WALES&WEST UTILITIES

Wales & West House
Spooner Close
Celtic Springs
Coedkernew
Newport NP10 8FZ

Tŷ Wales & West
Spooner Close
Celtic Springs
Coedcernyw
Casnewydd NP10 8FZ

T. 029 2027 8500
F. 0870 1450076
www.wwutilities.co.uk

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

13 July 2007

Dear Joanna,

GDPCR – WWU Response to Ofgem Initial Proposals

Please find attached to this letter our detailed response to your Initial Proposals (IP's) for the price review 2008 –13. Our response is in 4 parts;

1. An executive summary of key issues - outlining areas of major concern to WWU, and which we believe need further review.
2. The detailed response document – outlining our response to the questions posed by Ofgem in the IP's.
3. Additional papers
4. Specific attachments which support our arguments, and which are referred to in either the executive summary or response document

Whilst we have obviously responded fully to the Proposals in the usual way, we have written the executive summary to ensure that Ofgem and the Authority fully understand our major concerns.

For the avoidance of doubt, this response together with Appendix 1 may be placed in the public domain. In addition, all other appendices attached to this response may be placed in the public domain with the exception of those identified as confidential in part 4.

Yours Sincerely,

Bob Westlake
Head of Regulation
Tel: 029 2027 8544
Email: bob.westlake@wwutilities.co.uk

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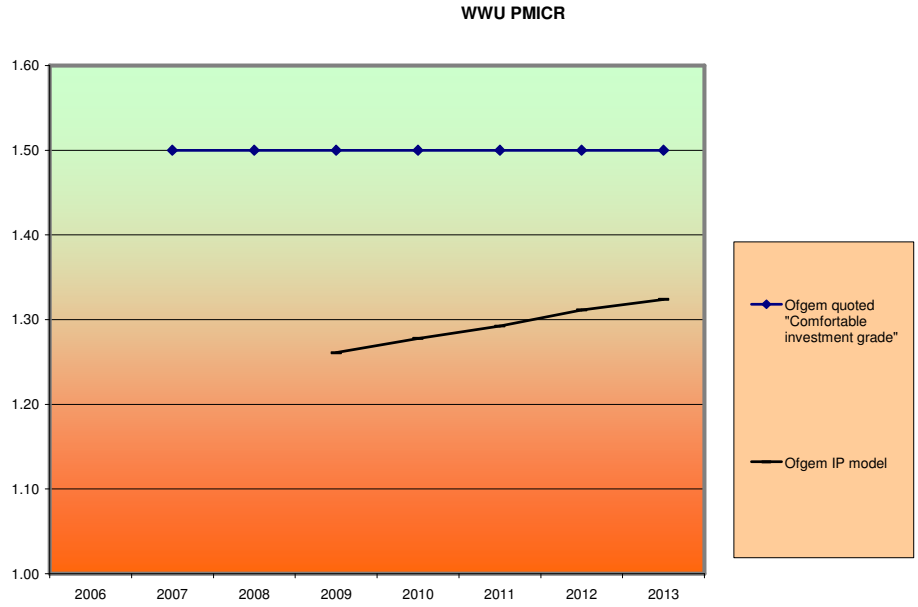
GAS DISTRIBUTION PRICE CONTROL REVIEW - INITIAL PROPOSALS

WALES & WEST UTILITIES LTD
RESPONSE TO THE INITIAL PROPOSALS

PART 1 – EXECUTIVE SUMMARY OF KEY ISSUES

1. FINANCEABILITY SUMMARY

The cost allowances and WACC return reflected in the Initial Proposals (IP's) would represent a huge challenge to WWU and have serious consequences for financeability. This is clearly reflected in the Ofgem modelling itself which shows Post Maintenance Interest Cover Ratio (PMICR) at around 1.3x. This is not consistent with the 'comfortable investment grade' rating of 1.5-1.6x recently quoted publicly by senior Ofgem officials, and set out as Ofgem's interpretation of credit rating agencies views in Appendix 10 of the Fourth Consultation Document. At the outset the ratio is also below the "lock up" (prohibition on distribution to equity and junior debt investors) ratio covenant of 1.3x set under WWU debt documents. The graph below clearly illustrates the position.



Comparison with previous financeability assessments

The IPs produce financial ratios that are not consistent with financeability tests set by Ofgem for the 2002-7 price control. This is illustrated below.

Price Control Period	Ofgem Model 2002/7 PCR 2006/7	Ofgem Model 2007/8 PCR 2007/8	Ofgem Model 2008/13 PCR 2008/9	Ofgem Model 2008/13
	Nominal debt	Nominal debt	Nominal debt	40% IL
Adjusted Funds From Operations (£m)	**70**	**66**	**64**	**64**
Interest (£m)	51	57	51	43
Post Maintenance Interest Cover Ratio	**1.38 x**	**1.15 x**	**1.26 x**	1.51
Headroom before 'lock-up' 1.3x (£m)	4	-9	-2	9

There are a number of key points we would make in relation to the financeability issue, which are summarised below.

- The financial model for the 2002/7 price period implied a PMICR for 06/7 of 1.38x with no index linked debt assumed.
- Previous Ofgem financial models also reported higher ratios consistent with Ofgem's view that "comfortable investment grade" requires PMICR of at least 1.50x. Average PMICR derived from the 2005 Electricity Distribution Price Control financial model was 1.57x, and PMICR from the 2006 Transmission Price Control was 1.49x. Neither model assumed that a proportion of debt was index linked
- WWU raised serious concerns about financeability during the 1 year review based on a nominal debt PMICR of 1.15x. This is well below investment grade requirement but we accepted the outcome following assurances from Ofgem that financeability would be addressed during this main review
- The current IPs show some improvement in PMICR due to a reduction in assumed cost of debt, but nominal PMICR still remains below that assumed for the current review period. WACC would subsequently need to be increased substantially from the current Ofgem modelling assumption
- However, rather than increase WACC we understand that Ofgem propose to assume a proportion of real rather than nominal debt. This is a significant change in funding assumption which increases regulatory uncertainty
- We understand that a number of lending banks have made representations to Ofgem raising the importance of PMICR as a key ratio, and subsequent concerns about the level for GDN's

Future financeability

WWU currently has a Baa1 investment grade rating from Moody's. Adjusted FFO, interest costs and PMICR under WWU's own financial model indicated a comfortable investment grade for 06/7.

However the actual 06/7 PMICR and the "headroom" above PMICR covenant "lock up" was adversely affected by the £15m reduction in transportation revenue in that year. Cash flows were also adversely affected in 05/6 by significant increases in

wholesale gas prices increasing shrinkage gas costs, and prior to this by increases in the cash cost of the defined benefit pension scheme in excess of Ofgem allowance. "Comfortable investment grade" requires headroom to cope with such cash flow stress. With this in mind there are number of significant risks on future cash flows remain which would have a significant impact such as;

- Failing to meet aggressive opex challenges
- The lack of a 'glidepath' to enable networks to implement the changes required to meet any efficiency targets, and no allowance for the obvious cost of implementing cost reduction measures, such as redundancy costs for example
- Reduction or elimination of non-formula contribution, for example the loss of metering work
- Any adverse working capital movements due to factors outside our control, for example changes in shipper transportation prepayment arrangements
- Potential costs in excess of allowances such as above inflation cost pressures, and necessary environmental remediation expenditure
- Potential events for which Ofgem has precluded the opportunity of a "re-opener", including changes in tax legislation, Health and Safety requirements, and pension costs

The 1 year review completed last year reduced projected PMICR well below "comfortable investment grade", but as stated above WWU accepted the outcome on the assurance that financeability would be addressed in the current review.

Our PMICR and other ratios have also been adversely affected by the amount of historic efficient capital expenditure classified as "pot 2", and only qualifying for WACC return and allowed depreciation five years after expenditure. For example PMICR would be improved by an average of 0.14x for the 5 year period and by 0.22x in 08/9 if the recognised efficient expenditure placed in "pot 2" had been treated as qualifying for RAV return and depreciation immediately (ie 'pot 3')

WACC

We believe that any assessment of the cost of debt to be assumed for the period 2008-13 must reflect the fact that;

- The Index Linked Gilt rate has been artificially reduced due to highly inelastic demand driven by pension regulations, and is at least 0.5% below the true risk free rate. The risk free rate should be assessed by examining interest rate swaps and international gilt yields, and in our view is at least 2.5%.
- The Monetary Policy Committee has increased interest rates 5 times in 06/7 and likely to increase further
- Medium term debt costs, and in particular cost of 2013 debt, has risen by 1% since WACC was set for the Transmission Price Control in 2006.

Cost of equity and WACC generally must reflect a full assessment of the risks of ownership of a GDN, including;

- an accurate comparative risk analysis to establish the appropriate WACC for the price period
- any incentive mechanisms, including IQI
- changes to the current exit and interruptions regime
- the appropriate use of cost indices, and remaining exposure to costs that due not move with RPI
- price control “re-openers” in relation to taxation, Traffic Management Act and pensions

The Energy Networks Association has submitted a report to Ofgem by Oxera which concludes that the equity beta for a gas distribution business is approximately 0.2 higher than a transmission business, which would suggest a post tax vanilla WACC approximately 0.5% higher than the 5.05% applied to the TPCR.

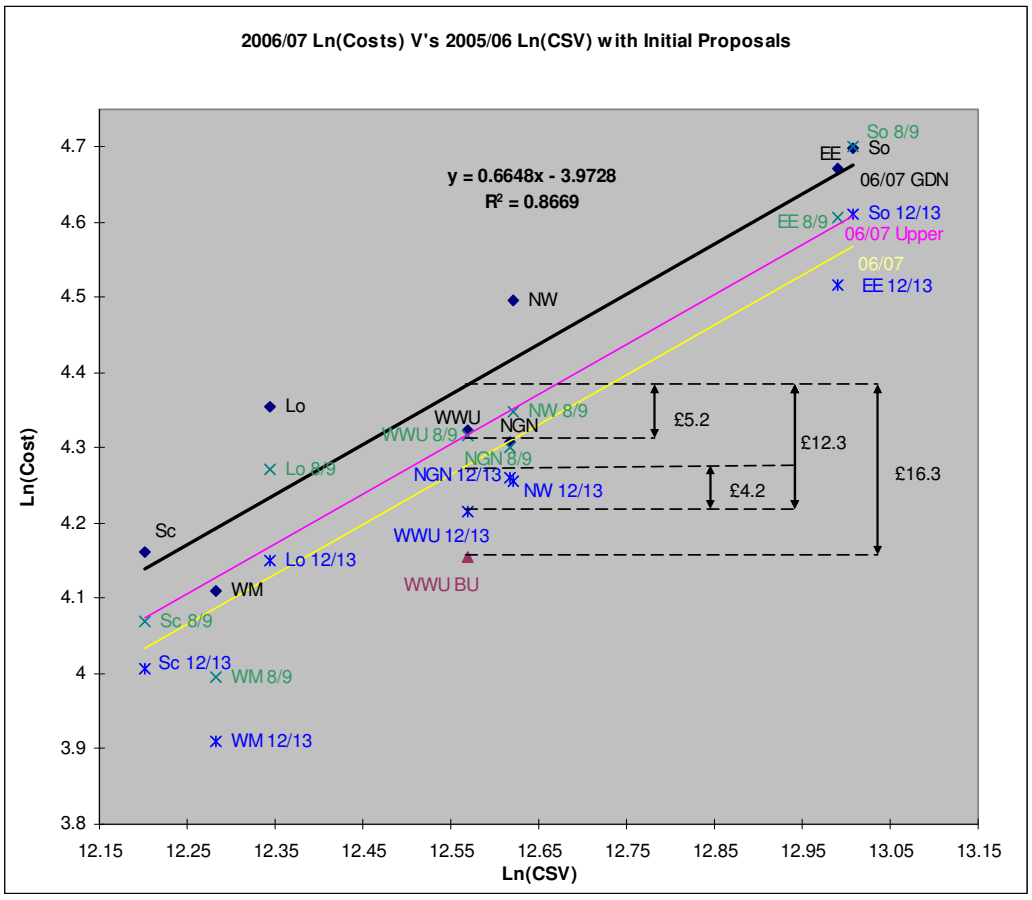
WWU will be making a further detailed submission on the issue of WACC in conjunction with the other gas networks in due course.

2. METHODOLOGY

Regression Analysis

WWU supports the use of appropriate and realistic benchmarks to determine comparative performance, particularly the use of recognised external best practice data. We have provided credible third party evidence to Ofgem that demonstrates that WWU is efficient for a significant number of its activities. We have already provided detailed comments and analysis in respect of both indirect costs and direct costs, so for the sake of brevity we do not repeat them here. Note that the consultants reports we have submitted previously form part of this response.

We believe the methodology employed by Ofgem in applying benchmarking together with efficiency challenges is creating outcomes that are inequitable. The following regression summarises Ofgem's results for each company in specific years (actual costs and benchmarks for 06/7, allowed costs for 08/9 and12/13). The regression highlights a number of anomalies which are explained below after the graphs.



- The regression is a replication of the one provided in the additional information on the opex regression. It illustrates the results shown on page 20 of the Main Supplementary Appendices to the IPs.

- We have superimposed the proposed allowances for 08/9 and12/13 from pages 28 to 35 of the Main Supplementary Appendices to the IPs, and also shown the bottom up allowances provided in the additional information.

- It can be seen that in all but two cases the bottom up analysis requires GDNs to have considerably lower costs than the frontier arising from the top-down regression. This would suggest that the bottom up analysis is flawed. This view is consistent with evidence elsewhere in this summary regarding the use of inappropriate cost drivers (largely revenue) to set the bottom up benchmarks.

- The IPs attempt to address concerns over the bottom up analysis by the use of the 5.6% uplift shifting bottom up top quartile allowances uniformly towards a "top-down" frontier. Unfortunately the use of top down frontier overrides any use of the upper quartile to deal with data issues and makes no allowance for data errors, as it places significant weight on the scores for one company. Companies for which the bottom-up analysis was particularly inaccurate or biased are penalised. A more appropriate error correction would be to uplift towards "top-down" top quartile, which we have estimated at 10.1%.

- The challenge placed on individual GDNs appears inequitable. Some companies that are currently achieving top quartile costs measured by top down regression are required to make significant further cost reductions, whereas other top quartile performers are not so challenged, eg;

    - West Midlands currently lies between the upper quartile and frontier, yet is required to out-perform the bottom up cost analysis by 12/13 – a cost reduction of over £11m.

    - Northern Gas who are at the cost frontier are required only to reduce costs by some £3.5m by 12/13 and under-perform the "bottom up" cost analysis.

  It is inequitable that each GDN is being set an inconsistent 2013 cost challenge.

- Relatively high cost networks appear to be rewarded, with Scotland currently above the average regression line but not required to meet the current cost frontier by 2012/13.

- We believe these results are inequitable, and we would urge that standard comparative technique of regression be used, which should be based on the top down upper quartile cost line to allow some leeway for data integrity. Cost challenge would then be applied equitably, informed by a credible bottom up analysis to provide a cross check on cost challenges.

3. INDIRECT OPEX

As part of our response to the Fourth Consultation Document we submitted a detailed analysis of indirect costs by the independent consultancy Third Horizon. The headline conclusions are summarised below.

Methodology and Economies of Scale

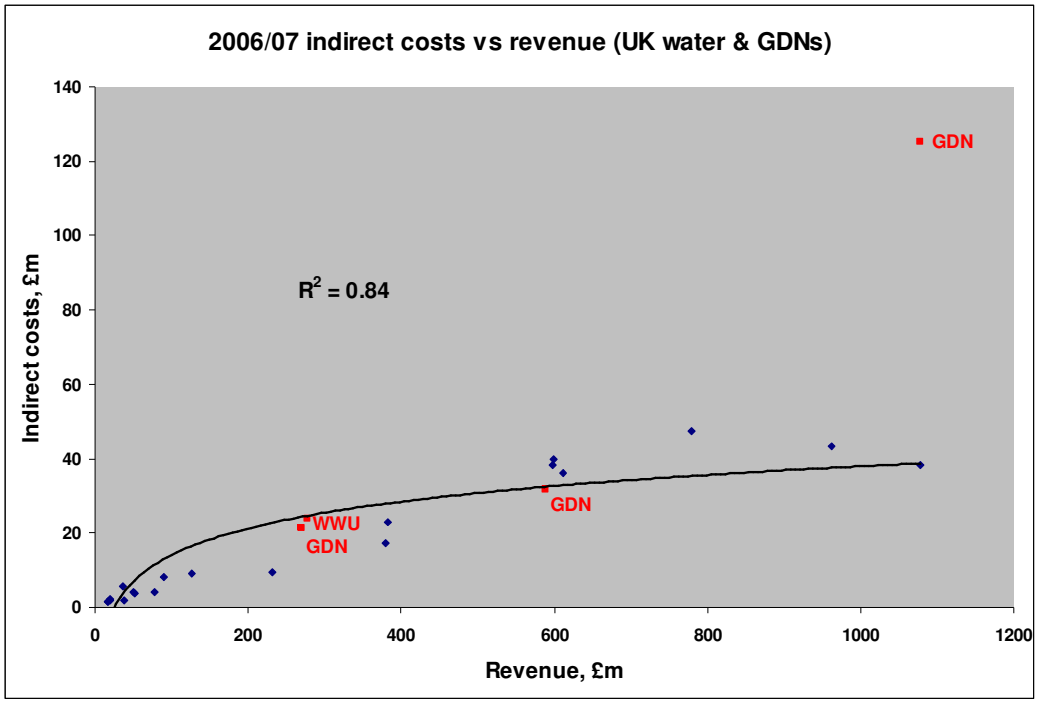
The philosophy of the LECG study assumes that all GDNs should be able to reach "best in class" status in all areas of cost management. There is an assumption that each GDN can reasonably aspire to this level of efficiency so that all GDNs would be best in class – an aspirational assumption.

