RIIO GD1 – OVERVIEW DOCUMENT

CHAPTER 1 - Introduction

Question 1: Do you have any comments on the proposed process and timetable for the review?

RIIO requires the process for a price review to start and be more intensive at an earlier point than was the case under RPI-x. Therefore it is incumbent on Ofgem, network companies and other stakeholders to ensure that this early start does not simply result in prolonged discussion and work on the price review over a longer period.

The timetable is dependent on major policy issues being resolved and primary output measures being fully defined by March 2011 to enable a complete business plan submission in July 2011 which is able to take proper account of risk and financeability. Whilst significant progress has been made to date on RIIO-GD1 given the volume of issues raised in this consultation and work there is still to complete the timetable looks very challenging.

CHAPTER 2 - Context

Question 1: Do you agree that we have identified the key challenges facing the gas sector, and our approach to accommodating these challenges within the price review?

Ofgem has broadly outlined at a high level some of the key challenges facing the gas distribution networks. However the other areas which we consider will be key challenges are:

- Most climate change predictions suggest increased frequencies of extreme weather events. The weather pattern seen in 2010 has demonstrated the significant impact this can have on gas network operations. Ensuring the right balance of base and contingency resources to deal with extreme events is an increasing challenge for network operators.
- Increasing customer expectations and a desire for compensation whenever those expectations are not met.
- An aging asset base which drives up operating costs where replacement decisions have to consider future uncertainties over the role of the gas network.
- The practical implications of the roll out of smart metering on our emergency service activity. There is significant uncertainty as to what role and in what volumes we will provide support to the roll out and whether any significant work on our assets will be required (e.g. relocating service positions).

We do not accept that the focus on the iron mains replacement programme has somehow resulted in a neglect or failure to understand risks associated with other asset types. NGN has a robust and sound understanding of the risks associated with all the assets which we manage.

CHAPTER 3 - Making sure stakeholders' views are heard

Question 1: Do you have any comments of the overall approach to stakeholder engagement?

NGN has had a programme of stakeholder engagement embedded within the organisation since its formation in 2005 prior to the commencement of the RIIO framework. That engagement has had a direct impact upon the way in which NGN focused its operational activities. Much of this engagement took the form of customer impression cards being delivered upon the completion of every Replacement, Repair and Connections job. The feedback from these impression cards is analysed and fed into action plans to address customer concerns. We believe NGN was the first GDN to adopt this approach as a direct link between the network and the people who used our services and/or were affected directly by our streetworks.

Additionally, through NGN's engagement with industry groups and bodies, such as NJUG, HAUC, MEUC and other avenues, we also had a direct link with stakeholders at a more strategic level.

The principle of engaging stakeholders in the development of the business plans of the GDNs is therefore a sound and one which NGN fully supports. However, there has to be recognition, as was

noted in DPCR5, that delivering full and meaningful engagement is challenging. Many stakeholders will only focus on the final outcomes and prefer to remain silent throughout the consultation process. Using feedback at a strategic level to feed into business plans is equally challenging. Nevertheless we believe there are areas where this can be achieved and we will seek to demonstrate this on our business plan submission and embed into ongoing processes for stakeholder engagement.

It should be recognised that stakeholder engagement in itself will not deliver a 'one size fits all' solution. Inevitably, there will be regional and even national differences of opinion, which will need to be balanced to give an industry overview.

Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?

From a company perspective RIIO will encourage the development of a more formal methodology and a robust mechanism for recording and capturing the views of stakeholders. We support the inclusion of a reward element in the broad measure of customer satisfaction related to stakeholder engagement. This should encourage continuous improvement.

It would have been helpful if Ofgem's own stakeholder engagement outputs had been available earlier, both to avoid the duplication in the use of key individuals and organisations, and to create a sustainable background against which the GDNs' own stakeholder engagement was carried out.

CHAPTER 4 - Outputs and Incentives

Question 1: Do you consider that the proposed outputs and associated incentive mechanisms, taken together with other element of the price control, will ensure that companies deliver value-for-money for consumers, and play their role in delivering a sustainable energy sector?

NGN is supportive of the output measures proposed however we believe there needs to be more incentives associated with output delivery and with increased potential risk and reward than currently proposed.

Where incentives related to output delivery are proposed these are overwhelmingly based on penalising non-delivery. We believe there needs to be a greater balance between risk and reward. Having a largely penalty only regime will encourage a conservative approach to output forecasting and delivery. The current proposals significantly weaken the incentive for companies to drive improvement in output delivery above the base level. We feel such behaviour is not in the best interests of customers and will not drive a best value for money approach. Neither do we feel this is consistent with the intentions of RIIO.

