion on reducing usage are likely to lower demand in the future. In previous price controls, the first year of the price control has had broadly fixed revenue with no revenue driver associated with it and NGN assumes that this will continue to be the case for the one year control and for 2008/09.

Question 3: What revenue and/or costs should be treated as excluded/de minimis/pass through? What principles should be used to classify revenues and/or costs as excluded/de minimis/pass through?

As part of the sale arrangements a number of temporary consents were granted to NGN to permit some services provided by us to be treated as de-minimus activities and these are considered below against the criteria for excluded services and the extent to which GDNs 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 to 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 GDN resources at times of low workloads and this benefits customers by reducing regulated costs. On this basis we believe it is appropriate for this to be treated as an excluded service in the next price review period. However, we do expect metering volumes to reduce in future periods from the high volumes of work undertaken since GDN sales.
- **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 GDN. However, all the intelligence we receive from suppliers indicates that there will be an enduring requirement for the GDN to provide emergency metering works. On this basis we believe it is appropriate for this to be treated as an excluded service in the next price review period.

Pass through items are appropriate (ie licence fees, network rates), but these should be supplemented with pass through of pension costs from NG retained liabilities as these are outside the control of GDNs.

NGN is comfortable with the Ofgem principles for assessing whether to include activities within price control as laid out in 2.15.

Question 4: Should Ofgem link some or all of allowed revenues to a price index other than RPI?

NGN's preference is to link some revenue to changes in the construction index – this reduces risk for both GDNs and customers as much of NGN's costs relate to construction price increases. A simpler alternative is to increase capex (and repex) allowances by a construction price index rather than by RPI.

Furthermore, it should be noted that RPI is not an appropriate basket of goods and services for infrastructure utilities. Utility costs are rising significantly faster than RPI. NGN accepts that RPI is a simple and transparent methodology to apply but the increase in costs faced by GDNs means that holding cost increases to RPI represents a major challenge and that achieving efficiencies above RPI may be difficult or impossible to achieve. The last few years have seen sharp falls in the cost, for example, of clothing and leisure items whereas the costs of utility inputs such as oil, raw materials and energy have increased significantly more than RPI. If using an alternative measure is not a practical option then the increase in costs relative to RPI needs to be recognised when setting efficiency targets for GDNs.

Question 5: Should Ofgem specify certain issues that could be the subject of a reopener and, if so, which issues?

We agree that price controls should be set as far as possible ex ante. However, a lack of reopeners increases risk (for both customers and networks) and this should be recognised in the allowed cost of capital.

It is appropriate for the TMA to be a reopener if costs are still uncertain when the price control is set. A further uncertainty is whether the current network sensitive loads will insist on having firm capacity status. This will require additional capex and if the full capex for making network sensitive loads firm is not allowed for within the price control, then the

cost of fulfilling requests for firm capacity investment should be a potential reopener or automatically allowed as “pot 3” capex. NGN estimates this investment cost at over £20m.

If the exit capacity regime is not fully implemented when prices are set then a reopener may be required for the impact of changes to exit arrangements not foreseeable at the time of final proposals.

CHAPTER: Three

One year control issues

Question 1: Is our approach to carrying out ex-post assessments of historical efficiency appropriate?

Given the scale of the overspend, NGN believes that Ofgem is taking broadly the correct approach. However, it should be recognised that the detailed assessments that Ofgem is carrying out represents more micro management of the capex programme than in previous reviews. Because of the difficulty of external assessment of efficient spend and the potential for a substantial amount of overspends to be disallowed, this represents a significant increase in regulatory risk which should be recognised in the allowed cost of capital.

Question 2: Is our proposed regulatory treatment of our conclusions on efficiency appropriate, transparent and practical?

NGN has a number of concerns with the details of the approach:

- There is no precedent for a detailed review of spend below allowance. The incentive for efficiency is the level of allowance given and it is inappropriate to disallow capex below allowance.
- The nature of the review is asymmetric as companies can only be penalised – there is no opportunity to gain for “super efficient” companies. This is contrary to the principles for opex where companies within upper quartile receive incentives. Overall, it significantly increases the risk of making investments in the network and, if implemented, the beta factor when setting cost of capital should be higher in the future than it has been in the past.
- Never allowing efficient unit costs in relation to an efficient workload into pot 3 if unit cost allowances are set too low incentivises companies to be very conservative in forecasting unit costs.
- Additionally, it is not appropriate to extrapolate any suggestions of past inefficiency into the period under new management.
- The Andrew Walker letter of March 2004 says “if there is clear evidence of wasteful and unnecessary expenditure then it will not be included” in RAV. Thus there is a need to demonstrate clear evidence. The letter also says that there will be adjustments “for each year of the period 2002/03 to 2007/08” so it is inconsistent with the letter, relied on when purchasing the Northern Network, to review pre 2002/03 expenditure.

