

Gas Distribution Price Control Review One Year Initial Proposals

A Response by National Grid Gas

October 2006

1. This is National Grid's response to the Gas Distribution Price Control Review One Year Initial Proposals published in September 2006. The Initial Proposals document provides a clear and fair description of the issues from both an Ofgem and a GDN perspective. There is, however, much work to do between now and the publication of the Final Proposals for the one year review in December.
2. Our response is in two sections. The first provides an overview of our fundamental concerns with the proposals, whilst the second provides answers to the specific questions raised by Ofgem in the document.

Section One: Our fundamental concerns

3. The current price control was the result of an extremely harsh review conducted by Ofgem in 2000/01. As well as an unprecedented Po cut of 16%, Ofgem also set extremely challenging targets for capital expenditure. One reason Lattice were able to accept the proposals was that Ofgem applied a pre tax rate of return which allowed Lattice the benefit of deducting replacement expenditure for tax purposes in the year in which it occurred.
4. During the current price control period, Lattice and National Grid have made a determined and successful effort to meet the operating cost targets set by Ofgem on an underlying basis but have been unable to meet the challenging capital expenditure targets. Returns to investors have been below the returns allowed by Ofgem as shareholders have funded; the large increases in exogenous costs to which the price control exposed them; the costs to achieve the operating cost targets; and the additional investment required to meet consumers' requirements.
5. National Grid expects the Final Proposals for the extension review to move towards a position which is more sustainable for investors. The Initial Proposals, in spite of a large headline Po price increase, fail to meet this challenge. This is a result of two principal factors.

Retrospective assessment of past investment

Previous Ofgem guidance

6. The Initial Proposal's sophisticated interpretation of the open letter on Gas Distribution Price Controls (March 2004) is not representative of the simple principles set out in that letter. The letter itself raises the possibility of:
 - Disallowance of unnecessary or inefficient spend;
 - Investors bearing for 5 years at least the **return element** of the financing costs for efficient overspend; and
 - Backdated pass through for efficient overspend that provides "significant benefit to consumers".
7. The Initial Proposals now interpret the letter in a way it was not possible to foresee;
 - It extends the impact of the 5 year disallowance to both the return element **and depreciation** for 5 years on efficient overspend, and
 - For efficient overspend which provides "significant benefit" to consumers, it distinguishes between additional workload driven by external factors and additional unit costs. Although the backdated pass through is indeed available on a proportion of additional workload, where the unit costs are above those used in setting the last control, the difference is subject to the 5 year penalty.

Disallowance of efficient non-discretionary spend

8. As well as the retrospective nature of the disallowance, the proposals are objectionable because they have the effect of destroying value in efficient, non-discretionary spend simply on the basis that the capital forecasts – which were a product of high-level negotiation and which were settled "in the round" during the last price control - were not met in detail. These efficient investments included mandatory investments in new connections, continued reinforcement to meet 1 in 20 security obligations and the removal of risk to the public, to secure the long term future of the gas distribution networks. We believe that all such efficient non-discretionary spend should be subject to backdated recovery.
9. If we had understood the interpretation of the letter that now underpins the efficiency assessment, we would have been forced to take a more short-term view of investment, and would have raised our concerns forcibly with Ofgem. Indeed, it is hard to see how we could have sanctioned significant levels of spend in UK gas distribution if we had realised that the rate of return on such investments would be less than **4%** on an outturn basis versus the benchmark **6.25% pre tax**.

Cost of capital

10. The second fundamental area of concern is the proposed move to a post tax cost of capital calculation. Ofgem are selectively choosing to adjust certain elements of the cost of capital calculation and are neither undertaking a simple roll forward of the current assumptions or completing a full review.
11. Ofgem argue that a simple roll forward has been conducted whilst taking into account regulatory precedent and accounting for the 'significant benefit' afforded to GDNs as a result of pre tax treatment.
12. However, Ofgem should recognise that the pre tax treatment was an intrinsic part of the 2002 settlement and an important consideration for Lattice in accepting a tough settlement. This point was reflected in the 'Letter of Comfort' from the then Chairman of GEMA (October 2001). Removing the pre tax treatment outside of a full review significantly worsens the financial position for GDNs.
13. Ofgem argue that they maintain a degree of balance in the Initial Proposals because a move to post tax is offset by specific increases in allowances in items such as shrinkage and pensions. We believe this is somewhat misleading. The recovery of the extra pensions contributions was envisaged in the 'Letter of Comfort'. This leaves shrinkage as the only example of additional allowances, and this merely corrects for the adverse movement in the external market. The additional monies allowed for shrinkage equate to around £25m at last winter's prices, in an environment of now falling gas forwards prices, whilst the loss of beneficial tax treatment equates to a concrete loss around £60m.
14. The unsustainable nature of the Initial Proposals is underlined by the fact that Ofgem's financial modelling shows the GDNs failing some of the key financeability tests.

