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Gas Distribution Annual Report for 2007-08

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Target audience: This document may be of particular interest to users of the gas distribution networks, licensees, providers of finance, consumer groups and other interested parties.

Overview:

This is the first annual report on the eight gas distribution networks, based on the regulatory reporting process introduced as part of the Gas Distribution Price Control Review for 2008-2013 (GDPCR).

The report sets out revenue, expenditure and returns on regulatory equity for the eight licensed gas distribution networks for the year ended 31 March 2008. It also updates benchmarking information produced for the GDPCR, summarises quality of service information, and gives Ofgem's provisional assessment of Regulatory Asset Value (RAV) for each licensee as at 31 March 2008. The RAV will be finalised at the next price review.

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Context

Ofgem regulates the eight regional gas distribution networks (GDNs), which are all natural monopolies, to protect the interests of current and future customers. As part of the Gas Distribution Price Control Review for the period 2008-13, we worked with the industry to develop a process for annual reporting of performance. This is the first annual performance report produced under this regime, and draws on the precedents set by cost reports for the transmission and electricity distribution sectors. It also draws on some information on the quality of service we have already published (see associated documents below). It is our intention to merge these two reports in future years.

The aim of the report is to present key information on the licensee's costs and performance in a meaningful and user friendly format. It forms the basis for developing the annual reporting process over the next four years leading up to the next Price Control Review (GDPCR2) for the gas distribution networks.

Associated Documents

- Gas Distribution Quality of Service Report, 2007-2008 (Ref. 164/08)
- Open letter - Reporting arrangements applying to gas distribution networks (Ref. 22/08)
- GDPCR Final Proposals, December 2007 (Ref. 285/07);
- GDPCR Cost Reporting Consultation (Ref.185/07); and
- GDPCR One Year Control Final Proposals, December 2006 (Ref. 205/06).

Copies of these documents can be found on our website (www.ofgem.gov.uk)

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Summary

The purpose of the review

Annual reporting of performance across a range of measures (revenue, operating costs, investment programmes, and quality of service) has already been successfully introduced by Ofgem for regulated transmission and electricity distribution networks, and has been in existence for other regulated networks for many years. Over time the information assembled in this way shows how efficiently and effectively businesses are delivering their customer service and other obligations, and provides an important input into future price control reviews. It also provides valuable information for the GDNs themselves to understand how well they are doing compared to their peers. Both regulators and businesses can therefore make use of such comparative performance information to help drive improvements in cost and service performance for the benefit of customers and other stakeholders.

Results for 2007/08

This is the first year for much of the regulatory reporting process summarised in this report. It also covers a 12 month period for which many expenditure allowances were set on a simplified basis, prior to the detailed determination of allowances and obligations for the subsequent Five Year Price Control period (2008-2013). We have therefore approached the reporting process and this first annual performance report as a trial for the approach to be adopted for the subsequent Five Year Price Control period.

Ofgem sets an annual maximum revenue allowance for each regulated network at a level that ensures that the network is able to finance its functions and deliver its customer service and safety obligations. Each network is then entitled – and expected – to make management decisions on what levels of expenditure are necessary to meet its obligations. Variations in expenditure from the levels assumed when Ofgem set revenue allowances are therefore a natural part of the incentive based regime. This report observes that in 2007/08:

- All networks have been able to achieve efficiencies in controllable operating costs whilst still maintaining levels of service to customers. Controllable operating costs for the industry as a whole fell by 1.2 per cent, and were just over 3.5 per cent lower than assumed when the One Year Price Control was set;
- There have been improvements in overall customer satisfaction survey scores and some reduction in gas lost through leakage. However, the number of reported interruptions has increased, most probably due to changes in reporting processes;
- Delivery of the industry's safety driven mains replacement programme over the timescale agreed with the Health & Safety Executive has continued to increase, and replacement expenditure ("repex") as a whole was over 9 per cent higher than in 2006/07 and 5 per cent higher than assumed in the One Year Price

Control, reflecting both additional workload (km of mains replaced) and higher costs;

- Capital expenditure increased by 25 per cent on 2006/07, but it was still 12 per cent less than assumed in the One Year Price Control. Investment in local transmission systems and storage was less than half that anticipated in the control;
- The level of debt for the industry as a whole has risen, with gearing up from 61 per cent in 2006/07 to 63 per cent in 2007/08 (compared with the 62.5 per cent assumed for modelling purposes in the One Year Price Control); and,
- Returns on regulatory equity have generally been higher than assumed in the One Year Price Control, principally because debt finance was available in the market in 2007/08 at a lower cost than assumed when allowances were set.

However, we need to be cautious before reaching firm conclusions on the basis of only one year's data. Additionally, National Grid have drawn to Ofgem's attention that they have potentially misreported data in relation to their mains replacement programme, and we are carrying out an investigation into the accuracy of the relevant information, the results of which are not available in time for incorporation in this report. Capital expenditure is lower than expected partly because some projects driven by predicted increases in customer demand are not coming forwards as quickly as forecast, and partly because some areas of activity have been slower than anticipated to mobilise. It is therefore probable that some of the under-spends in capital expenditure will be reversed in subsequent years. Whilst levels of service have been maintained in 2007/08, the number of unplanned interruptions in service remains volatile and interim figures suggest that they may increase in 2008/09. We will keep both of these aspects under review and report on them next year.

This overall picture is by no means uniform across all GDNs:

- returns on regulatory equity for three of the four networks sold by National Grid in 2005 have been the highest, with outperformance of assumptions on controllable operating costs and under-spends on capital expenditure contributing most to their above average returns;
- whilst all network operators put considerable management effort into initiatives to reduce costs or offset unavoidable cost increases, some were more successful than others in 2007/08. The four networks sold by National Grid in 2005 managed with lower – and in some cases significantly lower – operating costs than in 2006/07, whilst the four networks operated by National Grid saw costs increase; and,
- only Southern Gas Networks undertook more service connections in 2007/08 than in the previous year.

It is clearly too early to reach conclusions about the overall combinations of financial and quality of service performance being achieved by each network. Whilst it is clear that some GDNs have been more successful than others in reducing operating costs, whether this is sustainable and has any impact on the quality of service delivered to customers will only become evident in subsequent years.

1. Background and Introduction

Gas distribution in Great Britain

1.1. Natural gas is brought into Great Britain from the gas fields in the North Sea and Norway, via pipelines linking us with continental Europe and from liquefied natural gas (LNG) terminals. The national transmission system (NTS) is a network of pipelines that takes gas from where it is brought onshore and transports it at high pressures across Great Britain. The GDNs are linked to the NTS at various points called offtakes. The GDNs transport gas at lower pressures from the offtakes to the homes and businesses of gas customers.

1.2. The GDNs' main responsibilities are the operation, maintenance, repair and renewal of their networks, the provision of emergency service personnel to gas emergencies and the provision of gas connections to premises within their network area.

1.3. Customers buy gas from supply companies and not from the GDNs. The GDNs charge for the transportation of gas, which they do not own, via their pipeline networks. The GDNs are monopoly companies as they have no direct competitors for the distribution of gas. We regulate these companies by setting limits on the revenues that they can earn.

1.4. The GDNs earned revenues in 2007-08 equivalent to £94 per domestic customer, an increase of around £8-50 per customer on the previous year.

1.5. There are eight gas distribution networks in Great Britain: East of England, London, North West, West Midlands, Northern, Scotland, Southern and Wales & West. They are owned by four companies: National Grid Gas, Northern Gas Networks, Scotia Gas Networks and Wales & West Utilities.

1.6. Figure 1 on the next page shows the locations of the eight GDNs and the companies that own them.

National Grid Gas

1.7. National Grid Gas plc (NGG) is part of National Grid plc. It owns four GDNs, covering the East of England, London, the North West and the West Midlands. NGG previously owned all eight networks but chose to sell four of these in 2005. National Grid also owns and operates the NTS.

1.8. NGG’s four GDNs are covered by a single Gas Transporter's licence, though each of the GDNs has a separate price control.

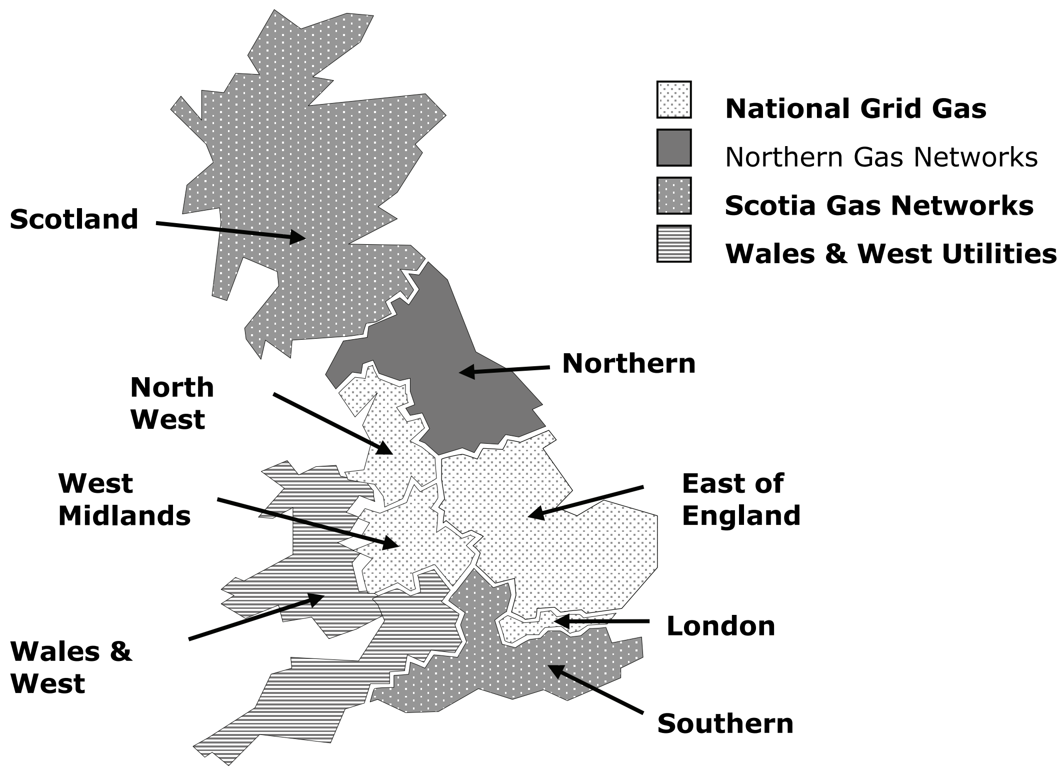


Figure 1- Gas Distribution Networks (GDNs) and their Owners

Northern Gas Networks

1.9. Northern Gas Networks (NGN) is the owner of the Northern GDN, having purchased it from NGG in 2005. This GDN covers the area between the Scottish border and South Yorkshire.