With respect to delivering a sustainable energy sector the proposed outputs and incentives are focussed on GDN activities that impact their own business carbon footprint e.g. shrinkage, fuel use etc. This makes sense as these activities are the most controllable by GDNs. Ofgem is also proposing to retain the current shrinkage / emissions incentives at there present levels in terms of the amount of total risk and reward faced by companies. We believe it is appropriate to increase rather than retain these levels given the increased importance customers and society in general attach to environmental issues.

One area that GDNs can play an important role is facilitating renewable gas connections e.g. bio-methane, CNG etc, Ofgem's proposals on connection standards if service and innovation funding are welcome proposals in this area. We believe Ofgem should consider further is the funding arrangements facilitating such connections - Ofgem have proposed ex-post funding for any distributed gas connections, we agree that this makes sense in today's context given the small number of connections, however this could change dramatically over an eight year price control especially given the likely changes in charging regarding the connection boundary and potential form of the Renewable Heat Incentive (RHI).

We believe it is worth exploring whether there could be a mechanism such as revenue driver that could be triggered by a certain volume of distributed gas connections possibly in addition some level of ex-ante allowance. As concluded in the GDNs and ENA work on gas futures bio-methane has huge potential in delivering a sustainable energy sector at an economic value to consumers. It is important that Ofgem ensures that this potential is not inhibited by the incentives in place during the next price control in particular Ofgem should ensure that incentives on GDNs to connect distributed gas are consistent with those on DNOs to connect distributed generation.

Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate (e.g. do we have too many or too few)?

As outlined in our response to the previous question across the six output areas we consider the incentives for output delivery are heavily weighted to penalising non-delivery with no rewards for improving base performance. They do not currently have the right balance between risk and reward. In our response to the Outputs and Incentives Consultation we suggest areas where we believe additional incentives should be introduced.

Question 3: Do you have any views on the proposed outputs or incentive mechanisms?

We are supportive of the proposed output measures but not the current proposed incentives associated with these outputs as stated in our response to the previous questions.

The changes Ofgem is proposing to make to the IQI and the published range for the core totex incentive significantly weaken the incentives for frontier companies and are a retrograde step. Across most of the existing incentive areas Ofgem is either reducing or at best maintaining the incentive to outperform. This appears to be contrary to the intentions of the RIIO principles.

CHAPTER 5 - Assessing efficient costs

Question 1: Is our proposed approach to cost assessment appropriate?

The proposed approach to cost assessment is appropriate. Given Ofgem's objectives regarding proportionate treatment and fast tracking of companies' business plans we believe that the primary focus in terms of time and resource should be on the top down opex and repex regression analysis as these have been shown to consistently deliver robust results year on year. Other analyses such as bottom up and totex should be used as a cross check on the top down analysis as they are less proven the amount of time Ofgem devotes to developing and applying these analyses should be proportionate to the use of their results in RIIO-GD1.

As shown in Ofgem's own analysis ,NGN has consistently achieved top quartile/frontier performance on opex and repex during this price control and in order to retain incentives to maintain and continue to improve on this performance NGN's overall cost allowances set in the next price control should be at least commensurate with the benchmark (upper quartile) plus significant recognition and reward for frontier performance.

We welcome Ofgem's recognition of the impact of loss of meter work on its cost assessment we agree that adjustments to reflect this must be made to avoid distorting the results this applies equally to the top down analysis as much as the bottom up. NGN firmly believes that the loss of metering revenue driver is the most robust, consistent and simple basis for making such an adjustment.

Question 2: Do you have any views on our proposed process for proportionate treatment?

We broadly agree with the proposed proportionate approach to the assessment of the price control package. The principle that a company that provides a well justified business plan; has a good record of delivery; and is operating at the efficiency frontier need not be exposed to the full price control review process is a sound basis for applying the proposed framework.

However, as Ofgem has itself recognised, in applying the principle of proportionate treatment the incentive properties of the whole RIIO framework need to be fully considered and not undermined by the approach taken. In particular, the application of the proportionate approach must:

- Not set the threshold(s) for proportionate treatment and in particular fast-tracking at a level that is unrealistically high. The incentives for companies to achieve fast-tracking must be real and achievable; and
- Not undermine the wider efficiency incentives of the RIIO framework. Companies who are fast-tracked or are subject to a reduced level of scrutiny must not be disadvantaged but should be positively rewarded by the proposed approach. The recognition of this point within the RIIO proposals is a welcome clarification and is key to the success of the proportionate treatment and fast track approaches.