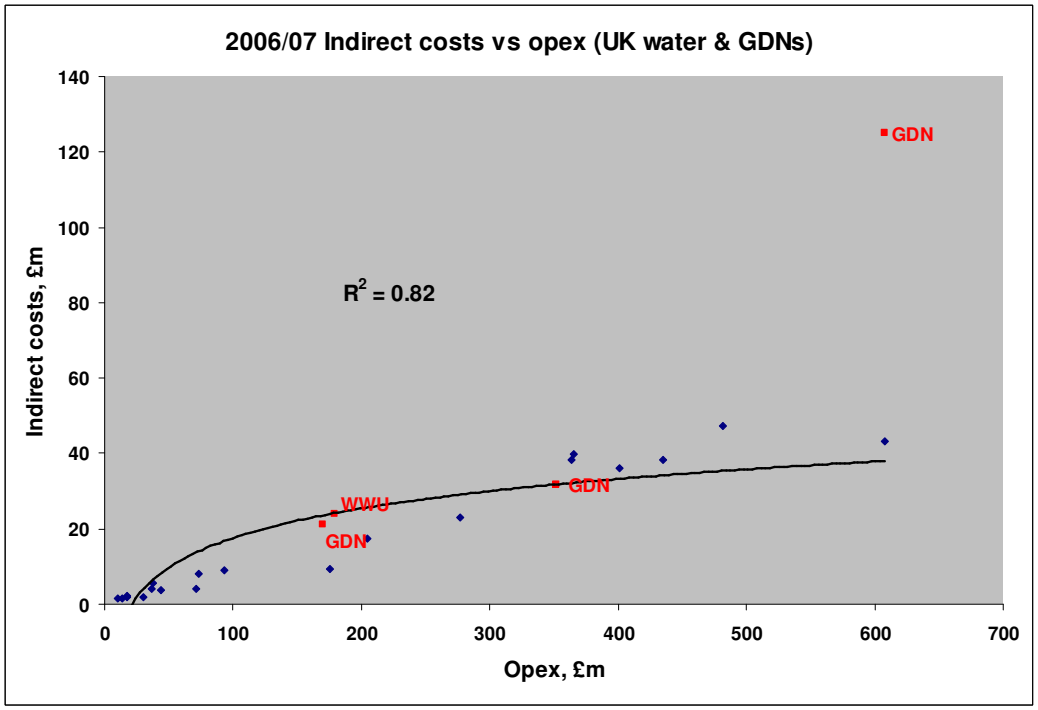
The effect of this approach is that the cost reduction targets outlined in the IP's are neither robust nor equitable across the GDN's. The most obvious illustration of this is outlined in the points below. They are also highlighted in the subsequent graphs which are an extract from the Third Horizon report.

- In the IPs the company with four networks under single ownership is being allowed £390m of indirect cost over the 5 years, which is some £65m more than the cumulative allowance for the four networks under the ownership of three separate companies.

- Economies of scale would suggest that the indirect cost of running 4 networks in single ownership should certainly not be 4 times the cost of running 1, but rather somewhere between 1 and 4 given the marginal cost impact. However in the IPs the allowance for running four single owned networks is significantly more than even the 4x1 - with the combined cost of the three other companies at around £325m. This cannot be right.

- The graphs below illustrate the economy of scale effect across the GDN's using the UK water sector as a credible comparator.





Robustness of the LECG analysis

The LECG study adopted a high level 'global' approach to benchmarking costs by group. In many cases costs have been assessed as a whole, in others an attempt has been made to break into smaller components. However, this has not been done in any systematic way to enable the total cost base to be understood at the right level of granularity. For any benchmarking comparisons to be capable of yielding robust conclusions, it is essential they are made on a true like-for-like basis, with a causal

link between the parameter being measured (in this case cost) and the underlying driver or drivers which influence these. This rigour clearly does not exist in the IP's.

Choice of benchmarks

The benchmarks chosen by LECG are inappropriate and do not correlate well to the actual cost drivers involved. There is an overriding preference for using revenue as the base for their comparative analysis, which we believe is inappropriate given the nature of these businesses, and creates an inequitable effect.

Where a measure of scale of activity is needed, total cost (Opex/ Capex/ Repex) is a more credible and realistic base for comparison. For some specific activities recognised industry benchmarks are available, for example HR professionals per population of staff. We would again refer you to the first Third Horizon report, which identified more appropriate external benchmarks and drivers of costs.

We believe it is critical that credible external benchmarks are used in this review, particularly given the immature nature of the GDN's to date. In contrast, there is very limited comparative data available about the GDN's at this stage.

Consistency of methodology

The choice of comparator benchmark used in the indirect cost analysis is inconsistent and biased towards those providing the highest savings estimates, rather than selecting ones which have a strong correlation to the activity being measured. In virtually all categories the analysis appears simply to favour the benchmark which provides the biggest cost challenge, rather than being based on well reasoned logic.

There is a quoted preference for using external benchmarks, but in reality these have been used as the basis for target savings only in a small minority of cases even though credible external data is available.

Similarly, even when credible external data is available it appears to have been disregarded by the Ofgem consultants. One graphic example of this is in relation to Human Resources benchmarking where;

- The industry benchmark ratio for HR staff to employees is 1:85
- The WWU ratio is 1:187

….and yet the IPs propose a cost reduction of 60% in the HR activity.

Variable cost analysis

All costs are assumed to be variable and that the cost base could be brought into line with an arbitrary target. There is no acknowledgement of different types of cost for different types of activity, for example;

- Mandatory activities – necessary for statutory or regulatory compliance
- Business critical – for example paying bills and producing monthly management accounts.

The LECG cost analysis fails to recognise the obvious distinction between fixed and variable elements, but rather all costs are considered fully variable and on a linear

basis. As a result the method used produces unrealistically high cost reduction targets for smaller companies.

It should also be borne in mind that when these functions were created in the new independent GDN's, they were built from the bottom up. In WWU we started with the absolute minimum resource needed to fulfil basic activities, and only add to this after rigorous examination of the requirement. We believe a bottom up review of our activities would reveal a very lean organisation.

Impact of the proposed reductions

Following publication of the IPs we re-engaged Third Horizon to take an objective view of what the business impact would be if they were implemented and their follow up report is attached. The key findings are;

- The proposed indirect cost allowance for 08/9 represents a huge and immediate reduction of almost 30% against the 06/7 actual indirect expenditure

- Roughly 65% of the current cost base is due to regulatory or compliance related activity or currently under term contracts with external service providers.

- In order to meet the IP targets WWU would have to remove around 95% of the current support services staff (around 94 people) - on the basis that staff costs are the most variable in the short term. We would also have to additionally reduce external expenditure by over 40%.

- Such aggressive cuts would seriously compromise our ability to achieve regulatory and statutory compliance and threaten current contract agreements.

4. DIRECT OPEX

In section 2 of this summary on methodology we illustrated the unrealistic results of the IPs on overall cost reduction. We have significant concerns in several areas of direct activity which are particularly hard hit - for example emergency costs, work management, and maintenance. We believe we are being penalised because of the benchmarking used and the impact of our difficult operating environment. We discuss this below.

Comparative analysis

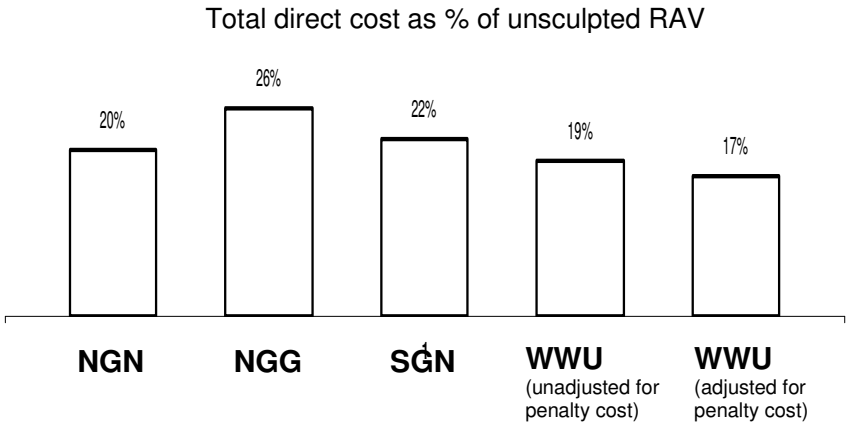
We have previously submitted a report to Ofgem by Third Horizon on the comparative costs of GDN's with both the UK water sector and US gas sector. Separately, evidence from a recent study of UK water companies indicated that there is a linear relationship between total direct costs and the size of the organisation. The results of the Third Horizon analysis concurs with this view and showed that;

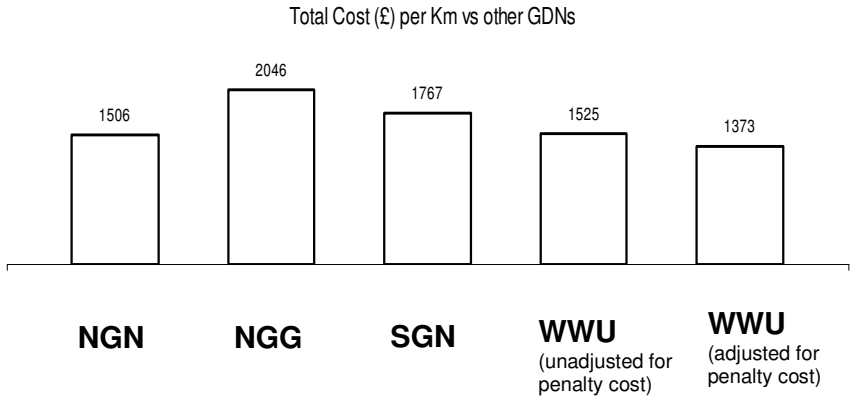
- The two smallest independent GDNs are shown to be leading performers across a number of direct cost measures
- When the 'penalty costs' (see section 5) associated with the characteristics of the WWU network are considered our position is even further improved
- When WWU is compared to the US gas distribution sector, the direct cost per km of pipeline of WWU approaches first quartile performance
- Similar benchmarks for the UK water industry also show WWU approaching first quartile performance
- Comparing WWU adjusted direct costs with the other GDN's on the basis of unsculpted RAV and length of network shows WWU as a frontier performer

The IP results are inconsistent with other utility regulators' view of costs for the WWU region. They derive from over reliance on revenue as a cost driver. Using revenue as a cost driver penalises smaller companies which face more difficult conditions and a combination of lower demand and higher unit costs, irrespective of any diseconomies of scale.

Comparing direct costs with other GDNs indicates WWU is a stronger performer.

The graphs below are extracts from the Third Horizon Direct Cost Review submitted to Ofgem on18 April, and clearly show WWU to be a leading performer amongst GDNs





Workloads

The volume of workload is obviously a critical factor of overall cost allowances, and we disagree with the assumptions made by PB Power in their forecast of WWU's Public Reported Escape workloads. We outline our rationale for this below.

Internal PREs

Whilst there was a reducing trend in Internal PREs from 02/3 to 05/6, we have based our forecast of a 1% per annum increase on a combination of the volume of new connections to the network, and increased CO awareness by the public. These factors represent an additional c1000 PREs per year across the Network.

External PREs

The IPs assume a 3% reduction in the number of mains PREs due to the ongoing mains replacement programme. However this is inconsistent with the evidence we have provided. Our data shows that although 1761km of metallic main has been abandoned in the last five years, there has been no reduction in the number of mains repairs resulting from external PREs. Indeed, there has been an increase in external repairs from 2002/03 to 2006/07 of 3%.

	02/03	03/04	04/05	05/06	06/07
Mains abandoned (kms)	303	309	354	392	403
External PREs (volume)	23080	21839	23784	24490	24116

Funding the gas emergency service

The PB Rune report recognised that the GDN emergency service activity requires staff to be geographically placed to enable the appropriate emergency response. We have previously submitted an independent report to Ofgem that illustrated the additional (penalty) cost incurred by WWU due to the shape and size of its area, coupled with its customer sparsity.

No other GDN has the same combination of wide spread operating region and low customer density, which has to be resourced in a way that allows the 1 hour emergency response target to be met. Taking almost 40% out of the cost allowance for this activity would seriously undermine our ability to meet our obligations. We cover this issue in more detail in the next section on WWU cost drivers.

Emergency staff also do the metering services work for National Grid Metering and Onstream as part of existing contracts. This work offsets the cost of the emergency resource to WWU through a non -formula revenue contribution. We have recently had indications from these customers that they are considering insourcing the metering activities, and should WWU lose this work then all the cost of this resource will fall back on the core emergency activity.

We recently received a request from Ofgem to provide information on the costs associated with the loss of metering contracts, and difference in costs associated with different levels of existing meter work. We are currently analysing this and look forward to discussions on this important issue with Ofgem to ensure the necessary allowances going forward.

5. WWU COST DRIVERS

The WWU operating region

The LECG report recognised that the WWU operating region was unusually large and elongated and suggested that a bottom up approach be carried out to quantify these effects. We commissioned an independent review by John Spiller Associates to analyse the impact of this, and a report was submitted to Ofgem on 25 April.

There are three significant features which impact adversely on our operating costs (described within the report as "penalty" costs because they are outside management control). These features are;

- The wide spread, irregular shape and form of our operating region with its triple aspect (three separate lengths across three very different geographic regions). For example it takes a 500km diameter circle to embrace the extremities of the WWU operating region

- Our customer density – we have the second lowest of all the networks

- Our extended network length - WWU necessarily has 11% more mains per customer, and 58% more Pressure Reduction Stations per customer than the average network.

Faced with these geographical constraints the only practical way to meet the legislative emergency service 1hr response standard is to provide a number of outbased depots - fully staffed and provided with materials, vehicles, and the necessary support and supervision. The independent report demonstrates that this extended network results in infrastructure 'penalty' costs of around £5.3m per annum, as well as the additional engineers required to provide the service in the field (see table on next page).

It is already recognised by the economic regulators in both water and electricity distribution sectors that regional characteristics impact upon operating cost - which subsequently flows through into charges. For example electricity distribution charges in the WWU region are between 47-71% more expensive than the lowest cost area of the South East of England. Similarly water supply charges in the WWU region are between 35 - 38% more expensive than the lowest cost area of Southern Water.

Emergency Costs

The provision of an emergency service is a legislative WWU activity where we have no control over the volume or location of escapes. No other GDN has the same combination of geographical spread coupled with low customer density to cover for emergency work. The area has to be covered by outbased staff to enable the 1hour standard to be met, whether an escape actually occurs or not.

Network specific factors are particularly relevant to the Emergency Service where employee numbers as well as the location and number of depots are determined by the 1 hour licence response requirement and the provision of standby cover.

WWU believes its emergency activity is relatively efficient compared with other GDN's, notwithstanding our more difficult operating environment. The table below illustrates this.

The table shows a comparison with an optimum shaped GDN such as West Midlands and shows that WWU emergency operatives cover a similar number of kilometres per FTE. However, in order to cover our much larger area and meet the emergency response standards we require around 46% more staff.

2004/5 figures	FTEs	PREs	PRE / FTE	Customers	Cust/ FTE	Network Length (Kms)	Kms / FTE
W.Mids	235	99309	423	1922305	8180	24112	102
WWU	343	119620	349	2380251	6940	34112	99

The additional resource is necessary due to the much wider area spread and lower customer density. However, when compared with the number of staff per square kilometre, we have the second most efficient coverage of all the GDNs. This is shown in the table below.

	Area '000 km^2	FTEs	FTEs/ '000 km^2	Ranking
Scotland	39.4	252	6.4	1
WWU	41.0	343	8.4	2
Northern	26.5	317	12.0	3
East England	36.9	463	12.5	4
West Midlands	12.5	235	18.8	5
South	21.3	515	24.2	6
North West	10.4	388	37.3	7
London	3.1	315	101.6	8

It is critical that network specific factors are taken into account when determining appropriate allowances, and the IP's do not allow sufficient opex over the next 5 years to enable WWU to achieve its emergency service standard obligations.

We note that further consideration is being given by Ofgem to these factors.

6. REAL PRICE EFFECTS

We believe the RPE's used in the IPs are not reflective of reality in the marketplace, and we have provided Ofgem with independent analysis by recognised cost consultants Chandler KBS which provided what we believe is a more accurate picture.

The table below compares the results of a) the WWU forecasts, b) the Chandler KBS analysis, and c) the figures used in the IPs.

	WWU Forecast %	Chandler KBS %	Ofgem IPs %
Contractors	4.5	4.1	2
Direct Labour	2	1.8	1
Materials	2.5	3.2	1

We believe the RPE's used in the IP's are artificially low and would have a dramatic effect on our ongoing cost allowances. They merely compound an already unrealistic cost challenge.

To overcome the obvious differences in this key area, WWU would be happy to utilise an appropriate independent index for establishing RPE's. This would also remove a significant risk that currently exists if estimates prove to be inaccurate over time.

Regional factors

We disagree with the assumptions made in the IP's in relation to regional factors for the following key reasons.

- Any consideration of whether regional pay factors should be applied needs to be considered in the context that up until 2006 a national pay scale for staff applied across the whole country. It is accepted that Weighting or Allowance has been applied in London. However given that pay awards have been broadly similar since the cessation of national pay bargaining, there is no justification for making further adjustments now.

- Similarly, in respect of contractor rates, their workforce tends to be mobile and follow the work. Their pay therefore can be considered to be consistent on a national basis. At the present time WWU has contractors from Manchester and Newcastle.

- We also pay national rates for virtually all of the key materials and services that we procure - from pipework to vehicles to IT services.

- Given the above factors we see no justification for reducing the WWU factor to 0.96.

7. GENERAL ECONOMIC EFFICIENCY

In our response to the Fourth Consultation to Ofgem we included an independent report by First Economics relating to the general economic efficiency opportunity. First Economics have updated this work and a headline summary is outlined below.

First Economics (GDN's) v Europe Economics (Ofgem)

- Ofgem indicated in our meeting on 27 June that it saw the First Economics work as a valid way of looking at the rate of frontier shift in network industries, but stressed that it was likely to use this only as a cross-check on the Europe Economics methodology deployed in the IP's. We are very concerned with this approach since they are certainly not complementary pieces of evidence. We believe the Europe Economics work has some serious flaws in its approach and that the First Economics work is the more accurate way of looking at frontier. We believe this can be substantiated by other credible independent pieces of research in this economic area.

- The weakness in the Europe Economics approach was described in some detail in Annex 1 of First Economics' April 2007 report. In both its analysis of relative Total Factor Productivity (TFP) growth and relative input price inflation, Europe Economics have measured expected GDN performance against the wrong 'averages'. Specifically, they mistakenly assume that the rates of TFP growth and input price inflation already captured by RPI are average UK TFP growth and average UK input price inflation. This ignores completely the contribution from goods produced overseas. This results in figures which are misleading and not representative of reality in our sector.

The Ofgem proposals

- We note that the IP's do to an extent correct the erroneous input price inflation assumptions, but that the basic calculation of relative TFP growth is not challenged. We consider this to be the weakest aspect of the Europe Economics analysis.

- Table 1 in the First Economics report asserts that the GDNs will out-perform average UK TFP growth, and that the machinery equipment, utilities, and communications industries provide realistic benchmarks for underlying TFP growth within GDN's. We do not believe these are valid comparators because;

    - the machinery and equipment industry is a very capital-intensive sector that bears no resemblance to the labour-intensive services sector of GDN's

    - TFP growth figures in the utility and communications industries are clearly distorted by the 'privatisation effect' of businesses transferred to the private sector in the 1980s and 90s. Europe Economics claim that they have stripped out this privatisation effect, but we do not see how this can be true.

The alternative First Economics methodology

We believe there are serious flaws in the Europe Economics approach, and that the approach of First Economics in estimating the rate of frontier shift affecting network industries is much more robust and sound. The First Economics approach does not separate TFP growth and input price inflation, so it does not require Ofgem to make assumptions about the rates of TFP growth and input price inflation already captured by RPI. We would make the following points on this issue.

- We acknowledge that First Economics make a series of judgments when choosing which components of RPI to include and exclude from their comparator indices, and would not expect Ofgem to agree with every single choice. However, we do not believe that First Economics demonstrate any systematic bias in their judgments.