Looking forward

15. While this section sets out our overall concerns, we have a number of more detailed points which we have covered in the response to Ofgem's specific questions. These are set out in Section 2. We look forward to exploring all of these points with Ofgem between now and Final Proposals in December.

Section 2: Responses to specific questions

2. Operating expenditure (opex)

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

16. We have noted in our previous responses that the workload to establish opex allowances for 2007/08 should be proportionate to the scope of the deliverable, and as such, some form of extrapolation would be appropriate. We note that the proposals follow this principle and overcome the issue identified in the second consultation with regard to the outdated allocation of allowances across GDNs.
17. The lack of a detailed bottom up analysis however at this stage does mean that our costs for 2007/08 are currently forecast to exceed the proposed allowance, as a result of costs for contractors, materials, fuel and maintenance increasing since 2004 and 2005.
18. Given these increases, the application of an efficiency factor of 2.5%, without the benefit of a full bottom up analysis, leads to an outcome which is not reflective of the position that GDNs find themselves. With many significant costs increasing at a rate in excess of RPI, we remain of the view that RPI-0% would in itself represent a tough challenge.
19. We also note that, in the calculation of allowed revenues, no allowance for the recovery of statutory environmental spend has been included. This item should be included in the income derivation, with the breakdown by Network at 2005/6 prices as follows:

North West	£0.9m
East of England	£1.3m
West Midlands	£0.9m
London	£1.1m

Question 2: Is Ofgem's proposed approach to setting pensions allowance for 2007-08 appropriate?

20. We support Ofgem's proposed approach with respect to pensions allowances for 2007/8 which is consistent with that included in the Transmission Price Control Review (TPCR). In respect of the current price control, we acknowledge Ofgem's view that the recovery of ERDCs post April 2004 should be a matter for shareholders, and not consumers, in line with the principles established as part of DPCR4.

21. It must be recognised however, that severance costs are often inevitable when delivering the efficiencies assumed as part of a price control from which the consumer immediately benefits. As such, this regulatory position should be re-examined as part of the main review.

Question 3: Is Ofgem's assessment of the costs and benefits associated with the three options for setting shrinkage allowances, as set out in the impact assessment, reasonable?

22. We support the conclusion of Ofgem's impact assessment, that Option 1a is the appropriate way forward in order to mitigate the price risk faced in respect of shrinkage. The implementation of an index based mechanism will ensure symmetrical treatment of any benefits between consumers and GDNs. To establish a fixed ex ante benchmark price will always be difficult, running the risk of substantial windfall gains or losses.

Question 4: Do you support Ofgem's proposed approach to setting shrinkage allowances (i.e. Option 1a)?

23. We support the proposed approach to setting shrinkage allowances which expose the GDNs to volume factors that they can influence, whilst offering protection against factors over which the GDN has little control. However, like the NTS scheme, an adjustment (uplift) to any ex-ante index will be required in order to capture the correlation between shrinkage volumes and the market price that leads to the volume weighted average price being consistently higher than the forward price.
24. Gas price indices are premised on an assumption of constant usage, whereas the required shrinkage volumes vary from day to day as a result of our obligation to 'be in balance' as a shrinkage provider. Due to the direct relationship between total LDZ demand and required shrinkage gas, we will always be required to purchase additional gas at times of high demand and less at times of low demand. This produces a systematic upward bias in the price that we are exposed to, relative to an index value.
25. The uplift applied to any index established as part of a GDN scheme will need to reflect the fact that daily shrinkage within the distribution system is more temperature dependent than that on the NTS, because of the greater heating load.
26. In establishing an allowance for the extension year, a simple uplift figure would be appropriate. In the longer term however, it may be appropriate to include an approved methodology which would allow the adjustment of the uplift factor on a year on year basis. For the extension year, our analysis suggests that an uplift factor of 6.38% is required. Further detail on the analysis to support this uplift has already been provided to Ofgem.