NGN supports the proposed sliding scale approach for non-fast tracked companies.

Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Are there any additional criteria that should be added?

The criteria proposed for assessing company business plans for a proportionate treatment and fast-tracking would seem to be appropriate. However, Ofgem should avoid setting the threshold for the proposed criteria at an unrealistically high or unattainable level. This particularly the case when the process is new and account must be taken of the longer term impact a decision to fast track or not will have on companies preparing for future price reviews.

Question 4: Do you have any views on the proposed role for competition in third party delivery?

The market for the construction and connection of new gas distribution assets is fully competitive and requires no further intervention from Ofgem.

Future investment on the gas distribution networks is likely to be primarily focussed on renewal or reinforcement of existing assets and we don't believe there is a role for third party operators like IGTs in carrying out such works. A large percentage of such works are carried out by specialist contractors at market rates as they are tendered to the competitive market in any event and therefore already generates the lowest cost solution to customers.

CHAPTER 6 - Managing uncertainty

Question 1: Do you have any views on the uncertainty mechanisms identified?

The list on page 34 sets out the main uncertainty mechanisms we would expect Ofgem to consider.

Question 2: Are there any additional uncertainty mechanisms required that we have not identified?

As mentioned in our response to question 1 in chapter four, we believe there is merit to considering a mechanism for funding bio-methane connections e.g. via a revenue driver and/or and ex-ante allowance. It is possible that over an eight year price control the economic conditions could turn out to be very favourable and the number of connections could increase dramatically well before RIIO-GD2. It is important therefore for Ofgem to ensure that the appropriate mechanisms are in place to ensure renewable gas connections are not inhibited in such circumstances.

Question 3: Are there any mechanisms that we have included that are not necessary and why?

No, as stated previously we feel the list on Page 34 captures the key items.

CHAPTER 7 - Innovation

Question 1: Do you have any views on the role of innovation in RIIO-TI?

The role of innovation within gas transmission will in most cases be unique to that business and therefore should be funded managed and delivered separate to the innovation under RIIO-GD.

However NGN recognise that there will be opportunities to collaborate where there is a mutual benefit for the customer. Such areas would include but not be limited to; offtake capacity statements; interruption regime; and emergency management procedures.

Consideration should be given to providing funds to facilitate collaborative projects between GDN's and transmission.

Question 2: Do you have any views on the time limited innovation stimulus?

NGN broadly welcomes and supports the proposed introduction of the broad innovation stimuli package which addresses some of the shortcomings of the previous framework. We are also pleased to see that the proposals plan to retain key elements of the current IFI framework for smaller projects that allows the GDNs to build upon the work carried out during GDPCR1.

i) Amount of Funding

Given the current uncertainty on the likely pathway for delivery of a low carbon future in the UK it is vital at this stage that the levels of funding allocated to each sector do not introduce unnecessary bias into the process for one sector compared to another.

The gas and electricity network sectors face different challenges in their potential role in the delivery of the required environmental targets. Many of the issues faced by gas networks are in their infancy and it is therefore difficult to identify fully at this stage the level of innovation funding required to address these over the period of the next price control.

Your proposals are to allow twice as much funding to electricity compared to gas. The levels applied need to ensure that no bias is being introduced into the identification of the solutions required to deliver a long term sustainable energy sector, and specifically does not introduce higher costs for customers in the longer term.

ii) Scope of what can be funded

We would agree that the scope for Gas Distribution innovation has a different scope from electricity and that an overall objective that encompasses sustainability and security of supply as well as low carbon would be more appropriate for gas distribution.

iii) Level of funding for projects

The incentives for large scale innovation projects would be severely reduced at the revised level of funding (reducing from 90% to 80%). Such projects would face a significantly higher hurdle rate for internal business case approval as a result.

Many of the projects that could help deliver a sustainable low carbon future would deliver benefits that accrue to parties other than GDNs. The higher overall amount of funding and higher level of project funding in electricity distribution is clearly introducing an unnecessary bias into the likely path of the future energy mix even at this early stage.

<u>CHAPTER 8 – Finance Issues</u>

Question 1: Do you consider that our proposed package of financial measures will enable required network expenditure to be effectively financed?