- If Ofgem is uncomfortable in any way about the composition of the First Economics indices, we would encourage a repeat of the analysis using its own comparators. We believe that it is impossible to construct a realistic comparator to the GDNs that exhibits price and cost trends that move on anything but a substantially above-RPI trend.

- We make the above assertion because RPI aggregates and averages two quite different trends affecting the products purchased by UK households, ie;

    - Below -RPI cost increases in the goods sector, and;
    - above -RPI cost increases in the service sector.

Since the factors that are contributing to below-RPI inflation in the goods sector (notably globalisation) are of no relevance to a GDN, it is entirely logical that comparator firms to GDN's are seeing costs move on an above-RPI trend. This in turn implies that there is an above-RPI frontier shift in these businesses.

If considered beneficial by Ofgem, we would be happy to work with them in arriving at a set of agreed RPI factors to be included within an appropriate index using information that is already in the public domain to make its calculation transparent

The Ofgem adjustments

Whilst we recognise that Ofgem may wish to make adjustments for capital-labour substitution and the comparative competition effect, we believe that the size of these adjustments have been significantly overstated in the IPs.

The scale of the comparative competition effect cannot be looked at in isolation from the way in which Ofgem has fixed the industry frontier in its comparative efficiency assessment. While we would accept that the 1.1% figure is a reasonable assumption where the industry frontier is defined by the upper quartile in Ofgem's top-down efficiency analysis, it is not compatible with Ofgem's decision to fix the frontier in line with the performance of the leading GDN for each activity separately.

8. REPEX & CAPEX

Repex Services

PB Rune has recommended a 2% per annum efficiency saving for mains and service replacement work without any real evidence or analysis underpinning this assumption. We believe this is an unrealistic challenge, particularly when proposed in conjunction with cost reduction challenges above RPI of;

- 2.5% on Contractor Labour
- 1% on Direct Labour, and;
- 1.5% on material prices.

These RPEs are significantly lower than those calculated independently by the third party consultants used by WWU. The IPs also propose that WWU can absorb increases in waste management cost, an area of growing and significant risk to WWU. All this represent an unrealistic level of challenge on our cost base, particularly recognising these activities are procured in the external marketplace.

Abandonment Ratios

The length of replacement main reduced due to a change in the lay:abandon ratio by PB Rune has not been justified in the IPs. If the upsized main that is classified as Reinforcement is added to our lay length then the network's overall ratio changes from 0.95 to 0.97. PB Rune's approach of adjusting our laid length removes 36 kms of legitimate activity over the period 08/9 to12/13.

Connections Capex allowances

The IPs base the WWU capex proposed allowances on the average of GDN's, rather than the robust bottom up analysis proposed by us. Considering the issues surrounding GDN data consistency and comparability highlighted by Ofgem's consultants, we believe this represents an inappropriate strategy to accurately determine all GDN's capex allowance.

GTMS & SOMSA

We believe it is wholly inappropriate to disallow the majority of costs (some £8m) for the Gas Transmission Management System (GTMS) replacement and exit from the System Operations Management System Agreement (SOMSA) currently provided by National Grid. We believe the following points are key in this issue

- It was fully recognised in the Ofgem consultant reports that GTMS is time expired and requires to be replaced. It is also clearly recognised that a collaborative approach is the most cost efficient method to replace this critical system.

- The requirement to create separate GDN control centres was very much a regulatory one, and not driven by optimum operating cost efficiency. Had it been merely a cost decision then realistically GDN's would not have embarked upon SOMSA exit, or considered replacing one system with several separate systems.

- As separation was driven by a regulatory requirement it is unfair to disallow the costs, provided of course they are reasonable and efficient. In reality, if the

original decision was based purely on cost then a single integrated system should have been maintained.

9. THE PRICE REVIEW PROCESS

Ofgem will recall that WWU expressed significant concern regarding aspects of the 1 year review, and, in particular the lack of engagement and meaningful consultation by Ofgem. We have similar concerns with the main review process to date.

In particular, we are very concerned by the fact that our key arguments and submissions to Ofgem have not to date been afforded adequate consideration, and that we have not been provided with sufficient information about key assumptions in the IPs to enable us to provide an intelligent response.

Consultation & Influence

A key example of our first concern is provided by the process between our response to the Fourth Consultation Document submitted on 25th April and publication of the IPs on 29th May. Although we made comprehensive submissions in response to the Consultation Document in a timely manner, it was evident from the subsequent bilateral meeting with Ofgem on the 2nd May that;

- Ofgem had not read our submissions and as a result were unable to engage on their content,
- Ofgem had already decided on the substance of the IPs since they outlined the content to us, and;
- There was no real prospect of influencing Ofgem as regards the content of the IPs since it was evident that the content had already been determined.

Information & timescales

There have been a number of instances when we have not been provided with sufficient information to allow us to understand the reasoning behind Ofgem assumptions. There have also been occasions where information has ultimately been received much later, leaving us insufficient time for proper consideration of this information. We are happy to provide a chronology of instances where we have identified concerns and shortcomings in the process if Ofgem requires further detail.

For us to be able to give informed consideration and make intelligent responses to any Ofgem proposals it is essential that;

- All materials that go to shape and explain the proposals being put forward are disclosed so that we are able to replicate how Ofgem and their consultants have arrived at their assumptions and conclusions, and;

Armed with the necessary information, we have sufficient time to undertake our own analysis to either verify or challenge those assumptions.

GAS DISTRIBUTION PRICE CONTROL REVIEW - INITIAL PROPOSALS

WALES & WEST UTILITIES LTD
RESPONSE TO THE INITIAL PROPOSALS

PART 2 - DETAILED RESPONSE

In accordance with the requirements of the Initial Proposals document, we set out below each of the Ofgem questions and our responses thereon. Where we 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 FORM, STRUCTURE AND SCOPE OF PRICE CONTROL

RESPONSE TO QUESTION 1

Question 1: Do you think that a wider deadband on the revenue recovery correction mechanism is appropriate in gas distribution?

Paragraph 2.22 – 2.27 Correction Mechanism

In response to the "revenue recovery correction mechanism" proposed by Ofgem we believe that such a scheme should generally have a symmetrical treatment for under and over recoveries. Firstly we believe that there should be symmetrically of interest rates. If the GDN under recovers it should be given the same interest rate that it is penalised by for over recovery. We contend that it is unfair not to apply the same interest rate rules to over and under recovery. Secondly, we believe there is sufficient evidence to justify a wider deadband than the 2% proposed. The evidence to support this position is:

- Approximately 35% of collected revenue is still subject to variation in throughput. Whilst we welcome the removal of the existing volume driver from allowed revenue, there is still a significant disconnect between allowed and collected revenue that could result in a level of over and under recovery of more than 2% even with the best intent of the GDN to achieve exact recovery.
- Pricing decisions are currently made in July in respect of an October price change and there is a "best endeavours" obligation on Transporters to limit price changes to once a year. At the time of the price decision there is still significant uncertainty in the volume of winter throughput, which is driven by weather factors, and many elements of allowed revenue.
- The Price Control Review for the period 2008/09 to 2012/13 is considering revisions to existing incentive mechanisms e.g. DNMRA and the introduction of new incentive mechanisms in relation to Offtake reform. This introduces a greater level of uncertainty over allowed revenue and places more allowed revenue at risk through these incentives. As these incentives are new and not yet defined there is clearly a greater risk of variability in allowed from the current position.
- Within all Transporters licences, there are already well established processes to incentivise the networks not to over recover revenues. These include Ofgem having the power to remove the price setting capability from a Network.

Paragraph 2.1 – 2.4 Revenue Drivers

We support the removal of the volume driver based on throughput as it removes uncertainty of Total Allowed Revenue related to throughput for GDNs.

The costs of the network will increase with the growth of the network, so some form of volume driver does need to be maintained, but not throughput which is not a significant factor in cost variation within the GDNs. Cost increases will arise from:

- Network maintenance
- Attendance at Public Reported Escapes
- Repairs
- Increased potential for compensation payments for loss of supply etc.

We would like to see a volume driver that takes into account the increase in consumers connected to our network and therefore capacity, this would enable additional revenue to be recovered as our network grows.

We propose an adjustment to allowed revenue to recognise increase in consumer numbers/capacity of the network. There are approximately 20,000 new connections per year, amounting to an increase in consumers of 0.8% per annum. A 4% increase in connections over five years would result in an increase in income of £8m if applied to Core Allowed Revenue, and £3m if applied to controllable costs.

Paragraph 2.5 – 2.12 Scope of the Price Control

We support the pass through of both payment claims associated with last resort meter supply and also in the costs incurred by suppliers investigating theft of gas, which are currently charged by xoserve to the GDNs, whilst the GDNs currently have no mechanism to pass on these variable costs to the Shippers. Please refer to our response to Chapter 8 in respect of "User-Pays" services provided by xoserve.

In respect of Rates, we are concerned by Ofgem's proposed approach of introducing and "Ex-post" adjustment to the rates allowance provided that the GDNs can demonstrate that they engaged with the relevant valuations offices and achieved an efficient level of costs. We contend that this is a subjective decision by Ofgem and require clarification over how Ofgem will measure "efficient" engagement. If this demonstration of an "efficient" level of spend ordinarily requires the GDNs to appeal any rating raised by the respective valuations offices, then we would also need to ensure that we can recover the costs of any such appeal.

Paragraph 2.13 – 2.14 Price Indices

We fully support the continued use of the Retail Price Index (RPI) for the calculation of allowed revenue once the price control is set (leaving aside the separate indexation for gas shrinkage).

However, 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 it.

All of which impact on the costs of the GDN not least through wage pressures in response to, for example the increasing costs of house purchases, and home loans. The process of calculating a five year price control in any case smoothes out annual fluctuations in revenues.

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).

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

There is also compelling evidence supported widely within the Economic Community and demonstrated by First Economics, that RPI can essentially be disaggregated into two forms.

It is essential that the setting of cost allowances reflect the real movement in a GDNs cost base. We set out our arguments and position on the issues raised in this and the preceding paragraph in detail in the relevant chapters further on in this document. Therefore cost allowances must be set using sector specific real cost inflators which will then need to be uprated by RPI each year to maintain their real value.

Paragraph 2.15 – 2.21 Dealing With Uncertainty, New Obligations and Costs

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

For non controllable costs such as permits to work in the road it would be appropriate to set pass through terms within the licence

The post-tax WACC needs to be adequate to ensure proper financeability and tax should then become a pass-through item. Tax costs can vary from original forecast for many reasons, including changes in corporation tax rate and changes in the tax treatment of particular activities.

We agree with the principle of an ex-post adjustment for adverse changes in tax treatment and rates from those assumed at the time the control is set. This is consistent with granting a post tax WACC return on investment where the Regulator has implicitly decided that the costs or benefits of managing tax risks and the associated tax efficiency should not be retained by the GDN. However, changes in the tax burden caused by changes in legislation are not controllable by the GDNs. If there is no mechanism for adjusting revenues to accommodate possible future changes to tax law then there will be a problem for future financing and financeability.

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

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

Any mechanism must ensure symmetry of treatment across GDNs. We can envisage circumstances where GDNs may have a different tax treatment for the same economic activity, due to differences in the approach of different tax officials.

Would a GDN retain the benefit of a favourable tax treatment if other GDNs were not able to agree this treatment with the Revenue?

In paragraph 2.15 Ofgem state that they do not support the use of a generic mechanism for dealing with uncertainty. We believe this view is inappropriate. Price cap formulae may adapt to changing conditions (e.g. by adjusting for changes in volume, or by indexing a price cap), but some changes are not amenable to such automatic adjustments. In such cases, it is necessary to adjust directly for the effect of changing conditions on specific costs and the final statement of the regulatory system (i.e. the licence) should set out how and when this adjustment will take place. The secret is to state clearly how such procedures will work, using criteria that have been properly reviewed and amended in the light of the comment.

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

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

GENERAL RESPONSE

Financeability

- WACC should be at least that given to Transmission - Ofgem should discount reductions in trailing debt premia:
    - Risk differential
    - Trailing debt cost offset by recent rises in interest rates
- Post tax vanilla WACC of 5.25% gave WWU PMICRs inconsistent with a comfortable investment grade. For the Extension Year Credit Rating Agencies have "lived" with the reduction as it was only for one year. Full assessment of financeability of GDPCR proposals are now required.
    - Moodys – 2004 Paper on rating GDNs sets PMICR for Baa1 at 1.5+
    - Fitch – issued discussion document highlighting the importance of PMICR
- Indexation of WACC has significant practical difficulties if it is not to increase funding risk in the short term
- Any increase in gearing in assessing WACC should recognise:
    - Increase in cost of debt as gearing increases
    - transfer of risk to equity means that higher equity returns are required
- Accept that PMICR ratios are improved by assuming an element of index linked debt, but this assumption is a change in regulatory approach – regulatory uncertainty increases required investor returns

PART 2 – DETAILED RESPONSE

CHAPTER 3 OPERATING EXPENDITURE ANALYSIS

RESPONSE TO QUESTIONS 1 AND 2

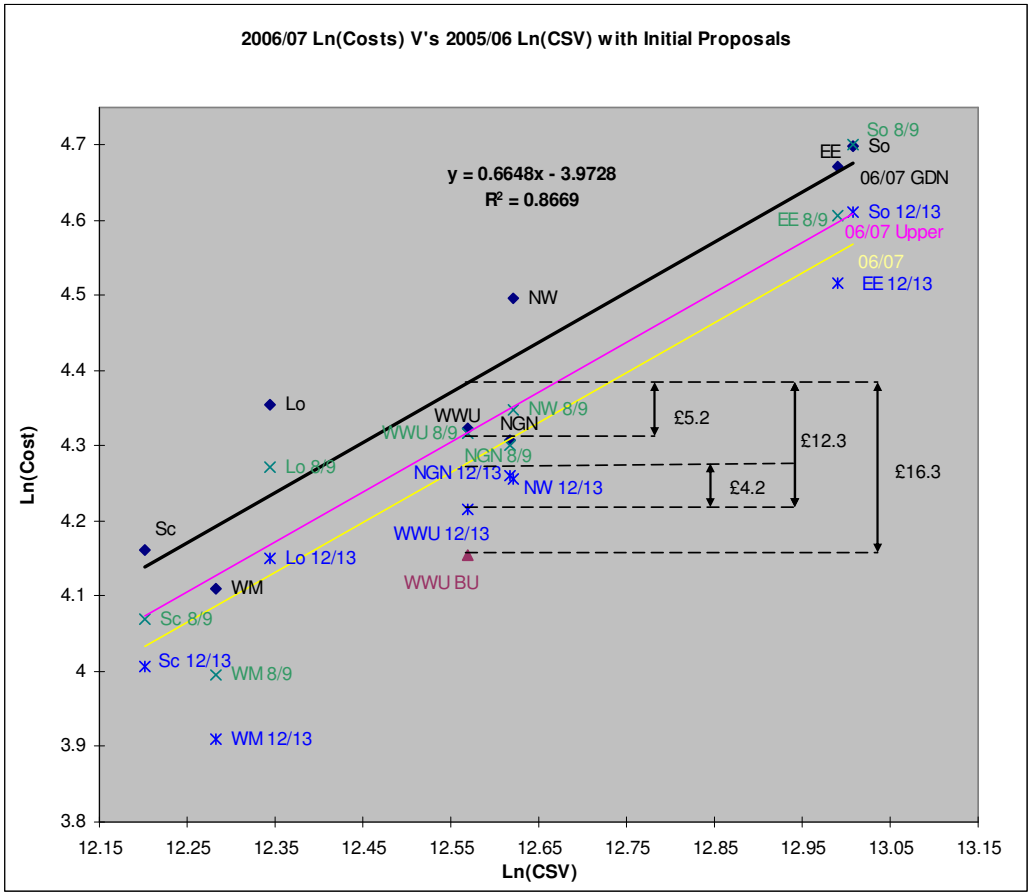
Question 1: Do you agree with our approach for setting opex allowances and the proposed allowances we have derived using that approach?

METHODOLOGY

Regression Analysis

WWU supports the use of appropriate and realistic benchmarks to determine comparative performance, particularly the use of recognised external best practice data. We have provided credible third party evidence to Ofgem that demonstrates that WWU is efficient for a significant number of its activities. We have already provided detailed comments and analysis in respect of both indirect costs and direct costs, so for the sake of brevity we do not repeat them here. Note that the consultants reports we have submitted previously form part of this response.

We believe the methodology employed by Ofgem in applying benchmarking together with efficiency challenges is creating outcomes that are inequitable. The following regression summarises Ofgem's results for each company in specific years (actual costs and benchmarks for 06/7, allowed costs for 08/9 and12/13). The regression highlights a number of anomalies which are explained below after the graphs.



- The regression is a replication of the one provided in the additional information on the opex regression. It illustrates the results shown on page 20 of the Main Supplementary Appendices to the IPs.

- We have superimposed the proposed allowances for 08/9 and12/13 from pages 28 to 35 of the Main Supplementary Appendices to the IPs, and also shown the bottom up allowances provided in the additional information.

- It can be seen that in all but two cases the bottom up analysis requires GDNs to have considerably lower costs than the frontier arising from the top-down regression. This would suggest that the bottom up analysis is flawed. This view is consistent with evidence elsewhere in this summary regarding the use of inappropriate cost drivers (largely revenue) to set the bottom up benchmarks.

- The IPs attempt to address concerns over the bottom up analysis by the use of the 5.6% uplift shifting bottom up top quartile allowances uniformly towards a "top-down" frontier. Unfortunately the use of top down frontier overrides any use of the upper quartile to deal with data issues and makes no allowance for data errors, as it places significant weight on the scores for one company. Companies for which the bottom-up analysis was particularly inaccurate or biased are penalised. A more appropriate error correction would be to uplift towards "top-down" top quartile, which we have estimated at 10.1%.

- The challenge placed on individual GDNs appears inequitable. Some companies that are currently achieving top quartile costs measured by top down regression are required to make significant further cost reductions, whereas other top quartile performers are not so challenged, eg;

    - West Midlands currently lies between the upper quartile and frontier, yet is required to out-perform the bottom up cost analysis by 12/13 – a cost reduction of over £11m.

    - Northern Gas who are at the cost frontier are required only to reduce costs by some £3.5m by 12/13 and under-perform the "bottom up" cost analysis.

  It is inequitable that each GDN is being set an inconsistent 2013 cost challenge.

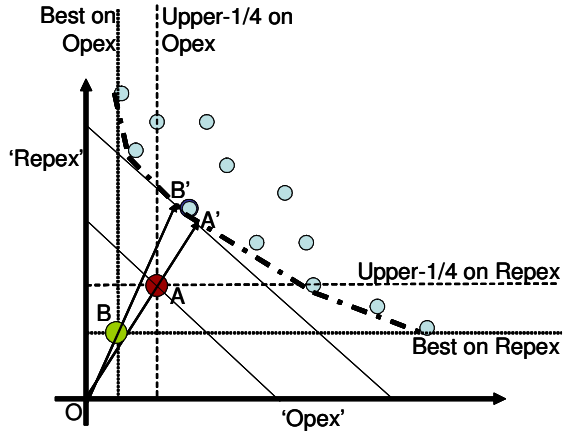
- Relatively high cost networks appear to be rewarded, with Scotland currently above the average regression line but not required to meet the current cost frontier by 2012/13.