Question 5: In the event that Ofgem adopts Option 1a for shrinkage, which market index (or indices) should GDNs' shrinkage allowances be linked to?

27. For simplicity, we propose using the gas cost reference price as currently used for the NTS shrinkage incentive scheme, based on the Heren price index.

Question 6: In the event that Ofgem adopts Option 1b for shrinkage, should allowances be based on shrinkage costs incurred by the average GDN or lowest cost GDN?

28. We do not support 1b. In the event that Ofgem chooses option 1b, the allowance should be based upon the average costs incurred by GDNs. Basing the allowance on the lowest cost DN allows only one GDN to cover their costs and leaves the others facing a loss (ignoring the possibility of a dead heat). This implies that, as a group, the GDNs are virtually certain to make a loss. It cannot be right that shareholders would be expected to subsidise shrinkage costs on a regular, ongoing basis.
29. Conversely, setting allowances based on the average performance will allow the GDNs as a group to cover their costs whilst rewarding good performers and penalising poor performance. However, the regime would still suffer from being based exclusively on the performance of the GDNs; there would be no reward should all GDNs perform well and no penalty should all GDNs incur higher costs than the market as a whole.

Question 7: Should Ofgem remove throughput-related shrinkage volume risk from GDNs?

30. We, in principle, support the removal of throughput related shrinkage volume risk from GDNs and look forward to further clarity on the proposals. Similarly Ofgem should also take this opportunity to remove the uncontrollable price – volume risk associated with weather variation by application of an uplift as discussed in our answer to question 4.

3. Capital and replacement expenditure (capex and repex)

Question 1: Do you agree with our proposals regarding expenditure that we should treat as wasteful and unnecessary

31. Whilst we agree with the principles outlined in the Initial Proposals, in that spend should only be allowed where both efficiency and necessity can be demonstrated, we strongly dispute the areas of inefficiency identified by Ofgem and its consultants. We believe substantial evidence has been provided in order to demonstrate both the efficiency and necessity in these areas. On the contrary, almost without exception, we do not believe that the necessary level of proof

has been achieved by Ofgem to justify the disallowance. Our specific concerns are outlined below.

LTS Projects

32. We believe PB Power have been selective in their analysis of LTS projects and in their resultant recommendations.
33. When projects are approved the authorised amount is determined within National Grid on a P50 basis, i.e. as likely to overspend as underspend. Therefore, by definition, some projects will overspend. This is particularly the case on large, cross country pipelines. This overspend is not indicative of inefficiency but, rather, demonstrates that projects are reasonably priced, taking account only of those sensitivities that have a reasonable likelihood of occurring.
34. Against this background, in terms of the specific reasons given for disallowance, we strongly disagree with the disallowance of expenditure relating to planning consent issues. Expenditure associated with resolving these issues should not be considered as wasteful or inefficient but as a necessary and unavoidable cost in delivering the project to meet customer demands. This particularly impacts on the Horndean to Newells Lane and Newbury reinforcement projects. The project completion reports for these projects clearly identify the reasons for additional expenditure, which were;
 - Horndean to Newells Lane – £0.5m of the £0.7m disallowed relates to a planning objection resulting in late planning consent, and a landowner refusing access to the site.
 - Newbury Reinforcement – £0.9m of the £2.2m disallowed relates to planning consent difficulties, primarily due to opposition from local residents. Much media attention was given to public opposition to the construction of the Newbury bypass in the same area.
35. The alternative to a P50 approach of including a contingency for such events in all projects, would lead to systematic overestimation and, as a result, inflated investment plans.

Lack of management information

36. We are disappointed that Ofgem continue with their assertion that a lack of management information in unit cost format can be taken as evidence of inevitable inefficiency. The way in which investment projects are managed has changed over the course of the price control, with average unit cost having given way to a target cost approach, thus allowing the specific

features of each individual scheme to be factored into monitoring, rather than relying on average unit cost guides. We believe this provides more robust cost controls and, therefore, it is not appropriate to make cuts to past investment based on the absence of outdated unit cost management information.

