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

25 April 2007

Dear Joanna,

Ofgem Consultation: Gas Distribution Price Control Review Fourth Consultation Document ("the fourth consultation document")

I am writing further to the publication of the above document on behalf of Wales & West Utilities (WWU) Ltd. Please find attached WWU's response:

- Part 1 – Executive Summary
- Part 2 – Detailed Response
- Part 3 – Additional Papers
- Part 4 – Confidential Consultants Reports as follows:-
  - Appendix A - Network Cost Drivers - A Bottom Up Approach Report prepared by John Spiller Associates
  - Appendix B - Direct Cost Review, Report prepared by Third Horizon Consulting
  - Appendix C - Support Services Review, Report prepared by Third Horizon Consulting
  - Appendix D - Review of Ofgem GDPCR (Capex/Repex) – Five Year Control - Report prepared by Mouchel Parkman (MP)
  - Appendix E - Wales & West Utilities Report on Price Indices March 2007 - Report prepared by Chandler KBS
  - Appendix F - Gas Distribution Price Control Review: Reports on Costs prepared by NERA
  - Appendix G – A Report Prepared by Willis Insurance Brokers Reviewing LECG's Report Relating to Insurance
- Part 5 – Non-confidential Consultants Report as follows:-
  - Appendix H - The 2007 Gas Distribution Price Control Review: A Top-down Analysis of the Scope for Real Terms Cost Reductions, Report prepared for the GDNs by First Economic

Our executive summary (Part 1) and detailed response (Parts 2 & 3) should be read in conjunction with the consultants reports (Part 4 & 5) which provide the detailed evidence to support our response.

We will be also be making a further submission on the Cost of Capital shortly, in time to be considered ahead of Ofgem making their initial proposals.

This response and WWU's consultants reports have been prepared on the basis of the draft PB Power, LECG and Europe Economics reports to which we responded in full on 16 March 2007. Therefore, the revised draft reports received on Friday 20th April will be subject to a further response once we have had time to consider and analyse them.

We look forward to engaging further with Ofgem in relation to the points raised in the fourth consultation document and our associated responses.

For the avoidance of doubt, Part 4 – Confidential Consultants Reports that accompany our response are all confidential. This letter, the Executive Summary (Part 1), Detailed Response (Part 2), Additional Papers (Part 3) and Non-confidential Consultants Report (Part 5) are not confidential and may be placed in the public domain. If you would like any further clarification please contact me.

Yours sincerely,

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OFGEM CONSULTATION: GAS DISTRIBUTION PRICE CONTROL REVIEW
FOURTH CONSULTATION DOCUMENT

WALES & WEST UTILITIES (WWU) LTD
RESPONSE TO CONSULTATION

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Appendix G A Report Prepared by Willis Insurance Brokers Reviewing LECG's Report Relating to Insurance

PART 5 – NON-CONFIDENTIAL CONSULTANTS REPORT (separate attachment)
Appendix H - The 2007 Gas Distribution Price Control Review: A Top-down Analysis of the Scope for Real Terms Cost Reductions, Report prepared for the GDNs by First Economics

OFGEM CONSULTATION: GAS DISTRIBUTION PRICE CONTROL REVIEW
FOURTH CONSULTATION DOCUMENT

WALES & WEST UTILITIES (WWU) LTD
RESPONSE TO CONSULTATION

PART 1 - EXECUTIVE SUMMARY

INTRODUCTION

The following executive summary should be read in conjunction with WWU's detailed response in Part 2, the additional information in Part 3 and the confidential appendices in Part 4.

This executive summary comprises three sections:

- An overview of the fundamental issues for WWU
- Executive summaries of our response to each of the Chapters in Ofgem's 4th Consultation Paper.
- Executive summaries from each of WWU's External Consultant reports which support our response (for the avoidance of doubt, these executive summaries can be placed in the public domain but the reports are confidential).

We previously provided initial views to Ofgem on 16 March 2007 on the various versions of the draft Ofgem Consultant's reports detailing the factual inaccuracies, fundamental flaws as well as the weak or erroneous analysis and assumptions, and our response should be read in conjunction with this earlier response.

PART 1 – EXECUTIVE SUMMARY
FUNDAMENTAL ISSUES FOR WWU

Opex Allowances

Based upon the analysis undertaken by our consultants we have presented a robust and detailed approach to assessing the relative performance of WWU.

For comparative purposes, a combination of robust regression analysis of 2006/7 direct opex costs using the appropriate cost driver of network length together with a benchmarking of indirect opex costs with appropriate external measures provides a realistic assessment of current performance and an informed view on the scope to improve efficiency. When setting allowances it is important that future cost pressures are recognised in addition to the base year costs used as part of the regression analysis.

Our consultants have also undertaken a high level benchmarking of direct costs. Again this shows WWU to be at or approaching first quartile performance across a variety of comparator groups.

The dispersed and irregular nature of our geography, low customer density and extended network imposes significant cost disadvantages upon us and must be reflected in the analysis. We have attached a paper to further support this entitled "Network Cost Drivers - A bottom up approach" prepared by John Spiller Associates as Appendix A demonstrating the case for local geographic and structural features to be considered as they significantly impact local direct and indirect operating costs (£5.3m).

Using disaggregated benchmarking and "cherry-picking" the comparator groups, leads to the creation of an artificially efficient GDN, which is totally unrealistic in the real world. The use of external benchmarking, although extremely limited within the LECG report, for indirect Opex is supported. However, the LECG approach does not disaggregate the support functions with their component parts or select appropriate cost drivers and comparator groups for the analysis. The benchmarking report submitted by WWU, prepared by Third Horizon Consulting attached as Appendix C, addresses the weaknesses of the LECG approach and provides a series of robust benchmarks against which the performance can be assessed.

Economies of scale play a major part in the overall efficiency of support costs in the Utility sector but the impact of these has been ignored by LECG. Analyses in this report examine the relationship between support cost and overall size using data from: the Australian Gas Distribution sector and the UK Water Industry. The existence of scale economies is robustly demonstrated by these examples and needs to be taken into account in any comparison between GDNs of different sizes. The analysis also demonstrates that once proper account is taken of economies of scale, WWU is shown as an efficient performer.

Capex and Repex Allowances

The independent review of capex by Mouchel Parkman strongly supports the investment forecasts included in the WWU BPQs. Our consultants concluded that the arbitrary reductions based upon GDN averages are unfounded and the full allowances should be reinstated.

Full allowance should be given for the installation of the new GTMS replacement system as it is no longer going to be safely supported from October 2009 and replacement would therefore have been required irrespective of the sale of the networks.

The mains replacement programme enforced by the HSE is based on the fact that iron mains cannot be maintained, therefore they must be abandoned. We agree that this programme, which replaces all 'at risk' iron mains within 30 meters of a building within 30 years, is wholly appropriate and should not be changed. WWU's philosophy to reducing risk is using the 20/70/10 approach which identifies sufficient size projects in the locations required as well as allowing WWU to optimise efficiency from our contractors.

Clearly the replacement programme is a significant proportion of a GDN's expenditure which is essential to meet the HSE requirements. The increases in costs associated with the replacement programme are for three reasons i) larger diameter pipes being identified as needing replacement ii) actual abandonment ratios and ii) the levels of above RPI increases (RPEs) experienced to date and anticipated to continue in contractor, materials and direct labour prices. The unit costs we have forecast in our BPQs are based on actual costs incurred, both for labour and materials and capitalised overheads and are essential if we are to meet the obligations for the mains replacement programme.

The Real Price Effects (RPEs) we have included in our BPQ submission for Capex and Repex have been supported by work undertaken by Chandler KBS who recommend the use of COPI and Baxter's indices to establish RPEs rather than ROADCON as follows:-

	WWU Forecast %	Chandler KBS %	PB Power %
Contractors	4.5	4.1	2.25
Direct Labour	2	1.8	1
Materials	2.5	3.2	1

This independent analysis clearly supports WWU's view that PB Power's proposed RPEs are unrealistic and therefore would lead to cost targets that were wholly unachievable. In addition, the contractor rates for both mains and services have been subjected to a competitive tendering process and reflect the current market rate for both mains and service activities.

Pensions

The statements regarding pensions in the fourth consultation document suggest that the pensions situation may not be fully understood. The main reason for the differences in future pension funding rates across the GDNs is that, despite having similar benefit packages, there are differences in specific actuarial assumptions (within the range of assumptions which are consistent with normal actuarial practice) adopted in the valuations and the effective date of the actuarial valuations are different. We believe there are issues with each of the 3 options for determining ex ante allowances. Our understanding of the Ofgem pension principles is that provided that the valuation and associated contribution rates are prepared in line with normal actuarial practice (and the guidance of the Pensions Regulator) then defined benefit pension costs will be allowed in full. Since the principles were established in 2003, they have been consistently applied in the Electricity Distribution, Transmission and

Gas Distribution Extension Year and stated in the Ofgem pension's letters of 2nd and 9th August 2004.

Financial Issues

Ofgem acknowledge that Gas Distribution is a more risky business than Transmission, our analysis also suggests this. A detailed evaluation will be submitted as evidence of this view, and this needs to be reflected in the WACC.

A key Ofgem licence requirement is for GDNs to maintain an investment grade credit rating. The key ratio used to assess and monitor the rating is PMICR. Both Moody's (who rate WWU) and Fitch both use PMICR. Also the principle debt providers for WWU use PMICR as the key covenant test. Consequently the parties concerned would resist Ofgem's proposals to dilute the importance of PMICR.

The ratios used to assess financeability (against Ofgem's test of a "comfortable" investment grade rating) should be the same as those which are used by the Credit Rating Agencies and providers of debt. As stated above, Moodys, who currently rate WWU, and Fitch both use PMICR.

Whilst we support appropriate incentives based on realistic cost assumptions all incentives, by their very nature, can affect GDNs revenues and costs. Therefore it follows that revenues and costs can rise or fall due to the impact of the incentives and this clearly introduces additional risk which needs to be recognised and accounted for in the level of the cost of capital. We will be making a submission on the Cost of Capital shortly, in time to be considered ahead of Ofgem issuing their initial proposals.

The price setting is at a stage where Ofgem has yet to formulate the package of incentives it intends applying during the next review period. Until Ofgem issues a draft of their proposed package we are unable to comment on the perceived risk which that package places on WWU and therefore how this would influence our view of WACC..We will comment further on our view of the incentives package, it's impact on the risk of the GDN and WACC once the initial proposals have been issued.

Scope for Real Term Cost Reductions

The RPI basket includes a wide range of goods and services, all of which are subject to slightly different cost drivers. Since the late 1990s, it has become increasingly apparent that some sectors of the UK economy are benefiting from large productivity savings and extremely benign input prices. It is therefore crucial that Ofgem understands that nature of the benchmark that RPI represents before considering the scope for GDNs to outperform.

Independent analysis of comparable UK companies to the GDNs suggests that costs have risen by around 2% above inflation in recent years.

Consequently before setting frontier shift assumptions, it is necessary to make adjustments for economies of scale/volume growth, capital substitution and the effects of comparative competition. Our analysis suggests that when accounting for these factors, this produces estimates for the underlying trend in GDN opex in the range of zero to +0.5% per annum (in real terms).

PART 1 – EXECUTIVE SUMMARY
SUMMARY OF RESPONSES TO EACH CHAPTER

Chapter 2 – Accounting Policy And Adjustments – Executive Summary

- We believe it is appropriate to continue to treat non-operational capital expenditure as capex. As the main components of this cost category are Information Systems (IS) and vehicles; the majority of which are capital investments to support operational activities
- The ability of a GDN to charge a margin on statutory connections activities is constrained by Section 10 of the Gas Act
- For all competitive connections activity we favour a policy that would allow profit margins to be achieved and therefore treat this work as outside of RAV as a competitive environment already exists
- Our view has not changed and one-off connections should remain as excluded services as by their nature they are difficult to accurately predict and vary significantly in value
- The boundary between competitive and non-competitive segments of the gas connections market should be updated annually using the published Connections Industry Review (CIR) statistics specific to each GDN's geographic area

Chapter 3 – Operating Expenditure Analysis – Executive Summary

- We have provided initial views to Ofgem on 16 March 2007 on the various versions of the draft Consultant's reports. Our responses detail the factual inaccuracies, fundamental flaws as well as the weak or erroneous analysis and assumptions. Our view is that these reports are not in a suitably robust state to be considered, even on a cross check basis on any judgements that may be made by Ofgem. We are particularly concerned about the lack of consistency and number of combinations of different operating expenditure figures that have been used in the various versions of the reports and the implications these inconsistencies have on the benchmarking analysis. The submissions from GDNs in response to Ofgem's consultants' reports should form a major part of Ofgem's analysis and consequential proposals for efficiency savings going forward. The 4th Consultation Document does not, in our view, give sufficient weight to this aspect.
- For comparative purposes, a combination of robust regression analysis of 2006/7 direct opex costs using the appropriate cost driver of network length together with a benchmarking of indirect opex costs using appropriate cost drivers and external comparator groups could provide a realistic assessment of current performance and an informal view of the scope to improve efficiency. When setting allowances it is important that future cost pressures are recognised in addition to the base year costs used as part of the regression analysis and that the future allowances take account of the allowances given for 2007/08.
- The dispersed and irregular nature of our geography imposes significant cost disadvantages upon us and must be reflected in the analysis. We are pleased to see the LECG report recognises the unusual length and spread of the WWU area. We have attached a paper to further support this "Network Cost Drivers - A bottom up approach" prepared by John Spiller Associates as Appendix A demonstrating the case for local geographic and demographic features to be considered as they significantly impact on local operating costs (£5.3m).
- Using disaggregated benchmarking and "cherry-picking" the comparator groups, leads to the creation of an artificially efficient GDN which is unrealistic in the real world. The use of external benchmarking, although extremely limited within the

LECG report, for indirect Opex is supported. However, the LECG approach does not disaggregate the support functions with their component parts or select appropriate cost drivers and comparator groups for the analysis. The benchmarking report submitted by WWU, prepared by Third Horizon Consulting attached as Appendix C, addresses the weaknesses of the LECG approach. In respect of glidepaths we suggest the first fundamental building block is to set allowances correctly; at that stage it will be possible to take a view as to whether glidepaths are appropriate.

- We believe the calculation of future Total Factor Productivity (TFP) efficiencies is fundamentally flawed due to an old data set being used in the analysis which does not take account of developments in the economy in the last eight years. In particular by the end of the price review the earliest data utilised will be 40 years old and there is an eight year "credibility gap" between the last piece of data in 1999 and the application of the output from the work during 2007
- The real price effects (RPE) contained within the consultants report are unrealistic, please refer to a report undertaken for WWU by Chandler KBS – Appendix E. Please also refer to the report prepared by First Economics in Appendix H.
- The statements in the 4th consultation document suggest that the pension situation may not be fully understood. The main reason for the differences in future pension funding rates across the GDNs is that, despite having similar benefit packages, there are differences in specific actuarial assumptions (within the range of assumptions which are consistent with normal actuarial practice) adopted in the valuations and the effective date of the actuarial valuations are different. We do not believe that the current regulatory approach might result in a medium term "stranded surplus" as contribution rates are adjusted at the actuarial valuation, which is performed triennially. WWU's actuarial deficit recovery plan is over 10 years which is the maximum period normally anticipated by the Pensions Regulator. Consequently, there is no evidence that customers are paying for higher contribution levels due to concerns about the employer financial structures. We believe there are issues with each of the 3 options for determining ex ante allowances. A confidential independent actuarial report will be submitted in due course which further supports our position as set out above. Our understanding of your pension principles is that provided contribution rates are prepared in line with normal actuarial practice (and the guidance of the Pensions Regulator) then they will be allowed in full. Since the principles were established in 2003, and followed up in the Ofgem pensions letters of the 2nd and 9th August 2004, they have been consistently applied in the Electricity Distribution, Transmission and Gas Distribution reviews.

