Investing in Britain's gas distribution networks

Factsheet 73 10.12.07 www.ofgem.gov.uk

Energy regulator Ofgem has published its final proposals for price controls for the four companies that run the networks transporting gas to homes and businesses. The price controls set the maximum revenue these companies can earn from charges to customers between 2008 and 2013.

First five-year price control since National Grid sold four of its gas distribution networks

National Grid completed the sale of four of its eight gas distribution networks (GDNs) in 2005. The Scotland and South of England networks were sold to Scotia Gas Networks. The Wales and West network was sold to Wales & West Utilities and the North of England network was sold to Northern Gas Networks. National Grid retained the remaining four networks: East of England, London, the North West and the West Midlands.

Separate ownership has enabled Ofgem to compare the performance of the new owners and National Grid. An interim one-year price control was agreed for 2007-2008 which gave Ofgem more time to compare performance data when setting the main price control from 2008-2013.

Benefits for customers

Separate ownership of the networks will result in savings for customers over time. This is because Ofgem will be able to set more challenging price controls for the GDNs encouraging them to operate more efficiently. Rivalry will build up between the management teams as they seek to out-perform the controls Ofgem sets.

At the time of the distribution network sales, Ofgem identified potential savings for customers of about £225 million over 18 years. The vast majority of these savings will feed through to customers after 2013, when the next price control is set. By that time Ofgem will have five more years of evidence of how the GDNs can improve efficiency.

Investing for a safer, better network

The price controls will allow the GDNs to spend a total of £5 billion on investment in the networks. This is 36 per cent more than they spent in the previous price control. The main area of investment will be the mains replacement programme, which is required by the Health & Safety Executive and is targeted at the replacement of ageing iron mains to create a safer network for everybody. The programme, introduced in 2002, involves the replacement of iron gas mains within 30 metres of homes and other premises over a 30-year period.

Comparing performance of the GDNs

The table below shows Ofgem's final proposals for expenditure allowances and how they compare to companies' forecasts for spending between 2008 and 2013, spending under the previous five-year price control and for the one-year price control (2007-2008).

The proposals are based on Ofgem's assessment of each GDN's actual spending in 2006-2007. This allowance is then rolled forward over the five years of the price control, taking into account Ofgem's views on future improvements in efficiency, and areas where costs are increasing faster than the rate of inflation.

	2002-07	2007-08	Average annual spending amounts 2008-13		
£m 2005-06 prices	**Average actual annual spending**	**One-year control**	**GDN forecast**	**Final proposals**	**Difference between GDN forecast and final proposals**
Operating expenditure	656.5	652.5	723.6	663.8	-8%
Capital expenditure	260.7	358.4	396.2	345.2	-13%
Replacement expenditure	491.9	588.0	787.5	722.0	-8%

The figures in the table take into account the information quality incentive which discourages the companies from bidding for higher capital expenditure allowances than they actually require.

Under the incentive, companies that put forward sensible projections will receive bigger rewards for outperforming the allowances. GDNs which request higher allowances will receive penalties where there is wide disagreement bewteen Ofgem and the company over the size of the allowance.

Targets to increase efficiency

The GDNs currently face pressures in a number of areas where costs are increasing faster than the rate of inflation. But Ofgem has demanded that the GDNs step up their productivity to cut the resulting level of operating expenditure by 2.5 per cent a year.

Cost of capital

In determining the revenue that GDNs can recover from customers, Ofgem estimates the allowed rate of return the companies earn from investment in their networks - this is the cost of capital. Ofgem's final proposals are for a cost of capital of 4.94 per cent. This is a weighted average of the pre-tax cost of debt and a post-tax cost of equity. The cost of capital for the GDNs is less than the 5.05 per cent for the 2007-2012 energy transmission price control and the 5.55 per cent for the 2005-2010 electricity distribution price control. The main driver for this reduction is a continuing fall in interest rates over the last ten years.

Cost to customers

Gas distribution charges, which for the average domestic customer are £100, make up about one fifth of a domestic customer's bill. Ofgem estimates that the final proposals will increase a household's bill by about £2 a year in real terms (excluding, for example, changes due to inflation).

Sustainable development of the networks

Ofgem has proposed a package of measures so that GDNs can tackle the environmental impact of the networks and contribute to the alleviation of fuel poverty.

Extending the gas networks can reduce fuel poverty by giving customers access to a cheaper source of fuel. It can contribute to environmental objectives as replacing fuel oil with mains gas for heating can cut household emissions. To make it easier for fuel poor households to get connected to the networks, Ofgem has proposed that upfront connection charges are reduced.

The GDNs will have a much stronger incentive to reduce leakage – the small amounts of gas which are lost during transportation through the distribution networks. They will be exposed to the Government's shadow price of carbon which puts a monetary value on emissions from the networks of, for example, methane – a powerful greenhouse gas. This means if a GDN reduces leakage it can claim extra revenue, but if it doesn't it will lose revenue.

In addition, further incentives will be available for a GDN that does an exceptional job in facilitating network extensions, reducing the environmental impact of gas distribution, or increasing awareness of carbon monoxide poisoning.

