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Dear Joanna,

Gas Distribution Price Control Review – Fourth Consultation Document

We welcome the opportunity to comment on your work to date. As with previous consultations on the review of the Gas Distribution price controls, many of the issues raised in your consultation document are of wider interest to energy network companies. I would therefore like to comment on those aspects that have more general relevance. Our answers to your specific questions are provided on the attached pages, however I highlight the following key points of our response below.

We recommend that your approach to determining efficient costs should not be mechanistic, but should instead make a judgement based on all available evidence. We caution against over-reliance on models, given the number of issues associated with cost normalisation and the atypical nature of recent years' costs. The existence of inconsistent results between models reinforces the doubt as to the reliability of benchmarks defined. We would expect that you would therefore need to build in a greater margin of error in setting company specific allowances than would be the case where a larger data set was available.

We believe that the extent of "frontier shift" efficiency improvements suggested by Europe Economics' analysis is overly optimistic. We believe that there is clear evidence that service-sector firms employing a predominantly skilled, UK-based workforce are almost without exception seeing their unit costs rise on an above-RPI trend. The existence of such real input cost increases means that projecting frontier shift improvements of 1.9 to 3.7% p.a. is unrealistic.

In setting allowances it is important that you recognise that singleton DNs incur higher levels of fixed costs than DNs in larger ownership groups and that the existence of these increased fixed costs makes it more difficult for singleton DNs to secure efficiency improvements. This reduced ability to make future efficiency savings should be taken into account in projecting allowances.

Joanna Whittington
Ofgem
Page 2 of 2

26 April 2007

We support your ambition to use incentives to align the interests of the licensee with the interests of consumers. We believe that the consultation provides a good set of first principles for the application of revenue drivers and note your caution regarding the impact upon charging mechanisms. In designing future incentives it is important that you take into account the potential interaction between incentives. Schemes should be designed to ensure that the intentions of one scheme are not undermined by other more powerful, interacting incentives. This “calibration” of incentive schemes may involve changes to the current incentive rates or “roller” arrangements, but they may also require more fundamental changes to the way in which incentive schemes are designed and – in particular – the way in which quality incentives interact with opex and capex incentives.

We are supportive of the IQI as a method of incentivising appropriate forecasting behaviour but remain unclear as to your proposals for its implementation. The notion of company ‘choice’ only applies if there is certainty in advance of its introduction, whereas you suggest this decision will not be made until the Initial Proposals.

We promote the consistent application of principles in determining the cost of capital across price controls. As such we believe that it is essential that you consider longer term average cost of debt and not rely on spot rates that will not be indicative of the debt held by a company. We would urge Ofgem to consider all ratios used by lenders in making financeability assessments; this should include PMICR which is now being given greater prominence by agencies.

Should you wish to discuss any of these matters with me please do not hesitate to contact me.

Yours sincerely,

Mike Boxall
Electricity Regulation Director

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CHAPTER 2 – ACCOUNTING POLICY AND ADJUSTMENTS

Do you agree with our proposed accounting adjustments? Are there any other accounting adjustments that we should be considering?

We believe it is important to fully normalise costs so that the underlying cost base of the companies can be reliably compared. It is worth spending effort now on the development of a fully normalised data set in order to provide a stable basis for the future. As part of this process it is important to distinguish between costs that are being disallowed and hence not funded through the price control and adjustments required to normalise costs between DNs so that reliable comparative efficiency assessments can be made. The latter would include non-recurring and atypical costs such as restructuring costs. Although these items are excluded from comparative assessments there still needs to be a mechanism to ensure that these costs are adequately remunerated when they are actually incurred.

Paragraph 2.2 refers to the generic term ‘accruals’ under non-cash items. Costs should only be adjusted for accruals relating to atypical items. Normal trading accruals should not be adjusted.

Do you agree with our adjustments for related party margins?

We agree with the approach proposed by Ofgem for the treatment of related party margins. It is sensible that companies are not penalised through the removal of margins where contracts have been let on a commercial basis. We can confirm that the arrangements between NGN and UUOL are fully commercial and the contract was awarded following an OJEU notice and a competitive tender process.