Chapter 4 – Capital and Replacement Analysis – Executive Summary

- The Real Price Effects (RPE) we have included in our BPQ submission have been supported by work undertaken by Chandler KBS recommending the use of COPI and Baxter's indices to establish RPEs rather than ROADCON as follows:-

	WWU Forecast %	Chandler KBS %	PB Power %
Contractors	4.5	4.1	2.25
Direct Labour	2	1.8	1
Materials	2.5	3.2	1

- Given the lack of any real meaningful indices that are specific to the Gas Distribution business, and the fact that the majority of WWU's costs are driven by national prices, regional indices should only apply to the these costs that are affected by regional prices.
- We believe a full allowance should be given for the installation of the new GTMS replacement system as it is no longer going to be safely supported after October 2009 and replacement would have been required irrespective of the sale of the networks
- The use of benchmarking to determine upper quartile performers for Capex and Repex is appropriate but GDNs that are clearly at the efficient frontier of performance should not be set further stringent unrealistic targets
- The adjustments proposed by PB Power are very severe and unrealistic. Any Capex and Repex targets set for performance improvements must be set using robust, credible and meaningful analysis
- The WWU replacement risk profile approach is the most efficient at reducing risk at this stage and will remain throughout the next formula period. WWU are satisfied that the 20/70/10 approach identifies sufficient size projects in the locations required allowing WWU to optimise efficiency from our contractors consistent with meeting the HSE risk targets
- The increase in costs over the period is due to larger diameter pipes being replaced, a realistic abandonment ration based upon experience and the levels of above RPI increases (RPEs) experienced to date and anticipated to continue in contractor, materials and direct labour prices.
- The 30 year replacement programme is reducing the number of External Publicly Reported Escapes but this is not a linear relationship

Chapter 5 – Incentives

- We do not think it is appropriate to retain the volume driver that applied to allowed revenue from 2002/03 – 2006/07. That volume driver implied a 35% variation in GDN costs (excluding shrinkage) with fluctuations in gas throughput volumes. In reality GDN costs do not vary to this degree with volume. Therefore WWU would support a much reduced driver that better reflects the actual variability of GDN costs
- We understand Ofgem's rationale for wanting to introduce an Information Quality Incentive (IQI or "capex roller") to strengthen the Capex incentive but recognise that Ofgem are at the early stages in their thinking and that the PB Power Consultants reports do not provide a credible basis for setting the incentives
- We agree with Ofgem that it is inappropriate to include items related to offtake and interruptions reform within the IQI due to the inherent uncertainty around these items. There are other areas where there is uncertainty in respect of forecasting, for example, connections, where GDNs should not be penalised for changes in uncontrollable items such as customer demand and new housing.
- Whilst we support appropriate incentives based on realistic cost assumptions all incentives, by their very nature, can affect GDNs revenues and costs. Therefore it follows that revenues and costs can rise or fall due to the impact of the incentives and this clearly introduces additional risk which needs to be recognised and accounted for in the level of the cost of capital. We will be making a submission on the Cost of Capital shortly, in time to be considered ahead of Ofgem issuing their initial proposals.

Chapter 6 – Methodology for Considering Financial Issues

- Ofgem acknowledge that Gas Distribution is a more risky business than Transmission, our analysis also supports this. A detailed evaluation will be submitted as evidence of this view, and this needs to be reflected in the WACC together with;
  - the risk introduced or removed by the final incentives packages adopted by Ofgem
  - the appropriate use of comparative indices and current long term trailing average rates
  - the ratios used to assess financeability (against Ofgem's test of a "comfortable" investment grade rating) should be the same as those which are used by the Credit Rating Agencies and providers of debt. As stated above, Moodys, who currently rate WWU, and Fitch both use PMICR. GDNs, including ourselves, have debt covenants which include PMICR. Whilst Ofgem have highlighted theoretical reservations about the applicability of PMICR to GDNs, the ratio is used in practice and consequently needs to be maintained in its current form
- 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.
- We do not see any scope for moving away from the present 50/50 treatment of repex. 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.

PART 1 – EXECUTIVE SUMMARY
SUMMARY OF WWU'S CONSULTANTS REPORTS

WWU have employed a number of independent consultants to firstly review the analysis and reports prepared by Ofgem's consultants and secondly to provide workable, pragmatic and robust alternatives.

We have provided the following executive summaries for each of the reports which can be placed in the public domain; however, the reports which are attached to this response remain confidential.

PART 1 – EXECUTIVE SUMMARY
Network Cost Drivers - A Bottom Up Approach Report prepared by John Spiller Associates – See Appendix A

1. The LECG report recognized that the WWU service area and network was unusually large and suggested that a bottom up approach be carried out to quantify these effects. This report does that.

2. There are four main features of the WWU service area which impact adversely on operating costs i.e. described as "penalty" costs:

   a. the wide spread geography, irregular shape and form

   b. low customer density

   c. the extended network length

   d. the proximity to the coastline

3. To meet the emergency service 1hr response standard, it is necessary to provide outbased depots, staffed and stocked with materials, vehicles etc and the necessary front line support. The penalty costs associated with this are £671k for indirect costs and £1,642k for direct costs.

4. WWU has about 11% more mains per customer than the average GDN and about 58% more Pressure Reduction Stations (PRSs) than the average GDN. These extended network effects incur penalty costs of £2,905k for additional repairs and maintenance.

5. The proximity to the coastline results in WWU using a painting frequency programme for gas holders of 9 years and this incurs a penalty cost of £72k.

6. The overall effect is to produce a total penalty cost of about £5.29m together with additional stock levels being held in outbased depots to the value of £0.21m

7. A similar cost impact occurs with Capex and Repex. Contractor's rates in North Wales are typically in the range 19 to 30% more than for South Wales and in Devon and Cornwall the contractor's rates are typically between 8 and 13% higher than in South Wales.

8. An independent check of electricity distribution use of system charges shows that the Wales and West service area is between 47 and 71% more expensive to operate than the lowest cost area of the South East.

9. An independent check of water charges shows that the Wales and West service area is between 35 and 38% more expensive to operate than the lowest cost area of Southern Water.

10. There is therefore an overwhelming case for a "Local GDN Effect" allowance to be made for WWU in the price control based on the factors outlined in this report which equate to £5.29m.

11. Despite these penalties, in 06/07 WWU has the second lowest operating cost per km of main and the third lowest operating cost per customer of all GDNs.

PART 1 – EXECUTIVE SUMMARY
Direct Cost Review, Report prepared by Third Horizon Consulting – See Appendix B

1. The general approach used by PB Rune has been examined by Nera Economic Consultants. It was found to be flawed and depends on a series of unjustified and unsubstantiated assumptions. This study has therefore focused on WWU's overall direct cost base.

2. WWU's direct costs were forecast to be some £68.8 million in 2006/7, based on WWU's BPQ submission to Ofgem. The format of this is identical to the projections for 2008/9 to 2012/13 which were used as the basis for PB Rune's analysis. PB Rune made adjustments to the figures to "normalise" them for transfers between categories and to conform to Ofgem policy. No validation has been made in this study as to the appropriateness or otherwise of these adjustments.

3. Evidence from a study of UK water companies indicates that there is a linear relationship between total direct costs and the organisation's size. The analysis in this document indicates that:

    a. Based on a comparison with UK water industry the two smallest independent GDNs are shown to be strong performers across a number of total direct cost measures

    b. When the penalty costs associated with the unique characteristics of the WWU network are considered this situation is further improved

    c. Furthermore, when WWU is compared to a portfolio of US gas distribution companies the direct cost per km of pipeline of WWU approach that of the first quartile

    d. Similar benchmarks for the UK water industry again show WWU approaching first quartile performance

    e. Comparing WWU's total adjusted direct costs with the other GDNs on the basis of unsculpted RAV and Km of network shows WWU as the frontier performer.

4. Acknowledging that WWU is already demonstrated as approaching upper quartile performance across a portfolio of external comparators and is shown as the leading GDN, it is considered that the cost reductions implied by the PB Rune report are unjustified and unrealistic.

PART 1 – EXECUTIVE SUMMARY
Support Services Review, Report prepared by Third Horizon Consulting – See Appendix C

1. The methodology and approach adopted by LECG is fundamentally flawed and the efficiency targets implied in the report lack justification and credibility. Consequently it is considered extremely unlikely that the level of cost reductions indicated are actually achievable

2. WWU's support cost level in 2006/7 amounted to some £23.9 million after certain adjustments made by LECG to "normalise" them for comparison between GDNs and to conform to Ofgem policy. No detailed validation has been made in this study as to the appropriateness or otherwise of these adjustments. Of this total cost base some £19.2 m (about 80%) has been subject to analysis and comparison with meaningful and industry recognised benchmarks by Third Horizon Consulting.

3. Economies of scale play a major part in the overall efficiency of support costs in the Utility sector but the impact of these has been ignored by LECG. Analyses in this report examine the relationship between support cost and overall size using data from: the Australian Gas Distribution sector and the UK Water Industry. The existence of scale economies is robustly demonstrated by these examples and needs to be taken into account in any comparison between GDNs of different sizes.

4. When these scale economies are properly recognised it becomes clear that WWU's efficiency compares well with other sectors/companies.

5. Using a more appropriate approach, and industry recognised tailored benchmarks, WWU's performance is shown to be significantly better than that shown by the LECG report. In all comparisons WWU is seen to be a strong performer and in many it is a frontier company.

6. WWU operates in a challenging geographic environment, the impact of this is that additional support costs are incurred, over and above those which would be incurred by a network of similar size operating in a more condensed and compact physical area. These additional costs have been referred to as "penalty costs". When these additional costs are taken into account WWU's performance is even stronger.

PART 1 – EXECUTIVE SUMMARY
Review of Ofgem GDPCR (Capex/Repex) – Five Year Control - Report prepared by Mouchel Parkman (MP) – See Appendix D

Mouchel Parkman has independently reviewed the capex elements in the response by PB Power/Rune Associates on behalf of Ofgem. Mouchel Parkman's (MP) review provides a fact based analysis of the projects, workload and cost issues.
This analysis identifies significant flaws in the theoretical analysis upon which PB Power/Rune Associates states its review is based. The principal flaws are summarised as:

1. LTS and Storage Capex

    a. Pipelines

        The WWU submission for LTS pipeline costs is supported by independent conceptual design studies which address the actual construction costs of the pipelines. These costs are therefore significantly more robust than the theoretical assessment based on a general national benchmark whose content and limitations are not stated. MP has undertaken a high level review of one of the independent reports and found the routing appropriate and the cost estimates properly incorporated by WWU.

        The MP view is therefore that the £27.1m negative adjustment against pipelines applied by PB/Rune is unjustified and should be reinstated.

    b. Storage

        PB/Rune's reference cost for inline storage is based on 1200mm pipeline. Their figure for storage in 600-900mm pipeline, accounting for 50% of total WWU storage, is £200m/mcm.

        The MP view is therefore that no capacity adjustment should be made.

    c. Pre-Heater Replacement

        MP has carried out physical inspections of a sample of water bath heaters defined within the WWU replacement programme. The inspection process has confirmed the validity of the Advantica Report and justifies the proposed replacement programme.

        MP however recommends that the WWU three year programme is extended to cover the full five years of the Price Control Period as the three year programme proposed is considered to be overly ambitious.

2. Connections Capex

    a. The arbitrary reduction of 20% is unjustified since no account has been taken of the geographical differences to other GDNs with which comparison has been made.

    b. Regression analysis is not applicable since the categorisation of costs historically when Fulcrum undertook the work is no longer valid.

c. In response to central government, Ofgem and local government drivers, WWU is seeking to develop a pro-active policy to market infills and should be allowed the capex that will arise.

The MP view is therefore that there is no reason to make the 20% reduction from the WWU LTS and Capex submission for the Price Control Period under negotiation.

3. Mains Reinforcement

No account is taken by PB/Rune of the significant cost pressures that efficiency savings from improved management and contracting arrangements have to counter and no justification is provided for making the year on year reduction.

The MP view is therefore that there is no reason to make this reduction from the WWU LTS and Capex submission for the Price Control Period under negotiation.

4. District Governors

The requirement is not questioned by PB/Rune. From the work completed by MP we believe that WWU has never received the funding for this workload and that the previous network owners programmed this work to be undertaken during the period between 1994 - 2010. No evidence has been seen that suggests that this work was undertaken or even started by the previous owner.

The MP view is therefore that there is no reason to exclude these costs from the WWU LTS and Capex submission for the Price Control Period under negotiation.

5. DSEAR

MP has carried out inspections at a sample of relevant WWU sites and, in line with the DSEAR requirements, has reviewed the associated WWU cost estimates. In reviewing these cost estimates MP has found individual discrepancies across the work elements that make up the total project costs but in aggregation these discrepancies are insignificant.

The MP view is therefore that legislative requirement, full funding should be allowed during the Price Control Period under negotiation.

PART 1 – EXECUTIVE SUMMARY
Wales & West Utilities Report on Price Indices March 2007 - Report prepared by Chandler KBS – See Appendix E

1. The assessment has been based upon the same published data as that used by PB Rune Associates.

2. Chandler KBS agree with PB Rune Associates that certain activities carried out by the GDNs cannot be closely correlated with RPI.

3. Chandler KBS question the use of RPE's as an adjustment factor to RPI, and suggest that the RPI plus RPE formula should be replaced by a single index.

4. Chandler KBS recommend that the following RPE's are adopted;

	PB Rune Associates	**ChandlerKBS**
Contractor's Rates	2.25%	4.10%
Materials	1.00%	3.20%
Direct Labour	1.00%	1.80%

PART 1 – EXECUTIVE SUMMARY
Gas Distribution Price Control Review: Reports on Costs prepared by NERA – See Appendix F

As part of WWU's response to the consultant's reports we sent a report to Ofgem from National Economic Research Associated (NERA). We have re-atttached this as a confidential appendix for completeness.

PART 1 – EXECUTIVE SUMMARY
A Report Prepared by Willis Insurance Brokers Reviewing LECG's Report Relating to Insurance – See Appendix G

Willis Insurance Brokers have prepared a report which comments on the efficiency of the WWU insurance programme, potential future savings and market premium forecasts for the price control period 2008 to 2013.

Having reviewed the report, WIllis believe that:-

- WWU's current programme appears efficiently structured and aggressively priced against its peers,
- the basis on which potential efficiency savings have been calculated within the report does not seem equitable, and
- the LECG report premium forecasts understate the likely increase in premium over the pricing review period.

PART 1 – EXECUTIVE SUMMARY
The 2007 Gas Distribution Price Control Review: A Top-down Analysis of the Scope for Real Terms Cost Reductions, Report prepared for the GDNs by First Economics – See Appendix H (report not confidential)

1. This report by First Economics examines the likely rate of 'frontier shift' affecting the costs of gas distribution businesses.

2. In its fourth consultation document Ofgem includes a number of illustrations in which movements in the industry's efficiency frontier permit the GDNs to make annual real reductions in total operating expenditure (opex) of 2% per annum. Because economywide productivity savings and economy-wide input price inflation feed directly into the annual increase in the retail prices index (RPI), such assumptions effectively imply that the GDNs will not only become more efficient, but also that they will do so at a significantly faster pace than other firms supplying goods and services to UK households.