The GDNs will have incentives to invest a total of £60 million on research and innovation to reduce the impact the networks have on the environment. Such work could include devising novel ways to reduce the environmental impact of gas distribution through lower levels of leakage. Similar incentives are in place for transmission companies between 2007 and 2012, and for the electricity distribution companies.

Ofgem has recognised that attracting and training gas engineers is an issue for the GDNs and has included in allowances £80 million for training and apprenticeship programmes.

Improving customer service

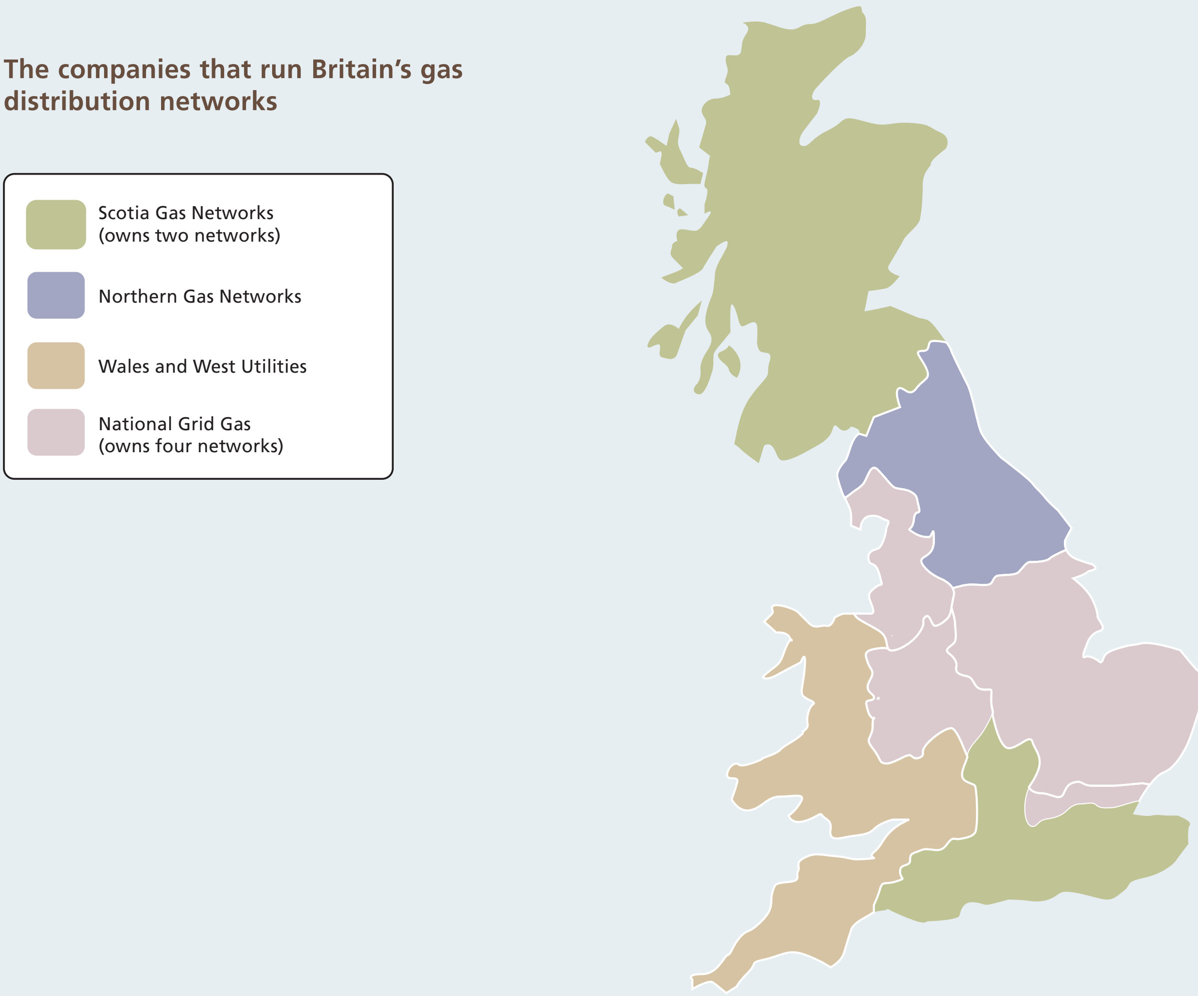
The obligations on the GDNs to offer good customer service will be strengthened. For example, the existing targets for handling calls about gas leaks and dealing with them will be specified in licence conditions. This obligation enables Ofgem to take more appropriate enforcement action against GDNs in the event of a failure to meet the specified performance level.

And the time allowed to complete reinstatement of roads after a GDN has finished work on a connection or repaired a pipe will be cut from ten days to five days.

Next steps

The GDNs have until 7 January 2008 to respond to the final proposals. If accepted by the companies the controls will take effect from 1 April 2008 and run to 31 March 2013.

The companies that run Britain's gas distribution networks



For further information please contact:

Mark Wiltsher, Head of Media Relations 020 7901 7006 email mark.wiltsher@ofgem.gov.uk
Chris Lock, Communications Officer 020 7901 7225 email chris.lock@ofgem.gov.uk
Rebecca Hill, Communications Officer 020 7901 7217 email rebecca.hill@ofgem.gov.uk