



26 January 2007

Joanna Whittington,
Director – Gas Distribution,
Ofgem,
9 Millbank,
London,
SW1P 3GE

Dear Joanna,

Ofgem Consultation: Gas Distribution Price Control Review Third Consultation Document (“the third consultation document”)

This document is the formal response to the above consultation by Wales & West Utilities (WWU) Ltd.

For the avoidance of doubt this reply is not confidential and may be placed in the public domain.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Bob Westlake".

Bob Westlake
Head of Regulation

**OFGEM CONSULTATION: GAS DISTRIBUTION PRICE CONTROL REVIEW
THIRD CONSULTATION DOCUMENT**

**WALES & WEST UTILITIES (WWU) LTD
RESPONSE TO CONSULTATION**

EXECUTIVE SUMMARY

The key issues contained within our response are summarised here for your convenience. However, we consider that it is essential that this summary is read in conjunction with the detail of our response as set out in the remainder of this document in order to gain a complete understanding of our thinking and the rationale for our conclusions.

Revenue Driver

We support the reduction of the existing 35% volume based allowed revenue driver as costs are not generally driven by throughput. This should be replaced with a driver that reflects the costs associated with network growth. We also support Ofgem's approach of matching the allowed revenue driver with the billed revenue driver, which are currently different and lead to issues in collecting the allowed revenues on a timely basis.

Re-openers

We agree that there needs to be a re-opener for TMA costs if the costs are not known with sufficient certainty at the time of setting the Final Proposals. There should also be a re-opener if the UK Government loses the case presently being brought against it by the European Commission for failure to implement correctly EC Directive 89/391/EEC regarding health and safety. A re-opener should be included in relation to any additional costs arising from changes to the Gas Safety Management Regulations (GSMR) requiring us to repair gas escapes within a shorter period of time (e.g. 12 hours). We also consider it appropriate that a generic reopener is implemented for other unexpected cost shocks. A reasonable materiality threshold should be set for this re-opener with the ability to cumulatively log up costs throughout the price control review period.

Setting Allowances

Any reasonable review of Opex allowances will have to reflect the diversity across the GDNs and take account of network length which is the key cost driver.

Incentives

Further detail on proposals for both Opex (Operating Costs) and Capex (Capital Expenditure) rolling incentives are required before we are able to take a clear view. It is essential that we do not place incentives upon incentives. The introduction of new incentives, such as the as yet undefined "interruptions and exit reform", increases the level of risk and potentially uncompensated costs and must be taken into account when setting the cost of capital.

Standards of Service

We support the removal of the Overall Standards together with notification of planned interruptions and responding to complaints becoming guaranteed standards. Any

revenue allowance must cover either the full cost of achieving 100% success or the expected compensation payments.

Financeability

Where post tax Weighted Average Cost of Capital (WACC) is operating, we agree with the principle of an ex-post adjustment for adverse changes in tax treatment to certain expenditure types, including Replacement Expenditure (Repex), provided that this is symmetrical. However, we do not believe that Ofgem should allow tax only if it believes that the Gas Distribution Network (GDN) has argued the point with the Revenue sufficiently, as this is a subjective measure which could be based on inequitable comparisons between GDNs due to their different circumstances and has the risk of being measured with the benefit of hindsight. In respect of depreciation, we do not consider there to be a need to change from the current 45 year asset life but our final view will be dependant upon the WACC outcome and financeability tests.

Treatment of Repex

We do not see any scope for moving away from the present 50/50 treatment. Our view on the benefit of increasing the repex portion treated as capital will depend on the final WACC determination and the impact on financeability and any measures introduced to mitigate its effect. We support Option 1 to retain the mains replacement incentive with symmetry of incentive. Services should be excluded from the replacement incentive mechanism because of the uncertainties around services numbers.

Network Extensions

We fully support the proposed new policy on network extensions and the assistance this provides in relation to fuel poverty. The model we have proposed in Option 5 will achieve the desired outcome in association with incentive Option 3b.

Regulatory Transparency

We are extremely surprised to find a definitive policy statement by Ofgem contained in the Appendices of a Consultation Document. This policy statement concerns Ofgem's view of the singleton allowance and is set out in para 1.31 of Appendix 5. This has not been the subject of consultation and needs to be, as it is of fundamental importance. Ofgem must recognise that the economies of scale do not exist in such clean stand alone companies. This principle is recognised in both water and electricity and should be addressed through the application of a singleton allowance. It would be unreasonable to estimate cost savings achievable only by someone owning four GDNs and to apply them to each of the other GDNs.. Ofgem must recognise that economies of scale do not exist in such clean stand alone companies.

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DETAILED RESPONSE

In accordance with the requirements of the third consultation document, we set out below each of the Ofgem questions and our responses to them.

CHAPTER 2 - HIGH LEVEL FRAMEWORK OF THE PRICE CONTROLS

Question 1: Do you agree with our initial view on which services could be given excluded treatment? Are there any additional services that we have not considered?

In assessing if services should be treated as “excluded” we need to consider the rationale for having excluded services. “Excluded services” are services that are either highly variable by their customer driven nature and where the costs are uncertain or are not considered core price control services.

We welcome the move to greater clarity in the use of the phrase “excluded services”. We consider that there is still further work on clarification which needs to be done in this area. Our aim is to ensure that there is consistency of approach, disclosure and treatment between GDNs, but without making regulation unnecessarily intrusive in commercial or competitive areas. This will also provide Ofgem with more consistently presented information, such as regulatory returns.

In the gas industry, “Formula revenue” has always been that derived only from shippers and only from activities provided to shippers in the distribution of gas through our pipelines. That gives a simple distinction. It has not been any impediment to Ofgem either to taking into account as part of the 5 yearly reviews the revenue received or to regulating the activity where deemed appropriate (as in Metering or in the emergency service provision to IGTs).

We repeat our comments on the correct interpretation of “excluded services” to which you allude in section 2.13. The focus of our reply is therefore much more on which services need to be “**deemed**” to be excluded (because they are revenue from shippers) or which have in the past (particularly at network sales) incorrectly been characterised as “de minimis”. Referring to particular sections in the consultation paper we would comment further:-

Para 2.5 We agree with this paragraph except that the emergency service to Independent Gas Transporters (IGTs), while an “excluded service”, is not one that needs to be “deemed” so, as the revenues are derived from IGTs not shippers they are by definition excluded. The revenues are, of course, still regulated by SSC A41 and we suggest that this level of regulation is appropriate.

Para 2.6 While we agree that there may be other services where greater regulatory supervision is appropriate, one should again distinguish between those which need to be “deemed excluded” (services to shippers such as user pays services to shippers) from those which are “excluded” (as they are not services to shippers, e.g.

extra services to IGTs). This distinction doesn't stop the service being regulated in an appropriate way.

Paras 2.8 - 2.13 We agree that the various services mentioned are, or should be, treated as “excluded services”, depending on the distinction above. In particular we agree with the correction of the classification of at least certain activities that GDNs provide to each other and the NTS as not being “de minimis”. We made very firm representations on this at the time of the network sales. In particular these activities simply represent activities that the GDNs had been doing pre-separation and will continue to do for each other for the foreseeable future. They are not “de minimis” activities: activities outside the scope of running a gas distribution network or metering business. We suggest therefore that they do not represent the same risks of being activities with which personnel and the businesses are not familiar with or which divert management attention away from core activities.

Para 2.14 While our comments might be regarded as technical, they represent how the gas industry has been regulated to date. If there is to be any change, particularly in the change of the definition of formula revenue, that must be properly consulted on and not treated as technical legal drafting. We do not consider any change is required for the reasons set out in our reply above; Ofgem has not, we suggest, encountered in the past difficulty in assessing overall the GDNs revenues and their appropriateness, and the GDNs have had reasonable commercial freedom to act, outside their core relationship with shippers, without the need to refer everything for consent by the Regulator. We consider that this is still the correct balance.