3. This is not something that should simply be taken for granted. The RPI basket includes a wide range of goods and services, all of which are subject to slightly different cost drivers. Since the late 1990s, it has become increasingly apparent that some sectors of the UK economy are benefiting from large productivity savings and extremely benign input prices. It is therefore crucial that Ofgem understands that nature of the benchmark that RPI represents before it decides that the GDNs will out-perform.

4. Disaggregating RPI into eight main subcomponents reveals that prices in the goods sector have been stable (i.e. constant in nominal terms) over a number of years. In this part of the economy shifts in production from western countries to the developing world have led to steep reductions in the prices of food and manufactured, traded goods. Asking any company to match the productivity gains and input price control that firms in these sectors are achieving represents a formidable challenge.

5. Within the service sector of the UK economy, it is clear that very few companies have been able to even hold their costs constant in real terms. Companies that rely on a skilled, UK-based labour force typically exhibit lower productivity gains and/or much higher input price inflation and so see their costs rise well in excess of RPI-measured inflation.

6. In understanding what might be expected of the GDNs, it is helpful to benchmark against comparable firms elsewhere in the UK economy. Under two different benchmarking approaches – one that involves excluding the contribution to RPI measured inflation of firms that have obviously different cost drivers and one that involves creating a new, more applicable inflation index from scratch – it is apparent that firms with similar characteristics to the GDNs have in recent times been seeing unit costs rise by around 2% above inflation.

7. Before applying such comparisons to the setting of frontier shift assumptions, it is necessary to make adjustments for economies of scale/volume growth, the capital labour mix and the effects of comparative competition. Accounting for these factors produces estimates for the underlying trend in GDN opex in the range of zero to +0.5% per annum (in real terms). However, they fall well short of substantiating an assumption that it should be possible for opex to fall in real terms.

8. Although this may at first seem a counter-intuitive result, it is important to stress that it does not in any way imply that the GDNs will not become more efficient during the course of the next control period. It simply highlights that real terms cost reductions are only deliverable if a firm is able to out-perform other companies whose products are included in the RPI basket. At a point in time when certain industries are demonstrating exceptional cost control, it is vital that Ofgem accepts that the costs of even the most efficient regulated company can easily move on an above-RPI trend.

OFGEM CONSULTATION: GAS DISTRIBUTION PRICE CONTROL REVIEW
FOURTH CONSULTATION DOCUMENT

WALES & WEST UTILITIES (WWU) LTD
RESPONSE TO CONSULTATION

PART 2 - DETAILED RESPONSE

In accordance with the requirements of the fourth consultation document, we set out below each of the Ofgem questions and our responses to them. Where have chosen to respond to a point raised in the paper that doesn't specifically form part of a question, we have noted the paragraph number(s) to which we are responding.

PART 2 - DETAILED RESPONSE
CHAPTER 2 – ACCOUNTING POLICY AND ADJUSTMENTS

EXECUTIVE SUMMARY

- We believe it is appropriate to continue to treat non-operational capital expenditure as capex. As the main components of this cost category are Information Systems (IS) and vehicles; the majority of which are capital investments to support operational activities
- The ability of a GDN to charge a margin on statutory connections activities is constrained by Section 10 of the Gas Act
- For all competitive connections activity we favour a policy that would allow profit margins to be achieved and therefore treat this work as outside of RAV as a competitive environment already exists
- Our view has not changed and one-off connections should remain as excluded services as by their nature they are difficult to accurately predict and vary significantly in value
- The boundary between competitive and non-competitive segments of the gas market should be updated annually using the published Connections Industry Review (CIR) statistics specific to each GDN's geographic area

RESPONSE TO QUESTIONS

Question 1: Do you agree with our proposed accounting adjustments? Are there any other accounting adjustments that we should be considering?

Whilst we are generally in agreement with the findings in the report there are a number of areas where we disagree. These are dealt with in turn below.

Paragraph 2.6 – Reconciliation to the Regulatory Accounts
We do not agree that the Regulatory Accounts are the more accurate data source. The £0.6m error for WWU came to light after the Regulatory Accounts were finalised and were not adjusted due to the immateriality of the amount involved. We consider the BPQ figure is the more accurate. We do understand that Ofgem may wish to ensure that its analysis is consistent with other published data. Note that, the twelve month 2005/6 data within the Regulatory Accounts, as agreed with Ofgem when the GDNs provided this information, is unaudited.

Paragraph 2.8 - 2.10 Atypical costs
Part of the atypical costs which Ofgem propose to disallow relate to Executive recruitment. Whilst we accept that the level of executive recruitment in 2005/6 could be described as atypical due to the start up nature of the business, we would argue that executive recruitment is an ongoing activity and that disallowing the entire cost is unreasonable.

Atypical costs also include compensation payments under the standards of performance arrangements. Whilst we concur with Ofgem that achieving 100% compliance and therefore nil compensation payments is the ideal, there is a significant cost in moving from our current compliance levels to this level of success which has not been incorporated within the BPQs as we don't have any clarity over what the new arrangements will be from April 2008 onwards. We consider that a certain level of compensation payments is inevitable and that the associated cost of achieving the move from a compliance percentage in the high nineties up to 100% compliance is typically prohibitively expensive and therefore not in the customers

interest. GDNs have always incurred some compensation costs and therefore it can be reasonably argued that improving the compliance rate or tightening the standard would increase costs above their historic and current levels for which Ofgem would be required to give allowance.

General Comment
Ofgem has acknowledged in their paper "Review of Accounting Issues" that 2005/6 is a start up year and that there is additional "noise" around the numbers as a result. Further, Ofgem state that they have not sought to identify any abnormally low levels of costs as part of their view. Thus, indicating that there may be areas of understatement within the BPQs which have not been adjusted in their attempt to normalise the results. Given that the independent GDNs have only been independently owned for less than two years, with only an eleven month period of accounts being audited, and that some spend will only occur on a cyclical basis in excess of one year, we would expect Ofgem to consider the risk that some areas of the BPQ may be understated when arriving at their proposals.

Question 2: Do you agree with our adjustments for related party margins?

It is important that in eliminating the impact of the margin on related party transactions that Ofgem do not distort their comparative analysis between GDNs.

As an example, where two otherwise identical notional GDNs choose to operate their connections business in different ways, with one in-sourcing the activity to a related party and the other undertaking the work via a third party contractor, then there is the risk that the GDN which uses a third party contractor will be treated as more expensive than the GDN using the related party once the related party margin has been eliminated. Both the third party contractor and the related party should be entitled to achieve a reasonable (market rate) margin on the work they undertake for the GDN and this margin should be reflected in the comparative analysis undertaken by Ofgem.

Rather than eliminating the full margin achieved by the related party, it would seem more appropriate to benchmark that margin and allow an efficient/market rate. This would then ensure that a true like for like comparison is undertaken between GDNs with differing business models. We are keen to ensure that artificially low benchmarks are not set by Ofgem in eliminating the full margin generated by related parties, but rather that a market rate margin is set for related party transactions which is then used by Ofgem in comparative analysis of costs between GDNs.

Question 3: Do you think we should change our treatment of non-operational capex?

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.

GENERAL RESPONSE

Paragraph 2.22-2.28 & Appendix 6 – Related Party Margins and Treatment of Connections Margins

Sections 2.11, 2.14 and 2.22 discuss the proposed treatment and removal of related-party connections margins by Ofgem.

The ability of a Gas Transporter to charge a margin on statutory connections activities (within 23 metres of a relevant main) is constrained by Section 10 of the Gas Act 1986, (section 10(5)), which refers to the recovery of cost only and not to the ability to make a reasonable profit. Thus, even if an applicant contracts to pay more than the cost of performing the connection, that part of the contract relating to the profit element is void and the applicant is entitled to that portion of his money back. This restriction only applies to connections within 23 metres of a relevant main.

It should be noted that cost is deemed to include the full cost of providing the connections service. Where these costs include third party activity (i.e. contract labour), then that third party cost is likely to include a margin to cover items such as risk premium and investor return.

As with our response to Question 2 above, we are keen to ensure that artificially low benchmarks are not set by Ofgem in eliminating the full margin generated by related parties, but rather that a market rate margin is set for related party transactions which is then used by Ofgem in comparative analysis of costs between GDNs.

Paragraph 2.22-2.28 & Appendix 6 - Existing one-off domestic housing and small non-domestic connections

We agree in principle that related-party profit margins should be removed to the extent that they are in excess of market rate margins as they do not constitute a true portion of the connections cost to the GDN and this mechanism would provide some protection for customers from avoidable costs.

We support removing such excess related-party profit margins made on existing one-off domestic housing and small non-domestic connections from the RAV where these are statutory connections and would be subject to Section 10.

Additionally, there are those connections which fall outside of the statutory connection 23 metre rule but for which no competitive market has yet developed. For this class of connection, we propose that the GDNs are permitted to generate a profit margin as with true competitive connections quotes. This approach, in time, would assist in developing these connections into a true competitive market in the future

Paragraph 2.22-2.28 & Appendix 6 - New housing and large non-domestic connections

Whilst WWU support the proposed approaches for related-party margins, we wish to clarify the treatment of “non-related-party” connections margins and ensure a consistent approach that allows GDNs to recover wholly legitimate costs.

“Non-related-party” margins are non-avoidable costs incurred by GDNs as part of an “arms-length” agreement. These margins should therefore be fully allowed within the price control process.

It is important that a clear distinction between “related” and “non-related” parties is made to avoid inappropriately penalising GDNs where justifiable “independent” third party margins have been charged and incorporated into the connections costs.

Paragraph 2.27-2.28 - Determination of Competitive versus Non-Competitive Markets

Whilst some competition has developed within the new housing and large non-domestic gas markets, these markets remain significantly dominated by the iGTs but their share of this work does vary annually. Therefore in order to determine the boundary between competitive and non-competitive segments of the gas market, we are supportive of using the annual published Connections Industry Review (CIR) statistics as a simple, measurable, basis for determining the percentage level of competition within the Connections industry. However, across the country, the level of competitive activity varies, therefore the CIR measure used to give the proportion of competitive connections activity needs to be region specific.

With the recent establishment of the independent GDNs, the industry is still evolving and the level of competition within each area of the market is likely to change over time. Therefore establishing a fixed pre-determined percentage of the market which is competitive at this stage would be inappropriate. Any ex-ante pre-determined percentage of competition would be arbitrary and unlikely to track closely to the actual establishment of competition.

PART 2 - DETAILED RESPONSE
CHAPTER 3 – OPERATING EXPENDITURE ANALYSIS

EXECUTIVE SUMMARY

- We have provided initial views to Ofgem on 16 March 2007 on the various versions of the draft Consultant's reports. Our responses detail the factual inaccuracies, fundamental flaws as well as the weak or erroneous analysis and assumptions. Our view is that these reports are not in a suitably robust state to be considered, even on a cross check basis on any judgements that may be made by Ofgem. We are particularly concerned about the lack of consistency and number of combinations of different operating expenditure figures that have been used in the various versions of the reports and the implications these inconsistencies have on the benchmarking analysis. The submissions from GDNs in response to Ofgem's consultants' reports should form a major part of Ofgem's analysis and consequential proposals for efficiency savings going forward. The 4th Consultation Document does not, in our view, give sufficient weight to this aspect.
- For comparative purposes, a combination of robust regression analysis of 2006/7 direct opex costs using the appropriate cost driver of network length together with a benchmarking of indirect opex costs using appropriate cost drivers and external comparator groups could provide a realistic assessment of current performance and an informal view of the scope to improve efficiency. When setting allowances it is important that future cost pressures are recognised in addition to the base year costs used as part of the regression analysis and that the future allowances take account of the allowances given for 2007/08
- The dispersed and irregular nature of our geography imposes significant cost disadvantages upon us and must be reflected in the analysis. We are pleased to see the LECG report recognises the unusual length and spread of the WWU area. We have attached a paper to further support this "Network Cost Drivers - A bottom up approach" prepared by John Spiller Associates as Appendix A demonstrating the case for local geographic and demographic features to be considered as they significantly impact on local operating costs (£5.3m)
- Using disaggregated benchmarking and "cherry-picking" the comparator groups, leads to the creation of an artificially efficient GDN which is unrealistic in the real world. The use of external benchmarking, although extremely limited within the LECG report, for indirect Opex is supported. However, the LECG approach does not disaggregate the support functions with their component parts or select appropriate cost drivers and comparator groups for the analysis. The benchmarking report submitted by WWU, prepared by Third Horizon Consulting attached as Appendix C, addresses the weaknesses of the LECG approach. In respect of glidepaths we suggest the first fundamental building block is to set allowances correctly; at that stage it will be possible to take a view as to whether glidepaths are appropriate.
- We believe the calculation of future Total Factor Productivity (TFP) efficiencies is fundamentally flawed due to an old data set being used in the analysis which does not take account of developments in the economy in the last eight years. In particular by the end of the price review the earliest data utilised will be 40 years old and there is an eight year "credibility gap" between the last piece of data in 1999 and the application of the output from the work during 2007.
- The real price effects (RPE) contained within the consultants report are unrealistic, please refer to a report undertaken for WWU by Chandler KBS – Appendix E. Please also refer to the report prepared by First Economics in Appendix H.

- The statements in the 4th consultation document suggest that the pension situation may not be fully understood. The main reason for the differences in future pension funding rates across the GDNs is that, despite having similar benefit packages, there are differences in specific actuarial assumptions (within the range of assumptions which are consistent with normal actuarial practice) adopted in the valuations and the effective date of the actuarial valuations are different. We do not believe that the current regulatory approach might result in a medium term "stranded surplus" as contribution rates are adjusted at the actuarial valuation, which is performed triennially. WWU's actuarial deficit recovery plan is over 10 years which is the maximum period normally anticipated by the Pensions Regulator. Consequently, there is no evidence that customers are paying for higher contribution levels due to concerns about the employer financial structures. We believe there are issues with each of the 3 options for determining ex ante allowances. A confidential independent actuarial report will be submitted in due course which further supports our position as set out above. Our understanding of your pension principles is that provided contribution rates are prepared in line with normal actuarial practice (and the guidance of the Pensions Regulator) then they will be allowed in full. Since the principles were established in 2003, and followed up in the Ofgem pensions letters of the 2nd and 9th August 2004, they have been consistently applied in the Electricity Distribution, Transmission and Gas Distribution reviews.

RESPONSE TO QUESTIONS

Question 1: How should we bring together the various consultants' analysis to establish an efficient cost benchmark and cost allowances? In light of our approach to setting a benchmark, what approach should we take to glidepaths?

We have provided our initial views on Ofgem's Opex Consultant's reports (Europe Economics, PB Power and LECG) 16 March 2007. We found factual inaccuracies in the data used as well as fundamental flaws in the analysis being used and weak and, in some cases, erroneous conclusions in the reports. Our strongly held view is that these reports in their present state are not in a suitably robust state to be considered even as a cross check on any judgements that may be made by Ofgem on benchmarking or allowances as part of the price control process.

We do believe that a possible way forward is to take a combination of robust regression analysis of 2006/7 direct opex costs using the appropriate cost driver of network length and add this to a benchmarking of indirect opex costs that have been derived using appropriate external measures. Such analysis undertaken thoroughly and after taking account of future cost pressures could provide a robust way of bringing the reports together.

