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Joanna Whittington,
Director – Gas Distribution,
Ofgem,
9 Millbank,
London,
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24 October 2007

Dear Joanna,

Gas Distribution Price Control Review - WWU Response to the Updated Proposals

Please find attached to this covering letter our detailed response and executive summary to Ofgem's Updated Proposals (UPs) for the price review 2008 –13.

Our response is in 3 parts, and Ofgem will already have received the executive summary, and appendices A-G on 22 October;

1. An executive summary of the key issues still of major concern to us which we believe require further substantive review (attached)

2. Attachments or external reports which supplement our arguments, and which are referred to in the executive summary (appendices A-G previously sent, appendix H attached)

3. The detailed response document – outlining our response to the specific questions posed by Ofgem in Updated Proposals, coupled with our own comments (attached)

Whilst we have responded fully to the Proposals in the usual way, we have prepared an extended summary to ensure that Ofgem senior officials and Authority members fully understand our major concerns with the Updated Proposals (UPs).

We request that a copy of this letter and our executive summary be circulated to Authority members in advance of our meeting on the 25 October. We also recommend that Ofgem senior officials and Authority members read the NERA, First Economics, and Third Horizon reports submitted with this response.

These reports, along with previous submissions by both ourselves and the other GDNs, give separate but consistent views of the inadequacies of the methodology employed by Ofgem - and whilst some have been specifically commissioned by WWU, we believe they have industry wide relevance.

For the avoidance of doubt, the executive summary and the detailed response together with the appendices may be placed in the public domain, with the exception of appendix C - Cost Drivers Report (updated) - JSA 181007 and appendix H - EU Skills Recruitment Model which are confidential.

Attached to the executive summary is an appendix outlining the list of external documents submitted previously by WWU in this price review and we confirm that all of these documents may be placed in the public domain.

Yours Sincerely,

Bob Westlake
Head of Regulation
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GAS DISTRIBUTION PRICE CONTROL REVIEW – UPDATED PROPOSALS

WALES & WEST UTILITIES LTD

RESPONSE TO THE UPDATED PROPOSALS

GAS DISTRIBUTION PRICE CONTROL REVIEW – UPDATED PROPOSALS

WALES & WEST UTILITIES LTD

RESPONSE TO THE UPDATED PROPOSALS

PART 1 – EXECUTIVE SUMMARY OF KEY ISSUES

This executive summary outlines the significant areas of concern which Wales & West Utilities (WWU) has with the Ofgem Updated Proposals (UPs) and discusses these issues at a summary level in this document. We expand on the key points made in this summary either in the detailed response document (Part 3), or alternatively through separate submissions by ourselves or independent consultants on our behalf.

Given our significant concerns with the Ofgem UPs we have asked a number of recognised external experts to review both the methodologies used by Ofgem and its consultants, and the resultant assumptions and conclusions. The following reports are submitted with this summary, which review specific subject areas in the UPs;

- Appendix A - Review of Ofgem Benchmarking Studies – NERA, 15th October 2007
- Appendix B - Top Down Analysis of the Scope for Real Terms Cost Reduction (a Follow up Note) - First Economics, October 2007
- Appendix C - Network Cost Drivers, A Bottom Up Approach (an updated report on behalf of Wales & West Utilities) - John Spiller Associates, 18th October 2007- please note that this report is confidential
- Appendix D - Impact Assessment of the Proposed Ofgem Opex Reductions - Third Horizon, 18th October 2007 (includes an assessment of industry benchmarking)
- Appendix E - The disposal to landfill of road spoil from the excavation of trenches from utility services. Review of the future implications of Landfill Tax – MJCA, October 07
- Appendix F - Response to Ofgem's updated proposals on the cost of capital – Oxera, 19th October 2007
- Appendix G - Loss of Metering Work and its Impact on Emergency Costs - John Spiller Associates, 20th October 2007
- Appendix H - EU Skills Recruitment Model

Where relevant we have referenced specific quotes or findings from these reports contained in this executive summary. Once again, all these documents with the exception of Appendix C - Network Cost Drivers, A Bottom Up Approach (an updated report on behalf of Wales & West Utilities) - John Spiller Associates, 18th October 2007 and Appendix H - EU Skills Recruitment Model may be placed in the public domain.

1. OVERVIEW

We recognise that this response is the last formal opportunity to influence Ofgem before the Final Proposals in December. We recognise the nature of incentive regulation is to continually challenge utility companies to improve their overall performance, which subsequently benefits the users of our services. The process also lays responsibility on the Regulator to ensure that companies like WWU can fulfil their licence obligations and properly finance their functions.

WWU believe that the Ofgem proposals as they currently stand place a huge (and we believe unfair) challenge on our company and would seriously compromise our ability to meet our obligations and standards of service. Throughout this review and the previous one year review before it, we have sought to fully engage with Ofgem to:

a) Fully understand the information and analysis that has informed Ofgem's assumptions and conclusions; and,
b) Put forward WWU's views and assumptions in our own submissions and proposals, utilising wherever appropriate, credible external expertise well recognised in the marketplace.

We have at various points through this review been frustrated and disappointed with the lack of detailed explanation from Ofgem about specific elements of its analysis and conclusions. Even at this late stage we still do not understand the background rationale and analysis behind some of Ofgem's decisions, despite repeated requests for the information. All this is particularly disappointing given the overall challenge that the current UPs present to WWU.

The challenge presented to WWU by the UPs is significant. Against the updated business plan submitted by WWU in July, the UPs reduce the allowances for our main categories of expenditure over the 5 years by:

- £74m in Opex (18.5%)
- £101m in Capex (29.5%)
- £60m in Repex (14.83%)

The reductions in Opex and Repex are primarily due to efficiency and real price effect challenges. To put all this into context, this significant level of challenge is being placed on:

- a company that has been built from the bottom up following network sale, and developed as a standalone GDN on a 'lean' basis with indirect activities only added on the basis of those essentially required; and,
- an industry which has been subject to incentive regulation for approximately 20 years, and has already achieved significant cost reductions during that period.

We urge Ofgem to revise the unreasonable, and we believe unfair, challenge on WWU. The sections that follow in this executive summary outline our major concerns with the different element of the UPs, and what we believe needs to happen to result in a set of Final Proposals, which whilst still representing a challenge to WWU, are ones we trust we will be able to find acceptable.

2. METHODOLOGY

2.1 Methodology weaknesses

- We remain extremely concerned with the methodology used by Ofgem and the fact that its findings are subsequently not robust. We believe its approach certainly does not provide sufficient justification for the significant legitimate costs being disallowed, as outlined in the overview. Our views on the methodology used by Ofgem are fully supported by our external consultants generally, and NERA in particular. These views can be summarised as follows:

  Ofgem's benchmarking analysis uses regressions which are unreliable because they use too few data points

  - Ofgem's benchmarking analysis produces results which are not consistent between methods

  - Ofgem has not allowed for the inability of its benchmarking techniques to distinguish 'inefficiency' from unmeasured differences between the different companies

  - Ofgem has not fully corrected for the unrealistic efficiency targets that arise from benchmarking different cost categories separately, and then adding these all together to create a 'best in class' composite

  - Ofgem has not applied a consistent policy regarding 'efficiency catch up', and has not allowed GDNs the cost of improving efficiency – particularly given it has not allowed any glide path to achieve these cost reductions

- We note that Ofgem has recognised the flaws in the bottom up approach to benchmarking by introducing in the UPs a top down upper quartile approach. However as this is still combined with a flawed bottom up analysis it still produces an inequitable and inconsistent outcome. The resulting difference between the two approaches confirms our view that only top down benchmarking is the reliable method for assessing overall cost efficiency.

- SGN indirect cost data is acknowledged to be based upon a marginal cost charging methodology for services provided by SSE. Ofgem have attempted to address this by using the next lowest company when SGN sets a bottom up benchmark. However the adjustment is not complete because SGN lower marginal costs are not corrected in the top down benchmarking towards which bottom up cost allowances are uplifted. Ofgem should omit them altogether from the analysis.

- NGN cost should be increased for benchmarking to allow for the increased expenditure necessary to meet required standards of service.

- We asked NERA to undertake an independent review of the benchmarking used by Ofgem for the UPs. The attached report supports our view of the lack of logic and rationale in most of the benchmarking. The following comments by NERA are reflective of the overall views in their report;

"Another example where Ofgem's benchmarking approach lacks economic logic relates to the choice of benchmarking variable for indirect opex. For the indirect opex benchmarking, Ofgem uses GDNs' revenue as a driver for costs in a number of activities (UPs, tables A7.3-A7.10). This approach makes GDNs appear less 'efficient' in indirect opex, if (compared to their comparators) they have reduced costs in other categories and therefore have lower revenues. Such perverse effects arise because Ofgem's consultants have adopted a number of ad hoc benchmarks without giving proper consideration to the economic rationale for their approach" (1.1.4)

- Even Ofgem's consultants themselves recognised that their benchmarking did not take account of unobserved or immeasurable differences between GDN's. For instance the LECG report on Indirect Costs states that:

  "variations in GDN performance may be due to factors such as difference in organisational structure. For example for FTE based metrics, a lower cost per FTE may be due to more outsourcing rather than efficiency" (2.18)

- Finally, we would draw Ofgem's attention to the obvious differences in approach to benchmarking between Ofgem in this price review, and the CAA initial proposals for Heathrow, Gatwick and Stanstead airports in December 2006. The attached Third Horizon contains a table showing the key differences in approach, which is reproduced below.

CAA Approach[1]	LECG Approach[2]	Impact of LECG Approach
Median approach to benchmark targets	Top Quartile approach to benchmark targets	Target reductions consistently set above industry average, and in most cases, above world class performance
Accounts for variations in comparison groups (i.e. customer profile and economies of scale)	No consideration of regional or GDN specific factors or the proven relationship between support cost and overall size	Allowances fail to reflect the unique environment WWU operates in
Benchmark analysis performed at the process level with consideration of performance drivers	Benchmark analysis performed at the functional level which does not account for performance drivers	Target reductions do not take into account size of operation and resulting support requirements
Consideration of the impact of cost drivers when analysing results (normalising a wide cross section of comparisons)	Comparison groups have not been normalised to account for individual cost drivers	Target reductions do not account for unique cost drivers, such as geographic reach
Consistent and formally defined approach to benchmark selection	Benchmarks 'cherry picked'	Efficiency targets implied by LECG lack justification and credibility
Alignment of processes to the needs of the business and consideration of quality of service	No consideration of the impact of cost reductions on quality of service	Target reductions will impact the quality of service offered by WWU to its clients
Consideration of the cost of projects in OPEX reductions (the ability to benefit from CAPEX projects)	No relationship acknowledged between CAPEX, OPEX and REPEX when setting targets	Target OPEX reductions will have an impact on CAPEX and REPEX creating even greater difficulty in achieving targets across the consolidated cost base

1. CAA initial price control proposals for Heathrow, Gatwick and Stanstead airports, Dec 2006
2. Update assessment of GDN indirect opex based upon 2006/07 actual performance. 24 September 2007

It is evident that the CAA took a much more balanced and transparent approach to benchmarking performance, with a clear reference to important factors such as:

- Consideration of the impact of cost drivers when analysing results
- A consistent and formally defined approach to benchmark selection
- Clear consideration of quality of service
- Consideration of variations in comparison groups (i.e. customer profile and economies of scale)

None of these factors have been taken into consideration by Ofgem's consultants, we believe at the specific instruction of Ofgem.

Given the obvious flaws in the methodology used to date by Ofgem and its consultants, we would urge Ofgem to set final allowances based on a simple top down approach, properly adjusted for SGNs marginal costs and NGNs performance, which whilst not without its issues, would at least remove most of the obvious discrepancies that are apparent in the current approach.

2.2 Productivity challenge

We believe that First Economics (FE) in their joint GDN sponsored review of the report prepared by Reckon for Ofgem, have presented compelling evidence that Ofgem's frontier shift adjustment is not well supported and lacks a solid foundation for its point estimate. They make the following general comments in their report:

> *"…the figures that Reckon has put forward in its report and which Ofgem has reproduced in its updated proposals document, are not therefore a measure of the underlying labour productivity improvement in comparator industries, but rather an entirely fictitious account of what labour productivity would be if the contribution that investment makes to TFP growth is arbitrarily marked down to zero. This is of no relevance to the exercise that Ofgem is engaged in. In order to set opex efficiency assumptions, Ofgem needs to know how much productivity growth the GDNs will be able to produce during a period in which their investment programme is dominated by like for like replacement. Simply assuming away the contribution that investment has been making to productivity growth in other industries is no way of taking on this task…" (2.2)*

FE go on to make the following pertinent comments in their report which supports their ultimate conclusions:

> *"Ofgem, in particular, lacks a solid foundation for its point estimate, so the key question is whether it makes sense to be forecasting that the GDNs will go on reducing opex in real terms indefinitely…"*
>
> *"One useful point of reference is the performance of other mature network businesses during the last five years. Our April 2007 work showed that opex in several industries had been drifting upwards in recent years and that out-performance had started to give way to under-performance..."*
>
> *"Finally, one can look to see where in the UK economy there is evidence that companies have been able to reduce opex in real terms year on year. Our work*

(using the RPI data set) indicated that the only part of the service sector in which this appears to be achievable is the telecoms sector. Everywhere else service sector firms are experiencing real terms cost increases from one year to the next.

All of the above factors lead us to conclude that Ofgem's frontier shift assumption is not well supported and not likely to describe very accurately the underlying trend in GDN costs…"

We believe Ofgem should revise their challenge to a more realistic level, by addressing two key issues:

1. Reduce the unrealistic 2.5% productivity assumption to a lower number that is supported by credible market place evidence. We note for example the recent review by the Competition Commission of the CAA price review of the London airports, where the efficiency challenge was set at 1.5% per annum with no frontier shift.

2. Give allowances for restructuring and redundancy costs, recognising (like the CAA in its review of NATS) that productivity savings cannot be achieved without cost, and that it is inappropriate for customers to benefit from lower future costs without paying upfront for the costs incurred during the transition to a lower recurring cost base.

- A final point on any proposed level of productivity challenge. There are a number of cost categories that are clearly outside our control but which are impacted by the generic productivity assumption used in the UPs. Two obvious examples of these are wayleave costs and the Network Services Agreement with National Grid for emergency call handling. The UPs take no account of these issues, and places a 2.5% challenge on all costs, including ones where WWU has very little or no influence.

2.3 Cost and rate of transition to achieve efficiencies

- Given the labour intensive nature of the GDNs, any significant improvement in productivity is likely to require restructuring and resultant redundancy costs. However Ofgem makes no allowance for such costs despite setting challenging productivity improvements. As FE point out in the attached report:

  "Given the type of business that the GDNs run, a significant proportion of any productivity savings will have to come through a reduction in the labour force. These manpower reductions are not costless; rather we would expect the GDNs to have to pay sizeable redundancy payments…we would expect these costs to be recognised somewhere within Ofgem's price controls and we note that there is regulatory precedent for this in the CAA's most recent review of NATS"

We believe that Ofgem needs to make allowance for the fact that achieving productivity improvements actually costs money, and that time needs to be allowed to achieve such improvements – both factors absent from the Ofgem proposals.

- In other regulated sectors where efficiency targets have been set, companies have been allowed time to achieve the benchmarks set by applying a 'glidepath' from the current level of costs. This allows additional revenue to finance the one off costs of reducing opex costs and reflects the clear understanding that reducing costs takes time. Providing no glidepath implies that the regulator is

confident that any 'excess' costs are being incurred unnecessarily and inefficiently, and can be immediately reduced.

- Even Ofgem's consultants recognise that achieving efficiencies takes time. In its updated September report, PB Rune's recommendations for work management, emergency and maintenance costs all assume that companies will be able to close 70% of an efficiency gap by 2012/13. If Ofgem decide not to allow such a glidepath, but to impose a benchmark level of cost immediately, it will clearly be acting against the recommendations of its consultants.

2.4 Regional factors

We strongly disagree with the assumptions made in both the IPs and the UP's in relation to Ofgem's application of the regional factor for costs. We summarise our concerns below.

- It is well accepted that Weighting or Allowance has been applied in London. However consideration of whether regional pay factors should be applied needs to be considered in the context that until 2006 national pay scales applied across the whole country, and 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, contractor workforces are highly mobile and follow the work across the country, with their pay rates considered to be consistent on a national basis. At the present time for example, WWU has contractors from places like Manchester and Newcastle.

- We also pay national prices for virtually all of the key materials and services that we procure, from pipework to vehicles to IT services. Given these factors we see no justification for reducing the WWU regional factor to 0.96.

- Despite the compelling reasons outlined above however, the differences have been further exaggerated through an increase in the London and inner M25 allowances. We have no complaint that companies should receive allowances that reflect the reality of the market place they operate in. However, any allowances given should not be at the expense of GDNs operating in other, still challenging environments. The data used to determine proposed allowances includes all professions and not just utilities, so will include finance and City workers which are clearly not comparable to the staff WWU employ.

- Ofgem's own consultants PB Power have said in their updated opex report (2.8.2) that WWUs regional pay is 0.98. They also state that London and Southern are not actually exposed to the whole uplift as the GDNs are not entirely within London, and a number of their activities are carried out elsewhere in the country.

In summary we believe Ofgem has overstated the London effect to the detriment of the regional GDNs and they should at a minimum use the 0.98 figure as proposed by their consultants.

3. INDIRECT COSTS

3.1 Benchmarking

We note that WWU submitted reports by credible independent consultants which covered industry wide issues applicable to all GDNs some months ago.

Although Ofgem commissioned external work by LECG which purported to benchmark indirect costs, we seriously question the validity of the work undertaken. In particular it is evident that Ofgem restricted the breadth normally required of such work. The following comments from the LECG report reflect this:-

"However, we have been instructed by Ofgem to consider the GDNs as equals..." (2.27).

"*I seemed to remember asking us to put something in that explained total efficiency saving, and analysis of the economy of scale point. Why have we ignored these. Are there any other points I raised that were ignored?...* (1.31).

There are a number of comments in the LECG report which make it clear that Ofgem had restricted the consultants from either broadening the breadth of their review or considering alternative benchmarking methodologies.

Against this background, and despite the use of an uplift factor applied by Ofgem, the proposed indirect cost reductions in the UPs still cause us major concern - based on the flawed methodology used and the significant business impact of the resulting cost reductions. They continue to be flawed based on a number of key factors:

- The benchmark comparators used by Ofgem and its consultants
- The use predominantly of revenue as a basis for benchmarking
- The fact that quality of service is totally ignored in the benchmarking
- Ignoring the obvious impact of economies of scale

The reports by both NERA and Third Horizon identify in detail the significant flaws associated with the benchmarking used by Ofgem. Whilst Ofgem portray these reports as unique to WWU, we believe they have relevance for all GDNs. We summarise our major concerns with the benchmarking in the paragraph below.

- The LECG report on indirect opex does not take account of any unobserved or immeasurable differences between GDNs. Whilst they acknowledged their benchmarking approach could mistake unobserved differences between companies for inefficiency (para 2.18), they completely ignored this factor throughout their report. Such factors will include regional differences in input prices, economies of scale, trade-offs between input categories, and many more besides. Ofgem's instructions mean that LECG's results cannot be taken at face value.
- Not only have LECG (and Ofgem) failed to take account of any unobserved or immeasurable differences between the GDNs, they have also failed to take account of any differences in GDNs' standards of service. With this in mind we

certainly question the validity of using NGN as the frontier company when they have clearly failed their standards of service for complaints and responding to emergencies within 1 hour for 2006/7.

On this specific point we would also draw Ofgem's attention to a recent benchmarking study commissioned by CAA as part of their review of BAA. The study looks at a number of categories of indirect cost and their proposals clearly strike a balance between cost efficiency and quality of service.

- We are concerned with the selection of separate individual benchmarks for each cost category. LECG themselves recognise that this approach has the potential to set efficiency targets which are unattainable - and recognising the limited data sources used in the analysis, the immaturity of the data, and the acknowledged flaws in the source data specifically from NGN and SGN (respectively, use of outsourcing and recharge from related party companies at marginal cost) - we are very surprised that Ofgem have continued to support this approach. The NERA report presents an analysis of these issues and compares estimated efficient benchmarks from a bottom-up and top-down approach. Not surprisingly, the top-down approach produces a much less dispersed set of results.

3.2 Quality and integrity of data

We have major concerns with the quality and integrity of the GDN data sources used by Ofgem in the UPs which ultimately influences the regressions and efficiency positioning. In particular we are very concerned that:

- SGN indirect cost data is acknowledged to be based upon a marginal cost charging methodology for services provided by SSE. Ofgem have attempted to address this by using the next lowest company when SGN sets a bottom up benchmark. However the adjustment is not complete because SGN lower marginal costs are not corrected in the top down benchmarking towards which bottom up cost allowances are uplifted. Ofgem should omit them altogether from the analysis.

- NGN indirect cost data has been derived form a combination of in-house costs, and costs apportioned from their outsourced provider. We continue to have concerns about the robustness of the cost allocation methodology given the business model involved.