We generally support the proposals and confirm the following points from Table 2.1:

- 1 Move last resort supply payment claims from excluded to pass through
- 2 Emergency services retain as excluded
- 3 Charges for theft of gas retain as excluded
- 4 Retain excluded service status for connections, as covering their costs through a price control formula would be impractical (or unnecessarily risky)
- 5 Metering services treat as excluded
- 6 Define services provided to other GDNs as excluded (not de-minimis)
- 7 xoserve – if users pay then treat as excluded

Additional Points Made by WWU

Revenue Driver

We support a reduction of the volume driver as the vast majority of a GDNs costs are unaffected by the volume of gas throughput. We believe that a more realistic approach would be to replace it with a driver that reflects the growth in the network. The exception to this are responses to emergencies where these are driven by weather factors. This could be addressed by automatically allowing additional costs of Publicly Reported Escapes (PREs) above those assumed at a price control or by retaining a significantly reduced volume driver element.

Para 2.11 Final Connection Allowance (FCA)

The obligation to pay the Final Connection Allowance is statutory not voluntary. The Gas Act allows the Transporter to recover the cost of supplying and laying the pipe but not connecting it. Section 10 establishes three separate concepts, "connect", "supply" and "lay". Since "connect" is not included within the charging powers of section 10(5) it is not open to the Transporter to charge for it. This was the view of

Ofgem's General Counsel in 1997/98 and there is no reason to believe that this view has changed. Transporters are therefore obliged to pay the allowance and any change to this would require primary legislation before it could be implemented or Ofgem could make a determination to that effect under section 27A of the Gas Act which, if needed, could be reviewed by the Court. The consequence for GDNs of charging for the final connection if it is not lawful, is that the charge is outside their powers and therefore recoverable by the consumer who has paid with no limitation period.

Para 2.13 Meterwork Services Income

Until the outcome of the Ofgem investigation into metering is completed it is not possible to take a definitive view. However Ofgem has proposed to allow for Emergency Metering Services (EMS) costs in full, and then apply a benefit sharing mechanism to any income. A key issue is whether the GDNs should be required to accept all the risk of renewal of meter service contracts given that the income derived from these contracts is cross-subsidising the fixed cost of carrying out licence requirements. Meter Asset Managers (MAMs) could procure their services elsewhere. The ability of the emergency workforce to provide other services but their ability to do so is constrained by the licence obligation. It is not considered possible to reduce the Emergency workforce, even with the loss of the metering contracts, whilst the response time constraints remain within the Licence. Because of the fixed cost associated with these obligations, coupled with the riskiness of both the cost and volume of emergency and metering work, some form of risk and benefit sharing is appropriate.

Question 2: Should domestic one-off connections be treated as excluded services or ordinary price controlled services?

In line with the Regulatory Principle that activities with uncertain or variable unit costs should be excluded services, domestic one off connections should remain as excluded services (where the revenue is derived from the customer direct) and as a deemed excluded service where the revenue is received through the shipper (which was the original assumption as to how connections would be carried out in the early 1990s). This is because the current standard charge approach to section 10 connections is arguably only convenient (both for the transporter and the majority of customers) and a customer could require a bespoke connection under the section. We do not believe it is appropriate to price control something which by statute can be inherently an uncertain cost, depending as it does on variables such as length, site conditions, labour market, geography etc., inappropriate charging can be dealt with through determinations under section 27A Gas Act. We do not consider this inconsistent with funding aspects of the connection (the first ten metres etc) as presently.

Question 3: Have we correctly identified the range of items that could be treated as pass through items? Should these items be treated as pass through items?

Costs not under the direct control of a GDN should be pass-through costs, as should costs for work on the NTS undertaken by GDNs. We totally oppose the proposed move to an ex-ante allowance for rates with the possibility of retrospective adjustment. Whilst we may make representations on the level of Rates they are de-facto not within our control and therefore must remain as pass-through. Introducing an ex post correction to a pre-defined allowance, without an automatic right of pass-through, just imposes unnecessary risk.

In addition, for the initial period when there are significant uncertainties with how any interruptions mechanism will operate, any payments made to customers under the new interruptions regime should also be subject to pass-through if the actual cash cost is lower than the return and depreciation element of the otherwise requisite reinforcement cost.

We also strongly support the point made in the third consultation document that National Transmission System (NTS) pension costs and payments associated with last resort supply should be treated as a pass-through cost in the price control formula or our licence.

We support consistency in the approach to shrinkage and pensions as adopted for the extension year.

Para 2.19 De Minimis

The de-minimis limit should be tested only against Turnover and not Share capital and reserves, as the structure of individual GDNs funding can differ significantly. As the 2.5% limit allows less than £5m of activity it is appropriate to raise this limit to 5%.

Question 4: Is there any reason why we should change our position on cost indices?

We fully support the continued use of the Retail Price Index (RPI) for the calculation of allowed revenue once the price control is set (leaving aside the allowance for gas shrinkage). RPI includes a significant basket of cost types which impact on the costs of the GDN not least through wage pressures in response to for example house purchases, and home loans. The process of calculating a 5-year price control in any case smooths out annual fluctuations in revenues.

A separate issue is how cost allowances are derived within the price controls. Here there is strong evidence to demonstrate that costs are more linked to specific "Construction" industry indices – particularly where contract market forces and materials affect expenditure on capital projects.

Therefore cost allowances should be set using sector specific real cost inflators which then need to be updated by RPI each year to maintain their real value.

Question 5: Is there any reason why we should change our position on re-openers?

We strongly support the proposal for a re-opener for Traffic Management Act (TMA) costs if these are not known with sufficient certainty at the time of the Final Proposals. This should be based on the electricity model where cumulative smaller amounts can be aggregated, or "logged up" over the period of the price control determination, to allow recovery against some reasonable materiality threshold.

The other matter that should be included as a re-opener is the effect of the UK Government having to change the Health and Safety at Work etc Act 1974 (and therefore all subordinate legislation, including, in particular, the Gas Safety (Management) Regulations 1996 and the Pipelines Safety Regulations 1996). The European Commission is presently bringing infraction proceedings against the UK Government (Case C-127/05) on the basis that the UK Government is in breach of Directive 89/391/EEC in the way that the Health and Safety at Work etc Act is drafted. The breach alleged is that the limitation on an employer's liability to protect

his workers and others from health and safety dangers “so far as is reasonably practicable” (SFAIRP) contravenes the Directive, which according to the Commission requires absolute liability, subject to much narrower exceptions. While the published opinion of the Advocate General (18th January 2007) supports the UK Government’s position, there is no guarantee that the Court will follow his opinion. The consequence of the Court not doing so, would be immense (affecting, for example, potentially the metal mains replacement programme and the obligation to attend gas escapes within 12 hours) and at this stage is wholly unquantifiable.

Ofgem’s statement in the first line of paragraph 2.26 confuses the need for incentives and the need to deal with uncertainty. Price cap formulae may adapt to changing conditions (e.g. by adjusting for changes in volume, or by indexing a price cap), but some changes are not amenable to such automatic adjustments. In such cases, it is necessary to adjust directly for the effect of changing conditions on specific costs and the final statement of the regulatory system (i.e. the licence) should set out how and when this adjustment will take place. The secret is to state clearly how such procedures will work, using criteria that have been properly reviewed and amended in the light of the comment.

Hence Ofgem’s position on general re-openers should be changed. Two of the most significant issues in the extension year review were the treatment of past capital expenditure overspend and the cost of shrinkage gas. Both of these issues led to unsatisfactory outcomes and lessons should be learnt from this process by implementing a generic re-opener. Re-openers exist within the Water regulatory framework and work satisfactorily.

This is intrinsically linked with the matter of financeability and the ability or otherwise of companies to absorb cost shocks. Through the successful successive operation of price controls and tightening of the regulatory regime there is no longer the ability to absorb cost shocks. Therefore there is a need for a defined re-opener mechanism.

Question 6: Should we introduce a two-tier correction mechanism for over and under recovery of allowed revenue, consistent with the arrangements that apply in electricity distribution?

We support the principle of symmetrical penalties, and more generally, the symmetry of incentives and penalties. On the question of collected income, we believe that a greater proportion of any incentive mechanism should be linked to capacity rather than commodity.

