

AW/DM/043

23 October 2006

Joanna Whittington
Gas Distribution Director
Ofgem
9 Millbank
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Dear Joanna

Re: Gas Distribution Price Control One Year Initial Proposals

I have pleasure in providing NGN's response to the Initial Proposals. The key points from our response where we do not accept the Initial Proposals are as follows:

- Ofgem has stated that it proposes "to roll forward the cost of capital unchanged" but the proposals represent a substantial reduction in allowed return. Applying a post-tax methodology and using "pro forma" modelling results in zero tax allowance and a reduction in total returns on RAV by an unprecedented 16% – from 6.25% to 5.25%. The resultant pro forma PMICR is just 1.2x which implies an investment downgrade, is below the requirements of our lenders and suggests to the financial community that the company is not financeable. It is inappropriate to use pro forma modelling to set a zero tax allowance and then to ignore the output when it concludes that the company is not financeable. NGN will be paying about £10m tax in 2007/08 and either this should be allowed in full through a tax allowance of £14m or the vanilla WACC should be increased to provide a return commensurate with the current allowed return and to ensure financeability. An alternative is that Ofgem's regulatory pro forma modelling should use the regulatory treatment of repex and capitalise 50%. The details are set out in our response to Chapter four, question 2.
- NGN accepts the broad principles used for assessing overspends in the current price review period but we do not agree with the detailed application of these principles in a number of instances. In summary, NGN believes that no more than £3.6m should be allocated to pot 1 and £11.4m to pot 2.
- Operating costs for the one year control should be based on 2006/07 allowances. Using actual costs rewards inefficient companies and does not provide regulatory incentives for efficiency.

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The overall result of the Initial Proposals is extremely disappointing to NGN as it rightly provides an increase in shrinkage and pensions allowances to match the actual expected costs (but with minimal opportunity for outperformance) but it then takes this away through a reduction in WACC due to the move from pre to post tax which reduces revenues by £13m.

Following our meeting to discuss Initial Proposals and after your consideration of the concerns raised in this letter we look forward to receiving a more acceptable Final Proposals. We will be happy to clarify any issues in this response in more detail when we meet on 7 November. Please note that the body of this response can be regarded as non-confidential but that we attach a confidential appendix.

Yours sincerely

A handwritten signature in black ink that reads "Alex Wiseman". The signature is written in a cursive style with a long, sweeping tail on the final letter.

Alex Wiseman
Regulation Director

Gas Distribution Price Control July 2006 Second Consultation Document

CHAPTER: Two

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

Ofgem has proposed two options for setting controllable opex excluding shrinkage and pensions:

- Rolling forward the 2006/07 allowance with a 2.5% reduction; or
- Taking the average of 2004/05 and 2005/06 actual costs with a 2.5% reduction.

Ofgem notes that most respondents favour rolling forward allowances but Ofgem has chosen the latter methodology. NGN strongly believes that the former option is the most appropriate for a number of reasons:

- The whole basis of incentive regulation is to reward efficient companies. The chosen option rewards inefficient companies by enabling them to continue to maintain a level of inefficient costs.
- The methodology favours companies that may have expensed some transition costs or expensed capital items.
- It does not take account of the fact that sold networks were still recruiting and gearing up operations from June 2005 to March 2006 and hence underestimates expected costs in 2007/08.
- The sold networks were purchased on the basis of published allowances and hence it is reasonable that allowances should be used to set 2007/08 controllable opex in the absence of any direct comparative data.

In summary, NGN can see little basis for using actual costs compared to rolling forward allowances as the latter rewards efficient companies.

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

Ofgem's approach is consistent with DPCR4 and NGN welcomes the resolution of the pensions issues in the one year control. NGN believes that the approach is appropriate.

Question 3: Is Ofgem's assessment of the costs and benefits associated with the three options for setting shrinkage allowances reasonable?

The assessment of the costs and benefits of the three options considered provides a sound basis for evaluating alternatives for addressing the issues raised by the risks imposed by purchasing shrinkage gas.

However, NGN favours option 2 for the five year review and we would expect that this option will be included in an impact assessment for that review.

Question 4: Do you support Ofgem's proposed approach to setting shrinkage allowances?

NGN supports Ofgem's proposal "to base shrinkage allowances on a pre-determined index of market prices, in effect removing gas price risk from companies". Ideally, all throughput related volume risk should be removed from GDNs as it is not controllable.

For the one year price control option 1a provides the most appropriate means for GDNs to hedge exposure to gas price risk.

Option 1b is not an appropriate solution as not all GDNs will have equal access to the market and there will be genuine differences in their ability to achieve similar prices to each other. Option 1b provides a strong incentive for risk taking in the GDNs' gas purchasing strategy. A prudent, structured, longer term risk management strategy for purchasing shrinkage gas may not produce an overall cost as low as more risky spot purchasing strategy. However the mechanism may reward excessive risk taking versus prudent risk management.

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

The index adopted should be independent, published and widely recognised (e.g. Heren or Platts). NGN notes Ofgem's proposed licence drafting for shrinkage (circulated to GDNs) but believes that this does not use a "pre-determined index of market prices" and for a number of reasons GDNs would be unable to hedge based on these proposals to remove gas price risk.

