

Delivering gas to the North of England



GDPCR Seminar 23 January 2007

Alex Wiseman



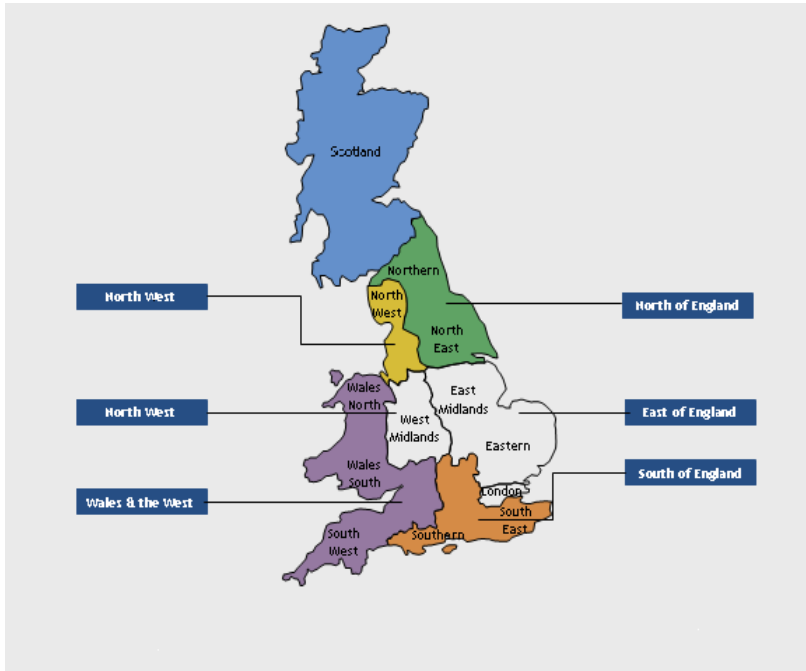


Agenda

- Introduction to Northern Gas Networks' Business Model
- Final proposals for 2007/08 price control
- Five year price control
- Summary

Network Region

DN Regions



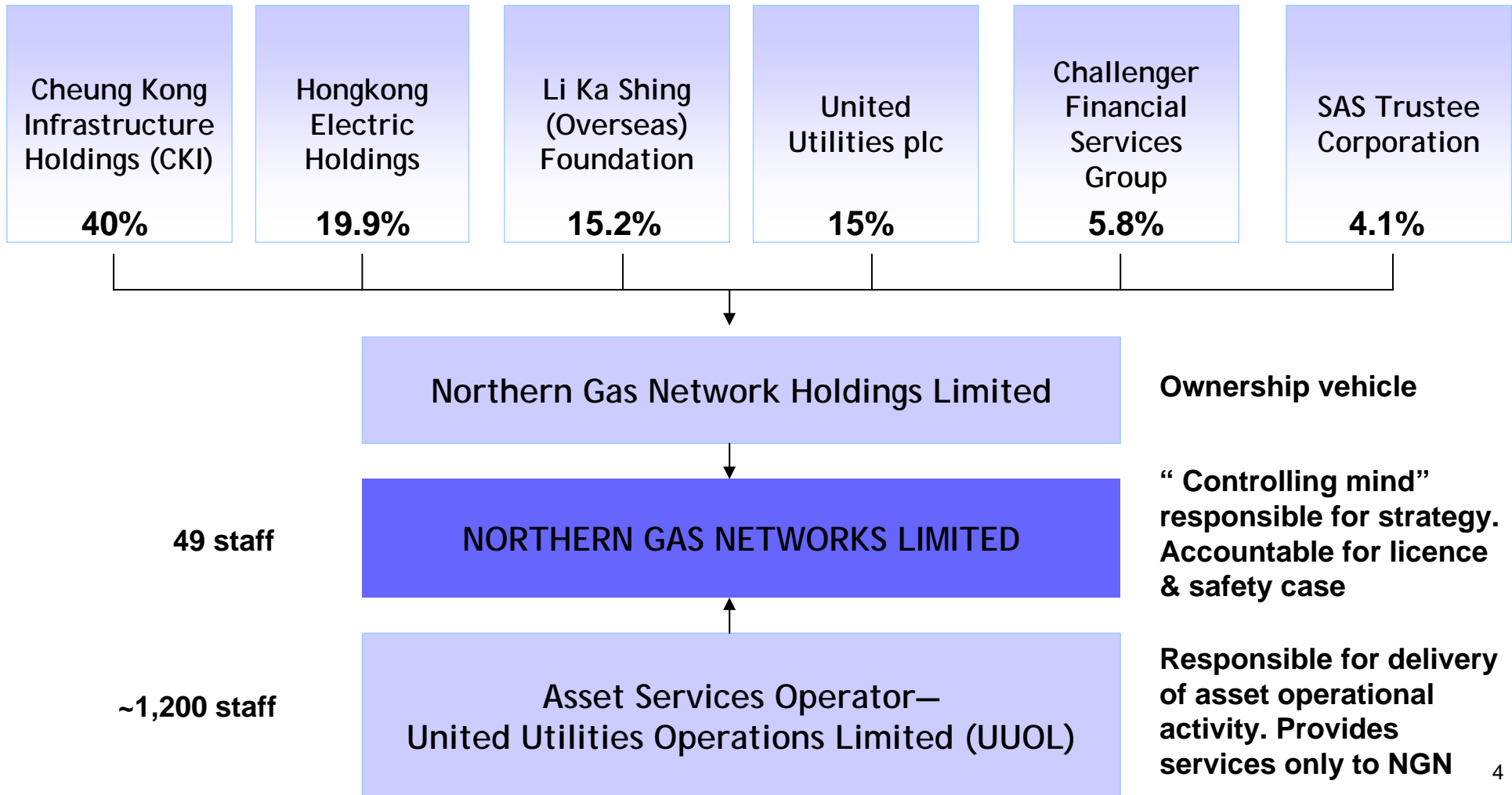
Population	6.7 million
Consumers	2.5 million
Length of Network	36,000 km
Gas Demand 2005	92 TWh