3.3 Economies of scale

Ofgem have stated it will not allow smaller GDNs any additional allowance for their inability to benefit from economies of scale when setting indirect opex allowances. Even though LECG themselves agree in their report that the efficient level of support service costs are affected by such factors as economies of scale and regional factors, Ofgem has instructed them to ignore economies of scale when undertaking the benchmarking. We find this approach irrational and counter intuitive to business and economic logic.

We believe the flawed nature of the benchmarking approach actually used by Ofgem subsequently results in cost allowances in the UPs which defy sensible logic. The table below illustrates the figures involved and the key points are made below the table.

GDN	Normalised Indirect Opex 08/09-12/13, £m/GDN/year	Updated Proposals, £m/GDN	Updated Proposals , £m/GDN/year
NGG	28.58	87.45	17.49
NGN	23.94	84.1	16.82
SGN	16.44	85.8	17.16
WWU	25.46	86	17.2

1. WWU normalised costs were identified in our Business plan submissions as £127.3m for the five years, equivalent to £25.46m per annum on average. These costs were benchmarked externally by Third Horizon against recognised market comparators and it was found that "WWU is already a strong performer across the various service sectors".

2. The average allowance proposed in the UPs for each of the four single owned NGG networks is greater than any of the independent networks, and clearly takes no account of the obvious economies of scale involved in owning four networks together. The result is not necessarily that NGG should received less allowance but that WWU should, on the grounds of being efficient, have a significantly greater allowance afforded to it.

3. SGN, who adopt a marginal costing approach to its two gas networks are given allowances equal to or greater than the two independent companies, and actually receive an allowance greater than their normalised submission costs.

These illustrations only serve to highlight the flawed nature of the way that the benchmarking has been undertaken. In the case of SGN, we also wonder if there is an issue of cross subsidy which Ofgem need to reflect on between SSE's electricity and gas businesses given the marginal cost approach with SGN.

The NERA report also makes the following comments on this specific issue:

"The results we present in Table 3.1 show that – as well as not accounting for economies of scale – LECG has recommended a higher indirect opex allowance 'per network owned' for NGG than for individual GDNs. It is difficult to explain this result either in terms of (ignoring) economies of scale or in terms of relative efficiencies. This outcome undermines confidence in the robustness or reliability of the methodology that LECG has chosen (or been asked by Ofgem) to adopt" (3.8).

- Following network sale, the stand alone WWU business has been built from a bottom up basis on a 'lean' philosophy, only adding indirect activities that were essential. This is a factor which even NGG themselves have recognised in previous responses to Ofgem. We believe our approach reflects industry best practice performance, a factor which is endorsed by the independent benchmarking reviewed by Third Horizon (see below). We are clearly being penalised by Ofgem's chosen analysis for being a smaller, independent company.

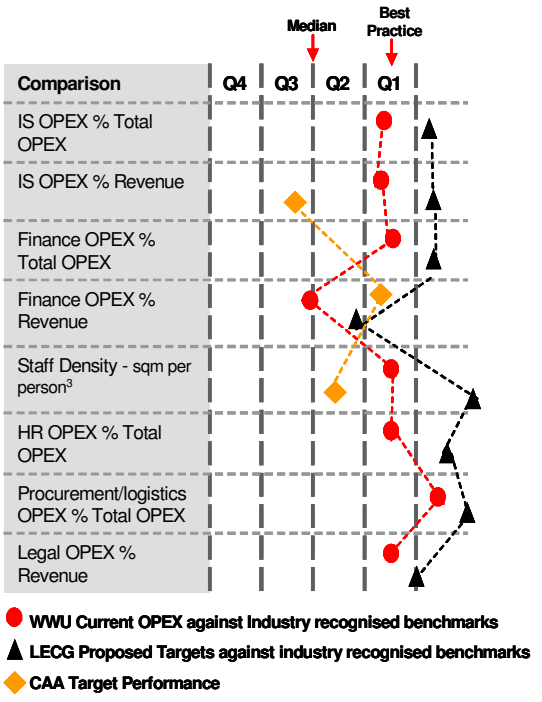
- Ofgem has, contrary to established economic theory and evidence, continually disregarded sound arguments based on economies of scale. This approach is

contrary to sections 4AA (1), 4AA(2), 4AA(5), 23 and 24 of the Gas Act 1986 (as amended) which require the Authority, amongst other things, to consider the circumstance of the particular license holder when exercising powers to amend licence conditions. To ignore issues such as economies of scale is therefore *ultra vires.*

With particular concerns on the flawed methodology and validity of data sources used by LECG, and the disregard of economies of scale by Ofgem, we asked Third Horizon to update their previous work with a specific review of:

- the position of WWU against external benchmarks well recognised in the marketplace; and,
- the specific impact of the UPs on our business activities and our ability to meet required service standards.

The attached Third Horizon report demonstrates that in virtually all cases the LECG target level of performance is in excess of currently acknowledged best practice (and coincidentally well in excess of the targets established by the CAA for BAA). The table below, which is an extract from the report, clearly illustrates this point.



	BP	Median	WWU[9]	LECG[10]	CAA[11]
IS opex % total opex[1]	4%	9%	5%	3%	
IS opex % revenue[2]		3.9%	2.9%	2.1%	4%
Finance opex % total opex[3]	2%	3%	2%	1%	
Finance opex % revenue[4]	0.4%	1.4%	1.4%	0.8	0.5%
staff density - sqm per person[5]	12	14	12	6*	13
HR cost % total opex[6]	1%	4%	1%	0.4%	
P&L opex % total opex[7]	2%	4%	1%	0.5%	
legal costs % revenue[8]	0.20%	0.40%	0.22%	0.17%	

1 *DTT Global Benchmarking Study*
2 *Meta Group 2005*
3 *2001 UMS Group Utility Benchmarks*
4 *The Hackett Group, 2004*
5 *Andersen 2001 Study (Multi Industry)*
6 *DTT Global Benchmarking Study*
7 *UMS Utility Benchmarks*
8 *PwC Study*
9 *Update assessment of GDN indirect opex based upon 2006/07 actual performance. 24 September 2007.*
10 *Based on comparison of high target savings*
11 *Civil Aviation Authority Benchmarks, 2006*
* Assume a 46% reduction in floor space in line with a 46% reduction in property OPEX

In summary, we do not consider the targets for indirect costs in the UP's are either reasonable or robustly based. Given the obvious flawed nature of the methodology and data we strongly recommend that whilst not without shortcomings, Ofgem adopts one of the following approaches outlined below:

- Ofgem should base their analysis on external data, which is readily available, and which WWU has provided Ofgem with some months ago. Such benchmarking should be based exclusively on acknowledged proprietary external benchmarks, or;

- In the event that Ofgem wish to continue to base the analysis on GDN data, they should revert to a simple top down analysis, clearly excluding SGN data and adjusting for standards of service issues.

4. DIRECT COSTS

4.1 Work Management activity

- We question the validity of cost allocation and normalisation carried out by PB Power in their updated report, which has significant subsequent impact on the regression analysis and allowances proposed. For example, PB Power indicate that Scotia has reallocated costs in 06/07 from Work Management to other activities. We believe there is inconsistency in the treatment of such costs across the GDNs which results in a reduction of allowance of almost £11m for WWU. Such cost movements resulting in these material differences are not credible.

- Our concerns over the suitability of the Composite Variable and the regression analysis used to produce the bottom up costs remain. The approach does 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, all of which impact on the number of operational staff required to work remotely from the core work management function.

WWU has been disproportionately and unfairly affected by the revised normalisation and cost allocation undertaken in the UPs by £11m. We request that Ofgem address this by removing Scotia from the analysis, as the numbers carry no credibility and create a distorted and inequitable outcome.

4.2 Maintenance activity

- There are significant inconsistencies in the data submitted by the GDNs and the allocation of costs within the maintenance activities. PB Power have themselves recognised this and in their updated report have attempted to address this by combining all maintenance activities, and then carrying out a regression analysis of total routine maintenance costs. However the analysis carried out to separate routine and non routine expenditure has not been sufficiently detailed or robust and we believe that PB Power have not recognised the full extent of "non-routine" maintenance expenditure within our 06/07 maintenance costs.

- In their report PB Power developed a composite scale variable based on the drivers of: Offtakes and PRS numbers, Network length (above/below 7 bar), non PE length, district governor numbers, low pressure holder numbers, network

throughput and repair numbers - giving each an equal weighting in their analysis. In the UP's these drivers have been amended by Ofgem and the revised categories then given a weighting based on the number of pressure reduction stations and NTS offtakes (66%), District Governors (26%) and gas holders (8%).

- There is no explanation as to why length of >7bar pipeline has not been included, nor any account taken of mains and service work which for WWU makes up 27% of 06/07 expenditure within the "other maintenance" activity. The subjective nature of the weighting means that WWU is being particularly unfairly treated as 35% of the cost incurred is not represented by a categorised cost driver.

The revised analysis used by Ofgem has reduced our allowance by £5m, while other GDNs have gained significantly. For example SGN's allowance has increased by £29m, and the resulting differences are significant. The analysis should include network length, which represents a more appropriate driver for activities like pipeline maintenance, mains and service cut offs, and leakage control. We request Ofgem to revise the basis of the analysis accordingly.

4.3 Emergency service

- We note that Ofgem has recognised the fact that WWU does have specific regional factors that influence the cost of running our region. However we believe the allowance in the UPs does not go far enough in adequately recognising the difficulty of the operating environment. Similarly, the regression analysis carried out by PB Power comprising the number of PREs, number of repairs and averages of GDN PREs and repairs does not reflect the specific regional factors of WWU. This is particularly the case with the emergency service where the one hour response standard coupled with the associated standby cover requirements significantly influences the employee numbers required, as well as the number and location of depots required. We believe the low value of R^2 in the Ofgem regression analysis confirms a poor correlation in the data.

- Despite some recognition of the characteristics of our network there is still a significant reduction in emergency allowance compared with our business plan. Such a reduction would have a major impact in our ability to meet the emergency standards of service.

  We would remind Ofgem that NGN who is at the efficiency frontier for emergency costs failed to achieve their service standard in 2006/07, so we cannot see how they can be determined to be the frontier performer. For our own part we were not much above the standard, which reinforces the view that any significant reduction in allowance (and hence resource) would have significant impact on performance.

- The UPs have disallowed £5m ongoing defined benefit pension cost as it is related to metering activity. We do not believe this is consistent with the IPs, which recognised that no emergency or other staff were employed exclusively in non-formula activity, and therefore this pension cost should be allowed (without double counting in the loss of metering revenue driver).

We request that Ofgem significantly raise the allowance for emergency service activities in the Final Proposals to a level which allows us to fulfil our obligations.

4.4 PRE workload

- The UPs contain a revised target of a 2% assumed reduction of mains repairs through the next 5 year period. We have provided data to Ofgem showing that the mains replacement programme has not had a significant influence on reducing mains repairs - indeed there has been a 3% increase in the number of actioned mains repairs over the five year period 02-07.

With this information of actual occurrence at their disposal, we request that Ofgem revise their assumptions for the incidence of mains repairs for the next 5 years in line with our own.

4.5 Impact of loss of meter work

- We note that Ofgem recognises the issue of loss of metering across the GDN's. However the proposals in the UPs for the 'tipping point' do not adequately reflect the residual costs of providing the emergency service. Emergency staff must be based in strategic locations to ensure that they are able to meet the 1 hour emergency response time, and the dispersed WWU service area with a low customer density requires a relatively larger number of emergency staff than most GDNs and any revenue driver should take this into account.

- We accept that with any loss of metering work contractors would be laid off first, and have assumed this in our analysis. The 'tipping point' should represent a hurdle at which point all avoidable costs have been eliminated (i.e. contractors) and GDNs are left with the fixed unavoidable costs that they have to incur to provide the required emergency service. These fixed costs should be "converted" into an ex ante allowance by an appropriate revenue driver.

- WWU has two significant metering contracts, both of which terminate early in 2008. The contracts are currently at tender stage, and the employer has required tenderers to provide dedicated staff to be employed on metering, which gives little option for the metering work to be used as infill work. WWU will therefore either lose the contract, or win it without being able to cover the fixed unavoidable costs imposed by our emergency service. Any revenue driver must therefore make allowance for this.

The proposed Ofgem model does not allow us the actual unavoidable fixed cost of losing meter work of £6m. We have recently submitted further detailed analysis to Ofgem which we believe clearly supports our analysis, and request they revise their allowance accordingly.

5. ADDITIONAL / OTHER COSTS

5.1 WWU network specific factors

We have been liaising with Ofgem for some time on the issue of WWU's specific regional factors, and we note that they have recognised the additional operating costs arising from the particular characteristics associated with our service area. However Ofgem has awarded less than 50% of the additional costs we identified in our detailed analysis to them, which results in an allowance of only £10m over the 5 years compared with the WWU analysis reporting the real cost as over £26m.

We received a number of supplementary questions from Ofgem in the lead up to the UPs, to which we fully responded. Ofgem's rationale for allowing significantly less than our submission was twofold:

- They believe their benchmarking already allows for a number of the factors which we raised; and,

- WWU's reasons for the higher costs have not been fully justified.

With these points in mind we asked John Spiller Associates (JSA) to see if they could address these issues. JSA have updated their previous work and this has already been submitted to Ofgem and a copy is attached to this response for completeness. In summary the updated piece of work;

- Responds specifically to the Ofgem challenges

- Updates the previous estimates of penalty costs by examining them in even more detail

- Develops a methodology which further improves the robustness of the previous 'penalty cost' calculations

- Fully aligns the costs with the recent submissions to Ofgem of supplementary question OP-WWU-1028.

This is the fourth piece of analysis provided to Ofgem on this specific subject, and we are confident that sufficient robust information has now been provided to allow Ofgem to revise their allowance in line with the WWU cost projections.

5.2 xoserve costs

We note from the UPs the significant cost reductions proposed by Ofgem in our allowed costs for xoserve – some £2m (13%) on opex and £1.5m (27%) on capex over the 5 years. These are costs which in reality ones we have very little influence over, and we have seen no analysis from Ofgem as to the rationale behind the reductions from our BPQ submissions.

5.3 Future skill shortages

We note that Ofgem recognise in the UPs the significant issue of skill shortages facing the GDN's over the coming years, and are proposing an allowance of £8.7m over the 5 years to cover the cost of recruitment and training. However they have disagreed with some of the underlying assumptions and questioned some of the analysis put forward collectively by the companies. We have responded separately to Ofgem with a detailed update of our analysis. The summary of our responses are as follows:

- Ofgem suggested that we did not make provision for apprentices in our BPQ submission. In fact we had submitted a figure of 12 per annum, which has now been increased substantially following further analysis.

- Ofgem suggested that GDN assumptions are unduly pessimistic about future shortages. In our case we believe the assumptions are actually conservative, for

example the assumption of 2% employee turnover against an actual current turnover rate in WWU of 3.7%.

- Following Ofgem's comments we have however revised our assumptions in some areas of the analysis, as follows:
  - the apprentice dropout rate has been reduced to 5%
  - workers being upskilled are assumed to be productive for 50% of the time, so employment costs have accordingly been reduced by 50%
  - assumptions have been amended to reflect apprentices being 30% productive in their final year, with employment costs reduced accordingly
  - We have also factored in alternative routes for gaining skilled staff, i.e. employment of migrant workers, contractors, direct recruitment from the market place, and the upskilling of existing employees.
- In order to address the obvious skills shortage we face in the coming years, we have calculated that it will be necessary to recruit around 340 new employees over the next 5 years, rather than the 125 being allowed by Ofgem. The difference is because Ofgem based the number of new recruits against current employee levels, whilst we have based our assumptions on the more representative numbers of projected leavers based on age profile. This in reality shows more accurately the gap we face.

Taking all the above factors together, we calculate that recruitment and training will actually cost a further projected £10.2m over the 5 year period, in addition to the £8.7m already allowed by Ofgem in the UPs. We request Ofgem revise the allowance accordingly.

6. REAL PRICE EFFECTS (RPEs)

- Ofgem have not changed the RPE assumptions used in the UPs from those used in the IPs, despite the lack of real objective evidence for their own assumptions. A substantial amount of credible external evidence has been provided by WWU and the other GDNs, and this external marketplace evidence is also reflected by the real price pressures actually being experienced by WWU. The table below illustrates the real prices movement experienced by WWU over the past two years, and the increases projected by key suppliers for the near future. Recent and expected materials price increases are well in excess of the proposed RPI+1% allowance.

Materials		% Increases in prices (Including RPI)		
		Actuals		Short-Medium Term
Main Commodity Type	Supplier	2006/2007	2007/2008	Projections(per annum)
Plastic Pipe and Fittings	Uponor	8.0%	14.0%	10.0%
Brass, Aluminium	Delta Fluid Products	8.5%	9.0%	6.0%
Copper	The Beck Co	68.0%	7.5%	6.0%
Stainless Steel, Bronze, Brass	George Fisher	10.0%	4.0%	5.0%
Reinstatement Materials	EPC	14.0%	23.0%	10.0%

We urge Ofgem to review the RPE assumptions in the face of credible marketplace information which we and the other GDNs have provided from well recognised cost consultants such as ChandlerKBS. Alternatively we reiterate our willingness to discuss the use of an agreed independent index for establishing RPEs going forward, which we believe would remove the significant risk that current estimates prove to be inaccurate over time.

7. CAPEX / REPEX

7.1 Productivity challenge

We note the reduction in the level of productivity challenge by Ofgem for capex to 1.5%, albeit maintaining the 2% challenge on repex. Ofgem has failed to provide any rigorous and objective assumptions underpinning these assumptions, or any rationale for the differences between the figures. Ofgem's comments in the UPs show the very subjective nature of how these figures are set:

"In response to initial proposals a number of GDN owners raised concerns regarding the productivity assumptions applied to connections, mains reinforcement and repex. We have reviewed these in the light of additional information and have revised the productivity assumptions for both mains reinforcement and connections to 1.5% per annum. We consider that a 2% per annum productivity assumption is still approporiate for repex based on the top end of the range of assumptions put forward by the GDNs."

Ofgem has not discussed why the figure at the 'top end' of the range is appropriate, or indeed why a figure quoted by one company would necessarily be appropriate for others. Even within the terms of Ofgem's own framework, the 'top end' estimate might include substantial 'catch-up' (which is not available to all GDNs), as well as 'frontier shift' (which would apply to all GDNs). These points serve to illustrate the lack of any real supporting evidence or justification for setting what appear to be very subjective targets. Our concerns are echoed in the attached NERA report, which says:

"In areas of capex other than connections, PB Rune has regressed costs on CSVs, but has not justified its choices of weights within each CSV, and in some cases has not even reported its choices. PB Rune has not reported the data used in these regressions, so others cannot replicate or review the analysis. This approach is not compatible with objective and transparent regulation" (2.2.1)

We believe these figures still represent an unrealistic challenge, particularly when overlaid on top of the base activity challenges set by Ofgem. We urge Ofgem to review these and set targets that are more reflective of reality in the external market place.

7.2 Local Transmission System (LTS) Investment

There are a number of specific and detailed factors relating to LTS which we have outlined in detail in the main response document. We summarise them here for the information of senior Ofgem officials and Authority members.

- We note that PB Power have recognised the risk of potential storage shortfalls in NTS storage provision and the subsequent need for us to construct pipelines to reduce our reliance on NTS. However we believe this issue should be addressed now and not deferred as recommended by PB Power, as the risk will only intensify with time.

- Assured system pressures from National Grid have been reduced which removes the previous uncertainty, and confirms the requirement to construct the Bancyfelin to Lampeter Velfrey pipeline (South Wales) in the period 2008 -13.

- PB Power recommended that the South West storage deficit can be addressed in part by securing gas from Southern. This would require a change to the Uniform Network Code to permit inter-network trading, and to complete such a change would require an agreement by the whole industry, which would probably take a minimum of six months to achieve.

- We are in any event surprised by this recommendation since in the UP's (4.18) there is reference to Southern needing to construct three major pipelines to provide storage for themselves, and PB Power recommending that storage can be taken from the NTS. Given such circumstances it would be very unlikely that Southern would be able to transfer any storage to WWU.

7.3 Mains reinforcement

- With this activity there is clearly some volatility of workload. We note from our analysis that there are some variations in workload length in 06/07, and in comparison with other years. We believe that the issues associated with this could be addressed by smoothing the analysis over two years of outturn figures, that being 05/06 and 06/07 so that an average of both years can be used in the regression analysis.

- We also note that NGG's unit cost for Mains Reinforcement is lower than their Replacement work. Intuitively this cannot be correct and is probably as a result of misallocation of cost. This distorts the regression analysis with regard to Mains Reinforcement.

Again, we believe that by using the average of two years of outturn figures from 05/06 and 06/07 will help to address any uncertainty that may arise from only using one year's data. This would increase WWU's allowance from £23m to just over £26m.