This issue has to be considered in tandem with the review of the revenue driver and structure of charges. Introducing a two tier level of symmetrical incentive/penalty can be considered more favourable where volatility is reduced by moving to more capacity based charging and a reduction of the volume driver. Clearly it would not be appropriate to move to such an incentive system whereby the weather volatility remains or has not been reduced significantly.

Variability Para 2.33 - Timing of changes to charges

We have considered the effect of changing the timing of the charges from October to April. Moving to an April price change better matches the price control period.

The current regulatory requirement for a 3 month consultation for changes to charges means that the next year pricing decision would be taken in December of the previous year, which is prior to the 3 months key collection revenue months

(January-March). It is our concern that if charges were set in April rather than October without changes to the revenue driver then price volatility may increase as forecasting is unlikely to be as accurate as it would be with the full twelve months data.

Clearly in October we have the benefit of access to actual total previous years allowed parameters which ensures that the charges are set as accurately as possible. However, if we were to change this to April we would only have estimated total annual figures for the previous year. As in our response in the previous section, this becomes less of an issue with any reduction in the volume (commodity) driver element and the change to increased capacity related charges.

It should also be noted that there is currently a penalty mechanism in place which is triggered if actual collected revenue differs from allowed revenues by more than predetermined percentages, with the size of the penalty increasing the more diverse the results.

Whilst we would prefer a move to pricing changes being implemented from April, we could only support such a move if the penalties for actual charges being different from K were relaxed to take account of the increased uncertainty which is introduced in the forecasting process as set out above and/or the changes to the revenue driver and capacity charging were introduced.

Variability Para 2.34 – reducing variability of charges

A GDN's costs do not vary significantly with the amount of gas transported. The exceptions to this are responses to emergencies, shrinkage and odorant costs where these are driven by weather factors. The incremental costs of emergency responses could be addressed by automatically allowing additional volumes of PREs above those assumed at a price control or by retaining a reduced volume driver element. We are therefore in favour of a move to charges being more highly weighted towards capacity charges and less to commodity as set out in our response to the previous section.

Removing the volume driver from allowed revenue but doing nothing with the collected structure could make "allowed" versus "collected" more variable. We support the use of a capacity based structure of throughput charges and welcome Ofgem's recent announcement on the structure of charges.

We would also support the move to looking at other volume drivers to the cost of operating a network, one of which could be network length. This is discussed further in our comments on Chapter 3 below.

Question 7: Should we calculate the GDNs' allowed revenues in a way that creates a smooth revenue profile over the course of the price control period.

The profiling of a GDNs regulated revenue streams may be net present value neutral but may impact financial ratios during the price control period and therefore should be subject to a financeability test. We favour a one-off P0 adjustment subject to the financeability ratios being satisfactory for the price control period.

CHAPTER 3 ASSESSING COSTS

General Approach

We support the approach to assessing opex, capex & repex as follows:

(i) Opex – reviewing forecast costs, top down benchmarking, total factor productivity, bottom-up activity-based analysis, external benchmarking and expert review of costs

(ii) Capex & Repex - assessment of policies, procedures and forecasting processes, reviewing forecast costs, bottom up benchmarking and expert review of costs.

We support a wide range assessment of costs. It is important that all aspects are considered. Of particular importance is understanding that direct operating costs are driven by the network's size, design and ratios of LTS and distribution together with the impact of the local geography and demography. This is a proxy for sparsity – i.e. the workforce do not have to travel to areas where there is no gas but do have to travel to myriads of small villages where there is supply. .

Whilst we support the use of comparative techniques we are of the view that each GDN has different cost drivers. For example the cost driver in sparse networks such as ours is clearly network length, whilst the cost driver for a dense urban area such as London may be entirely different. Any comparative technique will therefore need to respect the diversity across the GDNs, normalise and take account of these differences. However, we do not expect Ofgem to disallow costs without robust evidence of inefficiency. Even finding that several different methods provide similar results does not provide such evidence, if all the methods have overlooked a crucial factor. Only detailed discussions with each GDN will provide the evidence from the field needed to make such judgements.

Singleton Allowance

We are extremely surprised to find a policy statement by Ofgem contained in the Appendices. This concerns Ofgem's view of the singleton allowance as reported in the responses to the Second Consultation Document and is set out in para 1.31 of Appendix 5. This has not been the subject of full and proper consultation and needs to be, as it is of fundamental importance.

Ofgem must recognise that economies of scale do not exist in such clean stand alone companies. This principle is recognised in both water and electricity and should be addressed through the application of a singleton allowance. It would be unreasonable to estimate cost savings achievable only by someone owning four GDNs and to apply them to each of the other GDNs. Ofgem welcomed the introduction of new companies to act as comparators for the GDNs This should therefore be addressed through the application of a singleton allowance.

In Ofgem's policy statement on the treatment of electricity Distribution Network Operator (DNO) mergers it concluded that the value of a comparator is £32m. In other regulated industries such as Water, the concept of a small company premium is standard practice. We see no reason why singleton GDNs should not be treated in a similar way through the application of a singleton allowance.

Question 1: Is our proposed approach to setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?

We support the range of assessments proposed, clearly it is important to recognise the external drivers on costs such as contractor rates when assessing allowances. The age, design, ratio of LTS and Distribution mains, sparsity and size of the network are also material factors as we have discussed previously. In respect of non-operational capex, the main components of this cost category are Information Systems (IS) and vehicles. Vehicles are operational and a great proportion of the IS is operational for example despatch and work programming systems. Such assets have an economic life of many years and normal accounting procedures, as well as the desire to signal economic costs to different generations of gas consumers, would require that the initial expense be spread over several years through capitalisation and depreciation. We believe therefore that it is appropriate to continue to treat this expenditure as capex.

In assessing capex allowances due regard needs to be paid to the size and nature of the network. It should be borne in mind that when the sales of the GDNs took place the Regulatory Asset Value (RAV) of WWU was reduced by some 30% as the desired outcome of the process was to retain postalisated prices across the GDNs. Therefore capex allowances need to reflect the actual physical network rather than an economic value that was arbitrarily reduced by 30% to achieve the then desired outcome. It also needs to reflect the forecast growth in connections that will differ between GDNs.

Ultimately, however, the level of required capex depends on both (1) each GDN's detailed knowledge of network conditions and (2) investment policies (e.g. on risk assessment, timing of replacement etc). It is therefore essential that Ofgem and its consultants allow time for informed iteration between the detailed plans of the GDNs and Ofgem.

Question 2: Is our proposed approach to setting opex allowances for 2008-09 to 2012-13 appropriate?

We support the wide range of analysis as set out, but will expect any decision to disallow cost to be backed up by robust objective evidence, not just a large volume of similar analyses, which may all be missing a crucial factor. In particular, following the removal of those costs to be treated as pass through or through other mechanisms as with shrinkage, we believe it is essential to carry out separate assessments of direct costs and indirect costs. Direct costs are suitable for comparative analysis supported by external benchmarking, providing that it is possible to identify truly comparable costs in other companies. It is important to recognise the diversity across the GDNs and effective normalisation will be required. Indirect costs are predominantly of a fixed nature rather than variable and it is therefore more appropriate to use external benchmarks rather than comparative analysis.

Question 3: Is our proposed approach to updating the GDNs' RAV to 1 April 2008 appropriate?

It is appropriate to update the RAV for actual outturn expenditure. We accept that Ofgem may wish to update the analysis of efficiency, in order to see if all expenditure should be allowed. However, it will be against consumers' interests to deny the recovery of capex if there are no inefficiency grounds for doing so. We will therefore expect Ofgem to use rigorous standards to distinguish between excess costs due to inefficiency and cost overruns due to other reasons such as unforeseeable delays.

Ofgem will also need to take care to avoid perverse incentives due to the compartmentalisation of investment allowances by category. Whilst we accept it is also appropriate to update the analysis of efficient expenditure, GDNs must be allowed flexibility to respond to changing network needs by viring expenditure across different categories, and over time, and not be subject to retrospective adjustments against individual categories within years. Similarly it is important that GDNs are rewarded for efficiency gains achieved both through reducing costs and by legitimate deferral of capex.

