

**Gas Distribution Price Control Review**  
**One Year Control Initial Proposals**

**Response from Wales & West Utilities**

**CHAPTER 2 – OPERATING EXPENDITURE**

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

The approach for determining Opex allowances for 2007/8 is not appropriate. The resulting allowances are not appropriate.

The initial and second Ofgem consultation documents set out two options for a simple approach to setting allowances for 2007/8. In our response to the second consultation paper we stated "Our view has always been to support the concept of the extension year, namely to roll forward opex controls on as simple a basis as possible, and deal with the capex overspend." We retain that view. In addition, the proposal to set allowances on Option 2 penalizes those companies, such as ourselves, who have striven to reduce costs. Far from penalizing those companies Ofgem should seek to reward efficient behaviour by recognising the efforts made against the known 2006/7 Ofgem opex allowances.

We therefore continue to believe that opex allowances for 2007/8 should be set on the basis of rolled forward 2006/7 allowances, that is Option 1.

**Opex Roller**

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

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

**Shrinkage**

As the Ofgem Initial proposals recognise, gas purchase costs in respect of shrinkage are not within the control of a GDN. Given the material loss incurred in carrying out this obligation, we remain of the view that it would be entirely appropriate in this exceptional case to provide allowances to recover the losses of £20.1m unavoidably

incurred in the period up to March 2007. £20.1m is a material impact and disallowing recovery of this legitimate expenditure is inconsistent with the low risk profile of a GDN and the current cost of capital. Had it not been for the timing of the price control review such expenditure would have resulted in a disapplication submission.

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

We agree that the allowance for the defined benefit scheme should be equal to the contribution rates agreed between the pension trustees and the Company following finalisation of the 31 March 2006 actuarial pension valuation. This allowance should cover the employer cost of:

- Future service under the defined benefit and defined contribution sections of the Wales & West Utilities pension scheme
- Shortfall contributions to deal with the funding deficit over a period acceptable to the Pensions Regulator, which we assume will be a maximum of 10 years
- Administration costs
- Pension Protection Fund levy

In this context, since the submission of the April BPQs we have received an updated actuarial valuation for our pension scheme. This recommends higher contributions than previously estimated and the cost allowances included in the Initial Proposals. We have written to you separately on this matter. Price control proposals will also need to take into account contributions in respect of the defined Contribution Scheme.

We also agree with the proposal that an allowance will be made for changes in pension contribution resulting from changes in assumptions since the original price control was set. Pension scheme valuations are required every three years, compared with a five year regulatory price control cycle. We would therefore prefer the allowance to be spread over the three year period to the next actuarial valuation, enabling a re-set of allowance, if required, in 2009 following finalisation of the next triennial actuarial valuation.

Treatment of costs related to former employees of GDNs prior to sale as a pass through is appropriate.

**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?**

We agree with the conclusion. We agree that GDNs should only have responsibility for shrinkage volume percentages, as we cannot control throughput volumes.

The consultation paper says that adopting Option 1a or 1b would be likely to reduce the returns required by investors relative to the "do minimum" option. This is true only in context, in other words if it is first accepted that the gas price volatility experienced in 2004-5 to date is inconsistent with the equity return currently provided to shareholders in a GDN. Our present level of risk, and particularly the downside on returns that we have experienced, does not match up to the low risk cost of capital

previously assumed. If this situation is not remedied, in other words without adoption of Option 1a or 1b, a significant increase in equity return would be required.

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

We support Option 1a, provided the market index used to set the allowance is one at which a GDN can contract, and therefore effectively reduce its gas price risk.

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

Our analysis indicates that Heren Day Ahead has been the lowest price index in the past. Any index chosen, however, should be adopted for the whole of the price control period.

**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?**

We do not consider that Option 1b is appropriate.

There are many reasons why a GDN may purchase gas efficiently, but where the price paid is not equal to the lowest price paid by any GDN in a specific period. These include:-

- market share;
- ability to purchase from related parties;
- hedging strategy and shareholder's appetite to risk;
- view of short, medium and long term market fundamentals.

A benchmark set using lowest cost GDN could penalise a GDN which made a different assessment of the market, but purchased reasonably. These differences would be expected to reduce over a number of gas years. Consequently, if Option 1b is selected, which is not our preferred option, the benchmark should be set at average purchase price over the whole period of the price control review.

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

We agree that shrinkage gas volumes in proportion to the total volume throughput is to some extent within the control of the GDN, whereas total throughput itself is not. Volume is driven predominately by weather and wholesale gas prices over which the GDNs have no control. Therefore throughput related shrinkage volume risk should be removed.

**Other Comments**

Paragraph 2.8: The paragraph refers to an allowance for pass through. In theory an allowance is not adjusted further, whereas the concept of pass through is that there

is a subsequent reconciliation to the costs actually incurred. We assume that such a process will apply to the pass through costs for 2007/08.

Paragraph 2.9: The potential costs of water ingress in the present control were covered by insurance. If there is to be no change, it is important that any associated insurance costs that we incur is accepted as part of our cost base.

### **CHAPTER 3 – CAPITAL & REPLACEMENT EXPENDITURE**

Before responding to the specific questions raised in Chapter 3, we think it important to set those responses in context. We have put forward a number of concerns over the present approach, both in letters to Ofgem and in response to previous consultations. The concerns over the current proposals are as follows:

- there has been insufficient consultation on the impact of the proposals;
- notwithstanding Ofgem statements that any regulatory settlement has to be seen in the round, they are an explicit reopening of only certain elements of the previous settlement;
- they do not show the symmetry of upside and downside risk claimed;
- they impose a significant penalty on expenditure in excess of that previously forecast;
- they require an accuracy in forecasting that was not apparent at the time that the forecasts were agreed;
- At the time of the last price control review, Ofgem reduced the original forecasts yet GDNs who spent to the original forecasts are now being penalised through the application of the Pot 2 methodology;
- they discourage us in future from meeting customer needs;
- they add to regulatory risk by imposing requirements *ex post* rather than *ex ante*.