7.4 Non - operational capex

We note in the UPs that Ofgem are still not allowing the full cost of GTMS replacement and system control separation across the GDNs. We reiterate our firm view that system control separation to individual GDNs was specifically requested by Ofgem at network sale, and should therefore be fully allowed - subject of course to the usual challenge of efficient expenditure. In the case of WWU this amounts to over £11m in total, with Ofgem only currently allowing some £1.8m of the costs in the next 5 year period.

We request that Ofgem allow the full cost of GTMS replacement and system operation separation in the 5 year allowances going forward.

8. COST OF CAPITAL

We believe that the "modelling assumption" for cost of capital of 4.84% post tax "vanilla" used in the UP's is below that required to enable WWU to fund its activities and provide an appropriate return to those who have made a significant investment in the gas networks, and will be required to invest further to meet necessary capex and repex programmes. Our headline views are summarised below and these are expanded in the main body of the response and in the Oxera* report attached.

8.1 Business risk

We believe that the gas distribution business demonstrably faces higher business risk than the gas transmission business and consequently a higher cost of equity than given in TPCR is appropriate. We have previously submitted papers prepared by Oxera which indicate that the asset Beta of a gas distribution business is 0.2 higher than a transmission business.

In addition, we have considered qualitative differences in risk between Distribution and Transmission. The principal areas of incremental risk are:

- The significant proportion of GDN workload and activity which is driven by, and in response to, external factors such as new and existing consumers, Health & Safety Executive and Local Authorities.

- Being further "downstream" in the gas supply chain, GDNs work within the community its infrastructure serves, and are more affected by the external factors above on a day to day basis.

- Requirements to comply with standards of service set and monitored by Ofgem with penalties for failure, coupled with efficiency challenges and Real Price Effects below company forecasts.

- 'Re-openers' that require GDNs to bear a disproportionate unfunded cost before they apply, and exposure to areas, such as changes in Health & Safety legislation and its application where re-openers do not apply.

- Uncertain risks arising from the exit and interruption regime which is still under development.

- Biased penalty mechanisms which make no allowance for the diminishing returns on costs in achieving 100% compliance.

- Potential disallowance of future costs, such as rates or taxation, which are subject to a "best endeavours" test to be applied retrospectively.

The table below is an extract from detailed analysis which identifies increased cashflow exposure relative to Transmission and the increase in WACC required to compensate for these incremental risks. Incremental risk has been classified by risk driver as due to:

	Increase in "vanilla" WACC %
Methodology of price control	0.26%
Impact of re-openers and incentives	0.52%
Inherent risk difference	0.89%
	1.67%

Incremental risk due to price control methodology and the design of re-openers and incentives can be mitigated in the Final proposals by correction to the control. The inherent risk difference will, however, remain and should be reflected in gas distribution WACC.

Note that WWU's estimate of the inherent risk difference is 0.89%. This is higher than Oxera's estimate of the same effect of 0.1725% increase in post tax vanilla WACC (0.46% on cost of equity at 62.5% gearing) which should be considered the minimum differential.

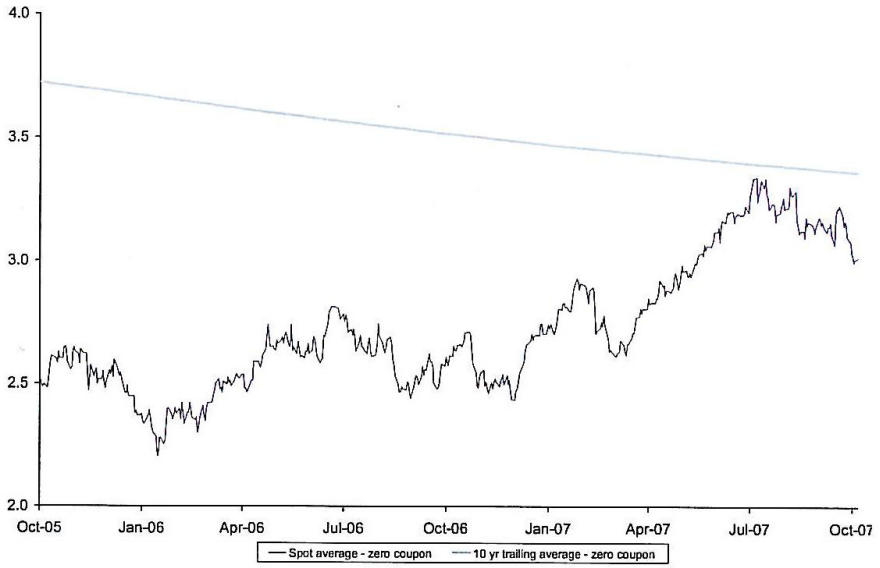
8.2 Cost of debt

We believe that the cost of debt to be assumed for the period 2008-13 must reflect the following considerations:

- 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%.

- Whilst 10 year trailing average interest rates have declined since the TPCR, short term rates have increased. The financial markets have been affected in the summer and autumn of 2007 by concerns over price and availability of credit. The "headroom" between 10 year trailing rates and spot rates has reduced, significantly since TPCR such that it is now entirely possible for future short term rates to be higher than the 10 year trailing average that Ofgem has previously used as a guide to an appropriate cost of debt. The 10 year trailing average should not be used.

Ofgem's interest rate Figure 9.1, Updated by Oxera



The minimum cost of debt to be adopted should therefore be at least a risk free rate of 2.5% plus a debt premium of 1.25% - consistent with TPCR and current 10 year debt premia for A/BBB rated debt.

8.3 Cost of equity

The appropriate cost of equity is at least the 7.5% that Ofgem has set itself as the maximum cost of equity for the price control due to the effect of risk differential between gas distribution and transmission businesses and the effect of gearing. Oxera have estimated in *GDPCR Response to Ofgem's updated proposals on the cost of capital** that the effect of risk differentials and gearing, when compared to TPCR, requires a cost of equity of 7.78%.

The notional gearing assumption of 62.5% is higher than that assumed in the TPCR of 60%. Economic theory requires a higher cost of equity as gearing increases. Oxera have calculated that this alone would result in higher cost of equity of 7.32%

Taking into account the effect of gearing and increased risk of distribution relative to Transmission supports a cost of equity of at least 7.78%:

Transmission Price Control (Dec 2006)	7.0%
Effect of gearing	+ 0.32%
Effect of increased business risk	+ 0.46%
	7.78%

As noted above, WWU's view is that Oxera underestimate comparative business risk, and cost of equity should be higher.

8.4 Financeability

We have previously commented on the importance of Post Maintenance Interest Cover Ratio (PMICR) when assessing financeability. PMICR is used by credit rating rating agencies, providers of finance, and is a key covenant in our debt structure. 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.

Ofgem's own modelling assumptions for the UPs show a Post Maintenance Interest Cover (PMICR) of around 1.3x which is below the 1.5x -1.6x quoted by Ofgem as indicative of "comfortable investment grade". However, Ofgem appear to have proposed two significant changes in its methodology for assessing financeability, to allow them to conclude that a low PMICR does not present a financeability issue, that is:

- assumed that a proportion of debt is index linked when assessing PMICR; and,

- reduced the acceptable benchmark for an appropriate PMICR based on 100% non-index linked debt to 1.3x. The equivalent 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 (both of which are close to "comfortable investment grade" criteria noted above).

WWU believe it is not appropriate for Ofgem to redefine supposed financial constraints in this manner.

Future financeability is also affected by the very real risks on our future cash flows which would have significant impacts, such as:

- Failing to meet the challenging opex cost reductions in the UPs, and potential costs in excess of allowances such as above inflation cost pressures.

- 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.

- Any adverse working capital movements due to factors outside our control, for example changes in shipper transportation prepayment arrangements.

- Potential events for which Ofgem has either precluded the opportunity of a "re-opener", such as Health & Safety requirements, or has set the de minimus level for a re-opener inappropriately low, such as TMA where costs of up to £2.5m per annum would need to be borne by the business before a re-opener.

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

8.5 Overall WACC

For all the reasons given above, we believe the post tax 'vanilla' WACC should be at least 5.26%.

	Oxera	WWU
Cost of Debt		
Risk free rate	2.5%	2.5%
Debt Premium	1.25%	1.25%
	3.75%	3.75%
Cost of equity		
Transmission Price Control (Dec 2006)	7.0%	7.0%
Effect of gearing	+ 0.32%	+ 0.32%
Effect of increased business risk	+ 0.46%	+ 2.37%
	7.78%	9.69%
Gearing 62.5%		
Post Tax "vanilla" WACC	**5.26%**	**5.97%**

9. FORM AND STRUCTURE OF THE PRICE CONTROL – DEADBAND

Ofgem consider a deadband of 3% is appropriate. We consider that this is insufficient and the deadband should be at least equal to the current limit of 4% for the following reasons:

- 2008/9 to 2012/13 GDPCR has increased incentive revenue as a proportion of total revenue and therefore revenue during the upcoming price control period is potentially still as volatile as currently, regardless of the removal of the volume driver.

- 35% of collected revenue is still linked to throughput.

- Exit Capacity has an incentive target of circa £ 40m

- The MSRA incentive now has services included, which adds over £20m to the incentive and the emissions incentive also adds more uncertainty. We accept there are caps to some of these incentives but they are additional and merit at least an equal deadband.

WWU recognises that without a volume revenue driver allowed revenues will be much more stable than in the past. However the ability to stay within the deadband proposed by Ofgem also depends on the volatility of actual revenue from tariffs. If tariffs have a volume driver, weather-related volatility will still affect actual revenues. In fact, if allowed revenues no longer vary up and down with the weather, weather variation may cause even bigger gaps than before between actual revenues and allowed revenues.

The deadband should be at least 4% due to the new incentives and weather related volatility.

10. UNCERTAINTY AND REOPENERS

- Whilst we note the proposals to deal with the future significant costs of the Traffic Management Act (TMA), we believe these can be refined to produce a more equitable outcome. There are a number of factors that will make up total TMA

costs - including, for example permit fees and fines and penalties. Some of these items are wholly outside of the GDNs control and should therefore be allowed as pass through items specifically allowed in the licence conditions. A good example is permit fees.

- There are other classes of expenditure involved that the GDNs can exert influence over such as fines and penalties. However it is clear from previous analysis provided to Ofgem that it is not economical for GDNs to resource up for 100% compliance. A pragmatic solution would be to allow for a small element of failures, with Ofgem providing allowances commensurate with a sensible "efficient" level of fines and penalties.

- We also support the proposed reopener on Tax, which should extend to cover the possible change in tax treatment of landfill waste - where we face significant potential increases going forward. From October 2007 the Landfill Regulations will require all non hazardous waste to be tested against Waste Acceptance Criteria (WAC) prior to disposal to landfill. This testing is likely to cost around £300 per time and would require the materials to be stored separately at a licensed site until the results are available.

- Advice we have received from specialist consultants MJCA also suggests there is considerable risk that some GDN waste will be reclassified to active resulting in a significant cost increase from £2 per tonne now to £32 per tonne from April 2008, and £48 per tonne by 2010.

In summary,

- We assume that the tax and TMA re-openers have a trigger of 1% of turnover in aggregate, to treat them separately would result in WWU potentially being exposed to un-compensated annual costs of £4.9m for the price control period.

- Due to the uncertainty surrounding this issue we believe that there should be a specific and ring-fenced reopener to cover waste management costs.

Appendix

The report below was submitted as part of our response to the Initial Proposals on 13th July 2007

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

The reports below were submitted as part of our response to the Fourth Consultation document on 25th April 2007 and also as part of our response to the Initial Proposals on 13th July 2007

- Network Cost Drivers - A Bottom Up Approach 25th April 2007 - Report prepared by John Spiller Associates
- Direct Cost Review 18th April 2007 - Report prepared by Third Horizon Consulting
- Support Services Review 18th April 2007 - Report prepared by Third Horizon Consulting
- Review of Ofgem GDPCR (Capex/Repex) – Five Year Control 25th April 2007 - Report prepared by Mouchel Parkman (MP)
- Wales & West Utilities Report on Price Indices March 2007 - Report prepared by Chandler KBS
- Gas Distribution Price Control Review: Reports on Costs 10th March 2007 – Report prepared by NERA
- A Report Prepared by Willis Insurance Brokers Reviewing LECG's Report Relating to Insurance April 2007 - Report prepared by Willis Insurance Brokers
- The 2007 Gas Distribution Price Control Review: A Top-down Analysis of the Scope for Real Terms Cost Reductions April 2007 - Report prepared by First Economics

GAS DISTRIBUTION PRICE CONTROL REVIEW – UPDATED PROPOSALS

WALES & WEST UTILITIES LTD

RESPONSE TO THE UPDATED PROPOSALS

PART 2 – APPENDICES

(attached as separate Adobe Acrobat documents)

- Appendix A - Review of Ofgem Benchmarking Studies – NERA, 15th October 2007
- Appendix B - Top Down Analysis of the Scope for Real Terms Cost Reduction (a Follow up Note) - First Economics, October 2007
- Appendix C - Network Cost Drivers, A Bottom Up Approach (an updated report on behalf of Wales & West Utilities) - John Spiller Associates, 18th October 2007- please note that this report is confidential
- Appendix D - Impact Assessment of the Proposed Ofgem Opex Reductions - Third Horizon, 18th October 2007 (includes an assessment of industry benchmarking)
- Appendix E - The disposal to landfill of road spoil from the excavation of trenches from utility services. Review of the future implications of Landfill Tax – MJCA, October 07
- Appendix F - Response to Ofgem's updated proposals on the cost of capital – Oxera, 19th October 2007
- Appendix G - Loss of Metering Work and its Impact on Emergency Costs - John Spiller Associates, 20th October 2007
- Appendix H - EU Skills Recruitment Model

GAS DISTRIBUTION PRICE CONTROL REVIEW – UPDATED PROPOSALS

WALES & WEST UTILITIES LTD

RESPONSE TO THE UPDATED PROPOSALS

PART 3 – DETAILED RESPONSE

In accordance with the requirements of the Updated Proposals (UP) document, we set out below each of the Ofgem questions and our responses thereon. Following the document structure, we have noted the relevant paragraph number(s) to which we are responding.

PART 3 – DETAILED RESPONSE

CHAPTER 2 – FORM STRUCTURE AND SCOPE OF THE PRICE CONTROL

Paragraphs 2.6 – 2.7

- Whilst we note the proposals to deal with the future significant costs of the Traffic Management Act (TMA), we believe these can be refined to produce a better and more equitable outcome. There are a number of factors that will make up the total TMA costs, including, for example permit fees and fines and penalties. Some of these items are wholly outside of the GDNs sphere of influence and should therefore be allowed as pass through items specifically allowed in the licence conditions. A suitable item for such treatment is permit fees.

- There are other classes of expenditure involved that the GDNs can clearly exert influence over such as fines and penalties. However it is clear from previous analysis provided previously to Ofgem that it is not economical for GDNs to resource up to a level that would achieve 100% compliance. We believe a pragmatic solution is to allow for an element of failures and thereby Ofgem should provide opex allowances commensurate with an "efficient" level of fines and penalties.

- We also support the proposed reopener on Tax, and believe it should be extended to cover the possible change in tax treatment of landfill waste where we face potential increases going forward. From October 2007 the Landfill Regulations will require all non hazardous waste to be tested against Waste Acceptance Criteria (WAC) prior to disposal to landfill. This testing is likely to cost around £300 per time and would require the materials to be stored separately at a licensed site until the results are available.

  Advice we have received from specialist consultants MJCA (submitted on 22 October 2007 as appendix E) suggests there remains considerable risk that some GDN waste will be reclassified from inactive to active, resulting in a significant cost increase from £2 per tonne now to £32 per tonne from April 2008, and to £48 per tonne by 2010/11.

  We assume that the tax and TMA re-openers have a trigger of 1% of turnover in aggregate, to treat them separately would result in WWU potentially being exposed to un-compensated annual costs of £4.9m for the price control period

  Reopeners whilst being individual should also be cumulative and not on an annual basis. For the avoidance we illustrate this point with the following example. Assume a 1% materiality threshold – turnover of £250m. A GDN incurs additional TMA costs of £1m each year. After three years the total GDN exposure will be £3m. At this point a GDN claim would be permitted and the full £3m costs recovered.

  In summary, due to the uncertainty surrounding this issue we believe that there should be a specific and ring-fenced reopener to cover waste management costs.

Paragraphs 2.8 – 2.10

We consider that the 3% deadband is insufficient and should be at least equal to the current limit of 4% for the following reasons:

- 35% of collected revenue is still linked to system throughput. We recognise that without a volume revenue driver allowed revenues will be much more stable than in the past. However the ability to stay within the deadband proposed by Ofgem also depends on the volatility of actual revenue from tariffs. If tariffs have a volume driver, weather-related volatility will still affect actual revenues. In fact, if allowed revenues no longer vary up and down with the weather, weather variation may cause even bigger gaps than before between actual revenues and allowed revenues.

- 2008/9 to 2012/13 GDPCR has increased incentive revenue as a proportion of total revenue and therefore revenue during the upcoming price control period is potentially still as volatile as currently, regardless of the removal of the volume driver.

- The mains and services replacement adjustment (MSRA) incentive now has services included, and in addition, exit capacity and emissions incentives also add more uncertainty. We accept there are caps to some of these incentives but they are additional and merit at least an equal deadband.

PART 3 – DETAILED RESPONSE

CHAPTER 3 – OPERATING EXPENDITURE ANALYSIS

Response to Questions 1-2

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

- We remain extremely concerned with the methodology used by Ofgem and the fact that its findings are subsequently not robust. We believe its approach certainly does not provide sufficient justification for the significant legitimate costs being disallowed, as outlined in the overview. Our views on the methodology used by Ofgem are fully supported by our external consultants generally, and NERA in particular. These views can be summarised as follows:
    - Ofgem's benchmarking analysis uses regressions which are unreliable because they use too few data points
    - Ofgem's benchmarking analysis produces results which are not consistent between methods
    - Ofgem has not allowed for the inability of its benchmarking techniques to distinguish 'inefficiency' from unmeasured differences between the different companies
    - Ofgem has not fully corrected for the unrealistic efficiency targets that arise from benchmarking different cost categories separately, and then adding these all together to create a 'best in class' composite
    - Ofgem has not applied a consistent policy regarding 'efficiency catch up', and has not allowed GDNs the cost of improving efficiency – particularly given it has not allowed any glide path to achieve these cost reductions
- We note that Ofgem has recognised the flaws in the bottom up approach to benchmarking by introducing in the UPs a top down upper quartile approach. However as this is still combined with a flawed bottom up analysis it still produces an inequitable and inconsistent outcome. The resulting difference between the two approaches confirms our view that only top down benchmarking is the reliable method for assessing overall cost efficiency.
- SGN indirect cost data is acknowledged to be based upon a marginal cost charging methodology for services provided by SSE. Ofgem have attempted to address this by using the next lowest company when SGN sets a bottom up benchmark. However the adjustment is not complete because SGN lower marginal costs are not corrected in the top down benchmarking towards which bottom up cost allowances are uplifted. Ofgem should omit them altogether from the analysis.
- NGN costs should be increased for benchmarking purposes to allow for the increased expenditure necessary to meet the required standards of service, some of which they failed to achieve in 2006/07.

- We asked NERA to undertake an independent review of the benchmarking used by Ofgem for the UPs. The attached report supports our view of the lack of logic and rationale in most of the benchmarking. The following comments by NERA are reflective of the overall views in their report:

  "Another example where Ofgem's benchmarking approach lacks economic logic relates to the choice of benchmarking variable for indirect opex. For the indirect opex benchmarking, Ofgem uses GDNs' revenue as a driver for costs in a number of activities (UPs, tables A7.3-A7.10). This approach makes GDNs appear less 'efficient' in indirect opex, if (compared to their comparators) they have reduced costs in other categories and therefore have lower revenues. Such perverse effects arise because Ofgem's consultants have adopted a number of ad hoc benchmarks without giving proper consideration to the economic rationale for their approach" (1.1.4)

- Even Ofgem's consultants themselves recognised that their benchmarking did not take account of unobserved or immeasurable differences between GDN's. For instance the LECG report on Indirect Costs states that:

  "variations in GDN performance may be due to factors such as difference in organisational structure. For example for FTE based metrics, a lower cost per FTE may be due to more outsourcing rather than efficiency" (2.18)

- Finally, we would draw Ofgem's attention to the obvious differences in approach to benchmarking between Ofgem in this price review, and the CAA initial proposals for Heathrow, Gatwick and Stanstead airports in December 2006. The attached Third Horizon contains a table showing the key differences in approach, which is reproduced below.

