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Dear Rachel

National Grid Gas Distribution through our gas distribution business, distribute gas in the heart of England to approximately 11 million offices, schools and homes and owns and operates the gas transmission system throughout Great Britain. National Grid Gas Distribution also owns and operates the high voltage electricity transmission system in England and Wales and as National Electricity Transmission System Operator (NETSO) operate the Scottish high voltage transmission system. The issues addressed in this consultation directly affect National Grid Gas Distribution.

National Grid Gas Distribution welcomes the opportunity to respond to Ofgem's Initial Strategy Document for RIIO-GD1 price control. These reviews come at an important time for the UK gas and electricity markets. Over the next decade significant changes will take place in the gas and electricity supply markets – driven by climate change policy and (to a lesser extent) by security of supply concerns. Whilst the direction of change is clear, the detail and timing of the changes is still uncertain. RIIO-GD1 will need to establish resilient and well judged frameworks for network regulation out to 2021.

We remain supportive of the RIIO framework and continue to work closely with Ofgem as we see these principles being applied in the two price controls. In particular we support the longer term focus including further development of asset health and risk frameworks, focus on the outputs our stakeholders and consumers want, evidence based business plans and innovation. However we remain concerned about the implementation of the

financeability proposals as evidenced by recent investor sentiment. We have a number of detailed comments about the proposed package of financial measures in our consultation response.

The current backdrop to the RIIO-GD1 review is unprecedented uncertainty facing the gas distribution networks due to government policy on climate change. Whilst we believe there are credible scenarios where the gas network has a clear role to 2050 in supporting the transition to a low carbon economy, recognition of the impact of this uncertainty on owning, maintaining and investing in gas networks is required. Ofgem's current proposals on gas distribution asset lives and proposed capitalisation of mains replacement programme expenditure extend the period over which cash flows are recovered, which sits uncomfortably with the impact of government policy uncertainty. Current proposals for accelerated depreciation, whilst helpful, do not mitigate the need for sizeable transitional arrangements to preserve financeability of the gas networks. We are further unclear on the principles underpinning Ofgem's consultation on a change to the RAV treatment of the mains replacement programme which are effectively a reversal of Ofgem's positions in previous price controls.

A second key uncertainty the gas networks are facing in this review is the outcome of the HSE-led review of the mains replacement programme. Any change in the programme will have a fundamental impact on the outputs that gas networks deliver. The mains replacement programme impacts the number of emergencies and repairs that we are required to attend, leakage of the network, customer satisfaction, and the level of skilled resource we have to manage our emergency work peaks. We understand that the HSE-led review will conclude with recommendations at the end of March. The current timetable with a well justified business plan submission in July cannot, therefore, accommodate significant policy change as a result of that review.

We have welcomed the opportunity to engage with our stakeholders and fully understand what our customers and stakeholders would like us to deliver against the RIIO output categories. We have participated fully in the Ofgem-led working groups and fed our views, informed by our stakeholder engagement, into this process. Due to the compressed timescales, we feel there is more detail that needs to be worked through between now and the final strategy document, to ensure the output measures are

proportionate, innovative and deliver long term value for money. Our response to this consultation document contains more detailed comments on where we feel the outputs package could be further developed. We will continue our stakeholder engagement process beyond March. We seek flexibility in the policy guidance on outputs in the final strategy document to enable us to submit in our July well justified business plan, alternative outputs and alternative means of measuring outputs where evidenced by our stakeholder engagement.

We believe the current proposals lack detail on the shape and quantification of the output related incentives package. We have shared a number of ideas where, informed by our stakeholder engagement, we feel the incentives package could be enhanced. In addition we have outlined that we do not believe the uncertainty mechanism proposed for the treatment of Traffic Management Act related costs is adequate for RIIO-GD1 and we have proposed an alternative approach. We reiterate these ideas in our consultation document response and believe it is important that time is allowed to develop these ideas further in conjunction with our stakeholders. We would welcome more granularity in the March final strategy document on the shape of the incentives package which is a critical for us in calibrating the financeability proposals in RIIO-GD1. If there are items that cannot be fully agreed due to the need for further development (which is likely to be the case), we would appreciate the March final strategy document setting out the principles of the incentives and the scope afforded to the networks to shape the parameters in our July business plans.

We believe that cost benchmarking is a key element of RIIO-GD1, enabling us to continually review and challenge our cost efficiency performance. We fully support Ofgem's proposal that benchmarking form the start of a conversation, rather than a mechanistic means of setting allowances. We welcome the fact that Ofgem recognises that it is still developing its top-down benchmarking approach. However, we are also worried about the lack of inclusion of regional factors, cost driver selection and how to marry bottom-up and top-down approaches, all of which need to be resolved in order to overcome the limitations of a methodology based on the upper quartile approach.

Finally, we support the rationale for the equalisation of efficiency incentive rates applying to opex, capex and repex (through the proposed IQI mechanism). However we have a

number of concerns around the implementation of the approach. Firstly, the range of the proposed IQI rate proposed (40%-60%) does not include our current effective totex rate (62%). When combined with the lowering of the bottom end of the range (from 52% in GDPCR1 to 40%) this results in a weakening of the overall power of the IQI incentive with no apparent underlying rationale. Finally, we are not in agreement with the preferred approach to compare first GDN submissions with last Ofgem proposal (for the reasons set out in our detailed response).

In the absence of further information on the strength of output incentives and uncertainty mechanisms and with the apparent weakening of the efficiency incentive range in the current proposals, it is not possible to be definitive on the required cost of equity at this stage. However, one thing that is clear is that with increasing cash flow risk and a need to set an allowed return that will be attractive to investors, the cost of equity that is allowed will need to be at least at the top end of the range proposed by Ofgem. As they stand, the RIIO proposals appear to increase the risks that equity holders face, yet the range of equity returns proposed offers little or no upside from the current controls.

We look forward to working with Ofgem to address these important concerns prior to the March final strategy document publication. We would appreciate some clarity from Ofgem on the process to achieve this.

Yours sincerely

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