- We believe these results are inequitable, and we would urge that standard comparative technique of regression be used, which should be based on the top down upper quartile cost line to allow some leeway for data integrity. Cost challenge would then be applied equitably, informed by a credible bottom up analysis to provide a cross check on cost challenges.

Adjusting to a "top-down" benchmarking corrects for the understatement of costs caused by choosing the lowest cost for each item. However, there is no justification for adjusting to a higher target for performance – the frontier – once Ofgem has acknowledged that the upper quartile is the appropriate performance target for individual cost items.

Figure 1 shows the effect of this approach. For simplicity, this model considers the trade-offs between two types of cost – 'repex' and 'opex'. The light blue dots represent the choices made by 12 firms. The curve of the frontier (dash-dot-dash) shows the combinations of repex and opex that appear to be feasible for these firms. Ofgem sets a target for opex equal to the level achieved by the firm with the third lowest opex (i.e. upper quartile firm out of 12) and a separate target for repex equal to the level achieved by a different firm with the third lowest repex. Point A represents the combination of these two benchmarks and the sloping (45°) line through A represents all points with the same total opex+repex. This target is not so punitive as it would be if Ofgem drew a line through Point B, the combination of the "best in class" for both opex and repex. However, even taking A as the target, none of these points lie within the frontier, meaning none of these points is feasible.

Figure 1: Definition of Benchmark



To correct for this bias, Ofgem adjusts to the frontier produced by "top-down" benchmarking, which is represented either by the dash-dot-dash frontier, or by the ringed point and the 45° line through it (i.e. points with the same total opex+repex). The adjustment takes the form of a proportional expansion of the target for all companies by the ratio of OA to OA'. However, by adopting the frontier, Ofgem is setting a tougher target than the upper quartile and making no allowance for data errors in the estimation of "inefficiency".

In fact, the process makes the whole process of benchmarking individual costs by reference to the upper quartile almost superfluous. There is practically no difference between the cost allowance at A' and the equivalent cost allowance at B' produced by shifting up to the frontier the combination of least-cost (best in class) opex and repex.

Hence, by making this adjustment, Ofgem has non-transparently reintroduced the "frontier" as a performance target, having previously stated that the upper quartile was an appropriate target.

Paragraph 3.7 – 3.11 Related Party Margins

xoserve Margins

We are concerned that as the work between Ofgem, xoserve, the GDNs and the Shippers on User Pays has not yet concluded and that as a result the GDNs may be expected to incur costs from xoserve for which they have not been provided an allowance. We do not believe that GDNs should be expected to suffer in this way because of a lack of agreement between these parties.

The efficient costs of operating xoserve in relation to price controlled activities should continue to be allowed within the price control settlement.

In general on xoserve margins, the Income and Corporation Taxes Act 1988 schedule 28AA contains the basic rules relating to transfer pricing which in effect covers transactions between two companies where one of the parties is controlled by the other.

Where the transaction takes place not on an arms length basis then the profits and losses of both parties for tax purposes are calculated as if they had been carried out on an arms length basis.

Under Self Assessment the responsibility is with both parties to make appropriate adjustments within their own tax returns.

The implications for xoserve of not charging a margin to Networks are:

- xoserve's sales to networks cannot be regarded as being on an arms length basis,
- National Grid is regarded as a controlling party of xoserve by virtue of their majority shareholding,
- An adjustment will be required to be made by xoserve and National Grid in both their tax returns as if the sales had been made on an arms length basis,
- This doesn't necessarily mean that the adjustment will be equivalent to the existing 6% margin – any margin imputed would have to be justifiable,
- The result of this would be that xoserve's profits for tax purposes would increase while National Grid's would be reduced by a corresponding amount, and
- In effect this would transfer value from xoserve to National Grid to the disadvantage of all other shareholders (£160k based on 2007/08 charges and the 6% margin).

It should be noted there is no penalty as such on either party for carrying out transactions not on an arms length basis, however the implications for xoserve are that, unless profitable business was generated to offset the post-tax losses, xoserve would be making an annual post-tax loss each year, which is clearly an unsustainable position over anything but the short term. However, if this situation continued without additional cash being made available xoserve would become insolvent. It could then face insolvency proceedings and its directors could face personal liability under the insolvency act 1986 and/or disqualification as a director.

Connections Margins

We concur with Ofgem's views that:

- margins should be permitted on competitive work, as the competitive environment should ensure that market returns are earned, and
- margins should be removed from non-competitive connections work, where the cost is added to RAV.

However, we would flag that clear guidance is required on which particular activities are deemed competitive by Ofgem in order that the correct approach is adopted. It should also be noted that the level of competition is likely to increase over the price control period and that accordingly the guidance issued by Ofgem may be subject to change, which could affect the performance of GDNs against their allowances over the five years of the price control review.

Removal of Related Party Margins

We concur with Ofgem's approach of including related party margins in the benchmarking exercise to help ensure that valid comparisons are made but then to reduce the allowance for GDNs with related party services by the amount of those margins to eliminate any double take of returns.

Paragraph 3.12 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 equipment 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 expenditure of this type as capex.

Question 2: Do you agree with the proposals to uplift allowances derived from disaggregated benchmarking so that they are consistent with the power of a top down approach?

Paragraph 3.17 Application of Benchmarking

We do not agree with the proposals to uplift allowances derived from disaggregated benchmarking so that they are consistent with the power of a top down approach. We believe that the top down regression should be used for 2006/07 costs with the performance target set at the upper quartile.

The use of the bottom up benchmarked results from the consultants' reports on direct and indirect costs is not supported due to the weaknesses present in the analysis. This is with regards to the creation of an artificially efficient GDN and the use of inappropriate benchmarks producing unrealistic proposals. This has been communicated in detail in responses to the individual reports and in the response to the Fourth Consultation Document and as there have been no changes in Ofgem's approach this remains the case.

In the review of all efficiency studies, it has never been shown that one company has managed to achieve frontier efficiency level performance across the whole of its operation. However this is the premise which Ofgem is applying to the GDNs as part of the current review.

The 5.6% uplift has been offered to address the weaknesses of the bottom up approach but we do not believe that this is an appropriate level. It does not seem reasonable to uplift by an average percentage when the range of the difference is between 3% and 13% at group level with WWU being more than double the average used at 13%. This therefore over rewards some GDNs where the differences between the top down and bottom up benchmarking was small and penalises others where this difference was significantly greater than 5.6%. As this is an attempt by Ofgem to use an error correction factor on the difference outcomes generated by their consultants between a top down and bottom up review of the efficiency frontier, each GDN should be corrected for the underlying error in the consultants work on that particular GDN.

It has been acknowledged that the upper quartile is the appropriate performance target for individual cost items in the bottom up approach. To be consistent, we believe that if the disaggregated benchmarked costs have to be used then they should be uplifted to the upper quartile level and not the frontier when comparing with the top down analysis. It can be demonstrated that in competitive industries no single company can demonstrate that they operate at the efficiency frontier across the entirety of their operations.

We agree that 2006/07 costs should be used which is consistent with the analysis and views held by all parties so far in the review. It has not been made clear as to why 2005/06 customer numbers and network length have been used to calculate the Composite Scale Variable (CSV). This is inconsistent when the remaining data used for the consultants work has been based on 2006/07 results, we therefore believe that 2006/07 data should be used throughout for consistency.

As previously communicated we strongly believe that network length and number of connections are the cost drivers that should be used because they are more representative of the main assets of a gas distribution business and the support required to maintain it in a safe and efficient condition.

Paragraph 3.22 Real Price Effects and On-Going Efficiency

As we have previously indicated in our response to the Fourth Consultation Document we believe the figures supplied by the PB Power report to be unrealistically low. We submitted an external consultants report prepared by Chandler KBS on real price effects which supported our views of the RPEs that should be applied. The table below compares the Chandler KBS findings with both our own forecast as well as and PB Power's recommendations for the level of above RPI increases.

	WWU Forecast %	Chandler KBS %	PB Power %
Contractors	4.5	4.1	2.25
Direct Labour	2.0	1.8	1.0
Materials	2.5	3.2	1.0

Following the publication of the IP Document, we note that the proposed allowance for real price effects are now even lower, reducing contract labour from 2.25% to 2%, which we believe to be wholly unrealistic.

This coupled with the ongoing efficiency target of 2.5% per annum for Opex means that it is effectively an efficiency saving of some 4.6%.

The EC Harris report commissioned by NGG is now out of date and the Chandlers KBS report attached as Appendix E is now more appropriate.

The following paragraphs cover our analysis on contract labour, materials and direct labour in turn.

Contract Labour

The Baxter Indices or price adjustment formula calculates the increase, or decrease, in contractor's costs over any period to the nearest month using indices published in

the Department of Trade and Industry's (DTI) "Monthly Bulletin of Indices". Various indices covering different types of activities within a construction contract or programme of work are weighted together to calculate an overall index.

The Baxter Indices are used to estimate the increase in prices on a specific contract. In order to calculate the appropriate overall index using the Baxter Indices, WWU would need to segregate the proportions of projected expenditure between various work categories i.e. labour and supervision, aggregates and various pipe materials.

The Baxter Index over the last four years for labour and supervision is averaging at 6.65% per annum. The projected trend is 7.29%. This would result in an RPE of 4.79% i.e. 7.29% less RPI of 2.5%.

Construction Output Price Index (COPI) measures price levels incurred on new build construction projects underway at the time of each index value. It is based on lagged values of tender price indices, cost indices of labour and materials, and on values of construction new orders for Great Britain. COPI is widely used within the water industry and is the preferred index adopted by its regulatory body (Ofwat). We note that WWU contractor prices include surface reinstatement and imported backfill material whereas pipes and fittings are issued free to the Contractors.

COPI has averaged 5.1% per annum over the last four years. The projected trend is 6.0% increase per annum. This would result in an RPE of 3.5% i.e. 6.0% less RPI of 2.5%.

The ROADCON index is derived from public sector road projects. The Department of Trade and Industry compiles the Road Construction Tender Price Index from the bills of quantity received by the Highways Agency from its regional offices and from local authorities. The PB Power report has used ROADCON as a comparator to the Baxter Indices. Chandler KBS {is Chandler KBS one word? We use both in this document} plotted the historical indices and extrapolated the results to forecast future trends.

ROADCON has averaged 4.2% over the last four years. The projected trend is 4.2% increase per annum. This would result in an RPE of 1.7% i.e. 4.2% less RPI of 2.5%. This index is very volatile and is therefore not particularly suitable for forecasting. Due to the fact that the index is derived from road construction projects, and due to its inherent volatility, we do not consider ROADCON to be an adequate index producing RPE's in the Gas Distribution Sector.

Having considered the trends for COPI and the Baxter Index, and discounting ROADCON, we conclude that a realistic annual increase for Contractor's rates is 6.6%. This would result in an RPE of 4.1% (based on an RPI of 2.5%).

It should be noted that the COPI index includes an element of materials. If the material element was discounted, it is likely that the projected price increase relating to Construction Prices only would increase above 6.0%. The inclusion of a material element within COPI could in theory lead to an understatement of the inflation trend for Construction Prices.

The Baxter Index (labour and supervision) is showing a future trend of 7.29% per annum. As a benchmark, the Baxter Index over the last four years for labour and supervision is averaging at 6.65% per annum. This compares favourably with the Chandler KBS assessment of 6.6%.

Materials

Chandler KBS has used the Baxter index as a means of measuring trends with regard to material costs. PB Power has estimated an RPE for material cost of 1% per annum. The total price increase estimated by PB Power is therefore 3.5% i.e. 2.5% RPI plus 1% RPE.

The cost of steel and plastic pipe has been rising at an average of between 5.0% and 6.4% per annum for the last four years. In late 2006 alone, there was a price increase for plastic pipe of circa 22%.

Having reviewed the above indices, we conclude that a realistic annual increase for Material Costs is 3.2% per annum. This will result in a total price increase of 5.7% per annum.

In addition to the above, Chandler KBS was requested to review price trends with regard to the following work categories:
• Pipes and Accessories - Plastic
• Pipes and Accessories - Steel

Chandler KBS plotted the historical indices and extrapolated the results to forecast future trends. As a result they believe that the following annual increases in pipe prices (not RPE) are appropriate;
• Spun and Cast Iron 5.57%
• Steel 6.43%
• Plastic 5.00%
• Labour and Supervision 7.29%

In relation to pipes, the proportion of cost segregated between labour and materials will depend on the pipe diameter. These proportions will influence the final costs when the different RPE factors are incorporated. A large diameter pipe will contain a higher proportion of material cost when compared to a small diameter pipe.

Direct Labour

Generally, earnings in the construction industry rose at a considerably faster rate than the economy as a whole. The average increase in wage settlements in the construction industry has averaged between 3.9% and 4.7% per annum over the last four years.

PB Power has estimated an RPE for direct labour costs at 1%. This results in a total price increase of 3.5% per annum i.e. 2.5% RPI plus 1% RPE.

Chandler KBS has used the following published indices for forecasting future direct labour cost increases:
• DTI Monthly Bulletin,
• BCIS Wage Increases, and
• National Statistics Digest.

Chandler KBS have extrapolated the above indices for forecast inflation factors between 2006 and 2010.

Having reviewed the above indices, Chandler KBS conclude that a realistic annual increase for direct labour costs is 4.3%. The RPE is therefore 1.8% i.e. 4.3% less 2.5%.

Paragraph 3.23 – 3.24 Regional Labour Rates and Other Regional Price Effects

We disagree with the assumptions made in the IP's in relation to regional factors for the following key reasons.

- Any consideration of whether regional pay factors should be applied needs to be considered in the context that up until 2006 a national pay scale for staff applied across the whole country. It is accepted that Weighting or Allowance has been applied in London. However given that pay awards have been broadly similar since the cessation of national pay bargaining, there is no justification for making further adjustments now.

- Similarly, in respect of contractor rates, their workforce tends to be mobile and follow the work. Their pay therefore can be considered to be consistent on a national basis. At the present time WWU has contractors from Manchester and Newcastle.

- We also pay national rates for virtually all of the key materials and services that we procure - from pipework to vehicles to IT services.

- Given the above factors we see no justification for reducing the WWU factor to 0.96.

Paragraph 3.29 – 3.33 Work Management

Our concerns raised in our initial response to the draft PB Power Opex report over the suitability of the Composite Variable and regression analysis used to produce the bottom up costs remain. This approach did not take into account network specific factors such as network spread and geography, total Network length (the analysis disregards all pipes above 7bar) and sparsity which impacts on the number of Operational staff based remote from the core Work Management function. No other GDN has the wide spread geography which WWU has and the only way of providing a practical coverage of customer service and asset management is to provide outbased depots staffed with materials and vehicles. The impact of the network geography on these costs must be reflected in the allowances.

The analysis undertaken by PB Power does not take account of work associated with the above 7bar pipelines. These pipelines require a significant preventative maintenance resource which is not reflected in the use of Repairs, Public Reported Escapes and length below 7bar as elements to derive the composite drivers. The composite drivers should include an element to take account of the above 7 bar/LTS activities. The drivers for these costs between GDNs will be different dependant upon the length of above 7bar pipeline maintained by each GDN. It should be noted that WWU has two and a half times the length of above 7 bar pipeline compared with the average GDN.

We note that Ofgem has made an initial allowance for environmental remediation works for WWU at £1m per annum. Broad estimates of the liability for WWU currently stands at in excess of £25m, in relation to statutory remediation only and based on the influence of current legislation especially in relation to Hazardous Waste Acceptance Criteria and Landfill. The expected spend over the next five years is £2.3m per annum. These costs are principally based on the removal of hotspots of contamination to landfill and exclude costs that may be incurred during on site

investigations, remediation of soil and groundwater, relocation and/or protection of plant and equipment, or change of use. Further increases in costs can be expected as legislation over the treatment and disposal of contamination becomes more onerous in this area.

Paragraph 3.34 – 3.43 Emergency & Repair

Workloads

We disagree with the assumptions made by PB Power in their forecast of WWU's Public Reported Escape workloads. The rationale for our forecast is outlined below:-

Internal PREs
Whilst there was a reducing trend in Internal PREs from 2002/03 to 2005/06, we have based our forecast of a 1% per annum increase in Internal Public Reports on a combination of the impact of the new connections to the network and increased CO awareness. We have combined the increase in connections to the Network and the expected increase in CO calls (but this does not include the cost of the CO testing being advocated by Ofgem) to forecast a 1% per annum increase in Internal PREs which represents just under an additional 1000 PREs per year or 3 per day across the Network. Please see the detail below:-

a) New connections to the Network

The number of new connections to the Network forecast to be carried out by WWU or its contractors over the review period is 81,500; a further 117,500 are expected to be connected by other Independent Gas Transporters (IGTs), giving total new connections of 199,000 over the five years.

As at 2005/06 the number of supply points connected to the network was 2,389,074 (excluding IGT customers). In 2005/06 there were 95,346 Internal Public reported escapes - which is 4% of the number of supply points.

If the number of supply points increases by 199,000 over the review period, a reasonable assumption would be that Internal PREs could increase by 7,960 (199,000 x 4%) over the period which is equivalent to 1,592 per annum. We view this as a maximum figure and have assumed a smaller value for our forecast.

b) CO awareness.

Two reports were issued by the Health and Safety Executive following its review of Domestic Gas Safety carried out in 2005. The first of these reports, by Frontline Consultants, investigates current arrangements for promoting domestic gas safety across the UK, and made recommendations for the future to raise awareness and training levels. The second report details a sample survey of the condition of gas appliances and householder awareness of potential CO hazards. One likely initiative from these reports is the setting up of a body to raise CO awareness generally throughout the country by a variety of means included media advertising and leafleting with energy bills, and the promotion of CO alarms.

In addition Ofgem are considering the possibility of the GDNs Emergency Service personnel carrying out CO checks as part of gas emergency investigations as stated in paragraph 3.40 of the Initial Proposals.

The effect of these two initiatives is to increase public awareness of CO. The result is predicted to be an increased number of visits being made by our engineers to properties in response to CO alarms and/or reports.

External PREs

Ofgem's consultants have assumed a 3% reduction in the number of mains PREs due to the ongoing mains replacement programme. However this is inconsistent with the assumptions made by the GDNs. WWU's data shows that although 1,761km of metallic main has been abandoned in the last five years, there has been no significant reduction in the number of mains repairs resulting from external PREs; in fact there has been an increase in external repairs from 2002/03 to 2006/07 of 3%.

	02 03	03 04	04 05	05 06	06 07
Mains Abandoned	**303**	**309**	**354**	**392**	**403**
External PREs	**23080**	**21839**	**23784**	**24490**	**24116**
Mains Repairs per diam.					
<3"	888	814	1004	1025	1190
>3"<6"	3918	4287	3841	4397	4271
>6"<8"	2158	1733	2065	1958	1959
>8"<12"	1269	1099	1308	1276	1213
>12"<18"	700	544	647	632	624
>18"<24"	159	119	136	164	139
>24"<30"	55	35	59	65	23
>30"	4	8	5	0	3
	9151	**8639**	**9065**	**9517**	**9422**

In completing the BPQs, we have analysed mains repairs by diameter and made assumptions on expected trends based on historical information and forecast replacement lengths.

