

30 May 2008

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Dear Rachel,

Ofgem Consultation on Gas Distribution Price Control – Review of process

Thank you for this opportunity to respond to the consultation regarding the Review of the GDPCR Process.

We will go through our main feedback, both positive and negative, in the main body of this letter. The detailed responses to Ofgem's questions are covered in Appendix A.

This response is not confidential so can be published in its entirety.

Overall, Northern Gas Networks (NGN) thought that the GDPCR process worked well. The timeline was established early and Ofgem adhered to it throughout the process. Ofgem's level of engagement at all levels was good and we never encountered any obstacles to schedule ad hoc meetings when necessary. We especially appreciated the use of the Bi-lateral meetings with David Gray/Joanna Whittington which avoided surprises in the Authority meetings. As a small player with limited price review resources, we also thought the single working group approach worked well.

From a data transfer perspective, we thought that two specific actions greatly enabled a more efficient process than had been observed in previous price reviews:

- The inclusion of the cost assessment consultants early in the design of the BPQ reduced the amount of additional information requests / re-statements
- The use of PBshare significantly improved the data transfer process between the Gas Distribution Networks (GDNs) and Ofgem

In addition, we found the use of three proposal documents (i.e. Initial, Updated and Final Proposals) very positive, as it provided more time to eliminate errors and resolve issues prior to Final Proposals.

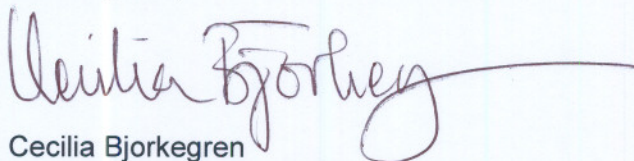
However, there were certain areas where improvements can be made for the next price review process. NGN's main concerns were around late policy decisions, the value of some of the consultants' output and their understanding of the process, and the level of post Final Proposals resource at Ofgem:

- Despite the 2.5 year process certain policy decisions were left very late, specifically the introduction and design of the shrinkage and leakage incentives. The result is that the Price Control has two incentives, Shrinkage and Leakage, that are both targeting measured leakage but in different ways. Had the Leakage concern been introduced earlier in the process, a more thorough review, including the gas purchasing arrangements, could have been conducted and additional alternatives could have been evaluated.
- Some of the consultancy firms asked questions at a level of granularity where the amount of resource required to respond seemed disproportionate to the value of the output. For instance:
 - explaining year on year cost movements of £0.1m when that is the rounding value
 - disaggregating activities to an extremely low level. For instance, we were requested to break down the cost of training, itself a sub-activity within HR, into a number of component parts which all sounded remarkably similar, e.g. 'learning and development', 'management development', 'running training, both internal and external' and 'procurement of training courses and materials'.
- NGN had difficulty in establishing a clear audit trail from BPQ input to consultant analysis, and then from consultant analysis to proposed allowance. In NGN's view, the main driver was that the design of the underlying tools (primarily regression spreadsheets) did not consider the GDNs' requirement for transparency at a detailed level. This resulted in delays to access the detail as well as a non-intuitive layout. Subsequently material GDN resources were diverted to unpicking the spreadsheets to understand what had actually happened with the original data provided. The consultants also spent valuable time reworking the spreadsheets to make them fit for distribution. It will be useful to brief the next set of consultants to keep in mind that the GDNs will expect to be able to follow the underlying detailed calculations and that this must be provided with data from other GDNs excised.
- After the publication of Final Proposals, the GDPCR team at Ofgem was quickly dismantled, with many transferring to DPCR5. Whilst this in many ways is understandable, the resources left in Gas Distribution seemed too stretched, delaying the detailed implementation of new policies, specifically Network Extensions (which suffered from loss of subject matter expertise) and the development of Cost Reporting RIGS (which suffered from a lack of manpower).
- More clarity on Ofgem's methodology for setting WACC, especially the cost of debt, would have been helpful in order to fully understand the underlying reasons for the final decision.