Do you think we should change our treatment of non-operational capex?

We believe non-operational capex should be 100% capitalised for the purposes of the price control and consideration given to using a shorter depreciation life than operational assets. This approach would be consistent with the accounting treatment in the regulatory accounts where assets are capitalised and depreciated over the expected life of the asset.

CHAPTER 3 – OPERATING EXPENDITURE

How should we bring together the various consultants' analysis to establish an efficient cost benchmark and cost allowances? In the light of our approach to setting a benchmark, what approach should we take to glidepaths?

(a) Establishing efficient cost benchmarks

It is essential that the outcome of your analysis of opex costs is that DNs are provided with allowances sufficient to fund legitimate expenses; providing challenging but achievable efficiency targets.

Key to achieving this is having confidence that the models used will accurately predict required costs. A number of issues make this particularly difficult in the case of gas DNs.

- The atypical nature of the 2005/06 costs and the estimated, and hence unaudited, nature of 2006/07 costs.
- The different reporting regimes of the companies mean that costs may be allocated differently between companies. Our experience of the electricity RRP

process highlights the existence of inconsistencies in reporting between DNOs even after two years spent refining definitions and approach.

- The small number of data points in the sample of DNs restricts the nature of analysis possible and increases the risk that outlying companies may skew results.

These difficulties are compounded by the desire to select a model that best predicts efficient costs. Your analysis demonstrates the differences in conclusions that may result due to different choice of approach. For example, contrasting the approach of PB Power and Ofgem in assessing possible direct opex savings shows widely differing results.

There is significant risk that simply combining the results of analysis on disaggregated blocks of costs will result in a “cherry picking” effect, where the resultant allowances are much lower than required to fund essential business activities. This is illustrated well in your table 3.7 comparing the projected savings associated with the LECG and PB Power assessment of support services and direct opex respectively compared to the projected savings from Europe Economics’ “top down” assessment based on total opex. The “cherry picking” effect projects allowances that differ by tens of millions of pounds over the five year period. Even when PB Power’s analysis is substituted with your own analysis, the “cherry picking” effect still remains significant. Use of different years’ costs by consultants in assessing efficient costs will further exacerbate this effect if costs have been allocated differently in different years.

The observed differences in results call into question the validity of relying on any one model in determining allowances. We question whether the models proposed are robust enough to rely on to mechanistically determine future allowances. In the absence of consistent costs, and with known examples of different business models skewing results and models that suggest materially different results, we believe that it is most sensible to avoid taking a mechanistic approach to allowance setting.

We recommend that all available information be considered in informing the allowance setting process. This effectively involves the use of available benchmarking data to test the validity of companies’ forecasts of future funding requirements. We suggest that – of all benchmarking data available – the Europe Economics’ top down approach to establishing efficient base year costs be given higher weighting within this judgement as it is least likely to be distorted by cost allocation issues.

(b) Projecting future changes to efficient costs

Europe Economics’ projected improvements in upper quartile costs seem overly optimistic. We believe that it is inappropriate to assume such large improvements in performance beyond the economy wide productivity improvement included within RPI. A large proportion of the goods in the RPI basket are now produced overseas. Globalisation means that the cost of many of these products has been falling in recent years, or at the very least increasing only very slowly, as producers gain access to cheaper foreign labour and more productive working methods. Assuming efficiency improvements well above RPI is inappropriate if input prices are rising more quickly in the UK than in other countries or if the rate of productivity improvement in the UK lags behind the gains being achieved elsewhere. We believe that there is clear and compelling evidence that service-sector firms employing a predominantly skilled, UK-based workforce are almost without exception seeing their unit costs rise on an above-RPI trend. It is this type of ‘nature of work’ comparison which Ofgem should consider relevant to calculations of frontier shift.

Support for these arguments may be found in the CAA's initial proposals for BAA price controls where the CAA argues that it should 'be cautious before concluding automatically that an airport company operating at the industry's efficiency frontier will go on continuously achieving real terms opex reductions'. The CAA concludes that it would be inappropriate to assume that frontier shift permits real terms cost reductions over and above the potential efficiencies it identified in its benchmarking. We believe that these arguments hold true across monopoly networks and hence application of such stringent frontier shift assumptions will result in unachievable targets being set.