Question 3: Is our initial view on how to set capital and replacement expenditure allowances for 2007-08 appropriate?

It is appropriate to use consultants' input to set capex and repex allowances, subject to opportunities for comment and challenge by GDNs. However, it is essential that the consultants' input is factual and not a judgement based on insufficient evidence. The consultants must take full account of the changes in work procedures and practices since sale of GDNs when assessing the efficiency of expenditure in 2007/08.

Question 4: Which of our options is most appropriate for setting the operating expenditure allowance for 2007-08?

Extrapolation from the existing allowance is more consistent with good incentive regulation than using companies' actual costs to determine future allowances. The alternative of using the cost information for 05/06 will reward inefficient companies or those that have inflated 05/06 costs. Additionally, it may be challenging to appropriately normalise 2005/06 costs as these include only 10 months in new ownership when there was significant restructuring and "bedding down" of operations. Consequently NGN strongly favours option 1, carrying forward the 2006/07 opex allowance, as we believe that this is the most equitable option and it avoids a significant amount of work. Note that continuing the 2.5% reduction in allowances for efficiency improvements will be extremely challenging and potentially unachievable in the current environment of costs increasing significantly above RPI.

In addition, because of the large and unforeseeable rise in gas prices, there should be a separate allowance for shrinkage and, as indicated in the consultation, pensions should be treated separately.

Main control issues

Question 5: Is our proposed approach for setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?

It is appropriate to assess asset management systems and companies' projections as proposed – future allowances should be based on company forecasts rather than relying on consultants' forecasts. However, it is important to recognise the minimal scope for efficiencies; security of supply, safety or risk reduction must not be compromised by setting challenging efficiency targets that may not be achievable in an environment of increasing costs.

TPCR suggests that costs related to exit reform will be disallowed and there is absolutely no basis for this.

Question 6: Is our proposed approach for setting operating expenditure allowances for 2008-09 to 2012-13 appropriate?

NGN fully supports incentive based regulation with the use of benchmarking to compare costs across businesses. However, it should be recognised that this modelling will never be perfect and can only provide an estimated frontier when there are only eight companies and four ownership groups. Consequently allowances should be set based on, say, median or upper quartile and not based on the frontier. As in electricity, an additional allowance should be given to singleton companies in recognition of the efficiency challenge facing these companies compared to those in multiple ownership.

Question 7: How should we deal with the uncertainty surrounding the level of costs associated with the Traffic Management Act (TMA)?

If the impact of the TMA is still unclear at the time of final proposals then there should be a cost pass through mechanism for TMA costs or the opportunity of a specific reopener to ensure that incurred costs, including an appropriate allowance for penalties, overruns, and administrative costs, are allowed.

Question 8: What are your views on our principles for assessing GTMS replacement costs, SOMSA exit and ongoing system operation costs?

Customers are benefiting from GDN sales and it is an Ofgem requirement that companies develop their own system operations function. Consequently, all costs associated with SOMSA exit, both capex and opex, should be allowed as they are an Ofgem prerequisite to achieving the customer benefits.

GTMS requires replacement as soon as practical. However, if Ofgem assesses that the system is not yet obsolescent, it would not be appropriate to disallow any costs unless Ofgem allowed deferral of replacement and the consequent deferral of GDNs exiting the SOMSA arrangements. It is inappropriate to disallow any costs incurred to facilitate SOMSA exit when GDNs have no choice about the timing of exit.

We do not believe that there has been any allowance already given to GDNs for GTMS replacement. However, it is irrelevant to the decision on allowing replacement costs whether or not there has been such an allowance as customers will have benefited from deferral of expenditure through the rolling capex mechanism.

CHAPTER: Four

One year control issues

Question 1: Is Ofgem's initial view on how to update the mains replacement incentive mechanism for 2007-08 appropriate?

Yes, updating the parameters by assessing the efficient unit costs of mains replacement work is appropriate. However, it is important to take into account the cost pressures on the business, in particular the increases in construction prices and material costs that are being experienced. In addition, the change in workload profiles should be taken into account when setting allowances. Furthermore, it would be appropriate to provide an additional row in the matrix for large diameter pipes, say those above 18 inches, as these generally cost significantly more to replace than 12 inch pipes. See also the answer to Q7 below.