#### ***Insufficient Consultation***

We consider that the policy on the treatment of overspends has not received sufficient consultation. Our reasoning is as follows;

- we think that the first substantive policy discussions on such issues were in the Initial Conclusions paper in June 2003, part of the series in Developing Network Monopoly Price Controls. Most of the relevant proposals in that paper were in terms of dealing with underspend, and whilst a number of options for dealing with capex variances were discussed (pages 34-36), no conclusion was actually offered;
- Ofgem sought to clarify the position on the treatment of overspends in an Open Letter in March 2004. That letter states that the approach to be adopted for GDNs is to be based on the principles set out in the December 2003 consultation paper on electricity distribution price controls. Again that paper tends to focus on capex underspend rather than overspend - with paragraph 3.77 noting that historically underspend has occurred and 'the treatment of overspend has not been an issue'. It then goes on to say that some DNOs have argued for greater clarity in this area, discusses options and presents a table of potential improvements without concluding on the policy stance of the Authority;
- it is important to realise that the Open Letter was written at the express request of National Grid to clarify the treatment of overspends, because of the doubt that

existed at the time. The fact that the letter was written confirms that doubt and the need to clarify the position. Furthermore, if the then policy was clear then the letter would specifically have referred to it. We consider the fact that it did not do so to be significant in terms of the industry generally, and the buyers in particular, believing that the letter was making new policy proposals, indeed that was its intent;

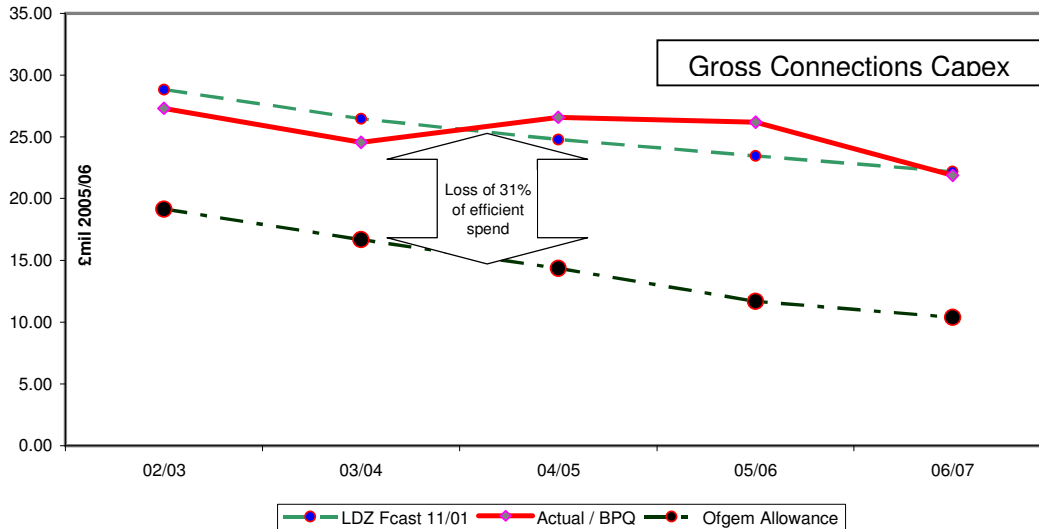
- we consider that the policy proposals in the Open Letter in relation to overspend were new, even though they were set in the context of previous capex policy proposals. In particular, whilst the letter does mention symmetrical treatment of over and under spend, it does not state that this is a capex roller or that the presumption is that overspend will go into Pot 2 unless 'exceptional', a word subsequently used by Ofgem to describe Pot 3 allocations in relation to overspends. Classifying Pot 3 expenditure as exceptional is a new proposal and not consistent with the definitions used in the Open Letter.

We accept that it is necessary to establish a methodology for the treatment of overspend. We consider however that there are many detailed points, that have implications for value, that have not been properly explored.

### ***Reopening 2002/07 Settlement***

The proposals specifically involve reopening very detailed elements of the 2002 price control settlement, without considering the fact that in that settlement, as in all others, the proposals had to be taken as a package. The approach thus ignores the inevitable tradeoffs that Transco had to make at the time. This is especially important as we know that in some areas initial Transco capex forecasts were subsequently scaled back by Ofgem and yet with hindsight those forecasts were more accurate than those on which the settlement was based. This matters because, as in any price control settlement, the company presumably looked at the overall impact, and implicitly accepted that some elements might not be correct but that overall the proposal could be accepted. To look again, more than five years later, at only one set of elements without considering the overall package within which they were only a part, is to ignore the basis of settlement that Ofgem itself always urges upon regulated companies.

The chart below shows the way in which value is affected by this emphasis on forecast accuracy, particularly when the original forecasts were accurate. It looks at capex forecasts for connections, where the original LDZ figures were very close to actuals, but which were significantly scaled back in the settlement and GDNs are now being penalised through the proposed loss of over 30% of the expenditure through the application of the Pot 2 methodology:



**Lack of Symmetry**

Ofgem state that the proposals are symmetrical, in that there is a balance between upside and downside risks. This is correct in theory, in that we receive income for investments not made, for a short period of time, and this is supposed to balance the discount that is placed on investments made in excess of forecasts. In practice, however, the volume of overspend is such that this symmetry is certainly not apparent in the present review – we lose far more than we gain. The only other source of symmetry would be if we underspend significantly in the next control period, which is highly unlikely given the requirement to invest in the network and the attention now being paid to capex forecasts. In any event, the regulator points out in virtually every consultation paper that it cannot fetter its discretion, so there is no guarantee that the Pots methodology will survive in 2013.

The emphasis on symmetry has to be seen in the context of previous capex spend profiles as compared to allowances. Until DPCR4 the trend in both gas and electricity distribution had been to underspend. For example, the February 2001 consultation paper Review of Transco's Price Control from 2002, noted this in relation to gas (for example paragraph 6.44 and 6.47). Similarly, paragraph 3.37 of the December 2003 document, and the fourth paragraph of the Summary of the subsequent March 2004 Policy Document make the same point in relation to electricity distribution. In our view it is not reasonable that when the balance swings from capex underspend to overspend, Ofgem proposes to change the treatment rules in ways which provide short term benefit for underspend and short term penalties for overspend. The advantages of symmetry most certainly do not apply to us in the present review.

**Penalty Imposition**

The detailed application of the proposed methodology means that for every £1m that is allocated to Pot 2, we eventually receive 69% of the cost to us of making the investment, and are expected to write off the other 31%. This is primarily because, when the investment is incorporated into our RAV, five years worth of return and depreciation are disallowed. This is justified by Ofgem on the basis of a symmetrical treatment, because underspend not made carries an offsetting 31% advantage until it is disallowed, again five years later. As set out above, however, there is no

symmetry based on the actual numbers, and this severe penalty for investment that is both efficient and of benefit to customers is not logical or reasonable.