Failure to re-tender EPC Contracts

37. We note that Ofgem focus on the decision to not re-tender EPC contracts in 2002, claiming that bilateral negotiations with suppliers will have led to inefficiencies across a range of capital and replacement activities. Since Ofgem shared the findings of the draft PB Power report, we have provided further detailed evidence, which, we believe demonstrates that our strategy at the time was an efficient one, and that re-tendering would in fact have been more likely to lead to a **step increase** in prices. We look forward to resolving this issue before the Final Proposals in December.

Related party margins

38. The proposed disallowance of £10m of connections capex on the basis of related party margins is both disappointing and surprising, as there has been no mention of this during the price control review prior to publication of the Initial Proposals.
39. We believe conceptually that the disallowance of £10m of net capex on the basis of excess cost, whilst at the same time disallowing a separate £18m of net capex on the basis that we have not charged consumers enough is illogical. We would argue that, in fact, we have not recovered the related party margins in the first place. We have to date seen no evidence from Ofgem that this has not been the case.
40. Separately, Standard Special Condition A6 requires National Grid Gas (NGG) to conduct its transportation business in the manner best calculated to secure that it neither gives to, nor receives from, any affiliate or related undertaking any unfair commercial advantage. Contracting on an arms length basis and on normal commercial terms is one way of ensuring that no such advantage is given or received. In fact, SSC A39 (indebtedness) puts NGG under a direct obligation only to enter into arrangements on an arms length basis and normal commercial terms. It is entirely normal for the commercial terms of any arms length arrangement to include a profit element. If we were to outsource our work to a non affiliate, there is, of course, no doubt that the new service provider would charge a profit. Charging a profit is therefore a normal commercial arrangement.

41. Furthermore, it is inequitable that where Fulcrum continues to provide a connections service to the non National Grid gas distribution networks after 1 June 2005, the margin is allowed into the RAVs of those companies but not into National Grid's RAVs.

Connections time lag issues

42. We are disappointed that Ofgem are currently proposing to disallow capex based on a view that National Grid took a conservative approach to charging consumers for new connections. Ofgem contend that steps could have been taken to base customer charges on the costs expected when the connection work was due to be completed and that the period for which quotations are valid could have been shortened.
43. Bearing in mind that the connections activity at the time was subject to an Enforcement Order, which specifically required us to provide 'accurate' quotations to consumers and led us to produce a charging methodology that was based on the rates current at the time of quotation, the application of cost prediction was not possible.
44. Prior to the Enforcement Order Transco had, in fact, used a charging methodology that did ensure connecting consumers paid for the infrastructure costs incurred at the time of construction, through the use of 'contingency rates'. The contingency rate was set to recover the average variation between the costs at the time of quotation and those costs incurred at the time of construction. The rate varied across Transco's LDZs but was typically around 10%.
45. However, following a number of formal competitive challenges at the Connections Steering Group and individual determinations undertaken by Ofgas, Transco removed contingency rates immediately prior to the introduction of the Enforcement Order. Ofgas viewed the variable geographic application of the rate and, in their view, the somewhat arbitrary nature of the calculation to be inappropriate in the context of an emerging competitive market. With the lifting of the Enforcement Order we have agreed a change in our charging methodology to allow for prospective pricing and are now looking to address the quotation validity period.
46. Given the depth and frequency of Ofgem's involvement in the key stages surrounding the derivation of customer charges over this sensitive time period, we think that to now suggest prices should have been set higher could be open to criticism of retrospective and inconsistent regulation.
47. With regard to the period for which quotations are valid, National Grid has previously sought to reduce the validity period, following a review of its Siteworks Terms and Conditions in

2003/4, but industry reluctance and the changing regulatory environment for connections meant that National Grid was required to retain the current arrangements.