Mechanistic approach

WWU agree that to apply a mechanistic approach would not be suitable at this stage due to the above reasons. In addition we have serious concerns about the number and combinations of Opex values that have been used in the various reports and benchmarking as there does not seem to be any consistency. For example, WWU do not believe that it is appropriate to use the work produced by Europe Economics to cross check any judgement made on benchmarking or to identify the scope for further efficiency savings. This is due to the inaccuracies, inconsistency and flaws found within the first two versions of the draft Europe Economics reports, the crude assumptions and 8 year credibility gap that exists within the data set used for setting

future efficiency gains. The fact that we are have just received a third rewrite of this report due to further changes in cost drivers and costs suggests that the credibility of this report is seriously undermined.

We also recognise that the new independent GDN management teams have only been in place for a short time. However we would stress the importance of the fact that WWU has reduced costs significantly in this short period and this must be taken into account in the final decision making on allowances.

Focus on disaggregated benchmarking

WWU agree with the key concern stated in the 4th Consultation Document using disaggregated benchmarking and "cherry-picking" the comparator groups, leads to the creation of an artificially efficient GDN which is unrealistic in the real world. We support the consistent use of external benchmarking for indirect opex. These external benchmarks are extremely limited within the LECG report and we have provided additional alternative external benchmarks, which we believe provide a far more credible basis upon which Ofgem can build their Initial Proposals of the proposed allowances. The present direct opex proposals as presented by PB Power are wholly unrealistic.

Judgement based on the evidence

This approach may be reasonable provided that the evidence is robust, and the process and calculations are totally transparent. We have gone to considerable lengths in our submissions to ensure that we do not just criticise the consultant's reports, but that we provide a serious alternative for Ofgem's consideration and acceptance. The submissions from GDNs in response to Ofgem's consultants' reports should form a major part of Ofgem's analysis and consequential proposals for efficiency savings going forward. The 4th Consultation Document does not, in our view, give sufficient weight to this aspect.

In order to provide further evidence to Ofgem which can be use to inform their future work, we are providing the following reports from WWU's consultants in Part 4 of our response. We would hope Ofgem take due consideration of the points made in these documents. Please note the reports listed below have been included as confidential appendices however a non-confidential executive summary for each has been included in Part 1 of our response:-

- First Economics - reviews the Europe Economics methodology and provides an alternative approach to frontier shift assessment (Appendix H).
- Third Horizon Consulting - reviews the LECG indirect cost report and provides alternative external benchmarking. Also provides evidence of economies of scale in the business that we believe should be taken into account in the review process (Appendix C).
- NERA - reviews the PB Power Opex Report and Europe Economics reports and comments on the methodology and statistical issues (Appendix F).
- Chandler KBS - reviews the forward projections of labour and materials and provides alternative trends (Appendix E).

WWU accept the use of appropriate regression analysis particularly in respect of direct opex to be used as part of the process of making judgements but these must be robust and transparent. The regression analysis graphs detailed in Appendix 7 of the fourth consultation document appear to be a move in the right direction. However

we strongly believe that network length should be used as the cost driver because it is more representative of the main assets of a gas distribution business and the support required to maintain it in a safe and efficient condition. Please note we have carried out a number of regressions and have generally found a better correlation between the data and the driver when using linear regression and not by taking natural logarithms.

Application of Benchmarking

WWU agree that it is too early to start using the analysis presented by Ofgem's consultants. As previously stated, there is a risk of "cherry picking" and bearing in mind the benchmarking is seriously flawed as indicted above, a significant risk of incorrect conclusions being reached. We cannot see how the proposed alternative benchmarking as set out in sections 3.67 & 3.68 of the 4th Consultation Document can be realistic at this stage.

Paragraph 3.69 – Glidepaths

In respect of the question raised concerning the Ofgem approach to setting a benchmark, and its implications for what approach should be taken to glidepaths, we take the view that the first fundamental building block is to set allowances correctly,. These need to be set after taking into account the GDNs specific factors and position in relation to appropriate benchmarks such as external benchmarks in respect of indirect costs. It is inappropriate at this stage to comment on glidepaths as Ofgem are still some way away from completing their cost analysis and taking a view on the appropriateness or otherwise of benchmarks and regressions. Only once this analysis has been completed and can be considered as robust can a view be taken on whether or not it is appropriate to apply glidepaths.

Question 2: Is there a case for making adjustments to allowances for real price effects, specifically direct labour, contract labour or materials?

Paragraphs 3.91 – 3.102

As we have indicated in our response to the PB Power report we have commissioned an independent study by consultants Chandler KBS into real price effects. Chandler KBS have recommended that the following above RPI increases should be used for future cost projections. The table below compares Chandler KBS's findings with both WWU's own forecast as well as and PB Power's recommendations.

	WWU Forecast %	Chandler KBS %	PB Power %
Contractors	**4.5**	**4.1**	**2.25**
Direct Labour	**2**	**1.8**	**1**
Materials	**2.5**	**3.2**	**1**

Appendix E includes a copy of the Chandler KBS report, which states that COPI and Baxter indices are more appropriate for the Gas Distribution business than ROADCON which specifically looks at public sector road construction projects. Chandler KBS discounted ROADCON because that indices is derived from road construction projects, and also because of its inherent volatility.

Question 3: Is there a case for making adjustments to allowances for regional factors and if so what approach should be adopted?

Paragraphs 3.82 – 3.90

As mentioned above Chandler KBS have undertaken an investigation into the impact of regional factors and to compare Building Cost Information Services (BCIS) with other published regional indices. They identified that the Public Sector and BCIS indices are very similar whereas the ROADCON index is markedly different. Chandler KBS concluded that ROADCON is not representative of the Gas Distribution Industry and is considered to be volatile.

The table below shows the different indices for the different regions of the UK.

	ROADCON	Public Sector	BCIS
North	0.98	0.96	0.99
Wales*	0.80	0.92	0.91
Midlands*	0.86	0.97	0.95
East	0.92	1.01	1.02
South West*	1.08	0.99	1.01
South East	1.15	1.07	1.04
London	1.28	1.09	1.15
Average*	0.91	0.96	0.96

* Regions impacting on WWU

Although the work by Chandlers KBS did identify regional differences in cost in a number of industries none of the indices were specific to the Gas Distribution business and therefore should be treated with caution. Indeed in a recent independent report by Mouchel Parkman (MP) – attached as Appendix D highlights the particular issues prevalent in the Wales and West area with the construction of a new transmission pipeline in Wales and the increasing demand for similar contractors that are also required for the water industry replacement programme. MP point to the fact that these drivers are increasing contractor rates for specific skill sets required by the Gas Distribution Industry across the country.

In addition, our suppliers of services and materials are predominantly national companies that are governed by national market forces and therefore regional adjustment factors are not appropriate. Notwithstanding this, our Direct Labour pay scales have been based on national pay bargaining, resulting in WWU inheriting the national pay scales from National Grid at the time of sale.

Given the lack of any real meaningful indices that exist that are specific to the Gas Distribution business we believe that regional factors just bring in another factor that causes inaccuracies and confusion. At the time of the next PCR (2013-2018) Ofgem will have meaningful comparative data specific to Gas Distribution. We believe it will be appropriate to use this real data at that time rather than coming up with some inappropriate regional factor that does not reflect the true economic pressures on each of the Gas Distribution businesses.

Question 4: 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)?

Please note Question 4 & 5 are answered together in the text that follows below.

Question 5: Should we change our pension recovery mechanism in order to avoid distorting incentives between making salary and non-salary cost savings?

We welcome Ofgem's confirmation (3.106) that the cash cost of servicing defined benefit pension schemes will be allowed in full, subject to being reasonable and prepared in line with normal actuarial practice. We also note that there is no evidence that would suggest that the actuarial assumptions used by the GDNs trustees and actuaries are unreasonable or out of line with normal actuarial practice, nor is there any evidence of failure of stewardship.

The consultation document identifies differences between each ownership group in future pension funding rate, despite having similar benefit packages. The main reason for this is differences in specific actuarial assumptions (within the range of assumptions which are consistent with normal actuarial practice) adopted in the valuations. Defined benefit pension scheme rules for the sold GDNs are the same as the Lattice scheme from which the members were transferred. These rules, in combination with UK pensions legislation, require actuarial assumptions to be set by the Pension Trustees. While the Trustees are required to seek the agreement of the Company, the rules and legislation place the Trustees in a strong position provided the assumptions are in line with normal actuarial practice. Funding rates have to be agreed by the Scheme Actuary, and be consistent with the guidance of the Pensions Regulator.

The draft actuarial valuation for Wales & West Utilities Pension Scheme was prepared with an effective date of 31 March 2006, and is therefore not directly comparable with other actuarial valuations prepared at different dates, in particular actuarial valuations with effective dates before December 2005 when the new Scheme Funding legislation came into force. Nor is the 2005 UK average pension contribution rate of 16% comparable, as this rate would be based on triennial actuarial valuations prepared up to three years previously, with effective dates up to four years previously. These contribution rates would therefore be determined primarily under the framework prior to various fundamental changes. These changes include more stringent legislation and wider recognition of the implications of increasing life expectancy on pension scheme funding.

General comparisons of contribution rates would be unlikely to reflect:

- differences in benefit levels – pension benefits are a relatively large proportion of total remuneration in the gas transmission industry, due to factors such as guarantees given at the time of privatisation; and
- differences in average age – the membership of the Wales & West Utilities Pension Scheme, with a salary weighted average age of 46, is older than the UK average, indicating a requirement for higher contribution rates than would apply for a younger membership. A major reason for this is a long period when most employees leaving the industry were not replaced, due to a downward adjustment in headcount in combination with efficiency measures.

We intend to provide a more detailed report, prepared by an actuary, setting out the reasons why future funding rates are different for each scheme, and concluding that the funding rate is appropriate for each ownership group, given their specific facts and circumstances.

With reference to section 3.110 of the Consultation Document, we do not believe that the current regulatory approach would be likely to result in a medium term "stranded

surplus". Actuarial valuations are performed triennially, and consequently contribution rates can be adjusted. The pension scheme membership of the sold GDNs consists mainly of active members. The combination of the membership profile and regular reviews means that it would be possible, subject to Trustee agreement, to use surpluses to assist in financing the cost of accrual of benefits. Consumers have benefited from pension fund surpluses in this way in the 1990s and the early part of the current decade.

WWU has an investment grade credit rating. The actuarial deficit recovery plan is 10 years commencing one year after the effective date of the valuation. This is the maximum period normally anticipated by the Pensions Regulator. Consequently, there is no evidence that customers are paying for higher contribution levels due to concerns about the employer covenant. Indeed, the Trustees' agreement to spread the deficit over the maximum normal period is evidence of confidence in the employer covenant.

Pension contribution rates can vary due to changes in economic circumstances, legislation, and actuarial assumptions, such as mortality rates, outside a GDNs control. Therefore a benchmark contribution rate as set out in Option 1 is not appropriate.

All things being equal, the long term cost of funding a defined benefit scheme will be similar, irrespective of the deficit funding period. Accelerated funding both reduces the credit risk borne by the pension scheme, and increases the value and therefore return on pension fund assets. This higher return can be recognised in the next triennial actuarial valuation which should result in a lower future funding cost. There does not appear to be any need, therefore, to assume funding for a "notional" GDN, as described in Option 2 when assessing allowed contributions.

An actuarial surplus can arise for many reasons other than "high contribution rates" including differences between actual and forecast investment returns and changes in actuarial assumptions applied at the valuation date (an increase in mortality for example). There are practical problems, therefore, with Option 3. If there is an actuarial surplus, no deficit reduction payments would be required, and the ongoing actuarial funding rate should take into account this surplus.

We believe that the financial management of the pension schemes and the strength of employer covenant mean that the potential problems noted in 3.110 of the Consultation Document do not apply. As discussed above, we see problems with options 1, 2 and 3, and consider that Ofgem's pension principles remain valid. Our understanding of Ofgem's pension principles is that provided contribution rates are prepared in line with normal actuarial practice (and the guidance of the Pensions Regulator), and do not arise from a failure in stewardship, then they will be allowed in full. We believe these principles can be met by allowing pension cost derived from triennial actuarial valuations, with ex post adjustments to allow for differences between actual contributions and allowances made through the Pensions Correction Mechanism.

GENERAL RESPONSE

Paragraph 3.5 & 3.6

We have responded separately on the factual inaccuracies contained within the draft consultants reports from PB Power, Europe Economics (EE) and LECG. We also sent an initial detailed response to these draft reports to Ofgem on 16th March 2007.

WWU's comments on these reports should be read in conjunction with our response to this fourth consultation document.

The PB Power adjustments are intended to bring down gross pension costs from WWU's 39% to 22%. We are advised that 22% is a number given to PB Power by Ofgem and that this is for the purpose of "normalising" all GDNs pension charges and that no inference to the percentage that will ultimately be allowed is given in Ofgem choosing 22%. In normalising the pension costs, PB Power have failed to take account of that element of the pension charge that has been taken to Repex/Capex along with the salary costs and have accordingly understated the 22% pension opex charge by circa £6.4m over the five years (in 2005/6 prices).

Paragraph 3.7 – TFP analysis

We support the use of the corrected ordinary least squares method for benchmarking costs. However, the use of 2005/06 data in the regression analysis is flawed because we were only responsible for 83% of costs in that year with the remaining 17% being provided by NGT. 2005/06 was also a year of change and transition and the costs are not therefore reliable. We believe that 2006/07 should be used as the base year for any regression or benchmarking undertaken as part of this review. We accept that the actual 2006/07 outturn figures will eventually be used in the final analysis. The exclusion of network length defies the accepted and practical principle which has been established in other utility network reviews that network length is a significant cost driver. It needs to be properly considered in the analysis.

Paragraph 3.9 – TFP analysis

The NISEC02 data set (produced by the National Institute of Economical and Social Research or NIESR) used by Europe Economics is well out of date and thus cannot reflect recent cost and productivity trends in the UK as a basis for establishing future potential efficiency gains. Similarly the chosen data set runs from 1973 to 1999 when it ceased to be produced. Thus by the end of the price review under consideration the earliest data utilised will be 40 years old, we question the validity of the use of such data. There is an eight year "credibility gap" between the last piece of data in 1999 and the application of the output from the work during 2007. The inclusion of a manufacturing index in the benchmarking is inappropriate because the Gas Distribution industry does not manufacture anything. There is a major inconsistency in the report concerning the privatisation effect, where it has been excluded from historical trends it is assumed that the effect lasts for 15 years whereas later in the analysis it is added back on, implying that the privatisation effect is continuing after 27 years. After 4 Regulatory Price Reviews we do not accept that a privatisation effect still exists. The report and analysis is largely based upon unjustified assumptions, made without any supporting evidence in the process of producing the future forecast of potential efficiency gains, thus placing considerable doubt on the reliability of the results. Due to the above mentioned problems, the calculation of future Total Factor Productivity (TFP) efficiencies is fundamentally flawed.

Paragraph 3.10 – TFP analysis

The calculation of frontier shift is flawed in that it does not use established econometric techniques. We do not accept the concept of a frontier shift in efficiency gains. The RPI–x formula provides this incentive and thus the inclusion of a frontier shift is "double counting". Such is our level of concern with the quality of the Europe Economics report in terms of data quality, accuracy, approach and unsubstantiated

assumptions we find it very difficult to see how Ofgem can use this report as input to the GDN Price Control.

An alternative approach is proposed which takes account of the twin track economy which has developed in the UK over the last 10 years or so. Please refer to Report prepared for the GDNs by First Economics entitled "The 2007 Gas Distribution Price Control Review: A Top-down Analysis of the Scope for Real Terms Cost Reductions" attached as Appendix H.