It is important that this discount is fully clarified. At several points in the Initial Proposals consultation paper, reference is made to the GDNs being exposed to capital charges for a period of five years. That means that we are penalised by 31% of such expenditure being disallowed, even though Ofgem itself classifies it as Efficient Overspend on page 21 of the Initial Proposals consultation paper. Whatever the theoretical discussion of symmetry and the need for accurate forecasting, the imposition of such a discount on expenditure that is of benefit to customers and classified as efficient is irrational and unfair.

### ***Customer Needs***

Virtually all of the overspend arose from meeting customer needs that were not incorporated into the forecasts underlying the 2002/07 settlement. It has been said that customers are paying 69% of the costs of such investment, and that it is somehow reasonable for the companies to pay the remaining 31%, because of theoretical symmetrical benefits that in practice do not arise. We cannot see the logic – if customers benefit, then in any other context it would be reasonable to expect them to pay for the full costs of efficiently incurred investment that produced that benefit.

Furthermore, we do not think that the proposed approach takes proper account of the need to invest in response to statutory and licence requirements, particularly where we have little or no discretion over investment in specific response to customer demand. Given that our discretion is limited, to penalise us for under-forecasting volume five years into the future seems perverse, and certainly a new risk that would not have been taken into account when the controls were agreed.

**Going forward, any application of such a policy would clearly discourage us from investing in excess of agreed forecasts, even if unanticipated need arises, because of the risk of disallowance or penalty.**

### ***Forecast Accuracy***

In the detailed application of the Pot methodology, great reliance is placed on the accuracy of capex forecasts. This has never been made clear previously, and the approach creates significant problems. It is compounded by the assumption, again never made clear or consulted upon, that there is to be no tradeoffs between spend in the same category across years, or between categories in the same year. This requires a degree of accuracy in forecasting that no company can achieve so far in advance. In addition:

- the implicit requirement to forecast accurately for around seven years ahead (taking into account the normal lead times in PCRs), by each sub-category of capex, creates the perverse incentive to over-forecast, to avoid the potential underspend penalty. Whilst we accept that to some extent such an incentive is always present, it is made worse by the penalties for underspending if there is no offset for overspends, because now the perverse incentive will be to over-forecast each sub category, as opposed to the overall figure, which will inevitably increase the total.

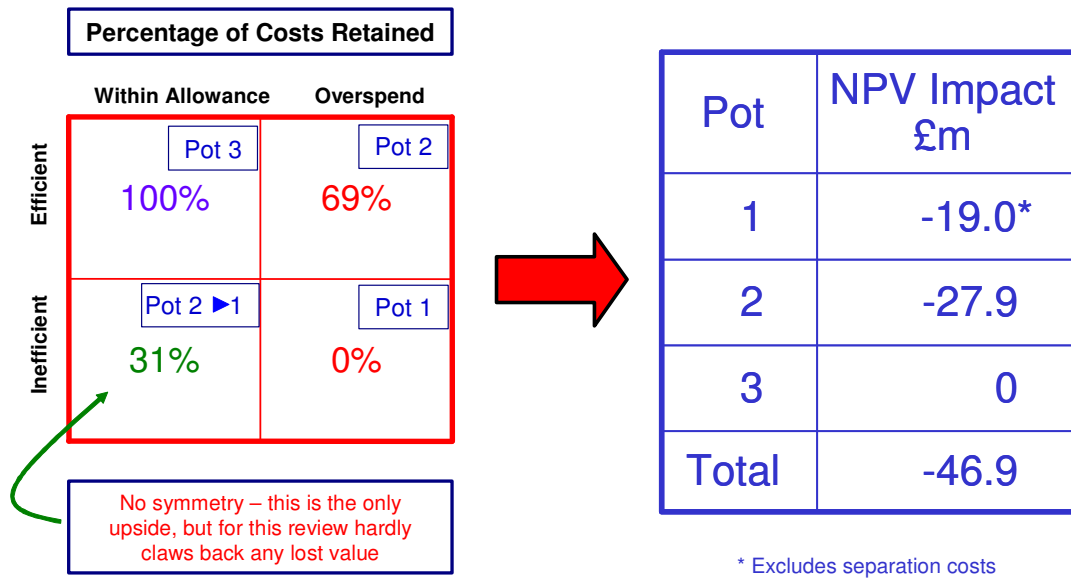
- perfectly sensible decisions to delay or advance projects, often taken because more information is available than at the time that the forecast was made, are discouraged by this requirement;
- the proposal does not appear to be consistent with the statement in paragraph 3.15 of the Developing Monopoly Price Controls consultation paper in May 2003. That paragraph says that deferment can represent an efficient decision. The proposed approach implicitly assumes that all delays are inefficient, because there is no viring between underspends and subsequent overspends. If instead it was assumed that underspends in one or more years are the direct cause of overspends in later years, then viring should be allowed between years;
- when allowances for the period were set, NG operated its gas distribution business as an integrated entity. It therefore would presumably have been managing each line item within its capex allowance over all eight networks as a whole. At a later date to assume, as the proposed approach does, that it should have managed them by network when it had no need or incentive to do that is inconsistent with the arrangements at the time, and assumes that NG should have known both that disaggregation would occur, and that a policy that was not stated at the time would subsequently apply. We do not think that the application of such hindsight is reasonable or consistent with minimising regulatory risk.

### ***Ex Post Risk***

We think it important to consider any proposals in the context of regulatory risk. We accept that the treatment of capex overspend relates back to fundamental questions about what sort of risks we are expected to accept as a monopoly gas transporter. Whilst we are willing to engage in that debate, it appears to us that it should be on the basis of *ex ante* proposals to apply during the next price control review. An *ex post* change to the rules after the controls were set is an example of regulatory risk that could not have been envisaged at the time those controls were accepted, and could not therefore have been taken into account. Had Transco known the importance that it is proposed should be attached to capex volume forecasts and unit costs, for example, it is reasonable to assume that it might have taken a different attitude to the tradeoffs inherent in any settlement. More generally, we think that *ex post* changes should be discouraged, as they inevitably increase perceptions of regulatory risk.

### ***Summary***

The Ofgem proposals impose a significant penalty on us, as the chart below indicates:



We set out below our specific arguments against Pot 1 allocations. Putting those to one side, the proposed approach penalises us by some £28m for investing to meet customer needs. This is neither fair nor reasonable.