Connections competitiveness

48. We disagree with Ofgem's view that one third of the Industrial and Commercial (I&C) market is non competitive. We have provided evidence based on the definitions in Section 10 of the Gas Act where National Grid has a duty to connect. On this basis, 65% of I&C connections would be non-competitive in nature.
49. We have since undertaken further analysis, following publication of Ofgem's Connections Industry Review (CIR) results for 2005/6, which suggests that a much higher proportion of the I&C connections is non-competitive. This analysis demonstrates that, on a national basis:
- GDN businesses constructed around 89% of all I&C connections
 - ICPs provided only 5% of all I&C connections for adoption by GDNs
 - IGT businesses (or ICPs on behalf of IGTs) provided the remaining 6%
50. We believe there are two principal reasons for the current lack of competition in the provision of I&C connections:
- Project value – the average value of an I&C connection undertaken by National Grid over the period is £2,400. Independent Connections Providers (ICPs) do not benefit from economies of scale, nor do they have a wide geographical coverage and therefore, one-off projects of this value do not contain a sufficient margin to encourage ICPs to undertake the work, in comparison with new housing projects which typically have a project value well in excess of £30,000. ICPs have indicated, that due to these reasons, they find it difficult to compete for projects with a value below £10,000.
 - NRSWA – the issues surrounding the NRSWA process and its impacts on competition in one-off domestic connections are well documented and understood by Ofgem. These same issues impact on competition in I&C connections, particularly given the low average value.

Question 2: Do you agree with our proposals regarding expenditure that we should treat as efficient overspend and, in particular, expenditure that should be subject to a reopener?

51. We remain very concerned that the proposals extend significantly beyond the principles outlined within the Open Letter on Gas Distribution Price Controls in March 2004, and, in particular, the interpretation of the “significant benefits to consumers” test. Where expenditure could be demonstrated as having significant benefit to consumers, such as new connections, ensuring security of supply or actions to mitigate risk to the public, it was our expectation that this would be allowed in full from the date incurred.
52. The vast majority of a GDN’s investment is non discretionary and customer driven, and hence the ability to defer investment is severely limited. Over the period, we have stringently controlled investment spend, not least through the innovative development of opex solutions and more short term incremental capital spend. Whilst this approach would be inefficient in the longer term, it is one that we would have continued, whilst seeking to re-open the price control, had we understood the interpretation of the letter that now underpins the efficiency assessment.
53. We welcome the decision to allow additional connections and repex services workloads into pot 3, on the grounds these workloads were unforeseeable, or in the latter case, because Ofgem made cuts to company forecasts in 2001. The decision to assess this workload at the **allowed** unit cost is unjust, as Ofgem also made significant cuts to Transco unit cost forecasts for these categories. Accordingly, we believe that the additional workload should be evaluated at the efficient unit cost.

Question 3: Do you agree with our proposed adjustments to the RAVs to reflect expenditure incurred between 1 January 2001 and 31 March 2002?

54. We have a number of comments on the proposed adjustments to the RAV. We have already expressed our views on the proposed disallowance of expenditure, so do not discuss that further here.

Pre 2002 RAV adjustments

With regard to the adjustments associated with dataloggers, meter governors and NTS offtakes, the pre 2002 RV adjustments have been inflated to 2005/6 average prices from an April 2003 price base. The source data is however April 2002 prices and thus understates the adjustment to be made.

Quarterback

55. We are disappointed that the Initial Proposals do not allow certain costs relating to the Quarterback (QB) project into the RAV. The QB project delivered a replacement for the life-expired private mobile radio (PMR) system, delivering both voice and data communications to our operational workforce, as well as other significant benefits in areas of safety, data quality and NRSWA compliance.
56. An allowance for PMR replacement and associated laptops/mobile devices of £92m (in 2000 prices) was provided in capex with no specific allowance in opex. Total spend on the QB system was below this amount, resulting in an enhanced solution at cheaper cost that will deliver enduring benefits to consumers.

Shared Assets

57. We note that no adjustment to the RAV will be made for pre-April 2002 investment in shared assets, given the sculpting of the RAV undertaken in 2003. However, as noted in paragraph 3.16 of the Initial Proposals, post April 2002, there was efficient expenditure on shared assets that were retained by National Grid at sale and, as such, support services provided to consumers solely within National Grid's geography.
58. Although the open letter on Gas Distribution Price Controls (March 2004) noted that a change to a physical asset was not a necessary nor a sufficient condition to trigger a change in RAV, it went on to state that RAV is calculated to encourage efficient behaviour and it may therefore be appropriate to adjust a RAV for the disposal or transfer of assets. As the assets were not sold, and now solely support the retained networks' consumers, it is appropriate that their depreciated value is transferred to National Grids' RAVs.
59. The capital expenditure associated with these shared assets was included within all GDNs' BPQ capex tables solely to enable reconciliation with the relevant management accounts which, pre-sale had this central spend allocated out on a simple basis.