(c) Approach to glidepaths

Your discussion covers three separate aspects of the conversion of benchmark analysis into future cost allowances. These need to be dealt with differently.

- (i) Lack of confidence in benchmarks – this is not a justification for glidepaths. Where benchmark data is unreliable, allowances should include an additional element for all companies that increases the benchmark value to mitigate the risks of insufficient revenue being allowed.
- (ii) Funding investment to allow catch-up – this implies that poorly performing companies should be given a helping hand to improve efficiency. If the benchmarking were robust, this would amount to a reduction in the penalty for past inefficiency or a reduction in the relative reward for good performance.
- (iii) Structural adjustments – during DPCR4 it was recognised that singleton licensees may have a higher level of fixed costs than licensees in multiple ownership and that their ability to conform to a benchmark established from observed performance of all licensees would be impaired. This provides a strong justification for continued use of glidepaths to reflect the particular circumstances of singleton companies without which incentives for continued mergers (and loss of comparators) would remain too strong.

(d) Specific observations

In addition to the general comments above, we have the following specific observations on the detailed analysis undertaken:

PB Power Direct opex

We welcome the approach of considering the use of logical cost drivers to assess costs. However, such an approach must be underpinned by consistent allocations of costs to cost categories. The inability to model some costs suggests cost normalisation issues that call into question the validity of the results in this instance.

Europe Economics analysis of Total opex

Selecting cost drivers based on data which are not consistent and are not audited increases the risk of selecting inappropriate drivers for models. We find it hard to believe that the only drivers of total opex costs are customer numbers and throughput.

The fact that DEA analysis undertaken by Europe Economics places the majority of DNs on the efficiency frontier adds further weight to the argument that deviation from "efficient costs" may not be attributable to inefficiency but may instead reflect errors in the models.

LECG analysis of Support Services

We welcome LECG's acknowledgement that support services costs can be shared across ownership groups. We suggest that such sharing of costs is also possible in the IT component of non-operational capex. However, their approach appears to be flawed in two ways: firstly the use of ratios of costs discounts the possibility that significant fixed costs may exist and hence may penalise singleton DNs and secondly we find it hard to accept that revenue is a driver of support services costs and hence cannot be an appropriate measure against which to assess efficiency of costs.

Their approach to allowance setting gives no credit to DNs who are performing better than benchmark in an activity, hence DNs are exposed to all downside with no corresponding upside – an extreme case of “cherry picking”.

Is there a case for making adjustments to allowances for real price effects, specifically direct labour, contract labour or materials?

We welcome the acknowledgement that certain costs are rising at rates greater than RPI and agree that adjustments should be made to take account of these real price effects.

- Labour: The increasingly large proportion of items in the RPI basket that are produced outside of the UK using cheaper labour inevitably means that UK labour rates are increasingly in excess of RPI. In addition, future competition for skilled resources, combined with an ageing workforce pose further upward pressure on labour rates.
- Contract labour: We agree that general skill shortages for engineers and manpower as a result of large UK infrastructure programmes, as well as shortages of experienced gas personnel is resulting in contractor prices increasing at a rate greater than RPI. No reliable index exists for predicting utility contractor costs. It may be more appropriate to review cost increases in recent contractor awards and adjust costs accordingly. An additional allowance dedicated to investment in future skills should be implemented. This will help to improve the supply side of the labour market giving customers benefits in the longer term.
- Materials: Increasingly, the measure of RPI bears little relationship to the basket of goods and services which utility companies purchase. In recent times there have been significant falls in the cost, for example, of clothing and leisure items whereas the costs of oil, raw materials, utilities and services have increased at a significantly faster pace than average RPI. Consequently, the costs of operating utilities are rising faster than inflation as measured by the RPI. This should be taken as a baseline for growth in material costs going forward.

Is there a case for making adjustments to allowances for regional factors and if so what approach should be adopted?

We do not believe that there are material differences between labour rates and contract rates in different areas of the UK, with the notable exception of the “London weighting” allowance provided to employees in the immediate London area. Terms and conditions in the gas distribution businesses have until 2005 been negotiated on a national basis with consistent terms across the country. The workforce is largely unionised is seeking to maintain this parity across the country. Whilst some differences will emerge over time it is unlikely to reflect national indices for some time.