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

We do not consider that the proposals are appropriate:

- we continue to be penalised on the Gilwern to Hafodyrnys LTS project, even though we have provided a full explanation as to why the delays and cost increases occurred. Ofgem continue to suggest we did not allow sufficient planning time to construct the pipeline although we have highlighted the fact that the project was identified in both the 1999 and 2000 Wales LDZ Business Plan (copies can be provided if required) for construction in 2003. This is four years before construction which is consistent with industry lead times for this type of work. The 2000 Demand Statements showed significant growth above the levels previously indicated. The reason for these increases was potentially high investment returns for gas fired power stations, incentives to cut harmful emissions and the addition of two large industrial customers; Alpha Steel and Corus. Although no commitment was given to provide gas to these customers every effort was made to facilitate their request and the decision was taken to advance construction. This did not have adverse cost consequences as we had already undertaken a lot of the initial development work. Once the project commenced there were then two principal causes for delay. The first was that the DTI decided to consult on the route, even though this was parallel to an existing pipeline, and in the event that consultation caused substantial delay. The second was the discovery, during site works, of unexploded ordnance which caused further delay. Given this analysis, there are three reasons why we challenge the disallowance. The first is that the advancement of the project did not have cost consequences. The second is that no reasonable person would have been able to forecast such delays, and the third is, even if they had have been forecast, the project would simply have started much later but the total costs would have been much the same as those finally incurred;
- the proposal to penalise an element of our connections expenditure does not appear to have dealt with the objections that we have previously raised, for example regarding timing issues associated with quotations and related party margins. We provide more detail in Appendix 1;
- a significant amount of expenditure has been moved from the Pot 3 allocation recommended by the consultants to Pot 2. The amount involved is £26.9m, which in terms of the discount mentioned earlier produces a loss in value to us of around £8m which we do not think has been properly justified;
- we are still being penalised by the allocation of £5.9m of IT spend to Pot 1, the reasoning now being an erroneous comparison between ourselves and Northern Gas Networks. We provide more information on why the comparison is erroneous in Appendix 2. We think that this is particularly difficult to accept, given that we offered up, and had accepted, £14.1m of separation costs, a figure that is much higher than any other network. It is also unfortunate that the disallowance has remained, even though we challenged, presumably successfully, the first reason given for it, namely that there was an additional cost for being the first network to develop and implement new IT systems. Furthermore, we have recently been told that the primary driver is now that the investment has not been properly justified on cost benefit grounds, although we understand that no other network has been penalised by such a disallowance, which does not appear consistent.

## **Mains Reinforcement, Connections Capex, Service Repex**

### **2003/04 Reinforcement Mains.**

During 03/04 the Network constructed the Swindon AGI to Drakes Way which was an expensive 12" IP Steel Pipeline, which was constructed predominantly in a Street Works area. Normally such work is undertaken in rural areas, often in parallel to existing roadways. The requirement to work in an urban area resulted from societal health and safety considerations that meant that the more normal plastic pipe could not be used in this case. This meant that the project was more expensive than a normal project of this type and this has distorted the unit cost for the year. In addition the general level of >180mm pipe work was proportionally higher than in the other years being reviewed and again has had an uplifting effect on the unit cost. In essence we do not believe that the relatively high unit cost figures was as a result of inefficiency but due to the nature and workload mix at that time.

### **Direct and Contract Labour costs**

Annex 2 of our submission of 7 April is a report by John Spiller Associates into EPC Rates in the WWU area and already provides information in relation to this point. The PB Rune report appears to ignore a number of the detailed points that we made in that Annex, however, when it suggests that the move to fixed rates with defined escalation clauses represents a 10% to 15% increase over open market rates available at the time.

The report assumes that the EPC contracts expired after three years, with an option to extend. In fact the contracts were actually for five years, with an option after three years to reduce the contract term by two years. It is important to understand that they were not three year contracts with an option to extend by two years, and whilst in practice the two forms are similar, some negotiation would have been involved in any early termination at three years.

At the time that the rates were changed, in April 2002, the EPC contracts had only just passed their second anniversary and it would have been a further 9 months before any termination could have been achieved. This would have been a year too late as is explained further.

The serious incident involving fatalities at Larkhall in November 2000 resulted in Transco being prosecuted and a major replacement programme for MPDI mains was introduced across the UK which had to be completed in two years. This was driven by the HSE and was a major challenge for the Gas Industry. As a result, severe skilled labour shortages occurred across the UK. As it takes in excess of six months to recruit and train new skilled labour, some contractors resorted to poaching skilled labour from other contractors in order to meet the immediate increased construction demands of Transco. This put immediate upward pressures on labour rates as contractors competed for available resources.

As a result of these direct pressures on available resources, contractor market rates and costs had been rising through 2001 and this was recognised by Transco. We understand that they did consider an open market tender option but the earliest this could have been introduced would have been April 2003, the contract option review date described above. The rising labour market rates and consequential costs to Transco were exacerbated by the requirements of the repex programme and the resultant cost pressures required immediate action. The introduction of Established

Prices in 2002 provided the necessary stabilisation of prices and passed more of the commercial risks back to the Contractor. It is highly unlikely that a re-tender exercise at this time, as implied in the proposal put forward by the consultants, would have produced reductions in prices and the evidence of skilled labour demands exceeding supply suggests that such an exercise would have enabled contractors to seize an opportunity to increase rates.

In our view, we believe that under the circumstances of a severe shortage of skilled labour and the urgent need to stabilise costs as soon as possible, Transco's action in re-negotiating existing contracts, rather than using an open market tender approach, was the most effective in controlling costs at the time. We therefore consider that the proposal put forward by the consultants, even with the benefit of hindsight, does not recognise actual market forces at the time and would have increased, not decreased, rates. We therefore do not accept the rationale for the reduction in service costs proposed.