Paragraph 3.7 & 3.11

This paragraph and the figures within Table 3.2 imply that the cost drivers used in Europe Economics regression analyses have been changed for a third time using throughput and customer numbers as the sole drivers in the two different regression options. To date the raw data and analysis has not yet been made available to the GDNs from either Europe Economics or Ofgem making it difficult for us to provide comments.

Paragraph 3.14

The dispersed and irregular nature of WWU's network imposes significant cost disadvantages on it but these Regional and Network Specific factors have not been fully reflected in the report. Please refer to Appendix A "Network Cost Drivers - A Bottom Up Approach" prepared by John Spiller Associates.

Paragraph 3.19 – Work Management

The Composite Scale Variable (CSV) is based on PB Power's own judgement of the proportion of factors that influence Work Management costs. PB Power have excluded above 7 bar workload from this variable. However, we believe that work management associated with above 7 bar is significant and should be accounted for within the composite driver.

Paragraph 3.20 – Emergency

We are concerned that the R^2value of 0.55 is far too low for the regression prepared for Emergency Opex versus Composite Variable, accordingly we do not believe that this can be considered a reliable benchmark. The bottom up analysis developed by PB Power made many assumptions and utilised averages of averages and as a result produced a much diluted analysis.

There is an additional productivity improvement of 2% per annum built into the PB Power projections which is not accompanied by any proposal on how this can be implemented or achieved by the GDNs. Additionally, this differs from the levels used for other activities within the same report with no explanation – e.g. 1% in repair and maintenance.

Also, we are concerned that no allowance is made by PB Power for network geography or sparsity issues which have an impact on the number of First Call Operatives WWU is required to employ in order to achieve engineering team response times of one hour imposed by Ofgem which also forms part of our safety case.

Paragraph 3.21 – Emergency

The forecasts for Public Reported Escapes within a GDN are estimated from the number of Internal, and External, Publicly Reported Escapes, each are dealt with in turn below:-

Internal Publicly Reported Escapes (PREs) - The number of supply points within the WWU network is forecast to increase by c39,000 pa over the review period. In 2005/06 there were 95,000 Internal PREs, 4% of the supply points. A reasonable assumption would therefore be that the increase in Internal PREs from new connections would be 1,560 (4% of 39,000). The HSE issues two reports following its review of Domestic Gas Safety in 2005 which investigated current arrangements for promoting domestic gas safety across the UK and surveyed the condition of gas appliances in homes. The likely outcome of these reports is that a body will be set up to raise Carbon Monoxide (CO) awareness which we believe will increase the level of internal PREs. We have therefore forecast a 1% increase in Internal Publicly Reported Escapes based on a combination of the increase in supply points, condition of domestic gas appliances and increased CO awareness.

External Public Reported Escapes (PREs) - PB Power stated in their Opex report that overall WWU's forecasting process was reasonable but despite this they still made adjustments after reviewing our assumptions. PB Power assumed a direct link between the lengths of mains replacement and the volume of mains repairs which are generated from External PREs. Our data shows that, despite ongoing mains replacement over a number of years, the level of mains repairs following reported escapes has not decreased noticeably. In the past four years WWU has replaced 1,200km of metallic mains with no significant effect on the number of mains repairs. An increase in the age of the remaining metallic network and its propensity to fracture will affect the level of External PREs and suggests they will increase.

Paragraph 3.22 – Emergency & Loss of Meter work

PB Power calculated additional costs on the regulated businesses following a potential loss of meter work within their analysis and proposed an allowance within their cost projections. We do not believe that PB Power's cost estimates adequately reflect the potential situation within WWU. It should be noted that WWU factored in the loss of some meter work within our BPQ projections from 2008/09 onwards.

Paragraph 3.23 – Repairs

In the 2007 Budget, the Chancellor stated that landfill tax will rise from the current £21 per tonne by £8 per tonne each year until 2010/11 (when the charge will be £58 per tonne). Additionally, the aggregates levy is set to increase by £2 per tonne from 1st April 2008. The landfill tax assumed by PB Power in the base year (2005/6) is only £18 per tonne.

The assumption by PB Power that the GDNs will be able to mitigate this increased costs due to changes in the Waste Management Regulations by improved management and broadening the scope of the measures already in place (e.g. minimisation of excavation, re-use of materials, recycling and reconditioning etc.) needs to be revisited on the basis of these new charges.

Paragraph 3.26 – Maintenance

The bottom up analysis conducted by PB Power of holder maintenance was a very simplistic view of the process and costs. We believe that this simplistic approach has understated the costs because of a number of reasons which have been provided to Ofgem. We consider that historic costs and workloads should be considered when deriving allowances going forward. Individual holder painting assessments are carried out under specification T/SP/PA/10 and WWU has submitted a robust programme of painting and cost estimates for its holders and we do not believe this has been considered in detail by the PB Power.

Paragraph 3.27 – Maintenance

PB Power recognised that there was a wide range of costs within maintenance and that there may have been some coding and allocation issues. It is important that GDNs are compared on a like for like basis because assumptions made for bottom up analysis on the basis of inconsistent cost allocations and based on the responses of only two out of the eight GDNs did not produce sufficient robust conclusions in the draft report.

Some of the drivers used are inappropriate for the activities being analysed. For example within "Mains & Service Repair" and "Maintenance" the number of PREs should not be considered the main driver; a considerable volume of work is service related (e.g. non chargeable alterations, Gas Safety Management Regulations cut offs) and there is an element of mains abandoned work (where there is no associated mains laid).

The exclusion of two GDNs as outliers in the regression analysis for District Governor and Instrumentation without investigating the wide range of costings forecast by the GDNs has produced distorted forecasts. Rerunning the regression including the two outliers produced an R^2 of 0.1982 which suggests little correlation in the data.

It is essential that network geography and network length are considered as factors in maintenance costs.

Paragraph 3.30 – 3.32 – Direct Opex Analysis – Ofgem

The discarded regression analysis carried out by Ofgem of total controllable direct operating costs excluding shrinkage using network length as a cost driver (which has not been published) should be included within Appendix 7 for transparency and completeness.

In Ofgem's summary of the points drawn from the analysis, WWU appear to have been excluded from those GDNs listed as being the most efficient.

Paragraph 3.35 – 3.41 – Indirect opex/support services – LECG

We concur with the need to identify and adopt appropriate external benchmarks, especially given the limited comparator group of GDNs and the early stage of their diversification following network sales. Third party benchmarks, by their nature, are independent and should be used for Indirect Opex. However, it is important that any external benchmarks are i) appropriate to the industry in which the GDNs operate, ii) of a similar size to the GDN companies, operate in similar geographies and iii) that appropriate metrics are utilised in calculating comparator statistics. Where appropriate the metrics also require tailoring to the relative size of the GDNs.

It is important that Ofgem acknowledges that GDNs have different operating models and that direct and support services should be compared on a like for like basis. Normalisation and cost allocation and related party margin issues need to be addressed in a consistent manner and need to be transparent. We believe that recognition should be made for those companies that cannot benefit from inter group support.

One aspect of the indirect opex/support services work which LECG has reviewed is the insurance costs of the GDNs. We do not concur with the findings LECG make in their report as there analysis is flawed. In support of this we attach a confidential report from Willis Insurance Brokers as Appendix G.

Paragraph 3.51 – Policy Issues Arising from the Opex Analysis

It is our view that regional factors other than prices do have a substantial effect on opex and these factors should be taken into account when setting benchmarks. There is further detail provided in the "Network Cost Drivers - A bottom up approach" prepared by John Spiller Associates included as Appendix A. Economies of scale should also be taken into account to reflect the major difference between the independent GDNs and NGG.

Paragraph 3.95 - Skills

As part of our previous response we expressed the concerns we have over the current age profile within the organisation, and our further concerns relating to difficulties in attracting adequately skilled applicants, in particular craft workers.

Acting as a focal point for the industry, EU Skills will assist WWU in securing both cost effective resources and long term future skilled employees, and as such WWU is fully supportive of their involvement, given that we have a 30 year programme of investment.

Whilst we consider that our projections and plans as submitted in the BPQ submission effectively address the skills challenges for the short/medium term, these could be inadequate in preventing shortages occurring in the long term, and some extra recruitment could be needed to ensure that longer term demands are met. Additionally there are still concerns over the funding of this type of investment, as the current regime and 5 year review period does not provide any incentivisation.

The use of EU Skills will allow future skills to be secured in a cost effective and consistent manner across all GDNs.

Paragraphs 3.103 – 3.117 Treatment of Pension Costs

The principles regarding the treatment of pension fund costs were established in the Developing Network Monopoly Price Controls document, published in February 2003 (05/03), and were followed up by the Developing Network Monopoly Price Controls: initial conclusions document (54/03).

Additionally, Ofgem issued a position paper on pensions on the 2nd August 2004, which was supplemented with an addendum on the 9th August 2004, which stated that 'contributions made to an occupational pension scheme in respect of attributable DN employment performed in the future will be eligible for recovery from future price controlled revenues. To the extent that, in any particular period, the amounts

contributed exceed or falls short of the amounts recovered (i.e. the allowance), the excess or the shortfall will be taken into account on setting subsequent controls'.

Since this time these principles have been implemented and applied as part of the Electricity Distribution Price Control Review in 2004 (265/04), the Transmission Price Control Review in 2006 (206/06) and the Gas Distribution Price Control Review one year extension.

As part of the fourth consultation document, Ofgem have stated that they are now considering three different options for the Gas Distribution Price Control Review, for determining ex ante allowances. These three options all steer away from the clear principles established in the documents referred to above, which have been in existence since 2003 and subsequently been applied to both the electricity distribution and transmission price controls. Indeed even Option 3, which most closely represents the current agreed principles, with the key difference being the mandatory use of surpluses to reduce future pension allowances.

This clearly does not represent best regulatory practice and we would consider it appropriate that Ofgem follow the precedents that they have previously set in respect of the regulatory treatment of pension fund costs. We have provided further details in Part 3 of this document - B. Treatment of pension fund costs - Report prepared by WWU (not confidential).

PART 2 - DETAILED RESPONSE
CHAPTER 4 – CAPITAL AND REPLACEMENT ANALYSIS

EXECUTIVE SUMMARY

- The Real Price Effects (RPE) we have included in our BPQ submission have been supported by work undertaken by Chandler KBS recommending the use of COPI and Baxter's indices to establish RPEs rather than ROADCON as follows:-

	WWU Forecast %	Chandler KBS %	PB Power %
Contractors	4.5	4.1	2.25
Direct Labour	2	1.8	1
Materials	2.5	3.2	1

- Given the lack of any real meaningful indices that are specific to the Gas Distribution business, and the fact that the majority of WWU's costs are driven by national prices, regional indices should only apply to the these costs that are affected by regional prices.
- We believe a full allowance should be given for the installation of the new GTMS replacement system as it is no longer going to be safely supported after October 2009 and replacement would have been required irrespective of the sale of the networks
- The use of benchmarking to determine upper quartile performers for Capex and Repex is appropriate but GDNs that are clearly at the efficient frontier of performance should not be set further stringent unrealistic targets
- The adjustments proposed by PB Power are very severe and unrealistic. Any Capex and Repex targets set for performance improvements must be set using robust, credible and meaningful analysis
- The WWU replacement risk profile approach is the most efficient at reducing risk at this stage and will remain throughout the next formula period. WWU are satisfied that the 20/70/10 approach identifies sufficient size projects in the locations required allowing WWU to optimise efficiency from our contractors consistent with meeting the HSE risk targets
- The increase in costs over the period is due to larger diameter pipes being replaced, a realistic abandonment ration based upon experience and the levels of above RPI increases (RPEs) experienced to date and anticipated to continue in contractor, materials and direct labour prices.
- The 30 year replacement programme is reducing the number of External Publicly Reported Escapes but this is not a linear relationship

RESPONSE TO QUESTIONS

Question 1: What are your views on PB Power's adjustments to the GDNs' forecast capital and replacement expenditure?

In addition to the individual challenges we have highlighted in our response to Chapter 4, Question 3 below, we observe that there are some major variances between the capex & repex figures published in the PB Power report and those quoted in the 4th Consultation Document. For WWU specifically the 4th consultation document is £30.1m higher for Capex and £3.5m higher for Repex than the corresponding PB Power report. We understand that a further draft Capex & Repex report will be issued by PB Power which we assume will reflect these revised numbers.

As a general point the adjustments proposed by PB Power are very severe and do not take into consideration:-

- The impact on the operational costs of the network of not undertaking capital or replacement work which PB Power has proposed should be deferred.
- The legal requirements placed on GDNs in meeting its 1 in 20 peak demand statutory obligations.

In addition, there is no real detailed analysis to underpin PB Power's findings and the basis of cost reductions.

Any targets set for performance improvements must be set using robust, credible and meaningful analysis and the points made above should be addressed.

Paragraphs 4.54 – 4.55 SOMSA Exit & GTMS

The Gas Transportation Management System (GTMS) uses technology from the 1980's 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 principally due to a dearth of people with the necessary programming skills and diminishing availability of spare parts. Timescales and cost efficiencies are the two drivers for GTMS replacement at Hinckley. PB Power has allowed some of the expenditure for GTMS replacement. However, because this is an allowable expense, the full cost as set out in our BPQ submission should be allowed.

Question 2: What are your views on PB Power's general approach to the assessment of costs?

As a general approach the use of upper quartile performance benchmarking derived from bottom up analysis utilising regression analysis is appropriate. What is not appropriate however is to penalise GDNs that are clearly already at the efficiency frontier by setting further stringent unrealistic targets.

In addition the use of regression analysis is appropriate for high volume repetitive activities, i.e. Replacement and Connections activities. It is not suitable for one off projects, such as LTS, Governors installation / replacement etc, with have varying job costs dependant on terrain, engineering difficulties and other unique factors to a specific project. In a number of cases PB Power have based their analysis on adopting an average unit cost approach, this was more acceptable when Gas Distribution was delivered by one company as costs could be averaged out but it ignores the specific issues facing a given GDN of geography, sparsity, and other unique regional factors which have an impact on a GDN's cost base and should be recognised when setting targets.

Question 3: What are your views on PB Powers' approach to the cost assessment for each activity?

The adjustments applied by PB Power to WWU are inappropriate for a number of reasons which we have summarised below.

PB Power has proposed significant reductions in the RPEs in all areas which has had the impact of reducing their view of our Capex allowances. We believe these reductions are unrealistic. As mentioned above, we have engaged Chandler KBS, to give an independent view of RPEs and they have recommended the following which are broadly in line with WWU's forecast. The response on Real Price Effects given

above, sets out our view on how this very important aspect of costing should be treated.

	WWU Forecast %	Chandler KBS %	PB Power %
Contractors	4.5	4.1	2.25
Direct Labour	2	1.8	1
Materials	2.5	3.2	1

NGG have confirmed that they will not be constructing pipelines to provide additional storage above that which currently exists and that will expect the GDNs to provide the necessary investment themselves. We cannot undertake an analysis of the impact on WWU of such investment and the least cost solution until the costs of NTS capacity and the relevant incentive mechanism is known. However based on the statement from NGG that they will not construct pipelines for additional storage our programme of work for storage should be allowed as local GDN expenditure will be required in some form to meet the growing network demand being forecast.

However, irrespective of the availability of storage from NTS, we are required to undertake the Bancyfelin to Lampeter LTS storage project to ensure we meet our statutory obligations, this is based on the demand forecast we received from xoserve. PB Power have deferred some £27m of Capex into the next price control period (2013/18). We believe that this project should be reinstated as the demand forecasts require it.