Appendix A provides the responses to Ofgem's list of questions.

Please do not hesitate to contact me if you have any questions or concerns.

Best regards,



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APPENDIX A - Responses to the Questions Posed by Ofgem in the Consultation

General Principles and Objectives

Were the objectives of GDPCR appropriate?

Yes, the objectives as listed in the consultation were appropriate.

Did our process conform to the principles of better regulation?

The principles of better regulation, as NGN understands them are: Transparent, Accountable, Proportionate, Consistent and Only Where Necessary. The GDPCR process conformed to all of these, apart from certain instances when the level of detail required in follow up questions were not following the 'Proportionate' principle.

Preparatory Work

Was our consultation on the process during the early stages of GDPCR helpful?

Yes it helped set the expectations and established a robust timeline early on in the process. More importantly, Ofgem followed the process and timeline throughout. This enabled NGN to plan the project proactively.

Was there anything else that should have been done at the planning stage?

No.

Communication

How effective were the channels and methods of communication?

Overall the different channels of communication worked well. The consultation documents were clear, the face to face communication through the various types of meetings worked well and the relevant Ofgem personnel were always available per e-mail and/or telephone when necessary.

Would it have been possible to make more use of electronic communication compared to face to face meetings?

No, face to face meetings are very important. However, electronic communication prior to a face to face meeting can make the face to face encounter more effective and efficient. Throughout the Price Review, Ofgem were good at publishing agendas early enough for NGN to prepare and send the appropriate people.

Were the appropriate individuals with responsibility for work areas within Ofgem clearly identified to interested parties?

Yes. In the extension year process, there was also a very helpful list of consultant contacts.

Were we open and receptive to comment and criticism?

Both Ofgem and NGN were understanding of honest mistakes when they were made. Ofgem in general seemed open to comment and criticism.

Did stakeholders have access to the appropriate levels of seniority within Ofgem to resolve issues as they arose?

In our experience, yes, we did not encounter any issues regarding access to the relevant Ofgem personnel. If a face to face meeting was not possible, Ofgem always suggested alternative access, such as teleconferencing.

Meetings and working groups

Did participants find our meetings and working groups useful?

NGN found the meetings and working groups useful. As already mentioned in the main body of the response, NGN especially appreciated the use of a single working group in which most topics were covered. Since NGN has limited regulation resource, this enabled us to cover all meetings without being unduly stretched.

Were the right people invited?

Ofgem were generally very good at sending out the agenda in advance so that it was possible to flex the NGN attendees based on subject matter. So even if the correct person was not always invited the first time, there was usually enough time to remedy that before the meeting.

NGN also appreciated the attendance of the cost assessment consultants during the design of the BPQ. It is our belief that it significantly reduced the amount of follow up questions and potential restatement of data.

Were there too many / too few meetings?

In general, meetings were productive enough to be warranted. NGN only experienced one meeting which was not useful; during the Cost Reporting design, Ofgem, due to resource constraints, had not processed the changes from the previous meeting. Hence that particular meeting should have been postponed until there were further issues to discuss.

Were meetings focussed on the right issues?

Yes.

Were they held at appropriate stages of the process?

Yes.

Were the discussions in meetings sufficiently transparent?

Yes, mostly. At times, however, some additional feedback on background to conclusions/likely outcomes would have been welcomed.

Balance between one year control and main control

Did we spend too much time, too little time or about the right amount of time focussing on the one year control?

Ofgem asked for a large amount of forecast data (for Opex, Capex and Repex) in the one year BPQ. This data was never used, as updated forecasts were required for the Main Review. Apart from that, the one year control had about the right time spent on it.

Did any problems arise during the period when the two controls overlapped?

No.

Did our strategy of dealing with certain issues as part of the one year control work well?