Question 2: Is Ofgem's initial view on rolling incentives during the one year control appropriate?

There should be (at least) a five year rollover for capex to ensure sufficient incentives on GDNs to continue to make efficiency savings (but note answer to question 6 below).

Question 3: How should Ofgem determine shrinkage allowances? Should Ofgem adopt one of the options presented in this chapter or a different option?

From 2008/09, NGN's preference is for option 2 (whereby shippers have responsibility for purchasing shrinkage gas) which is simplest to operate, does not distract management from running the business and retains full incentives on managing losses. An additional criterion in Ofgem's qualitative assessment (table 4.2) should be risk management and option 2 comes out significantly ahead of the other two options with gas purchase risk retained by shippers who are best placed to bear this risk. This reduces risk (and hence

cost) for customers. This option is consistent with arrangements for electricity DNOs, however NGN recognises that some industry change would be required to implement this option. If the scale of industry change is too challenging to undertake, NGN favours Option 1a (market index) over 1b as it is easier to implement and enables GDNs to better manage the risk.

It is probably not possible to implement Option 2 in time for the one year control, hence Option 1a is NGN's preferred choice for 2007/08.

Question 4: Should Ofgem carry out any further work on incentives as part of the one year control review, other than that set out in paragraphs 4.1 to 4.23?

NGN favours the "strong capex roller" methodology as proposed for the main review because it is simpler to operate and it will enable GDNs to manage their capex programmes as a whole rather than manage each element against discrete allowances (but see answer to question 6 below).

Main control issues

Question 5: Should the interruptions and NTS offtake incentives on the GDNs be part of the overall RPI-X price control or separate incentives with caps, collars and sharing factors? How should the price risk for each of these incentives be addressed?

It will be a challenge to assess the interactions between interruptions, offtake and capex incentives and to set appropriate revenue allowances at this stage. Consequently, risk may be better managed by separate incentives with caps, collars and sharing factors. We would suggest that the caps and collars are relatively small to begin with and that, as confidence in the operation of the new regimes increases, the incentive mechanisms can be reviewed. Alternatively, an integrated approach will require liberal parameters because of the uncertainty on outcomes.

NGN is not in favour of the methodology outlined in 4.29 as it significantly increases regulatory intervention in GDN decision making and it may be difficult to analyse objectively.

Question 6: Is it appropriate to adopt rolling incentives and an information quality incentive mechanism for capital expenditure for gas distribution? If so, what should be the features of the incentives?

Rolling incentives are essential to encourage consistent and efficient behaviour throughout the price control period. NGN's view is that a five year roller is too short a time period and results in about 30% of the NPV benefits of efficiency accruing to the company whereas customers achieve about 70% of the benefits. 30% is inadequate and means that many capex efficiency opportunities that would ultimately benefit customers would not pass an investment appraisal and hence are not undertaken. Surely it is better for customers to have a smaller share of the much larger cake that would result if benefits were shared equally? The 20 year life of electricity DNO assets results in electricity companies receiving about 40% of the NPV benefits of capex efficiency savings. For GDNs to achieve the same benefits would mean extending the capex roller to about 7 years.

NGN favours the proposed option of a strong capex roller as this provides similar incentives on companies as would a detailed post hoc scrutiny of capex and it avoids the need for the time-consuming detailed review of expenditure. However, the strong capex roller will only work effectively if outputs required by customers that could not be foreseen

at the time of the review were allowed. This can be achieved to a large extent by including revenue drivers for connections and load growth and by including repex services within a repex adjustment mechanism as for mains. However, if there is to be no ex-post scrutiny of capex then stronger incentives may be required to encourage GDNs to achieve efficiencies. Capex requirements to make network sensitive loads (NSLs) and Transco nominated interruptibles (TNIs) firm may need to be treated separately as part of the interruption arrangements or alternatively fully allowed within the capex programme.

Ofgem suggests that the strong roller would be combined with an information quality incentive. This appears to have worked reasonably well for electricity DNOs and may be appropriate for GDNs. However, it does require confidence in the ability of the consultants to accurately predict costs.

Question 7: Should the mains replacement incentive mechanism be carried forward in its current form, adjusted for particular factors such as service pipes, or abandoned in favour of a more generic incentive?

The mains replacement incentive mechanism appears to have worked well in the current price control period and has effectively dealt with uncertainty over the length of different pipe types replaced each year. The HSE requirement to replace based on risk makes the programme difficult to predict five years in advance and the mains replacement incentive automatically adjusts the allowance based on actual pipe diameters replaced. Consequently it is appropriate for this mechanism to continue during the next price control period.