WWU erroneously omitted any RPEs when forecasting our LTS storage projects. Therefore it is incorrect for PB Power to reduce our costs for these. In fact, our costs should be increased by PB Powers estimated RPEs.

The unit cost approach taken by PB Power ignores the engineering difficulties, specific environmental impact and geographic terrain of a given pipeline corridor. These incorrect adjustments to standardise unit costs of pipeline construction should be added back into our Capex allowance as they are fully justified and reflect the real costs of undertaking the work.

Deferring 33% of the pre-heater expenditure into the next PCR period is inefficient and will result in increased maintenance costs, which have not been reflected in our Opex BPQ, and lead to adverse environmental impact. If PB Power's proposals are accepted by Ofgem then the increased Opex costs will clearly need to be added back into our Opex allowance.

The 2% per annum efficiency saving for mains reinforcement work used by PB Power in their report has no supporting evidence to substantiate it. Therefore this adjustment is not considered to be credible and should be removed.

PB Power has removed the Dangerous Substances Explosive Atmospheric Regulation's (DSEAR) related work and associated cost from our BPQ submission. This work is required to be undertaken as a statutory requirement obligation. Therefore the £5.9m that PB Power has removed should also be reinstated into our capex allowance.

The HSE require us to complete all non conforming governor work by 2010 and therefore this work needs to be included in our Capex allowance. PB Power contend that this work was allowed within the 2002/07 price control settlement and should therefore not be allowed within the next price control review period irrespective of

whether the work was actually undertaken or not. The work was not undertaken during the last price control review, had it been, all GDNs capex overspend for that PCR would have been greater and thus the Regulatory Asset Value would be correspondingly greater higher.

The disallowance of our planned expenditure in Other Operational Capex will mean that this work will have to be deferred. However this work was intended to increase public safety and meet our current obligations. The deferral of this work is anticipated to result in higher levels of Public Reported Escapes and increased shrinkage, therefore these consequential increased opex costs will need to be allowed.

PB Power has proposed to disallow £18m of System Operation Management Services Agreement (SOMSA) cost on the basis that this expenditure was all separation cost and disallowed specifically as part of the network sale agreement. However, the cost disallowed by PB Power include telemetry cost associated with pressure management outside of the scope of the SOMSA project. There is also c£5.5m of allowable Gas Transportation Management System (GTMS) replacement cost included in the £18m. Therefore these incorrect disallowances must be reinstated into our Capex allowance. It is also important to note that there would be costs incurred by GDNs even if SOMSA exit was not a requirement of separation, it is therefore important a level of these costs if allowed.

PB Power has proposed a 1.75% per annum efficiency savings for mains and service replacement work. This proposal has no supporting evidence to substantiate any level of efficiency saving. We do not believe that this level of savings can be achieved. PB Power has also included the length of upsized main in our lay replacement figure and claim that our lay:abandon ratio has changed from 0.95 to 0.97. This would be the case as the lengths that are upsized would be spine mains and would be replaced on a 1:1 ratio. This was an incorrect application of the lay:abandon ratio by PB Power and both the required cost and mains length should be reinstated.

In respect of LTS Repex we have now identified a high pressure pipeline that needs to be replaced due to low levels of cathodic protection along its length. Therefore the £6.1m disallowed by PB Power in 20012/13 should be reinstated into our LTS Repex allowance to enable this project to go ahead.

Mains lengths for new connections have been reduced by PB Power based on average GDN lengths. We do not consider that the use of an average in this area is appropriate due to the issues of sparsity within our geographic area. The 20% reduction to our connection mains lengths should therefore be reinstated.

We have considerably reduced our connections costs, taking out £6.8m of Gross cost from 04/05 (in 05/06 prices) when compared to 2006/07. We consider that our current connections costs are efficient. Therefore further efficiency savings of 3% per annum are unjustified and are unrealistic. This adjustment should therefore be removed.

The Final Connection Allowance either needs to be allowed or charged to the connectee.

Question 4: Is it appropriate at this time to reconsider the approach to prioritisation within the risk model and should the approach to encroachment and diversions should be amended?

In response to the points raised in the 4th Consultation Document under the heading of Repex Programme we have prepared a paper which supports the summarised view below, this is entitled "30/30 Risk Replacement Programme - Report prepared by WWU" and is attached in Part 3 A. of this document.

Paragraph 4.50

We agree that the cost of the repex programme is a key driver of GDN costs. The increase in costs over the price control review period is due to larger diameter pipes being replaced and the levels of above RPI increases (RPEs) experienced to date and anticipated to continue in contractor, materials and direct labour prices. We believe that the current 20 (Seed) – 70 (Within 5 Year threshold) – 10 (Any risk) approach used for risk modelling will continue to be used throughout the period as an efficient method of risk reduction rather than a zonal approach.

WWU note the change in replacement strategy being adopted by NGG (who are moving to zonal replacement). However, to address our current risk profile we need to continue with the 20-70-10 philosophy. This approach maximises risk reduction for the same equivalent length compared with the zonal (20 – Seed – 80 – Any risk) approach being used by NGG. WWU are satisfied that the 20/70/10 approach identifies sufficiently sizeable projects in the locations required allowing WWU to maximise efficiency from our contractors. WWU believe that this will continue to be the case throughout the next Price Control Review period. As such, the replacement workload included in WWU's BPQ submission has been based on the work generated through a 20-70-10 approach.

As stated above, the WWU risk profile is such that a 20-70-10 approach is the most efficient approach at reducing risk at this stage. At some point in the future the WWU risk profile will be such that changing the methodology utilised to identify replacement work, either adopting 20-70-10 or 80-20, will have little impact on the overall level of risk reduction and therefore maybe considered after the end of the next price control period (from 20013/14 onwards), WWU do not envisage that this will be the case throughout the next formula period 2008/9 to 2012/3.

Paragraph 4.53

As encroachment is predominantly experienced in city locations where the pipes already have a level of risk, then the main impact is to raise the risk to a higher level. Encroachment generates very little zero risk to risk growth.

Within this section in the 4th consultation document a reference is made to *'the GDNs replace some of their pipes each year with PE pipes through general capex work or condition monitoring and the encroachment level is not adjusted to take account of this work'.* We are unclear about the point that is being made and would ask that further clarification be given so that we can provide an appropriate response.

With regard to mains diversions within WWU, chargeable diversions are not counted towards the GDNs level of risk replacement whereas non rechargeable diversions of risk mains are. As can be seen from WWU's BPQ submission the level of non rechargeable diversions is minimal.

WWU does not believe any adjustment is required to the repex programme to take account of encroachment and diversions as neither generates significant lengths of additional work.

Repex - General Points

The level of risk that society is prepared to tolerate is constantly reducing, the 30 year replacement programme is an integral part of the gas industry's response to this expectation in addition to the increasing requirements from the Health and Safety Executive. Furthermore incidents on the gas network which result in loss of supply or worse, death, will cause considerable damage to the reputation of companies involved in the industry.

General deterioration of the metallic gas main network is increasing as it continued to age, and low pressure ductile iron corrosion is becoming an increasing problem. Ductile iron replacement will represent a higher proportion of the replacement programme in the next formula period.

With regard to repex unit cost we have applied Real Price Effects (RPEs) year on year to our cost at 2005/06 prices for both Mains and Services. The levels of RPEs applied has been supported by an independent piece of work undertaken by Chandler KBS. The Mains and Service unit cost we have put forward are based on actual cost incurred, both Labour and Materials, we have also included the relevant level of capitalised overheads. The mains allowance expenditure is subject to the incentive mechanism set by Ofgem while services are based on current market rates to lay a service.

The contractor rates for both mains and services have been subjected to competitive tendering process and reflect the current market rate for both Mains and Service activities. WWU is aware that Ofgem intend to revise the Mains incentive mechanism and propose the inclusion of Services in the revised version.

PART 2 - DETAILED RESPONSE
CHAPTER 5 – INCENTIVES

EXECUTIVE SUMMARY

- We do not think it is appropriate to retain the volume driver that applied to allowed revenue from 2002/03 – 2006/07. That volume driver implied a 35% variation in GDN costs (excluding shrinkage) with fluctuations in gas throughput volumes. In reality GDN costs do not vary to this degree with volume. Therefore WWU would support a much reduced driver that better reflects the actual variability of GDN costs
- We understand Ofgem's rationale for wanting to introduce an Information Quality Incentive (IQI or "capex roller") to strengthen the Capex incentive but recognise that Ofgem are at the early stages in their thinking and that the PB Power Consultants reports do not provide a credible basis for setting the incentives
- We agree with Ofgem that it is inappropriate to include items related to offtake and interruptions reform within the IQI due to the inherent uncertainty around these items. There are other areas where there is uncertainty in respect of forecasting, for example, connections, where GDNs should not be penalised for changes in uncontrollable items such as customer demand and new housing.
- Whilst we support appropriate incentives based on realistic cost assumptions all incentives, by their very nature, can affect GDNs revenues and costs. Therefore it follows that revenues and costs can rise or fall due to the impact of the incentives and this clearly introduces additional risk which needs to be recognised and accounted for in the level of the cost of capital. We will be making a submission on the Cost of Capital shortly, in time to be considered ahead of Ofgem issuing their initial proposals.

RESPONSE TO QUESTIONS

Question 1: Is it appropriate to retain the current volume driver?

WWU's position has not changed from previous responses in that we do not think it is appropriate to retain the volume driver that applied to allowed revenue within the 2002/3 to 2006/7 PCR. We support the reduction or removal of the volume driver as the vast majority of a GDN's 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 PREs above those assumed at a price control or by retaining a significantly reduced volume driver element.

Question 2: 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?

The previous volume driver implied a 35% variation in GDN costs in relation to volume. Recent work with Ofgem demonstrates that GDN costs do not vary to anywhere near this degree with gas throughput volumes. Therefore WWU would support a driver that better reflects the reduced variability of GDN costs. This would also support the desire by shippers for reduced unpredictability in GDN charges.

Revenue drivers should reflect actual cost drivers. Whilst a proportion of our costs are driven by changes in customer numbers, analysis shows that network length and

plant such as district governors are more appropriate cost drivers than simple customer numbers.

In addition WWU would again like to make the point that the variations in Collected Revenue should match variations in Allowed Revenue to ensure there is no large uncertainty over charging changes. WWU welcome the recent direction on charges and continues to work with Ofgem in this area.

Specific Comments on each of the Drivers are covered below:-

Volume driver: WWU do not think that the previous volume driver is appropriate for future price control reviews. We have submitted data to Ofgem to show that costs do not vary with or to the degree the volume driver suggests. The volume driver places additional risks and uncertainty on GDN allowed revenue without reflecting the fluctuation in the underlying cost base. The throughput of a GDN is impacted by weather that in turn impacts the volume driver and GDNs cannot control the weather. The driver can reduce allowed revenue when customer numbers and other cost pressures are impacting the costs of GDNs.

Capacity Related Driver: WWU accept that it would be difficult to define and measure an actual capacity based measure and that this could duplicate or compromise any Exit/Interruption incentives. As an alternative WWU have previously raised the possibility of using Network Lengths as a basis of a driver as it has been shown that it is Network Length/Age/sizes and type of material that are better linked to costs rather than a volume related driver.

Customer Related Driver: WWU accept Ofgem's point about whether the level of change in customers numbers would be material enough to justify a driver. However customer increases do impact on costs. We would also like to make the point that a large proportion of GDN costs are generally fixed and we would therefore not welcome any driver that substantially impacted costs to the degree of the previous volume driver did.

Connections Related Driver: We believe this has merit and we look forward to engaging in any debate around a Connections related driver with Ofgem.

Question 3: Is it appropriate to strengthen the capex rolling incentives?

Whilst we understand Ofgem’s rationale for wanting to introduce an Information Quality Incentive (IQI or "capex roller") to strengthen the Capex incentive and the associated benefits and incentives it is designed to provide to customers & GDNs respectively, we believe that Ofgem's current thinking is at too early a stage for us to comment in detail.

We particularly believe that it is important that GDNs are awarded appropriately for necessary, efficient spend whether this spend was anticipated at the time allowances were set, or not. Conversely, where GDNs spend inefficiently or wastefully then they should be appropriately penalised.

The underlying assumption within the sliding scale incentive is that the analysis provided by PB Power and Ofgem is correct as this is the benchmark against which the GDNs bid for capital and actual capital spend is measured. It is therefore particularly important that these benchmark values are as accurate as possible and that any current unsupportable reductions in GDN capital or replacement requests proposed by PB Power are removed.

Because Ofgem's thinking is at such an early stage, there needs to be discussion around the approach to the incentive and how this will operate. In particular:

- Whether the incentive will operate on discrete years or on a cumulative basis,
- How any over or under spend against the preset allowance will be treated,
- How the efficiency incentive, rewards & penalties etc will operate, and
- How any ex-post adjustments for efficiency of spend during the PCR period will be calculated.

Whilst we support appropriate incentives based on realistic cost assumptions all incentives, by their very nature, can affect GDNs revenue. Therefore it follows that revenues can rise or fall due to the impact of the incentives and this clearly introduces additional risk which needs to be recognised and accounted for in the level of the cost of capital.

Question 4: Are our proposals for the treatment of offtake reform related costs and mains replacement costs under the IQI appropriate?

We agree with Ofgem that it is inappropriate to include items related to offtake and interruptions reform within the IQI due to the inherent uncertainty around these items.

We would support an approach whereby any IQI is adjusted for the anticipated capital costs of offtake and interruptions reform once there is clarity on the approach to be adopted. However, there will need to be engagement between the GDNs and Ofgem over the allowance for these capex costs within the IQI. We would also anticipate that costs associated with the Traffic Management Act are adjusted for within the IQI once they are known.

We would also point out that paragraph 5.48 states that "….GDNs have not provided us with the capex costs associated with these reforms as part of their BPQ responses." whereas, GDNs were specifically asked to exclude costs associated with offtake & interruptions reform from their BPQ submissions by Ofgem.

We would welcome further clarification on the statement made in Paragraph 5.50 of the 4th consultation document where it states "capex costs associated with offtake and interruptions reform should be subject to the IQI incentive strength"

PART 2 - DETAILED RESPONSE
CHAPTER 6 – METHODOLOGY FOR CONSIDERING FINANCIAL ISSUES

EXECUTIVE SUMMARY

- Ofgem acknowledge that Gas Distribution is a more risky business than Transmission, our analysis also supports this. A detailed evaluation will be submitted as evidence of this view, and this needs to be reflected in the WACC together with;
  - the risk introduced or removed by the final incentives packages adopted by Ofgem
  - the appropriate use of comparative indices and current long term trailing average rates
  - the ratios used to assess financeability (against Ofgem's test of a "comfortable" investment grade rating) should be the same as those which are used by the Credit Rating Agencies and providers of debt. As stated above, Moodys, who currently rate WWU, and Fitch both use PMICR. GDNs, including ourselves, have debt covenants which include PMICR. Whilst Ofgem have highlighted theoretical reservations about the applicability of PMICR to GDNs, the ratio is used in practice and consequently needs to be maintained in its current form
- 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.
- We do not see any scope for moving away from the present 50/50 treatment of repex. 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.

RESPONSE TO QUESTIONS

Question 1: 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?

In the Transmission Price Control Review Final Proposals Ofgem acknowledge that there is some evidence to suggest that transmission is a lower risk activity than distribution. We agree that the risks of managing a Distribution Business are greater than that of a Transmission network and therefore an accurate comparative risk analysis is important in establishing the appropriate WACC for the GDPCR.