1.10. NGN is owned by a consortium of four companies. NGN's operational delivery is carried out by one of these companies - United Utilities.

Scotia Gas Networks

1.11. Scotia Gas Networks (SGN) owns two GDNs, Southern and Scotland. The Southern GDN extends from Milton Keynes to Dover in the east and Lyme Regis in the west. It also covers those London boroughs south of the Thames. The Scotland GDN covers Scotland and includes the five independent networks at Stornoway, Wick, Thurso, Oban and Campbeltown, which are not connected to the main distribution system.

1.12. Unlike the GDNs owned by NGG, the two networks owned by SGN are contained within two separate companies. These are called Scotland Gas Networks and Southern Gas Networks. Each company holds its own gas transporter's licence.

1.13. SGN's ultimate owners are the energy group Scottish & Southern Energy plc (50 per cent) and two Canadian pension funds (25 per cent each).

Wales and West Utilities

1.14. Wales and West Utilities (WWU) owns the Wales and West GDN. The network covers Wales and south-west England from Swindon to the tip of Cornwall. WWU is owned by a consortium led by the Macquarie European Infrastructure Fund.

Independent Gas Transporters

1.15. There are a number of Independent Gas Transporters (IGTs) which operate relatively small distribution networks, typically covering newly built properties. The licence conditions that apply to these companies are different to those that apply to the eight large GDNs and, for this reason, IGT performance is not covered under this report.

xoserve

1.16. xoserve is the organisation that provides common gas management and billing services across the industry, including administration of supply points to customers and recording volumes of gas flowing through networks. Originally an operating division of National Grid Gas, it became an independent company - wholly owned by the gas distribution and transmission businesses - when National Grid Gas sold off four networks in 2005. xoserve charges its users - still principally the GDNs and the National Grid National Transportation System - for the services it provides and the investment it needs to make to maintain and develop those services. Charges from xoserve therefore form a part of each GDN's costs.

Regulatory reporting on gas distribution

1.17. Annual reporting of performance across a range of measures (revenue, operating costs, investment programmes, and quality of service) has already been successfully implemented by Ofgem for regulated transmission and electricity distribution networks. It has operated successfully for other regulated sectors (including water and sewerage businesses) for many years. Over time the information assembled in this way shows how efficiently and effectively businesses are delivering their customer service and other obligations, and provides an important input into future price control reviews. We therefore concluded that it

would be in all stakeholders' interests to introduce an annual reporting process for gas distribution networks (GDNs).

1.18. As part of the Gas Distribution Price Control Review, we consulted on the reporting arrangements which might be developed. In particular, we issued a consultation document on the cost reporting arrangements in July 2007 (Ref. 185/07) and subsequently developed the detail of our proposals through a series of working groups attended by GDNs and, in the case of the Quality of Service working group, energywatch. In March 2008 we issued a set of detailed reporting guidelines and templates (Ref 22/08), to be used for the first round of regulatory reporting and as a basis for the further development of reporting arrangements in the light of experience with the first year's exercise.

Objectives

1.19. Annual reporting of revenue information by the regulated gas distribution networks is a Licence Condition. It enables us to monitor the way in which regulated businesses are complying with the revenue restrictions set at Price Control Reviews, without the need for annual approval of changes to regulated prices. Accurate and consistent information from all regulated businesses are a pre-requisite for us to be able to do this. Publishing a summary of the compliance reports for each regulated business enhances the transparency of the regulatory process and provides all stakeholders with assurance that the regime is operating as intended.

1.20. In our consultation on the development of an annual cost reporting regime, we stated that we intended to use the cost information thus collected to:

- facilitate effective monitoring of expenditure compared to price control allowances;
- allow an interim RAV to be calculated;
- enable the reconciliation of costs reported in the prescribed format under the annual reporting process to the audited regulatory accounts for each network business; and,
- inform future price control reviews.

1.21. We share with GDNs the view that it is imperative to have a robust structure in place for monitoring performance and informing the next price control review based on consistent interpretation by GDNs of definitions and reporting requirements. This will not only reduce the burden on all parties for the provision and review of historic financial and other information at the time of a price control review, but will enable the development and application of critical analysis and assessment methodologies before the review itself.

1.22. Feedback on the consultation on the annual reporting regime, as well as on the information presented in our Gas Distribution Price Control Review Final Proposals, highlighted the importance stakeholders attach to the benchmarking

information used to inform expenditure allowances, and the valuable role that regular updates on performance against such benchmarks could play in driving performance improvements for regulated businesses. Such updates can also help us work with regulated businesses to improve the consistency of expenditure analysis across networks and, where appropriate, identify enhancements to the analysis techniques and cost drivers used.

1.23. We think that it is important to understand revenue and expenditure performance in a broader context. In particular, these are only two components of overall financial performance and do not address how well assumptions we have made in Price Control Reviews on financing activities are standing up in practice. We have therefore developed a measure of "return on regulatory equity" as a means of comparing the holistic financial performance of businesses with the assumptions built into price allowances, and to provide some context for the more detailed assessments of components of expenditure performance arising from the annual cost reporting process.

1.24. Financial performance also needs to be set alongside performance in delivering service to customers if a more rounded picture of overall performance of regulated businesses is to be achieved. This is the sixth year that we have published an annual report on the quality of service provided by gas distribution businesses. Together with a compensation scheme (where the regulated businesses pay customers if they fail to meet certain standards) and Licence Conditions requiring them to meet specified performance standards, annual reporting of quality of service information enables us to ensure that the service provided by regulated businesses is of sufficiently high quality. Further enhancements to customer service measurement and reporting were introduced from 1 April 2008, and will feature in future reports. Over time, we shall look across financial and customer service performance together, to understand if there are consistently high performers on all measures and where trade-offs may be being made.

1.25. An additional over-riding objective for this first year of annual reporting has been to test the reporting formats and processes, and capture enhancements for use in future years. This will always feature in the first time any new process is implemented, but is accentuated for the gas distribution networks for 2007/08 because of the way in which price control allowances were set for this particular year. More precisely, the "roll forward" approach to operating cost allowances (see details in Section 2 below) means that there is less information available on the breakdown of price control allowances than there will be for subsequent years. We therefore regard the 2007/08 updates of some of the benchmarking approaches used in the main price control review as a first step in their further development for use in future price controls.

Process for 2007/08

1.26. Following the consultations on regulatory reporting guidelines referred to above, final reporting packs and guidelines were issued to GDNs and xoserve in May 2008, with a request for submission of some tables in mid-September and for the main packs, commentaries and supporting information by the end of September. The reporting timetable adopted for the more established processes for transmission and electricity distribution businesses is for reports to be submitted by the end of July. We accepted that this would be neither practical nor appropriate for this first round of reporting, and will be considering (in conjunction with the businesses affected) the timetable for future years.

1.27. All businesses achieved good compliance with the agreed timetable, despite the inevitable unforeseen hitches encountered with a new process. All submissions came in on time, there were no significant omissions and the commentaries were of a good quality. We are grateful for the efforts of all involved.

1.28. Ofgem undertook an initial desktop review of the submissions and raised clarification questions through an agreed formal process where necessary.

1.29. Visits were then undertaken to each ownership group in early November, to help get a better understanding of performance in the round and more detailed understanding of particular areas. Businesses were well prepared for these visits, and provided much helpful information to support their initial submissions and explain their approach and performance, in accordance with detailed pre-agreed agendas. Conversations during these visits were often probing and challenging, but were always completed in a good spirit of co-operation. Some key areas for future development, and the need for some further explanatory information, were identified.

1.30. A full set of resubmissions to address issues identified by the process to date were provided at the end November. The volume of changes required varied, from changes affecting the majority of tables to limited changes to a handful. Despite this, data issues have continued to be identified by both Ofgem and GDNs themselves, and further resubmissions have been necessary for some networks. There remain areas where interpretations of requirements differ and consistency can be improved.

1.31. In November, National Grid Gas drew to Ofgem's attention potential misreporting of mains replacement data it had provided. Ofgem and NGG are currently in the process of verifying the accuracy of the data provided by NGG. Pending the outcome of this work, the figures on mains replacement contained in this report may be subject to change and should be checked against subsequent publications before use.

1.32. An outline of the scope, format and key comparisons to be made in this report was shared with the businesses affected in December 2008 and each

business has had an opportunity to verify its own data as used in all comparisons prior to publication. The scope, approach and conclusions of this report, however, remain Ofgem's. We welcome comments from all stakeholders on this first report, which will help us shape future years' publications.

1.33. We consider that a good start has been made on establishing an efficient, effective and transparent process. Regulated businesses have worked hard to make the process a success - in contributing to the development of the reporting regime, complying with the timetable for submissions and subsequent stages in the process, providing good quality information on the performance of their businesses, and in assisting with the further development of the process. There are improvements that can be made in the clarity and purpose of reporting requirements, accuracy and consistency in reporting, and in the quantification of the impacts of key cost drivers.

2. Review of Performance

Returns on Regulatory Equity

2.1. We consider it is important to understand how well our approach in Price Control Reviews encourages behaviours that we think are in customers' interests. This will help us to identify ways in which settlements and associated incentives could be improved. We think a useful way to look holistically at how companies are performing under the control is to make an assessment of each company's return on regulatory equity compared to the assumed return used in setting allowed revenues. This approach is being adopted in our current Price Control Review for electricity distribution businesses and is applied to gas distribution businesses for the first time in this report.

2.2. We have developed this measure to assist us in assessing overall price control performance. It will not necessarily be consistent with standard accounting return on equity metrics. We think it will help us (and all interested parties) understand better how companies have performed, the range of shareholder returns that have been available to network owners from the settlement, and the relative rewards that the eight businesses earned in 2007-08. Our analysis is provisional, and only applies to 2007-08, for which a One Year Price Control was in place. For future reports, it will be extended to the period covered by the Five Year Price Control (2008-13). We may also decide to make changes to the methodology in light of responses to this report and to the ongoing consultation on the electricity distribution price control.