Other points raised by WWU

Paras 3.28 and 3.29 Gas Transportation Management System (GTMS) replacement

It is an Ofgem requirement that GDNs establish independent control of gas flows across their supply networks in order to achieve commercial separation from NG. This is the overarching driver for System Operation Managed Service Agreements (SOMSA) Exit.

The driver for GTMS replacement is the imminent obsolescence of the control system which is basically 1980's technology, that has been upgraded over many years. NG has demonstrated that this system is expected to cease to be safely supportable by October 2009. This is due to a dearth of people with the necessary programming skills and the diminishing availability of spare parts.

Timescales and cost efficiency are therefore the drivers for the two phased approach to SOMSA Exit. Replacement of the GTMS System at Hinckley constitutes the 1st phase. The 2nd Phase will commence with the exit of the first GDN in autumn 2008. WWU are currently programmed to exit in autumn 2009. In order for all GDNs to exit efficiently within the required timescales, all have agreed that the systems to be migrated will be identical in functional specification; differences will only occur in interfaces with the respective company's existing IT systems.

With regard to additional functionality to meet customer needs, in view of the timing of Exit Reform it is prudent, cost effective and a prerequisite to modify/replace some of the existing Non Supervisory Control and Data Acquisition (SCADA) systems in order to meet the new requirements for forecasting and data transfer. All GDNs are therefore currently cooperating in the replacement of the Predict application with Forecaster and also in reviewing the functionality of SC2004. Costs have yet to be defined but these enhancements must qualify for allowance, especially as the cooperative approach has been applied. In our Board Paper, previously provided, we have indicated that ongoing operational costs will be of the same order as those incurred under SOMSA. The derogation on operational control is to be removed and the requirement for individual GDNs to have their own operational control through SOMSA is a regulatory one and therefore the costs must be allowed. If the driver for this activity is cost alone then the present integrated system should remain.

CHAPTER 4 OUTPUTS

Question 1: Do you support the proposed changes to the quality of service outputs?

We broadly support the proposals. However it is essential that the revenue allowance includes the cost of providing the level of service that is reasonably expected to meet the standards, together with the costs of compensation payments where compliance costs would be prohibitive. At one extreme, that means allowing the cost of 100% compliance and no penalties; in practice, however, it may be cheaper overall to assume a lower level of service and some compensation for non-compliance.

There should be no change to either the level of compensation payments or required performance under the Standards during the price control period unless there are commensurate increased revenue allowances to match the increased costs. Equally this applies to any changes or additions required or agreed with the health and Safety Executive.

It is important that any compensation payments remain proportionate to the inconvenience caused and take into account the level of transportation charges paid by customers each year.

Monitoring and reporting costs must also be taken into account as they involve both opex and capex spending on for example IS systems.

We respond to this question in more detail as follows under the following headings:

Para 4.6 Customer research

It is imperative that the consumer research that is being undertaken includes a willingness to pay section. Customers will always want better service but it's essential that we understand what level of service they are willing to pay for and they understand the cost implications of improvements. Please refer to our response to the initial draft of this survey sent to Nicola Love on 09 November 2006.

Para 4.7-4.10 Option 1 Do nothing re present quality of service

We agree that we should be striving for continuous improvement to the existing quality of service but it is important that we focus on the areas that are of interest and value to customers and are subject to proper cost benefit analysis.

Para 4.11 Option 2 Changes

We believe it is worth looking at the option of measuring fewer quality of service outputs that firstly really matter to customers and secondly are capable of robust and comparative recording and measuring. Incentive programmes can then be focused on these areas.

Para 4.14 Overall Standards (OS)

As mentioned in our previous responses, we support the removal of the overall standards. In our opinion some of the standards can be removed and others can be replaced with guaranteed standards or included within the licence. However the original concept of overall standards was to have incentives in activities where individual measurement was not appropriate. While this could be achieved through

licence conditions the drafting of such conditions must be proportionate. Please refer to the detail of our response below.

Para 4.18 OS1 Telephone calls

We believe that OS1 can be removed and that there is no need to replace this with a licence modification. Firstly the performance greatly exceeds the 90%, currently running at an average of approximately 97%. Secondly, as we have no direct influence over the performance we would not support the inclusion of this within our licence. We could, however, include this performance level in the commercial terms of the contract that we have with National Grid for carrying out this activity. Note that the reports provided by NG are not split between the 8 GDNs, as they are in fact, national statistics, Therefore it is not appropriate to regulate this aspect of service on an individual GDN basis.

Para 4.20 OS2 Notification of planned interruptions

We agree that OS2 could be turned into a guaranteed standard as long as the compensation payment is set at a suitable level. We would suggest a maximum of £20 per failure to notify because there will, of course, be a cost to WWU of complying with such a standard as the current requirement is to meet the standard in 95% of cases and therefore assuming this level of performance is achieved we will be required to pay for the remaining 5% of cases for non-compliance. It is essential that an allowance is given to GDNs for these payments or the increased costs of full compliance.

Para 4.25 OS3 Notification during unplanned interruptions

As mentioned in previous responses, we do provide a greater level of service but this is difficult to measure. We do not believe that this could be meaningfully incorporated into the licence however we agree that the performance should continue to be measured by the existing customer satisfaction survey.

Para 4.27 OS4 Complaints

We agree that this is an area that directly impacts the customer and therefore could be turned into a guaranteed standard provided the compensation payment is set at a suitable level. We would suggest a maximum of £20 for failing to respond within 10 working days. As the current target is 90% it is essential that we are given an allowance for the compensation payments we would be required to make or the increased costs of full compliance. We would not support the introduction of a guaranteed standard for complaints if the 10 working day period was to be reduced unless appropriate allowances are provided for the additional manpower and system resources that will be required.

Para 4.29 OS5 Attending emergencies

We agree that responding to gas emergencies is a very important area of service to customers and ensures safety but it is not worth having a single standalone overall standard. This does also form part of our safety case which is agreed and closely monitored by the Health and Safety Executive (HSE) so we see no need for inclusion in the licence. If the HSE require changes then we would expect to be provided with commensurate allowances.

Para 4.31 Guaranteed Standard (GS)1 and GS2

We agree that GS1 and GS2 should remain and that the associated compensation payments are suitable for the level of inconvenience.

Para 4.34 GS3 Alternatives for cooking and heating

We currently provide a level of service that exceeds the performance target as we offer all customers alternative heating and cooking facilities, regardless of whether they are priority customers. We are happy for this to be included as a general provision within the licence with commensurate allowances and welcome the removal of the reporting burden.

Para 4.36-4.38 Connections Guaranteed Standards of Performance (GSOPs)

The connections guaranteed standards that are currently in place are extremely demanding to achieve. At WWU we have implemented systems not only to report against these standards but also to monitor our performance regularly, and in some cases on a daily basis. We are therefore content with the current reporting requirements and do not wish to see these changed particularly if it involves system changes purely to simplify the reporting format.

Para 4.39- 4.40 Measuring Standards

Reporting the number and duration of interruptions is a complicated area with significant system requirements and the direct read across from electricity cannot be made. In electricity this is much simpler and is used as part of the Information & Incentives Project (IIP) to reward/penalise DNOs. However the gas system does not electronically record interruptions and we are therefore dependant upon the dates and times entered manually in the system being correct. We understand this is an area that Ofgem are keen to see improved reporting but we question whether this is a relevant measure at all given the difficulties above.

Para 4.41-4.42 Scope of customer satisfaction survey

We are pleased to be able to confirm that WWU has already implemented a new connections survey from January 2007 as we are keen to obtain information from our customers since bringing connections in-house. This is being undertaken on our behalf by an external third party. There is currently a questionnaire that surveys customers experiencing an emergency; this is the repair survey that we are required to undertake on a quarterly basis under Standard Special Condition (SSC) D9. We therefore do not understand what further survey could be undertaken in relation to emergencies and would welcome clarification on this point in para 4.41.

