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30 September 2010

Dear Rachel,

Response to Open letter consultation on Gas Distribution Price Control Review 2 (GDPCR2) – the way forward

Wales & West Utilities Limited (WWU) is a licensed Gas Distribution Network (GDN) providing Gas Transportation services for all major shippers in the UK. We cover $^{1}/_{6}{}^{th}$ of the UK land mass and deliver to over 2.4 million supply points. WWU is one of only two Licence Operators that focus solely on Gas Distribution in the UK.

This letter is a response to your open letter on the Gas Distribution Price Control Review 2 (GDPCR2) dated 30th July 2010. We cover our key issues in the main body of this letter and provide our initial feedback on the "other issues" raised, within appendix 1 of this letter.

The key issues for the review

The final decision on the new "sustainable regulatory framework", which will be applied to GDPCR2, is likely to significantly impact the upcoming review process. Applying untested and unproven principles will bring additional challenges to the many "content" issues that will need to be addressed through the GDPCR2 process. The key issues we would like to cover in the main body of this letter are:

- The financeability and length of the Price Control review
- The development of Outputs and associated incentive regimes
- The Replacement programme
- The impact on costs and revenues associated with a Supplier led Smart Meter programme
- Environmental issues
- The 'Fast Track' process

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Financeability and the proposals to move to an eight year review period.

The "Regulating energy networks for the future RPI-X@20 recommendations consultation" published by Ofgem on 26th July 2010 contains some recommendations, that if implemented, will introduce significant additional risks for networks and investors and have significant negative funding consequences for networks.

The price review process must provide sufficient funds to allow efficient networks to fulfil their licence obligations and deliver the appropriate outputs at a reasonable cost to their stakeholders.

Every Network Operator in the UK has given Ofgem clear feedback on the potential negative impacts of some of the key recommendations contained in Ofgem's most recent recommendations; most notably on financeability and the length of the price control review process. Our investors have also provided comments back to you. We hope that Ofgem acts on this feedback to ensure the positive principles contained within the consultation are not undermined when it makes its final decision later this year. We also note comments from British Gas in their response to the consultation that state, "*We have concerns that an eight year price control will fail to provide substantially greater revenue certainty for the networks, while the range of uncertainty mechanisms being considered could result in a material increase in the volatility of network charges".* These comments support the feedback we have previously had from stakeholders through our collective forums.

The potential financeability impact associated with the review of energy regulation in the UK is therefore the key issue for this, and future reviews. We attach our response to the "Regulating Energy Networks for the future RPI-X@20 recommendations" as appendix 2 to this letter.

The development of Outputs and incentive regimes

We acknowledge the principle of linking funding to the delivery of tangible outputs. We accept this principle could provide the evidence to consumers of the value received from networks, which costs the average domestic consumer circa £10 per month.

We are currently engaging with Ofgem, and the other networks, to introduce an appropriate set of outputs and incentives. We are fully engaged in all the new "GDPCR2 Output workgroups" and want to ensure that we introduce a set of outputs, with incentives, that are both workable and sustainable into the future. To avoid uncertainty, onerous reporting, micro management and unintended consequences, it is vital that we "test" the introduction of any outputs against a common sense set of characteristics.

Before any outputs are introduced we must ensure they contain some basic characteristics. Examples should include, but may not be limited to:

- Controllable
- Auditable
- Measurable
- Comparable between networks
- Not result in unintended behaviours

If we introduce a suite of outputs and associated incentives without the robust challenge and review, there could be significant risks imposed on consumers and/or networks. Our view appears to be supported by the comments made by John Stern, CCRP, City University in his response to your regulating energy Networks for future, RPI-X@20 recommendations consultation.

We will continue to participate fully in the "Outputs" workgroups and support the principle of linking funding to outputs, but hope the terms of reference for these groups take account of their potential significance to the overall price review process.

Replacement expenditure

WWU welcomes the Ofgem suggestion of reviewing how the 30:30 programme can be delivered in the most effective and efficient way and will offer its complete assistance to the HSE in its review. We have already been engaged with you and the HSE and we are committed to working with HSE, Ofgem and the other networks to ensure an appropriate outcome is achieved that does not increase risk to consumers and does not expose networks to unacceptable risks.