**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?**

In our general remarks relating to the approach we gave our reasons for challenging the overall approach. In terms of the specific question:

- we do not consider it appropriate or reasonable for expenditure that Ofgem itself classifies as efficient should be penalised by a 31% discount;

we agree that hurdles for classifying expenditure should be set at an appropriate level. We remain concerned that the differences between Pots 2 and 3 are hard to define, and therefore the rules relating to the hurdles need further consideration. The Open Letter in March 2004 that introduced the Pots concept clearly found it difficult to spell out the distinction, because it defined Pot 3 as of significant benefit to customers, and hence by implication Pot 2 is not of significant benefit. That hardly sits well with our statutory and licence duties, which require us only to undertake investment that is beneficial. Given this difficulty, and the discount associated with Pot 2, we think it unreasonable for the default to be Pot 2, in terms of the hurdles to be applied. Instead, we consider that any efficient expenditure that is of benefit to customers should be allocated to Pot 3, because we think it unreasonable to impose a severe penalty for underforecasting. If the investment is required, and there are a number of important tests that are always applied to justify investments, then surely customers should pay for it. The counter-factual is the circumstances that would apply had the forecasts been correct, in which case customers would, as is reasonable, pay for 100% of any investment. To treat overspends differently solely because of forecasting error is to assume a degree of accuracy that can never apply in the real world. It is even more bizarre to disallow recovery of expenditure when that expenditure was consistent with the GDN forecast and only inconsistent with the allowances reduced by Ofgem in their 2001 final price control document. This explicit offsetting is not appropriate; the increases in allowances are only to meet increased costs that we face, and we have no ability to find savings to offset the reduction in return resulting from the move to a post tax WACC.

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

We agree in principle with these proposals. Again, we do not consider it reasonable that a proportion of this investment is put into Pot 2, given the substantial discounts that apply to such investment when it is allowed into the RAV.

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

We do not consider that the proposed allowance for REPEX is appropriate. Ofgem has proposed an allowance of 0.9, whereas our recent ratio experienced in the field is 0.96 of mains laid to abandoned, which is the support for our forecast. We are predominantly using insertion as the preferred technique to replace those pipes at risk. This is because insertion is the most cost effective method of replacing the mains pipes and at the same time reduces disruption to the public and helps meet our NRSWA requirements. Given this reliance on insertion, driven by cost efficiency and minimum customer disruption, we see no reason why our actual ratio of lay to abandon will not remain at the 0.96 level that we have stated in our BPQ submission.

In respect of Capex, the £6.6m I.T Expenditure in 2007/8 consists of two principle components, £3.5m for GTMS replacement and £3.1m ongoing IT spend. Therefore when comparing our spend against the GDN average it is necessary to assess the £3.1m against the £3.5m figures stated to be the average level of spend for other networks, and consider the GTMS replacement expenditure separately.

**The £1.8m reduction in the allowance for our replacement programme is inappropriate as the work is being undertaken by contract labour at rates that reflect market rates.**

In addition the volume of service relays associated with the mains replacement programme have been reduced from 24,746 in the extension review (a revised figure of 25,096 was provided in the main review) to 23,261 by Ofgem in its proposed allowance for 2007/08. This proposal appears to ignore the 9% increase in our HSE main targets from 332Kms in 2005/06 to 361Kms in 2007/08. The actual outturn figure for relays associated with the mains replacement programme in 2005/06 is 23,065, and increasing that by the same percentage gets to the revised figure for relays given in our main review submission.

In addition, the density of services has also increased in those areas where we are planning to undertake replacement projects. This has the effect of increasing the number of service workload numbers which we have included in our BPQ response.

As with mains above the service work is being undertaken by contract labour at current market rates, through competitive tender. We believe that these costs reflect accurately the current rate for undertaking this activity.

The reduction in volumes on services appears to be based on the reduction applied by Ofgem to the mains laid / abandon ratio. This is inappropriate as there is no correlation between this ratio and the number of services to be replaced. The number of services are fixed for a given project.

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

The replacement incentive mechanism changes from 2006/07 to 2007/08 have been made with no clear explanation being provided in either the Initial Proposals or the PB Rune report. We believe that a full explanation should be provided on the basis for this change, in particular the underpinning analysis should be made available for review and comment by all parties before this is implemented. At present, we are unable to comment further in the absence of this supporting detail. We are currently awaiting a detailed explanation from Ofgem and we will respond fully once we understand the adjustments.

**CHAPTER 4 – FINANCIAL ISSUES**

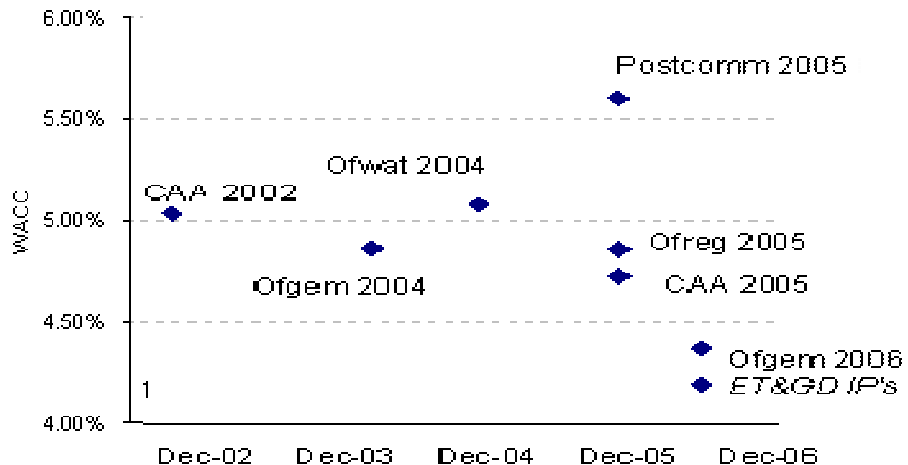
**Question 1: Do you agree with our proposed approach to calculating the cost of capital to apply for 2007-08?**

We consider that the move to a post-tax WACC without consideration of the overall cost of capital has resulted in a fundamental change to that cost of capital which materially affects WWU. We also do not consider that the full implications of such a proposal have been properly explored, nor subject to adequate consultation. In addition, given the material impact of the proposals a full Regulatory Impact Assessment must be undertaken.

The cost of capital which has been applied in the 2007/08 initial proposal is based upon the current GDN price control of 6.25% pre tax, 4.38% post tax and 5.25% on a vanilla basis. This cost of capital was accepted by Transco on the basis that it was to be paid pre tax and with consideration of all other elements of the price control in the round.

Given the same pre-tax cost of capital can result in differing post tax and vanilla outcomes depending on the constituents, it is unreasonable to assume that the pre-tax WACC level of 6.25% was accepted on a post tax or vanilla basis. At the time this cost of capital was accepted, Ofgem would have been aware that Transco's effective tax rate was less than 30% and therefore the implied post tax cost of capital using the actual tax rate paid is higher than the effective calculation assuming 30%.