Para 4.43 Initial view of Option 2

We do not believe that IGTs should be required to provide a different level of service to the GDNs and therefore support the incorporation of the application of these requirements to IGTs in relation to their customers, particularly where they have more than 500,000 customers.

Para 4.44 Assessment of Option 2

We look forward to receiving the impact assessment that will be published with the initial proposals.

Para 4.45 Comparisons between GDNs

At this stage we believe it is appropriate to ensure that the reporting by GDNs is accurate before preparing a balanced scorecard. It will also be important that any scorecard suitably weights the relevant measures and we would welcome further discussion with Ofgem in relation to this. It is important that the costs of monitoring and reporting are recognised and allowed for and that any inter-GDN comparison takes account of network specific factors.

Question 2: Do you support the proposed changes to third party damage and water ingress proposals?

We respond to this question as follows under the following headings:

Para 4.52 Option 2 – incorporate into guaranteed standards

We agree that consumers should receive compensation for incidents caused by third party damage and water ingress. We therefore do not have any issues with the proposal to incorporate these arrangements within the Guaranteed Standards (Regulation 7) for domestic customers as long as the reporting remains separate from GS1. It is essential that an opex allowance is set to cover the compensation payments as stated in para 4.46 and the level of this allowance needs to be consulted upon as soon as possible. The allowance set for Transco at the last price control review to cover the insurance premium must be maintained at that level as it represents a realistic cost of insuring against these arrangements. However, the allowance set for the payments made beneath the excess was far too low. Based on our own experience of third party damage and water ingress incidents from 2002/03 to 2006/07 the cost of the payments beneath the excess were at least double the allowance from the last price control review. We would therefore stress the importance of increasing the allowance for these payments.

Para 4.54-4.56 Option 2 – non domestic

We agree that non-domestic customers need to be afforded the same protection as domestic customers and this can be facilitated either by an amendment to the Failure to Supply Gas arrangements in the Uniform Network Code (UNC) or an amendment to the regulations. Our preference would be to see this all contained within the regulations rather than in two separate places. If this is the case we are not clear about your intention to “cross reference with the UNC”. We doubt that this is appropriate for a statutory instrument to be amended by a private contract. Clarification of this point is required.

Para 4.57-4.58 Limiting GDN exposure to third party and water ingress events.

We agree that it is appropriate to implement a cost pass through mechanism similar to the storm compensation arrangements in electricity with the 5% liability of subsequent payments being the absolutely maximum after the 1.5% of revenue has been paid. It is important that ‘revenue’ is defined in this context, is this actual revenue, allowed revenue or turnover, please clarify this point. There should also be a force-majeure clause.

Para 4.59 Similar exposure for IGTs

Many IGTs are growing in size and it is important that they are subject to the same standards and requirements as GDNs, particularly where they have more than

500,000 customers. There is no longer any justification for discriminating in favour of IGTs as many of them have as many as or more customers than many of the smaller water only companies who receive the small company premium.

Para 4.60 Event cap

We understand the reason for wanting to reduce the event cap from 50,000 to 30,000 premises because such an event is extremely unlikely to occur. However, we do not support the subsequent reduction in the opex allowance referred to in para 4.60. In obtaining insurance or otherwise we factor in the likelihood of such a large event and as this is unlikely to affect 50,000 premises, we assumed a lower level for our own purposes. This in no way reduces the cost of the insurance premium for WWU or the cost of any payments assuming we chose not to take out insurance. We therefore stress the importance of the opex allowance at least remaining at existing levels subject to the appropriate uprating by RPI.

Para 4.61 Option 2

We agree that Option 2, incorporating the third party damage and water ingress into a guaranteed standard, is the preferred option in order to ensure all customers are protected.

Question 3: Do you support our proposals for improving the accuracy of pipeline records?

We have implemented a scheme whereby we will support third parties to locate mains. This provides for compensation in certain circumstances. We would want to see how this relatively new initiative works before placing new obligations on Transporters. Furthermore we consider this to be primarily a matter for the HSE.

Question 4: Is it appropriate to introduce network capacity output measures? If so what type of output measures are appropriate and what sort of rewards/penalties should GDNs be exposed to?

Our output is primarily security of supply and capacity. Therefore the outputs are the 1 in 20 analysis and the design criteria of the network and components such as Governors.

Para 4.70-72 Longer Term Performance

WWU would generally support the gathering of information that would allow medium and longer term performance to be quantified and compared between GDN's, However any performance comparators used must be properly costed and funded, and should take account of individual GDN demographics. Data will need to be normalised for the inherent characteristics of individual networks.

Para 4.78 Riser replacement

There are complex legal arguments that need to be considered very carefully in respect of the customers' right to a gas supply and Human Rights legislation. From an economic viewpoint WWU are broadly supportive of the idea of introducing an economic test to determine if replacement of risers should be undertaken. However, it is important that non economic factors also be considered as it is important that housing associations / local authority and individual owners / tenants are given the right to choose their fuel of choice.

WWU recognises the difficulty of repairing/replacing risers to, in particular, high blocks of flats. These difficulties are not simply financial. They involve the Health and Safety Executive's view as to what is safe gas engineering and building regulation practice, and they involve the individual types of construction of the buildings themselves. It is often the latter consideration that causes the greatest difficulty - the construction of the building does not facilitate the replacement, even if any requisite landlord's consent and/or planning permission required is forthcoming.

A gas transporter is still however bound by its duties under the Gas Act, in this context section 10(2) which applies to connections both under section 9 and section 10. However section 10(9) provides savings as set out in sections 10(9)(a) and (b). It is likely that in many cases the issues raised above would cause the duty in section 10(3) to be excused.

As a matter of determining when that should happen and therefore potentially whether there should be some sort of compensation to the affected persons, sections 10(3) and 10(9) fall within the Authority's determination powers in section 27A Gas Act. Each tenant of a block of flats and the landlord would be entitled to request a determination. To avoid a plethora of cases and to deal with conflicting points of view in a process that would give legal certainty, WWU suggests that the section 27A process should be used, involving all parties with interests in such a building, by way as it were of a class action. That would, as noted, give legal certainty, would ensure that all parties interests had been properly considered and would enable the Authority not only to determine when the transporter should replace as not to and, if it did not, so saving opex, make a ruling on the level of corresponding compensation to be paid. A fully transparent process could therefore be followed.

Failure to do that leaves an opaque process and potential for discrimination between customers. No voluntary buy out agreement would be binding on tenants or others affected, as one cannot contract out of the Gas Act.

Where it is economically viable we do explore the possibility of purchasing new electric cookers for owners / tenants rather than replace the riser. This is only in situations where there are only a low number of flats consuming gas within the building and we have gained the prior agreement of the housing association / local authority and the owner / tenants.

Para 4.79 Riser replacement

Currently we only replace risers based on condition. In most cases the condition identification results from a proactive survey (T/PL/LC20 Inspection, Maintenance and Monitoring of internal supplies to High Rise Buildings). This is unlike pipes in the ground where the general condition of the pipe cannot be easily assessed, therefore we have a 30 year replacement programme agreed with the HSE to replace all metallic mains within 30 metres of a property.

However, there is a high risk of corrosion of risers in coastal areas as a result of salt water corrosion and we have replaced a number of these risers in recent years. Unprotected steel risers on the outside of the buildings are also at high risk of corrosion and again we have identified a small number of these that have required replacement. We have objectives agreed with the HSE for which we carry out risk assessment and risers form part of that assessment.

We currently have 187 buildings on our database in the principality of Wales and the South West region of England. As we have indicated in previous responses, we believe that this record is incomplete and we are proactively building on our data to ensure we have a comprehensive record of high rise buildings within the network.

We consider that the current process and policy is working well and there is no need to move to wholesale replacement of risers within high rise buildings at this point in time. The survey results within WWU's network are indicating that most risers are in satisfactory condition and do not require replacing.

Clearly, as most risers were installed in the 1960's it may become prudent in the future to undertake wholesale replacement of the risers with full consideration being given to safety and economic drivers.