2.3. We think it is important that investors and company analysts understand the basis of our calculations but also why actual shareholder returns and company performance may differ from that presented in our analysis. Our analysis is based on a combination of actual data and regulatory assumptions. We do not, for example, take account of actual levels of company gearing and companies with higher (or lower) levels of gearing may earn higher (or lower) returns than if they had gearing of the same level as our notional assumption.

2.4. Further, we have only made adjustments for what we consider to be material variances from allowances, and have taken account where relevant of expected ex post adjustments. We have excluded "non-controllable" costs, since any variance will be recovered ex post. Our variance on operating costs includes the impact of variances in expenditure on asset replacement ("repex") that is treated in the same way as operating cost variances. Our variance on capital expenditure makes no assumption about whether under-spends or over-spends against the One Year Price Control assumptions will be reversed in the subsequent Five Year Price Control period (In other words, timing differences get treated in the same way as permanent efficiencies or inefficiencies.) This is the same approach as used for a Five Year Price Control period, but its impact is exacerbated with a single year control such as operated for gas distribution businesses in 2007-08. We have not

looked at the impact of any profits made on services or activities which are outside the price control.

2.5. We measure return on regulatory equity by assuming the companies are geared at our notional assumption of 62.5 per cent of RAV - not their actual level of gearing. We have reflected the difference in actual interest rates from the allowance by using a benchmark based on actual 10 year rolling average bond yields for a comfortable investment grade issuer. This allows a like for like comparison between GDNs. In practice, GDNs' actual returns will depend on their level of gearing and the extent to which their actual cost of debt has tracked market rates. (This will in turn depend on the maturity of their debt and the extent to which, for example, they have fixed or indexed linked debt.) These are decisions for the companies, but in considering our approach to financial issues at price control reviews we will consider whether, in the light of actual company finance structures and market data, our assumptions about gearing when setting the cost of capital remain reasonable.

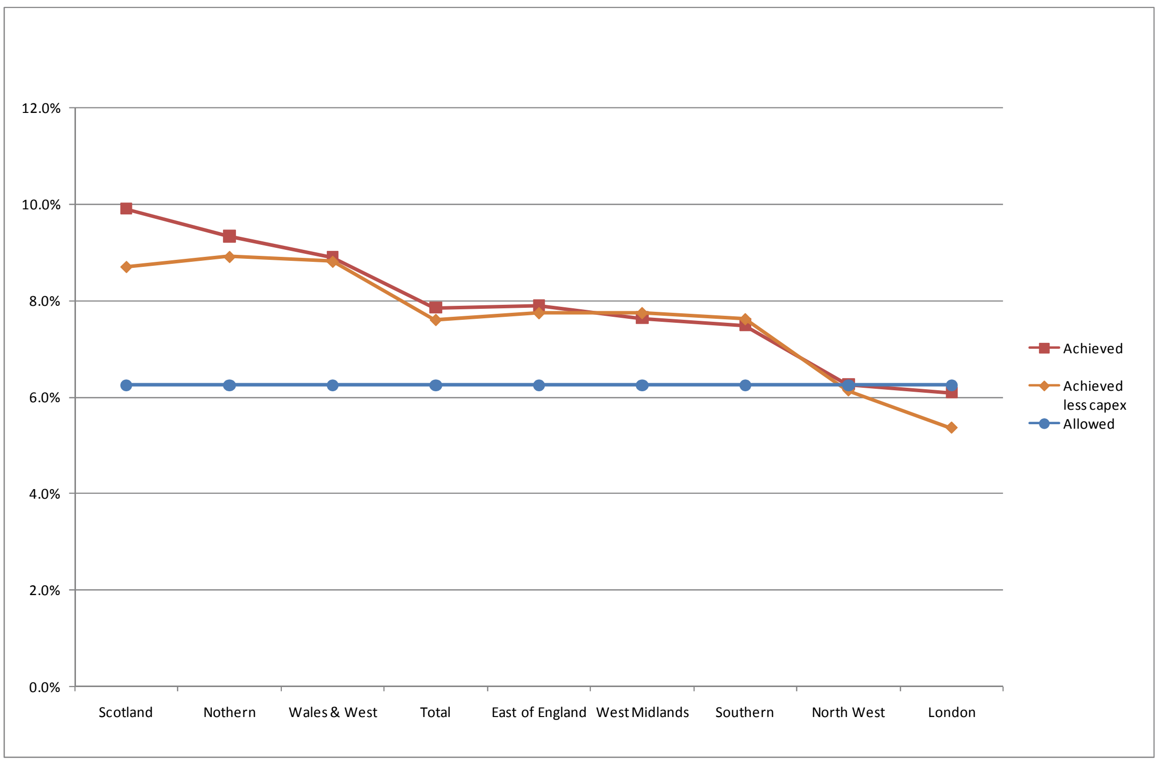
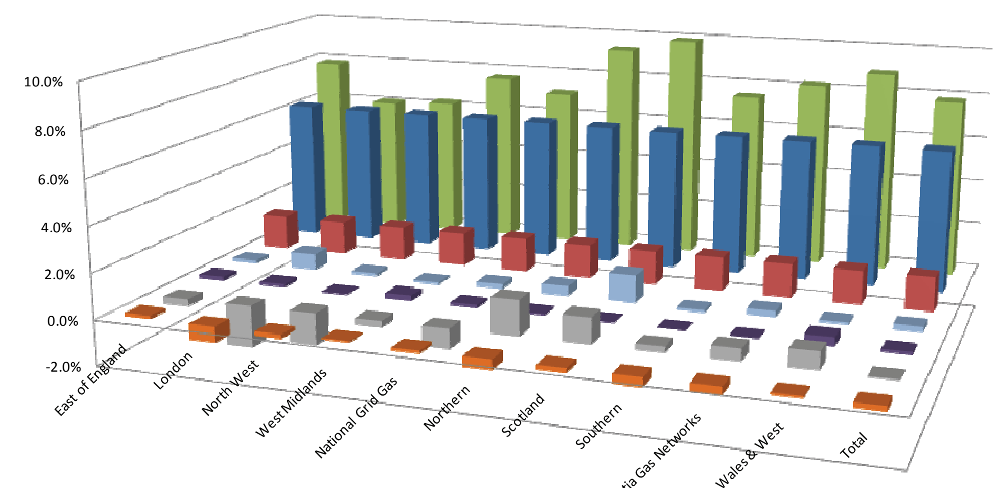


Figure 2 Return on Regulatory Equity by GDN, 2007/08

2.6. Figure 2 above shows for each GDN the 6.25 per cent return on regulatory equity assumed in the One Year Price Control compared with the actual returns achieved, both taking into account and ignoring the impact of variances in capital expenditure. It is important to recognise that whilst variances on capital expenditure have a significant effect on this measure (reflecting the share of under- or over- spends which will ultimately fall to shareholders), these may be reversed in subsequent years if the variances are purely related to the timing of

expenditure (which in many cases GDNs have said they are, reflecting the fact that many are approaching the One and Five Year Price Control periods as a single, six year programme).

2.7. With these caveats about the impact of variances in capital expenditure, all GDNs achieved returns higher than we assumed when setting price allowances (driven largely by the lower cost of borrowing available in the market in 2007-08). Figure 3 below shows the components contributing to the overall variance in the returns on regulatory equity in this analysis.



	East of England	London	North West	West Midlands	National Grid Gas	Northern	Scotland	Southern	Scotia Gas Networks	Wales & West	Total
Total Repex	0.1%	-0.7%	-0.2%	0.1%	-0.1%	-0.4%	-0.2%	-0.4%	-0.3%	-0.1%	-0.2%
Controllable Opex ex ongoing pensions costs	-0.3%	-1.8%	-1.4%	-0.3%	-0.9%	1.5%	1.1%	0.3%	0.5%	0.8%	-0.1%
Exit and shrinkage incentives	0.2%	0.1%	0.0%	0.2%	0.1%	0.1%	0.0%	0.0%	0.0%	0.4%	0.1%
Capex	0.1%	0.7%	0.1%	-0.1%	0.2%	0.4%	1.2%	-0.1%	0.3%	0.1%	0.2%
Market interest rates	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Allowed	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%
Achieved allowing for tax	7.9%	6.1%	6.3%	7.6%	7.1%	9.3%	9.9%	7.5%	8.2%	8.9%	7.8%

Figure 3 - Components of Variance in Returns on Regulatory Equity

2.8. The single largest contribution to the generally higher levels of return on regulatory equity than we assumed has, as already been mentioned, the lower cost of debt available in the market during 2007-08, which had the potential to add 1.5 per cent to all GDNs returns. This largely reflects the approach to setting the overall cost of capital for the One Year Price Control, which was simply to carry forward the assumptions from the previous price review, pending a full reassessment for the Five Year Price Control. The cost of debt assumed in the Five Year Price Control was actually reduced by 1.1 per cent, thus reducing scope for outperformance. On the other hand, the cost of equity assumed was 1 per cent higher at 7.25 per cent, so the earnings before outperformance in the Five Year Price Control are higher. It is also important to note that GDNs' actual financing decisions may mean that they have performed better or worse than this. Variances on capital expenditure in the year added 0.2 per cent to average

returns for the industry as a whole, but the range of impacts was substantial (from +1.2 per cent in Scotland to -0.1 per cent in Southern and West Midlands), reflecting the scale of under- and over- spends relative to returns on equity across GDNs. Clearly, we shall monitor closely the impact of variances in capital expenditure by GDN over the Five Year Price Control period.

2.9. In aggregate the industry outperformed allowances for controllable operating costs for 2007/08 by over £25m (or just over 3.5 per cent). However, when the variance on on-going pension costs has been taken into account (as GDNs are ultimately only funded for actual pension contributions to defined benefit schemes), variations in operating costs have minimal impact on returns of equity for the industry as a whole. However, as with capital expenditure, the range across GDNs was significant - impacting on returns on regulatory equity by between +1.5 per cent (Northern) and -1.8 per cent (London).

2.10. The impact on returns on regulatory equity of the incentive mechanisms built into the One Year Price Control was actually modest. Whilst additional work done under the Mains Replacement programme allowed GDNs to generate an additional £37m of revenue (see section on Revenue Reporting, paras. 2.19 - 2.21 below), this was offset by equivalent expenditure and had no impact on returns on regulatory equity. In fact, incentives on asset replacement ("repex") reduced the aggregate return on equity for the industry as a whole by 0.2 per cent, but again the impact on individual GDNs varied - from +0.1 per cent in East of England and West Midlands to -0.7 per cent in London. In contrast, all bar two networks were able to enhance their return on regulatory equity by outperforming on the incentives to control shrinkage and exit capacity costs.