Yes; it was good to have sorted the historical costs and pensions treatment prior to the main review. It was also very helpful to have the starting RAV established early on. The fact that Shrinkage was revisited later in the review still does not detract from the benefit of clarifying an interim solution for the one year control. One lesson from this practice is that it is helpful to tackle some of the more complex issues early in the review to ensure that there is not an overload later on in the process.

Did our strategy of explicitly rolling over the previous control in some areas work well?

Yes, it was useful that the expectations were clear from the outset.

Use of consultants

Did we use consultants in an appropriate manner?

From the outside, it was unclear how much of the benchmark thinking was the product of consultants versus Ofgem itself. In NGN's view, Ofgem should be the main decision maker on methodology, with the consultants possibly being used as initial advisors and/or extra resource. However, if consultants are indeed used for the actual benchmarking, they should be experts in the field (and not gas engineers).

Were consultants employed at the right time?

As previously mentioned, it was very helpful that the cost assessment consultants were involved at an early stage.

Was the output from the consultants fair and unbiased?

Yes the output was unbiased, but NGN is not entirely convinced that all the consultant output was useful. The methodologies used should be robust and defensible, but in this case the quality of the output varied widely between the consultants.

Should we be doing more or less of the work in house?

It depends on whether the expertise can be found in house. As mentioned above, the main 'thinking' work should ideally be done by Ofgem, in house.

Consultation Documents

Was the overall consultation process too lengthy, about right or too short?

The length of the process was about right.

Did we produce the right amount and level of information so that all interested parties could understand the GDPCR?

As discussed earlier, there was a lack of timely, detailed information to be able to trace the allowances back to the original submissions. Otherwise, the information provided in the public consultations was clear, usually correct, and should have provided all interested parties with enough information to participate effectively in the consultation process.

Were there too many, too few consultation documents? Were all relevant issues consulted on?

NGN thought the number of consultation documents worked well. Apart from a couple of late entries (i.e. leakage, revision to shrinkage, and WACC) most relevant issues were consulted thoroughly.

Were the response periods for these documents sufficient? Was there any conflict in timescales with any other consultations?

Yes, the response periods for the consultations were sufficient. In NGN's experience, there were no large conflicts in timescales with any other consultations apart from interruption and exit reform, which did not dovetail with the Price Review process as well as was initially envisaged.

Did our documents give a fair and balanced account when respondents had contrary or conflicting views?

Yes.

Use of Impact Assessments

Were our impact assessments useful?

NGN believes that impact assessments could be more useful if Ofgem manages to engage positively with industry participants. Currently there is a perception that RIAs are done to justify decisions already taken.

Did we produce too many, too few or the right number of impact assessments?

The number of impact assessments was appropriate.

Requests for and Use of Information

Were our requests for information reasonable and proportionate?

As discussed previously, the inclusion of the cost assessment consultants in the BPQ design process enabled discussion about reasonableness at an early stage which was helpful. There were instances later in the process, however, when follow up questions focussed on immaterial areas or cost variances that fell within the rounding criteria. These took a disproportionate amount of time.

Was the consultation on draft information requests useful?

Yes, the working group discussions on draft BPQs were helpful in gaining an understanding in the relevance of the information and normalising submissions.

Were consultants sufficiently integrated in the drafting of information requests?

Yes, see previous comments.

Did we give appropriate explanation and justification for our information requests?

In most instances, yes. However, in some instances the consultants focussed with great detail on immaterial issues.

Did regulated companies have sufficient time to meet our information requests?

Yes; NGN encountered few difficulties in meeting the deadlines.

Could we have avoided some of the initial information requests / follow up information requests?

As previously mentioned, by applying materiality criteria certain follow up information requests could have been avoided.

Timeline

Were the timelines for the various work streams appropriate?

Yes, the timelines worked well, especially in the Main Review.

Which issues were addressed too soon/too late in the process?

As discussed in the main body of this response, the revised shrinkage incentive and new leakage incentive were addressed too late in the process. Not only did it leave Ofgem and the GDNs with a very short time to design the incentives; it also precluded a more thorough review of the current arrangements, including the gas purchasing obligation itself.