Para 4.82 Private networks

We welcome Ofgem's commitment to address any regulatory barriers. We support the case by case approach and the recognition of the need to include in the RAV and provide appropriate operating and replacement allowances.

CHAPTER 5 INCENTIVES

Question 1: Have we identified all the issues for each of the incentives?

The issues identified appear to be comprehensive at this time.

Question 2: is it appropriate to better align capex and opex incentives?

It is impossible to disagree with the suggestions that incentives should be “better aligned”, but it is less clear to us what that would mean in practice. There are different cost drivers for each of these components and GDNs will need flexibility to respond to changing circumstances and to make commercial judgement about trade-offs between capital operational expenditure. The degree of alignment can only be assessed by seeing if GDN decisions have been directed excessively towards one or other kind of expenditure in the past, or if there is an acknowledged bias in future incentives. Alignment will depend on a number of factors including the level of the cost of capital and any rolling incentive mechanisms. Further clarity is required before a detailed assessment can be made and it should be borne in mind that the scope to reduce costs is now extremely limited.

In considering incentives it is important that incentive overload does not occur where incentives are placed on top of other incentives, so that the sum total will create perverse outcomes.

Question 3: Do you agree with our initial view that a capex rolling incentive and information quality incentive should be implemented?

We need to see the details of any such scheme and the strength of the incentives before we can comment in detail. Clearly the introduction of new incentives increase the level of risk and this must therefore be taken into account when setting the cost of capital. We also need to be clear on what the benefits will be, not only to ourselves but also to consumers. Again there seems to be the risk of heaping incentive mechanism on top of other incentives. In practice, our investment policies depend to a large extent on long-term prospects for cost recovery, i.e. on the way in which Ofgem rewards investment at each review, rather than on short-term incentives. We would therefore wish to be convinced that a rolling incentive would achieve identifiable benefits. In setting capex incentives, incidentally, it is important that Ofgem and their consultants are working to the same planning criteria as the GDNs.

Also, we note that Ofgem abandoned its attempt to introduce a rolling opex incentive for electricity DNOs in 2004, because it became apparent that accounting standards were not sufficiently tightly defined to permit its implementation. We would be concerned if Ofgem promised rolling incentives but found out later that similar problems prevented their implementation in GDNs. It should therefore be a pre-requisite to check that accounting rules clearly specify what costs are covered by any rolling incentive.

Any incentives introduced need to be symmetrical.

Question 4: Given the issues raised is there a case for an opex rolling incentive?

Until the likely level of future opex allowances are set it is not possible to take a view on such an incentive. Clearly the introduction of new incentives increase the level of

risk and this must therefore be taken into account when setting the cost of capital and looking at the financeability of GDNs.

Question 5: Do you agree with our proposals to retain the mains replacement incentive?

We support the continuation of the incentive matrix but there should be symmetry in the pain/gain incentives.

We oppose the inclusion of service costs due to uncertainty surrounding services numbers and costs as demonstrated during the agreement of the current five year price control review. In simple terms (before allowing for the 33%/50% sharing of the difference between the basic revenue allowance and actual costs), the form of the incentive matrix is a complex price cap formula with separate prices for each metre of pipe replaced at each diameter:

Basic revenue allowance

- = (price per metre of 6" pipe x metres of 6" pipe replaced)
- + (price per metre of 8" pipe x metres of 8" pipe replaced)
- + (price per metre of 10" pipe x metres of 10" pipe replaced)
- + etc....

This approach is suited to mains replacement, because the prices per metre are relatively stable, whilst the length of pipe replaced is not. The problem with services is the difficulty of setting an appropriate price per metre, even for a standard pipe diameter, due to the wide variation in local conditions at each connection. Therefore, services are not suitable for inclusion in this arrangement.

We agree with the proposals for the addition of risers to the mains replacement incentive provided a separate allowance for this expenditure is given.

Of the Options outlined in para 5.50 to 5.53, we support Option 1, since it allows for the possible variation in lengths replaced and provides a strong incentive for cost minimisation, whereas the other schemes all impose unnecessary risk on the GDNs by failing to adjust the revenue allowance for unforeseeable variation in activity (metres of pipe replaced at each diameter) and costs (per metre of pipe replace).

Question 6: Is flexibility capacity the key incentive to focus on for the capacity outputs? Should we assume that the use of existing NTS flex capacity is the most efficient flexibility capacity product?

It is not possible to make any sound assessment until there is clarity on both the commercial and regulatory arrangements.

Nevertheless if it is assumed that any investment required for Flat Capacity (NTS or Local Distribution Zone (LDZ)) will be remunerated through the price control, and there will be a target for interruption costs, then flexibility capacity is the only product which the DN can use to make "trade off" decisions. However it is unclear at the moment which model will be adopted under the proposed Offtake Reform. These models range from a constrained product being purchased at auction to an allocation of a product by UK Transmission (UKT) with a calculated unit cost which is not currently defined. It is difficult therefore to develop a clear picture of the capacity output Ofgem will use and how they will assess our requirements to decide at what level to set the targets. The current NTS product is DN specific (not available to

other connected parties) and may not be the product that exists in the reformed market.

Question 7: Is it appropriate to assume that NTS and LTS flat capacity are complementary products? Should we incentivise tradeoffs between flat capacity and interruptible capacity?

Options 1 & 2 are similar to the 3 options proposed for the 1 year review. Our collective views on them are in the interruptions response (Ref 191/06).

It is difficult to express an opinion on which option we would support without understanding the detail and seeing how this would operate in practice. In general, the revenue formula needs to adapt to changes in the volume and unit cost of investments in additional capacity (for whatever reason). We would expect Ofgem to review investment projects separately to check that they are worthy of cost recovery by reference to standard procedures for investment appraisal and implementation. It is very unlikely that any short-term (5-year) incentive will have much impact on the efficiency of investment decisions involving detailed long-term trade-offs.

As an interim measure, it would be preferable to extend the 1 year incentive framework possibly to 2 years with the final capacity output incentive coming in after that for 4 years in order for the impact to be better understood.

Quality of Service Incentive

We have commented in detail in Section 4 with respect to the increase in the scope of the guaranteed standards. We agree that two of the overall standards could be turned into guaranteed standards and have suggested a maximum compensation payment of £20 for failure. We do not support any increases in the level of compensation payments for the existing guaranteed standards. We consider that the current level is more than adequate to reflect the inconvenience caused to customers in the event of a failure. We are not willing to accept the additional risk associated with two new guaranteed standards in addition to an increase to the compensation payable under the existing standards. Our margins are already running at levels only just sufficient to handle our current risks and loading additional risks onto GDNs will put future financing at risk. In any event it is essential that an allowance is given to GDNs for the payments under the new standard where currently 100% performance is not required.

Question 8: Should we incentivise accuracy of pipeline records? If so, how could accuracy be measured and audited?

This is primarily an issue for the HSE and we have an agreed plan of work with them to address these issues, which the HSE will enforce through its own mechanisms. We acknowledge that historically there have been issues with inaccurate records that can have commercial implications specifically in the area of new connections, and that these issues have not all been resolved satisfactorily. There are however a number of ongoing initiatives within the business such as the Mains Location Agreement and Cost Recovery Scheme for Independent Connection Providers (ICPs)/IGTs and the DR4 (Drawing Records) error correction process which WWU believes negates the requirement for an incentive scheme to encourage GDNs to maintain accurate records.

WWU, along with the other GDNs are actively progressing completion of the records backlog project which will ensure all undigitised pipes are digitised by a set date, in WWU's case this will be complete by March 2007.

In summary, WWU believes that the industry initiatives, backed by HSE scrutiny, and current management focus on ensuring accurate records provide a comprehensive and effective programme and that Ofgem does not need to impose any additional incentive mechanism.

Question 9: Is there a case for an innovation funding incentive (IFI)?