2.11. We shall explore what more we can do at future price control reviews to align the ranking of GDNs' regulatory earnings with their actual performance in terms of service and efficiency. As a first step, we are bringing financial and customer service performance reviews together in this first annual performance report.

Revenue Reporting

2.12. Table 1 below shows the build up of the maximum revenue each network was entitled to recover in charges in 2007/08, the actual revenue received in the year, and the differences between the two in absolute and percentage terms.

£m	East of England	London	North West	West Midlands	Scotland	Southern	Northern	Wales & West	GDN TOTAL
Base revenue, adjusted for inflation	371.4	213.9	254.7	193.8	181.3	382.5	243.6	228.8	2,070.1
Pass through items	70.1	34.4	36.4	28.3	17.1	58.6	36.0	27.3	308.2
DN exit capacity costs and incentive revenue	2.0	0.3	-0.4	1.4	0.0	0.4	0.1	2.7	6.6
Mains Replacement expenditure adjustment	-1.9	10.7	12.3	6.9	3.7	6.2	0.0	-0.8	37.2
Distribution Network shrinkage incentive revenue	9.1	5.4	7.2	5.6	4.2	10.7	6.7	7.1	56.0
Adjustment for under recovery in previous year	19.0	8.7	10.0	6.9	6.3	7.9	0.2	3.4	62.5
Maximum Distribution network transportation activity revenue	469.8	273.5	320.3	242.8	212.5	466.5	286.6	268.6	2,540.5
Actual distribution network transportation activity revenue	467.4	267.0	310.7	242.2	209.6	470.5	292.9	265.6	2,525.8
(under)/over recovery for year	-2.3	-6.5	-9.7	-0.6	-2.9	4.0	6.2	-3.0	-14.7
(under)/over recovery as % of maximum revenue	-0.5	-2.4	-3.0	-0.3	-1.4	0.9	2.2	-1.1	-0.6

Table 1 - Components of Maximum Allowed Revenues, 2007/08

2.13. The actual revenues charged by the networks in total were within £15m, or 0.6 per cent of the maximum recoverable revenues of just over £2.5bn. This suggests that the GDNs are proficient in setting their distribution charges appropriately and in their forecasting of revenues to be generated through the incentive mechanisms. Of the eight GDNs, two recovered more than the maximum recoverable amounts and six recovered less. Under- and over-recoveries are corrected in the following charging year.

2.14. Base revenues include allowances to cover each GDN's operating and capital expenditure, as well as an allowance for depreciation and a return on the value of the regulatory asset base. Base revenues accounted for around £2.1bn of the £2.5bn recoverable in 2007-08.

Revenue adjusting events

2.15. In addition to the base revenue allowances, the One Year Price Control settlement included provision for full recovery of certain costs that were deemed beyond management control ("pass through" items) or were too uncertain to be included in Price Controls ("approved income adjusting events"), and for three specific incentive mechanisms (for exit capacity, shrinkage, and the mains

replacement programme). There were in fact no "approved income adjusting events" in 2007/08.

Pass through items

2.16. The GDNs were allowed to recover £308.2m in revenues on the specified pass-through items - network rates, the Ofgem licence fee and payments towards the deficit on the NTS pension scheme. This value differs from the one given in Figure 5 for non-controllable operating costs, as the latter includes bad debt and additional pension deficits or surpluses, which are included in Base Revenues in the Licence Condition governing revenue control (and therefore in Table 1). The additional payments towards pension deficits are the principal reason for the increase in non-controllable operating costs shown in Figure 5 below. Paragraphs 2.39 onwards below provide more details of pension payments in 2007/08.

Exit capacity costs and incentive revenue.

2.17. The exit capacity incentive relates to the bookings of flat and flexibility NTS offtake capacity. It provides GDNs with separate daily flat and flexibility capacity volume targets. These are multiplied by the exit capacity charges and converted into an overall cost target. Between a cap and collar, the GDNs retain any savings and are exposed to any cost overruns against these targets. The incentive also sets an allowance for payments to be made to sites where the supply of gas has been interrupted by the GDN for more than 15 days. The GDNs retain any of this allowance that is unspent.

2.18. Through this mechanism, £6.6m was recoverable by the GDNs in 2007-08. This sum is derived from a mixture of outperformance against the volume targets and savings made on payment to customers interrupted for more than 15 days. (There were no such payments made in 2007-08).

Mains replacement adjustment

2.19. The mains replacement revenue adjustment allows GDNs to vary the workload from that assumed at the time of the price control in order to meet the programme agreed with the Health & Safety Executive.

2.20. Additional revenues of £37.2m were recoverable through the mains replacement expenditure adjustment mechanism. This sum is around 10 per cent of the mains replacement expenditure assumed in the One Year Price Control. Three GDNs exceeded the mains incentive allowance cap, which is the total mains matrix costs plus 15 per cent. However, all three of these are NGG GDNs and, as the remaining NGG network spent less than its ex ante allowance, the total NGG mains incentive revenue came in marginally below the cap.

2.21. £18.6m of the £37.2m additional revenue recovered under the mains replacement incentive mechanism was due to additional workload, priced at the

same unit costs as used for determining the cost of the programme in the One Year Price Control. The remaining £18.6m additional revenue arises from the share of over- and under-spends on assumed unit costs that are paid for by customers under the incentive mechanism. Most networks incurred higher unit costs, which are paid for equally by customers and shareholders. Two of the GDNs carried out replacement works at less than the allowed unit costs. Shareholders in these GDNs retain one third of the under-spend. The remaining two thirds are subtracted from the revenue allowance and are therefore benefits retained by customers.

Shrinkage incentive revenue

2.22. The shrinkage factors for each network area were set at the price control, and are the assumed proportion of gas lost in each network through leakage, own-use and theft. The amount of revenue recoverable through the incentive is calculated by multiplying the quantity of gas that passes through a network by an assumed reference price and the shrinkage factor. Therefore, the GDNs will benefit if they are able to purchase less gas than was assumed in setting the shrinkage factor or if they purchase the gas at a cost lower than the reference price.

2.23. Under the shrinkage incentive, £56.0m was recoverable by the GDNs in 2007/08. The GDNs charged only £52.5m against profits for shrinkage gas in the year. £2.7m of the £3.5m difference relates to amounts owed to some of the GDNs by shippers as a result of their procuring of more shrinkage gas than was required in the year 2005/06. The balance represents out performance of both volume and price assumptions in the One Year Price Control.

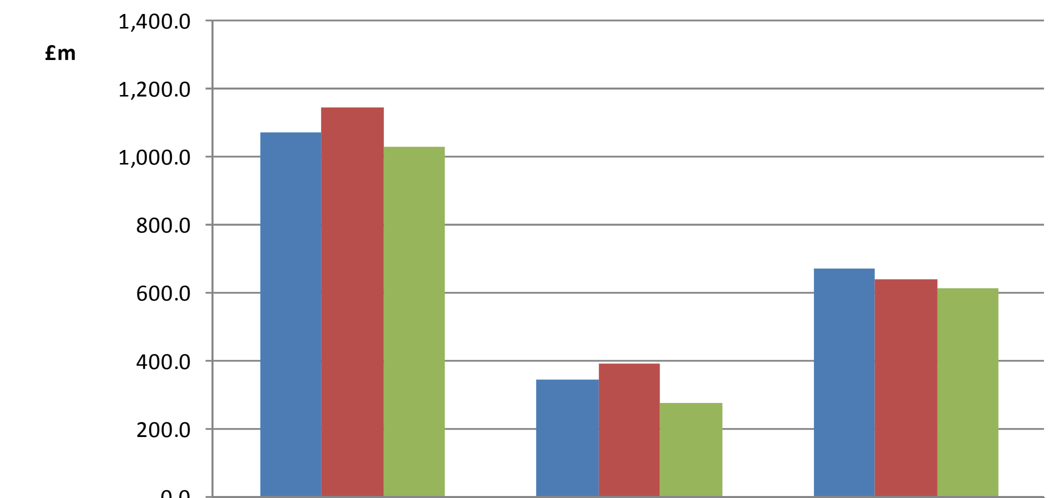
2.24. Figure 5 below indicates that £95.1m was initially included in the One Year Price Control. This was based on the much higher price of gas prevailing in the market at the time the One Year Control was finalised (and was being reflected in the cost of shrinkage in 2006/07). The mechanism put in place under the One Year Price Control, whilst protecting GDNs from increases in the unit price for shrinkage gas also ensured that customers benefited from the reduction in price between the time at which allowances were originally calculated and the time at which GDNs had to make purchases for 2007/08.

Adjustment for under recovery in previous year

2.25. The revenue restriction provides for an adjustment to be made to the maximum recoverable revenues of each GDN based on under- or over- recovery in the previous year. It is difficult for the GDNs to avoid some degree of under- or over recovery, as certain elements of the maximum recoverable revenue are not known at the point where the distribution charges are set. For example, the GDNs have to make assumptions regarding the cost of gas and of replacing mains. The actual costs will not be known until later in the year. As each of the GDNs recovered less than the maximum last year, there is a positive adjustment of £62.5m in 2007/08.

Total Expenditure

2.26. Price limits for gas distribution businesses encompass allowances for three principal streams of expenditure - for operating costs, for new capital expenditure (including extension of the asset base to accommodate growth in customer usage), and for the repex programmes (dominated by the mains replacement programme required by the Health & Safety Executive). Figure 4 below shows actual expenditure in each category, compared with assumptions in price allowances and with expenditure in 2006/07 (in 2006/07 prices), for all eight gas distribution businesses in aggregate.