Further, the GDPCR initial proposal states that 4.38% is "broadly equivalent" to market conditions by comparison to Ofgem's initial proposal for electricity transmission of 4.2%. However, 4.2% is defined as a modelling assumption only which is yet to be accepted by the industry. Aside from the increased risk profile of the GDNs when compared to electricity transmission, analysis that we have carried out to date does not support a level of 4.2% or 4.38% for either industry based upon existing market conditions or regulatory precedent. The following chart illustrates a number of recent regulatory precedents which clearly demonstrate that Ofgem's current initial proposals materially differ from other regulators and even from the DPCR4 outcome only two years ago.



We consider the proposed move to a post-tax WACC is a fundamental change to the cost of capital and one that requires due consideration, an R.I.A. and consultation of the overall cost of capital and its constituent parts. As such, we would expect that for the extension year the cost of capital remain unchanged on the basis it is paid and that the level and impact it has on licensees and consumers be considered as part of the five year review. If instead the intention remains to move to a post tax WACC then that can only properly be done if consideration is given at the same time to the appropriate WACC to be applied, rather than simply assuming roll forward of the present rate.

In the event the overall cost of capital was to be considered as part of the 2007/08 extension year control, we believe that Ofgem's findings in DPCR4 of 4.9% post-tax is the most appropriate agreed regulatory precedent to be considered. Further, we support the independent Oxera submission on behalf of all GDNs in July 2006 which concluded an appropriate range of 4.6-4.8% for the energy network sector generally. We would then expect Ofgem to consider the relative risks of gas distribution compared to other utilities in supporting a cost of capital higher than this level. We do not agree with the TPCR initial proposal modelling assumption of 4.2% and believe that the Smithers findings which support this are flawed in respect of their equity risk premium assessment and in particular, their calculation of Beta. Given the significance of cost of capital on the overall price control outcome, we expect a detailed consultation process to take place in respect of both the move to post-tax and the overall cost of capital as part of the five year review.

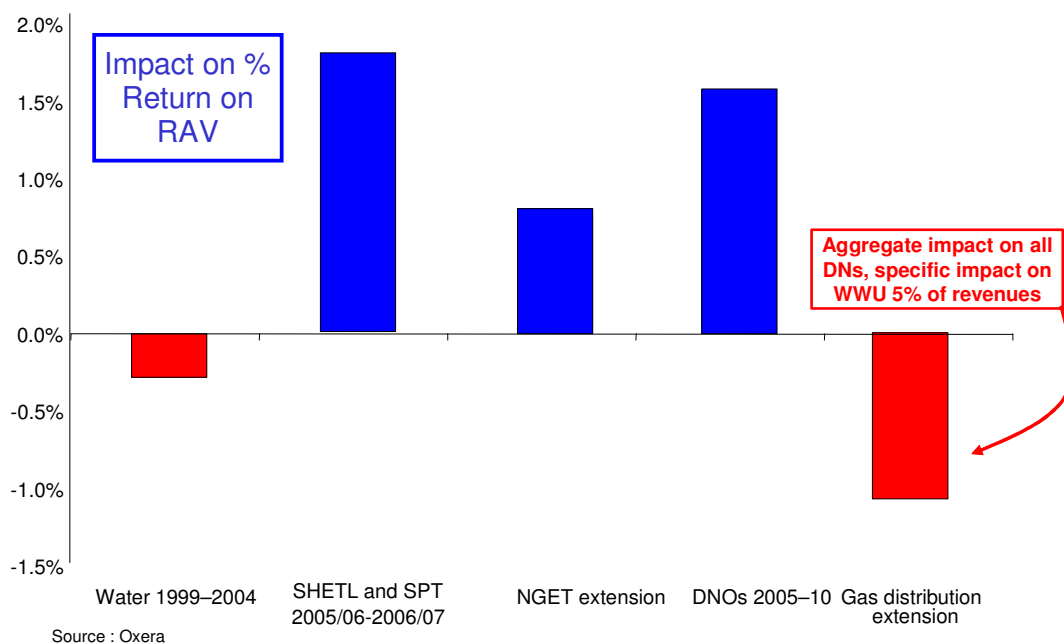
**Question 2: Do you agree with our proposed approach to the treatment of tax?**

Aside from the concerns expressed in response to question one above, we accept that adoption of a post tax cost of capital in the future is consistent with Ofgem's approach to regulating other networks. The issue is to ensure there is an adequate return and at present the cost of capital is inadequate. We have two particular concerns with the present proposals relating to their overall impact and the implications which then arise regarding financeability.

***Overall Impact***

The Initial Proposals recognise the "significant" impact of a move to a post tax cost of capital at the level proposed on the GDNs, but prior to publication of the Initial Proposals and the financial model in September there had been no detailed assessment of that impact. The impact of the introduction of a post-tax cost of capital on the GDNs is an average reduction of 5.1% on total revenues. This equates to an equivalent reduction in controllable operating costs of some 16%. While the introduction of post tax has been accepted by other industries in the past without detailed consideration of the cost of capital, we believe this has only been because the overall impact has been positive. It must also be noted that in the case of SHETL and SPT, the overall cost of capital was increased from 6.5% to 6.9% to align it with the work carried out in respect of DPCR4. The chart below illustrates that the GDNs are the only energy network group that is adversely affected by the move to post tax:

## WWU's response to the GDPCR Initial Proposals



Financial models for Wales & West Utilities reviewed by Ofgem prior to granting a distribution licence assumed a move to post tax cost of capital from the start of the next price control period, and that had always been our assumption. Additionally the rate contained in the model was much higher when moving to a post tax cost of capital. Ofgem were fully aware of this prior to the GDN sales. The proposed move would cost us around £12m in revenues in 2007/08, which is about 5% of our total revenues or 16% of our controllable costs. Such a significant change in the actual cash return on RAV should be part of a full price control determination and is inappropriate for an extension year.

### **Financeability**

Each licensed entity requires a sufficient cost of capital, pre or post tax, to ensure financeability and an appropriate return to debt and equity providers for past and future investment. Whilst you have advised that it is not your intention to conduct a detailed assessment of financeability in the extension review, we believe that the move to a post-tax cost of capital materially impacts financeability and therefore necessarily requires its consideration. We are concerned that the comments regarding financeability in the proposals indicate that insufficient analysis of the impact of the proposals has been carried out.