CAA Approach[1]	LECG Approach[2]	Impact of LECG Approach
Median approach to benchmark targets	Top Quartile approach to benchmark targets	Target reductions consistently set above industry average, and in most cases, above world class performance
Accounts for variations in comparison groups (i.e. customer profile and economies of scale)	No consideration of regional or GDN specific factors or the proven relationship between support cost and overall size	Allowances fail to reflect the unique environment WWU operates in
Benchmark analysis performed at the process level with consideration of performance drivers	Benchmark analysis performed at the functional level which does not account for performance drivers	Target reductions do not take into account size of operation and resulting support requirements
Consideration of the impact of cost drivers when analysing results (normalising a wide cross section of comparisons)	Comparison groups have not been normalised to account for individual cost drivers	Target reductions do not account for unique cost drivers, such as geographic reach
Consistent and formally defined approach to benchmark selection	Benchmarks 'cherry picked'	Efficiency targets implied by LECG lack justification and credibility
Alignment of processes to the needs of the business and consideration of quality of service	No consideration of the impact of cost reductions on quality of service	Target reductions will impact the quality of service offered by WWU to its clients
Consideration of the cost of projects in OPEX reductions (the ability to benefit from CAPEX projects)	No relationship acknowledged between CAPEX, OPEX and REPEX when setting targets	Target OPEX reductions will have an impact on CAPEX and REPEX creating even greater difficulty in achieving targets across the consolidated cost base

1. CAA initial price control proposals for Heathrow, Gatwick and Stanstead airports, Dec 2006
2. Update assessment of GDN indirect opex based upon 2006/07 actual performance. 24 September 2007

It is evident that the CAA took a much more balanced and transparent approach to benchmarking performance, with a clear reference to important factors such as:

- Consideration of the impact of cost drivers when analysing results
- A consistent and formally defined approach to benchmark selection
- Clear consideration of quality of service
- Consideration of variations in comparison groups (ie customer profile and economies of scale)

The Competition Commission were comfortable with this approach.

We believe that on the specific instruction of Ofgem, none of the above factors have been taken into consideration by Ofgem's consultants.

We have a number of specific concerns which we have set out below:

i) Productivity Challenge

We believe that First Economics (FE) in their joint GDN sponsored review of the report prepared by Reckon for Ofgem, have presented compelling evidence that Ofgem's frontier shift adjustment is not well supported and lacks a solid foundation for its point estimate. They make the following general comments in their report:

> *"…the figures that Reckon has put forward in its report and which Ofgem has reproduced in its updated proposals document, are not therefore a measure of the underlying labour productivity improvement in comparator industries, but rather an entirely fictitious account of what labour productivity would be if the contribution that investment makes to TFP growth is arbitrarily marked down to zero. This is of no relevance to the exercise that Ofgem is engaged in. In order to set opex efficiency assumptions, Ofgem needs to know how much productivity growth the GDNs will be able to produce during a period in which their investment programme is dominated by like for like replacement. Simply assuming away the contribution that investment has been making to productivity growth in other industries is no way of taking on this task…" (2.2)*

FE go on to make the following pertinent comments in their report which supports their ultimate conclusions:

> *"Ofgem, in particular, lacks a solid foundation for its point estimate, so the key question is whether it makes sense to be forecasting that the GDNs will go on reducing opex in real terms indefinitely…"*
>
> *"One useful point of reference is the performance of other mature network businesses during the last five years. Our April 2007 work showed that opex in several industries had been drifting upwards in recent years and that out-performance had started to give way to under-performance..."*
>
> *"Finally, one can look to see where in the UK economy there is evidence that companies have been able to reduce opex in real terms year on year. Our work*

(using the RPI data set) indicated that the only part of the service sector in which this appears to be achievable is the telecoms sector. Everywhere else service sector firms are experiencing real terms cost increases from one year to the next.

All of the above factors lead us to conclude that Ofgem's frontier shift assumption is not well supported and not likely to describe very accurately the underlying trend in GDN costs…"

We believe Ofgem should revise their challenge to a more realistic level, by addressing two key issues:

1. Reduce the unrealistic 2.5% productivity assumption to a lower number that is supported by credible market place evidence. We note for example the recent review by the Competition Commission of the CAA price review of the London airports, where the efficiency challenge was set at 1.5% per annum with no frontier shift.

2. Give allowances for restructuring and redundancy costs, recognising (like the CAA in its review of NATS) that productivity savings cannot be achieved without cost, and that it is inappropriate for customers to benefit from lower future costs without paying upfront for the costs incurred during the transition to a lower recurring cost base.

- A final point on any proposed level of productivity challenge. There are a number of cost categories that are clearly outside our control but which are impacted by the generic productivity assumption used in the UPs. Two obvious examples of these are wayleave costs and the Network Services Agreement with National Grid for emergency call handling. The UPs take no account of these issues, and places a 2.5% challenge on all costs, including ones where WWU has very little or no influence.

ii) Cost and rate of transition to achieve efficiencies

- Given the labour intensive nature of the GDNs, any significant improvement in productivity is likely to require restructuring and resultant redundancy costs. However Ofgem makes no allowance for such costs despite setting challenging productivity improvements. As FE point out in the attached report:

  "Given the type of business that the GDNs run, a significant proportion of any productivity savings will have to come through a reduction in the labour force. These manpower reductions are not costless; rather we would expect the GDNs to have to pay sizeable redundancy payments…we would expect these costs to be recognised somewhere within Ofgem's price controls and we note that there is regulatory precedent for this in the CAA's most recent review of NATS"

We believe that Ofgem needs to make allowance for the fact that achieving productivity improvements actually costs money, and that time needs to be allowed to achieve such improvements – both factors absent from the Ofgem proposals.

- In other regulated sectors where efficiency targets have been set, companies have been allowed time to achieve the benchmarks set by applying a 'glidepath' from the current level of costs. This allows additional revenue to finance the one off costs of reducing opex costs and reflects the clear understanding that

reducing costs takes time. Providing no glidepath implies that the regulator is confident that any 'excess' costs are being incurred unnecessarily and inefficiently, and can be immediately reduced.

- Even Ofgem's consultants recognise that achieving efficiencies takes time. In its updated September report, PB Rune's recommendations for work management, emergency and maintenance costs all assume that companies will be able to close 70% of an efficiency gap by 2012/13. If Ofgem decide not to allow such a glidepath, but to impose a benchmark level of cost immediately, it will clearly be acting against the recommendations of its consultants.

iii) Direct Cost Benchmarking

Our concerns with elements of the direct cost analysis and benchmarking remain.

We believe that bottom up benchmarking of individual activities does not fully reflect all the drivers impacting on costs and does not take into account factors such as geographical spread sparsity and network length.

In our responses to the 4th Consultation Document and the Initial Proposals we have provided historic data to support our workload forecasts for both Emergency and Repair activities and we maintain that Ofgem's projections for decreases in workloads in these areas are overstated.

Work Management activity

- We question the validity of cost allocation and normalisation carried out by PB Power in their updated report, which has significant subsequent impact on the regression analysis and allowances proposed. For example, PB Power indicate that Scotia has reallocated costs in 06/07 from Work Management to other activities. We believe there is inconsistency in the treatment of such costs across the GDNs which results in a reduction of allowance of almost £11m for WWU. Such cost movements resulting in these material differences are not credible.

- Our concerns over the suitability of the Composite Variable and the regression analysis used to produce the bottom up costs remain. The approach does 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, all of which impact on the number of operational staff required to work remotely from the core work management function.

WWU has been disproportionately and unfairly affected by the revised normalisation and cost allocation undertaken in the UPs by £11m. We request that Ofgem address this by removing Scotia from the analysis, as the numbers carry no credibility and create a distorted and inequitable outcome.

Maintenance activity

The revised analysis used by Ofgem has reduced our allowance by £5m, while other GDNs have gained significantly. For example SGN's allowance has an additional £29m, which is an increase of 40% from Initial Proposals, with South obtaining an extra £20.2m.

This must surely lead Ofgem to question the cost allocation and normalisation process and the validity of the drivers used in their analysis.

- *Normalisation*

We believe there are still a significant number of inconsistencies in the data submitted by the GDNs and the allocation of these costs within the Maintenance activities.

PB Power addressed this issue in their updated report by combining all three Maintenance activities and then carrying out a regression analysis of total routine maintenance costs.

However the analysis carried out to separate routine and non routine expenditure has not been sufficiently detailed or robust and we believe that PB Power have failed to recognise the full extent of "non-routine" maintenance expenditure within our 2006/07 maintenance costs.

The analysis of Storage non routine expenditure, amounting to £10.5m has included holder painting, working at heights and demolition but elements of expenditure on major repairs to holders remain within the sums identified by PB Power as routine maintenance.

For example in our response to a supplementary question (WWU176) we indicated that our costs for High Pressure Storage in 2006/07 included expenditure of £142k on painting of our HP receivers at Weston Super Mare; these costs have not been removed by PB Power prior to their regression analysis of total routine maintenance.

Within LTS the costs of On Line Inspections of LTS pipelines has been identified as non routine expenditure and removed prior to the regression analysis, but repair work resulting from these inspections is treated as routine and left within the main analysis.

Within Other Maintenance we believe there has been insufficient investigation into the range of costs and activities included. Our District governor maintenance costs for 06/07 include an element of building remedial work which could be considered as non routine, which has a value of £200k.

- *Analysis*

PB Power developed a composite scale variable based on drivers of Offtakes and PRS numbers, Network length (above and below 7bar, Non PE length, District Governor numbers, Low Pressure holder numbers, Network throughput and Repair numbers giving each an equal weighting in their analysis.

Within the Updated Proposals analysis these drivers have been amended by Ofgem with no rationale given for the choice or weighting of the drivers used.

The revised drivers are the number of pressure reduction stations and NTS offtakes (weighting 66%), District Governors (weighting 26%) and holders (weighting 8%). There is no explanation as to why length of >7bar pipeline has not been included, nor any account taken of mains and service work which for WWU makes up 27% of 06/07 expenditure within the "other maintenance" activity.

The subjective nature of the weighting means that WWU is being particularly unfairly treated as 35% of the cost incurred in 06/07 is not represented by a categorised cost driver.

We believe that Network length which represents a more appropriate driver for activities like pipeline maintenance, mains and service cut offs, and leakage control has an impact on WWU maintenance costs and that it should be taken into account by Ofgem in their analysis.

- Non routine costs

- WWU highlighted to Ofgem's consultants (within the BPQ narrative, cost visit and response to supplementary WWU136) a requirement to carry out additional condition monitoring work of 555kms of its HP pipelines at a cost of £480k (£160k pa for three years from 08/09). These costs have not been included within WWU's allowances.

- There appears to be inconsistencies with costs removed prior to regression analysis and those added back to form total allowed expenditure. For example £1.5m of HP Storage Non Routine costs were removed prior to regression; only £1.1m was added back – £200k has been lost in rounding and £200k removed altogether (with no explanation why they have been disallowed).

- We have previously provided details of our Low Pressure Holder painting programme and forecast costs. All our 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. PB Power have assumed this constitutes 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 Holder 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 painting 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 would urge Ofgem to reassess the allowance of £1m for holder painting to ensure it is sufficient for WWU to carry out its proposed programme over the review period which we forecast to be £1.9m.

Other direct activities

We note the revision in methodology adopted by Ofgem but are concerned that this requires an 18% reduction in forecast costs over the review period.

Emergency service

- We note that Ofgem has recognised the fact that WWU does have specific regional factors that influence the cost of running our region. However we believe the allowance in the UPs does not go far enough in adequately recognising the difficulty of the operating environment. Similarly, the regression analysis carried out by PB Power comprising the number of PREs, number of repairs and averages of GDN PREs and repairs does not reflect the specific regional factors of WWU. This is particularly relevant to the emergency service where the one hour response standard coupled with the associated standby cover requirements significantly influences the employee numbers required, as well as the number and location of depots required. We believe the low value of R^2 in the Ofgem regression analysis confirms a poor correlation in the data.

- Despite some recognition of the characteristics of our network there is still a significant reduction in emergency allowance compared with our business plan. Such a reduction would have a major impact in our ability to meet the emergency standards of service.

  We would remind Ofgem that NGN who is at the efficiency frontier for emergency costs failed to achieve their service standard in 2006/07, (attendance at uncontrolled escapes within one hour) so we cannot see how they can be determined to be the frontier performer. For our own part we were not much above the standard, which reinforces the view that any significant reduction in allowance (and hence resource) would have significant impact on performance.

- The UPs have disallowed £5m ongoing defined benefit pension cost as it is related to metering activity. We do not believe this is consistent with the IPs, which recognised that no emergency or other staff were employed exclusively in non-formula activity, and therefore this pension cost should be allowed (without double counting in the loss of metering revenue driver).

We request that Ofgem significantly raise the allowance for emergency service activities in the Final Proposals to a level which allows us to fulfil our obligations. Ofgem should reinstate the £5m disallowed pension costs.

PRE workload

- The UPs contain a revised target of a 2% assumed reduction of mains repairs through the next 5 year period. We have provided data to Ofgem showing that the mains replacement programme has not had a significant influence on reducing mains repairs - indeed there has been a 3% increase in the number of actioned mains repairs over the five year period 02-07.

With this information of actual occurrence at their disposal, we request that Ofgem revise their assumptions for the incidence of mains repairs for the next 5 years in line with our own.

Impact of loss of meter work

- We note that Ofgem recognises the issue of loss of metering across the GDN's. However the proposals in the UPs for the 'tipping point' do not adequately reflect the residual costs of providing the emergency service. Emergency staff must be based in strategic locations to ensure that they are able to meet the 1 hour emergency response time, and the dispersed WWU service area with a low customer density requires a relatively larger number of emergency staff than most GDNs and any revenue driver should take this into account.

- We accept that with any loss of metering work contractors would be laid off first, and have assumed this in our analysis. The 'tipping point' should represent a hurdle at which point all avoidable costs have been eliminated (ie contractors) and GDNs are left with the fixed unavoidable costs that they have to incur to provide the required emergency service. These fixed costs should be "converted" into an ex ante allowance by an appropriate revenue driver.

- WWU has two significant metering contracts, both of which terminate early in 2008. The contracts are currently at tender stage, and the employer has required tenderers to provide dedicated staff to be employed on metering, which gives little option for the metering work to be used as infill work. WWU will therefore either lose the contract, or win it without being able to cover the fixed unavoidable costs imposed by our emergency service. Any revenue driver must therefore make allowance for this.

The proposed Ofgem model does not allow us the actual unavoidable annual fixed cost of £6m for the loss of meter work. We have recently submitted further detailed analysis to Ofgem which we believe clearly supports our analysis, and request they revise their allowance accordingly.

iv) Indirect Costs

a) Benchmarking

Our consultants' reports considered the position from the perspective of the industry as a whole, rather than just from the standpoint of Wales & West. Specifically, the reports we submitted to you, prepared by ChandlerKBS, Third Horizon, NERA and First Economics, are based on independent sources and external data, draw comparisons with other efficient companies in the gas industry and in other utility sectors and are of industry-wide application. With this in mind, we took the decision to make these reports publicly available. We also provided you with all relevant source information and background data for ease of analysis.

We note that WWU submitted reports by credible independent consultants which covered industry wide issues applicable to all GDNs some months ago.

Although Ofgem commissioned external work by LECG which purported to benchmark indirect costs, we seriously question the validity of the work undertaken. In particular it is evident that Ofgem restricted the breadth normally required of such work. The following comments from the LECG report reflect the:-

"However, we have been instructed by Ofgem to consider the GDNs as equals..." (2.27).

"*I seemed to remember asking us to put something in that explained total efficiency saving, and analysis of the economy of scale point. Why have we ignored these. Are there any other points I raised that were ignored?...* (1.31).

There are a number of comments in the LECG report which make it clear that Ofgem had restricted the consultants from either broadening the breadth of their review or considering alternative benchmarking methodologies.

Against this background, and despite the use of an uplift factor applied by Ofgem, the proposed indirect cost reductions in the UPs still cause us major concern - based on the flawed methodology used and the significant business impact of the resulting cost reductions. They continue to be flawed based on a number of key factors:

- The benchmark comparators used by Ofgem and its consultants
- The use predominantly of revenue as a basis for benchmarking when this does not drive the majority of costs incurred.
- The fact that quality of service is totally ignored in the benchmarking
- Ignoring the obvious impact of economies of scale

The reports by both NERA and Third Horizon identify in detail the significant flaws associated with the benchmarking used by Ofgem. Whilst Ofgem portray these reports as unique to WWU, we believe they have relevance for all GDNs. We summarise our major concerns with the benchmarking in the paragraph below.

- The LECG report on indirect opex does not take account of any unobserved or immeasurable differences between GDNs. Whilst they acknowledged their benchmarking approach could mistake unobserved differences between companies for inefficiency (para 2.18), they completely ignored this factor throughout their report. Such factors will include regional differences in input prices, economies of scale, trade-offs between input categories, and many more besides. Ofgem's instructions mean that LECG's results cannot be taken at face value.
- Not only have LECG (and Ofgem) failed to take account of any unobserved or immeasurable differences between the GDNs, they have also failed to take account of any differences in GDNs' standards of service. With this in mind we certainly question the validity of using NGN as the frontier company when they have clearly failed their standards of service for complaints and responding to emergencies within 1 hour for 2006/07.

  On this specific point we would also draw Ofgem's attention to a recent benchmarking study commissioned by CAA as part of their review of BAA. The study looks at a number of categories of indirect cost and their proposals clearly strike a balance between cost efficiency and quality of service.
- We are concerned with the selection of separate individual benchmarks for each cost category. LECG themselves recognise that this approach has the potential to set efficiency targets which are unattainable - and recognising the limited data sources used in the analysis, the immaturity of the data, and the acknowledged flaws in the source data specifically from NGN and SGN (respectively, use of

outsourcing and recharge from related party companies at marginal cost) - we are very surprised that Ofgem have continued to support this approach. The NERA report presents an analysis of these issues and compares estimated efficient benchmarks from a bottom-up and top-down approach. Not surprisingly, the top-down approach produces a much less dispersed set of results.

b) Quality and integrity of data

We have major concerns with the quality and integrity of the GDN data sources used by Ofgem in the UPs which ultimately influences the regressions and efficiency positioning. In particular we are very concerned that:

- SGN indirect cost data is acknowledged to be based upon a marginal cost charging methodology for services provided by SSE. Ofgem have attempted to address this by using the next lowest company when SGN sets a bottom up benchmark. However the adjustment is not complete because SGN lower marginal costs are not corrected in the top down benchmarking towards which bottom up cost allowances are uplifted. Ofgem should omit them altogether from the analysis.

- NGN indirect cost data has been derived form a combination of in-house costs, and costs apportioned from their outsourced provider. We continue to have concerns about the robustness of the cost allocation methodology given the business model involved.

c) Economies of scale

Ofgem have stated it will not allow smaller GDNs any additional allowance for their inability to benefit from economies of scale when setting indirect opex allowances. Even though LECG themselves agree in their report that the efficient level of support service costs are affected by such factors as economies of scale and regional factors, Ofgem has instructed them to ignore economies of scale when undertaking the benchmarking. We find this approach irrational and counter intuitive to business and economic logic.

We believe the flawed nature of the benchmarking approach actually used by Ofgem subsequently results in cost allowances in the UPs which defy sensible logic. The table below illustrates the figures involved and the key points are made below the table.

GDN	Normalised Indirect Opex 08/09-12/13, £m/GDN/year	Updated Proposals, £m/GDN	Updated Proposals , £m/GDN/year
NGG	28.58	87.45	17.49
NGN	23.94	84.1	16.82
SGN	16.44	85.8	17.16
WWU	25.46	86	17.2

- WWU normalised costs were identified in our Business plan submissions as £127.3m for the five years, equivalent to £25.46m per annum on average. These costs were benchmarked externally by Third Horizon against recognised market comparators and it was found that *"WWU is already a strong performer across the various service sectors."*

- The average allowance proposed in the UPs for each of the four single owned NGG networks is greater than any of the independent networks, and clearly takes no account of the obvious economies of scale involved in owning four networks together. The result is not necessarily that NGG should received less allowance but that WWU should, on the grounds of being efficient, have a significantly greater allowance afforded to it.

- SGN, who adopt a marginal costing approach to its two gas networks are given allowances equal to or greater than the two independent companies, and actually receive an allowance greater than their normalised submission costs.

Ofgem should consider whether SGN, who operate on a marginal costing basis should have an efficiency challenge placed upon them, rather than electricity customers bearing costs which now should be partly borne by gas customers.

These illustrations only serve to highlight the flawed nature of the way that the benchmarking has been undertaken. In the case of SGN, we also wonder if there is an issue of cross subsidy which Ofgem need to reflect on between SSE's electricity and gas businesses given the marginal cost approach with SGN.

The NERA report also makes the following comments on this specific issue:

> *"The results we present in Table 3.1 show that – as well as not accounting for economies of scale – LECG has recommended a higher indirect opex allowance 'per network owned' for NGG than for individual GDNs. It is difficult to explain this result either in terms of (ignoring) economies of scale or in terms of relative efficiencies. This outcome undermines confidence in the robustness or reliability of the methodology that LECG has chosen (or been asked by Ofgem) to adopt"* (3.8).

- Following network sale, the stand alone WWU business has been built from a bottom up basis on a 'lean' philosophy, only adding indirect activities that were essential. This is a factor which NGG has recognised in previous responses to Ofgem. We believe our approach reflects industry best practice performance, a factor which is endorsed by the independent benchmarking reviewed by Third Horizon (see below). We are clearly being penalised by Ofgem's chosen basis of analysis for being a smaller, independent company.