We agree with Ofgem that the risks a regulated business face include those which arise from the price control packages themselves. Therefore, the potential impact on cash flows of incentive mechanisms and changes to the current exit and interruptions regime need to be fully understood before Final Proposals are published so that a complete assessment of WACC can be made.

We believe that the risk free rate for debt should take into account historic yields for the Eurozone and US markets to avoid the potential effect of UK Index Linked Gilt yields being reduced as a result of the long term effects of changes in pension funding requirements. This is consistent with the increasingly international source of utility debt finance.

We do not believe that the use of long term trialling averages should be avoided when assessing risk free rates and debt premia because the GDNs were acquired in 2005. Only 4 of the 8 GDNs were acquired in 2005 and financed at that time.

All GDNs need to maintain sufficient funding to operate, reinforce and extend their networks, and compete for funds now and in the future to achieve this. Ofgem have traditionally assessed financial issues using a model of a "notional" network and estimating debt costs for the forthcoming regulatory period using a long run time series as a proxy for future costs. Moving away from this would reduce regulatory certainty and may result in increases in cost of capital.

Question 2: Is the range of key ratios we have identified adequate for carrying out an assessment of financeability?

We noted in our previous response our view of the key ratios which should be used for assessing financeability as follows:-

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

Our views, which remain unchanged from our 3rd consultation document response, included the need to consider adjusted interest cover ratios, which contain PMICR, remain the same. The ratios used to assess financeability should be the same as those which are used by Credit Rating Agencies and providers of debt. Moodys, who currently rate WWU, and Fitch both use PMICR. GDNs, including ourselves, have debt covenants which include PMICR. Whilst Ofgem has highlighted theoretical reservations about the applicability of PMICR to GDNs, the ratio is used in practice and consequently needs to be considered in setting allowances.

We assume that financeability assessments will include stress testing against the ratios chosen, taking into account, amongst others, the risk factors considered in the comparative risk analysis above such that the aim of "comfortable investment grade" is achievable.

Question 3: Is our approach to the issues raised by adjusted interest cover ratios appropriate (see Appendix 10 for details)?

All financial ratios are a function of the cost of capital. As stated above, the ratios used to assess financeability should be the same as those which are used by the Credit Rating Agencies and providers of debt. Also, as stated above, Moodys, who currently rate WWU, and Fitch both use PMICR. GDNs, including ourselves, have debt covenants which include PMICR. Whilst Ofgem have highlighted theoretical

reservations about the applicability of PMICR to GDNs, the ratio is used in practice and consequently needs to be considered in setting allowances.

Moodys have stated their position in their March 2004 paper *"UK Independent Gas Distribution Companies: Similar Fundamentals to Regulated Water at Slightly Lower Leverage"*

" For regulated utilities in the UK, the two most important measures that we utilise in assessing the financial strength are the adjusted interest cover ratio (after deducting from post tax cashflows the capex spend required to maintain the RAV) and the ratio of debt to the RAV."

Recent discussions with Moodys, who rate WWU have re-confirmed this position.

PMICR is an important ratio for assessing both short and medium cash generation, for financing debt interest cover and longer term debt refinancing risk. Adjusting free cash to take account of RAV maintenance recognises

- the need for GDNs to have funds available for investment in maintenance of the regulatory asset, and
- the need to be able to refresh debt funding to finance long term assets over the long term.

PMICR is a constraint on WACC for good reason – it highlights the effect of short term reductions in WACC on the long term financeabilty of the business. Increasingly, networks are funding their businesses using long term debt.

We note that in Table 10.1 (with 62.5% nominal debt) that the notional utility only achieves a PMICR of 1.5x (Ofgem's estimate of the minimum Fitch requirement for Comfortable Investment Grade) in the year following the end of the 5 year price control period. Reference to improvements in PMICR, all things being equal, over a 15 year period is not relevant as under the current regulatory regime WACC is re-set every 5 years and this apparent improvement may never materialise.

We agree that PMICR is improved if 50% of debt is index linked. However introducing a further modification to the well understood model of the "notional" network again has the potential to reduce regulatory certainty and may result in increases in cost of capital.

PART 2 - DETAILED RESPONSE
OTHER ISSUES

There are a number of issues we would like to bring to your attention at this stage in the price control process which are not specifically raised in the consultation document. These are as follows:-

Consumers, Estate Agents and Redress Bill

We are concerned about the potential implications of the introduction of the Consumers, Estate Agents and Redress Bill. In particular we do not believe sufficient consideration has been given to the additional costs for GDNs associated with the consumer redress scheme due to be implemented as part of the new regime of consumer representation after the abolition of energywatch.

Clearly to fulfil the aims of the new scheme and influence companies to improve their handling of complaints and ultimately customer service, additional costs will be incurred in changing processes, systems, training and possible employment of additional staff.

Martin Crouch from Ofgem, wrote to Andy Phelps from the Energy Networks Association on 30 March 2007 and we are pleased to see that there is an acknowledgement that "In setting future price controls, we [Ofgem] would expect to take account of efficient cost levels, of course"

Under the current arrangements, energywatch is part of the price control as a pass through item. We therefore welcome clarification that future costs associated with Consumer Voice will be recovered in the same way.

Sub-deduct networks

A sub-deduct Network is where there is a 'primary' meter that feeds more than one premise (which may in turn also have a meter). In most instances the pipework from the primary meter is on private land. We currently own, and are therefore required to maintain up to the primary meter emergency control valve.

Currently Ofgem are of the opinion that the GDNs are not responsible for these networks, however owing to the fact that they may well be in poor condition, the issue of ongoing ownership and maintenance obligations needs to be clarified.

We are very reluctant to 'adopt' these networks. However if the GDNs were to adopt these sub-deduct networks, as Ofgem have suggested as a suitable way forward, a realistic programme of adoption or re-engineering (which is preferable) would need to be proposed and agreed. In any event there will need to be an allowance for either increased opex to enable us to maintain these networks which are in poor general condition or a specific capex allowance to enable us to replace or re-engineer these networks.

Emergency Contact Details

As part of Interruption Reform we will have to demonstrate to the HSE that our ability to manage a Gas Supply Emergency will not be impacted. During the annual emergency exercises, the GDNs have not been able to optimise the firm load shedding process due to poor contact information and low levels of end user awareness. Whilst the obligation to provide Emergency Contact Details lies with the

Shippers, we have a duty to manage the network, which is the main area of concern to the HSE. Whilst the interruption reform does not come into force until October 2011, the HSE will be looking for demonstration of compliance much sooner than this.

In order to satisfy the HSE, activities to be undertaken by the GDNs would be likely to include:

- Quarterly phone exercise to confirm contact details and maintain end user awareness;
- Annual visits to the top 50 customers (including a site visit by Operations to confirm the isolation arrangements);
- Installation of additional telemetry and Remotely Operated Valves (ROV) at key sites;
- Annual liaison with Local Authorities and Health Authorities;
- Identification of potential areas for isolation; and
- Desktop exercises to test large scale isolation plans

Currently, none of the above activities are funded through the GDPCR, and in order for GDNs to undertake these activities, this position would need to be reviewed.

OFGEM CONSULTATION: GAS DISTRIBUTION PRICE CONTROL REVIEW
FOURTH CONSULTATION DOCUMENT

WALES & WEST UTILITIES (WWU) LTD
RESPONSE TO CONSULTATION

PART 3 – ADDITIONAL PAPERS

A. 30/30 Risk Replacement Programme, Report prepared by WWU

B. Treatment of pension fund costs - Report prepared by WWU

PART 3 – ADDITIONAL PAPERS
A. 30/30 RISK REPLACEMENT PROGRAMME, REPORT PREPARED BY WWU

In this paper WWU answers the following questions :-

Question 1
Is the current WWU risk replacement strategy of 20/70/10 correct when compared to NG's 20/80 (post code) strategy? (see body of report for definitions)

Question 2
Can WWU justify the 30/30 risk replacement programme in light of the reducing risk level associated with iron mains?

Background

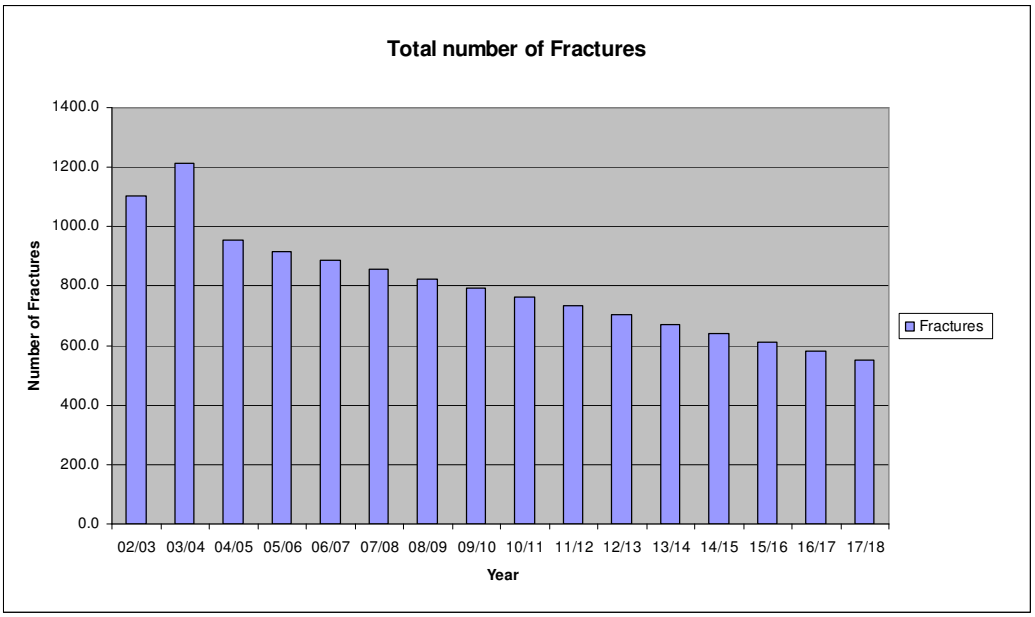
Under the Pipelines Safety Regulation (PSR) 1996, regulation 13, gas conveyors are required to maintain their networks in a safe condition.

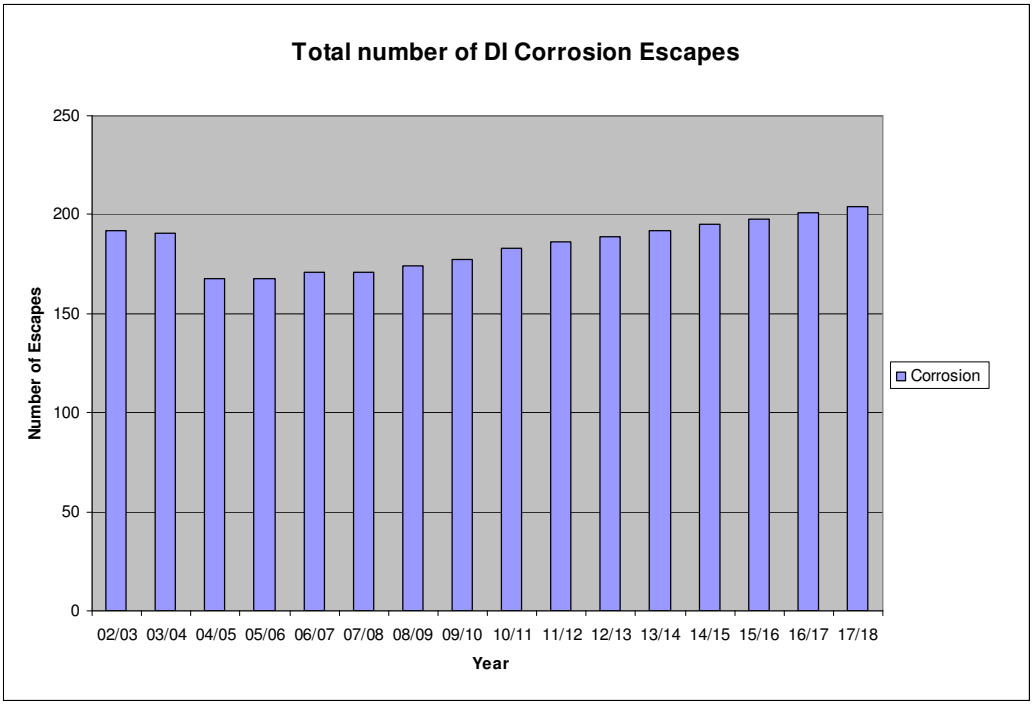
In respect of iron gas mains, there is currently no feasible alternative to maintaining the network other than to decommission it and replace it with a more suitable material, usually polyethylene (PE). This is the basis of the HSE's enforcement policy published in September 2001, which describes an intended 30 year replacement programme for the abandonment of all iron mains within 30m of property (the so called 30/30 programme).This followed a high level of public concern about the potential consequences of gas mains failure.

The HSE considered it realistic and practical for Transco plc, who owned and operated all the gas distribution networks, to speed up its rate of mains replacement over the 5 year from April 2002 - March 2007 so that it was in a position to complete the replacement of all the remaining 'at risk' iron mains within 30 years.

Given the uncertainty about this issue, the HSE undertook to review the policy before the end of the first five years so that an agreed programme could be confirmed for the following period. The HSE published its report 'Review of the Health and Safety Executive's enforcement policy for the replacement of iron gas mains' in September 2005. This policy updates the 2002 - 2007 policy taking account of the review, the structural changes in the gas distribution industry since 2001 and new legislation concerning approved mains replacement programmes.

Gas mains failure which causes high level society concern results mainly from fracture of cast iron and spun iron mains or corrosion of ductile iron mains. These failure types are the prime causes of gas in buildings and hence explosion incidents.
Cast iron and spun iron fracture numbers are forecast to reduce broadly in line with the replacement programme, whereas ductile iron corrosions are forecast to increase as the material ages and continues to deteriorate.





Failures therefore remain at a significant level throughout the next formula period and beyond, and each fracture/corrosion has the potential to cause an incident.

Is the current WWU risk replacement strategy of 20/70/10 correct when compared to NG's 20/80 (post code) strategy?

All risk replacement work prior to 2000 was carried out on a strict top down risk basis in line with the risk model pertaining at the time. This meant that individual mains were being replaced in discrete locations throughout WWU. This was an inefficient use of resources.

In 1997 Transco, Ofgas (now Ofgem) and the HSE developed a tripartite approach to the development of a new prioritisation model that estimated the risk of incident presented to the public by individual iron mains units. The structure of the new model was developed by April 1999; further work continued in relation to the development of particular elements within the model and its means of implementation.

Application of the output from the new model, the Mains Risk Prioritisation System (MRPS) in conjunction with a decision support tool (Smallworld), enables both the estimation of the total level of risk presented by the iron mains population and the estimation of the amount of risk that different replacement strategies should remove. The MRPS is a consistent risk tool which is utilised by all of the GDNs. It was implemented throughout Wales & West Utilities in January 2000 and from mid 2000 was used to prioritise replacement of the cast iron and low-pressure ductile iron mains population.