We have not assumed a direct proportional link between mains replacement and mains PREs; because the priority of the current mains programme is the removal of risk rather than replacement due to condition. In our view the adverse impact on mains PREs of the asset ageing of the remaining network needs to be taken into consideration. Our analysis has forecast a reduction in repairs by diameter, and these are shown in the following table:-

Diameter	Change pa
<3"	-1.5%
>3"<6"	-1.0%
>6"<8"	-0.4%
>8"<12"	-0.5%
>12"<18"	+0.5%
>18"<24"	+2.4%
>24"<30"	+1.5%
>30"	0

The forecast shows a reduction in the <12" diameter repairs but a significant increase in >12" repairs. The overall effect is a reduction of 0.7%

There is an element of interference damage repairs within our forecasts. We consider initiatives by ourselves and the HSE will lead to a decrease of 1% per annum in mains repairs following third party interference. However, we have little influence over the level of service damage caused by third parties and have forecast

a constant level going forward. Given the level of inward investment within Wales and the South West together with the demand for housing and road and infrastructure development, we consider this to be a prudent assumption.

Repair costs will be affected by the increases in Landfill Taxes and Aggregates Levy proposed in the 2007 Budget over the review period. We understand that additional allowances are being considered as part of the update work for September.

D2 Rechecks
Where repairs are ongoing there is a requirement to return to monitor the site until and on completion of repairs - known as D2 rechecks. These rechecks amount to a significant number of visits (over 40,000 for WWU). The Consultants recognise this in their bottom up approach but we believe that the numbers are not included in the unit cost analysis. Although there has been some discussion at working meetings on this issue, we suggest Ofgem should ensure that each GDNs figures have been compiled on the same basis.

Network Specific Factors

Within our response to the Fourth Consultation document we provided evidence that WWU costs are influenced by the size, shape and sparsity of its network (Appendix A of the Response to Fourth Consultation Document "Network cost Drivers - a bottom up Approach"). That report should be read in conjunction with this response.

Network specific factors are particularly relevant to the Emergency Service where employee numbers as well as the location and number of depots are determined by the 1 hour licence response requirement and the provision of standby cover.

A comparison with a more compact GDN such as West Midlands using 2004/05 figures shows that WWU Emergency First Call Operatives (FCO's) cover a similar number of kilometres per FTE. However, in order to cover our much larger area and meet the emergency response standards we require 46% more Emergency FCO's. This is demonstrated in the table below:

	FCO FTEs	PREs	PRE per FTE	Custs	Cust. per FTE	Network Length (Kms)	Kms per FTE
W.Mids	235	99309	423	1922305	8180	24112	102.6
WWU	343	119620	349	2380251	6940	34112	99.5

The requirement is necessary due to the much wider area spread, and also the lower customer density. However, when compared with the number of Emergency First Call Operatives per square kilometre, we have the second most efficient coverage of all the GDNs. This is shown in the table below:

	Area '000 km^2	No of FTEs	FTEs per '000 km^2	Rank
East of England	36.9	463	12.5	4
London	3.1	315	101.6	8
North West	10.4	388	37.3	7
West Midlands	12.5	235	18.8	5
Scotland	39.4	252	6.4	1
South	21.3	515	24.2	6

Northern	26.5	317	12.0	3
WWU	41.0	343	8.4	2

It is essential that network specific factors are taken into account when determining appropriate allowances and we note that further consideration will be given to these factors for the Emergency Service.

CO Monitoring

As mentioned above, we note that Ofgem are considering whether there are safety benefits to requiring GDN's Emergency Service personnel to carry and use carbon monoxide measuring equipment during gas emergency investigations. Prior to giving a view on this WWU would require more information on the scope of the work that is required to be carried out. There will be a training and qualification requirement for operatives, additional time spent on the job checking appliances and additional administration costs to record findings and store information. As Ofgem note, these costs are not currently included within their IPs.

Paragraph 3.44 – 3.49 Maintenance

In our response to the PB Power draft Opex report submitted on 16 March 2007 we raised concerns that no allowance had been given for the costs of maintenance of our High Pressure Storage Vessels and equipment. There is no indication within these initial proposals that this issue has been addressed. We maintain that the bottom up analysis of low pressure storage maintenance is a very simplistic view of the process and that the following issues have been omitted or not considered:-

- no allowance has been made for the wide geographic spread of the holder sites in WWU,
- the weekly task estimate is too low. We use two man contract teams on holder maintenance with increasing emphasis on Health and Safety (e.g. working at heights).
- oil removal costs (imperative for holder cup monitoring) and cup cleaning costs have not been considered.
- there is no reference to call outs (holder cup alarms, hose failures etc) nor instrumentation maintenance or repair costs
- there is no consideration of COMAH (Control of Major Accident Hazards) compliance costs, Health and Safety Executive visits etc.
- the allowance of one man day for repairs is totally inadequate

PB Power noted that on average each of WWU's holders is larger in volume than holders across all GDNs. The bottom up approach adopted by PB Power did not take account of this and failed to recognise the expenditure needed for major repairs which can be considerable.

As part of our BPQ submission we included a sum of £1.3m per annum for holder demolition and maintenance of decommissioned holders and ex operational sites. Within their Opex report PB Power recommended that this sum only be allowed for two years starting in 2007/08. WWU feel that these costs should be allowed in full to allow it to meet its obligations to ensure the safety of the public, the environment and its employees.

WWU have provided details of its Low Pressure Holder painting programme and costs from 2002/03 to 2012/13. All holders have some painting activity proposed over a nine year period; and based on the current condition of the holders, some of

this work will involve patch and crown painting only. Therefore, this does not constitute a policy of repainting holders every nine years; some holders will require more frequent painting e.g. due to salt and corrosion.

The use of a set painting frequency is not a robust method of determining painting costs for the GDN and is not set out in any Maintenance policy. This is because requirements for individual holders vary, e.g. holders close to the sea require painting more frequently than others. Assessments of individual holders are carried out in line with T/SP/PA/10 to determine painting requirements.

The use of historical costs to determine the level of costs going forward does not necessarily take into account additional works now required under the Working at Height Regulations as scaffolding costs can now make up a substantial proportion of the total cost

We contend that, as a result of the issues raised above, the allowed costs for WWU holder painting have been reduced to a level where we will be unable to carry out all our proposed works over the review period

Paragraph 3.50

We disagree with Ofgem's view that an allowance should not be given for the recruitment of substantial numbers of employees over the GDPCR period to replace the ageing workforce. Ofgem contend that the new workforce, whilst being less well trained and experienced than the current workforce will not require additional funding because:

- they will be typically at a lower point on the pay scale than those they are replacing and therefore funding for training and less efficient working are already built in, and
- they are younger and fitter than the ageing workforce, they can operate more quickly than the current workforce to compensate for their lack of experience.

We disagree with Ofgem's assumptions for a number of reasons:

- Firstly, the time taken to achieve full competency is typically between 3 and 4 years, depending on the discipline. So there will be a number of years when these new employees are operating at an efficiency level significantly below that which is currently achieved, even given their youth and ability to work faster,
- Secondly, there is a statutory obligation for the GDNs to provide the out of hours emergency service, so efficiency savings gained by increased productivity do not mean a reduction in the number of employees as staff rotas need to be maintained, and
- Finally, there will not be savings made in terms of salaries for industrial staff following the recruitment of new staff on lower salary bands, as these bands do not exist, rather all industrial staff are paid spot salaries rather than salaries dependant on experience. These terms were inherited from NGG and were negotiated with by them the relevant unions.
- Given the shortfall of competent personnel within the industry, in order to meet workload demands it is highly likely that we will need to recruit directly from the marketplace at a premium, and therefore future costs are likely to be higher than those assumed in PB Powers RPE assumptions. Additionally, it is worth pointing out that this is only effective in the very short term as available labour is scarce, and once this limited pool has been exhausted, there are no other stocks to draw upon.

Consequently, in light of the above it is clear that this issue has to be tackled and additional allowances are required in order to overcome the ageing workforce issue.

Paragraph 3.55 – 3.69 Indirect Operating Costs

Indirect Operating Costs

We submitted our detailed views on the LECG analysis in March 2007 and as part of our response to the fourth Consultation document. As part of that submission we included a report from our consultants, Third Horizon, reviewing the LECG report and considering more appropriate alternative external benchmarking, rather than the, generally, internal benchmarking adopted by LECG. We maintain that appropriate external benchmarks should be used for the analysis; third party benchmarks by their nature are independent.

It is important that Ofgem acknowledges that the GDNs have different operating models and that direct and support services should be compared on a like for like basis. It is our view that economies of scale should also be taken into account in this review process.

We believe that recognition should be made within the allowances for those companies that cannot benefit from inter group support. We note that the four GDNs that remain in NGG ownership have a total cost of £390.6m of indirect allowances for the five years of the GDPCR (averaging £97.7m per GDN) whilst for those four GDNs in new ownership the total of indirect allowances is £325.9m (averaging £81.5m per GDN).

We demonstrate in the paragraphs that follow that the methodology and approach adopted by LECG is fundamentally flawed and the efficiency targets implied in the report lack justification and credibility. Consequently we consider that the level of cost reductions indicated by LECG is unrealistic.

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.

Economies of scale play a major part in the overall efficiency of support costs in the Utility sector but, on instruction from Ofgem, the impact of these has been ignored by LECG. Analyses in the Third Horizon report attached as appendix 1 examine the relationship between support costs and overall company 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.

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

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.

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.

IS

We believe that the rationale used in the benchmarking analysis is fundamentally flawed and is not a representative guide to the efficiency of Information systems support across the GDNs. We do not believe that using Information Systems costs as a proportion of revenue is a reliable measure of efficiency. No account has been made for economies of scale, nor of the differing cost drivers across the different Information Systems support activities.

The number of users supported by the Information Systems function is clearly a major driver of Information Systems support costs. However there are numerous other complex drivers and these need to be considered at an activity level. It is too simplistic to try to benchmark Information Systems costs at a total level. For example:

1. Resource – Some costs will not vary by size of operation. It is likely there will be only 1 Information Systems Director whether a company has 1 or 2 networks. Similarly if the same applications are being used to serve both networks, then the number of business analysts required should not change. However, resource like desktop engineers would need to increase to service more PCs.

2. Infrastructure Support – Some costs will not vary by size of operation e.g. Network monitoring tools, backup software, maintenance charges on an enterprise SAN etc, whilst others will vary such as leasing of additional network links to other offices.

Finance Audit and Regulation

We consider the benchmark used by LECG to be inappropriate. The LECG comparison is driven by the departmental costs divided by the price controlled revenue rather than more appropriate drivers. In addition, the analysis ignores economies of scale and therefore produces erroneous results.

It should be noted that the benchmark companies here all have a turnover in excess of £500m, whereas the turnover of WWU is less than half that figure.

Property Management

We believe that the facilities management costs have not been compared on a like for like basis. Within the BPQ costs WWU has submitted for Property Management we have included operational energy costs and it is not clear from the analysis whether other GDNs have done the same.

Corporate Centre and Communications

We believe it is inappropriate to use percentage of total operating costs for benchmarking this activity. The core work undertaken by a Corporate Centre and Communications function is not proportional to the size of its company's operations. As with other areas of central costs we consider there to be fixed and variable elements.

There is a minimum cost to undertaking these activities and the assumption that all costs are totally scaleable penalises WWU in relation to other Networks.

HR
In the GBP benchmarking study used by LECG it states that 16 firms used were based in Europe. However, European companies generally have a different approach to Human Resources management because of differing cultural factors and the fact that employment legislation and practice differs markedly from country to country. We feel that in these circumstances using such companies as suitable benchmarks is entirely inappropriate.

We are however pleased to note that allowances for training and apprentice costs are still pending. The work that we are currently undertaking on collaboration will help to inform Ofgem's decision making process going forward.

Legal
We do not concur with the findings LECG make in their report as their analysis is flawed; we submitted a confidential report to support this view as an appendix to our response to the Fourth Consultation document, which we again append to this report.

Procurement and Logistics
We note and welcome Ofgem's intention to review additional costs incurred by WWU due to the dispersed shape of its Network as part of the updated proposals. We continue to be available to inform debate with Ofgem on this and any other subject related to the GDPCR.

Paragraphs 3.74 to 3.88 - Pensions

We do not agree that the higher pension contribution rates of WWU referred to should be construed as being as a result of our gearing. As an investment grade rated company, our employer covenant is good. The pension contribution rates are purely driven by the formal valuation of the pension fund undertaken as at 31 March 2006.

We concur with Ofgem's proposal to reject benchmarking pension costs as part of operating costs and that the GDNs will be able to recover ongoing pension cost and scheme deficits based on actuarially recommended contribution rates. We agree that it is not appropriate to allocate any of the pensions deficit to the metering business.

Proposals on the ex-post treatment of surpluses require further clarification. We foresee practical difficulties in how a surplus is tested to establish whether it has arisen due to "accelerated funding" or to "high contribution rates" referred to in the Fourth Consultation Document. A surplus may arise for other reasons, including changes in market rates used to estimate the present value of scheme liabilities, or increases in market value of pension scheme assets; both of which have the potential to reverse. Given their responsibilities to present and future pensioners, the Trustees of the Pension Scheme may legitimately be reluctant to agree reductions in scheme contributions where there is a risk of the pension scheme reverting to deficit.

We would like to understand why Ofgem have assumed a "modest turnover" of employees in the DB scheme. Our experience to date is that turnover of staff has been extremely low, at less than 2%. Consequently DB pension costs will not reduce materially over the five years due to reductions in the number of members.

We have asked Third Horizon to review the proposed allowances against the present business to assess the effects. Their findings are contained in their report attached as Appendix 1. In brief their key findings are:-

- The adjusted 06/07 indirect OPEX expenditure was £24.05m1 against an average proposed allowance of £17.3m2 (£6.7m or 28% reduction).

- Roughly 65% of the cost base is due to regulatory or compliance related activity or currently under contract with external service providers. This translates to an other cost base of approximately £8.51m3

- In order to meet Ofgem targets, WWU would have to remove 97% of support services labour (93.7 FTE)4 and further reduce external expenditure by 41%.

- In many functional areas Ofgems reductions exceed the non contracted and regulatory and compliance costs currently incurred, resulting in contract violations and a fall in regulatory and compliance activity.

GENERAL RESPONSE

SPARSITY

1. There are four main features of the WWU service area which impact adversely on operating costs i.e. can be described as “penalty” costs:
   a. the wide spread geography, irregular shape and form,
   b. low customer density, and
   c. the extended network length.

2. 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 £3,025k for direct costs.

3. 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.

4. The overall effect is to produce a total penalty cost of about £6.67m together with additional stock levels being held in outbased depots to the value of £0.21m.

5. 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. In Devon and Cornwall the contractor’s rates are typically between 8 and 13% higher than in South Wales.

6. 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.

7. 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.

8. There is therefore an overwhelming case for an allowance to be made for WWU in the price control based on the factors outlined in this report which equate to £6.67m.

PART 2 – DETAILED RESPONSE

CHAPTER 4 CAPITAL AND REPLACEMENT EXPENDITURE ANALYSIS

RESPONSE TO QUESTIONS 1 AND 2

Paragraph 4.9 – 4.16 Approach to the Cost Assessment For Each Activity – Local Transmission System (LTS) & Storage Capex

Question 1: Do you agree with our approach for setting capex allowances and the proposed allowances we have derived using that approach?

We do not believe that PB Power's approach is appropriate, for the reasons given in the response below.

Paragraph 4.14 Approach to the Cost Assessment For Each Activity – Local Transmission System (LTS) & Storage Capex

A unit cost analysis is totally inappropriate for this type of work as there are significant engineering difficulties associated with type of work. It is therefore more appropriate that this type of work should be based on individual project costs, rather than unit costs. There are also geographical issues prevalent to WWU which impact on project costs and these cannot be ignored. In addition, we contend that independent feasibility and conceptual designs should form the basis of calculating the costs for individual projects.

Paragraph 4.15 Approach to the Cost Assessment For Each Activity – Local Transmission System (LTS) & Storage Capex

We are still of the opinion that it is inappropriate to use a unit cost approach for LTS projects as each individual project has it's own unique environmental and engineering difficulties associated with it's construction. This is particularly pertinent in comparing the construction of a pipeline over several kilometres of open countryside, to that through an urban environment. The argument for a unit cost approach may have been considered for one national company, where overs and unders can be more easily offset between projects, but for a regional company that has to operate within its own topography this is totally inappropriate.

Clearly within WWU there are particular issues with the rural nature of the network in the South West and the mountainous terrain within Wales.

Paragraph 4.16 Approach to the Cost Assessment For Each Activity – Local Transmission System (LTS) & Storage Capex

We have written to Ofgem under separate cover to explain how we intend to provide updated LTS & Storage forecasts in the light of the various unknowns; namely cost of NTS flex capacity, outcome of the interruptions auctions and the incentive mechanism. That response should be read in conjunction with this letter.

Paragraph 4.17 – 4.28 Approach to the Cost Assessment For Each Activity – Connections

Proposed Reduction in Forecast Mains Lengths

The IPs base the WWU capex proposed allowances on the average of GDN's, rather than the robust bottom up analysis proposed by us. Considering the issues surrounding GDN data consistency and comparability highlighted by Ofgem's consultants, we believe this represents an inappropriate strategy to accurately determine all GDN's capex allowance.

Efficiency

WWU have already made significant cost-savings bringing Connections in-house. The application of a flat-rate efficiency factor to all GDNs that ignores previous efficiency improvements is inappropriate. The efficiency saving should be specifically set for each GDN, and after taking into account individual factors such as size, buying power and ability to achieve economies of scale.

GDN Gross Connections Costs

Ofgem's proposal to accept the PB Power regression analysis of total connections costs against weighted average workload for Existing Housing, New Housing and Non-Domestic does not take account of the differences between GDNs of overhead allocation across each of these three Connections categories.

Data consistency issues between Networks has been highlighted by PB Power, where the consultants note that allocation of costs varies between Networks. This has been raised in each of the responses by WWU and in our meetings with Ofgem as it is clear that the allocation of overhead can dramatically distort unit analysis. The combing of Mains and Services for each activity, e.g. New housing, improves the benchmarking but does not deal with the allocation of overheads between the three activities of New housing, Existing housing and Non-domestic.

As Networks differ in the way in which they have allocated overheads between these three activities, there will be a distortion effect on the regression analysis and the consequent calculations of the efficiency frontier undertaken by PB Power in each case. This is because part of the supposed frontier will derive simply from a lower than average overhead allocation. This will distort the benchmark and results in a flawed benchmark of 'efficient' gross unit cost that will have been determined from the GDN allocating the least overheads to that particular activity, and does not reflect a truly efficient level of cost for that category of Connections work.