Similarly, it has proved difficult to estimate the number of services that require replacing. Iron service pipes now have risk scores and can drive replacement projects in the same way as mains. It would therefore be appropriate for these costs to be recovered under the mains incentive mechanism (based on length and diameter) rather than as individual non-domestic services. Risk for customers and companies would be reduced if a similar mechanism to the mains replacement incentive operated for service pipes. The allowance for services during the next control period must reflect the HSE obligation to replace all small diameter steel services connected to the replaced mains pipeline.

As discussed in question 1, a larger diameter band should be introduced into the mains matrix.

Now that the incentive mechanism is well established it should be a symmetric mechanism between customers and companies. We would suggest 50:50 sharing.

Question 8: Is it appropriate to adopt rolling incentives for operating expenditure for gas distribution?

The price control may distort management decisions as significantly greater benefits are achieved from making operating cost efficiencies at the start of a price control period and there is a disincentive to make savings towards the end of a period as deferral will enable companies to achieve the benefits over five years. Consequently, there should be a five year (or longer) rolling opex incentive. This would align the treatment of opex with the proposed treatment of capex.

Question 9: How can the quality of service arrangements be improved? In particular what are your views on the high level options proposed by Ofgem for the quality of service and outputs arrangements for 2008-2013?

One of NGN's corporate objectives is to be benchmarked in the top 2 comparable utilities for standards of service and consequently we would welcome a combined performance measure to allow comparative assessment of GDN's performance. This would, for example, include the quarterly customer satisfaction survey; this survey should be extended from repair and replacement to also cover connections. NGN would like to see Ofgem publish a league table of quality of service.

Standards of service targets tend to focus on timely response rather than service quality and there may be scope for shifting the emphasis towards service quality.

NGN strongly objects to the removal of the aggregate caps for third party and water ingress arrangements. That these caps have not so far been breached does not mean that the risk is not real. NGN devotes significant effort to risk management and if the cap was to be lifted then we would certainly insure for the eventuality of a large event. The risk could be reduced by extensive capital investment, but it would be more cost effective to retain the aggregate capping mechanism. It is inappropriate to place uncapped and unquantified risk on a GT where the failure is not due to its actions or adequate funding has not been allowed. In a normal contractual situation relief from obligations would be available from a force majeure type event which water ingress is. Therefore if customers are to get compensation regardless of cause then the estimated cost (or the cost of insurance) should be allowed in revenue and the cost of capital adjusted accordingly for the additional risk.

The innovation funding incentive (IFI) has worked well in electricity distribution to achieve innovations that benefit customers. Innovation is low in gas distribution and an IFI in gas similar to the DNO scheme should lead to new solutions and benefits for customers with minimal downside risk. Some examples where technical innovation may reduce costs are provided in the answer to question 12 below.

Question 10: What are the advantages and disadvantages of the different approaches to setting capacity outputs and providing appropriate incentives for efficient behaviour by the GDNs in the next price control?

NGN agrees that incentives need to encourage efficient behaviour, but without penalising GDNs for fulfilling their legal and licence 1 in 20 obligations. Further work is required to develop coordinated incentives, but as a principle these should be implemented so as to avoid the need for future regulatory intervention. NGN needs sight of the forthcoming UNC modification proposal to be raised by National Grid NTS in September/October 2006 before it can fully comment, but we will be happy to comment further once the details are known.

Question 11: Are there any other areas where outputs or output based incentives for GDNs should be developed including safety and the accuracy of gas pipeline records? If so, what should they be?

NGN believes that it is near the frontier for safety and accuracy of asset management systems and consequently we would welcome incentives in these areas. Both are important for customers and appropriate incentives would benefit customers by ensuring continuous improvement in safety standards and record accuracy.

Question 12: Does any aspect of the operation of a GDN require more investment in technical innovation than occurs at present?

There are a number of areas where technical innovation may reduce costs if the investment could be justified, for example pipe laying, leakage monitoring systems,

cathodic protection monitoring, on-line inspection, pressure management systems, storage utilisation and asset life evaluation.

Question 13: Should Ofgem consider any other form of incentive mechanism in the context of GDPCR?

NGN currently has no views on additional incentive mechanisms.

CHAPTER: Five

One year control issues

Question 1: Is Ofgem's approach of calculating a post-tax cost of capital and an ex ante tax allowance appropriate?