	Total Operating Costs	Capex	Repex
07/08 Actuals	1,069.4	339.6	670.1
07/08 Allowances	1,144.0	387.1	635.1
06/07 Actuals	1,028.4	271.5	612.2

Figure 4 - Total Expenditure by Category

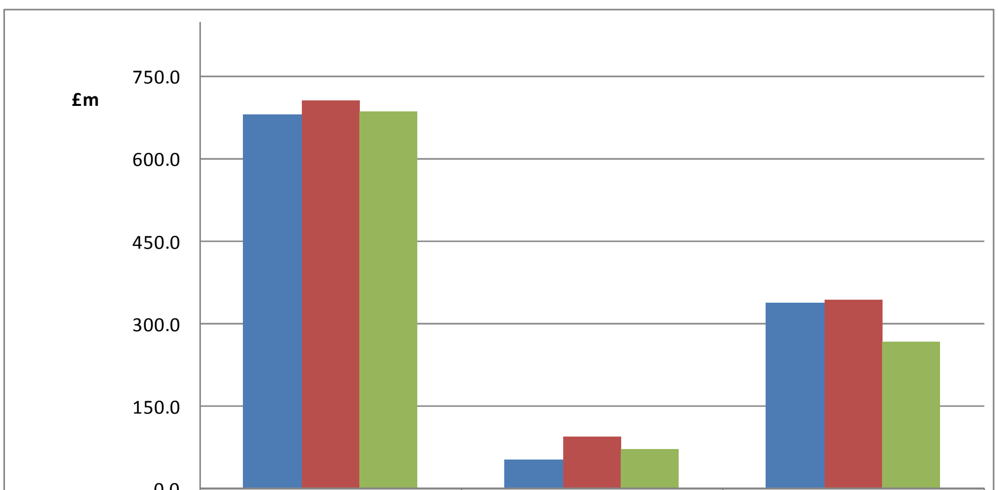
2.27. Industry total expenditure of nearly £2.1bn in 2007/08 was an increase of over 8.5 per cent on the prior year, largely reflecting the continued ramp up in the industry's mains replacement and capital expenditure programmes. However, total expenditure was 4.1 per cent below the assumption in price allowances, with additional repex investment being offset by aggregate under spend of capital expenditure allowances and tight control of controllable operating costs.

Operating Costs

2.28. Operating cost allowances for each of the eight GDNs were set for 2007-08 in the One Year Price Control Review in three parts:

- an allowance for "controllable" operating costs - those costs which are not subject to specific cost drivers beyond management control - based on the average expenditure on these items in 2004/05 and 2005/06 by each GDN, with a common efficiency target of 2.5 per cent. The businesses carry the risk of overspends on these allowances, but also keep the benefits of out performance;
- estimated costs for business rates, Ofgem licence fees and contributions to the NTS pension scheme deficit. These costs are deemed beyond management control in the short term and are therefore subject to a "pass through" mechanism which removes the risk of variations in these costs from the businesses by allowing actual costs to be recovered through revenues within the price control period; and,
- a specific mechanism for incorporating "shrinkage" costs into allowed revenue, as described above.

2.29. Figure 5 shows aggregate expenditure on each of these three categories of operating costs compared with allowances and with expenditure in 2006/07. In the case of shrinkage and non-controllable costs, the allowance represents our assumption at final proposals, and thus the difference between this figure and out-turn costs does not represent out- or under-performance.



	Controllable Operating costs	Shrinkage	Non Controllable Costs
07/08 Actuals	679.5	52.5	337.3
07/08 Allowance	705.0	95.1	343.9
06/07 Actuals	687.6	72.8	268.0

Figure 5 - Breakdown of Industry Total Operating Costs

Controllable Operating Costs

2.30. GDNs' tight control of operating costs meant that they were able to outperform assumptions for operating costs built into the One Year Price Control by over £25m, or just over 3.5 per cent. In fact, total controllable operating costs for the industry as a whole actually showed a small - 1.2 per cent - reduction from those of the previous year, despite the impact of general inflation and specific costs pressures from real increases in the price of material and some bought-in services, and from additional service obligations. This was achieved through a wide range of management initiatives, some enabled by capital investments in 2007/08 and immediately preceding years.

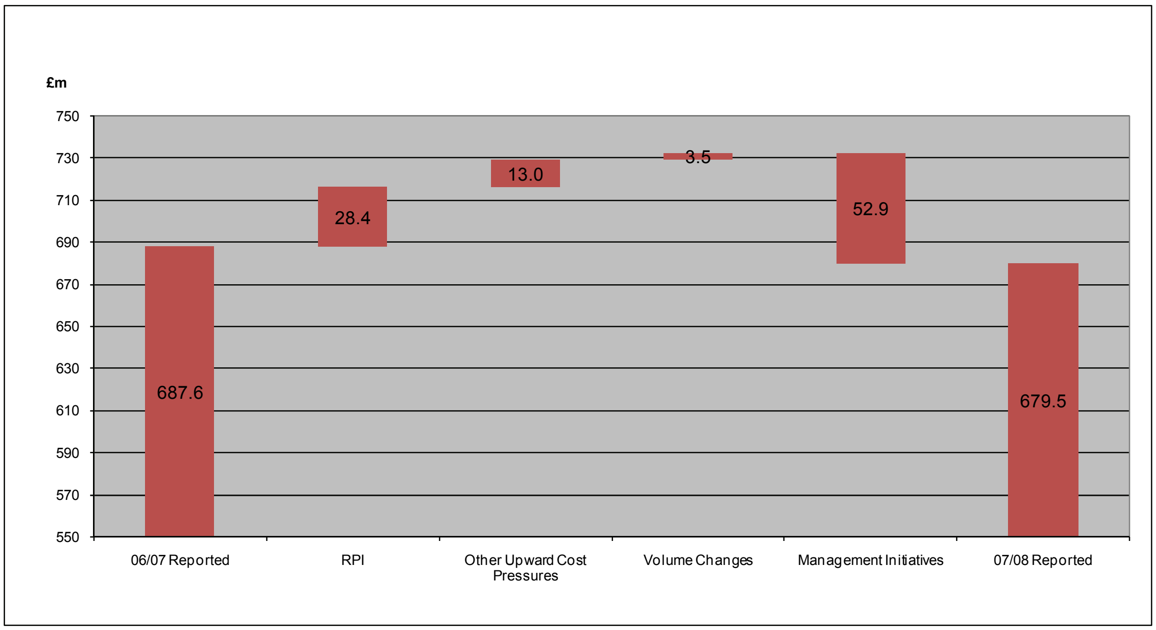
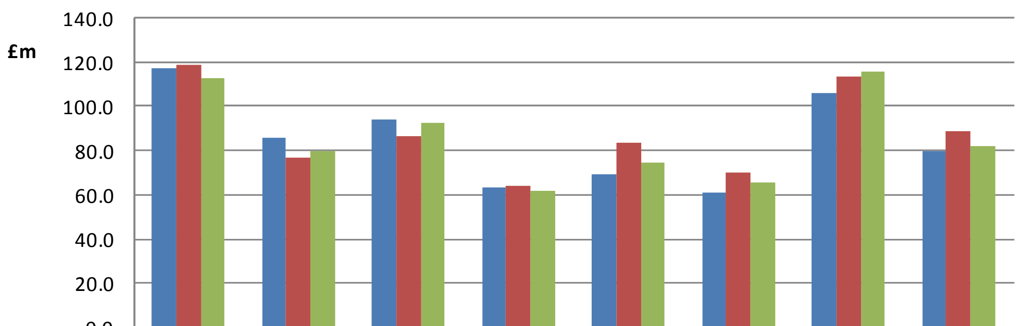


Figure 6 - Year on Year Movement in Controllable Operating Costs

2.31. Figure 6 above shows the key components of the movement in controllable operating costs from 2006/07 to 2007/08 for the industry as a whole. The impact of general inflation (represented by RPI) and some upward cost pressures were common across networks, and all businesses have been able to identify at least in broad terms the impact of management initiatives to mitigate cost increases or reduce operating costs in real terms. However, there are significant differences in the impact of changes in workload and work mix across networks. In particular, National Grid highlighted the impact of the loss of services provided to other networks - and the associated income - in pushing up the residual cost base of network operations. Other GDNs, in contrast, had recognised that significant management and support costs were being incurred in support of associated businesses or the capital and repex programmes, and had recharged the costs accordingly (thereby reducing the residual cost to controllable operating costs).

2.32. Quantifying the impact of upward cost pressures, and of the benefits achieved in the reporting year from management initiatives, featured in our discussions with all GDNs. Management highlighted the difficulties of pinpointing precisely which initiatives had delivered which benefits to particular areas of the business, particularly when several linked initiatives were often required to unlock efficiency savings. We accept that a degree of estimation and management judgement is required in any such analysis, and recognise that detailed tracking mechanisms can become more burdensome than worthwhile. Nevertheless, we do consider that understanding what has driven historic costs (capital and repex, as well as operating) upwards, as well as downwards, are important when setting allowances going forwards. This will therefore be an area for which we shall be looking to build up a better understanding in future years.

2.33. The movement in controllable operating costs from 2006/07 to 2007/08, and 2007/08 expenditure against the One Year Price Control assumptions varied by GDN. Figure 7 shows the position for each GDN.



	East Of England	London	North West	West Midlands	Northern	Scotland	Southern	Wales & West
07/08 Actuals	117.6	86.2	94.4	63.9	69.3	61.5	106.5	80.0
07/08 Allowance	118.7	77.4	86.8	64.7	83.5	70.4	114.1	89.3
06/07 Actuals	113.0	79.8	92.8	62.5	74.8	66.0	116.3	82.4

Figure 7 - Controllable Operating Costs by GDN

2.34. Figure 7 shows that all GDNs except London and North West spent less than was assumed in the One Year Price Control. Moreover, the four GDNs sold by National Grid in 2005 managed 2007/08 controllable operating costs at less than, and in some cases, significantly less than actual expenditure in 2006/07 - having offset general inflation and real price increases by management initiatives.

2.35. Not evident from the analysis by GDN are the overall operating costs for xoserve, which increased by 7 per cent in 2007/08 as compared to 2006/07. The UK LINK technology refresh required a higher level of revenue expenditure during 2007/08, and there was an increased level of revenue expenditure in support of industry reform implementation during 2007/08. In addition, there were cost

pressures as a result of a large expansion in the number of users of xoserve's Internet Access to Data service.

Top down Regression

2.36. A "top down" regression of controllable operating costs in aggregate was used in the Five Year Price Control Review to moderate the results of the individual activity regressions for allowance setting purposes, recognising that the combination of frontier performance for each activity could result in an overall level of performance that no business was actually achieving. It also overcomes possible issues of cost attribution, as all controllable operating costs (excluding only the GDN's share of xoserve costs and non-routine maintenance) are included within the analysis. Figure 8 below shows the results of the update of the regression undertaken at the time of the review for 2007/08 costs (alongside the original regression based on 2006/07 costs).