We note Ofgem's concern over the cost of the mains replacement programme, but we would like to draw your attention some key points that must be considered within the review of the Replacement programme.

- **Societal concern.** Preceding the establishment of the 30:30 programme, there was a high level of societal concern about the consequences of gas mains failure, as a number of significant incidents had led to multiple fatalities for example, Putney (in 1985 - 8 fatalities), Rutherglen (in 1985 - 5 fatalities) and Larkhall (in 1999 - 4 fatalities). The particular concern related to iron pipes, which in many cases were over 40 years old and were failing on a frequent basis. It is our view, given a recent ruling by Lord Gill (July 2009) that societal concern has not changed. Nine people died as a result of an explosion relating to fractures on an LPG gas explosion at Grovepark Mills. The explosion was caused by the same failure mode as apparent in the natural gas industry. An aging metallic pipe which failed resulted in gas entering a building and a subsequent explosion. Within the recommendations, the first and most urgent priority was to immediately identify and replace all underground metallic pipe work with polyethylene on a systematic and prioritised basis. WWU believes this most recent examination of society's concern is of immediate relevance to the iron natural gas mains system and supports WWU's view that not only should the 30:30 programme continue, but society would expect it to be accelerated where practical.

- **Duties of the Operator of Pipelines.** The Pipeline Safety Regulations set out the duties of the Operator of pipelines, which include an absolute duty to maintain pipes in a fit state of repair. The only practical way to maintain such pipes is to replace them, but given the scale of the iron pipe system, an agreement was reached to replace these pipes over a 30 year programme. Understanding that mains within 30 metres of property presented the highest risk, HSE agreed that only such pipes would be deemed risk pipes, and a defence to prosecution under Regulation 13 was drafted (Regulation 13A) to cover pipes within the 30:30 programme. The timing of the programme was agreed both on the grounds of practicality, cost and with a goal of ensuring deterioration of the network did not accelerate.
- **Steel pipe system.** In addition to the iron mains condition, WWU has noted the deterioration of the steel pipe system, notably the pipes operating at low pressure. These pipes are replaced when encountered as part of the 30:30 programme and when a pipe is identified in poor condition such as when attending a public reported escape, but there has been less focus on steel pipes that may not be evident as posing an immediate risk, but are likely to fail in the near future. WWU considers that such pipes should be included in the programme in addition to the iron pipes and hence meet society's concern over such events described above.
- **Environmental impacts.** With regard to the cost of the programme, WWU believes that the real cost of the programme should be examined, i.e. the net present value, taking into account the other benefits in addition to the clear safety imperative. These benefits include the reduction in shrinkage gas costs, the avoidance of the nuisance and cost of undertaking ad hoc repairs to pipes following public reported escapes and the carbon abatement value of the programme by the reduction of methane leakage, a powerful green house gas, 21 times more damaging than carbon dioxide.

In summary, It is our view that reducing the existing 30:30 Mains replacement programme would lead to an increase in fractures over time and hence a reduction in safety levels. This does not appear appropriate and does not meet the Government's strategy to improve safety performance.

Environmental Issues

WWU has always adopted a practical approach to the environment and has built an enviable reputation in our region as a leading company in this field. WWU recognises that emissions from the network assets represent the vast majority of its green house gas emissions and has consistently followed investment cases and working practices that would minimise these emissions. WWU has consistently cut over 50,000 tonnes of CO2 equivalent per annum though its investment programme and proactive management of system pressures. Much of the benefit has been achieved by replacing old iron mains with new polyethylene mains which exhibit near zero emissions compared with iron pipes whose joints are prone to leakage. We provide further feedback on the potential review of the leakage model and issues to be addressed as we transition to a low carbon economy within appendix 2 of this response.