NGN consider that the package of financial measures currently proposed have a potentially significant negative impact on projected cash flows for the gas networks. This impact is driven by 2 key elements of the proposals: 1) the proposed changes to capitalisation policies (primarily repex) which may significantly impact financeability; and 2) the proposed changes to allowed return (through changes to both the allowed cost of debt and cost of equity returns).

This reduced cash flow is likely to have two effects;

- It will lead to a downgrade in the network credit ratings, as the credit rating agencies place considerable weighting on both cash flow metrics interest cover ratios as well as gearing and overall business risk when setting the ratings. This in turn will have a significant effect on the ability of the networks to raise finance, and the associated cost of this finance.

- It will lead to an increase in the markets 'perceived' risk in the sector, potentially increasing the cost of capital. Market perception of the risk in the sector will also be effected by the changing nature of regulation and lack of regulatory certainty.

NGN believe that effective medium to long term transitional arrangements plus adjustments to key revenue building blocks i.e. capitalisation and depreciation policies (e.g. to fast/slow capitalisation split), and allowed return rates, must be used to mitigate this risk to financeability and preserve true current relationships between cash flow levels and gearing levels, and hence existing credit ratings.

Question 2: Do you have any views on our proposed approach to capitalisation and depreciation policies?

The current proposal of moving to a 'Totex' approach with a fast / slow money split based on 100% capitalisation of Repex will have a potentially significant negative impact on cash flows. This reduced cash flow is likely to lead to a downgrade in the network credit ratings if not addressed, as the credit rating agencies place considerable weighting on cash flow metrics when setting the ratings. This in turn will have a significant effect on the ability of the networks to raise finance, as well as the associated cost of this finance.

Without shortening regulatory depreciation period and leaving it close to actual accounting life will have a negative impact on cash flow and equity investors should be expected to demand higher return to compensate for the risk inherent in having to wait longer to recover their investment. Reduced cash flows will also have a negative impact on credit quality. The higher consequent cost of equity and cost debt may increase the life-time costs to the consumer. In effect today's consumers would benefit at the expense of greater overall costs to future customers.

We also note comments in recent OFGEM publications regarding the varying forecasts for usage of natural gas in the UK during the next 40 years. Ensuring a fair intergenerational distribution of the costs of financing energy infrastructure is clearly important. The risks of dramatic changes to the type and delivery of energy used in the UK over the medium term introduces uncertainties that will, unless sensitively addressed, risk increasing the cost of capital to the sector. Rating agencies and investors generally will be wary of the risk stranded assets and in this context, a front ended depreciation profile for gas infrastructure assets would be sensible.

Another approach would be for OFGEM to address upfront how it would deal with the recovery of outstanding RAV on stranded assets in the event that changes to the structure of energy delivery in the UK during the proposed economic lives.

Regardless of the approach taken, any transition should be extended over as long a period as possible to avoid potential short term cash flow dislocations and the negative implications for company credit ratings.

In addition to the negative cash flow and credit implications of the proposed change in regulatory depreciation policy, changes to the approach to funding Repex under GD1 also has potential credit implications for GDNs compared to current arrangements since these assets will need to be financed with more investor capital.

Given the uncertainties regarding long term future of the gas industry in the UK, it seems perverse to lengthen the duration of capital at risk, and in this context, the impact on required returns on capital does not appear to have been addressed.

NGN believe that the fast / slow money split and other adjustments such as front loading deprecation and reducing asset lives must be used in order to maintain sustainable levels of cash flow in relation to stable gearing in order to mitigate any risk of credit rating downgrades and associated risk to financeability.

Question 3: Do you have any views on our proposed approach to implementing any transitional arrangements required to address cash-flow affects from a change in our repex capitalisation policy?

Ofgem's proposal to introduce transitional arrangements is acknowledgement of the potential materiality of the impact of the proposed changes to the regulatory formula and in particular the importance of maintaining cash flow metrics. NGN support the use of transitional arrangements in order to maintain sustainable levels of cash flow in order to maintain financeability metrics, and to mitigate any change to perceived risk in the sector. However, the current proposal to front load depreciation for new investment will not resolve the issues and other measures need to be considered.

The key here is that any commitment needs to be sustainable in the long term, and potentially cover more than one price control. Markets and credit ratings agencies are forward looking and will take into account long term prospects and forecasts, especially considering the long term investment nature of the utility sector and hence NGN believes that transitional arrangements may have to cover more from the price control if the overall regulatory package does not improve returns and strong cash flow metrics for constant gearing.