The impact of the move to a post-tax cost of capital without consideration of the overall cost of capital level raises significant concerns over the financeability of the industry and WWU in the short to medium term. Using Ofgem's own model it can be seen that the Post Maintenance Interest Cover Ratio (PMICR), the primary ratio used by analysts when assessing financeability, falls from 1.29x in 2006/07 to 1.17x in 2007/08. This compares to a minimum investment grade requirement of 1.20x to 1.40x at the assumed gearing levels and a WWU specific lockup level of [ ]. We are concerned that this ratio is inconsistent with a long term investment grade credit rating which is a license requirement.

Aside from being below the generally accepted minimum criteria for investment grade debt, this raises real concerns over WWU's ability to accommodate business shocks and finance its capital expenditure requirements in the short term. These concerns should not be treated lightly given the recent experiences with shrinkage gas costs;

pensions; the failure to recover past shrinkage costs and the disallowance of efficient capital expenditure with over 30% of the cost borne by the GDN and that the actual PMICR calculation is impacted by working capital fluctuations which in this industry are material.

This also raises further medium to longer term considerations which cannot be underestimated. Our discussions with the ratings agencies have indicated that they have applied discretion in respect of the detrimental impact of pensions and shrinkage on covenants since separation on the expectation that these would be resolved in the one year extension. Although the issues of pensions and shrinkage are being addressed, the current proposal on the move to the post-tax cost of capital will mean that there is no marked improvement in ratios in the extension year. As a result the rating agencies may well take the view that this is an indication of the longer term prospects. While ratings agencies expect a future move to a post tax cost of capital, they expect a return which balances risk with equity return and ensures appropriate financeability tests are met. On this basis there is a real risk of a ratings downgrade which has the potential to impact existing debt costs, the cost of any future financing, the overall borrowing restrictions and the ability to refinance any of the existing debt in place.

Financeability is important for customers. PMICR, being a ratio based on cash generated by the business, would be reduced if we incurred unforeseen exceptional costs which initially fall to equity, but would be expected to increase business efficiency in the medium term and consequently be of long term benefit to consumers. We do not believe that consumers benefit in the long term if business operations are restricted due to financeability constraints.

Ofgem's financial modelling indicates a net cash return to equity, based on generic gearing, of 4-4.3% nominal per year. Investors funded historic expenditure on the basis of the then prevailing equity cost of capital (6.25% pre tax real) and it is not appropriate to reduce this. The GDNs are competing for future capital with amongst others, electricity and water and may find it difficult to attract the investment required given the significantly lower proposed cost of capital.

With regard to the detailed proposals, we would expect to consult on these during the five year review, however our key concerns are:

- Use of generic gearing assumptions for calculation of expected tax charge is appropriate, as the final decision regarding funding structure is a matter that should be left to each GDN.
- An *ex post* adjustment for GDNs with a higher gearing or interest cost than assumed is inappropriate for the same reason. An increase in gearing increases pre and post tax risk to equity, [the reward for which should not be clawed back – wording]
- Removal of any benefit deriving to equity investors from past tax planning and structuring is unlikely to incentivise a GDN to future tax efficiency
- It is unclear whether there would be a re-opener if there was a change in tax law, or a change in tax treatment agreed with the Inland Revenue (for example on tax deductability of repex) which resulted in a higher tax cost than allowed.
- Full cash allowances for Pensions should be provided in 2007/8

**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?**

As is apparent from a number of the above responses, we do not consider that the proposals taken in aggregate strikes the right balance between consumer and GDN interests. In particular:

- the move to a post tax WACC takes £12m, or 5%, out of our revenues for next year;
- the statement in paragraph 4.3 of the consultation paper that this impact is offset by the changes relating to shrinkage and pensions is incorrect. In particular, the other changes are to bring revenues into line with cost increases; we do not obtain a cashflow benefit, so there is no offset;
- in addition, we have not been allowed any recovery of previous significant losses amounting to £20m arising from shrinkage gas, the only part of the gas supply chain that has not been able to recover such costs from customers;
- we see a further £28m reduction in value from the proposed methodology for dealing with capex overspends. We have set out numerous concerns with this approach, not least its partial reopening of the previous control, the lack of a clear distinction between Pots 2 and 3 and the *ex post* nature of the proposals;
- we also see a reduction of £19m from disallowed capex, although we have set out a number of specific comments challenging the basis of the proposed disallowances;
- we see further reductions in income from proposals on repex that do not take into account empirical evidence or an increase in laid lengths arising from HSE requirements.
- There are also significant adjustments resulting from changes to the modelling methodology that account for £1.6m being removed from revenues. These are unsignalled and have not previously been the subject of consultation.

Overall this demonstrates to us our concerns that the initial proposals are being tempered by the issue of perception of price increases no matter how justified they might be. Ofgem themselves state in paragraph 4.3 when referring to the cost of capital that "Although the impact will be significant, as highlighted in Figure 4.1 (page 34), it is offset by the specific increases in allowances we are proposing for other items such as shrinkage and pensions."

The overall impact is a serious deterioration in our finances and one that is not consistent with striking a reasonable balance between customer and company interests. It is important to keep in mind that the impact of price controls has meant that gas distributors have been the only part of the gas supply chain not to have been able to increase prices in response to the tripling of wholesale gas prices. Of course price increases are unpopular, but it is important that GDNs are able to recover their costs and receive a fair return on their investments. Instead, the table below shows how one-sided the present proposals are:

	<b>Revenue Impact 2007/08 5 Years</b>		
<b><u>Previous Losses Not Recovered</u></b>			
Shrinkage	(20.1)	(20.1)	
<b>Net Benefit/(Loss)</b>	<b>(20.1)</b>	<b>(20.1)</b>	No relief for past losses
<b><u>Discretionary Policy Changes Having a Negative Influence</u></b>			
Post Tax Model	(11.4)	(67.9)	
RPI Methodology Change	(0.2)	(1.2)	
Modelling Change	(1.6)	(9.2)	
Introduction of Pots Concept	(5.2)	(8.6)	
<b>Net Benefit/(Loss)</b>	<b>(18.4)</b>	<b>(86.9)</b>	No beneficial offset
<b><u>Changes Only Reflecting Increased Costs Incurred by Gas Networks Going Forward</u></b>			
Shrinkage	7.9	39.5	
Pensions	4.8	24.0	
<b>Total</b>	<b>12.7</b>	<b>63.5</b>	Zero cash benefit, all offset by cost increases

In summary, the proposals affect our financeability now and into the future.