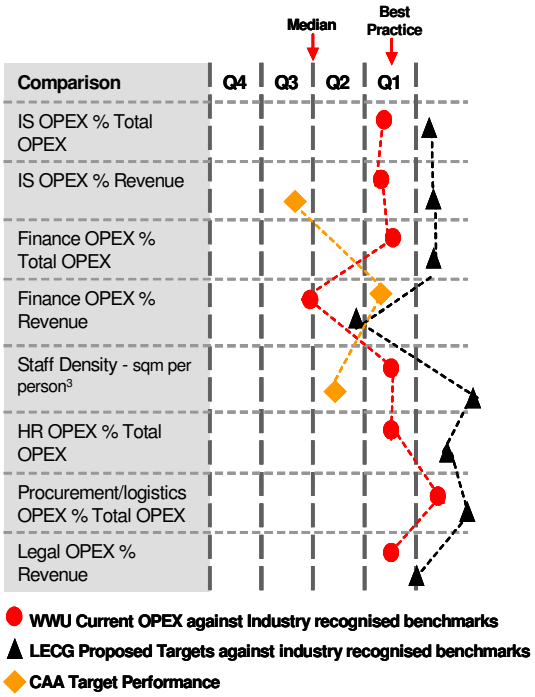
- Ofgem has, contrary to established economic theory and evidence, continually disregarded sound arguments based on economies of scale. This approach is contrary to sections 4AA (1), 4AA(2), 4AA(5), 23 and 24 of the Gas Act 1986 (as amended) which require the Authority, amongst other things, to consider the circumstance of the particular license holder when exercising powers to amend licence conditions. To ignore issues such as economies of scale is therefore *ultra vires.*

With particular concerns on the flawed methodology and validity of data sources used by LECG, and the disregard of economies of scale by Ofgem, we asked Third Horizon to update their previous work with a specific review of:

- the position of WWU against external benchmarks well recognised in the marketplace; and,

- the specific impact of the UPs on our business activities and our ability to meet required service standards.

The attached Third Horizon report demonstrates that in virtually all cases the LECG target level of performance is in excess of currently acknowledged best practice (and coincidentally well in excess of the targets established by the CAA for BAA). The table below, which is an extract from the report, clearly illustrates this point.



	BP	Median	WWU[9]	LECG[10]	CAA[11]
IS opex % total opex[1]	4%	9%	5%	3%	
IS opex % revenue[2]		3.9%	2.9%	2.1%	4%
Finance opex % total opex[3]	2%	3%	2%	1%	
Finance opex % revenue[4]	0.4%	1.4%	1.4%	0.8	0.5%
staff density - sqm per person[5]	12	14	12	6*	13
HR cost % total opex[6]	1%	4%	1%	0.4%	
P&L opex % total opex[7]	2%	4%	1%	0.5%	
legal costs % revenue[8]	0.20%	0.40%	0.22%	0.17%	

1 *DTT Global Benchmarking Study*
2 *Meta Group 2005*
3 *2001 UMS Group Utility Benchmarks*
4 *The Hackett Group, 2004*
5 *Andersen 2001 Study (Multi Industry)*
6 *DTT Global Benchmarking Study*
7 *UMS Utility Benchmarks*
8 *PwC Study*
9 *Update assessment of GDN indirect opex based upon 2006/07 actual performance. 24 September 2007.*
10 *Based on comparison of high target savings*
11 *Civil Aviation Authority Benchmarks, 2006*
* Assume a 46% reduction in floor space in line with a 46% reduction in property OPEX

In summary, we do not consider the targets for indirect costs in the UP's are either reasonable or robustly based. Given the obvious flawed nature of the methodology and data we strongly recommend that whilst not without shortcomings, Ofgem adopts one of the following approaches outlined below:

- Ofgem should base their analysis on external data, which is readily available and applicable to all GDNs, and which WWU has provided Ofgem with some six months ago for just such a purpose. Such benchmarking should be based exclusively on acknowledged proprietary external benchmarks; or;
- In the event that Ofgem wish to continue to base the analysis on GDN data, they should revert to a simple top down analysis, clearly excluding SGN data and adjusting for standards of service issues and costs which NGN would require to incur to meet service standards.

Paragraphs 3.7 - 3.11 Updating for 2006-07 actual costs

Ofgem, in 3.11, note the IDNs concern that NGG, which owns half of the DNs receives 55% of the indirect Opex allowance in spite of the fact that it should benefit from economies of scale. Even as a result of the UPs NGG receives 50.6% of the proposed allowances for indirect Opex, which still does not appear to reflect accurately NGG's ability to benefit from economies of scale.

Indirect costs comparison - WWU and other GDNs

Indirect Costs per Group

	Actual	**Actual**	**Actual**	**Updated Proposals**
	04/05	**05/06**	**06/07**	**08/09**
NGG	89.69	110.51	98.81	72.40
NGN	27.81	16.10	19.42	15.30
SGN	41.40	35.66	29.10	34.00
WWU	20.83	23.19	22.98	17.00
Total	179.74	185.46	170.31	138.70

Note: all figures are in 05/06 prices
Excluded 07/08 data as no breakdown given in Final Proposals for 1 year extension

Data Sources
04/05 & 05/06 data from GDN BPQ
06/07 data from Ofgem Top Down – Bottom Up Regression
08/09 data from Updated Proposals

The above table shows the movement of Indirect costs over time and particularly from pre-sale when they were all under common ownership, to post sale.

- Actual indirect costs in 2006/07 were 5.2% below those in 204/05
- The UPs show a significant incremental challenge on this cost saving

- It is within Ofgem's remit to increase indirect costs allowances for WWU and other single GDNs whilst still ensuring that customers as a whole benefit from efficiencies gained following DN sale

- WWU with its cost base of £22.98m in 2006/07 has been benchmarked as at least an upper quartile performer against peer groups

Comments on analysis of individual indirect activities

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 or 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.

Insurance and Property Management

We are confused as to what the correct benchmarks Ofgem are proposing for these two activities.

Page 36 of Appendix 7 identifies that Ofgem have used the "second best" GDN as the benchmark instead of the upper quartile in all functions.

On page 14 of the Updated Proposals document Ofgem suggest that Scotia Gas Networks are the best performer for all activities apart from Property and Insurance leading us to believe these two activities would be benchmarked against upper quartile and not 2nd best.

Table A7.5 within Appendix 7 gives the benchmarking figures for Insurance and Scotia is best at 0.95%. However WWU as the second best at 1.04% is selected as the benchmark. Paragraph 1.21 in Appendix 7 also states that the second lowest cost group has been used to set the benchmark.

However the upper quartile benchmark has been used to calculate efficient costs in the Ofgem workbook for Insurance.

The bottom up benchmark figure for Insurance used by Ofgem is 2.01, this is the 08/09 figure which has been derived from rolling forward the 06/07 figure into the 07/08 and 08/09 years by the Marsh index.

This is in contrast to all the other components of the indirect benchmark costs that have been calculated through the 06/07 benchmarking process and that number is then used as the opening 08/09 number without any adjustments applied.

Table A7.6 within appendix 7 suggests that for Property Management the second best GDN has been used in both benchmarks but the Ofgem workbook uses the upper quartile to calculate efficient costs.

A third of our insurance costs relate to uninsured claims and arise due to events in our distribution network. The cost of these claims is dependent on the frequency and severity of the event and is completely unrelated to the alleged cyclical nature of the insurance market. Applying the Marsh index to claims costs as a whole is therefore inappropriate.

We submitted a report by Willis Insurance Brokers to support this view as an appendix to our response to the 4th Consultation Document, and the Initial Proposals which stated that:

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

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

We believe that there have been errors in the normalisation process where costs removed by LECG as part of their analysis have not been added back into the Direct Opex activities. For example Occupational Health (£0.12m pa) deducted from HR but not added back into Work Management and Travel (£0.20m) deducted from HR but not added back to Work Management.

Legal

We do not concur with the findings LECG make in their report as their analysis is flawed. The Third Horizon report, dated April 2007 makes this perfectly clear.

xoserve

Ofgem state "As a result of comments back from GDNs there is a slight reduction in the efficiency savings proposed for xoserve. In addition, a total across all networks of £2.8m per annum has been moved from xoserve to a user pays category." This explanation in the UPs is at odds with the numbers that we have been given. In summary we submitted a request for £15m Opex and £5m capex. The initial proposals gave use £14.1m Opex and zero Capex. The updated proposals give us £13.1m Opex and £4m Capex. The allowances given in the UPs are far short of our requirements.

These are costs which in reality we have very little influence over, and we have seen no analysis from Ofgem as to the rationale behind the reductions from our BPQ submissions.

Overall Operating Costs

Question 2: Do you agree with our approach to the additional operating cost items included in these proposals covering the areas where our work was incomplete at initial proposals?

We do not agree with Ofgem's approach and methodology to the additional operating cost items as follows:

Training and apprentice costs

We note that Ofgem recognise in the UPs the significant issue of skill shortages facing the GDN's over the coming years, and are proposing an allowance of £8.7m over the 5 years to cover the cost of recruitment and training. However they have disagreed with some of the underlying assumptions and questioned some of the analysis put forward collectively by the companies. We have therefore responded to some of the specific points in our response below.

Ofgem have stated that we did not make provision for apprentices in our BPQ submission. This is incorrect, as we had submitted a figure of 12 per annum. Since submitting out BPQ, a large amount of analysis has been undertaken, and these numbers have now increased significantly, but we have not been allowed to resubmit revised figures.

Ofgem have suggested that the assumptions that the collaboration group have agreed are unduly pessimistic, and we have therefore revised our assumptions in the following areas:

- The collaboration group has discussed the 10% drop out rate, and it has been agreed that this rate be reduced to 5%. We believe that this is conservative based on the drop out rate of employees within National Grid shortly after qualification. The drop out rate for graduates has however been left at 10% as it is felt that this is reflective of graduates failing to complete programs within organisations.

- The collaboration group has also made the assumption that the upskilled category of workers are 50% productive, so we have therefore reduced the salary and overheads by 50%.

- The collaboration group has also assumed that apprentices are 30% productive in their final year so we have therefore reduced the salary and overheads by 30% in that year.

We have used a rate of 2% for natural wastage however we feel that this is conservative, rather than pessimistic as the actual turnover we are experiencing is higher, and is continuing on an upward trend as follows:

- For the three years preceding network sales the rate of attrition for industrial staff excluding voluntary redundancy was 2.58%, and the attrition rate for first line managers and gas specialists excluding voluntary redundancy was 0.76%.
- For the two years post sale, both figures have increased, with the industrial staff figure now being 2.88%, and the staff figure 2.31%. There have been no instances of voluntary redundancy.
- For the twelve months October 2006 – September 2007 the figure for Maintenance is 5.95%, of which 5.10% is natural wastage and 0.85% is retirements. Similarly the figure for the Repair and Emergency processes combined is 2.9%, which provides an average industrial staff turnover rate of 3.7%. Again there have been no instances of voluntary redundancy.

The impact of using a nominal rate of 2% versus the actual rates being experienced is detailed in the two tables below:

Table 1 – Category of employee, nominal against actual department turnover

Category	**Natural Wastage %**	**2012 Surplus/ Shortfall**	**2017 Surplus/ Shortfall**
Maintenance	Nominal 2%	11	16
	Actual 5.1%	-10	-25
	Difference	**21**	**41**
Emergency	Nominal 2%	-9	3
	Actual 2.9%	-23	-22
	Difference	**14**	**25**
Repair	Nominal 2%	22	10
	Actual 2.9%	-14	-5
	Difference	**36**	**15**
Total Difference		**71**	**81**

Table 2 – Category of employee, nominal against average turnover

Category	Natural Wastage %	2012 Surplus/ Shortfall	2017 Surplus/ Shortfall
Maintenance	Nominal 2%	11	16
Emergency	Nominal 2%	-9	3
Repair	Nominal 2%	22	10
Total	Nominal 2%	24	29
Maintenance	Average 3.7%	0	-8
Emergency	Average 3.7%	-35	-44
Repair	Average 3.7%	4	-23
Total Deficit	Average 3.7%	-31	-75
	Net Difference	**55**	**104**

The tables 1 and 2 above demonstrate that if we were to use actual turnover rates rather than the nominal two percent natural wastage rate, we would need between 55 and 71 additional new recruits over the next price control review, depending on whether we use the actual departmental rates or the WWU average. This would increase the number of new recruits from 340 to around 400. As we have discussed previously, we do not have the capability both within WWU and externally with course providers to recruit these additional numbers, so we have not updated our model to reflect this.

- Routes for gaining skilled staff:
  - Migrant workers – there is no guarantee of long term supply and issues such as communication, competency and valid qualification may be significant;
  - Contractors – aggressively recruiting from this pool of workers will lead to greater overall wage increases than Ofgem's current assumption of 1% RPE for direct labour and 2% RPE for contract labour;
  - Recruitment from the market place – this pool has been explored and numbers have been incorporated into the resource model;
  - Upskilling of existing employees – we have recruited a number of semi skilled workers from our contract partner, and there is an opportunity to train some of these up to Craftsperson level over a period of time. This has also been incorporated into the resource model.

Use of contractors

We currently utilise contractors through our existing Engineering Period Contracts (EPC) to ensure that we deliver our annual workload. Whilst there is some scope to continue to utilise contractors going forward, this pool of resources is scarce, and like our direct labour workforce, continues to age, without any significant replenishment with younger individuals.

Proposed Recruitment

In order to address the long term skills issue using the assumptions already submitted to Ofgem, we propose to recruit 340 apprentices, employees that require upskilling, competent persons and graduates over the coming PCR period. Of the 340 required, 306 are industrial staff and 34 are staff. Whilst Ofgem have proposed an allowance of £8.7m over 5 years, the model, which is attached as appendix H demonstrates that **at least a further £10.2m** over the 5 years would be required in order to ensure that we have the necessary skilled resources in place.

The figure required is vastly different from the allowance proposed by Ofgem for a number of reasons, but it is primarily because Ofgem has based the number of new recruits on the number of FTEs within each GDN, rather than basing recruitment on the expected number of leavers, based on GDN age profiles which gives a far more accurate picture of the loss of skills over the next five years and beyond.

Ofgem has stated that the allowance is for 25 apprentices per year over the next review period (125 in total), and in order to bring the resources back into balance, based on our age profile, we believe that we would need to recruit in the order of 70 new employees per year. Ofgem has also stated that the apprenticeships are two years in duration, however in order to ensure that employees are competent we believe that the apprentice programme will take between three and four years depending on the workstream to which that the employee is aligned. We do though concede that there will be some productivity from the employees during the last year of their apprenticeship.

Ofgem have stated that the cost per apprentice to cover recruitment, salary and training costs is £30,000 per annum. We believe that this figure is marginally too high for apprentices (although their apprenticeship is longer than two years) and too low for graduates (who will cost us around £40,000 per annum).

The cost allowances takes no account of the need to have an internal infrastructure to support the ongoing recruitment and development of the increased number of apprentices, and it is anticipated that as a minimum we would need to put in place a scheme co-ordinator, and train some additional internal trainers, assessors and verifiers.

These costs also do not take account of any available funding for training, which we are aggressively looking to secure. If funding is secured, the training costs will be reduced or cancelled.

Environmental Decontamination

We acknowledge Ofgem's proposal to make provisions for decontamination costs within the allowances.

The number of sites potentially affected by contaminated land issues within our area is approximately 125, of which 72 are either shared or jointly owned by National Grid.

A broad estimate of our liability in 2006 was around £25 million, which is in relation only to statutory remediation. These costs are based principally on site specific desktop exercises that consider issues such as the removal of hotspots of contamination to landfill in order to meet statutory requirements. They exclude costs

that may be incurred during off site investigations, remediation of soil and groundwater, relocation and/or protection of plant and equipment, or change of use.

It should be noted that recent legislation such as the Landfill Directive has led to a reduction in the number of landfill sites generally and those willing to accept Hazardous Waste in particular placing upward pressure on haulage costs, tipping charges and Landfill taxes.

Our comments on Ofgem's proposals on the sale proceeds following disposal of land after decontamination are given in our response to paragraphs 4.55 to 4.60.

Waste Management

We highlighted, in a response to a supplementary question on potential increases in Waste Management costs, that from 30 October 2007 the Landfill Regulations will require all non hazardous waste to be tested against Waste Acceptance Criteria (WAC) prior to disposal to landfill. This testing is likely to cost around £300 per time and would require the materials to be stored separately at a licensed site until the results are available.

It is also possible to interpret from the Regulations that any spoil contaminated with gas or bituminous materials will be treated as hazardous waste and therefore will require disposal at a dedicated hazardous waste site thus costing considerably more to dispose of than at present. It is important to note that in addition to the increasing cost of landfill there are now fewer sites in total and even fewer sites able to accept active waste, so travel distances will increase with an associated increase in costs.

Total compliance with the Regulations is likely to increase WWU costs and other utility's costs considerably.

Within our submission we assumed that the Regulations would not be enforced in this way and have not made allowance for the potential additional costs.

The application of the Regulations is the subject of review at European and National levels. There is very little information currently in respect of the progression of these reviews and the likely implications in respect of the costs of disposal of excavated materials (particularly road spoil).

Advice we have received from Specialist Consultants (MJCA) suggests that there remains a considerable risk that some GDN waste will be reclassified from inactive to active resulting in a cost increase from £2 per tonne now to £32 per tonne from April 2008 and to £48 per tonne by 2010/11. The MJCA report is attached as appendix E.

It is important that Ofgem recognise the uncertainty involved, the potential impact full implementation would have on WWU's costs, and acknowledge the requirement for further discussion on this matter when a more definitive interpretation and timescales for implementation are available.

In summary, due to the uncertainly surrounding this issue we believe that there should be a specific and ring-fenced reopener to cover waste management costs.

WWU network specific factors

We have been liaising with Ofgem for some time on the issue of WWU's specific regional factors, and we note that they have recognised the additional operating costs arising from the particular characteristics associated with our service area. However Ofgem has awarded less than 50% of the additional costs we identified in our detailed analysis to them, which results in an allowance of only £10m over the 5 years compared with the WWU analysis reporting the real cost as over £26m.

We received a number of supplementary questions from Ofgem in the lead up to the UPs, to which we fully responded. Ofgem's rationale for allowing significantly less than our submission was twofold:

- They believe their benchmarking already allows for a number of the factors which we raised; and,

- WWU's reasons for the higher costs have not been fully justified.

With these points in mind we asked John Spiller Associates (JSA) to see if they could address these issues. JSA have updated their previous work and this has already been submitted to Ofgem and a copy is attached to this response for completeness. In summary the updated piece of work, which:

- Responds specifically to the Ofgem challenges;

- Updates the previous estimates of penalty costs by examining them in even more detail;

- Develops a methodology which further improves the robustness of the previous 'penalty cost' calculations; and

- Fully aligns the costs with the recent submissions to Ofgem of supplementary question OP-WWU-1028.

This additional analysis has identified the cost of £5.2m per annum which should be given to us as an allowance to reflect our specific network factors.

This is the fourth piece of analysis provided to Ofgem on this specific subject, and we are confident that sufficient robust information has now been provided to allow Ofgem to revise their allowance in line with the WWU cost projections.

Other comments

Paragraphs 3.19 & 3.26 – 3.29 - Regional labour costs

We strongly disagree with the assumptions made in both the IP's and the UPs in relation to Ofgem's application of the regional factor for costs. We summarise our concerns below.

- It is well accepted that Weighting or Allowance has been applied in London. However consideration of whether regional pay factors should be applied needs to be considered in the context that until 2006 national pay scales applied across the whole country, and 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, contractor workforces are highly mobile and follow the work across the country, with their pay rates considered to be consistent on a national basis. At the present time for example, WWU has contractors from places like Manchester and Newcastle.

- We also pay national prices for virtually all of the key materials and services that we procure, from pipework to vehicles to IT services. Given these factors we see no justification for reducing the WWU regional factor to 0.96.

- Despite the compelling reasons outlined above however, the differences have been further exaggerated through an increase in the London and inner M25 allowances. We have no complaint that companies should receive allowances that reflect the reality of the market place they operate in. However, any allowances given should not be at the expense of GDNs operating in other, still challenging environments. The data used to determine proposed allowances includes all professions and not just utilities, so will include finance and City workers which are clearly not comparable to the staff WWU employ.

- Ofgem's own consultants PB Power have said in their updated opex report (2.8.2) that WWU's regional pay is 0.98. They also state that London and Southern are not actually exposed to the whole uplift as the GDNs are not entirely within London, and a number of their activities are carried out elsewhere in the country.

In summary we believe Ofgem has overstated the London effect to the detriment of the regional GDNs and they should at a minimum use the 0.98 figure as proposed by their consultants.

Paragraphs 3.69 – 3.72 Real Price Effects

We are extremely surprised that Ofgem have not changed the RPE assumptions used in the UPs from those used in the IPs, despite the lack of real objective evidence for their own assumptions. A substantial amount of credible external evidence has been provided by WWU and the other GDNs, and this external marketplace evidence is also reflected by the real price pressures actually being experienced by WWU. The table below illustrates the real prices movement experienced by WWU over the past two years, and the increases projected by key suppliers for the near future.