NGN fully concurs that the treatment of tax should be to avoid ex-post adjustments. This is entirely consistent with Ofgem's treatment of opex and maintains incentives on companies to be tax efficient which will ultimately benefit customers. Also note that the comments under Q4 on the calculation of tax allowances also apply for the one year review. However, consideration should be given to allowing ex-post adjustments for both the one year and five year control for unforeseeable factors beyond GDNs control such as legislative change.

The move to a post-tax regime has a substantial negative effect on GDN revenues and hence on the effective allowed cost of capital. A report commissioned from Oxera by the GDNs shows that the impact of moving from pre-tax to post-tax is substantially greater for GDNs than for other regulated infrastructure companies – around 1% of RAV. The financial impact on the business should be reflected by adopting a more conservative approach to other aspects of the price review, in particular in setting the allowed post tax cost of capital. Alternatively, Ofgem could consider a continuation of the pre-tax approach for the one year control pending further analysis of the impact on GDNs.

Question 2: What, if any, financial indicators should be used to assess financeability (also relevant for the main control)?

It is important that regulators are consistent with the requirements of the capital markets. Consequently, it is essential that there is dialogue between Ofgem and rating agencies to ensure that the key financial ratios required by rating agencies are used to establish financeability.

The licence requires GDNs to “take all appropriate steps to ensure that the licensee maintains at all times an investment grade issuer credit rating”. This means that GDNs must be substantially above investment grade to allow for any unforeseen circumstances that may reduce the rating. Consequently, we would suggest that an appropriate credit rating to use to determine minimum levels required of financial ratios is the Standard & Poor's A⁻ rating (or equivalent).

Main control issues

Question 3: Should Ofgem use its traditional approach to calculate the cost of capital or should other approaches be considered?

Ofgem should consider other approaches alongside CAPM to validate (or otherwise) the CAPM output. In particular, the Fama French three factor model and the dividend growth model are alternative approaches to assessing an appropriate cost of capital.

Long term averages rather than spot rates should be used as there is substantial evidence that interest rates, etc, are cyclical.

The allowed cost of capital needs to be sufficient to attract investment and, given the range of investors in gas infrastructure, needs to compete with returns available internationally.

Question 4: How should Ofgem approach the issue of the level of gearing to be used in the calculation of the tax allowance? Should Ofgem ensure that consumers share in any benefits arising from companies having higher actual gearing than the regulatory assumption?

The financial modelling needs to be consistent with the assumptions used in setting the allowed cost of capital. Consequently, the level of gearing used in the tax allowance should be the same as that used in the allowed cost of capital. If, for example, a higher gearing was used, than there would be inconsistency as one would expect a higher equity beta and higher costs of debt as a result of the increased risk associated with higher gearing.

Ofgem has previously indicated that the financial structure should be a matter for companies and not regulators and NGN concurs with this view; consequently there should not be sharing of any theoretical benefits arising from higher gearing.

It is important that Ofgem recognises the proposed changes to taxation in setting allowances, for example the convergence of UK GAAP to IFRS. The allowance should use actual tax accounting rather than regulatory accounting to ensure that allowances are sufficient to cover actual expected tax charges. A shift to post tax is likely to result in a reduction in allowed taxation, and this effective reduction in allowed cost of capital should be recognised when setting the WACC as companies have made investments based on the current WACC including tax allowances.

Question 5: Are there any arguments for changing the depreciation rates used in the price control?

There is no clear rationale for changing depreciation rates. If Ofgem is considering increasing the percentage of repx that is capitalised then this should be at least partially offset by reducing asset lives to increase depreciation.

Question 6: Is Ofgem's initial view on the treatment of pensions, and in particular the treatment of the GDNs' pension deficits, appropriate? Should all ERDCs be for the account of shareholders within GDPCR?

NGN welcomes the treatment of pensions outlined to allow GDNs the statutory costs relating to the regulatory business and to recover excess pension costs paid during the current price review period is appropriate.

DPCR4 laid out a clear rationale and methodology for recovery of some of the ERDC payments and it would be entirely appropriate for distribution ERDCs to be funded in line with the principles established for the DNOs. It should be noted that some of the National Grid NTS ERDCs pre GDN sale relate to GDNs and consequently recovery of these should be part of the GDPCR and not the TPCR.

To achieve the efficiencies required by price reviews, rationalisation and redundancies may be required. These costs, required to achieve the target efficiencies, should be

recoverable through the regulatory process as otherwise a company with costs (excluding redundancy costs etc) in line with allowances will not be able to achieve its allowed cost of capital.