Question 4: Do you have any views on our preferred approach to assessing the cost of debt?

In principle we do not object to the proposal of indexing the cost of debt within regulatory allowances. The current system of setting the cost of debt lacks transparency and the proposed changes have this advantage and is also relatively simple. However, the applicability of such an approach will ultimately be dependent upon the exact detail of the index, in this regard we have concerns about the proposed indices to be used, and in particular the 10 year A rated corporate bonds index which relies on relatively few bonds to drive the output data.

We believe the proposed debt indexation approach systemically under-allows for the cost of debt, on three fronts:

i) A simple 10-year trailing average implies that the average age since issuance of existing debt is approximately 5 years. This is simply too short in many cases.

ii) As stated above we also have concerns about the proposed indices to be used, in particular the 10 year A rated Corporate Bond Index, which relies on relatively few bonds to drive output data.

This apparent reliance on limited data points exacerbates issues regarding the breadth of membership of the indices where the A rated corporate index even includes Sovereign issuers like Portugal and Israel. This increases the risk that the index outputs may diverge substantially over time from the actual cost of financing UK utilities. A related point is that most utilities finance themselves with debt which has an average maturity typically of much longer than 10 years, indeed 20/30 years in some cases, and there has been a trend towards longer average maturities in recent years. It is incorrect, as Ofgem asserts, that as a general matter there is little difference between the cost of 10 year debt and, say, 30 year debt – this depends on the shape of the yield curve which changes over the long term.

The proposed methodology creates the risk of significant mismatches, therefore, both in terms of basis and timing between the index-calculated cost and the actual cost of debt from time to time. At worst this may encourage utilities to change their funding strategies to more closely emulate the proposed index, which is inconsistent with a more appropriate strategy of matching long life liabilities to long life assets.

iii) Using ten year bonds as the average does not reflect the increased costs to networks (assuming a normal yield curve) of issuing longer average tenors, (which companies use to manage their maturity profiles and risk profile). Within this approach, 10 years is closer to the minimum tenor of debt issuance than the average, as most tenors issued are greater than 20 years.

Energy Network companies cannot raise all our financing needs at this maturity in the market and to even target this would create significant issues with rating agencies. Such an approach could actually be viewed as encouraging dysfunctional behaviour by driving funding only by cost and to the disregard of prudent maturities. In addition one of the underlying principles of regulation has been the incentive to outperform and the proposed mechanism removes the incentive to fund at attractive times in the debt cycle.

iv) No allowance is made for issuance costs such as legal, rating agency and bank costs and in the case of pre 2007, ongoing monoline guarantee costs. To argue as Ofgem does that past outperformance more than compensates for this is to penalise the networks for out-performance.

v) The additional costs of bond finance (in Sterling) above secondary credit spreads (of a similar credit at the same tenor) can be broken down into a new issue credit spread premium, fees and related insurance costs such rating agency fees and documentation costs. Companies also have costs related to maintaining liquidity lines (typically undrawn Bank facilities) or holding cash. An additional allowance to the indexation of debt costs would be one method of addressing these costs.

Please refer to our response to the RIIO GD1 Finance document, Chapter 3, Question 5 also. In that response the mechanism for debt indexation is analysed in detail.

Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent (real post-tax)?

The high-level considerations that Ofgem need to take into account in assessing the cost of equity in the first RIIO price reviews include:

- The new risks likely to be associated with longer duration cash flows, longer-term price controls and more powerful incentivisation of output delivery
- The relationship between gearing and equity risk;
- The paucity of directly relevant market data;
- The relative stability of market equity returns, when compared with the stability of the CAPM components of those returns.

When all of these factors are considered, they suggest that the effective range for cost of equity may be higher rather than lower than that eventually considered for DPCR5. Consequently the lower end of the range quoted by Ofgem would be viewed by investors and rating agencies as way outside an acceptable range of equity returns.

Question 6: Do you have any views on the other elements of our financeability proposals?

NGN support the focus within the review on performance and efficiency incentives. However the overall impact of the proposals unless revised or rebalanced through increased incentives and improved cost of capital returns will have to have a significant negative impact on cash flows, and increase markedly both uncertainty and perceived business risk in the sector. Investors can be expected to demand a higher return to compensate for the risk inherent in having to wait longer to recover their investment. They are and unfortunately they will be unlikely to rely purely on the Regulator to guarantee this. This is likely to have a knock on effect on both the cost of debt and equity, as well as underlying credit ratings for the energy network companies.