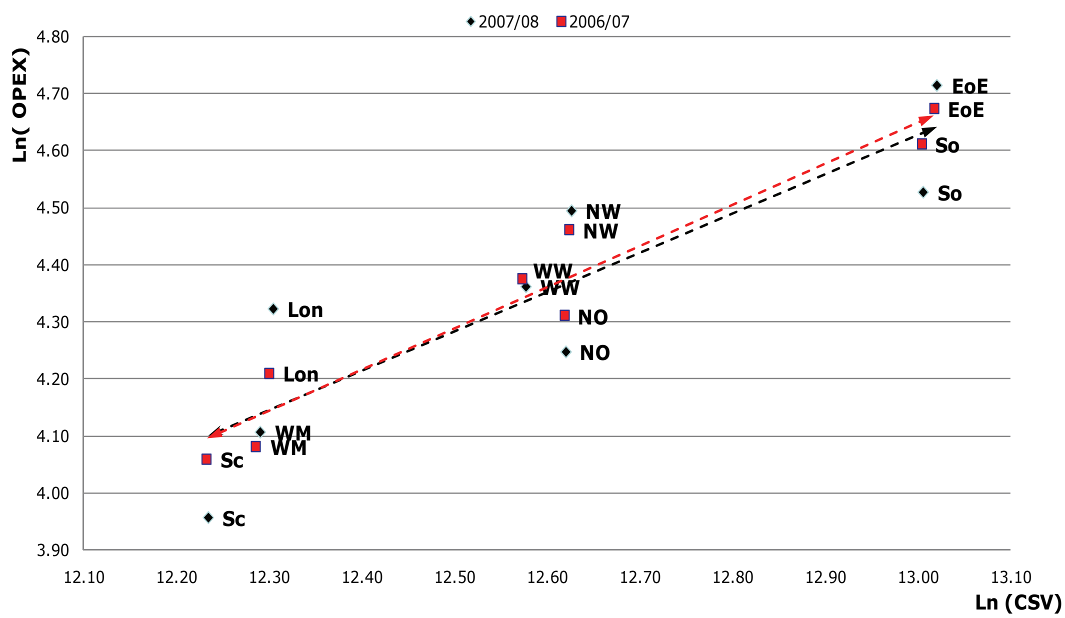


Figure 8 "Top Down" Regression of Controllable Operating Costs, 2006/07 & 2007/08

2.37. In aggregate the line of best fit has hardly moved, reflecting the fact that in aggregate controllable operating costs for the industry have only changed (reduced) by 1.2 per cent. However, there has been a noticeable increase in the spread of networks across the line of industry average performance, as three of the lower cost networks in 2006/07 have achieved significant costs reductions in 2007/08, whilst three of the higher cost networks saw costs increase. Nevertheless the relatively simple workload drivers (network length and number of customers) still perform well in explaining the variation in costs. The further reduction in the controllable operating costs of the lowest cost networks also

augurs well for customers in the longer term, as the reductions (if sustained) offer the prospect of allowances (and ultimately, prices to customers) at future price reviews being lower than would otherwise have been the case.

2.38. The detailed regressions of individual activities undertaken for the Five Year Price Control are updated for 2007/08 expenditures in Appendix 4.

Pensions

2.39. This year has seen further payments to pension schemes by GDNs to make up deficits, notably at Scotland and Southern. All companies have, however, under spent the total funding level assumed for the One Year Price Control. These savings were achieved mainly as a result of underlying cost controls and not reductions in the assumed contribution rates.

2.40. For the GDNs, the triennial valuations of their pension schemes were carried as at either 31 March 2006 or 2007 with the results becoming available during 2007/08. The impact on contribution levels and deficit funding should be seen from 2008/09 onwards.

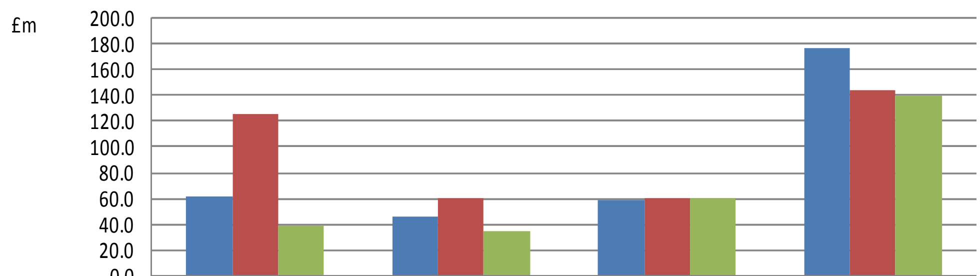
2.41. We have been consulting on the future funding of pension costs for gas and electricity distribution and transmission licensees. This has led to a data gathering exercise covering all licensees' schemes to understand the different approaches taken by licensees. This will enable an approach to pension funding to be developed in the interests of all stakeholders, including customers.

	Allowances 2007/08 prices			**Actuals**			
	Ongoing cost	**Deficit**	**Total**	**Ongoing cost**	**Deficit**	**Total**	**(Under)/over spend to allowance**
East of England	14.4	1.2	15.6	11.0	2.6	13.5	-13%
London	10.5	0.6	11.1	7.1	1.4	8.5	-24%
North West	10.5	0.8	11.2	8.2	1.6	9.8	-13%
West Midlands	7.9	0.5	8.4	5.7	1.2	6.9	-18%
Northern	11.0	3.7	14.7	7.5	3.6	11.1	-24%
Scotland	9.0	4.2	13.2	7.3	5.4	12.7	-4%
Southern	14.2	9.7	23.9	11.2	8.1	19.3	-19%
Wales & West	14.0	5.6	19.7	9.7	5.2	14.9	-24%
Total	91.4	26.4	117.7	67.7	29.0	96.7	-18%

Table 2 - Pensions Costs Compared to Allowances

Capital Expenditure

2.42. Industry capital expenditure (net of capital contributions) of £339.6m in 2007/08 was 25 per cent higher than in the previous year, but over 12 per cent less than was assumed in the One Year Price Control. As noted in the Summary, each network is entitled – and expected – to make management decisions on what levels of expenditure are necessary to meet its obligations. Variations in expenditure from the levels assumed when Ofgem set revenue allowances are therefore a natural part of the incentive based regime. As Figure 9 below shows, there were significant variations in expenditure when looked at by the type and purpose of assets being acquired.



	LTS & Storage	Mains Reinforcement & Governors	Connections	Other Capex
2007/08 Actuals	60.7	44.8	57.8	176.3
2007/08 Allowances	124.8	59.5	59.1	143.7
2006/07 Actuals	38.5	34.1	60.2	138.7

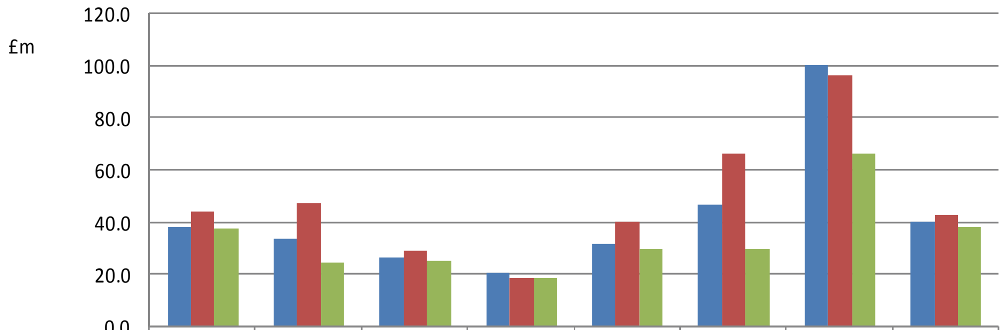
Figure 9 Net Capital Expenditure by Asset Type

2.43. In particular, expenditure on major pipeline and storage schemes to meet increases in customer demand was less than half of forecasts at the time of the One Year Price Control, while "Other Capex" (including vehicles, property and information systems costs) was over 20 per cent greater than assumed. Further details are given in Appendix 5.

2.44. Capital expenditure in total also varied against forecasts in the One Year Price Control (and against 2006/07) by GDN. Figure 10 below shows that two networks over spent the Price Control assumptions, whilst the other six under-spent by between 5 per cent (Wales & West) and nearly 30 per cent (London and Scotland).

2.45. One of the key messages most GDNs were keen to get across during the reporting visits was that they have generally regarded 2007-08 as the first year of a six year capital and replacement expenditure programme, and where there were

under- and over-spends in 2007-08 these would generally be corrected over the coming years. This will clearly be something we shall focus on in future reports.



	East of England	London	North West	West Midlands	Northern	Scotland	Southern	Wales & West
2007/08 Actuals	38.8	33.6	26.5	20.8	31.7	47.0	100.7	40.5
2007/08 Allowances	44.1	47.7	29.3	19.2	40.7	66.7	96.8	42.7
2006/07 Actuals	37.8	24.5	25.7	19.0	30.1	29.8	66.3	38.3

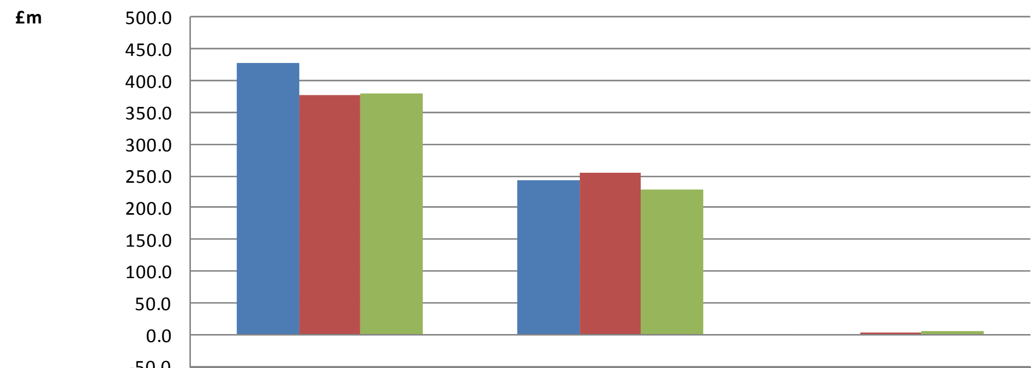
Figure 10 Net Capital Expenditure by GDN

Replacement Expenditure

Overview

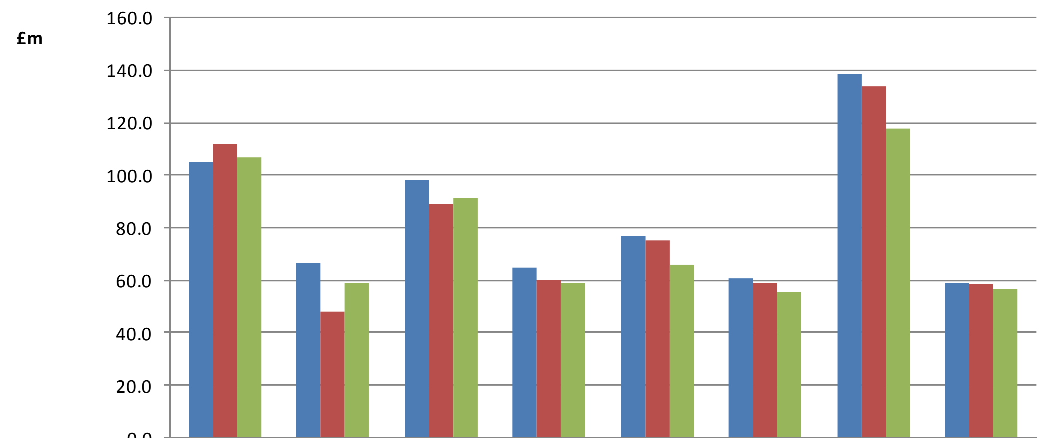
2.46. The industry's Replacement Expenditure ("repex") is dominated by the response to the Health & Safety Executive's requirement for all cast iron mains within 30 metres of premises to be replaced progressively over thirty years from 2002. 2007/08 was the first year by which resources and rate of mains replacement were expected to reach the run rate needed to achieve this long term objective. Figure 11 over shows that net replacement expenditure (including services re-laid either as part of mains replacement projects, or under independent projects) reached nearly £670m in 2007/08, some 9 per cent higher than in 2006/07 and 5 per cent higher than was assumed in One Year Price Control allowances.