## **CHAPTER 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?**

We believe that the proposed licence modifications are in principle correct, although we have some high level comments. In particular:

- under “Setting a Price Control Allowance”, we require confirmation of whether there will need to be any particular drafting to deal with K?
- under the “Exit Capacity Incentive” we believe this drafting should not be included as it is not a price control matter; this should be dealt with separately.

In addition we would propose that Ofgem consider removing SSCD5 Licensee’s procurement and use of system management services. As discussed with Ofgem previously this condition is onerous in terms of the documentation and audits required and this adds little value.

## **Appendix 1**

### **Comments on Connection Disallowance Proposals**

#### **Time Lag Response**

Costs associated with time lag are inevitable and cannot be avoided. In consequence, they are allowed in electricity and water; gas distribution is the only sector where it is proposed to introduce penalties in relation to them.

Accepting that there will always be some time lag issues, the principal concern to be addressed is whether or not they are at an efficient level, not necessarily the same as at a minimum level. We consider that there are three issues to be considered in that regard:

- whether our quotations should be reviewed more regularly, and in effect match up to the reviews of contractor rates;
- whether our quotations should hold firm for a much shorter period of time;
- whether contractor rates should be reviewed more frequently, to check whether or not they are consistent with quotations

Before answering these particular points, it is important to consider the nature of the connections process and its interplay with contract rates. In general, we issue quotations that hold firm for a period of time, and which rely on cost information derived in part from contractor rates. Once accepted, there is usually a further time gap until the works are planned and executed. Even with tight quotation periods and work scheduling arrangements, it is still likely that three months or more can elapse from the issue of a quote until practical completion. Unless quotes were not firm, therefore, there will always be time lag effects, because there is little or no lead time associated with agreements on revised contractor rates. The practical effect of this is that, once rates increase, they will apply to all quotations issued, accepted and where work still has to be undertaken, even though those quotations will have been based on the previous level of rates.

Considering now how costs could be minimised, we could look to increase the frequency of reviews of the rates going into quotations. We are reluctant to do this, because:

- many customers obtain more than one quotation for us for the same works. For example, if more than one supplier is providing a quotation to supply, each has to be given a different quotation. Sometimes the customer changes his or her mind over details of the work, requiring a new quotation for essentially the same work. In these and other cases, increasing the frequency of rate reviews will only increase the risk of two or more quotations for the same work being developed from different rate bases, which will in turn increase the frequency of queries and complaints. The latter will inevitably lead to greater overhead costs to deal with them;
- more generally, rate reviews are not cost free and would by their nature increase overheads;

Another approach would be to hold firm quotations for a shorter period of time. Again there are problems associated with this, including:

- the time lags inherent in providing quotations for the same property to different suppliers means that the risks of different quotations for the same service increase;
- reducing the charging review period to quarterly would mean going against the historic precedent agreed in principle by OFGEM, whereby connections charging would be reviewed bi-annually;
- again overheads would have to increase to deal with the increased volume of work that would arise from both the review process itself and the formal procedures to put the review into effect.

Looking at the problem from a different perspective, we could review contractor rates more frequently. As our recent history has been relentless upward pressure on rates, we are reluctant to do this as we see it only leading to cost increases.

As a regulated company we are well aware of the need to make the cost of gas connections 'reasonable and affordable' for customers, particularly the fuel poor. We consider that the additional costs that would result from quarterly review of EPC rates and reduced quotation lead times would not be to the benefit of gas consumers.

Furthermore, from a regulatory perspective we do not consider it appropriate to apply *ex post* reasoning to an issue that was known at the time of the previous price control review. At that time the issue was not discussed, as far as we know, and therefore it is reasonable to assume that the policy in relation to contractor rates and quotations was acceptable. If Ofgem wishes to change this approach, then it is reasonable to discuss that in the context of quotations going forward, but we do not think that we should be penalised for past performance, as there has been no demonstration that we have inefficiently applied policies that were presumably known to the regulator.

If policy does change going forward, then we will revise our quotations policy and both increase the frequency of rate reviews and reduce the currency of a quotation, and would seek cover for the consequential increases in overhead that would arise.

In respect of customer contributions the Initial Proposals assume a higher contribution from customers. Clearly if this is not recovered from customers there will be a shortfall in capex allowances for 2007/8. We are therefore reviewing the policy as a matter of urgency with a view to ensuring we can recover from customers the contributions contained within the Initial Proposals. This will result in higher charges for customers.

### **Related Party Margins**

The two contracts are not comparable and the 2.9% disallowed value £3.0m should be allowed as efficient expenditure for the following reasons:-

- The Fulcrum Connections contract was set up on the basis of a 5 year agreement with an exclusivity period for the first 3 years. This exclusivity period tied both parties in to the agreement but only for three years. After this period there was no guarantee of work and either party could terminate the contract. As such the

margins associated with this contract represented the risk exposure of the service provider.

- Paragraph 3.56 of Ofgem Initial proposals references 4% margins associated with UUOL and NGN contract. This is significantly different from the Fulcrum contract in that the duration is 8 years which reduces UUOL risk exposure and hence it is not priced in to the contract.
- The UUOL contract also covers new connections mains and replacement mains unlike the Fulcrum contract which was new connections only. The effect of this is to double the workload that UUOL would be undertaking over a 60% longer time frame when compared to Fulcrum contract. On this basis the offer of a contract over a longer period with significantly more work would attract lower margins due to certainty and lower risk.
- Interest rates over the period have reduced and hence the new UUOL contract would reflect the change in market rates. The expectation of profit was greater at the time that the Fulcrum contract was let as was interest rates.

**Appendix 2**

**Comparison of IT Spend between WWU and Northern gas Networks**

<b>Issue</b>	<b>WWU Approach</b>	<b>NGN Approach</b>	<b>Comment</b>
Back Office Systems	No existing systems to exploit, purchase as new	Build on UU existing SAP application	WWU costs significantly higher due to need to develop and implement new SAP system
Back Office Systems	Bring connections in house and develop appropriate systems	Maintain existing contracts, no need for new systems	WWU costs in areas where NGN do not incur costs
Front Office Systems	Design and build new systems, enhance once installed	Design and build new systems, enhance once installed	Some cost comparability, but enhancement plans likely to differ and create different costs
Infrastructure	No existing infrastructure to exploit, purchase as new	Build on existing UU infrastructure	WWU costs significantly higher due to need to develop and implement new infrastructure