Question 4: Is our proposed approach for determining capex and repex allowances for 2007-08 appropriate? Are the resulting allowances appropriate?

60. We believe that the principles underlying Ofgem's approach for determining capex and repex allowances, i.e. a review of expenditure plans for 2007/08, are appropriate. We do have concerns however with the assumptions that appear to have been used to underpin the repex allowance.

Repex

“Abandonment to Lay” ratios

61. We believe that Ofgem’s current proposal to amend our planned “abandonment to lay” ratio used to calculate the proposed repex allowances is flawed, in that it takes two separate analyses (i.e. one for unit costs and one for abandonment ratios, both of which may be valid in isolation) and mechanically combines them, failing to take account of the strong inverse relationship between cost efficiency and abandonment ratios caused by the joint dependency on the amount of open cut being used.
62. We have worked hard over the last two years to increase the proportion of mains abandoned using no-dig techniques, as they deliver significant cost savings, customer and environmental benefits. As a result, National Grid’s networks take three of the top four efficiency places in Ofgem’s unit cost assessment. The growth in no dig techniques continuing, with the latest figures from our Alliances for the first six months of this year showing that 93.8% of their work has used no-dig techniques, a significant increase from the 70% or so being achieved only two years ago. Understanding these developments should reinforce why it is not appropriate to take forward looking unit costs that are underpinned by very high levels of insertion and then overlay historical abandonment ratios that are no longer possible given the high levels of insertion.
63. The simple solution for the Final Proposals appears to be to use the abandonment ratios submitted in our BPQ, which are consistent with the frontier lay unit costs included. Alternatively, Ofgem’s comparator analysis should be re-run but based directly on the forecast unit costs of abandonment – the output actually being delivered – thus avoiding the unnecessary and troublesome two-stage approach of assessing lay unit costs and then having to overlay some assumption on global abandonment ratios.

Changes to the replacement programme as per HSE agreement

64. Since our BPQ submission in April 2006, we have agreed a revised mains replacement programme with the HSE, specifically relating to large diameter iron mains. Consequently, the workload mix we are planning to undertake in 2007/08 will be different from that contained within our April plans. We note and welcome Ofgem’s commitments to review repex allowances, in light of this new information, before the Final Proposals.
65. We would also draw your attention to the fact that, following completion of the detailed workload for 2007/08 planning this summer, around 90km of work previously included within

East of England network in relation to the 'Outer Met' area has now transferred to the London network.

Capex

66. With respect to capex, significant developments have occurred since the April submission which will impact on the level of expenditure required for 2007/08, as outlined below.
67. The April submission included the Harefield to Southall LTS pipeline reinforcement project, the design and build of 18km of 48" pipeline in order to secure supply to 350,000 firm consumers in West London. Detailed design, siteworks and procurement events have revealed increased costs, including changes to the route of the pipeline, orientation, length and depth of many of the crossings of roads, railways and watercourses. Reviews of the ongoing design and project alternatives have confirmed that the scheme remains the most efficient solution. In addition, three key IS projects also require revised costing and / or phasing since the extension year submission, including those driven by the delayed implementation of the Traffic Management Act.
68. We are confident that our plans represent a solid P50 submission, with sufficient stretch and challenge included therein. We note that Ofgem would prefer to apply the agreed incentive methodology for the main review to the outcome of the extension year. National Grid will seek further clarity as to whether the expectation for 2007/08 is one of managing outputs within a pre-agreed allowance or delivering to a pre-set list of outputs with the revenue flexing accordingly.

Question 5: Is our proposed update of the mains replacement incentive mechanism for 2007-08 appropriate?

69. Whilst we are disappointed that Ofgem have not taken the opportunity to expand the coverage of the incentive mechanism to include larger diameter mains, we acknowledge that the proposed approach to update the mains replacement incentive mechanism is both pragmatic and appropriate given the timescales for the extension year review.
70. We are however very concerned with the application of the proposed abandon to lay ratios and the subsequent impact on the MRIM as described in our response to the previous question.

4. Financial issues including overall impact of Initial Proposals

Question 1: Do you agree with our proposed approach to calculating the cost of capital to apply for 2007-08?