The fast track process

The proposed 'Sustainable Regulatory' principles include the provision of a 'fast track' process. The proposals 'rule in' those companies that:

a) have an evidenced track record of performance and

b) submit a robust business plan, having consulted effectively with stakeholders

We aspire to be a company that is considered for the fast track process but we need to fully understand how the process would work. The GDPCR2 timetable suggests a fast track decision would be made between July 2011 and December 2011. This is twelve months ahead of the likely "Final Proposals" document. Historically, many significant building blocks are not finalised until the latter stages of the review process. In summary, we need to understand what commitments would be given as part of the fast track process.

We have raised a number of key process and activity issues in this response and we look forward to further discussions with you . We intend to be fully engaged with you, our stakeholders and the other networks during the price review process.

Yours sincerely

Steve Edwards

Head of Commercial and Regulation

Wales & West Utilities

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Appendix 1

The following paragraphs give some initial feedback on the points raised by Ofgem within the Open letter on GDPCR2 dated 30th July that we have not covered in the main body of this letter.

Demand uncertainty

We were surprised by the comments in your letter which stated concerns over

- The accuracy of the demand forecasts
- The limited incentives to make improvements and
- The need to take a longer term view of trends

We would welcome further discussions with you to fully understand your concerns in relation to demand forecasting as we believe the process is well established and has been applied consistently.

We think there is general recognition of the unusually warm weather in recent years and the difficulty this adds to the forecasting process. We are working hard, in conjunction with National Grid Transmission, to fully understand the recent weather and the impacts on future network capacity requirements.

We think the current revenue and cost incentives are appropriate to protect consumers and promote efficient network decisions. In addition to the existing incentives, we think the existing licence obligations are clear and appropriate. You will be aware that we also provide "Long Term Development Statements" which are updated annually to provide users a longer term view of network developments.

Review of the Leakage model.

The modelled approach currently used in gas distribution to calculate emissions continues to be proportionate to the scale of the losses, which are approximately ten fold less than losses on the electricity distribution network. WWU will be happy to review the methodology currently utilised within Gas but our initial view is that we do not think it is the appropriate time to consider a move to the methodology utilised by the electricity DNOs. We understand the electricity methodology calculates the loss by subtracting the electricity metered from end users from the electricity measured into the DNO. We do not think this would better reflect actual losses in Gas for the following reasons:

- The modelled losses in gas indicate a percentage loss of less than 1% of the volume transported through the network. The actual meter reads from end users may not be accurate enough to record to the required level of accuracy
- The vast majority of meters are not read on a daily basis and in many cases not read for over three months. This would not allow accurate daily calculations to be carried out.

- The current process within gas is a pure calculation on losses. It does not suffer from any errors that could occur in the "energy into / energy out" of calculations
- Once all meters are "smart meters" (post 2020) it may be appropriate to consider the electricity model.

Transition to a low carbon economy.

WWU believes that the following considerations will be important over the next period:

- **Climate change adaptation**. WWU has been proactive in working with DEFRA and Cranfield University to develop a climate change risk assessment to ensure that critical plant and equipment are protected from the expected impacts resulting from the changing climate.
- **Biomethane Entry**. WWU welcomes Ofgem's consideration of the removal of barriers to the entry of bio-methane into the network. WWU has focused its attention on the HSE/DECC view on gas quality requirements; recognising the need for low cost gas quality and metering equipment; the provision of capacity information and mapping and finally the appropriate ownership of connection assets. In addition, WWU has conducted an industry consultation on DN Entry to seek stakeholders' views on these matters.
- **Land management and historic structures**. WWU is mindful of its historic legacy and is keen to ensure all environmental impacts are included within its business plan. This will include the assessment and management of risk from historic gas making activities, the removal of redundant structures that pose a risk and the facilitation of development in the vicinity of WWU sites by releasing land for regeneration and the withdrawal of hazardous substances consents. Both HSE and our neighbours have welcomed our approach and WWU would seek to continue such dialogue.
- **Waste and discharges**. A key part of WWU environmental impact relates to waste disposal and discharges. WWU has a track record of innovative solutions to the reduction of such environmental impacts and will seek to continue this strategy.

Cost of compliance to the Traffic Management Act

There is a clear drive from central Government to reduce local authority budgets given the current Government funding crisis. There are also significant developments in the "Streetworks Code of Practice" and application of the Traffic Management Act.