2.47. As with capital expenditure, the comparison with assumptions made in the One Year Price Control, and with the rate of expenditure in 2006/07, varied significantly by GDN. Figure 12 below shows that replacement expenditure in total was greater than assumed in the One Year Price Control (as well as in the previous year) in all bar one network.



	Mains Repex	Services Repex	Other Repex
2007_08 Actuals	428.6	241.9	-0.4
2007_08 Allowances	378.0	255.4	1.7
2006_07 Actuals	379.5	227.9	4.8

Figure 11 - Industry Replacement Expenditure



	East of England	London	North West	West Midlands	Northern	Scotland	Southern	Wales & West
07/08 Actuals	104.9	66.3	98.3	64.8	77.0	61.0	138.5	59.3
07/08 Allowances	112.1	48.3	88.9	60.0	74.9	58.9	133.7	58.3
06/07 Actuals	106.5	58.9	91.4	59.3	65.7	55.7	117.7	56.8

Figure 12 - Total Replacement Expenditure by GDN

Mains Replacement Programme

2.48. Natural gas is distributed through a network of around 275,000 km of pipes constructed mainly of cast iron, ductile iron, steel and polyethylene. Iron pipes (which include cast iron, spun iron and ductile iron) fail through fracture and

corrosion or as a result of accidental damage and have resulted in serious gas explosions. Under certain circumstances, these leaks can result in a fire or explosion, and although the number of major incidents has been low, there are each year a number of gas releases which occur as a result of mains failures. Iron mains within 30m of buildings present the greatest hazard and are referred to as 'at-risk' pipelines.

2.49. Since the early 1970s, GDNs have undertaken a series of asset replacement programmes, which have contributed to a significant decrease in the number of incidents harming people or damaging property. However, the fracture rate per unit length of the remaining iron mains population has not decreased.

2.50. In 2002, following discussions with Ofgem and the GDNs, the Health and Safety Executive (HSE) published an enforcement policy, aimed at the major gas distribution network operators, requiring all 'at-risk' iron mains in Great Britain to be replaced ('decommissioned') with pipes made of safer materials (usually polyethylene) within 30 years. At that time there were approximately 110,000 km of iron mains and the timeframe for replacing them was that which could practicably be achieved given the length of mains involved. The policy consisted of an agreed rate of replacement each year such that the remaining pipes could be replaced within 30 years.

2.51. Ofgem has put a mechanism in place through the Price Control Reviews in accordance with the HSE's targets to incentivise GDNs to carry out the mains replacement work efficiently. The mechanism includes a mains replacement allowance with a supplementary incentive which adjusts GDN revenue depending on the volume and diameter mix of the mains replaced. The supplementary incentive provides the GDNs with the flexibility to vary the annual spend in line with their need to replace a different diameter mix of pipes from that originally forecast, but avoids the possibility of disproportionate costs being passed through to customers if there is a major rebalancing of workload between diameter. It also protects consumers by capping the mains replacement allowance at 15 per cent above the total matrix costs set in Price Controls.

2.52. The reported total length of mains decommissioned in 2007/08 was 3,945km, some 64km more than was assumed when the One Year Price Control was completed. Confirmation of the total length of mains decommissioned will be dependent upon the outcome of the on-going investigation into potential misreporting by National Grid.

2.53. The treatment of over-spends and under-spends against allowances provides strong incentives. In 2007/08 most networks incurred higher unit costs, which are paid for equally by customers and shareholders. Two of the GDNs carried out replacement works at less than Ofgem's prescribed unit costs. Shareholders in these GDNs retain one third of the under-spend with the remaining two thirds being subtracted from the revenue allowance. The impact of these mechanisms in 2007/08 has been described in the section on Revenue Reporting earlier in this report.

2.54. Since GDN sales in 2005 the GDNs have made a number of changes to the way in which they manage delivery of the replacement programme. NGG have moved from the common "20/70/10" model - where 20 per cent of the mains abandoned must be from the highest risk pipes, 70 per cent of the work selected from the next 5 year's rankings and 10 per cent of the work selected to make projects more cost effective - to a zonal approach. The zonal approach enables NGG to build larger projects based on postcode areas, with the aim of delivering the overall programme more efficiently. This programme of work is being carried out along with an increased focus on the larger diameter (>12") cast iron mains.

2.55. Whilst the other GDNs have continued with the 20/70/10 replacement model, the contracting arrangements and approach to the delivery of the replacement programme have changed substantively. SGN are delivering the majority of the programme in the South LDZ through SGN Contracting, a wholly owned subsidiary of the Scotia Group, whilst the remainder of the programme in Southern GDN is being carried out by third party contractors, which provides SGN with a comparison on both costs and quality of work. NGN are delivering the programme through contractors working for United Utilities Operations Ltd (UUOL), who are the service provider for most of the business operations in Northern GDN.

Services Replacement

2.56. As part of the mains replacement programme, GDNs are required to carry out the replacement, or transfer, of any associated service pipes connected from the mains to be abandoned to consumer's premises. The mix of services re-laid to transferred is a factor governed by both the historic configuration of the network and whether any of the services have been replaced under a previous programme (such as the bulk service renewal programme undertaken in previous price control periods), or re-laid following a gas escape on a service. For the One Year Price Control the service replacement allowance is a fixed allowance and is not adjusted or incentivised in the same way as the mains component. As Figure 11 shows, total expenditure on replacement of services was 5 per cent lower than anticipated in the One Year Price Control, with additional expenditure on service replacement associated with the mains replacement programme being more than offset by substantial under spends on the independent programmes to replace services to certain multi-occupancy buildings, which have been slower to mobilise than anticipated at the time of the Price Control Review.

Efficiency Assessment of Replacement Expenditure

2.57. Allowances for replacement expenditure in the Five Year Price Control were informed by regression analysis of 2006-07 expenditure (normalised for the additional unavoidable costs of working within the M25) against a weighted average workload. As with operating costs and capital expenditure, we think it right to include an update for 2007/08 expenditure, employing the same normalisation adjustments and cost drivers as consulted on for the Five Year Price Control.

2.58. Figure 13 below shows the regression for 2007/08 alongside that already published for 2006/07 at 2007/08 prices. All networks except North West show costs increasing relative to workload. However, rankings remain largely unchanged – with Northern and Wales & West continuing to show the lowest costs of delivery relative to workload, while Southern and Scotland networks have the highest costs. Further work will be undertaken to review, and where appropriate, enhance the approach before the next Price Control Review. The findings of the joint investigation into potential misreporting by National Grid Gas may also impact upon this analysis.

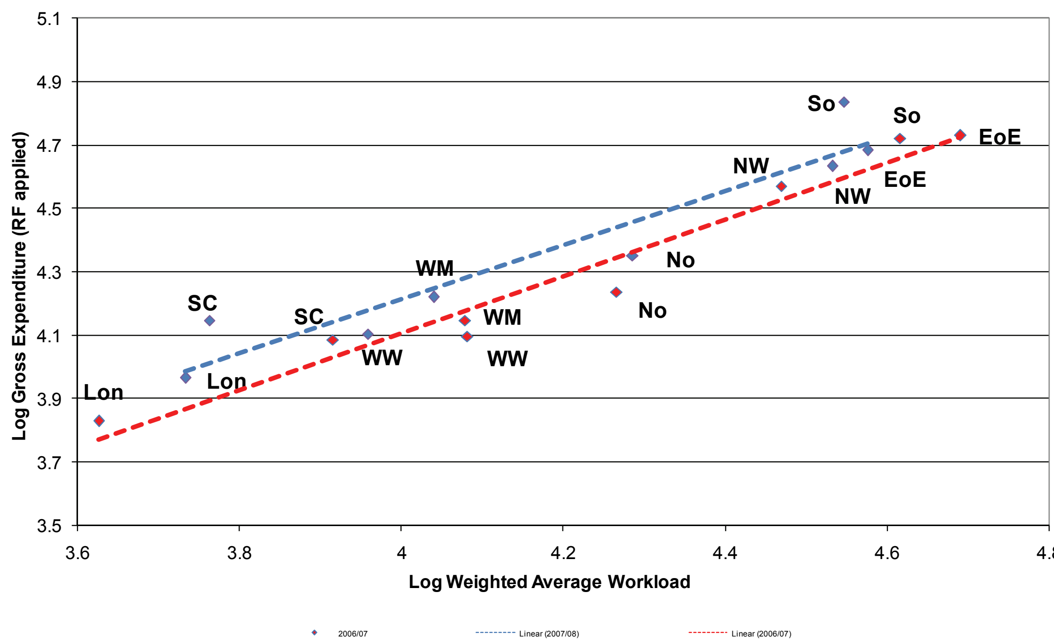


Figure 13 - Regression of Replacement Expenditure

Provisional Updates to RAV & Gearing

RAV roll forward

2.59. Our current view of the roll forward of each GDN's Regulatory Asset Value is shown in Table 3 below. In calculating the RAV rolled forward from 1 April 2007, we have applied the methodology consistent with that set out in pages 44-48 of the Five Year Price Control Final Proposals document. This has been used since the one year Price Control document was not specific in this respect. The figures shown are indicative and subject to final confirmation at the next Price Review.