71. We do not agree with Ofgem's proposals for calculating the cost of capital for the extension year. We contend that Ofgem are selectively choosing to update elements of the cost of capital calculation and therefore not undertaking either a simple roll forward of the current assumptions or a full review.
72. Ofgem argue that a simple roll forward has been conducted whilst taking into account regulatory precedent and accounting for the past 'significant benefit' afforded to GDNs as a result of pre tax treatment. The loss of the tax treatment is deemed to have been offset by the additional allowances made for shrinkage and pensions. We strongly disagree with both these points, as discussed below.

Removal of the pre tax treatment

73. Ofgem has failed to recognise in the Initial Proposals that the pre tax treatment was an intrinsic part of the 2002, settlement, and one which made the overall outcome just acceptable, as noted in the 'Letter of Comfort' between the then Chairman of GEMA and Lattice (in October 2001). Removing the pre tax treatment in isolation significantly shifts the balance of the original settlement, and hence the balance of the one year settlement further away from shareholders. Indeed, the move to post tax arguably gives to consumers, for a second time, benefits which Ofgem captured at the last review by setting exceptionally tough opex, capex and repex allowances.

Offsetting additional pensions and shrinkage allowances

74. Ofgem argue that they maintain a degree of balance in the Initial Proposals because a move to post tax is offset by specific increases in allowances for shrinkage and pensions. We believe this is somewhat misleading. The recovery of pensions revenue was effectively guaranteed by the 'Letter of Comfort' at the time of the last review, and so is not an example of increased allowances, but delayed funding of the previous period's efficient costs. This leaves shrinkage as the only example of additional allowances, and this simply corrects for the adverse movement in the external market, effectively putting GDNs back to where they started. The additional monies allowed for shrinkage equate to around £25m (based on last winter's gas prices) for National Grid's networks, given the environment of falling gas forwards prices, whilst the loss of beneficial tax treatment equates to a concrete £60m.

75. We believe that Ofgem should, at the very least, consider the use of a glide path to minimise the impact of the loss of post tax. For example, respecting the regulatory treatment of repex in the tax calculation.

Question 2: Do you agree with our proposed approach to the treatment of tax?

76. The proposal to adjust the tax allowances should actual gearing levels exceed the notional level assumed within Ofgem's calculations seems sensible. The proposals will also need to reflect any potential variations to the methodologies underpinning the calculation of our tax bill.

Question 3: Do our Initial Proposals, taken in aggregate, represent a reasonable outcome that both protects the interests of consumers and ensures that GDNs are able to finance their activities during 2007-08?

77. The proposals as presented in the document represent a significant erosion in terms of the balance of the original 2002 settlement. We do not believe that they represent a positive or even a neutral outcome for GDNs for the reasons covered in the previous questions, but including;

- Disallowance of efficient investment spend
- Repex underfunding in 2007/08, i.e. 1:1.1 abandonment to lay ratio
- Post tax treatment in relation to the cost of capital

78. We note that Ofgem do not believe that financeability is an issue for 2007/8, and this is something we dispute. We believe that a sustainable financial position would see the GDNs meeting the financeability tests in each year. Whilst Ofgem rely solely on Moody's ratings (which do not include expensed repex), consideration of other rating agency tests show GDNs failing some of the key financeability tests and are not consistent with the current regulatory benchmark of a single A rating.

79. Ofgem have argued that, since revenues are not changing significantly, financeability should not be an issue. This is clearly contrary to the results of Ofgem's own modelling, indicating that either the model, or the conclusion, is inconsistent with the evidence.

80. Whilst the income in 2007/08 is forecast to be higher than 2006/07, the increase is 7%, not the stated 11% in the Initial Proposals. The difference, we believe, arises from the use of allowed pass through costs rather than actual pass through costs.

5. Timetable and process

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

81. The high level Licence drafting changes proposed in Appendix 10 are, in our opinion, those that are relevant to the one year control. In changing Special Condition E2B, we would also highlight the need to change the dates within clause 11 “Disapplication of the Distribution Network transportation activity revenue restriction” to reflect the additional one year control.
82. We note that Ofgem are taking this opportunity to conduct a number of house keeping changes to the Licence and would suggest that Ofgem may also like to consider the deletion of Part 1a and Part 2 which became redundant following the separation of the Transmission and Distribution Licences.