GDNs should have the ability to fully hedge shrinkage gas before the start of the formula year. Ex-ante forward prices should be used. Any ex post measure of prices is not achievable, particularly when trading small volumes. NGN suggests the following process for using a market index.

Prices in February 2007 could be used as the benchmark. In February, the monthly forward price for each month April 2007 to March 2008 is used as the index for that month. The allowed revenue for any month would be this forward price in February times the allowed shrinkage factor times the actual (ex-post) throughput. To avoid market makers increasing prices on any particular day, the monthly forward prices should be averaged across each working day in February.

Quarterly forward prices are inappropriate to use as indices as volumes required change substantively across quarters and it will be impossible to hedge for actual volumes. For example, from April to June volumes are decreasing but the higher volumes in April will have to be purchased at a higher price. A quarterly index will assume an average volume across the period. If such a contract was purchased, a GDN would have to "top up" with expensive gas at the start of the quarter and sell back when prices are likely to be lower at the end of the quarter. Thus a GDN could not achieve the index.

Note that even fully hedging a monthly index will not be achievable in practice as:

- Projected volumes vary within months, particularly in autumn and spring, and prices are higher when volumes are higher.

- Similarly, it will not be possible to hedge against colder than expected weather in the winter when volumes will be higher than forecast and prices could rise substantially as was experienced in November 2005 and March 2006.
- Singleton GDNs with relatively low volumes to purchase will be unable to directly match an index.

In consequence there needs to be an additional allowance for:

- The unhedgeable monthly variance mentioned above.
- The additional volumes above projections required when winter weather is colder than expected and prices increase substantially (as experienced for example in November 2005 and March 2006).
- The cost of purchasing shrinkage gas.

Based on NGN's experience for 2005/6 the additional cost is about 5% of the cost of shrinkage suggesting a multiplicative factor of around 1.05x is applied to the monthly indices ensure that the allowance is adequate and achievable. We will be happy to share our analysis with Ofgem.

It should also be noted that there are economies of scale when purchasing gas and that single DNs and those without gas shippers within their group will be disadvantaged.

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

For the reasons provided under question 4 as not all GDNs will have equal access to the market and there will be genuine differences in their ability to achieve similar prices to each other if 1b is adopted then the average GDN is more appropriate than lowest cost GDN; nevertheless this would still put NGN at a disadvantage.

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

All throughput related shrinkage volume risk should be removed from GDNs as it is outside their control.

CHAPTER: Three

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

NGN does not agree that £13m (Pot 1/2a plus related party margin and connection charge under-recovery) of wasteful and unnecessary expenditure has been incurred in the current price control period.

A detailed response to items disallowed is provided in the confidential appendix to this letter where we state the reasons why we consider the level of expenditure incurred was efficient.

NGN is also concerned that there is asymmetry in Ofgem's treatment of inefficiencies in Pot 1 & 2a and efficient underspend being in Pot 2c. There is no opportunity to offset the effects of overspent projects (which are invariably those concentrated upon by efficiency consultants) with those delivered at below efficient average costs which are always removed from the RAV after 5 years. Symmetrical treatment would allow such offsetting thereby incentivising "super efficiency" (i.e. below efficient average cost).

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 re-opener?

We consider the elements identified in response to the previous question as additional efficient overspend.

In terms of expenditure allocated to pot 2 NGN accepts that elements of this expenditure should have been forecasted at the last price review (e.g. connections unit costs) and therefore accepts the symmetrical treatment of such spend. However, at the time the price control allowances were set in 2000 there was significant uncertainty surrounding the requirements to replace services as part of the mains replacement programme. We also understand that adjustments were made to NGG forecasts. Therefore the levels of service replacement were not foreseeable and it is inappropriate to use hindsight to judge otherwise.

In total we accept that £11.4m is applicable for pot 2 but the £27.7m attributable to repx services expenditure should be treated as pot 3.

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

It is difficult for NGN to comment on expenditure incurred during this period as the network was operated as separate LDZs with a unified price control. However, the adjustments applied seem reasonable.

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

NGN broadly agrees with the methodology used to set capex and repx allowances. However it should be noted that the cost pressures on the business such as projections of contractor cost increases of 4% per year and material cost increases of 2% per year will make it extremely challenging to achieve the unit costs reported for

2004/05 and 2005/06. We have some detailed comments in the attached appendix on the use of regional factors within the repex calculation.

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

The methodology to update the matrix is appropriate.

CHAPTER: Four

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

NGN agrees with the broad strategy “to roll forward the cost of capital unchanged”. NGN also accepts the use of a post-tax methodology with an allowance for the expected tax incurred.

Question 2: Do you agree with our proposed approach to calculating the cost of tax

The proposed approach to calculating the cost of tax is unacceptable. The impact that occurs from moving from a pre-tax to a post-tax cost of capital is a substantive 16% cut in the return allowed (from 6.25% to 5.25%) due to the zero tax allowance. Such a decrease is unprecedented between reviews and particularly when the one year review is denoted as a “roll forwards”. Investors have funded existing assets on the basis of overall returns of 6.25%. Initial Proposals justify this reduction in returns as an offset against increases in shrinkage and pensions. However this is not the case as the adjustments in shrinkage and pensions just restore the status quo with no opportunity for outperformance to offset the 16% reduction in returns.