Read-across from the construction industry statistics is not appropriate and should be treated with significant caution. National tables tend to combine a number of specific skills; in reality the shortages of experienced utility personnel create a national market in contractors for utility companies.

Should we adapt our pension principles to address the forecast defined benefit pension contributions, which are both extremely high and vary widely across GDNs (despite funding very similar benefit packages)?

Should we change our pension recovery mechanism in order to avoid distorting incentives between making salary and non-salary cost savings?

We believe that it is important to distinguish between normal pension contributions and deficit repayments in considering the most appropriate treatment of pension costs. Pension deficit positions will differ between companies. The level of deficit costs to be incurred is not controllable by companies and does not represent current efficiency differences between companies. As such, it is logical that pension deficit costs should be excluded from comparative efficiency assessments and a separate allowance made at the price control. We believe that the mechanism developed to ensure pass through of actual costs provides the right remedy for deficits arising in the past. Allowances should be based on actuarial evidence on deficits/surpluses on the schemes.

However, companies do have a degree of control over the levels of normal pension contributions that they incur through their management decisions regarding staffing levels, remuneration policies, etc. As such a different treatment for normal pension contributions would seem sensible. Normal pension contributions should be included in comparative efficiency assessments – at the actual rate incurred – and included within opex allowances and subject to any opex efficiency incentive scheme. This approach would provide DNs with an incentive to reduce aggregate employment costs.

It will be important not to compromise the position of the Trustees as independent stewards of the pension schemes, bearing in mind that their role is scrutinised by the Pension Regulator. We support Ofgem's continued acceptance of decisions of the Trustees, for example, regarding the level of risk and associated costs implied by the pension scheme investment strategies they approve.

CHAPTER 4 – CAPITAL AND REPLACEMENT EXPENDITURE ANALYSIS

What are your views on PB Power's adjustments to the GDNs' forecast capital and replacement expenditure?

What are your views on PB Power's general approach to the assessment of costs?

What are your views on PB Power's approach to the cost assessment for each activity?

We note that PB Power have adopted a hybrid approach to assessing capex projections and, as such, it is difficult to comment on the process of analysis without further understanding of the detailed approaches employed. It is also unclear how the different approaches outlined are combined into an overall assessment of future capex requirements. We also note that the scope of PB Power's assessment is wider than that undertaken at DPCR4, for example including activities such as non-operational capex.

We do note however, the notion of 'benchmark' costs – it is unclear whether these include a volumetric assessment or are simple unit cost comparisons. Where the latter are explicitly referred to (4.29), we note the removal of additional costs for specific circumstances for comparison purposes but would be concerned to ensure that adequate allowance is made for such situations, otherwise the benchmarking is based on an atypical mix of relatively 'simple' solutions.

We welcome the consideration of real price inflation effects by PB Power in 4.20 but are confused by the resulting illustrations in Figures 4.1 & 4.2 which indicate overall reductions of cost with time. There are numerous references to "efficiencies" but these are neither quantified nor elaborated upon so it is unclear whether they relate mainly to volumetric or unit cost considerations.

Is it appropriate at this time to reconsider the approach to prioritisation within the risk model for the Mains Replacement Programme and should the approach to encroachment and diversions be amended?

It is inappropriate for us to comment on the proposals for the Mains Replacement Programme as we do not have access to the data which would allow us to make informed comment.

CHAPTER 5 - INCENTIVES

Is it appropriate to retain the current volume driver?

We acknowledge that the current throughput revenue driver effectively provides an incentive on companies to increase energy consumption and that this could be seen to be in conflict with sustainable development objectives. We understand that the relationship between throughput and costs is not strongly correlated. Given that the strongest relationship lies between throughput and shrinkage costs and that companies have been allowed specific allowances linked to wholesale gas prices we believe that it would be appropriate to remove the revenue driver.

Is it appropriate to implement any of the revenue drivers discussed in this chapter and are there any other drivers that we should consider that we have not included in this chapter?