Materials		% Increases in prices (Including RPI)		
		Actuals		Short-Medium Term
Main Commodity Type	Supplier	2006/2007	2007/2008	Projections(per annum)
Plastic Pipe and Fittings	Uponor	8.0%	14.0%	10.0%
Brass, Aluminium	Delta Fluid Products	8.5%	9.0%	6.0%
Copper	The Beck Co	68.0%	7.5%	6.0%
Stainless Steel, Bronze, Brass	George Fisher	10.0%	4.0%	5.0%
Reinstatement Materials	EPC	14.0%	23.0%	10.0%

Recent and expected materials price increases are well in excess of the proposed RPI+1% allowance, and now look to be in excess of our own forecasts of RPI+2.5%.

Furthermore we have been told that the January 2008 Ethylene price will be in the region of 950 Euros/tonne, which would represent an 11% increase from January 2007. Crude oil is forecast to show a similar increase in the same period, with considerable peaks during the year. As the raw material elements constitute approximately 80% of the product unit cost it is wholly irrational to expect to see any relaxation of prices to WWU moving forward.

The table below compares the results of a) the WWU forecasts, b) the ChandlerKBS analysis, and c) the figures used in the Updated Proposals.

	WWU Forecast %	ChandlerKBS %	Ofgem UPs %
Contractors	4.5	4.1	2
Direct Labour	2	1.8	1
Materials	2.5	3.2	1

We urge Ofgem to review the RPE assumptions in the face of credible marketplace information which we and the other GDNs have provided from well recognised cost consultants such as ChandlerKBS. Our own experience to date is detailed in the table above which sets out materials price increases. Alternatively we reiterate our willingness to discuss the use of an agreed independent index for establishing RPEs going forward, which we believe would remove the significant risk that current estimates prove to be inaccurate over time.

Paragraphs 3.73 to 3.79 Carbon Monoxide (CO)

Requiring GDNs Emergency Service personnel to carry and use 'carbon monoxide in air' measuring equipment during gas investigations will have a major impact on manpower numbers, and hence increase costs and this proposal will require careful consideration.

It is important that the value to customers is assessed carefully before implementation, as this is the largest fundamental change in the Emergency Service since privatisation.

There are also other issues to be considered including:-

- The upskilling of the workforce within a limited marketplace will make the First Call Operatives (FCOs) more attractive to other installers. This will inevitably result in market forces prevailing with the likely outcome being that wages will increase.
- The additional FCOs required to carry out this work will not be easily available and may need to be trained from scratch.
- Phasing of any implementation will need to be considered to ensure availability of resources, equipment and training facilities.

We are already seeing increased levels of awareness on CO issues with Local Authorities and other agencies already increasing public awareness of CO and we are seeing an increase in calls in areas where Local Authorities have installed CO monitors. There is a concern that once people become aware that the local gas distributor gets a free CO check when phoning in a gas leak that the system will be overloaded and we will see a real increase in the level of PREs.

As part of a response to supplementary question WWU-190 we provided our estimates of the manpower requirements and likely costs associated with this additional work.

We note that Ofgem held an industry workshop on this issue in October which gave no clear guidance on how the issue would be taken forward. If any obligation is to be raised in the Final Proposals we would need to participate fully in discussions.

PART 3 – DETAILED RESPONSE

CHAPTER 4 – CAPITAL AND REPLACEMENT ANALYSIS

Response to Question 1

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

We do not believe that PB Power's approach is appropriate, for the following reasons:

Productivity challenge

We note the reduction in the level of productivity challenge by Ofgem for capex to 1.5%, albeit maintaining the 2% challenge on repex. Ofgem has failed to provide any rigorous and objective assumptions underpinning these assumptions, or any rationale for the differences between the figures. Ofgem's comments in the UPs show the very subjective nature of how these figures are set:

"In response to initial proposals a number of GDN owners raised concerns regarding the productivity assumptions applied to connections, mains reinforcement and repex. We have reviewed these in the light of additional information and have revised the productivity assumptions for both mains reinforcement and connections to 1.5% per annum. We consider that a 2% per annum productivity assumption is still appropriate for repex based on the top end of the range of assumptions put forward by the GDNs".

Ofgem has not discussed why the figure at the 'top end' of the range is appropriate, or indeed why a figure quoted by one company would necessarily be appropriate for others. Even within the terms of Ofgem's own framework, the 'top end' estimate might include substantial 'catch-up' (which is not available to all GDNs), as well as 'frontier shift' (which would apply to all GDNs). These points serve to illustrate the lack of any real supporting evidence or justification for setting what appear to be very subjective targets. Our concerns are echoed in the attached NERA report, which says:

"In areas of capex other than connections, PB Rune has regressed costs on CSVs, but has not justified its choices of weights within each CSV, and in some cases has not even reported its choices. PB Rune has not reported the data used in these regressions, so others cannot replicate or review the analysis. This approach is not compatible with objective and transparent regulation" (2.2.1).

We believe these figures still represent an unrealistic challenge, particularly when overlaid on top of the base activity challenges set by Ofgem. We urge Ofgem to review these and set targets that are more reflective of reality in the external market place.

LTS

The Bancyfelin to Lampeter Velfry pipeline (also known as Phase 2 of the West Wales reinforcement) was first identified in the year 2000 as part of the 2001

planning process. Since it was first identified, considerable changes have taken place to the network planning assumptions and to the demand distribution on the network.

This response indicates how inputs to the annual planning process have altered the timing of the Bancyfelin to Lampeter Velfry pipeline project.

Updated Assured Offtake Pressures

	Plan year				
	2004	**2005**	**2006**	**2007**	**2008**
Gilwern	55	55	55	55	55
Dowlais	51	51	51	51	51
Duffryn	50	50	50	50	50

All inlet pressures in bar

As a part of the planning process additional assured pressures were requested from NG but were refused. These additional pressures would have alleviated the requirement to construct this pipeline in the 2008/13 price control period using the 2007 National Grid price uplifted Demand Forecast.

To assess the current timing of the Bancyfelin to Lampeter Velfry pipeline, Uskmouth power station was removed from the model. This power station is forecast to be taking its full nominated load in 2010 and will be connected to the network via a different offtake to that feeding the proposed reinforcement pipeline.

The need for the pipeline was assessed for 2010/11 through to 2012/13.

Price corrected NG demand forecast in mcmd	2010/11	2011/12	2012/13
Total LDZ	17.59	17.71	17.96*
Gilwern	3.87	3.89	3.95
Dowlais	9.66	9.73	9.86
Duffryn	4.06	4.09	4.16

*This total does not sum due to rounding

Given the revised pressures from National Grid, the Bancyfelin to Lampeter Velfry pipeline is required to be completed by October 2011. We will require the appropriate levels of funding as outlined in our BPQ submission (£27.6m) to be made available by Ofgem to allow this pipeline to be constructed.

We have written to Ofgem under separate cover (supplementary question WW-209, submitted 10 August 2007) to explain how we intend to provide updated LTS and 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 correspondence should be read in conjunction with this response. The key points being that if current interruptible loads were to be converted to firm WWU will need to construct six pipelines in South Wales and eight in the South West to meet the additional firm demand requirement and ensure security of supply of the network is not compromised. There would be no construction required in North Wales. Our response also highlights that as an alternative a number of loads can be converted to Network Sensitive Loads status at strategic points on our network.

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We are pleased that PB Power recognise the risk of potential storage shortfalls in NTS storage provision from Zone 7 and 14, in addition to the need for us to construct pipelines to reduce our reliance on NTS. However we believe this issue should be addressed now and not deferred as recommended by PB Power as the risk will only intensify with time.

PB Power recommended that the South West storage deficit can be addressed in part by securing gas from Southern. This would require a change to the Uniform Network Code to permit inter-LDZ trading, and to complete such a change would require an agreement by the whole industry which would probably take a minimum of six months to achieve.

We are also very surprised by this recommendation since in the UPs (paragraph 4.18) there is reference to Southern needing to construct three major pipelines to provide storage, and PB Power recommending that storage can be taken from the NTS. Given such circumstances it would be unlikely that Southern would be able to transfer any storage to ourselves.

Although PB Power have now moved to a unit cost range for each diameter band we still believe that this does not address totally the issues around significant engineering difficulties associated with this type of work. As we have stated in our previous responses, we still believe that it is more appropriate that this type of work should be reviewed on an individual project by project basis, rather than by unit cost. There are also geographical issues prevalent to WWU, which impact on project costs and these cannot be ignored. For example, it is not possible to compare the construction of a pipeline over several kilometres of open countryside, to that through an urban environment. In addition, we contend that independent feasibility and conceptual designs should form the basis of calculating the costs for individual projects.

The argument for a unit cost approach may have been considered appropriate for National Grid when it owned all eight distribution networks, where overspend and underspend 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.

Mains Reinforcement

With regard to Mains Reinforcement there is clearly some volatility of workload. We note from the analysis that we have undertaken that there are some variations in workload length in 06/07 in comparison with other years. We believe that the issues associated with this could be addressed by smoothing the analysis over two years of out turn figures, that being 05/06 and 06/07 so that an average of both years can be used in the regression analysis.

In addition, we also note that NG's unit cost for Mains Reinforcement is lower than their Replacement work. Intuitively this cannot be correct and is probably as a result of misallocation of cost. Clearly, the impact of this is to distort the regression analysis with regard to Mains Reinforcement. Again, we believe that by using the average of two years of out turn figures from 05/06 and 06/07 will help to address any uncertainty that may arise from only using one year's data.

In an attempt to understand the impact that this analysis would have on our GDN we have taken the average of 05/06 and 06/07 work load drivers and applied them to the revised regression. The outcome of this analysis is that our allowances will increase from £23.1m to above £26m for the period 2008/9 to 2012/13. Although this is still subject to the impact of regression, productivity and RPE adjustments which makes the Reinforcement allowance extremely difficult to achieve adopting this approach does address the anomalies of using one years data.

We have previously stated that the 1.5% increased productivity assumption for mains reinforcement as indicated by Ofgem has no supporting substantiating evidence, and should therefore be removed. We continue to hold this position. In addition, the impact of real price effects and efficiency savings 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.

Governors

We note that our workload programme as presented has been accepted. However, we are still disappointed by the RPE adjustments that have been applied to this category of work. This has been discussed more thoroughly in section 3 above.

Non Operational Capex – GTMS and SOMSA

Replacement of the non-SCADA systems is a joint collaboration between all GDNs. We are actively involved in this collaboration and are fully supportive. 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 the GDN's have jointly 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 each GDN setting up their own system operations control centre. In addition to the new equipment the expenditure also addresses both the development and training requirements to allow these control centres to become fully operational with the new GTMS equipment.

We believe it is wholly inappropriate to disallow all but £1.8m of over £11m costs 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.

Even in the cost area that Ofgem have allowed in principle (GTMS replacement), WWU's project management costs have been disallowed. Project management costs are clearly an integral and essential part of the overall expenditure and must be included in our overall allowance. Not to do so means we are being unfairly treated compared with National Grid simply on the basis that they are implementing GTMS first.

Connections Capex

We have already made significant cost savings by bringing Connections in-house. The application of a flat-rate efficiency factor to all GDNs that ignores previous efficiency improvements is therefore inappropriate.

We disagree with the allocation of net costs on the basis of percentage of gross costs. Net Capex is made up of Domestic Load Connection Allowance (DLCA), Final Connection Allowance (FCA) and Employer Ordered Works (EOW). We believe that having established the efficient unit value of these allowances, net capex becomes more transparent and is simply the unit allowance multiplied by the volume in the period.

We have provided supporting reasoning for the application of the Final Connection Allowance in previous submissions. Our legal view remains that GDNs have an obligation to pay the Final Connection Allowance 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 Final Connection Allowance. The Domestic Final Connection Allowance forms a part of the 10 metre Domestic Load Connection Allowance. The value of the Final Connection Allowance for small diameter connections has been £89 for many years and we are currently undertaking a work study to assess the actual costs of the Connection for inclusion in our charging statement.

The historic £89 allowance applies for connections up to 63mm in diameter. We connect many services that are in excess of 63mm and eligible for the allowance. The allowance for connections above 63mm are valued on an individual basis and shown as an allowance in the customer quotation.

We support Ofgem's review of the Final Connection Allowance, in particular the legal interpretation, and await the amended allowances which will result.

Repex

We do not believe that Ofgem's approach to Repex is appropriate for the following reasons: 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 (letter to Joanna Whittington, dated 12 April 2007) 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 surprised and disappointed to note that along with the 2.5% reductions in RPEs for contract Labour and 1% for Direct Labour and 1.5% for materials Ofgem have also continued to maintain efficiency savings at 2% for replacement activities despite the fact that other comparable activities have been reduced to 1.5%.

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 utilising allowances in the round and deferring capex to offset the higher repex costs. These levels of cuts are being carried forward into the main price control period making it difficult for us to meet our HSE targets.

Multiple Occupancy Buildings

We note with interest the application of a Capex rolling incentive for multiple occupancy buildings and that Ofgem will be undertaking further work to assess the cost of risers for the final proposals. However, we are concerned by the approach taken by Ofgem in allocating allowances for risers by just taking a mid point between the views of the GDNs and PB Power. Our submission is based on the market rates to undertake this activity and as such should be fully allowed.

Other Comments

Paragraphs 4.49 - 4.51 Information Quality Incentive

We still remain concerned that Ofgem are baselining the IQI using only the reports they received from PB Power and that accordingly any error in PB Power's analysis, or weakness in a GDNs discussions with them, or indeed misunderstandings between a GDN and PB Power may result in an unfair penalty against the GDN. Consequently, we believe that Ofgem should allow for any such risk by starting the IQI matrix allowed expenditure at a figure higher than 100% when the GDN "agrees" with the consultants view of efficient spend. This uplift would be akin to the bottom up/top down difference uplift applied to the Opex allowance where the estimated error in PB Power and LECG's bottom up analysis against a top down view has been allowed by Ofgem.

Paragraphs 4.55 - 4.60 Treatment of property disposals

We disagree with Ofgem on their premise in paragraph 4.55 that "In the vast majority of cases, this (the physical asset base) has been funded by consumers, either through inclusion in the opening Regulatory Asset Value of the gas network at privatisation, or through inclusion in the RAV when purchased by the network owner."

We contend that when the gas business was privatised, the underlying physical asset base was purchased by the then shareholders. We further contend that at each subsequent share sale and purchase the purchase paid for and acquired those assets.

Though the return which the regulated entity is entitled to earn on RAV from the customers, those customers are entitled to the enjoyment of the use those assets bring them. However, as with the enjoyment which a leaseholder receives from renting a property, the ownership of that property remains with the freeholder. In the case of the distribution network, this is owned by the shareholders and rented to the customers.

Therefore RAV belongs to the shareholders from time to time of a regulated entity, whilst the customers are entitled to the benefits that paying for the use of that asset brings.

In paragraph 4.56, we agree with Ofgem that it may be appropriate for GDNs to dispose of assets where there is no longer an operational need.

In paragraph 4.57 we disagree with Ofgem that customers have funded the assets. The assets were purchased and are owned by the regulated entity, from the funds of the regulated entity: such funds having been made available by that entity's shareholders. These funds were not purchased by the customers and given to the companies; they were funded by the shareholders out of the companies' working capital, cash balances and loan facilities.

Consequently we do not see that customers should receive any benefit from the regulated entity disposing of non-operational assets and that the customer should only receive a benefit from the disposal of operational assets where there is a resultant detriment in service.

With reference to paragraph 4.58, we do though concede that where operational assets which are giving benefit to current customers are sold, there should be some benefit passed back to those customers where those customers have suffered a detriment in service. This would be reflected in the customer receiving the benefit of a RAV Reduction five years after the asset is disposed of equivalent to the net proceeds of that disposal.

PART 3 – DETAILED RESPONSE

CHAPTER 5 – QUALITY OF SERVICE ARRANGEMENTS

Response to Question 1

Question 1: Do you agree with our updated proposals for the quality of service arrangements??

Overall we agree with Ofgem's general intentions for the quality of service arrangements in the UPs. However we are concerned that the impact of a number of the detailed aspects have not been considered carefully enough by Ofgem. The allowances that Ofgem have proposed are not adequate to cover the extra risk and costs that the changes expose us to. Please see our detailed comments below which are in the order of the issues raised in the UPs.

Supply Restoration

We remain very concerned by the compensation arrangements proposed to cover instances where an interruption originating on one network affects customers on another. Should these proposals be implemented the increased level of risk to the GDNs needs to be recognised with an increase in Ofgem's allowance for the Supply Restoration Standard. Our key concern is how these arrangements would work in practice and we believe that Ofgem need to consider further, the practicalities and implications of their proposals.

In the scenario where an upstream interruption affects customers downstream, we are concerned about the potential impact of the lack of specified timescales in the current proposal regarding notification that an interruption has occurred. We are particularly concerned that without such timescales there is an increased likelihood that the customer will not receive payment within the specified 20 days, and this will lead to us becoming liable for unnecessary payments under guaranteed standard 12.

If the notification process is to be implemented, it almost certainly needs to be revised. We refer you to our response to the GDPCR Initial Licence drafting consultation for further detailed comments.

For the proposal to work regarding the recovery of compensation paid whereby a failure has occurred and another distributor holds partial or full responsibility for this failure, it will be necessary to prove three criteria. Firstly that the distributor in question has some duty to the claimant, secondly that a failure had occurred and thirdly that there has been physical loss or damage to the claimants property. We believe that these criteria would be very difficult to satisfy. There would have to be some contractual arrangement between gas transporters, and a mechanism for Ofgem to require the transporters to enter such arrangements. It may be that between licensed gas transporters such arrangements can be put in place by an equivalent to standard condition 20 of the electricity licence as has been proposed. It is currently not clear however, how Ofgem proposes to introduce the provisions between licensed gas transporters and exempt gas transporters as there is no contractual nexus between them.

Our concerns on this issue and the legal standpoint of the proposals are further discussed in our response to proposed changes to the Gas (Standards of Performance) Regulations 2005 as part of the GDPCR Initial Licence drafting consultation.

Reinstatement

As raised in our response to the initial proposals the tightening of the reinstatement standard is likely to increase our costs due to increased contractor rates. We remain of the view that Ofgem should provide an additional allowance to cover this.

The more stringent timescales proposed will increase the likelihood of failure of the standard and will therefore increase the amount of compensation due. The majority of our reinstatement is carried out by contractors, and as compensation payment requirements are 'back to back' in the contractor's rates, these rates will inevitably rise, thereby to ensure compliance with the standard our costs will increase.

Contractors' costs will also rise as a result of having to adjust current efficient working practice to meet the tighter standard. Currently the contractors are able to organise reinstatement jobs into one day. If a tighter standard is introduced they are likely to have to spread this work across a number of days, as they will have to carry out the reinstatement at some premises earlier in order to meet the standard. This inflexibility will increase their costs. In addition, the contractors will lose the benefit of being able to minimise wastage of reinstatement materials, because they will be required to purchase minimum loads from the quarries which may not be used.

Alternative Heating and Cooking

We support Ofgem's decision to make this standard customer claimable and we appreciate Ofgem's concerns regarding the provision of these facilities to priority customers. We are however concerned that the existing standard places a drive on recording the specific time each facility is offered, rather than on providing these facilities as quickly as possible to affected customers. We have previously raised with Ofgem the difficulties that we face in accurately recording the specific times the facilities are provided, particularly in the case of an incident, and we urge Ofgem to take these difficulties into consideration.

Our current practice is that we offer these facilities to **all** customers affected (unless we have an incident of an exceptionally large size) and we will continue with this practice going forward.

Advance Notice of Planned Interruptions

We agree with the proposal that GTs should notify customers at least five working days in advance of a planned supply interruption and believe that it is reasonable for GTs to state a period of seven days in which they expect to interrupt a customer. We do however have concerns with the arrangements proposed whereby one days notification can be given and a revised period offered if the GT is unable to interrupt in the period they originally specified. Our key concern is that in the scenario where the GT experiences difficulties that are not within it's control and the seven day period originally stated has already begun, and as a result we cannot interrupt the customer within this period, there is no exemption to prevent us becoming liable to make a payment.

Throughout the course of planned work our field staff liaise with customers to keep them informed of likely interruption timescales. Ofgem can monitor the satisfaction of customer in this area with the customer satisfaction survey results and likewise, we can monitor this internally through complaint volumes in this area. We would suggest that the important point is not whether we interrupt the customer within the specified

period of 7 days but more how satisfied the customer is with the information we provide and our actions in relation to this information.

We agree with Ofgem's decision that this is customer claimable and we welcome the additional allowance in this area, however should the proposals be implemented as they stand with no exemption relating to difficulties, we do not believe that the allowance will adequately cover the extra costs that the GTs would be exposed to in ensuring compliance with the revised standard.