NGN forecasts a tax bill of approximately £10m (outturn prices) in 2007/08 and either this should be funded (via a grossed-up tax allowance of £14m) or the vanilla WACC should be increased to provide adequate returns.

The relatively low statutory tax bill for NGN as a percentage of allowed rate of return arises from the tax treatment of repex which is allowed 100% against revenue. If Ofgem is using pro forma modelling then it should use the regulatory treatment for repex and capitalise 50% for tax purposes. Consequently, the pro forma regulatory treatment of repex should be to capitalise 50% for tax purposes in Ofgem’s modelling. This would provide NGN with a taxable deduction of approximately 50% of £70m repex, ie a tax allowance of £10m.

The table below shows tax for 2007/08 in nominal prices. Column A is Ofgem’s pro forma modelling, column B is NGN’s proposal of adjusting Ofgem’s pro forma modelling using the regulatory treatment of repex and column C is NGN’s expected 2007/08 tax bill based on the April BPQ submission.

	A Ofgem Pro-forma	B NGN Proposed	C April BPQ
	£m	£m	£m
Profit after interest before tax	(27.7)	(27.7)	16.0
Add: 50% capitalised repex	0.0	36.4	0.0
	<u>(27.7)</u>	<u>8.7</u>	<u>16.0</u>
<i>Add</i> Accounting depreciation	48.0	48.0	34.0
<i>Add</i> Goodwill amortisation	3.9	3.9	3.9
<i>Less</i> Capital allowances	(23.1)	(23.1)	(23.1)
<i>Add:</i> Other disallowables			4.0
Pension deficit funding contributions	(3.5)	(3.5)	
<i>Less</i> Capitalised pension contributions	(1.3)	(1.3)	
Profit subject to current tax	<u>(3.7)</u>	<u>32.7</u>	<u>34.8</u>
Corporation tax charge @ 30%	<u>0.0</u>	<u>9.8</u>	<u>10.4</u>

Using Ofgem's pro forma approach if applied consistently, that is using the regulatory treatment of repex, NGN would expect to recoup tax of £9.8m. This tax recovery would be broadly in line with the actual forecast tax of £10.4m. A recovery of £9.8m tax would require an increase in allowable revenue in the form of a (grossed up) tax allowance of £14m.

The 100% tax relief for repex is comparable to the 100% non-load relief available for DNOs prior to April 2005. The change in tax treatment was accommodated in the regulatory review such that financeability was maintained for DNOs whereas the move to post-tax has produced a substantial one year decrease in tax allowance for NGN.

Ofgem's pro forma modelling concludes that the allowance provided would result in NGN not being financeable as it results in a PMICR of 1.2x for 2007/08. NGN's lenders require returns of 1.4x which is an increase in revenue of approximately £12m from that allowed in Initial Proposals. Furthermore, a PMICR of 1.2x would be likely to result in a downgrading of NGN's credit ratings of Baa1/BBB+. Additionally, there needs to be a buffer to allow for exogenous non-controllable cost shocks. It is inappropriate to provide an allowance that results in non-financeability as this will send the wrong messages to providers of finance.

In summary, NGN does not agree with the approach to calculating cost of capital and tax. Either the full forecast tax bill should be funded or the vanilla WACC increased sufficiently to cover the tax liability. A consistent approach would be for the modelling to assume the regulatory treatment of repex. It is inappropriate and inconsistent to use the pro forma modelling to justify a zero tax allowance when NGN's projection is a tax payment of £10m, but then ignore the pro forma modelling when it implies that the GDN is not financeable and revert to statutory rather than regulatory pro forma modelling for specific items (repex).

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

NGN's main concerns with these proposals, which mean that taken in aggregate they do not represent a reasonable outcome, are the impact on the ability of NGN to earn its allowed cost of capital and finance its functions due to:

- The substantive reduction in the total allowed cost of capital from 6.25% to 5.25% with zero allowance for expected tax of £10m is not acceptable. It results in Ofgem's own pro-forma modelling suggesting that the company will have a challenge to finance its functions as a PMICR of 1.2x suggests a credit rating of, at best, BBB, which is not acceptable to our lenders and shareholders and provides no scope to cater for any cost shocks that may impact the business.
- The disallowance of 43% of the value of NGN's overspend which is inappropriate for the reasons highlighted above. It appears inequitable and against the principles of incentive regulation that the company that has contained capex and hence achieved the smallest overspend should be penalised by the greatest percentage.

CHAPTER: Five

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

The drafting changes are appropriate at a high level. There may additionally be some terms that should be deleted for the one year review, for example the volume driver of revenue.

The detailed drafting will be critical, particularly for shrinkage and we have highlighted some specific issues that should be addressed in our response to chapter two, question 5. We have substantive concerns on the detailed shrinkage licence drafting circulated to GDNs and NGN will actively contribute to the further development of the licence drafting.