We believe that the consultation provides a good set of first principles for the application of revenue drivers. We see the key point here being how to take account of future variations in costs that cannot reasonably be predicted during price control allowance setting process – but which DNs have some control over at the time that they are incurred. To successfully and equitably achieve this it is essential that (a) a direct relationship exists between short term variation in a cost driver and short term increases and decreases in costs and (b) variations in the cost driver cannot be fully forecast at the time of completing business plan forecasts. It does not necessarily follow that these short term drivers will be the same as the longer term drivers. For example, whilst long term average gas throughput clearly is a driver of average costs, short term variations in throughput will have little impact on short term costs. It is also worth noting the potential for confusion in discussing revenue drivers in a chapter headed "incentives". Revenue drivers could act as incentives on a licensee to increase volumes of the driver, but much of the discussion is about how to avoid distorting the cost efficiency incentive by using inappropriate scaling of allowed revenue.

Capacity related revenue driver

We agree that DNs will have greater control over short term capacity variations than throughput variations. It is also true that many of the marginal costs incurred by DNs due to customer-driven work will be driven by increasing capacity rather than throughput. We agree that it is sensible to consider capacity as an alternative to throughput as a revenue driver. However, it is important that the design of such a revenue driver does not effectively encourage DNs to build unnecessary overcapacity into their network in order to exploit the regime.

Connections based revenue driver

We recognise that there may be scope for a connections based driver but that considerable work must be completed to develop the scope and form of the driver. Given the proximity of the Initial Proposals document, this work is unlikely to be available in time for suitable consultation.

Is it appropriate to strengthen the capex rolling incentives?

We welcome your proposal to use the DPCR4 capex rolling incentive and IQI for the DNs. This emphasises the consistent approach used in both distribution price controls.

In designing future incentives it is important that you take into account the potential interaction between incentives. Schemes should be designed to ensure that the intentions of one scheme are not undermined by other more powerful, interacting incentives. This “calibration” of incentive schemes may involve changes to the current incentive rates or “roller” arrangements, but they may also require more fundamental changes to the way in which incentive schemes are designed and – in particular – the way in which quality incentives interact with opex and capex incentives. We recognise that this is not an easy objective to fulfil and would be happy to discuss our thoughts with you further.

Are our proposals for the treatment of offtake reform related costs and mains replacement costs under the IQI appropriate?

We agree that it is sensible to exclude certain items from the calculation of the IQI incentive. We suggest that these exclusions should include:

- Items where future spend levels are very uncertain and hence it would be unreasonable to incentivise a DN on the “accuracy” of their projections e.g. the costs associated with interruption reform
- Items where spend levels are defined by a third party e.g. repex programme
- Items where expenditure will be shareholder funded e.g. SOMSA expenditure

Such adjustments will ensure that the incentive is calculated based on the most appropriate components of DNs’ submissions.

CHAPTER 6 – METHODOLOGY FOR CONSIDERING FINANCIAL ISSUES

Do you agree with our proposed plan of work to determine the cost of capital? Are there other key areas of analysis that we should be carrying out?

Generally we support the approach to calculating the cost of capital as set out in the consultation. In particular, we support the approach to calculating the cost of debt using long term average data. This should allow for the historic profile of the debt and interest rates and maintain consistency with previous price control assumptions.

We welcome Ofgem's decision to publish the results of the financial model and share the model and data at key stages in the price control review. Beyond the DNs it would be appropriate to only publish the detailed financial model at an industry aggregate level to maintain company confidentiality.

Is the range of key ratios we have identified adequate for carrying out an assessment of financeability?

Is our approach to the issues raised by adjusted interest cover ratios appropriate?

Wherever possible, Ofgem needs to maintain consistency in their approach to financeability. We support the use of FFO Interest Cover, Retained Cash Flow/Debt and RAV based gearing as appropriate indicators. However, the range of indicators and weightings needs to keep pace with those adopted by the rating agencies and used in debt covenants. We would therefore urge Ofgem to also include PMICR in their financeability assessment, which is now being given greater prominence. Companies are required to maintain an investment grade credit rating and any price control settlement should allow companies to maintain its current position in line with the rating agency requirements.