Response to Complaints

Overall we agree with Ofgem's proposals in this area, however we remain concerned to see that Ofgem are not proposing to provide an allowance for this change. We are also concerned that across the industry there is no common definition of what constitutes a complaint and we are worried that the lack of such a definition may lead to the comparison of company complaint volumes that are not like for like. Therefore a common definition is required.

We offer our comments on the definition of a substantive response in our response to proposed changes to the Gas (Standards of Performance) Regulations 2005 as part of the GDPCR Initial Licence drafting consultation.

Cost allowances for the quality of service arrangements

We appreciate that Ofgem have provided a small additional allowance for the supply restoration and third-party and water ingress arrangements. However, as we pointed out in the IP's, these events are largely outside of our control, and furthermore the allowance still does not reflect the risk we face with 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.

We remain concerned that Ofgem have not allowed any costs for interruptions reporting. Although an allowance was given for this in the previous price control, GDNs will no doubt have to make additional system adjustments and employ additional resource to reach the new proposed completeness (95%) and accuracy (90%) targets which will take effect from April 2009. The impact of the proposals on WWU would require as a minimum one additional FTE and would cost an additional £30k per year (including overheads). We would ask Ofgem to revisit their conclusions in respect of additional allowances.

Our comments in relation to the allowances for the other quality of service arrangements can be found above, however for clarity we believe that if the standards are implemented as they stand then Ofgem should revisit their allowances for; the new arrangements for the supply restoration standard, the tightening of the reinstatement standard, the new Advance Notice of Planned Interruptions standard and the new complaints standard.

Our comments in relation to the allowances for the other quality of service arrangements can be found above.

We are pleased that Ofgem have begun to acknowledge the costs that GDNs will incur as a result of establishing an Ombudsman scheme for consumer complaints under the Consumer Redress Scheme, however we do not believe that the allowance proposed will adequately cover the costs that GDNs will incur as a result of having to initially set up the scheme and to fund it going forward. It is inevitable

that with the introduction of compensation payable under the new complaint handling standard that complaint levels will increase. With a redress scheme in existence there will be a further incentive to gain financial compensation, and as such the instances of referrals to the scheme and the number of resultant cases will no doubt be over that which has been anticipated. We therefore urge Ofgem to revisit their allowances to take account of this.

Emergency services standard

Our concern remains that we highlighted in the IP's that with the requirement being in our safety case, as a requirement under the Gas Safety Management Regulations and with the current proposals as a Licence obligation 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. Please see our detailed comments on the legal implications of including this in Licence condition D10 in our response to the GDPCR Initial Licence drafting consultation.

Consumer satisfaction surveys

We welcome the interaction between GDNs and Ofgem on the detail of the customer satisfaction surveys to include connections and emergency services and we will continue to engage with Ofgem to ensure that the results of the surveys can be used effectively to monitor the true practice of the networks across these key areas.

Interruptions Reporting

We feel that further discussions need to take place between the GDNs and Ofgem before we can offer a firm view on the proposed introduction of a Licence requirement to specify minimum levels of performance for the accuracy and completeness of interruptions data. In particular we require Ofgem to provide detailed definitions of 'accuracy' and 'completeness' and also request that Ofgem provide guidance as to how GDNs are expected to measure these. We agree as discussed, that confidence in the reported number of interruptions can be confirmed with a sense check against secondary data (encompassing particular job types which are expected to have an associated interruption), however it is essential that if GDNs are to use such analysis that Ofgem recognise and allow for the fact that there will be certain scenarios where an interruption is expected but there are completely valid reasons for not interrupting and also where more than one interruption is necessary. We remain unclear as to how we can confirm confidence in the reported duration of interruptions as there is no secondary data available to validate this as it is entered directly by staff in the field.

General Comments

Paragraph 5.37

We support the proposed introduction of the Discretionary Reward Scheme (DRS). The categories are appropriate. We welcome Ofgem's view that the DRS is to recognise and reward companies that establish best practise and is not meant to provide funding for any given initiative.

Paragraph 5.40

We support the introduction of the balanced score card and the items listed for inclusion. However as with any information recorded and reported it will require clear definitions of how is to be measured and take cognizance of the available systems capability of recorded and reporting on the information.

We have concerns regarding the reporting of the data for the number of unplanned interruptions which are explained under 'Cost allowances for the quality of service arrangements' and 'Interruptions Reporting ' above.

Paragraphs 5.42 – 5.48 Private and sub-deduct networks

The capability/willingness of DN's to conduct a survey

As mentioned in our response to the Fourth Consultation Document, we have no obligations or responsibility for these sites beyond the primary emergency control valve and there is no direct benefit for us in adopting them.

We are willing to undertake a survey of sub-deduct configurations, as we appreciate that due to our position within the industry we may be best suited to organise such a task, however we are not resourced or funded to undertake such activities. We would therefore look to award a contract via competitive tender for this work. To undertake such a scheme of works would only be possible if it were fully funded by Ofgem, however, it is unclear how funding for this, or any subsequent engineering works, would be treated.

Further to the survey being competed, we would require further dialogue with Ofgem and the other GDNs to determine how to progress the issue. For the avoidance of doubt we would like to state at this stage that we would not be willing to adopt these configurations under any circumstances, rather we would look to re-engineer them (laying new mains/services) to remove the prime and sub-deduct configurations. There is reference to the GIR Scheme in the Consultation Document, which we do not believe to be relevant.

The practicalities and challenges involved

There are several issues which are immediately apparent, such as asset ownership and landowners' consent:
- Access as these sites may be difficult as they include, for example, private dwellings, schools, hospitals and Ministry of Defence sites.
- Establishing current ownership and getting agreement of responsibilities. The consultation document assumes that no one claims to own these networks. If a landowner takes full responsibility for ownership there needs to be a separate chain of events to establish any exemptions that may be required (we would not be involved with this although we would need to remove the Prime and Sub-deduct configuration from our systems).
- Clarity as to what the survey is to achieve is critical, for example, it may be to identify the premises and layout, identify the location and condition of existing pipework, establishing the information required to engineer out the configurations.
- The precise specification of the objectives of the survey will affect its specification and the resources required.

The timeframe required

We do not have the required resources in-house to undertake this activity and as such would need to award a contract via competitive tender. Depending on the scope of works, and the level of detail required, this process from start to finish is likely to take in the region of 18 months.

An estimate of the costs involved per network

The costs associated with such a programme of works are dependent on the purpose of the survey, i.e. is it to just identify these configurations, or would Ofgem require details of how such configurations would be re-engineered and the costs associated with this? The following issues would need to be clarified before we are able to comment on the costs involved.

Alternative methods of resolving this situation

The alternatives to GDNs undertaking the survey activity are as follows:
- Do nothing during the next price control period
- Ofgem independently commission and undertake a national survey
- Ofgem/HSE pursue landowners to establish responsibility as incumbent owners of these configurations
- Ofgem engage with iGTs as they could also carry out such work and, where appropriate, the Prime & Sub-deduct configuration would become a Connected System Exit Point (CSEP).

PART 3 – DETAILED RESPONSE

CHAPTER 6 – INCENTIVES

Response to Questions 1-7

Question 1: Do you agree with our view that an opex rolling incentive is not appropriate?

As set out on page 62 of our response to the IP's (para 6.22 – 6.26 Opex Rolling Incentive), we continue in principle to support the incorporation of an Opex Roller within the proposals.

Question 2: Is our approach to capping the expenditure under the mains and services incentive appropriate?

The options discussed are: i) an aggregate cap at the five year forecast of expenditure; ii) an uplift to be applied to this; iii) a cap on the five year total workloads. We agree with Ofgem that options one and two are inappropriate. We are of the view that there should not be a cap at all. The workloads are scrutinised by the HSE and any inefficiencies in unit costs are dealt with via the incentive mechanism. Our concern of implementing a workload cap is that legitimate efficient work would be penalised.

Question 3: Is our approach to allocating domestic purge and relight costs to services costs appropriate?

We agree that the Ofgem methodology for allocation of Purge and Relight costs to domestic services is appropriate.

Question 4: Do you agree with our approach to the capacity outputs incentive? What are the issues raised by incentivising or not NTS flex capacity?

We believe further time and discussion is required in this area to ensure a fair and robust incentive regime is developed. The UPs have been the first document to discuss the basis of Ofgem's proposals in this area and we believe there are still many issues to be developed.

Ofgem is seeking to introduce an incentive framework that will encourage GDNs to make appropriate trade offs between investing in their Network, purchasing NTS capacity and buying interruptible capacity. We understand and agree with the spirit of the developments and are working with the industry to implement Offtake reform, but have significant concerns about the current proposals for both Non-Network Sensitive Load (NSL) and NSL interruption incentives contained within the UPs.

- For non-NSL interruption, the proposed incentive seeks to create a simple trade off between interruption payments and the purchase of NTS Flat Exit Capacity. We believe that this simple incentive is not appropriate. We also believe that Ofgem need to address potential GDN exposure to costs before we could reasonably implement such an incentive. Reasons as to why we believe this simple incentive is not appropriate and the potential cost exposure areas are detailed below.

    - The level of cash available to purchase interruption should be more than just the NTS exit capacity saved. The decision trade off would have to

include relevant GDN costs as well as NTS Flat Capacity payments to compare against the Interruptions payments. Therefore the incentive should take into account other efficient GDN spend in arriving at this decision as well as NTS Exit capacity payments themselves. GDN general reinforcement, possible Offtake and PRS costs as well as any other associated above ground capex costs are relevant to the trade off.

- There is concern about the treatment of required GDN spend associated with all loads going firm regardless of the incentive regime. This concern also relates to the application of the economic test.

- The NTS Exit Capacity Target is a function of volumes and market prices. The market prices change and are currently unknown for 2011/12 and future years. The non-NSL interruptions incentive is therefore currently unknown for 2011/12 and 2012/13. Interruptions auctions take place from spring 2008 relating to 20011/12 and 2012/13. We will not know how we have performed under the incentive at the time of the auctions. This is not an acceptable situation.

- Interruptible customers currently receive GDN and NTS interruptible discounts to their Transportation charges. One possible scenario is that these customers may value their interruption bids at a price equivalent to this total discount currently received. The cash amount available under the simple incentive is proposed to be equal to the NTS portion only. WWU believe there is potential that the incentive cash is insufficient to purchase interruption. This may lead to GDN overspends against the incentive. Our concern is that this may be the efficient least cost solution but GDNs are penalised for the overspend under this incentive form.

- Should the GDN elect to purchase capacity no allowance has been made for the physical limitations of the network and therefore any necessary investment as described above even though exit capacity purchase is chosen.

- The methodology used by WWU to identify the level of interruption required in an interruption zone is to incrementally add the existing interruptible loads to the Network until the peak 1 in 20 conditions are exceeded. The volume which could not be accommodated under this threshold is therefore that required to be interruptible without reinforcing the Network. Therefore, by definition, any shortfall in meeting this level of interruption will require investment by ourselves.

  We believe that the mechanism is currently flawed and needs considerable development before it can move from these initial Ofgem/industry thoughts to a final workable proposal.

For NSL interruption, the proposed incentive target is based on comparing the discounted level of the GDN exposure to the cost of reinforcement with the interruption payments. As with the Non NSL incentive we have several issues that we believe need to be further developed.

- The reference to “GDN exposure” could be interpreted as assuming that the customer has made a capital contribution as a result of the application of the economic test. Ofgem are aware, through discussions with the GDNs, that the application of such a test has not been consulted upon and did not form

part of the Mod 0090 development although has been tacitly accepted as best practice.

- Any increase in capacity for the NSL sites is not reflected in the Flat Capacity Target.

In summary we feel strongly that the timetable for consultation will not allow adequate time to develop appropriate incentives for the new interruption regime. In the Initial Thoughts document Ofgem acknowledges that "setting a capacity outputs incentive beyond September 2011 is complicated" by the uncertainty surrounding enduring Offtake arrangements and the outcome of the first interruption auction. They also state that the incentive should be compatible with the regime. We do not believe that this can be the case at this time as the proposed incentive does not correctly reflect the alternative arrangements.

Question 5: Should the volume targets for the flat capacity incentive vary with changes in the calorific value (CV) of gas?

We believe that the volume targets should be adjusted for changes in the calorific value of gas.

Question 6: Is it appropriate to allow a price control re-opener (subject to certain criteria) for any capex spend that may be required following the interruption auctions?

We are actively working with the industry to ensure engagement from the community in the interruption auctions process. We believe it is wholly appropriate to allow a re-opener for any capex spend that may be required following the interruption auctions as the capital requirements could be substantially different to those in the capex allowances if participation is not as perceived. Without a re-opener there is a large potential that the GDN could not fund projects to meet it's safety and licence obligations. We do not consider that there should be any trigger point before this reopener is applied.

Question 7: Is it appropriate to have an adjustment mechanism for the treatment of emergency services costs arising from the loss of metering? If so do you agree with our approach and methodology for the parameters?

It is appropriate to have an adjustment mechanism for emergency service costs if metering work is lost. As indicated below, there is a strong possibility that WWU's meter work will be either lost entirely or ring fenced and it is therefore very important that the emergency service is fully funded on a standalone basis.

Whilst we agree the general approach by Ofgem to the revenue driver, we would make the following points:-

The emergency service is not optional and emergency staff must be based in strategic locations to ensure that they are able to meet the 1 hour emergency response time. The WWU long and narrow service area with a low customer density requires a larger number of emergency staff than most GDNs and any revenue driver should take this into account.

We have recently submitted further analysis on the derivation of FCO numbers to Ofgem on this subject area, which we believe will illustrate our points.

We agree that with an initial loss of metering work, contractors can be laid off with minimal impact on emergency costs - and this has already been done by WWU. The tipping point should therefore represent a “hurdle” at which point all avoidable costs have been eliminated (e.g. by laying off contractors) and GDNs are left with additional unavoidable costs. These additional costs should be “converted” into an ex ante allowance by an appropriate revenue driver.

GDNs are already using infill work to reduce waiting times to the minimum but there is a limit as to the type of work that can be employed. It has to be close to the area where the First Call Operative (FCO) is based and has to be capable of a quick closure when the emergency call is received. This is more difficult in the rural areas where the opportunity for this type of work is more limited.

The type of GDN metering contracts will also affect the revenue driver. We have two contracts both of which terminate early in 2008. This work is not therefore subject to competition on a job by job basis and thus the loss of metering work is not a gradual process. The WWU situation is a “go” “no-go” situation where the re-tendered contract is either won or lost. Even if the new National Grid Metering Services (NGMS) contract is won, it stipulates that dedicated staff should be employed on metering work which gives little option for the metering work to be used as infill work by metering staff.

Thus almost overnight, we will have additional unavoidable costs imposed on its emergency service and any revenue driver must make allowance for this if the emergency service is to remain viable.

We appreciate that the proposed calculations by Ofgem are attempting to produce a relatively high level revenue driver that “fits” all GDNs. However, the calculations used, rely heavily on a relatively crude measure of waiting time and are somewhat cumbersome.

A simpler approach that closer represents the practicalities of operating an emergency and metering business is proposed in a separate report, appendix C by John Spiller Associates (JSA) (Network Cost Drivers: A “Bottom Up” Approach, October 2007) that accompanies this response.

General Comments

Paragraphs 6.1 - 6.3 Rolling incentives ~ Capex Rolling incentives

We note that Ofgem, in paragraph 6.3 is proposing to apply the IQI to be used in the main 2008/13 control to the 2007/08 extension year. This was raised as a potential position by Ofgem in their Second Consultation document, but hasn’t formed part of subsequent published documents. We are therefore surprised that Ofgem has raised this issue in the UPs and this unacceptable at this late stage.

Paragraph 6.7 Opex Rolling Incentives

We note Ofgem’s intention not to introduce a rolling Opex incentive in this price control period. The important issue is the recovery mechanism associated with achieving cost reductions. We address this point in the productivity challenge section mentioned earlier.

Paragraphs 6.37 – 6.48 The Loss of Meter Work Driver and Appendix 11

It is appropriate to have an adjustment mechanism for the treatment of emergency services costs arising from the loss of metering.

Ofgem has recognised part of the costs of the potential loss of metering across the GDN's. However we are concerned that the Ofgem proposals in the UPs for the tipping point do not adequately reflect the residual costs of providing the emergency service.

The emergency service is not optional and emergency staff must be based in strategic locations to ensure that they are able to meet the 1 hour emergency response time. The WWU long and narrow service area with a low customer density requires a larger number of emergency staff than most GDNs and any revenue driver should take this into account.

We have recently submitted further analysis to Ofgem on this subject area, which we believe will illustrate our points.

We agree that with an initial loss of metering work, contractors can be laid off with minimal impact on emergency costs - and this has already been done by WWU. The tipping point should therefore represent a "hurdle" at which point all avoidable costs have been eliminated (e.g. by laying off contractors) and GDNs are left with the stranded unavoidable costs. These stranded costs should be "converted" into an ex ante allowance by an appropriate revenue driver.

GDNs are already using infill work to reduce waiting times to the minimum but there is a limit as to the type of work that can be employed. It has to be close to the area where the FCO is based and has to be capable of a quick closure when the emergency call is received. This is more difficult in the rural areas where the opportunity for this type of work is more limited.

The type of GDN metering contracts will also affect the revenue driver. We have two contracts both of which terminate early in 2008. This work is not therefore subject to competition on a job by job basis and thus the loss of metering work is not a gradual process. The WWU situation is a "go" "no-go" situation where the re-tendered contract is either won or lost. Even if the new contract is won, it stipulates that dedicated staff should be employed on metering work which gives little option for the metering work to be used as infill work by metering staff.

Thus almost overnight, we will have stranded unavoidable costs imposed on its emergency service and any revenue driver must make allowance for this if the emergency service is to remain viable.

We appreciate that the proposed calculations by Ofgem are attempting to produce a relatively high level revenue driver that "fits" all GDNs. However, the calculations used, rely heavily on a relatively crude measure of waiting time and are somewhat cumbersome.

A simpler approach that closer represents the practicalities of operating an emergency and metering business is proposed by WWU in a separate report that accompanies this response.

PART 3 – DETAILED RESPONSE

CHAPTER 7 – SUSTAINABLE DEVELOPMENT

Response to Questions 1-8

Question 1: Is it appropriate to roll forward the existing shrinkage incentive and if so do you consider the leakage volumes appropriate?

Whilst we would prefer pass through in this area we broadly support an allowance for Shrinkage revenue based on an ex ante volume/factor linked to a gas index.

Based on the latest updated proposals and latest data supplied by Ofgem we do not consider the leakage volumes appropriate. Ofgem has accepted in meetings subsequent to the issue of the UPs that the data in tables 7.1 and 7.2 and the associated graphs in the appendices to the UPs needed updating. Following a further issue of the accuracy of the data a joint GDN meeting was held with Ofgem and the GDN's are currently working with Ofgem to ensure that all GDN data and Ofgem's interpretation of that data is acceptable. As agreed at the joint meeting on Tuesday 16 October the GDN's will comment specifically on the leakage volumes once the final version is received from Ofgem.

The updated proposals recommend significant changes to the basis of the calculation of volumes within the shrinkage incentive compared to the existing incentive. These changes will have significant cost and implementation issues for the industry to deal with once implemented. Currently the Shrinkage incentive is based on a Shrinkage Factor. For billing shippers this factor is applied to daily throughput and deducted from volumes billed to shippers. This mechanism is carried out at xoserve on behalf of all of the Gas Distribution Networks. The introduction of a fixed Leakage volume with a percentage for own use and theft will mean that the xoserve billing process will need to be changed if the actual GDN processes are to mirror the licence conditions. This will also require changes to the UNC. The concern is that GDNs have no allowance for the cost of the changes and any change both to physical xoserve systems and UNC changes will not be in place for 1 April 2008. We would anticipate that Ofgem takes account of these issues in the final proposals.

Question 2: Is the gas reference price formula appropriate?

We would support proposals to set the gas reference price for calculating allowed revenue as the day-ahead price plus an uplift factor. This basis for the gas reference price based on historical information would expect be a cheaper outcome for consumers compared to the current M-3 + 3.5%.

Question 3: Should Ofgem establish a new incentive to target harmful environmental emissions?

We already manage the network to minimise leakage. The GDPCR process includes a robust challenge on our leakage volumes and leakage costs. The system is managed to minimise leaks, which result in costs of attending Public Reported Escapes and Repairs. Our view is that this provides sufficient incentive to minimise harmful environmental emissions. We therefore do not see the need for additional incentives in this area. (Please also see our response to question 4 below.)

Question 4: Do you support the design of the environmental incentive and its parameters?

We have reservations as to how much we will be able to influence the actual leakage levels below our challenging forecasts without significant additional investment. It is our view that we have already factored in to our forecast volumes the benefits of all reasonable actions one could undertake to influence Leakage levels. Our response to Supplementary Question OP-WWU-1038 in August 2007 detailed what is already being done and the cost implications further actions.

Pressure Management Actions:

In Wales North LDZ (our smallest LDZ) we have already committed to install pressure management to cover 54% of low pressure metallic mains networks and factored the benefits of this action into our forecast. This leaves little scope for further reductions in leakage in this network. Wales South and South West already have over 90% of the LP metallic mains network covered by pressure management. Again, there is little scope to further influence leakage levels.