Whilst the local authorities within Wales and South West have not actively pursued Lane rentals, Permits to Work or increased fines, there are indications of significant potential increases to Network costs which may be outside of our control. We therefore need to ensure that there are clear re-openers to address new emerging legislation and ex-ante allowances for identifiable costs associated with current legislation. We are continuing to work with local authorities, NJUG and other networks to fully understand the likely impacts but this is an area with significant cost implications for networks during the next price control period.

Carbon Monoxide

WWU believes that deaths and injuries caused by Carbon Monoxide are a serious issue for the industry to tackle. As an outcome of the first distribution price control review (GDPCR1), WWU and other networks provided a range of options, with funding implications, for Ofgem to consider; we still await the outcome of this from Ofgem. As part of the GDPCR2 there is a clear opportunity for networks to re-assess their contribution to this industry issue. We will be including options to stakeholders as part of our stakeholder engagement process and will address the outcomes in our business plan submission.

Xoserve

Xoserve has provided an efficient interface for all shippers and networks since network sales. The Government mandate to roll out Smart meters is likely to have an impact on the licence obligations for networks and consequently, xoserve. Whilst there are significant and material issues to address, we think the materiality of cost to networks and impact on end consumers is relatively small and any review effort should be proportionate to this value. We will consult with stakeholders, probably on a collective basis on the xoserve issues and will continue to support the Ofgem/DECC Smart Meter Implementation Program.

Technical surveys of Sub-deduct networks

We have completed a full technical survey of our Sub-deduct networks which included a cost estimate analysis. Notwithstanding the safety concerns that Ofgem/DECC have with networks that are subject to the Gas Act exemption (that includes all sub-deduct networks), these networks create a significant administrative burden on end users, shippers/suppliers, transporters/xoserve. We believe that GDPCR2 presents an ideal opportunity to resolve this industry wide issue and therefore would propose an upfront allowance in line with our analysis to complete the work that would have significant safety and practical benefits for consumers and the industry.

The impact on costs and revenues of a Supplier led Smart meter rollout programme

The Government has now mandated a rollout of ‘Smart meters’ by 2020 to replace existing domestic gas and electricity meters. The Government has mandated a supplier led rollout and this mandate has two potential impacts for us.

- **Loss of Meterwork contracts**. As many suppliers will require contractors with “Dual Fuel“ installation capabilities it is going to be more difficult to win meterwork contracts. This issue will be further exacerbated as electricity meters will dominate the installation populations. You may be aware that the largest domestic gas supplier has indicated that they will manage their Smart meter rollout programme with in-house labour. The loss of meterwork volumes will have an impact on the costs of running a standalone emergency service.

- **Additional Call Out volumes**. The rollout could have significant implications for "callout" volumes for our engineers. In our geography we have over 2 million domestic gas meters and it is highly likely that there will be a level of faults associated with installations, the new smart meter assets and consumer confusion. Even if there are a small percentage of issues, the strain on our workforce could be considerable given the total population volumes. EG: a 2% problem could result in over 40,000 calls over an eight year time frame. This equates to a circa 8% increase in annual workloads for our service engineers.

As part of the price control review process we need to address the appropriate funding for the Emergency Service which is delivered by the service engineers that will be impacted by the changes in the metering landscape.

Appendix 2

WWU's Response to "Regulating energy networks for the future: RPI-X@20 recommendations"

Many of the proposals can be described as more "evolution" than "revolution", building upon a number of policy areas that were addressed and discussed during DPCR 5. We support the core concepts of Sustainable Network Regulation:

- Sustainable energy sector
- Sustainable network services
- Network companies to "play a full role"
- A focus on long term value for money
- A focus on longer term cost considerations
- Appropriate enhanced role for Consumers
- Enhanced engagement with stakeholders

We agree that the documents help to promote a common understanding of these concepts. Some of the additional discussion around policy areas is helpful – in particular more detail and guidance explaining Ofgem's current policy thinking regarding:

- Stakeholder engagement
- Outputs and incentives
- The key components of a "well justified business plan"