In addition to this long term approach, serious concerns about the integrity of medium pressure ductile iron (MPDI) mains arose as a result of the Larkhall incident in Scotland in December 1999, which involved fatalities. As a result, the HSE's MPDI Improvement Notice issued in September 2000 placed a requirement on Transco to accelerate the Mains Replacement programme with respect to MPDI and subsequently Ofgem agreed to increase the relevant repex allowances to cover the associated expenditure. In that Notice, Transco was required by the HSE to cease conveying gas at medium pressure in ductile iron pipes within 30 metres of buildings by 31 December 2002, subsequently extended to 30th April 2003. Ductile iron pipes known to have been operating at medium pressure within 30 metres of buildings were either decommissioned or down rated to low pressure in accordance with the HSE requirements. Usually decommissioning also involved replacement of the relevant pipe with PE

Since the completion of the MPDI programme in April 2003, all replacement work in WWU has been carried out in accordance with Policy T/PL/REP/1 and Procedure T/PM/REP/2 (both documents now rebranded). This facilitates the move away from the top down risk basis to the 20/70/10 approach – note this required an additional 10% workload to achieve the same risk reduction as top down, justified by the anticipated improvement in contractor efficiency .

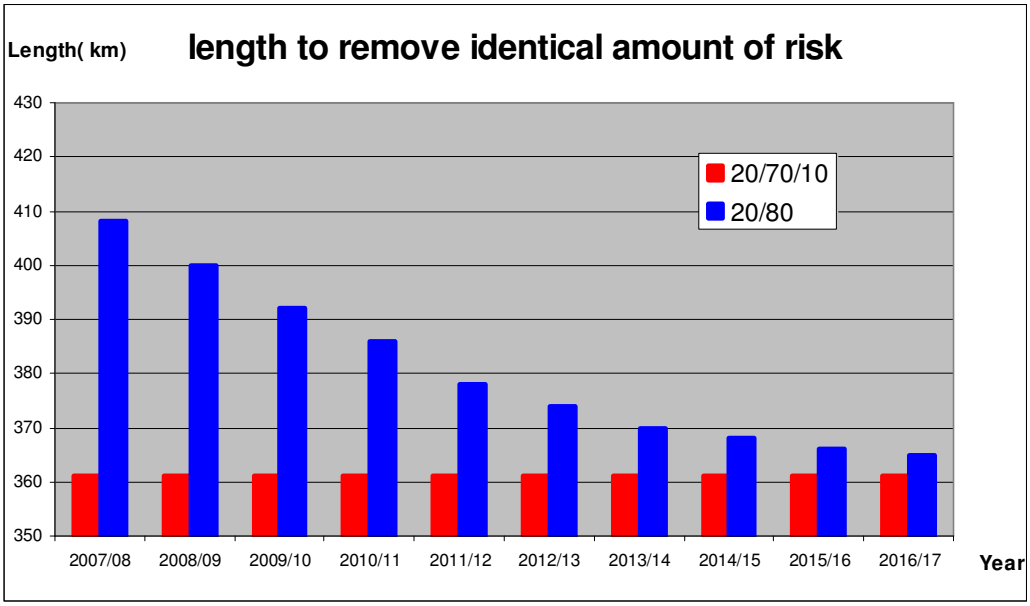
The 20/70/10 approach facilitates the generation of larger projects around the 20% Seed pipes (those pipes with the highest risk scores), along with 70% of pipes that would be replaced within 5 years (known as the secondary minimum threshold, SMT) and 10% of low risk pipes (ie those below the SMT).

WWU is satisfied that this approach maximises risk reduction and generates projects of sufficient size to produce high levels of contractor efficiency. WWU also anticipates that this approach will continue to produce appropriately sized projects throughout the formula period 2008/9 to 2012/13.

NG have amended their approach away from the 20/70/10 philosophy to 20/80, viz 20% of seeds and 80% of any risk mains around the seed locations, this is known as the 'Post Code' philosophy.

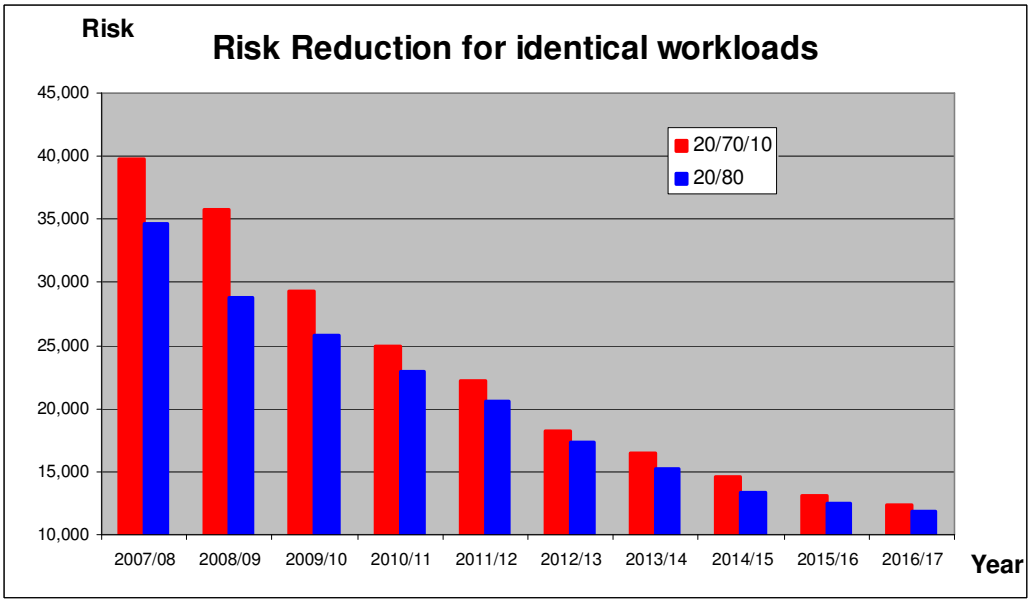
WWU has carried out analysis of the two philosophies in relation to the WWU network, and indicates the results in the graphs below:-

Length to remove same risk



It can be seen from the above graph that WWU adoption of the 20/80 philosophy would require an additional 47 kms of mains abandonment to achieve the same risk reduction as the 20/70/10 approach for 2007/8 (viz 408 kms compared to 361 kms).

Risk Reduction Graph



It can be seen from the above graph that towards the end of the next formula period 2012/13 the risk reduction from both methodologies with identical workloads become very similar, it is currently anticipated that at this stage WWU would consider adoption of the 20/80 approach. This situation will be constantly reviewed throughout the intervening period.

Can WWU justify it's 30/30 risk replacement programme in light of the reducing risk level associated with iron mains?

Risk scores are determined by the Mains Risk Prioritisation System (MRPS). This application calculates a risk score for all iron mains based on the individual attributes of the pipe, such as diameter, material, maintenance history (fractures/corrosion), its location relative to properties and the attributes of those properties, for example do they have cellars, gardens etc. Risk scores are updated by walking surveys, which are undertaken annually for medium and intermediate pressure pipes and once every five years for low pressure pipes.

All existing and previous risk replacement strategies focus on abandonment of the highest scoring pipes. MRPS is a predictive statistical model that identifies the highest risk pipes in any network, and hence those most likely to cause incidents.

It should be noted that the last four incidents in WWU resulting from fractures have been on relatively low scoring mains, one from a main above SMT level and three from mains below SMT level. This indicates that the three mains concerned were not planned for replacement for at least five years from the date of the incident, with one of the three (Sainsbury's petrol station) not planned until well into the 30 year programme.

Fracture Related Incidents

Date of Incident	Address	Incident Description	Size of Pipe	Mat	Pressure Tier	Action Taken	Risk score	Threshold 20% Seed	SMT
19.10.04	19 Twinings, Greenmeadow, Cwmbran, Gwent, NP44 4ST	Domestic property explosion fracture 4" SI main found outside	4"	SI	LP	Fracture repaired and main programmed for replacement	180	301	84
22.08.04	9 Ffordd Lifon, Llangefni, Gwynedd. LL77 7PA	CH Boiler exploded in garage, structural damage to house	4"	SI	LP	Fracture repaired and main programmed for replacement	72.7	301	84
13.10.05	Sainsbury's Petrol Station Forecourt, Llewelyn Road, Cwmbran, Wales NP44 1UL	Explosion at Sainsbury's petrol station forecourt kiosk. 2 injured (suspected broken arm, cuts, bruises and shock)	14"	SI	LP	Fracture repaired and main programmed for replacement	1	234	71
30.12.05	37/39 Elan Avenue, Close, Swansea. SA6 7LP	Explosion in Flat 1 injured (burns) 8 x evacuated	6"	SI	LP	Fracture repaired and main programmed for replacement	49.8	234	71

This highlights that whilst MRPS indicates the most likely mains to fracture and hence cause incidents, relatively low scoring mains can also cause incidents.

As previously stated, the 30/30 risk replacement programme resulted from the high level of society's concern resulting from gas related incidents. The level of risk that society is prepared to tolerate is constantly reducing, and the 30/30 programme was and still is an integral part of the gas industry's response to this expectation. It is anticipated that this will continue to be the case throughout the remaining period of the 30 year programme.

Conclusions

WWU is satisfied that it's current 20/70/10 risk replacement strategy is appropriate for now and the duration of the next formula period 2008/9 to 2012/3. This situation will be monitored throughout the period and strategy amended should circumstances change.

Because of the low level of risk that society is prepared to accept, as fractures and ductile iron corrosions are forecast to remain at a significant level throughout the next formula period and beyond and as incidents are known to result on occasions from low risk mains then it is acknowledged that the 30/30 programme will be required until it's conclusion in 2033. In fact, with the level of society's risk acceptance constantly reducing an argument could be made for accelerating the 30/30 programme.

PART 3 – ADDITIONAL PAPERS
B. TREATMENT OF PENSION FUND COSTS - REPORT PREPARED BY WWU

Establishment of Regulatory Principles

The principles regarding the treatment of pension fund costs were established in the document entitled Developing Network Monopoly Price Controls published in February 2003 (05/03) which explained that in setting price controls Ofgem makes an allowance for the efficient level of costs it expects companies to incur over the period of the price control review. This includes costs incurred to fund their pension schemes.

This was followed up by the Developing Network Monopoly Price Controls: initial conclusions document (54/03) which proposed seven principles, which are as follows:

- Consumers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks;
- In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these have been estimated;
- Pension costs should be assessed using actuarial methods, on the basis of reasonable assumption in line with current best practice;
- Increases or decreases in the future costs of providing accrued benefits resulting from under- or over-funding in prior periods will need to be considered on a case-by-case basis;
- Increases or decreases in the future costs of providing accrued benefits resulting from differences between ex ante and post investment returns in prior periods will also need to be considered on a case-by-case basis;
- Liabilities in respect of the provision of benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in the price control; and
- Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the costs of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

Additionally, Ofgem issued a position paper on pensions on the 2nd August 2004, which was supplemented with an addendum on the 9th August 2004, which stated that 'contributions made to an occupational pension scheme in respect of attributable DN employment performed in the future will be eligible for recovery from future price controlled revenues. To the extent that, in any particular period, the amounts contributed exceed or falls short of the amounts recovered (i.e. the allowance), the excess or the shortfall will be taken into account on setting subsequent controls'.

Ongoing Application of Regulatory Principles

Since this time these principles have been implemented and applied as part of the Electricity Distribution Price Control Review in 2004 (16/10/03 document and 265/04), and included the most recent actuarial valuations and forecasts of

contribution rates in respect of both normal contributions and deficit recovery as follows:

- normal contributions
  service during 2005/10 calculated using forecasts of future pensionable salaries, adjusting to take account of the extent that Ofgem's allowances for capex and opex differ from the DNO's forecasts, then applying the latest estimates as advised by the scheme's actuary, and;

- deficit recovery
  calculated over 13 years which is the average remaining service life across all DNO's with the exception of one which has a lower average remaining service life, and the actual has been applied

The principles have also been applied to the Transmission Price Control Review in 2006 (206/06), where again an amount for ongoing normal contributions, based on current actuarially recommended funding rates, and; deficit recovery, which assumes that repair payments are over 10 years. Pension contributions take account of the statutory contributions payable to the Pension Protection Fund.

The principles have further been applied to the Gas Distribution Price Control Review one year extension initial proposals (169a/06) and final proposals (205/06). The initial proposals confirm that pension costs incurred by the GDNs are significantly more than the costs assumed in setting the previous price control, and that these cost increases are being experienced throughout the UK economy, driven by factors outside of the GDN's control. The one year extension confirmed that the approach adopted would be the same as the Electricity Distribution Price Control Review.

Fourth Consultation Document Proposals (49/07)

Ofgem have reconfirmed that their pension principles state that the cash costs of servicing defined benefit schemes will be allowed in full, subject to being reasonable and being prepared in line with normal actuarial practice.

Ofgem have concluded that whilst the funding valuation uses actuarial assumptions which are reasonable and in line with best practice, then the costs will be allowed in full.

Ofgem are considering three options for the Gas Distribution Price Control Review, for determining ex ante allowances, which are:

Option 1
As with the total operating cost review, the ex ante operating cost pension allowance based on a benchmark contribution rate, derived from analysis of GDN and comparable company contribution rates.

Option 2
As with tax or the return of capital, the allowance should reflect the contributions that would be made by a notional GDN with comfortably investment-grade financial position. To the extent that the observed contribution rates of those network companies with a more aggressive financial profile are higher, Ofgem would set an ex ante allowance which they have evaluated as a best estimate of the contributions which would be made by such a notional GDN.

Option 3
The ex ante approach should be maintained at present, but to the extent that a surplus arises in future, there will be an ex post review of whether than surplus has arisen as a result of high contribution rates. If so, then that surplus will be used for the benefit of consumers to reduce future pension allowances, regardless of whether the Trustees agree to reduce future cash contribution rates.

Analysis

The three options outlined above, all steer away from the clear principles established in the documents referred to previously, which have been in existence since 2003 and subsequently been applied to both the electricity distribution and transmission price controls.

Option 3 most closely represents the current agreed principles, the key difference being the mandatory use of surpluses to reduce future pension allowances.

Option 1 represents the greatest divergence from the agreed principles, whereby a comparable company's rates could be imposed as the benchmark rate, e.g. electricity Transmission rates are 25% which is currently significantly lower than the 39% required for WWU, and the other GDNs which range from 31% - 37%.

Option 2 appears to have a lesser divergence from agreed principles as it suggests that allowances should be that of a notional GDN without high gearing, however, all GDNs range from 31%-39%.

Conclusions

The following can be concluded from this paper:-

1. There is clear evidence of consultation and establishment of principles.

2. There is consistent implementation through three reviews

3. There is a clear expectation by the GDNs, actuaries and pension Trustees that these principles will continue

OFGEM CONSULTATION: GAS DISTRIBUTION PRICE CONTROL REVIEW
FOURTH CONSULTATION DOCUMENT

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PART 4 – CONFIDENTIAL CONSULTANTS REPORTS
(attached as separate Adobe Acrobat documents)

Appendix A Network Cost drivers, Report prepared by John Spiller Associates

Appendix B Direct Cost Review, Report prepared by Third Horizon Consulting

Appendix C Support Services Review, Report prepared by Third Horizon Consulting

Appendix D Review of Ofgem GDPCR (Capex/Repex) – Five Year Control - Report prepared by Mouchel Parkman (MP)

Appendix E Wales & West Utilities Report on Price Indices March 2007 - Report prepared by Chandler KBS

See Appendix F Gas Distribution Price Control Review: Reports on Costs prepared by NERA

Appendix G A Report Prepared by Willis Insurance Brokers Reviewing LECG's Report Relating to Insurance

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FOURTH CONSULTATION DOCUMENT

WALES & WEST UTILITIES (WWU) LTD
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PART 5 – NON-CONFIDENTIAL CONSULTANTS REPORT
(attached as a separate Adobe Acrobat document)

Appendix H The 2007 Gas Distribution Price Control Review: A Top-down Analysis of the Scope for Real Terms Cost Reductions, Report prepared for the GDNs by First Economics