2.60. Across the industry, actual RAV is close to that assumed in the price control allowances. This is as expected for a one year control (in view of the proximity to the review) although the Price Control assumed that capital expenditure would be

£387m (£47m higher) and replacement expenditure would be £318m (£16m higher). This is offset by opening values being higher than assumed in the Price Control.

2.61. Table 3 below shows the roll forward in year average prices with the right hand column showing the balance in a year end price base. Companies will also benefit from a return on outperformance of the capex allowances to the extent of between 33% and 36% of the value of the outperformance.

	2007/08 year average prices						
£m	Opening RAV b/f 1st April 2007	Repex Additions	Capex Additions	Disposals	Depreciation	Balance as at 31st March 2008	Balance in year end prices as at 31 March 2008
East of England	2,341	52	39	(1)	(84)	2,348	2,387
London	1,315	29	34	(1)	(47)	1,330	1,352
North West	1,502	39	27	(1)	(53)	1,514	1,539
West Midlands	1,169	28	21	(4)	(41)	1,173	1,193
Northern	1,443	37	32	(0)	(51)	1,460	1,485
Scotland	988	26	47	(0)	(33)	1,028	1,045
Southern	2,343	59	101	(1)	(82)	2,420	2,460
Wales & West	1,307	31	41	(0)	(45)	1,333	1,356
Total	12,409	302	340	(10)	(435)	12,606	12,818

Table 3 - RAV Roll Forward - Ofgem Preliminary View

Gearing to RAV

2.62. Table 4 below shows each GDN's gearing (defined as net debt to RAV), which is our primary measure of gearing for both the One Year Price Control period and the Five Year Price Control review.

	Net Debt	RAV	Gearing at 31 March	Gearing at 31 March
	As at 31 March 2008 £m (nominal)		2008 %	2007 %
East of England	1,225	2,387	51%	48%
London	661	1,352	49%	51%
North West	817	1,539	53%	49%
West Midlands	605	1,193	51%	48%
Northern	1,002	1,485	67%	68%
Scotland	745	1,045	71%	72%
Southern	1,638	2,460	67%	67%
Wales & West	1,402	1,356	103%	101%

Table 4 - Year End Debt to RAV Ratios

2.63. The gearing ratio used in the One Year Control cost of capital was 62.5 per cent compared to the overall industry weighted average gearing of 63 per cent (2006/07 - 61 per cent). The ratios have been reported on the basis set out in Ofgem's open letter of 5th December 2008.

2.64. GDNs' individual debt and gearing varies depending on the company's own financing structures within individual ownership groups. During the year, overall net debt has increased by £584m whilst the RAV has increased by £689m.

2.65. Wales and West have a high level of gearing, reflecting the company's complex financing structure, which includes subordinated intercompany debt.

Quality of Service

2.66. The quality of service provided by the GDNs remains a key priority for Ofgem. The term quality of service covers a wide range of areas: from the number of gas supply interruptions that customers experience and the amount of greenhouse gasses lost from the pipeline networks to the replacement of gas mains under the mains replacement programme.

2.67. Our principal objective is to protect the interests of gas and electricity consumers and there are a variety of ways in which we ensure that the service provided by the GDNs is of a sufficiently high quality. These include a compensation scheme where GDNs pay customers if they fail to meet certain standards, Licence conditions requiring the GDNs to meet specified performance targets and other reporting requirements.

2.68. We have published six annual stand alone reports on the quality of service performance of the GDNs. The latest report covers four key areas of quality of service: interruptions, customer satisfaction surveys, the mains replacement programme and environmental issues. We have seen some improvement in customer satisfaction survey scores and a reduction in gas leakage over the past year. On mains replacement, the industry has managed to meet the HSE target for the decommissioning of iron pipelines. The number of reported interruptions has increased over last year, with the most probable cause for this being changes made to the GDNs' reporting processes.

2.69. Following the implementation of the latest price control review on 1 April 2008, the GDNs have been subject to a number of new or strengthened incentives covering such areas as mains and service replacement and environmental emissions. We anticipate that this will serve to further drive up the quality of service provided by the GDNs over the coming years. The key findings of our review of the quality of service in 2007/08 are summarised below.

Interruptions

2.70. Unplanned interruptions result in the loss of gas supply to customers' premises. These events are predominantly due to an element of network failure caused either by equipment failure or damage to the gas distribution assets. The total number of unplanned interruptions minutes - the number of minutes where a customer is off gas following an unplanned interruption - has fallen from 75.7 million minutes in 2006-07 to 68.3 million. Around one third of all of the unplanned minutes lost in 2006-07 were caused by a single incident, so a major decrease was anticipated. Though the number of unplanned interruption minutes decreased, the actual number of unplanned interruptions has increased to 87,000 in comparison to 72,000 last year. The increases in this area have largely been attributed to mechanical failures of pipes and plant and leaking service pipes, although changes to the GDNs' interruption recording processes appear to be the principal reason for the increase in the number of interruptions reported this year. We will be monitoring closely the results in this area to understand what effect these new processes have had on the GDNs' interruptions data.

2.71. Planned interruptions are associated primarily with the GDNs mains replacement programme. The number of planned interruptions has increased from 380,000 reported in 2006-07 to 529,000 in 2007-08 and the number of interruption minutes from 172 million to 207 million.

Customer satisfaction surveys

2.72. The results of the quarterly customer satisfaction surveys show that levels of customer satisfaction for the industry as a whole have increased slightly in the last year. The average scores for both repair and replacement stand at 3.97 on the five-point scale, up on 3.93 and 3.90, respectively, last year.

Mains replacement programme

2.73. The GDNs' programme of decommissioning at least 3,500km of 'at risk' gas mains continued in 2007-08 and the reported total length of mains decommissioned was 3,945km.

Environmental issues

2.74. Driven by the mains replacement programme and advancements in the use of pressure control equipment, the amount of methane emitted by the GDNs has continued to decrease. Seven of the eight GDNs' methane emission figures were lower than those reported last year.

3. Next Steps

Lessons Learned from 2007-08 Process

3.1. As noted in Section 1 above, the process adopted for this first annual reporting process has generally worked well. All businesses achieved good compliance with the agreed timetable, submissions came in on time and were generally of a high quality. The formal question and answer process dealt with issues of fact and understanding in an efficient and controlled manner. The visits to each business were invaluable in providing context for the reporting pack, building understanding of key business drivers and sharing expectations. Sharing an outline of the report, providing an opportunity for each GDN to verify its own data as used in all comparisons, and holding a workshop to share key messages contained within this report were useful steps in maintaining transparency and ensuring businesses continued to remain engaged in the completion of the process.

3.2. The broad approach does not therefore require fundamental change. Nevertheless there are obviously areas that can be improved:

- the instance of potential misreporting by National Grid is still the subject of an independent investigation, but highlights the importance of data assurance and governance processes operated by all businesses. A full description of the assurance and governance processes operated for each area of reporting should feature in the commentaries accompanying annual returns in future years;
- it is clear that inconsistencies between businesses in the categorisation of some costs and activities remain and guidance needs to be tightened and reinforced in some instances;
- some information captured in the regulatory reporting packs developed for 2007/08 was used more extensively than other parts of the pack – and some information used for undertaking benchmarking at the last Price Control Review was not captured in the annual reporting pack. A review of the usefulness of all the information captured – and the value of information not captured in this first year – will be undertaken;
- quantifying the impact of upward cost pressures, and management initiatives to offset such pressures, is of key interest to all stakeholders, and more can be done to achieve this consistently across GDNs for all areas of expenditure (operating costs, capital investment, and the renewal of existing assets); and,
- the submission date for this first year of annual cost reporting for gas distribution businesses was set two months later than the equivalent date for other reporting (including transmission and electricity distribution cost reporting), squeezing the time available for analysis and dialogue with GDNs and pushing back the time of publication. The timetable for future years need to be considered to balance the needs of the businesses

undertaking the reporting and the time within which performance information becomes available for stakeholders.

3.3. These areas for improvement will be reflected in updates to the guidelines for reporting on 2008/09 performance, which will also reflect revised reporting arrangements already put in place for 2008/09 for measurement of the quality of service to customers.

Future Work Programme

3.4. Apart from the enhancements to the annual regulatory reporting process arising from the experience of this first exercise for gas distribution businesses, there are areas where further work will be helpful for the next Price Control Review, and ought to be incorporated in the work programme leading up to the Review. Obvious examples from the work undertaken in connection with this first round of regulatory reporting include:

- consideration of appropriate means for considering financial and customer service performance in the round, including identification of consistent high (and low) performers and of any trade-offs that are being made, or are being encouraged by the regulatory regime;
- enhancement of existing models for assessing efficiency in operating and asset investment activities, including updating cost differentials for operating within the M25 and considering alternative model drivers and forms;
- development of models to cover areas of activity not currently captured in activity-specific assessments; and,
- continuing to improve the consistency of information reporting by different businesses, to enhance the reliability and value of comparisons between GDNs.

3.5. In each of these areas, the continued support and assistance of the gas distribution businesses themselves will be critical, and we look forward to progressing this work together.

Appendices

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Appendix 1 - The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.[1]

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly[2].

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- Contribute to the achievement of sustainable development;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them[3]; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[4]

[1] entitled "Gas Supply" and "Electricity Supply" respectively.
[2] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.
[3] under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.
[4] The Authority may have regard to other descriptions of consumers.

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- Promote efficiency and economy on the part of those licensed[5] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[6] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[5] or persons authorised by exemptions to carry on any activity.
[6] Council Regulation (EC) 1/2003

Appendix 2 – Glossary

1.1. We have produced a glossary of terms relating to gas distribution and related matters in Appendix 3 of the Gas Distribution Price Control Review: One Year Control Final Proposals (Ref 205/06), which can be found on the Ofgem website.

1.2. A much more detailed list of definitions can be found in Appendix 3 of the Price Control Cost Reporting Rules: Instructions & Guidance, which can also be found on the Ofgem website.

Appendix 3 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Does the report adequately reflect your views? If not, why not?
- Does the report offer a clear explanation as to why not all the views offered had been taken forward?
- Did the report offer a clear explanation and justification for the decision? If not, how could this information have been better presented?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- Please add any further comments?

1.2. Please send your comments to:

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