Question 7: Is Ofgem's proposal on the mechanism for recharging NTS pension costs appropriate?

The mechanism to recharge NTS costs is appropriate providing that GDNs are given full pass through of the recharge with no risk to the GDNs of underfunding.

Question 8: What should be the timing of allowances for under recoveries from the current price control and deficit repair costs?

Under recoveries from the current period should be recoverable either at the start of 07/08 or 08/09, with the amount grossed up for the WACC from the date that the under recovery was incurred.

Deficit repair costs should be recoverable over the time period recommended by the pension advisors (based on the requirements of the pension regulator) for each company.

Question 9: How will the changes to pensions law affect the price control?

There needs to be alignment between Ofgem and the Pensions' Regulator during the period over which GDNs will be given allowances to repair deficits. There are several areas where changes to pension law may increase costs in future years:

- The PPF Levy is currently based around a Dun & Bradstreet rating mechanism which is very volatile. Changes to the basis of calculation of the levy may arise over future periods which may increase costs accordingly.
- Age discrimination legislation comes into effect from October 2006 and this may have cost implications for pensions. However these are not currently clearly understood by pension advisors and thus have not yet been factored into NGN's projections.
- Introduction of the National Pensions Saving Scheme from approximately 2012 will require employer contributions, proposed to be 3%, if the employer does not provide alternative pension arrangements.
- The government is reviewing the calculation of transfer value payments to members. This could lead to an increase in the amounts paid out in the future.
- There are plans for increased pensions disclosures under UK and International GAAP. In particular, there is pressure to disclose more details of actuarial assumptions, especially mortality. This may push companies towards more conservative assumptions (i.e. higher liability values). Additionally, this will result in increases in both administration costs and professional fees to support these requirements.

CHAPTER: Six

Question 1: Are the three options for the funding of xoserve appropriate? Should we consider different options?

The three options outlined are appropriate. NGN favours option 3, core service plus user pays. However, the core service needs to be clearly defined and any excluded services must be optional services that the industry accepts will not happen if they are not funded by users. Capital expenditure that benefits both transporters and shippers, for example on UK Link, should be fully funded as part of the price control as there is no certainty of selling additional services to shippers. Furthermore, there will need to be a change in the contractual arrangements with shippers, for example xoserve currently has no status in these arrangements and thus cannot enforce payment.

Question 2: Should Ofgem consider the outcome of an industry dialogue as part of its assessment of the funding required to replace UK-Link?

NGN welcomes a dialogue with the industry to ensure that the replacement of UK-Link meets user requirements. However, it must be recognised that it may be challenging to reach full industry agreement on the specification of the replacement. The required expenditure needs to be allowed as there will be a clear requirement during the price control period to replace UK-Link.

Question 3: Which, if any, of the 5 options for facilitating network extensions should Ofgem consider in more detail?

NGN would welcome the opportunity to work with Ofgem to facilitate the extension of networks to fuel poor communities. Changing the application of the 10 metre rule would assist fuel poor communities but increase the cross-subsidy of new consumers by existing consumers. NGN agrees with this approach, however this is a social policy decision for Ofgem. If implemented, it will be important that the additional volume of work is estimated correctly, or alternatively there could be a mechanism such as the mains repex incentive mechanism to reduce the risk to customers and companies of inaccurate estimates. GDNs would need an assurance that the required capex would be allowed as it may not tie in with the existing obligations for expenditure to be economic and efficient.

NGN would welcome some form of incentive scheme to encourage network extensions as proposed in option 3.

Option 5 is a clever variant of option 4 whereby the benefits that GDNs receive from network extensions are used to fund the cost of the extension and the increase in volumes is not largely passed straight back to all customers via the operation of the revenue driver. Hence the extension is effectively self-funded with fewer cross-subsidy issues and consequently NGN favours option 5 over option 4.

In summary, NGN favours options 2, 3 and 5 and these should be considered in more detail.

Question 4: Should Ofgem introduce a licence condition that requires NGG NTS to recover the excess costs associated with independent systems on behalf of GDNs?

Independent systems could either be funded by GDNs through the price control or by the NTS through its price control. Either solution is appropriate providing that the costs can be accurately predicted.

CHAPTER: Seven

Question 1: What issues to be addressed as part of GDPCR should be considered in an impact assessment?

NGN agrees that the issues outlined in 7.5 are appropriate to be addressed within an impact assessment. However, impact assessments need quantification of the customer impact and there may be a need to undertake customer research to evaluate the benefits.