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Dear Rachel,

Second Gas Distribution Price Control (GDPCR2) - Open Letter Consultation

Thank you for the opportunity to comment on the key facets of the review at this early stage of the process.

Our response is structured to cover the following areas:

- Context for the review;
- Application of the RIIO principles to gas distribution;
- Key issues for the review; and
- Timetable and process for the review.

<u>Context for the Review</u>

The context in which GDPCR2 will be conducted contains two significant and interlinked changes compared to the initial gas distribution price control. The first is the UK government's low carbon agenda and the increased environmental duties on Ofgem. The second is the implementation of the new sustainable network regulation framework (RIIO). Whilst both of these changes raise questions over the future use of gas and the associated networks they do not specify any definitive outcome. Gas will remain, for the foreseeable future, the most cost effective and lowest carbon generating means of providing heating to domestic customers and requires no form of subsidy. There are scenarios where the 2050 carbon targets can be met with significant usage of gas and these may represent better overall value for money for UK plc. Consequently the review should recognise that uncertainty exists, but it is important that decisions over investment (or legitimate alternatives) in the networks are based on what is required to maintain a safe and reliable gas network over the longer term rather than any presumed outcome from the environmental debate.

This is the second price review of gas distribution as a standalone entity and the first in which Ofgem will have good comparable data on the overall performance of the individual companies over several years. What is already clear from data published to date is that the decision by Ofgem to allow the sale and break up of the gas distribution networks has delivered significant benefits to customers and fully justified this decision. It is important that those companies such as NGN which have driven the delivery of these benefits are recognised during the review.

Application of the RIIO principles to Gas Distribution

Overall NGN supports the principles that have been developed under the RPI-x@20 project and now incorporated into the new sustainable network regulation framework (RIIO). Whilst in the area of financeability we believe the Authority should consider further adaptation in its final decision on RIIO, the focus now has to switch into how RIIO will be applied in practice during GDPCR2. There are a number of issues we think need to be carefully managed and clarity provided to ensure the benefits are delivered as envisaged.

- The move to economic asset lives for calculating depreciation which in gas distribution may lead to a change in the current 45 year asset life and removal of the 50% expensing of replacement expenditure. These changes coupled with the move to a totex approach need to be carefully managed to ensure they do not significantly disturb the overall cash flows of the companies as this could lead to an increase in the perceived risk in the sector and consequently the cost of capital.
- NGN welcomes the opportunity of an eight year price control but it is critical that the framework for the proposed mid-term review does not in practice turn this into two separate four year controls.
- Where Ofgem determines that it is appropriate to apply the fast track approach to a company it is essential that such companies have a track record of performance as well as a well justified business plan. The incentive framework for a fast track company should ensure that it is appropriately rewarded for past performance, maintains opportunities for future outperformance and genuinely does receive less regulatory intrusion during the price review relative to non-fast tracked companies.
- It is clear from previous stakeholder feedback that stability and predictability of transportation charges are key concerns of shippers and suppliers. Under RIIO, the annual calibration of the cost of debt and other incentive mechanisms has the potential to reduce the stability and predictability of transportation charges. Therefore we should carefully consider how this effect can be negated.
- Stakeholder engagement is a critical feature of RIIO but it should be conducted in a manner which does not raise unrealistic expectations or concerns and seeks to deliver a balanced and informed input into the review process. We should recognise that stakeholder engagement is not a panacea and will provide sometimes inconsistent and conflicting messages. Ultimately the key decisions on the review will remain with Ofgem and the companies.
- Output measures in many areas of gas distribution are well developed but in some areas it may not be possible to develop from day one a consistent and detailed framework and, like DPCR5, it may be necessary to work through the detailed implementation of the measures during the early years of GDPCR2.

We look forward to working with Ofgem during the review process to address these issues.

Key issues for the Review

Replacement Expenditure (Repex)

NGN has always sought to deliver the Repex programme in the most cost efficient manner which is demonstrated by our continuing frontier position on the benchmarking of Repex costs since 2005. However, we recognise Ofgem considers this issue of primary importance and given the cost that it is appropriate to review jointly with HSE the future of the programme. NGN will actively support this process with an open mind. However, the Pipeline Safety Regulations and other potential legal liabilities do currently restrict our ability to make significant changes.

We are pleased that the review will consider the wider environment and operational benefits delivered by the programme as well as the primary safety benefits.

It should be recognised that if the repex programme is significantly changed or even abolished then investment will be still be required to at least contain the level of risk at present levels.

Environmental Issues

Broadly we believe the arrangements to incentivise leakage reduction in GDPCR1 are appropriate and should form the building block for arrangements in GDPCR2. A radical switch to a similar methodology to that used in electricity distribution would in our opinion not lead to a more accurate measurement of leakage and would introduce a range of factors outside the control of the network companies into this calculation.