Regulatory consistency

Were there any unexplained changes in regulatory policy during the course of GDPCR?

Overall, there were very few unexplained changes in regulatory policy. However, NGN was surprised by Ofgem's use of disaggregated opex benchmarking and total cost uplift. This was not consistent with previous approaches in Electricity and underplayed relative efficiency.

Was the process followed during GDPCR consistent with your expectations?

Yes.

Transparency

Were the processes and analyses conducted by us and our consultants sufficiently transparent?

As already discussed in the main body of the response, NGN experienced difficulty in tracing the submitted data all the way through the analyses and proposed allowances. We believe that this was driven primarily by the consultants not being aware of the level of detail that the GDNs expect to see during the price review. The provision of this type of information did improve during the price control, but could be a lot better in the next price control.

Was the underlying data provided by GDNs sufficiently transparent?

This question is for other parties to assess.

Access to Ofgem and the Authority

Were interested parties satisfied with the extent that they were able to meet with Ofgem and/or the Authority during the GDPCR process?

Yes.

Was Ofgem properly represented at such meetings?

Yes.

Were Authority members willing to engage at appropriate stages of the process?

The Authority generally takes the approach of listening to company submissions and views rather than actively responding to points raised. It would be more helpful if a section of these meetings could be used by Authority members to question the companies directly. For instance, that would enable the Authority to check views against those prepared by Ofgem for the Authority.

Were these meetings productive?

Yes.

Process Delivery

Overall did the process work?

Overall the process worked well.

Did we deploy sufficient resource, too much or too little and at the right time in the process?

The level of resource seemed sufficient, apart from at the post Final Proposals stage, when the Ofgem team was dismantled a little too quickly as it impacted the implementation of Network Extensions and Cost Reporting in particular.

Were our teams comprised of the correct range of competencies to deliver an effective price control?

Overall, yes. A potential improvement would be to increase the amount of in house work at the 'thinking' stage, including the main benchmarking work. This is based on the external perception that a lot of the benchmarking was designed and produced by the consultants rather than Ofgem and the consultants appointed were not experts at benchmarking.

Positive Points

What part of the process worked well?

As described in the main body of the response, the involvement of Ofgem at all levels, the adherence to the original timeline and the working group processes all contributed to an overall well functioning process.

Which elements added the most value to the process? What aspects should be retained for future review?

As previously discussed in the main response, the main positives, which by their nature should be retained, are:

- Engagement at all levels of Ofgem
- Adherence to a set timeline
- Early involvement by relevant contacts (i.e. GDNs and potential consultants) in the design of BPQs
- Provision of an on-line data transfer system (i.e. PBshare)
- Use of the three stage process with Initial, Updated and Final Proposal documents

Potential Improvements

How could the overall process be improved?

NGN's view is expressed in the main body of the response, however, in summary the main improvement points are:

- Ensure all main issues covered earlier in process
- Apply a filtering process to consultants' questions
- Improve transparency of consultants' analyses
- Ensure that all data requested will be used during the price control process
- Keep Ofgem price control team for longer post Final Proposals

What were the biggest problems with the GDPCR process?

See above

What changes should be made to the process to avoid a repetition of these problems?

See improvement points above. In particular:

- Require consultants to deliver outputs in a form that can be shared with the GDNs
- Define a materiality threshold for questions, or simply restrict the number of questions asked in order to focus on key/material issues

Other Issues

Are there any other observations that should be made regarding the GDPCR?

No.

Are there other issues we should be addressing in 2008 and 2009 as early preparation for GDPCR2?

In light of emerging issues regarding the potential necessity to restate the DNO cost reporting to make it useful for DPCR5, Ofgem needs to ensure that the cost reporting team within Gas Distribution is keenly aware of the type of benchmarking and other analyses that Ofgem is expecting to conduct at GDPCR2.