Reinforcement:

Our PCR submission and our leakage forecast includes significant Reinforcement in Wales South to enable the reduction of the Maximum Operating Pressure down to 50mb. This will allow better control of the pressure management system and enable us to maintain lower average system pressures. This is dependant on renegotiation of some of the highest contractual pressures of IGT sites. South West network maximum operating pressures are already capped at 50mbar and hence no additional reinforcement for this reason is planned in this network.

To further reduce leakage by 1 GWh within WWU by undertaking further pressure management actions would cost anything between £225k and £500k per GWh depending on the LDZ. Under the proposed incentive this would give us incentive benefit of circa £29,700 (the Shadow Price of Carbon quoted in 2005/06 prices).

The alternative tools to pressure management would be significant targeted Replacement above the 420 kilometres that we are currently undertaking, stopping downsizing of replacement mains (insertion technique of Replacement) and Gas Conditioning. Our response to Supplementary Question OP-WWU-1038 highlighted the uneconomic cost and lack of scope for further leakage reductions. For example, it would take an additional 1093 kilometres of replacement main at a cost of circa £145m over the next 5 years to reduce LP leakage by 99 GWh across the GDN over the five year period. The cost per additional GWh would be £1.5m. This would compare to a benefit under the proposed scheme of £30,000 per GWh per annum.

It is quite clear that within WWU each LDZ, let alone GDN has very different system management features and there is the potential that this incentive could affect GDNs at differing levels.

The proposals are to link the incentive to the governments Shadow Price of Carbon with Caps and Collars. It is not clear whether the incentive would be fixed at a certain reference point or move if the Shadow Price of Carbon moves. This could make the incentive quite volatile. The other obvious sensitivities to such an incentive would be agreement of the baselines and levels of Caps and Collars. Please see our response to question 1 above that covers the current issues about the baselines

proposed. We would propose that any Caps and Collars applied should be very tight. We think that the proposals contained in the UPs – a total of between £7 and £10m per annum across all LDZ's are too high.

Question 5: Are the strength and baselines for the incentive appropriate?

Please see responses to questions 1 and 4.

Question 6: Are the cap and collar arrangements appropriate?

We have real reservations, as pointed out earlier as to the influence we can have over and above our forecast levels of Leakage. Therefore we would propose that any Caps and Collars applied should be very tight. We think the levels contained in the updated proposals – a total of between £7 and £10m per annum across all LDZs are too high.

Question 7: Is it appropriate to introduce a mechanism to address the periodicity of investment?

If the rationale of the environmental incentive is to reward GDN's for behaviours that reduce Leakage below baselines, the introduction of a rolling incentive allowing GDN's to keep benefits for five years would be a positive step and encourage investment. On balance we would agree with the UPs that it is too early to introduce a rolling incentive due to the lack of historical information. This could be dealt with by reflecting this aspiration in the level of the next GDPCR incentive levels. As an alternative to a rolling incentive we would propose that any capex spend to reduce leakage could be allowed without the application of the IQI.

Question 8: Are the leakage model and governance arrangements appropriate?

Whilst there are minor issues to be addressed with the existing Leakage model, the Leakage model and existing governance arrangements are well established and transparent to the industry. We would welcome further joint work with Ofgem and the other GDNs to ensure continued consistency and transparency. Under the new emissions incentive Ofgem will require further reporting and governance of the model, inputs and documentation which will make the need for consistency even more appropriate.

Other Comments

Paragraph 7.41 – Network Extensions

We have consistently supported and indeed proposed our own initiative for facilitating network extensions. We therefore welcome Ofgem's proposals to introduce regulatory mechanisms to enable the costs of the extensions to be recovered. We note that the existing charging methodology statements require to be amended. However clarification of regulatory treatment is required. For example for connections taking place it is crucial that these are funded through a mechanism within the price control licence conditions or included in RAV in the following price control period with a value adjustment from date of spend.

Paragraph 7.47 – Innovation Funding Initiative

We support the introduction of IFI incentives. Funding at 0.5% of allowed revenue seems appropriate together with a partial carry over of unused allowance of 50%. We agree that a GDN IFI Good Practice Guide be developed and look forward to taking part in its development through the ENA.

PART 3 – DETAILED RESPONSE

CHAPTER 8 – OTHER ISSUES

Paragraph 8.5 – 8.7 Independent Systems

We have two Independent systems not connected to the main gas network; both are 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 GDN. These Networks are supplied by LNG transported to site by road tanker and stored in tanks.

We have submitted our response to the Department for Business, Enterprise and Regulatory Reform consultation on its "Proposal to continue cross subsidy arrangements for Independent gas systems".

We have no reason to support a change from the current arrangements except for a possible move to an LDZ basis for the subsidy arrangements for the conveyance of Gas.

An alternative to the current cost of circa £0.1m per annum incurred by WWU is funding either by the consumers within the Independent Systems, or by all existing consumers, of over £5m of capital investment which is an estimate of the likely capital costs that would be required to connect the two Independent Systems to the gas distribution network.

The UPs have inadvertently not included the £0.1m costs and this requires to be addressed prior to the Final proposals.

PART 3 – DETAILED RESPONSE

CHAPTER 9 – FINANCIAL ISSUES

Response to Questions 1-5

Question 1: Does our risk analysis support a range for the cost of equity of 7.0-7.5per cent?

The appropriate cost of equity is at least the 7.5% that Ofgem has set as the maximum cost of equity for the price control due to the effect of risk differential between gas distribution and transmission and the effect of gearing.

The notional gearing assumption of 62.5% is higher than that assumed in the TPCR of 60%. Economic theory requires a higher cost of equity as gearing increases. Oxera have calculated that this alone would result in higher cost of equity of 7.32%

We believe that the gas distribution business demonstrably faces higher business risk than the gas transmission business and consequently a higher cost of equity than given in TPCR is appropriate. We have previously submitted papers prepared by Oxera which indicate that the asset Beta of a gas distribution business is 0.2 higher than a transmission business.

In addition, we have considered qualitative differences in risk between Distribution and Transmission: The principal areas of incremental risk are:

- The relative ratios of Opex:RAV. This is higher in Distribution than Transmission and therefore increases risk.
- Percentage of activity which is driven by external factors (i.e. customers/consumers) with standards of service set and monitored by Ofgem with penalties for failure.
- "Re-openers" that require the DN to bear a disproportionate unfunded cost before they apply, and exposure to areas, such as changes in Health & Safety legislation and its application where re-openers do not apply.
- Uncertain risks arising from the exit and interruption regime which is still under development.
- Significant efficiency challenges and Real Price Effects below DN's forecasts.
- Biased penalty mechanisms which make no allowance for the diminishing returns on costs in achieving 100% compliance.
- Potential disallowance of future costs, such as rates or taxation, which are subject to a "best endeavours" test to be applied retrospectively.

The addendum to this response identifies increased cashflow exposure relative to Transmission faced by Gas Distribution and the increase in WACC required to compensate for these incremental risks. The table below is an extract from detailed analysis which identifies increased cashflow exposure relative to Transmission and the increase in WACC required to compensate for these incremental risks. Incremental risk has been classified by risk driver as due to:

	Increase in "vanilla" WACC %
Methodology of price control	0.26%
Impact of re-openers and incentives	0.52%
Inherent risk difference	0.89%
	1.67%

Incremental risk due to price control methodology and the design of re-openers and incentives can be mitigated in the Final proposals by correction to the control. The inherent risk difference will, however, remain and should be reflected in gas distribution WACC.

Note that WWU's estimate of the inherent risk difference is 0.89%. This is higher than Oxera's estimate of the same effect of 0.1725% increase in post tax vanilla WACC (0.46% on cost of equity at 62.5% gearing) which should be considered the minimum differential.

We have some concerns with Ofgem's analysis of risk:

- It cannot be assumed that overspend on a project due to change in scope may offset the need for future capex – it may not, and even if it did may offset spend in a different price control, and therefore this risk should be considered.
- It should not be assumed that all capex is discretionary or flexible – It may be required due to new customer connections over which GDN has little control but has to complete to comply with Licence and other obligations.
- Assessing risk of capital overspend by examining 9 gas distribution capital projects does not take in to account the capex profile for GDNs which is biased toward multiple smaller customer driven work. WWU overspent against RAV allowances for 2002-7 by approximately £150m. The majority of this overspend was due to inappropriate assumptions regarding workload and cost for small customer driven work, such as connections and service replacements and not due to cost over-runs on high value projects.
- Review of relative risk by comparing out-turn's in previous price control compares "managed risk" rather than "raw" risk.

We do not agree that acceptance of TPCR and GDN TPCR by Transco in 2002 for 2002-7 "could only confirm that they thought the balance of risks across the different controls was acceptable."

Acceptance of a price control where the alternative is a referral to the Competition Commission does not confirm the balance of risks was acceptable – only that it was not so unacceptable that Transco should resort to the Competition Commission.

At that time Transco accepted the price controls as owner of both Transmission and Distribution, but this does not mean that the GDN balance of risks was acceptable individually. Transco may have different views about the balance of risks it accepted with hindsight, having borne shrinkage gas cost in excess of allowance and a significant proportion of efficient capex and repex for customer benefit being either disallowed or not being allowed to provide a regulatory return until 5 years after

expenditure (resulting in a 31% impairment in value). Ofgem's own calculations show the shrinkage and service repex overspend amounted to 0.8% of RAV, We should not forget that a price control is accepted "in the round", and that Transco would, presumably, offset risk imbalance against a "pre tax WACC" allowance, any perceived benefit of which has now been removed.

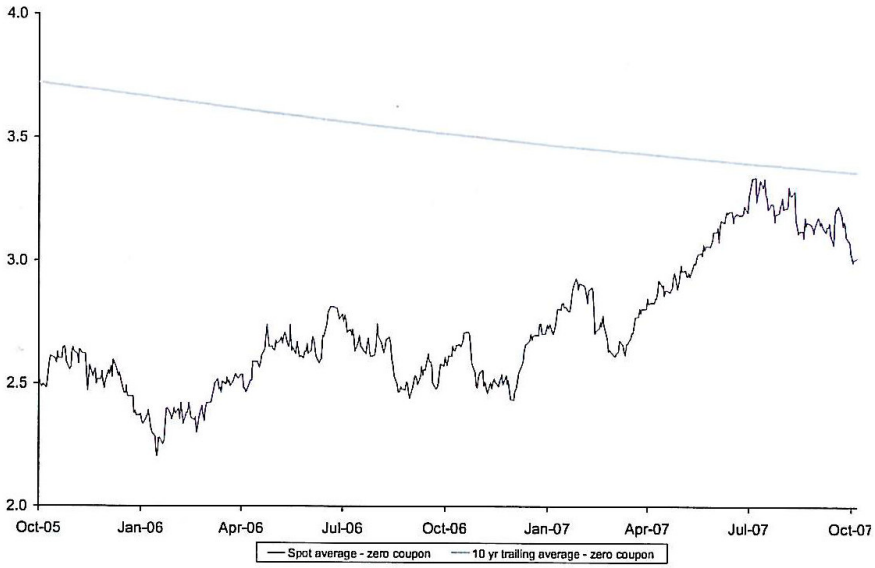
Question 2: Is it appropriate to continue to maintain a consistent approach to cost of debt to that taken in TPCR?

We believe that the cost of debt to be assumed for the period 2008-13 must reflect the following considerations:

- 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%.

- Whilst 10 year trailing average interest rates have declined since the TPCR, short term rates have increased. The financial markets have been affected in the summer and autumn of 2007 by concerns over price and availability of credit. The "headroom" between 10 year trailing rates and spot rates has reduced, significantly since TPCR such that it is now entirely possible for future short term rates to be higher than the 10 year trailing average that Ofgem has previously used as a guide to an appropriate cost of debt. The 10 year trailing average should not be used.

Ofgem's interest rate Figure 9.1, Updated by Oxera



The minimum cost of debt to be adopted should therefore be at least a risk free rate of 2.5% plus a debt premium of 1.25% - consistent with TPCR and current 10 year debt premia for A/BBB rated debt.

We note below that the Ofgem financial model does not report PMICR ratios consistent with A/BBB rated debt, which implies a higher debt premium than the 1.25% quoted above.

Question 3: In the light of both the results of our risk analysis and the levels of actual gearing observed in the sector, is there a compelling reason to change our notional gearing assumption from 62.5per cent?

The gearing assumption should not change but the higher gearing than that assumed in the TPCR should be reflected in estimates of the cost of equity Economic theory requires a higher cost of equity as gearing increases. Oxera have calculated that this alone would result in higher cost of equity of 7.32%.

Question 4: Is our approach to determining the GDNS' tax allowances appropriate?

We are concerned that the DN is exposed to increased risk by the uncertainty regarding a "best endeavours" retrospective adjustment to allowances for tax payments.

Question 5: Should we make a financeability adjustment in cases where a GDN fails to meet our target ratios because of its own actions, such as penalties incurred under incentive schemes?

When assessing financeability, Ofgem should recognise that the DN may be unable to achieve the challenging cost reductions set out in the UPs or will incur a cost

despite it being "disallowed". In addition the GDN may incur costs which are unfunded (such as redundancy costs) in order to achieve required cost reductions.

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".

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.

Financeability

We have previously commented on the importance of Post Maintenance Interest Cover Ratio (PMICR) when assessing financeability. PMICR is used by credit rating rating agencies, providers of finance, and is a key covenant in our debt structure. 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.

Ofgem's own modelling assumptions for the UPs show a Post Maintenance Interest Cover (PMICR) of around 1.3x which is below the 1.5x -1.6x quoted by Ofgem as indicative of "comfortable investment grade". However, Ofgem appear to have proposed two significant changes in its methodology for assessing financeability, to allow them to conclude that a low PMICR does not present a financeability issue, that is:

- assumed that a proportion of debt is index linked when assessing PMICR; and,

- reduced the acceptable benchmark for an appropriate PMICR based on 100% non-index linked debt to 1.3x. The equivalent 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 (both of which are close to "comfortable investment grade" criteria noted above).

WWU believe it is not appropriate for Ofgem to redefine supposed financial constraints in this manner.

Future financeability is also affected by the very real risks on our future cash flows which would have significant impacts, such as:

- Failing to meet the challenging opex cost reductions in the UPs, and potential costs in excess of allowances such as above inflation cost pressures.

- 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.

- Any adverse working capital movements due to factors outside our control, for example changes in shipper transportation prepayment arrangements.

- Potential events for which Ofgem has either precluded the opportunity of a "re-opener", such as Health & Safety requirements, or has set the de minimus level for a re-opener inappropriately low, such as TMA where costs of up to £2.5m per annum would need to be borne by the business before a re-opener.

Overall WACC

For all the reasons given above, we believe the post tax 'vanilla' WACC should be at least 5.26%.

	Oxera	**WWU**
Cost of Debt		
Risk free rate	2.5%	2.5%
Debt Premium	1.25%	1.25%
	3.75%	3.75%
Cost of equity		
Transmission Price Control (Dec 2006)	7.0%	7.0%
Effect of gearing	+ 0.32%	+ 0.32%
Effect of increased business risk	+ 0.46%	+ 2.37%
	7.78%	9.69%
Gearing 62.5%		
Post Tax "vanilla" WACC	**5.26%**	**5.97%**

PART 3 – DETAILED RESPONSE

CHAPTER 10 – OVERALL IMPACT OF THE PROPOSALS

10.2 - 10.7 Overall Impact of the proposals

We note Ofgem's proposals on dealing with shrinkage, loss of meterwork and the Innovative Funding Incentive. Our individual responses to these issues are dealt with in our responses to the sections of the Updated Proposals dealing with each of these points. Shrinkage - Chapter 7, Loss of Meterwork - Chapter 6 and IFI - Chapter 7.

PART 3 – DETAILED RESPONSE

CHAPTER 11 – NEXT STEPS

Paragraphs 11.4 - 11.5

We have provided a response to Ofgem on 21 September on the cost reporting consultation and are now awaiting further guidance. Ofgem have given early 2008 as the publication date of the RRP & RIGs. We would like to state however that the content of the RRP and date of publication needs to be taken into consideration when setting the deadlines for the 2007-08 stats return and the ability of GDNs to provide this information, given that definitions are not yet agreed.

ADDENDUM

Differences between Gas Distribution and Gas Transmission

	Issue	Comment	Financial Risk	Exposure (£m)	Probability (%)	WACC 1200 (% of RAV)	Classification of risk: Methodology errors	Correcting reopeners/ incentives	True risk differences
1	**Operating Environment**	There are a number of general areas where the risk in Distribution is higher than in Transmission. These can be classified under three generic areas of: (i) the relative ratios of Opex:RAV, (ii) Percentage of activity which is driven by external factors							
		(i) Repex programme,	Inflexibility of the Repex programme which is driven by HSE and risk modelling						
		(ii) Emergency and R&R costs in response to consumers/network condition.	Number of repairs is driven by weather as well as age & condition of the network. Upside risk as a result of worse weather than the base year used for the GDPCR.						
		(iii) Lack of flexibility	Constraints on operational change imposed by safety case Relative size & lack of ability to absorb or spread any "shocks" ~ lack of portfolio effect.						
		(iv) Liaison with general public	Operations activity is within rather than near to population centres, and is constrained by regard to safety and consumer experience						
			Estimated combined impact (underlying data is available)	2.5	60%	**0.125%**			0.125%

2	**Non-Formula Revenue**	D has significant exposure to the loss of metering infill work of emergency workforce due to failure to renew these competitively tendered contracts. To the extent that avoidable costs exist, the D is exposed to cost increases.	Stranded costs £6m. But trigger to operate at circa £3.8m, thus this is the exposure level	3	60%	**0.150%**	0.150%		
3	**Tax**	Uncertainty re tax treatment of repex, and Ofgem's retrospective best endeavours test for recovery of tax arising	If repex becomes taxable but Ofgem do not allow DN to recover potentially significant cost (assume £60m repex, tax cashflow difference would be £15.8m).	15.8	10%	**0.132%**		0.132%	
4	**TMA**	Distribution has significantly greater exposure to TMA than Transmission. UP's state that TMA to operate as with DPCR4	TMA re-opener – triggered at 1% of turnover. Exposure to WWU up to the trigger	2.5	10%	**0.021%**		0.021%	
5	**Exposure to increased waste costs**	Ofgem proposals are that the GDNs can absorb increased waste costs	Land fill tax is due to increase from £24/tonne in 2006/7 by £8 p.a. until 2009/10 at £48/tonne. Average annual cost per tonne increase £30.40.	1.7	80%	**0.113%**	0.113%		
6	**Re-openers**	Because of "proximity" to consumers D is more exposed to changes in regulation and legislation but does not have a re-opener. Additional costs could arise, for example from:							
		HSE changes		1	40%	**0.033%**		0.033%	
		12 Hour rule - strict enforcement		7.8	20%	**0.130%**			0.130%
7	**Rates Pass through**	Rates passthrough subject to ex-post evidence test	£5m per annum, but only for 2010/11 onwards	3	20%	**0.050%**		0.050%	
8	**Real Price Effects**	The impact of the Ofgem imposed view increases over time as the cumulative effect of the above inflation increases diverge between the two views	The impact on Opex of the reduction in RPEs imposed by Ofgem versus those proposed by WWU amounts to some £20m over five years.	4	100%	**0.333%**			0.333%
			The impact on Repex of the Ofgem imposed reductions in RPE compared to WWU's view amounts to some £28m over five years. Half of this is recovered through the 50% of Repex treated as Capex whilst the other 50% is left as exposed. (35% exposed along with 3	1.5	100%	**0.129%**			0.129%

			Repex in Capex £2.8m @ 31% (the exposure of WWU to the IQI)	0.9	100%	**0.072%**				0.072%
			Capex RPE difference amounts to circa £15m over five years. This should be recovered via the IQI, but only at 69% for WWU	0.9	100%	**0.078%**				0.078%
9	**Penalties**	Customer facing penalties result in increased risks to GDN over T. Purge & relight etc	Compensation payments (failures of standards of service) in 2006/7 cost Opex £0.3m per submitted BPQ, removed bp Ofgem's consultants in arriving at proposed allowances.	0.5	50%	**0.021%**				0.021%
10	**Exit regime**	Exit capacity	Annual risk is £35m @ 10% (cap/collar limits) = £3.5m. Assumed 50% risk going forward	3.5	50%	**0.146%**			0.146%	
		Interruptions	Under the UPs Ofgem has the ability to disallow this recharge of capacity charges to other GDN customers should they deem the level to be inefficient.	3	20%	**0.050%**			0.050%	
		Reinforcement/LTS etc.	LTS/storage & reinforcement spend, wanted £179.9m, UPs £96.5m. Risk on balance £83.4m (average of £17m p.a.) of which WWU bears 31% under the IQI	5.27	20%	**0.088%**			0.088%	
	Total					**1.671%**	**0.263%**	**0.520%**	**0.888%**	