Final Connection Allowance

WWU's legal view remains that GDNs have an obligation to pay the Final Connection Allowance (FCA) in respect of all statutory connections both Domestic and Non-Domestic. In the Gas Act there is no distinction between the Domestic and Non-Domestic FCA. The Domestic FCA forms a part of the 10m Domestic Load Connection Allowance. Not allowing the Non-Domestic FCA would inadvertently discriminate and allow for 'cherry-picking' of eligible customers.

GDN Net Capex

Based on our reasoning in "GDN Gross connections costs" above we believe that Ofgem's basis for determining an efficient gross connections capex is unsound. Therefore calculating the GDN Net Capex as a percentage of the pre-determined 'efficient' gross capex will further distort the benchmark for Net Capex. Ofgem have provided no rationale or reason for this approach.

In addition, we are seriously concerned that all of our own BPQ submissions have been ignored. This includes the findings of our studies which constituted the basis of the revised BPQ submission following the Consultant's visit in December which identified net capex components from bottom up analysis. Instead an average of other GDN Net Capex has been applied to WWU solely on the basis that we have included the FCA within Net Capex. The FCA was an item specifically identified in our analysis.

Considering the issues surrounding the lack of GDN data consistency and comparability highlighted by Ofgem's own consultants, this represents a completely inappropriate strategy. A more justifiable and acceptable approach would be to reduce WWU Net Capex by the total FCA and then forecast Net Capex as a percentage of gross capex as for the other GDNs.

The standard FCA allowance has remained at £89 for a number of years. Based on the forecast workload of 1,000 Non-Domestic Connections each year the total maximum value FCA would be £0.09m. This constitutes only a very small proportion of WWU Net Capex and does not justify the revised allowance of £5.8m, which is a £0.5m reduction compared to previous proposals.

As the majority of Net Capex is comprised of the 10m DLCA and in light of Ofgem's strategy to alleviate fuel poverty, reducing Connections Net Capex to £5.8m will increase the financial burden on Existing Housing customers who will have to pay a much higher proportion of the Connections costs, and will be likely to deter them from connecting to gas.

Paragraph 4.29 – 4.36 Approach to the Cost Assessment For Each Activity – Mains Reinforcement

We have previously indicated that the 2% increased productivity assumption for mains reinforcement as indicated by PB Power has no supporting evidence to substantiate it, and it should therefore be removed. We continue to hold this position.

In addition, the effects of real price effects and efficiency savings previously mentioned are also relevant to this category of work. Clearly, with the reduction in real price effects and the addition of efficiency savings, the achievement of the proposed allowances for this category of work is impossible.

Paragraph 4.37 – 4.39 Approach to the Cost Assessment For Each Activity – Governors

We are pleased to see that there has been recognition of the R6 governor replacement workload as the HSE require us to complete all non conforming governor work by 2010. We support the removal of the cost adjustment, given that no allowance has been made for this work historically.

Paragraph 4.40 – 4.43 Approach to the Cost Assessment For Each Activity – Other Operational

Ofgem have stated that allowances will be set based on upper quartile performance. Due to the geography of WWU and the requirements to respond to the relevant standards of service for PREs we have greater costs in terms of land and buildings than other GDNs.

Also, owing to our vast geography and the fact that we are required to meet standards of service we require more teams than other GDNs, and accordingly therefore require more plant and equipment. Further, the plant and equipment that we have is becoming obsolete and is in poor condition, and is in urgent need of replacement.

In addition we are in the process of recruiting more direct labour teams and therefore they will need to be fully equipped.

We are however pleased to see that the DSEAR costs of £3.5m have been added back in, and would stress that it is imperative that these allowances remain as we are obliged to undertake the work in order to meet a statutory obligation. Although this is a governor activity it is specifically mentioned under Other Operational costs.

Paragraph 4.44 – 4.45 Approach to the Cost Assessment For Each Activity – Non Operational Capex

Replacement of the non-SCADA systems is a joint collaboration between all GDNs. We are actively involved in this collaboration and are fully supportive. However, to allow costs to replace the non-SCADA systems on the basis of one system, rather than one system per GDN is unrealistic and not in the spirit of the comparative regulation model which Ofgem has striven to achieve. It is our view that, provided that the costs are efficiently incurred, they should be allowed.

The cost of GTMS equipment is driven by antiquated technology and we have determined that it will be necessary to incur this expenditure during the course of this GDPCR period as outlined in previous correspondence with Ofgem.

This expenditure will be phased over a number of years from 2006/07 to 2009/10 to meet the requirements of setting up our own system operations control centre. In addition to the new equipment the expenditure also addresses both the development and training requirements to allow the control centre to become fully operational with the new GTMS equipment.

GTMS & SOMSA

We believe it is wholly inappropriate to disallow the majority of costs (some £8m) for the Gas Transmission Management System (GTMS) replacement and exit from the System Operations Management System Agreement (SOMSA) currently provided by National Grid. We believe the following points are key in this issue

- It was fully recognised in the Ofgem consultant reports that GTMS is time expired and requires to be replaced. It is also clearly recognised that a collaborative approach is the most cost efficient method to replace this critical system.

- The requirement to create separate GDN control centres was very much a regulatory one, and not driven by optimum operating cost efficiency. Had it been merely a cost decision then realistically GDN's would not have embarked upon SOMSA exit, or considered replacing one system with several separate systems.

- As separation was driven by a regulatory requirement it is unfair to disallow the costs, provided of course they are reasonable and efficient. In reality, if the original decision was based purely on cost then a single integrated system should have been maintained.

Question 2: Do you agree with our approach for setting repex allowances and the proposed allowances we have derived using that approach?

We do not believe that Ofgem's approach is appropriate for the reasons detailed below.

In spite of our previous representations on PB Power's allowances for Repex being too small, it is disappointing to note that the Repex allowance has been reduced further. We demonstrated in previous correspondence that we believe the targets to be unrealistic, and this makes fulfilment of the HSE obligations in respect of replacement of mains and services difficult.

We are pleased to note that Ofgem have allowed the full amount of expenditure in relation to pre-heater replacement.

We are surprised and disappointed to note that along with further reductions in RPEs Ofgem have also increased the efficiency savings from 1.75% to 2%, and we do not believe that it is possible to meet the required targets. See our previous comments to Paragraph 3.22 on these factors.

We are pleased that Ofgem have recognised the importance of the need to replace the Lampeter Velfrey to Pembroke Dock pipeline (28.3km). This will allow us the funding to maintain a safe and secure network in that part of our network.

In previous responses we have stated that the allowances proposed for our replacement activities are insufficient. Indeed this was further emphasised in our discussions with Ofgem with regards to the targets we were given for 2007/08 and the severe cuts that have been made to our BPQs for this activity is making the replacement activity only possible by the cross subsidy of capex expenditure, in particular on replacement services. These levels of cuts are being carried forward into the main price control period making it extremely difficult for us to meet our HSE targets.

PART 2 – DETAILED RESPONSE

CHAPTER 5 OUTPUTS

RESPONSE TO QUESTIONS 1 - 3

Question 1: Do you support our proposals for changes to the outputs and quality of service arrangements?

Please note questions 1 & 3 are answered together in the following text.

Question 3: Is Ofgem's proposed approach to setting allowances for the outputs and quality of service arrangements for 2008-13 appropriate?

Please note questions 1 & 3 are answered together in the following text.

We generally agree with Ofgem's option to rationalise and update the outputs and standards of performance arrangements. Please see our detailed comments below which are in the order of the issues raised in the Initial Proposals.

Consumer Research Para 5.11-5.13
We are pleased to see that Ofgem undertook consumer research in the area of customer service but would we suggest the results should be treated with caution as customers will always want a better service but usually at the same or a reduced cost. It is important to note that improvements in customer service such as those set out in the Initial Proposals are only achievable at a cost which must be accounted for as part of the price control allowance.

Removal of Overall Standards of Performance Para 5.16 – 5.17
We generally welcome the removal of the overall standards of performance. We do, however, have comments to make in respect of each alternative.

Telephone Calls – Para 5.18-5.20
We believe that moving the requirement to answer 90% of emergency calls within 30 seconds into the licence is unnecessary. As you are aware, the GDNs have a contract with National Grid and this requirement should be an integral part of that contract to ensure that they are provided an acceptable level of service on behalf of us all. The fact that the results are only aggregated on a national basis means that an individual licence condition for each GDN is meaningless. In addition the performance for 2006/07 was well above the 90% target (c.97%) and therefore we do not see the need to strengthen this requirement.

Advance Notice of Planned Interruptions – Para 5.21 – 5.25
We understand that customers would benefit financially by moving the requirement to notify of planned interruptions into a guaranteed standard. We are concerned however, as mentioned above in response to the consumer research, that the additional costs incurred by GDNs to achieve this standard have not been recognised. There are a number of areas where WWU's costs will increase, firstly the cost of the actual compensation payments. Under the current overall standard, a 5% failure rate is acceptable because the target is set at 95% so we therefore should be allowed the cost of either achieving 100% compliance or the cost of the compensation payments due for achieving the 95% target. Secondly there are additional costs of actually processing the payments, both in terms of admin support to write to the customer and the cost to us of processing the cheques. Thirdly, the 'best practice' proposal suggested in the Initial Proposals to send a notification giving

one months notice will result in double the workload and therefore we will need to double the size of our team responsible for issuing planned notifications. It is essential that Ofgem revisit their justification for not providing an allowance for these increased costs.

In addition to the cost issues there are some definitions which will need to be made clear in the Statutory Instrument. In particular when the notice is required to be sent (e.g. at least 5 working days before the interruption, or between at least 5 working days and not more than one month before the interruption etc.). We also require clarity in the wording of the Statutory Instrument that proof of notification is taken from GDNs systems, it is inappropriate to rely on the customers word or the postal system. It is important that this standard is customer claimable and does not require automatic payment.

Informing customers of when they are being reconnected Para 5.26 – 5.30
We welcome the removal of this overall standard which was very difficult for GDNs to measure. We agree that the customer survey is the correct place to identify GDNs performance in this area. As these new questions are designed to replace the OS3 requirement, we would ask that a statement is inserted prior to the new questions advising the customer only to respond to these questions if they were off gas for more than 24 hours. We do not want distorted views from the survey results where customers answer these questions when they may have only been off gas for an hour, clearly our communication in this instance would be significantly different compared to a longer incident which has a greater effect on and increased inconvenience to the customer.

Response to Complaints Para 5.31 – 5.34
We understand that customers want a prompt response to complaints and therefore recognise the move of this standard into a guaranteed standard. We are concerned however to see that Ofgem are not proposing to provide an allowance for this change. It is important that the wording of the statutory instrument is clear, in particular the definition of a complaint needs to be clear to ensure accurate reporting across GDNs.

Gas emergencies Para 5.35 – 5.37
We agree that responding promptly to gas emergencies is our first priority and we are pleased to see that customers did not see this as an area for improvement. The 97% standard to respond to gas emergencies is currently within our safety case which has been accepted by the HSE. We also have a requirement under the Gas Safety Management Regulations to attend gas escapes as soon as is reasonably practicable, which has been considered as 97% (on an annual, company basis) by the industry for many years. Failure under the regulations would result in penalties and enforcement action by the HSE. We therefore believe that this provides the protection that customers require to ensure we endeavour to urgently attend to gas escapes. If this requirement is duplicated into a licence condition we are concerned that in the unlikely event of failure, GDNs will be exposed to double the risk (i.e. enforcement action and/or penalties by both the HSE and Ofgem) which is unacceptable. We therefore consider that, as the existing requirement is part of the Gas Safety Management Regulations and the 97% target is in our safety case, this is a suitably strong and enforceable requirement. We therefore consider that it is inappropriate to have this duplication and remain of the view that matters of health and safety enforcement should remain, in accordance with established regulatory practice to date, solely with the HSE.

Changes to the Guaranteed Standards of Performance Para 5.38

We are pleased to see just minor changes to the guaranteed standards of performance, our specific comments are noted below:-

Supply Restoration Para 5.39 – 5.43
In respect of the change to include the smaller non-domestic customers into the guaranteed standard, we will require suitably precise wording in the Statutory Instrument in order to enable us to identify which additional customers will be due payment under GS1. We accept the reduction of the event cap from 50,000 to 30,000. We are very concerned, however, by Ofgem's proposal to amend the standard to require us to pay compensation to customers who are connected to another GDN or IGT network. This increases the risk to the GDNs so any payments incurred, should this proposal be implemented, must be funded as part of our price control allowance.

Compensation arrangements for third party damage and water ingress interruptions Para 5.44 – 5.47
We agree that it is important to maintain separate reporting for interruptions caused by third party damage and water ingress if the requirement is moved into the Statutory Instrument. As these events are largely outside of our control, we do not support the requirement for GDNs to be exposed to the cost of the payments up to 1.5% of revenue and the additional cost of the 5% liabilities above the pass through threshold. This exposes GDNs to increased risk which is in no way reflected in the proposed allowances indicated in table 5.1 (£0.41m for WWU over the five years).

Allowance for payments under the supply restoration standard Para 5.48 – 5.49
We support Ofgem's statement "we consider it appropriate to provide GDNs with an allowance for an efficient level of compensation payments" but the level of the allowance detailed in table 5.1 is clearly too low (unplanned £0.03m for WWU over the five years. Please see our comments above in respect of the allowance for third party damage and water ingress incidents.

Reinstatement Para 5.50 – 5.53

The majority of our reinstatement is carried out by contractors and the current schedule of rates that are in place with WWU's contractors have been priced based on the requirements of the current standards of service. In reducing the timescales to complete private reinstatement, there is an inherent increased likelihood of failure. The compensation payment requirements are 'back to back' in the contract rates and these rates will inevitably rise as the contract risk increases. The contractor is also likely to increase its management fee to resource the increased management requirement.

Currently the contractors are able to organise reinstatement jobs in one day however, with a tighter standard they may be required to undertake the reinstatement at some premises earlier in order to meet the standard. They therefore do now have the advantage of undertaking all of the work in one day and this lack of economies of scale is likely to increase their costs. In addition, the contractors will lose the benefit of being able to minimise wastage of reinstatement materials because they will still be required to purchase minimum loads from the quarries which may not be used.

Also, in order to meet this tighter guaranteed standard, we will require closer monitoring of our reinstatement work both for Direct Labour and Contract Labour which will require additional management information to be produced and increase management time in order to ensure reinstatement is completed within 5 working days. We anticipate we would need at least two additional FTE's. We are

disappointed to see that Ofgem have not allowed the additional costs associated with this in the Initial Proposals and urge them to review their proposals.

Alternative Heating and Cooking Para 5.54 – 5.58
We are pleased to see that Ofgem acknowledge the difficulties faced by GDNs in reporting against the existing standard. We will need further detail to enable us to comment in detail on this revised guaranteed standard, for example will we will still be required to provide the facilities within a certain timeframe, if so, will the timeframe be extended as we're now extending the requirement? How we will be required monitor and prove the time we took to provide the equipment from the time the customer requested it? We also need confirmation that we will not be required to report on the priority customers separately and that this standard will be customer claimable and not require automatic payment.

Connections Guaranteed Standards of Performance Para 5.59 – 5.60
We are pleased to see that Ofgem have not made any substantive changes to the connections guaranteed standards. We welcome the simplification for customers of merging some of the standards in one. We would appreciate confirmation of whether this changes the D10 requirements and reporting.

Other Changes to the outputs and quality of service arrangements
Performance Reporting under licence conditions Para 5.61 – 5.62
We welcome the removal of any duplication of reporting. We suggest that the cost reporting framework is the best place to collate the majority of the performance reporting.

GDNs Interruptions Reporting Para 5.63 – 5.67
We understand that the number and duration of interruptions is an important area which enables Ofgem to monitor the quality of service for each GDN. There is an acknowledgement within the initial proposals that there have been a number of issues with reporting this data, some of which WWU have made Ofgem aware through our regular meetings with the quality of service team. We are, however, concerned that Ofgem have not allowed any costs to enable GDNs to reach the new proposed completeness (95%) and accuracy (90%) targets which will take effect from April 2009. We would ask Ofgem to revisit their conclusions in respect of additional allowances. Ofgem state that they plan to publish the interruptions performance on a disaggregated basis for each GDN from 1 April 2008, we would, however, request that this is delayed until the implementation of the new licence condition requirement in April 2009 to ensure the reporting is as complete and as accurate as possible. We will also need clarification of the definitions of the new licence condition requirement in respect of "accuracy" and "completeness".

In paragraph 5.66 Ofgem state the GDNs will be required to develop appropriate auditing and governance procedures. We require clarification from Ofgem about what this requirement will entail and whether or not it will form part of the licence requirement. We believe that it is unnecessary duplication for Ofgem to undertake their own audit, unnecessarily increasing costs to customers.

Expanding GDNs quarterly customer satisfaction surveys Para 5.68 – 5.69
We welcome the inclusion of a customer satisfaction survey for connections, as you will be aware WWU have already introduced a similar survey. We require confirmation of the number of surveys to sent but assume it will be in line with the 400 we're required to send for repair and replacement. It is important that the connections survey is only sent to those customers whose connections have been substantially completed within the period.

Question 2: Do you support our proposals for improving the accuracy of pipeline records?

Paragraph 5.70 – 5.76 Other Changes to the Outputs and Quality of Service Arrangements – Accuracy of Pipeline Records

It is noted that Ofgem will be implementing a monitoring regime of four specific metrics outlined in 5.73. Three of these metrics are ones that we have recently developed B/W reports for (% digitised within 30 days, number of undigitised records and oldest undigitised record), whilst the last metric will require access to the DR4 and DR8 databases. This monitoring regime required by Ofgem essentially replicates what we will be required to report to the HSE.

Ofgem do not anticipate financially incentivising this area as they believe the reporting regime will provide sufficient incentive, this concurs with our views.

Paragraph 5.77 – 5.80 Mains Location Process

Ofgem consider that the current Mains Location Process (MLP) has a number of shortcomings which can be improved and have given the timeframe of 1st April 2009 for completion. During Ofgem's consultation on the Designated Registrar of Pipes, GDN's were asked to consider whether the MLP could be enhanced to 'ensure that the level of compensation takes account of size and complexity of particular works'. We do not currently pay compensation but do pay the cost of additional works in relation to additional pipe laid, if Ofgem are considering that this should be one of the MLP improvements then this could have significant financial implications to WWU.

Ofgem also point out the 'lack of timescales for the GDN to complete location or additional mains laying where the IGT/UIP declines to do this itself' within the MLP. On a best endeavours basis, we provide the location service either on the day or within one or two days, whilst the laying of additional mains could involve a lead time of four weeks dependent on road notice requirements. Should Ofgem require more immediate and formalised timescales then this would result in disruption to Operations and additional costs.

Balanced Score Card Para 5.81 – 5.83
We agree that the areas proposed for the balanced scorecard are those which are of highest importance to customers. We would welcome discussion at the next price control review about suitable weightings for each of the areas and possible financial incentives that may be available.