WWU recognises that the current funding regime for GDNs does not encourage research and development, or investment in innovative unproven technology. There are a number of areas of activity in the GDN that would benefit from a properly structured research and development programme. Consequently some form of funding for this work would be welcomed and hence WWU would support the concept of the IFI for GDNs. R&D has the potential to improve efficiency and productivity and it is important that GDNs have the incentive to retain the benefits of any outperformance that accrue from any initiative or IFI deliverable. Such outperformance should be treated as any other costs and the benefits transferred to customers at the next price control review. WWU look forward to providing proposals for inclusion in the scheme, once the scope of the scheme is clear.

Long Term Skills Shortages in the Gas Industry

We consider that our current Learning and Development projections and plans detailed in our BPQ submission effectively address the skills challenges presented by the work programmes and operational requirements of the next formula period commencing April 2008. However, looking to the end of the next formula period and beyond, we are concerned that there are potential shortfalls in the availability of people with the skills needed to both deliver the projected workload volumes and to find innovative and effective solutions to the changing operational demands placed upon the network. Workload projections together with age profiles suggest that these shortfalls could occur in a number of key skills areas. In the long term these skills shortages could jeopardise the scale of our capacity to both renew and effectively operate the network.

We want to work with Ofgem, the GDNs and other relevant stakeholders to explore ways of addressing these long term skills issues. As part of this work we would wish to look at the funding of such long term skills investment. We believe that the current RPI – X regime, coupled with the 5 year review period, does not incentivise this type of investment. We would like to work with Ofgem to find a mechanism that does.

CHAPTER 6: FINANCIAL ISSUES

Question 1: Should we allow for an ex post adjustment for changes in tax treatment of certain kinds of expenditure, as outlined in paragraphs 6.3 and 6.4?

The post-tax WACC needs to be adequate to ensure proper financeability and tax should then become a pass-through item.

Tax costs can vary from original forecast for many reasons, including changes in corporation tax rate and a change in tax treatment of an activity.

We agree with the principle of an ex-post adjustment for adverse changes in tax treatment and rates. This is consistent with granting a post tax WACC return on investment where the Regulator has implicitly decided that the costs or benefits of managing tax risks and tax efficiency should not be retained by the GDN. Changes in the tax burden caused by changes in legislation are not controllable by the GDNs, The risks associated with possible future changes to tax law create a problem for financing, if there is no provision for adjusting revenues accordingly.

However, we believe greater clarity is required regarding the approach to allowances for tax.

- The current proposal implies that a retrospective adjustment is only available if Ofgem believes that the GDN has taken sufficient action to mitigate the charge. As a result, tax is effectively a “pass through” cost that is allowed only if the GDN achieves an undefined “best endeavours” judgemental benchmark which is set with the benefit of hindsight. Such a situation does little to mitigate the risk.
- Any mechanism for automatic pass-through can include incentives for a GDN to be tax efficient, and to exceed a benchmark – which could ultimately benefit customers.

Any mechanism must ensure symmetry of treatment across GDNs. We can envisage circumstances where GDNs may have a different tax treatment for the same economic activity, due to differences in the approach of different tax officials. Would a GDN retain the benefit of a favourable tax treatment if other GDNs were not able to agree this treatment with the Revenue?

Question 2: Which key ratios should we use as financeability indicators?

The key ratios used as financeability indicators should be those that are currently used in the Gas Distribution sector by Credit rating agencies, analysts and banks in funding documentation.

The key ratios are therefore:

Ratio	Basis
PMICR (Post Maintenance Interest Cover Ratio) – Historic and Projected	Adjusted Funds From Operations (FFO)/ Interest
Interest Cover Ratio – Historic and Projected	FFO/Interest
Regulated Asset Ratio (RAR)%	Debt/RAV

Question 3: How should we finance replacement expenditure, having regard to its impact on the overall financeability of the price control?

This question is misspecified, since Ofgem is not responsible for deciding how repex, or any other form of capex, is financed. Rather, Ofgem has a statutory duty to ensure that the licensee can finance its licensed activity. In practice, fulfilling this duty means that Ofgem must offer investors a reasonable prospect that future revenues will cover costs. A precondition for meeting this standard is setting out transparent and predictable rules and procedures for determining allowed revenues, as we have indicated above. The methods of setting cost allowance must also be designed to ensure that they do not prevent cost recovery in all but extreme conditions (e.g. by imposing unrealistic “frontier” costs at every opportunity, along with a low risk rate of return derived from “average” stock market performance). Given clear rules and a reasonable prospect of cost recovery, licensees will be able to attract the capital needed to finance efficient investment of all kinds.

We recognise that increasing the percentage of Repex that is capitalised into RAV would reduce the amount that would have to be funded by customers in the short term. Our view on whether to retain the current treatment where 50% of repex activity is deemed to be opex and 50% capex is dependent on:

- Determination of WACC return on the investment in RAV,
- Clarity on the capex roller incentive, and
- The impact on financeability, which is particularly relevant as the projected cost of the repex programme we are required to deliver by H&SE is forecast to increase due to cost drivers outside our control.

At the present time we do not see any scope for moving away from the present 50/50 treatment.

Question 4: Should we change our depreciation rate for new assets in response to the changing mix of assets being capitalised?

There are two reasons for adjusting depreciation rates: to reflect economic lives more accurately and to improve short-term cash flows.

With regard to changing depreciation rates to reflect changing average asset lives, the current capital expenditure mix should be reviewed to determine whether the apparent increase in Information Systems or non-operational spend with a shorter economic useful life represents a long term trend. “Short life” Capex additions continue to be a small proportion of overall RAV despite the forecast increase in capex over the Price Control Review period. We do not currently see changes in long term trends which would require a change in the previously assessed average economic life of the RAV asset.

The continuing development of the gas infrastructure to ensure security of supply of gas to the UK, and the growth of the networks to help alleviate fuel poverty, support an assumption that the transportation asset will be required to be in use for the foreseeable future.

CHAPTER 7: SUSTAINABLE DEVELOPMENT

Para 7.1-7.3 Shrinkage

We support leakage targets providing adequate capex and opex allowances are made to achieve the reductions if that is the policy aim. However, it is important that the process for estimating the shrinkage factors is accurate and is reflective of the effort which GDNs expend in reducing leakage.

Question 1: Which of the two forms of the network extensions incentive scheme should we adopt going forward?

In respect of network extensions we support Option 3b. This will enable all GDNs to participate and provide funding directly related to the desired outcome, that is the number of fuel poverty homes connected to mains gas. Other schemes will not provide such clearly defined incentives.

Question 2: Do you agree with our assessment of the risks, costs and benefits attributable to the options for facilitating network extensions (see Appendix 6)

We broadly support the assessment noting that if IGT licences are amended, the effect on competition will be positive for Option 5.

Question 3: Is our proposed methodology for quantifying the costs and benefits associated with the various options appropriate (see Appendix 6)?

We support the proposed methodology. It is important to recognise a range of benefits that mains gas will bring through reducing fuel poverty and green house gas emissions. The use of the Design & Demonstration Unit (DDU) information is supported.

Question 4: Is it appropriate to set an incentive scheme which recognises the initiatives that some companies undertake with respect to their corporate social responsibilities (CSR)?

We fully support the introduction of a CSR incentive. We believe this should be separate to any incentive on network extensions as this will avoid any distorting effect.

Question 5: What other criteria should be included in a Corporate Social Responsibility incentive scheme for GDNs?

Any CSR incentive must focus solely on the benefits in relation to networks and their customers. That is benefits solely funded by the network as distinct to those provided by commercial suppliers or shippers. Given the crucial issue of safety, an appropriate measure such as numbers of lost days should be included in any assessment.

CHAPTER 8: OTHER ISSUES

Question 1: Do you agree with our assessment of the risks, costs and benefits attributable to the two options for the funding of xoserve?

We are disappointed that a more radical approach is not being undertaken. We fully support the user pays approach providing that the details of the scheme are such

that the costs of changes fall on those parties who requested or benefit from the change.

If we don't move to a user pays model, then the GDN will require insulation from the risk of shippers requesting additional effort, for which the GDN pays (currently with no opportunity to increase charges to compensate). Cost pass through could be an alternative.