North of England Region



Region has 2 major industrial conurbations, but is largely rural outside these areas

Business Structure





CKI Philosophy

- Long term ownership and long term stewardship of assets
- Looking to widen its experience in owning and managing utility assets into Europe
- Focus is on predictable, low-risk businesses
- Strong emphasis on corporate governance and reputation



Innovative Business Model

- The operation and maintenance of assets have been contracted out with NGN retaining ownership of the assets and full strategic responsibility for asset management including all licence and safety case obligations
- Competitive procurement process used to select service provider. UUOL selected as a service provider on basis of UU's market experience and success in similar utility contracts
- UUOL operates under a contract (the Asset Services Agreement) with NGN
- UUOL is incentivised to deliver a series of KPIs, mostly linked to licence and safety requirements



NGN Business Vision



To be benchmarked by Ofgem and the HSE in the top two comparable utilities in

- Safety Management
- Efficiency
- Customer Service



NGN – achievements to date

- Completion of FOMSA project on time within budget
- Lowest overspend of all GDNs
- Only GDN forecasting lower controllable opex (exc shrinkage and pensions) in 07/08 than in 05/06
- Improving safety performance

But still to do....

- Improve customer service



Final Proposals 2007 /08

Positives:

- Ofgem's open, transparent and consultative process
- Reduction in shrinkage gas price risk
- Resolution of pensions and RAV issues



Final Proposals 2007 /08

Concerns:

- Savage cut of 16% in cost of capital return allowed on RAV from 6.25% to 5.25%
- Disallowance of 41% of our overspend despite Ofgem's confirmation that the majority was efficient and in customer interest
- Cut in controllable opex allowance of 8%

Business Environment for the Five Year Price Control

There are some significant challenges for the GDNs in the next price control period resulting from:

- **Legislative changes (e.g. Pension Act, Traffic Management Act, Landfill Tax, IFRS convergence)**
- **Regulatory changes – offtake and interruption reforms introduce new risks and uncertainties in gas distribution**
- **Increased investment due to asset ageing and HSE programme**
- **Labour market conditions (e.g. shortage of contractors and increasing demand driven by utility investment programmes and London Olympics)**
- **The need to invest in apprentices in response to ageing workforce**
- **Energy market prices (high gas and oil prices)**
- **Increased security requirements due to potential terrorist threat**
- **Increased safety and environmental responsibilities**
- **Increasing expectations for safety and customer service**



Five Year Price Control Issues

- Ofgem's comprehensive consultation process and willingness to consider innovative approaches (for example, regarding network extensions, xoserve funding) is welcome
- Opex – the industry is mature and the scope for future reductions is diminished. There is minimal scope for outperforming RPI as utility costs are rising substantially faster than inflation in the wider economy
- Investment – GDNs have an increased investment requirement in the next period due to larger repex programme and a number of LTS investments required in 2008-13. NGN will seek accreditation to PAS 55, the new asset management standard
- Investment is required by Ofgem in a separate distribution control centre – this should result in benefits in the longer term. It would be inappropriate to disallow this investment or any associated efficiently incurred opex



Five Year Price Control Issues ...cont

- Exit and interruption reform represent substantial changes to the commercial framework for gas distribution, consequently proportionate allowances and incentives are required
- Cost of capital – needs to be attractive to investors and recognise that gas distribution is riskier than transmission and other utilities given the safety issues, the 30 year repex programme, exit reform and the importance of security of supply
- Exposure to items outside the control of GDNs should be limited, for example, NGN does not support Ofgem's proposals for water ingress and other third party damage to be a guaranteed standard
- Uncertainty about future gas demand



Main review - Incentives

- The price control framework should provide the right incentives for investment and reward efficiency and improved customer service
- NGN supports a “strong roller” for capex. NGN believes strong incentives will encourage efficiencies and discourage overspends providing benefits for customers. NGN is comfortable to link this to an incentive mechanism that rewards accurate forecasting
- NGN supports an opex roller to remove the perverse incentives to make efficiency savings at the start of the review period and not at the end
- NGN supports Ofgem proposals for incentives for innovation, quality of service, corporate social responsibility and pipeline accuracy



Summary

- Ofgem's consultative approach to the price control is welcome
- There is a continuing need for GDNs to attract funding for investment against competing demands for capital
- The industry requires incentives that encourage improvements in efficiency and customer service to ensure that customers obtain maximum benefits
- The challenge in the forthcoming review will be to set a cost of capital that does not discourage investment in the industry and to ensure that opex targets are achievable given the cost pressures on the business.