Auditing the outputs and quality of service arrangements Para 5.84 – 5.85
We are pleased to see that Ofgem are not specifying an audit regime for GDNs, we believe this is something that should be driven by the individual GDN. We agree that it's important for GDNs to have appropriate and robust corporate governance procedures in place to ensure that data collected and reported to Ofgem is reliable and accurate. The GDN's procedures will include audits where appropriate and we therefore consider it unnecessary for Ofgem to undertake their own audit which will lead to unnecessary costs to customers.

Paragraph 5.89 – 5.94 Riser Replacement

Risers tend to be more expensive to repair and replace than regular mains as the traditional methods of replacement, such as open cut and insertion are cannot be

used. Instead skilled welding contractors are required to fabricate the new riser and lateral, and works will need to comply with the Working at Heights Regulations. There will also be associated costs such as scaffolding.

We will always try to identify the most efficient and cost effective method of dealing with repairs or replacement of risers.

We note Ofgem's support and understanding that on some occasions, rather than working on the riser, this may mean providing consumers with alternative forms of heating and cooking facilities. It should be recognised however that this may not always be possible as consumers have the right to choose their energy source.

We are currently undertaking a survey of the riser population within WWU in line with policy T/PL/LC 20. We have no planned programme of work to replace risers, but clearly, during the next PCR there are a number of risers that are likely to require replacement, as the majority were installed during the 1950s to 1970s. We have had recent experience of replacing a number of risers on low level buildings (less than 6 storeys), and have therefore included 2000m of riser and lateral replacement in our Repex forecast. We will be looking for Ofgem's support in funding these. We have also identified an issue with risers in one high rise building from our initial 10% high rise building.

Paragraph 5.95 – 5.99 Private Networks

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

PART 2 – DETAILED RESPONSE

CHAPTER 6 INCENTIVES

RESPONSE TO QUESTIONS 1 - 3

Paragraph 6.2 – 6.15 Capex Rolling Incentive and Information Quality Incentive

Question 1: Are the proposals for the capex rolling incentive and IQI appropriate?

We note and agree with Ofgem's comment in the Impact Assessment Appendices, Appendix 17 paragraph 1.14 that subsequent to Ofgem publishing the final IQI the GDNs will be expected to resubmit their capex forecasts in order to encourage the GDNs to provide them with their most accurate capex forecast. This process is an important part of the implementation of the IQI.

We are in general agreement with the concept of rolling incentives and IQIs. However we do have a number of reservations as set out below. Additionally we continue to believe that further discussion is needed on this matter in order that the risks and rewards associated with the incentive are fully understood.

Paragraph 6.2 – 6.4 Capex Rolling Incentive and Information Quality Incentive

Whilst we acknowledge that there is the risk of GDNs being encouraged to forecast higher and thereby achieve outperformance by beating the allowance, we are concerned that using the Ofgem forecast as "the target" may operate in exactly the opposite way, with Ofgem subconsciously acting to underplay the allowances. It is therefore important that realistic targets are set against which the IQI is measured.

There is also the risk that Ofgem or their Consultants incorrectly set allowances due to misunderstandings between themselves and/or the GDNs.

We are therefore more favourable to an incentive mechanism which acknowledged that there may be errors in the allowances set by Ofgem and which offered a comfort zone by way of compensation. This comfort zone could mean that provided the GDN forecast is within say 10% of the Ofgem allowance, then the full benefit of the incentive is allowed together with a premium.

The Initial Proposals indicate in paragraph 6.4 that "GDNs maximise their overall income by choosing a forecast that matches their intended capex spend." However, GDNs actually maximise their expenditure where the Ofgem allowance, the GDN forecast and the actual expenditure all coincide. Should the GDNs be unable to convince Ofgem or their consultants of their required spend, then they are effectively penalised even if the actual spend is in line with the GDN forecast.

Paragraph 6.5 – 6.11 The IQI Matrix

In terms of the operation of the IQI:
It appears from paragraph 6.6 that the IQI is intended to operate on a five year basis in total, rather than annually, during the price control. This raises a number of questions:

- How is the additional income to be earned and spread across the price control review period?
- How will adjustments from Ofgem and GDN forecasts to actual spend be dealt with? Will this be annually, at the end of the price control period, or on some other basis?

Paragraph 6.11 indicates that the table contains data very similar to that within DPCR4. However 6.7 indicates that benefits or penalties are retained for a longer period than DPCR4. Why has the modelling been done this way if the intention is that DPCR4 and GDPCR incentives are the same?

We still consider it necessary for further debate to be had on this matter prior to finalisation of the IQI methodology and prior to final submission of BPQs for Repex and Capex. In particular, all parties need to be fully aware of the actual operation of the IQI and its potential impact on allowances.

Perversely, Ofgem are indicating that the IQI is incentivising GDNs to bid close to the Ofgem determined allowance. However, should GDNs be encouraged to understate their spend in order to bid closer to the Ofgem number then if their actual spend is as they originally predicted the effect of the efficiency incentive penalty is greatest, at 40%.

Para 6.11 - The situation and scenarios used in the electricity price control review concluded in 2004 are comparable with those of gas. The base case scenario in DPCR4 assumed an “as is”, that is no adjustment for Quality of Supply or raised Standards of Service for example. An alternative scenario or scenarios was submitted by the DNOs assuming Quality of Supply improvements. Therefore there is no justification for not allowing the 5% uplift on the allowances

Paragraph 6.12 – 6.15 The Scope of the IQI

Whilst we support the introduction of an IQI we believe that further consultation on the detailed implementation and operation of the IQI needs to be undertaken. In particular:

- Is there any retrospective ex-post adjustment process for an efficiency review of spend during the PCR?
- How will any unplanned, but necessary, spend incurred during the period dealt with? i.e. finding a UXB during a new pipeline project, causing timing issues & additional costs.
- How will underspend in one period, due to delays that result in an overspend in the next period be resolved?
- Is the incentive designed to work annually or on a cumulative basis through the PCR period?
- Can costs be shifted between categories/years during the PCR period?

Paragraph 6.16 – 6.21 Mains Replacement Incentive

Question 2: Are the proposals for the mains and services replacement incentive appropriate?

We are not against having a replacement mains allowance with a supplementary incentive that adjusts GDN revenue for changes in volumes abandoned and diameter mix of replacement mains.

The initial proposals contain three options for adjusting the current mains incentive mechanism, as detailed in Appendix 18. Options 1a and 1b discuss the inclusion of services within the existing incentive mechanism whilst Option 2 is a single annual replacement allowance for mains and services.

In respect of Options 1a and 1b, we understand the rationale for the inclusion of services relayed or transferred. If the incentive mechanism was adjusted to include services we would prefer Option 1b, which is the option where there are separate unit costs for volumes of services as opposed to having a composite cost for mains including services, which is option 1a. The introduction of a composite rate would require extensive analysis and agreement about numbers of services in relation to each Bandwidth, and also an agreed proportion of transfers to services relayed. We believe that option 1a would be too complex and would also drive additional data capture costs.

Option 2 proposes a single annual mains replacement allowance with a five year cap limited to the costs generated under Option 1a and/or 1b. This would be simple to implement and has merits linked to "Overall Replacement Cost management" that would remove any drive for Networks to "game" between mains and services costs. There are however drawbacks of such of scheme, linked to the possibility of large annual losses or gains and increases in uncertainty. Agreement of the annual amount would be very important, and we would require further clarification as to how volumes of mains laid, mix of bandwidth abandoned and service volume variations would be dealt with.

We understand and could accept the introduction of additional bandwidths that would cover 12 to 18 inch, 18 to 24 inch and above 24 inch. The cost of abandonment of these diameters would vary enough to therefore justify the introduction of these bands.

We would also support an equal pain/gain incentive that would be symmetrical. We understand from the impact assessment in Appendix 18 that this would be 31%.

We do not think that individual Network incentives around replacement are appropriate, and we would prefer Networks to be treated equally in this area. Volumes are agreed via a consistent process with the HSE and all Networks have the same decisions and opportunities to make around cost management. Individual incentives have the scope to be unfair if underlying analysis at individual Network level is flawed.

We note in paragraphs 4.46 to 4.60 that there are items that are still not fully reflected in the Replacement Mains costs; indeed, the allowances include nothing for Waste Management, the additional costs of which have been imposed upon us by the local authorities.

PB Power has included the length of upsized main in our lay replacement figure and have claimed that our level of lay abandoned 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 1:1. Because of the nature of these mains it is virtually impossible for us to reduce our lay length from those identified in our BPQ submission and should be reinstated along with the required funding.

Paragraph 6.22 – 6.26 Opex Rolling Incentive

Question 3: Is it appropriate to implement an opex rolling incentive?

In principle we support the implementation of an opex rolling incentive as a way of dealing with periodicity effects. However until allowances are known and confidence increased in the comparability of data it is not possible to evaluate if there is any benefit in the introduction of such a mechanism.

Any symmetrical incentive mechanism will by its very nature increase risks on the GDN. This will need to be reflected in the Cost of Capital. Given the real costs pressures faced by the GDNs scope for outperformance seems extremely limited.

An alternative way forward would be to introduce an asymmetrical incentive whereby GDNs could retain any benefits for 5 years whilst not being penalised further for suffering real cost pressures or cost shocks. The introduction of a generic reopener as we advocate in 2.15 – 2.21 would address our concerns.

Paragraphs 6.27 – 6.28 Opex Rolling Incentive

We are supportive of removing funding to overcome long terms skills shortages from opex, and support it being ring fenced as part of a separate incentive, such as the Electricity and Transmission Innovation Funding Incentive to tackle long term skills shortages.

This will encourage continued long term investment and savings, and will provide the GDNs with a framework upon which to be measured against, which will ultimately benefit consumers, as outlined in the Initial Proposals document.

We would be supportive of a separate incentive, rather than the use of the opex rolling incentive, one reason being due to time constraints.

Paragraph 6.29 – 6.44 Capacity Outputs Incentive

We are very disappointed that Ofgem think that it is not appropriate to set out the capacity outputs incentive arrangements in the initial proposals. We were asked to update our Capex BPQs, and following agreement of assumptions with Ofgem we are updating them to show the impacts of the exit and interruption reform. However we are still not in a position to be able to make any commercial judgements about the impact of the capacity outputs incentive.

PART 2 – DETAILED RESPONSE

CHAPTER 7 SUSTAINABLE DEVELOPMENT

RESPONSE TO QUESTIONS 1 - 5

Question 1: Do you agree with our assessment of the risks, costs and benefits attributable to the options for facilitating network extensions (Appendix 14)?

Question 2: Do you agree with out initial proposal (i.e. Option 3 complemented by a discretionary reward scheme)?

Question 3: Do you consider our proposed method to implement Option 6 appropriate (i.e. through GDN's connection charging statements)?

Paragraph 7.1 – 7.7 Gas Shrinkage Arrangements

We note that Ofgem see merit in strengthening the financial incentives on shrinkage to reflect the environmental cost of leakage gas, and that further work will be undertaken in advance of updated proposals.

Ofgem proposes to roll forward the shrinkage incentive arrangement with a modification to the uplift factor, and Ofgem also plan to replace the point estimate with a pre determined licence based methodology for determining the uplift factor based on the prevailing market conditions. We are happy with Ofgem's proposal to maintain incentives on GDNs by basing the allowance on a "Target Shrinkage" factor.

Paragraph 7.8 – 7.14 Network Extensions

We support the proposals to extend the gas network, however proper allowances need to be made in order to finance this. To this end, a discretionary reward scheme (DRS) lottery approach is not acceptable.

We have consistently supported the idea of extending the gas network as a means of addressing fuel poverty.

Question 4: Do you consider the Government's Index of Multiple Deprivation to be an appropriate index to identify which fuel poor non-gas communities qualify for special treatment for gas network extensions? If not, what do you recommend?

Yes, we support the use of the deprivation index.

Paragraph 7.15 – 7.24 Discretionary Reward Scheme

Question 5: Do you support our proposals for the introduction of a Discretionary Reward Scheme for GDNs and its format given the larger reward?

Whilst we fully support then introduction of a discretionary reward scheme (DRS) we have concerns over the items listed as appropriate for possible awards under this scheme as they are so intrinsically important that funding under a DRS is not appropriate for a base level of service. Therefore we support raising awareness of CO, network extensions and initiatives to reduce leakage but believe this must be done through proper operating cost allowances. The DRS should be used to reward those companies who have gone further than the core requirements thereby giving a real incentive to innovate.

We also believe that it is appropriate to fund other schemes through the discretionary scheme, such as improving the awareness of gas safety, and we are currently working with the other GDNs on this key issue. In order to fully understand how the discretionary scheme would work going forward, we would like to further discuss this with Ofgem.

PART 2 – DETAILED RESPONSE

CHAPTER 8 OTHER ISSUES

RESPONSE TO QUESTIONS 1 - 4

Paragraph 8.1 – 8.19 Funding of xoserve

Question 1: Do you agree with our proposed approach to the funding of xoserve?

We understand the reasons why Ofgem propose to implement a user pays mechanism (Option 2). We do however have several reservations around the implementation of this option at this time.

Firstly, the impact assessment (Appendix 15) is very thin in relation to the costs and benefits to the industry of a user pays option. Secondly, there appears to be great difficulty in getting industry agreement on which services are user pays. Thirdly, implementation is proposed for April 2008 which would mean that Ofgem would need to decide on GDN/xoserve allowances in time for final proposals.

Against these reservations our major concern is that xoserve is an important, single interface between GDNs and Shippers, and GDNs as shareholders sign off and then pay the xoserve costs.

Our current observations of implementing a user pays option for April 2008 appear to indicate there would be a risk that costs and revenues highlighted as user pays would not materialise and would end up as a cost to GDNs with no allowance. Also, within the impact assessment there is no reference to current value for money that the industry as whole receives from the current structure.

It is our view that one single entity acting on behalf of eight Licensees with one head office and one suite of systems is an efficient mechanism for the industry.

Question 2: How should we address any benefits arising to xoserve from redundancy created from the replacement of UK Link?

There is an assumption in Appendix 15 that user pays services would be between 5 and 10% of xoserve revenues, and that this would lead to 5 to 10% of spare/redundant capacity within the £70m system investment. We see no evidence in the impact assessment to make that link.

Therefore we are not convinced there will be redundant capacity. We accept that there should be a further review of UK-Link proposed spend and ensure that it takes into account any developments in the industry, not just changes as a result of user pays. We would support developments that make billing systems simpler and more transparent. For example we would support a shortening of the Reconciliation by Difference (RbD) timeframe, removal of small value invoices and a move to a more capacity based charging methodology. All of these items could impact the level of spend projected for the UK link refresh.

We understand that xoserve have submitted cost estimates for UK Link Refresh which are based upon providing a similar level of service as is currently required by the industry. We also understand that the cost of UK Link Refresh could increase

significantly due to regulator, governmental or industry requirements, and the range of possible outcomes means it is not possible at this stage to provide a definitive cost estimate for UK Link Refresh in its final form. We therefore believe it is important for the owners and Ofgem to arrive at a funding mechanism reflects these uncertainties and allows recovery of efficient expenditure on UK Link Refresh through operating or RAV allowance.

Question 3: Do you agree with our approach of modifying SSC A15 to facilitate governance arrangements for user-pays?

We believe that the current obligations within SSC A15 are adequate and any changes can be facilitated via the modification process. From the Initial Proposals, we understand that Ofgem believe that the governance arrangements should be left to the GDNs, xoserve and the industry outside of the GDPCR, and we accept this view.

Question 4: Do you think that the existing arrangements are adequate to ensure enforcement of the range of services and outputs delivered by xoserve in light of these proposals?

The views expressed in our answers on funding of xoserve support the view that existing arrangements are adequate to enforce the range of services and outputs delivered by xoserve. We see the opportunity for development of limited user pays mechanisms but within timescales that do not put at risk key industry processes.

Paragraph 8.20 – 8.25 Independent Systems

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

We will need details of the proposed alternative arrangements before commenting further but in any event the operating costs associated with these independent systems within WWU are in the region of £50k per year.

Alternatives could include:
1 connecting these communities to mains gas under any new arrangements implemented, or;
2 should the undertakings lapse requiring those customers to pay the actual costs of the service they receive.

If the Statutory Undertakings remain, the costs of connecting these networks should become part of the RAV or the costs of providing other services should be straight pass-through.

In general we support the costs of such services being borne by the customers of the GDN.

Given the separation of the GDNs it does not seem appropriate for cross subsidy between GDNs in different ownership.

PART 2 – DETAILED RESPONSE

CHAPTER 9 FINANCIAL ISSUES

EXECUTIVE SUMMARY

- our analysis shows Gas Distribution is a more risky business than Transmission, 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 price indices and current long term trailing average rates
- the current "modelling assumption" post tax vanilla WACC of 4.84% fails to meet the criteria for Ofgem's test of a "comfortable" investment grade rating for PMICR – WWU achieves a PMICR of 1.26 – 1.32x which is below;
    - Ofgem's own quoted assumption for comfortable investment grade of 1.5x to 1.6x.
    - The PMICR rations applied in the GDNs 2002-07 price control, and the financial model for the 2005 Electricity Distribution Price Control and the 2006 Transmission Price Control
    - WWU debt covenants which require PMICR to be in excess of 1.3x
- Ofgem have noted that they may assume that the notional GDN has a proportion of index linked debt – improving the PMICR. We are concerned that changing financeability assumptions decreases regulatory uncertainty and will have long term adverse consequences for GDN funding.
- We believe that WWU has also been adversely affected by the issues which Ofgem believe have impaired Scotland GDN financeability In particular, the proportion of RAV asset classified as "pot 2" has reduced WWU PMICR in 2008/09 by 0.22x
- When assessing WACC, Ofgem should also consider
    - Debt costs are currently increasing – both risk free rate and corporate debt premia. In particular, cost of 2013 debt has risen by 1.0% since the Transmission Price Control was finalised in 2006.
    - the real cost of debt has tended to underestimated in the past by failing to adjust for the distorting short term effects of demand for index link gilts due to changing pensions regulations.

RESPONSE TO QUESTIONS 1 - 4

Question 1: What are your views on the factors relevant to our consideration of cost of capital?

Factors affecting cost of capital

Cost of debt

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. We note that

historic trailing cost of debt appears to have reduced since 2002. However, the Monetary Policy Committee has voted for 5 increases in bank rates in 2006 and 2007 and the cost of medium term debt, and particularly 2013 debt, has risen by 1% since the Transmission Price Control was finalised in December 2006. Consequently it is imprudent to assume that cost of debt for the future price control period to 2013 will continue to decline.

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. NERA recently prepared a report commenting on the CAA's proposed risk free rate for the 2007 Airport Price Control. This report concludes that Index Link Gilt rate has been artificially reduced due to highly inelastic demand driven by pensions regulations and is at least 0.5% below the true risk free rate. Risk free rate should be assessed by examining interest rate swaps and international gilt yields and in our view is at least 2.5%.

We envisage a number of practical problems in adopting a cost of debt within WACC based upon a debt "index", or alternatively adjusting WACC during or after a price control period if movements in a debt "index" exceed "trigger" points. These include:

- Defining the index with respect to:
    - Debt quality – gilt or investment grade
    - Debt tenor
    - Mix of nominal and "real" debt
    - Historic or forward market information

  which implicitly requires the regulator to make judgements about how a regulated utility should be financed; traditionally a judgement that regulators have concluded is not within their remit.