Appendix 7 clearly sets out Ofgem's view of the risks, costs and benefits attributable to the two options, this has been used as the basis for the Industry Dialogue Workgroup that we have played an active part in. We do, generally, agree with the assessment but believe that there are still many areas that need further work and clarification. We have always been supportive of a User Pays scheme as it attributes costs directly to Users that are responsible for them. We would like to add further comment on the key areas:

Cost Efficiency - we agree that the funding arrangements should establish incentives for GT's and Users (shippers) but believe that we are already incentivised to do this under the current Price Control mechanism. If future 'incentives' on GT's were to include only allowing for a proportion of fixed costs to be recovered through existing services (core or user pays), and the remainder to be funded through promotion of new user pays service, that this would be wholly inappropriate and will be double regulation. We do not believe that there are a plethora of services that xoserve could offer as new commercial services that would adequately cover other fixed costs, this would lead to the GT's being inadequately funded which would be unacceptable. We do not see User pays as mechanism for increased revenue and believe it should be seen as a way of targeting costs correctly.

Where usage of a service is discretionary a User Pays arrangement would allow Users direct control over costs and hence scope to reduce them. Even if a service is not discretionary by adopting a User Pays arrangement it would give greater transparency to Users of the costs that they are incurring, GT's / xoserve already report agency costs on an Activity Basis (as required by Standard Special Licence Condition A15(3)(ii) of the GT Licence) which would assist in moving to a User Pays arrangement.

Although it is reasonable to expect xoserve's overall costs to reduce under Option 2, consideration must be given for costs that would be incurred in setting up a User Pays framework, related IT costs and Governance arrangements.

Responsiveness - GT's / xoserve already have incentives in place to respond to the needs of Users and Industry as a whole. New commercial services are already available from xoserve and the User Pays arrangements would go some way to reinforce this position. However, it is unclear how, or why, GT's should be incentivised to provide new services to shippers or to other parties?

Promoting Competition - A User Pays arrangement, and appropriate governance, would ensure any new service offered by xoserve would be done on a fair and competitive basis. Whether a new service relies on the usage of regulated assets or not, and how these services are priced and treated, is a key issue that will need to be resolved.

xoserve's Service Standards - The Workgroup has considered the concept of varying service standards based on a 'premium' User Pays arrangement. This would add extra complexity but could be achieved through individual contracts / agreements

with Users. We do not believe that there is appetite within the Shipper community for such 'premium' services with varying service levels and, as stated in the consultation document, this would be a matter for UNC modification process.

Simplicity - Unfortunately, although it is our preferred option, User Pays would add a level of complexity in both implementation and ongoing administration. Hopefully any extra cost and complexity can be minimised and we are confident that the Workgroup will be able to recommend steps to achieve this.

We agree that the ambiguity relating to the regulatory treatment of xoserve's additional services will need to be resolved to prevent any future issues.

Question 2: If we adopt a core services plus user pays approach (Option 2), how should we define core services and user pays services?

In the absence of a more fundamental approach we support Option 2. The essential requirement when considering the division between user pays and core is absolute clarity. All parties must be under no doubt as to whether the service is core or requires user pays. At this point it is not possible to make that distinction and we will need to consider this in detail once the information is received following the survey in February.

The Workgroup has considered the following criteria for identifying candidate user pays services and has suggested the following:

- The key stakeholders are Users and
- Users have discretion on either whether or how to use the service and
- The cost of the service line is usage dependant.

Although we agree that these are valid criteria we disagree that all 3 are required in order for a service to become a User Pays service. If a service is mandatory due to licence or UNC obligations it should not preclude it from becoming a User Pays service and could be defined as 'core user pays'. These services are currently paid for by Users through Transportation charges, by becoming a User Pays service it could be argued that many of these services would be being charged on a fairer system (portfolio size / transactional basis rather than gas volumes) and would certainly be more transparent to the User.

An alternative way of defining xoserve services would be look at current and future services (including changes to existing service lines) and whether they are funded through the GDPCR or through User Pays arrangements. The Workgroup has concentrated on existing service lines and whether or not they are candidates for User Pays arrangements, further work is required within this area.

For future services it becomes more complicated. It is unclear what the funding arrangements for a new service line would be, regardless of UNC or licence obligations, that is not a candidate for users pays? Either a provision within the GDPCR for 'industry change', or a mechanism for allowing cost pass through of such changes within a PCR period, would be required.

The funding arrangements for services that can become user pays are much clearer. However, many UNC Modifications result in changes to xoserve service lines or result in the addition of new ones. The UNC Modification process would need to be modified to allow each Modification Proposal to be assessed for cost (implementation and future costs) and decisions made on applicable Users. Appropriate governance and controls would need to be in place to ensure that this process does not prevent

industry developments being furthered and/or implemented as the existing Class 3 Modification process seems to.

Question 3: What costs/benefits would your organisation incur in the event that we adopt Option 2?

It is not possible to comment in detail until the proposed discussion is clearer. However, with the use of a Users Pay arrangement the cost of such services will be more transparent to Users and efficiencies should be realised.

There would be initial costs in implementing a user pays framework, and the associated ongoing costs, but the magnitude of these is currently unknown. Depending on the charging methodology developed, xoserve could be faced with under or over recovery of costs due to demand changes from Users. The ability to vary prices annually, within a PCR period, would be required to ensure that sufficient funding is available. When over recovery occurs it is envisaged that a proportion of this would be returned to Users in the next PCR period and also reflected in annual service line price variations.

We do not believe that user pays arrangements should incorporate an incentive for GT's / xoserve to promote and sell additional services in order to recover fixed costs that have not been allowed through the GDPCR process. This would potentially lead to insufficient funding as we do not see xoserve as an additional revenue stream based on the limitations on extra commercial services that they can offer Users. It will also require xoserve and the GTs to take on higher risks which will need to be reflected in the cost of capital.

Question 4: What questions do we need to ask GTs, xoserve and shippers in order to accurately quantify the costs associated with Option 2?

A clear and comprehensive list of all the activities and services performed by xoserve is required. Costings will then be required each for each of the individual activities. The Workgroup has been tasked with recommending which of the existing services are candidates for user pays arrangements and this work is ongoing. The survey issued in February, a more detailed impact assessment and the final report from the Workgroup should allow for the costs associated with Option 2 to be accurately quantified.

Question 5: In the event that the Secretary of State requires GDNs to put in place further alternative arrangements relating to independent systems, should the excess costs associated with independent systems be:

- spread across all GB consumers via transmission charges; or,**
- borne by customers located in gas distribution areas where independent systems are located (primarily in Scotland)?**

We will need details of the proposed alternative arrangements before commenting further but in any event the operating costs associated with these independent systems is c.£50k per year within WWU. Alterations may include connecting these communities to mains gas under any new arrangements implemented or should the undertakings lapse requiring those customers to pay the actual costs of the service they receive. If the Statutory Undertakings remain the costs of connecting these networks should become part of the RAV or the costs of providing other services should be straight pass-through.

In general we support the costs of such services being borne by the customers of the GDNs. Given the separation of the GDNs it does not seem appropriate for cross subsidy between GDNs in different ownership.

WWU has two Independent systems not connected to the main gas network; Llanwrtydd Wells and Llanfyllin. The networks are Statutory Undertakings; customers are treated in the same way as for the natural gas parts of our network. These networks are supplied by LNG transported to site by road tanker and stored in tanks.

The Llanwrtydd Wells site is fed by a single tank farm that underwent some reinforcement works in 05/06. Additional tanks were installed and the regulator replaced. Llanfyllin is fed by 2 tank farms. There are capacity constraints on this network; a possible solution is to re-site the tank farm to a new larger area. The existing site does not have sufficient space for additional tanks and is accessed via a bridge that is subject to a weight limit. This causes complications in filling the tanks.

APPENDIX 5, Para 1.31 : SINGLETON ALLOWANCE

We are extremely surprised to find a policy statement by Ofgem contained in the Appendices to a Consultation Paper. We have addressed this issue in the main body of our response.