Rather than just consider removing potential barriers to the development of economic options for the injection of bio-methane we think it is important to consider more pro-active incentives on the networks to connect such plants. At the very least this should match similar incentives on electricity distributors to connect distributed generation plant as we have already encountered schemes which are considering whether to inject into the gas network or generate electricity on site and connect to the electricity network.

Demand Uncertainty

We believe the methodology for demand forecasting is robust but we are happy to consider whether improvements can be made. Whilst Ofgem is correct that some areas of expenditure are linked to the 1 in 20 forecast in the case of NGN we believe this will be a relatively small percentage of overall forecast expenditure in GDPCR2.

Xoserve

Xoserve have responded in more detail on these issues separately on behalf of all the GDNs. The one comment we would like to emphasise is that the concept of user pays sits more closely with the RIIO principles of users determining directly the services they require in a framework which directly links to the costs they will pay for those services. Therefore we should consider how this approach can be expanded in relation to Xoserve.

Network Extensions

This scheme has generated significant benefits in connecting households in areas of multiple deprivation and reducing both fuel poverty and carbon emissions. Connecting to mains gas remains the most practical and cost efficient way of delivering these benefits. In our opinion these benefits have been delivered at a relatively low overall cost and it would be counter productive in the current environment to abolish or radically change the scheme after a relatively short period of operation.

Carbon Monoxide

NGN is happy to consider what additional role GDNs can play in reducing incidents of carbon monoxide poisoning.

Financial Issues

The methodology of assessing the overall price control package by reference to the return on regulatory equity (RORE) developed during DPCR5 is now more broadly understood but it would be helpful if Ofgem provided the detailed model it intends to use for RORE at an early stage of the review process so we can make use of this in developing our business plans.

It is important that the RORE methodology continues to allow additional return and continuing outperformance opportunities for frontier companies.

The precise mechanistic index that will be used by Ofgem for setting cost of debt will be a critical component of the price review and it is essential that work begins early with the companies on developing the appropriate index.

Other Issues

Based on our experience, the loss of metering activity does have a demonstrable effect on operation of the business and the emergency service in particular. This needs to be reflected in Ofgem's benchmarking analysis and considered further in GDPCR2.

We agree with Ofgem that we can see no overriding reason to make changes to the Gas Act (Exemptions) Order but will fully participate in any review of these requirements.

Unfortunately, future costs associated with theTraffic Management Act remain unclear at this point. Out latest intelligence is that there is unlikely to be any permit schemes under the Act within our region before our business plan submission in July 2011. We fear therefore it may not be possible to set firm allowances and we will have to fall back on some form of re-opener or uncertainty mechanism.

Issues not contained in Open Letter

There are two issues not outlined in your letter which we consider need to be addressed during GDPCR2.

- Role of GDNs as provider of last resort services in the metering market and provider of certain meter reading services. We consider these roles historic anomalies and should be removed. Should these obligations remain then the associated metering price controls need to be re-set as it is now a considerable number of years since they were reviewed.

- The impact of smart metering on GDN operations. We can foresee that a roll out of this magnitude needs only a relatively small percentage of problem installations or customer misunderstanding to generate significant volumes of activity for our emergency service. In addition we also understand that smart meters cannot be installed in semi concealed meter boxes which are a relatively common feature in gas. This may generate significant requests for us to alter service positions. Whilst we and the other GDNs will endeavour to work with the supplier community to reduce the impacts there is significant potential for us to incur additional costs.

<u>Timetable and Process for the Review</u>

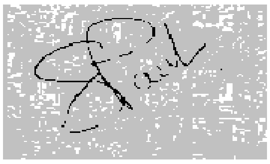
NGN supports the proposed approach for taking forward the development of outputs and believe the primary outputs set out are a reasonable starting point for the working groups to develop further. We are providing our detailed comments on these areas through the working groups.

It has always been a concern for network companies that policy issues are not resolved until quite late in the review process. We support the drive to address as many of these issues as possible during the period up to the strategy document publication in March 2011. Overall we believe the proposed timetable is appropriate.

The major potential stumbling block to this ambition is the outcome of the Repex review and we believe this should be addressed by assuming for the business plan submission in July 2011 that the current programme continues. If the final review outcome is some form of significant change that requires amendments to the Pipeline Safety Regulations then this would extend timescales significantly and business plans would have to be significantly revised accordingly. If the final review outcome is largely the retention of the current arrangements then the building blocks would be in place to conclude the price review in accordance with the proposed timetable.

I hope you find our comments helpful and if you or any member of your team wish to discuss further any areas of this response please do not hesitate to contact myself or Gareth Mills. Our response can be regarded as non-confidential.

Yours sincerely



Stephen Parker
Regulation and Commercial Director