- The use of an index may encourage companies to rely upon short-term debt, so as to be able to respond more easily to changes in the debt index or trigger points, which credit rating agencies may view reduces credit quality due to introduction of refinancing risk.

Cost of equity

We believe 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. ENA has submitted a report prepared by Oxera which concludes that the equity beta for a gas distribution business is approximately 0.2 higher than a transmission business, which would require a post tax vanilla WACC approximately 0.5% higher than the 5.05% applied to the TPCR.

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 including IQI
- changes to the current exit and interruptions regime
- the appropriate use of cost indices, and remaining exposure to costs that do not move with RPI

- price control "re-openers" in relation to taxation, Traffic Management Act and pensions

need to be fully understood and considered before a complete assessment of WACC can be made.

We note that the Competition Commission are expected to publish the results of their review of CAA's proposed cost of capital at around the same time as the GDPCR proposals. Any application of the Competition Commission's conclusions to other regulated entities must be done with caution, and reflect the relative treatment of "risk" between the CAA and other price controls. We understand that the CAA has made allowance for risk within the price control allowances, and consequently the cost of capital proposed is not adjusted to recognised non-systematic risk.

"The CAA's intention is to take account of systematic risks – which cannot be diversified – in setting the cost of capital allowance. On the other hand, the CAA would expect to take account of non-systematic risks in its assumptions for operating costs, capital expenditure and commercial revenues, for example, in the form of making appropriate allowances for contingencies, or otherwise recognising these risks in the projections and allowances it makes.' ***Price control review – CAA recommendations to the Competition Commission for Heathrow & Gatwick Airports March 2007 Para 11.30***

WACC for the GDN's should reflect risks taken by equity holders inherent in the GDN price control.

Gearing

When considering an increase in notional gearing Ofgem should address the impact of increased gearing on both the cost of debt and equity. It is observable that as gearing increases, either the cost of debt increases or mechanisms are put in place to transfer risk to equity, or give debt providers additional security Consistent with traditional financial theory, the returns required by equity also increase both as gearing increases, and as the mechanisms referred to above lead to increased risk.

Financeability

All financial ratios are a function of the cost of capital. As we have said before, the ratios used to assess financeability should be the same as those which are used by the 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 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.

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 financeability of the business. Increasingly, networks are funding their businesses using long term debt.

WWU PMICR within Ofgem's initial proposal financial model (notional cost of debt and gearing) is between 1.26x to 1.32x throughout the price control period. This is significantly less than the 1.5x to 1.6x recognised by Ofgem as the PMICR that the credit rating agencies believe is consistent with "comfortable investment grade".

Price Control Period	**Ofgem Model 2002/7 PCR 2006/7**	**Ofgem Model 2007/8 PCR 2007/8**	**Ofgem Model 2008/13 PCR 2008/9**
	Nominal debt	**Nominal debt**	**Nominal debt**
Adjusted Funds From Operations (£m)	**70**	**66**	**64**
Interest (£m)	51	57	51
Post Maintenance Interest Cover Ratio	**1.38 x**	**1.15 x**	**1.26 x**
Headroom before 'lock-up' 1.3x (£m)	4	-9	-2

Ofgem's proposals are not consistent with financeability tests from the 2002-07 price control.

- The financial model for 2002-07 PCR implied a PMICR for 2006/07 of 1.38x with no index linked debt assumed.
- Previous Ofgem financial models also reported higher ratios consistent with Ofgem's view that "comfortable investment grade" requires PMICR of at least 1.50x. Average PMICR derived from the 2005 Electricity Distribution Price Control financial model was 1.57x, and PMICR from the 2006 Transmission Price Control was 1.49x. Neither model assumed that a proportion of debt was index linked
- WWU raised concerns re financeability regarding 2007/08 PCR, with a nominal debt PMICR of 1.15x which is below investment grade, but accepted the Price Control having been assured that financeability would be fully addressed during the 2008-13 PCR
- The 2008-13 initial proposals show an improvement in PMICR due to reduction in assumed cost of debt, but nominal debt PMICR still remains below that implied by the 2002-07 Price Control. WACC would need to be increased significantly to achieve parity with 2002-07 price control and the Electricity Distribution and Transmission Price controls
- Rather than increase WACC, Ofgem propose to allow an assumption of a proportion of real rather than nominal debt. This is a significant change in funding assumption which reduces regulatory certainty.

In common with Scotland, our PMICR and other ratios is adversely affected by the amount of expenditure that was classified by Ofgem as "pot 2" in the extension year price control. Our PMICR would be improved by an average of 0.14x for the price control period (and by 0.22x in 2008/09) if "pot 2" expenditure had been treated as "pot 3"

We agree that PMICR is improved if a proportion of debt is index linked. However introducing a further modification to the well understood financial model of the

"notional" network again has the potential to reduce regulatory certainty and may result in increases in cost of capital.

Question 2: Are the factors affecting financeability set out in paragraph 9.36 the responsibility of shareholders or the regulator to address and how should they be addressed?

We have not seen the detailed workings behind Ofgem's assessment of financeability of Scotland and Southern GDNs

We address the factors affecting financeability raised by Ofgem below:

- ***Relatively high level of "pot 2" expenditure in 2002-07***

  WWU also has a high proportion of "pot 2" RAV, which we discuss in more detail below. The proportion of GDN expenditure into RAV that Ofgem concluded should be treated as "pot 2" and the consequent adjustments to allowed revenue for expenditure classified as "pot 2" which according to Ofgem's own presentations removed approximately 30% of the value of efficient expenditure for customer benefit, were not decisions made by the GDNs.

  We have in the past put forward a number of concerns over the approach to "pot 2" adopted by Ofgem in the extension year Final Proposals, both in letters to Ofgem and in response to previous consultations, including:

  - The expenditure was efficiently incurred for customer benefit
  - The treatment imposed a significant penalty on expenditure in excess of that previously forecast; and required an accuracy in forecasting that was not apparent at the time that the forecasts were agreed;
  - it had potential to discourage GDNs in future from meeting customer needs;
  - the treatment increased regulatory risk by imposing requirements *ex post* rather than *ex ante.*

  All capital expenditure is driven by the need to meet our obligations to maintain a safe and efficient network. The only decision the GDNs made was to accept the Extension Year price control "in the round", and on the understanding that there would be a full assessment of financeability as part of the 5 year review. Consequently we cannot agree that financeability issues arising due to the cash flow consequences of expenditure being classified as "pot 2" should not be a matter for Ofgem.

  WWU allowed income is reduced by £47m over 6 years due to efficient capital expenditure for customer benefit being treated by Ofgem as "pot 2" rather than "pot 3". This has a significant impact on our financeability. For example PMICR would be improved by an average of 0.14x for the 5 year period to 2013 and by 0.22x in 2008/09 if the recognised efficient expenditure placed in "pot 2" had been treated as qualifying for RAV return and depreciation immediately.

- ***Cash penalty under information quality incentive***

There are a number of valid reasons, including differing opinions regarding future workload requirements and differences in unit cost projections which result in a GDN's capex and repex proposals being different from those of Ofgem and its consultants. The IQI illustration in the initial proposals recognises that a lack of symmetry of information may mean that a GDN's estimates are more accurate, and consequently the proposed mechanism ensures that a GDN is least "badly off" if its expenditure is consistent with its own, rather than Ofgem consultant's forecast. Consequently, it does not follow that Ofgem should not take account of any financeability issues arising from the "cash penalty" due to differences in estimates of future expenditure between GDNs and consultants – the financeability issue may be real because the consultants views are incorrect.

- ***Impact of RAV sculpting***

WWU RAV was also "sculpted", with some 30% reduction in RAV in preparation for sale of GDNs. Consequently capex and repex spend will typically be a higher proportion of RAV than for a GDN with unsculpted RAV which will put a strain on financeability. We agree with Ofgem that it is appropriate to make financeability adjustments for this.

Other factors that impact financeability assessment

Any assessment of financeability must include a "stress" test of the financial model to consider the robustness of the overall Price Control to reasonably foreseeable adverse events. Actual WWU 2006/07 PMICR and "headroom" above PMICR covenant "lock up" was adversely affected by a £15m reduction in transportation revenue due to reduced heating load during the warm winter and consumers reacting to increases in retail gas prices. "Comfortable investment grade" requires headroom to cope with cash flow stress which includes:

- Failing to meet the opex efficiency challenges set by the price control,
- No "glidepath" to enable GDN to implement changes required to meet efficiency targets, or allowance for the costs of changing resource structures
- Reduction or elimination of contribution of non-formula activity
- Adverse working capital movements due to factors outside GDN's control including shipper transportation prepayment arrangements
- Risk of costs in excess of allowances due to factors such as above inflation cost pressures documented in BPQ and unpredictable, but necessary environmental remediation expenditure
- Risk of events for which Ofgem has precluded the opportunity of a "re-opener" including changes in tax legislation, Health and Safety requirements, and pension costs

Consequently the price control should allow "headroom" against key ratios to ensure financeability and recognise the risks being borne by the Licensee.

Addressing financeability concerns

We note the range of individual inputs to cost of capital in table 9.2 and the recognition that any assessment of WACC must also take into account the risk and

rewards anticipated to be taken by the Licensee. Financeability concerns are an indicator that WACC has been set too low, and the primary adjustment to address financeability concern is to increase WACC.

We have concerns over the alternative options discussed in paragraph 9.39.

- Measures which advance cash but are NPV neutral (for example accelerated RAV depreciation or increasing the opex proportion of repex) typically do not improve PMICR, which is a key indicator of financeability used by the rating agencies and debt providers.
- We do not understand why financeability concerns that are highlighted by modelling a GDN with notional gearing, currently 62.5%, are addressed by enabling measures that reduce that notional gearing.
    - Given the financeability concerns, what certainty is there that equity funding could be secured?
    - Raising equity decreases gearing, which implies a higher WACC should be allowed

GAS DISTRIBUTION PRICE CONTROL REVIEW - INITIAL PROPOSALS

WALES & WEST UTILITIES LTD
RESPONSE TO THE INITIAL PROPOSALS

PART 3 – ADDITIONAL PAPERS

LONG TERM SKILLS SHORTAGES

Owing to the ageing workforce GDNs need allowances for the recruitment of additional skilled employees. The cost data used for benchmarking and setting allowances from 2008/09 is from 2005/06 and 2006/07. As very little recruitment and training took place in those years it follows that there are no costs of any significance to cover the future costs of recruitment and training in the 2005/06 and 2006/07 BPQs. Given the present methodology used for deriving proposed allowances post 2008/09, GDNs have little to no allowances to address this critical business and customer service issue.

We therefore disagree with Ofgem's view that an allowance should not be allowed for the recruitment of substantial numbers of employees to replace the ageing workforce. This is for a number of reasons in addition to the point above which are as follows:

Firstly, the time taken to achieve full competency is typically between 3 and 4 years, depending on the discipline, so there will be a number of years when these new employees are a cost to the GDNs, but do not undertaken any productive work, therefore are purely a cost burden.

Secondly, there is a statutory obligation for the GDNs to run the out of hours emergency service, so efficiency savings gained by greater productivity do not mean a reduction in the number of employees.

Finally, there will not be savings made in terms of salaries for industrial staff following the recruitment of new staff on lower salary bands, as these bands do not exist, rather all industrial staff are paid spot salaries rather than salaries dependant on experience. These terms were inherited from NGG and were negotiated with by them the relevant unions.

Given the shortfall of competent personnel within the industry, in order to meet workload demands it is highly likely that we have to recruit directly from the marketplace at a premium, and therefore costs will be higher. Additionally, it is worth pointing out that this is only effective in the very short term as available labour is scarce, and once this limited pool has been exhausted, there are no other stocks to draw upon. This scarcity also has the knock on effect of driving up the cost of contract labour rates which are extensively used in respect of repex and capex programmes.

Consequently, in light of the above it is clear that this issue has to be tackled and additional allowances are required in order to overcome the ageing workforce issue.

We are pleased to note that allowances for training and apprentice costs are still pending. The work that we are currently undertaking on collaboration will help to inform this work going forward.

Given the magnitude of this issue we are supportive of funding to overcome long terms skills shortages being ring fenced as part of a separate incentive For example through mechanisms such as the Innovation Funding Incentive.

This will encourage continued long term investment and savings, and will provide the GDNs with a framework upon which to be measured against, which will ultimately benefit consumers, as outlined in the Initial Proposals document.

APPENDIX 13 – LICENCE DRAFTING

We acknowledge receipt of Roger Morgan's letter dated 11 July 2007 re the Final Connection Allowance. Please note that we will be considering any potential impact of this letter on the licence drafting and we will include this as part of our response to Ofgem's letter.

Process for modifying the licence conditions

We welcome the opportunity to comment on the licence drafting at this early stage and welcome further discussion with Ofgem over the coming months. Our initial specific responses are below, for the avoidance of doubt these responses are solely in respect of the licence modifications, not the principles behind these modifications to which we have responded in the main body of our response. We anticipate our responses being updated as a result of the series of planned meetings with Ofgem between now and the final drafting changes being issued.

As Ofgem is considering consistency between the Special Condition E conditions and the Standard Special Condition, it should be noted that a phrase which has been included, and defined, within the Standard Special Conditions "the pipeline system to which this licence relates", see for instance Standard Special Condition A27 Definition of Transportation Asset.

This formulation duplicates without obvious reason a definition in Standard Condition 1, namely "the licensee's pipeline system". This is suggested that the phrase "pipeline system to which this pipeline relates" be changed throughout to accord with Standard Condition 1 Definition.

Special Condition E2A

We agree that this condition needs to be updated to reflect any new terms or to remove redundant terms. We also suggest that it is timely to review the definitions in the Standard Condition for completeness.

In particular we have the following comments:

- Definition of Distribution Network

  While this Definition made sense in Transco's own disaggregated licence (when Transco owned all of the LDZs comprising of the whole of Great Britain), we would suggest that it is not so well at ease with an independent DN, particularly as the independent DN's authorised area is the entirety of Great Britain. The effect of the Definition is to confine formula revenues to those derived from distribution services within the distribution network, so that if pipelines were laid into an adjacent non-DN owned LDZ they would not as a matter of construction be formula revenue. The condition need only refer to "the transportation business" for an independent DN.

  Distribution Network Transportation Activity

  For an independent DN having no NTS part of its licence, this definition duplicates the definition of "the transportation business" in Standard Special Condition 1 and therefore can be deleted.

- Distribution Network Transportation Activity Revenue

  This definition is still required, although the references to a Distribution Network within it will be amended in accordance with the changes outlined in this note and so simply refer to "transportation revenue"

- Supply of Distribution Network Services

This definition duplicates the definition of "supply of transportation services" (in Standard Special Condition 1) and for an independent DN is superfluous

- Transportation system
  This definition is already contained in Standard Special Condition 1 and for an independent DN is unnecessary duplication.

Special Condition E2B

We agree that this condition is currently difficult to navigate through and we would welcome a re-structure. The main problem is that, given the length of the condition, it is very difficult to tell which individual subparagraphs are subparagraphs of which paragraph. One way, although we accept that it is not normal statutory drafting, would be to number each subparagraph in full, as is commonly done in contractual drafting. Otherwise we would suggest that the simplest way would be to set out the principal terms in separate sections rather than re-numbering the licence condition.

Para 1.22 refers to the areas where there is overlap in the reporting between E2B and E6 and removing the reporting obligations into E6. We would welcome further discussion on these specific changes, it is important that the definitions and algebra remain in E2B but we agree that there is no need for reporting to be duplicated.

We note Ofgem's position regarding Special Condition E2B 1B 8.11. However our position does not change from our previous representations in relation to this Condition and Ofgem has not given any justification why the continuance of the Condition operates against the public interest. While the position in Transmission it is noted that this is a Special Condition and therefore arguments on the consistency on their own are not sufficient.

Special Condition E3

We support the review of whether an audit is required as we believe it delivers little value. We agree it would be sensible to combine these reporting requirements with the cost reporting obligations

Special Condition E4

We look forward to clarification as to what Ofgem mean here. In our view the two Licence Conditions are consistent and are understandable in law.

Special Condition E6

We have raised the issue of the metering price caps on previous occasions. Our position is that:

1) the proportion of pre payment meters provided by WWU is higher than that in the population as a whole and therefore WWU believes that the price caps should be reviewed.

2) the proposed merger of NGM and Onstream will move all NG's meters out of the regulated business and therefore the price caps will not apply. WWU will still be providing its few meters of last resort meters as regulated meters. This means, whereas NG could rebalance their charges, WWU could not and therefore WWU could face a further increase in the proportion of prepayment meters.

3) Metering competition is sufficiently developed to remove the need for a last resort obligation. We note that Ofgem is proposing to remove some of the obligations on suppliers for metering and the same should apply to transporters.

SSC A10, A43 & A46
We believe that a review of the related licence conditions A10, A43 and A46 is also appropriate, as these conditions may also need to be modified.

SSC A33 & A34
We are pleased to see Ofgem are planning to review the need for these licence conditions for the singleton companies. It is our view that the obligations can be removed.

SSCD3
As our allocation is not available until the end of September, we would request that the deadline be changed from 30 September to 31 October in respect of Long Term Development Statement in order to allow us time to assess our allocation.

SSC D5 & D7
As we have said in previous discussions with and responses to Ofgem we do not consider either of these licence requirements are appropriate and welcome Ofgem's review of these conditions.

SSC D10
We concur with Ofgem in looking to clarify the reporting periods in D10, but it is important that the 90% target remains an annual target despite the frequency of reporting. We would also welcome discussion as to whether the reporting will alter as a result of the merging of the three quotation guaranteed standards and the two planning guaranteed standards.

Standard Condition 4B
In principle we are opposed to increased scrutiny by Ofgem, and do not believe that this is relevant to the price control process.

Timetable for consultation
We look forward to working with Ofgem as part of the working group to discuss the drafts at the end of the summer and through the autumn.

We note that there are no proposals at this stage within appendix 13 in respect of the specific reopeners for TMA or tax, we presume that this is an omission and look forward to further discussion in this respect.

OFGEM CONSULTATION: GAS DISTRIBUTION PRICE CONTROL REVIEW
FOURTH CONSULTATION DOCUMENT

WALES & WEST UTILITIES (WWU) LTD
RESPONSE TO CONSULTATION

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

- Appendix 1 - Support Services Review 13th July 2007 - Report prepared by Third Horizon

Previous independent Consultants Reports submitted to Ofgem on 25 April 2007 as part of our response to the Fourth Consultation Document.

Fourth Consultation Response - Part 4

- 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

Fourth Consultation Response - Part 5

- 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

Note: All the reports outlined above can go into the public domain. The exception of the following reports which should remain confidential at the present time:-

- Appendix F - Gas Distribution Price Control Review: Reports on Costs prepared by NERA
- Appendix C - Support Services Review, Report prepared by Third Horizon Consulting