However, we do have real concerns over key areas where proposals are "revolutionary" and in our opinion, have not been tested, and will not result in better regulation. Key concerns are:

- ***Financing efficient delivery*** - Changes to the way in which Ofgem will carry out its obligation to assess financeability, which we believe introduces regulatory risk which will increase the cost of capital and may result in a network not being able to finance it's business. Key areas are:
    - ***Regulatory certainty***
    - ***Weakening of the financeability test***
    - ***Timing of cash flows***
    - ***Annual adjustment to the cost of debt***
    - ***Regulatory depreciation***
    - ***Capitalisation rates***

- ***Eight year Price Control*** – Five year price controls remain appropriate with no reason to depart. The proposal to move to an eight year price control, with a four year "mini-review" introduces complexity and has not been demonstrated to be expected to result in better regulation. Key areas are:

  - ***The lack of evidence for change***
  - ***The inability of the regulator to commit***
  - ***Uncertainty***
  - ***Complexity***

- ***Greater role for third parties in delivery –*** The list of conditions that need to be met and the structure of the Gas Distribution network appear to limit this tool to Transmission activities. Despite these points we do not believe the option and the associated recommendations by Ofgem will add to regulatory commitment or enhance sustainable regulation within Gas Distribution. Particular points are with
  - ***The appropriateness of Ofgem as the economic regulator to run tenders***
  - ***Ofgem's view of when they would consider giving third parties a greater role in delivery and***
  - ***Networks ability to dispute an Ofgem decision to use this mechanics***
  - ***Compensation for past investment provided***

- ***Challenge to Regulatory Decisions*** – Alternative review mechanisms should to be considered:
  - ***Accept a Price Control or appeal to the Competition Commission***

We address these key issues in the main body of our letter, and provide further comments on the proposals in the attached appendix.

A common theme throughout the proposals document is "regulatory commitment" which will, when effective, give transparency and enable stakeholders to make informed judgements about the long-term regulatory outcome of alternative options. Indeed, the change in approach regarding assessing financeability and the proposed eight year price control is predicated on Ofgem being able to articulate "regulatory commitment" sufficient to be able to satisfy:

- equity and debt investors - that reduced return on investment and sub-investment grade credit metrics during a current price control will be compensated over the long term, and
- shareholders and management - that when considering acceptance of an eight year price control, assurance that a future mini-review in year four will be carried out in accordance with an objective, pre-defined scope in a symmetric manner that does not distort the risk profile underlying the first four years of the price control.

Our concern is that however much Ofgem would like to be able to provide a "regulatory commitment", it is constrained by circumstances:

- A regulator cannot bind its successors and fetter future discretion; and
- A regulator cannot bind Parliament, which could make changes to the regulatory regime.

It will be extremely difficult, if not impossible, for a regulator to provide the "firm commitments" it describes which undermines Ofgem's ability to implement the proposals as described.

Financing efficient delivery

We have a number of concerns regarding the proposals.

Regulatory Certainty

As discussed above, the proposals assume that the Regulator can sufficiently articulate financeability principles that will be applicable over successive price controls, and create a regime of "regulatory certainty" or commitment. Current and future investors, and credit rating agencies, will be able to have regard to "regulatory certainty".

The clear assumption of this approach is that "financeability" adjustments to price controls are less likely to be required:

- As credit rating agencies should be able to rate the licensee "through" sub-investment grade credit metrics arising from a current price control, in the knowledge that efficient licensees will be allowed to recover deferred cashflows in the future sufficient to compensate the business and secure credit-worthiness over the long term. A belief by credit rating agencies that investors will take the same view is implicit in this assumption.
- If credit rating agencies are not sufficiently assured in respect of the ratios and
    - an equity injection is required to improve financial ratios; or
    - further funds are required by the licensee to support its operations (during a period of negative cashflows for example),

  then investors, and particularly equity investors will provide these, in confidence of a compensatory higher return in subsequent price controls.

For the reasons set out above it will be extremely difficult, if not impossible, for a regulator to articulate financeability principles that creates "Regulatory Certainty" sufficiently robust to achieve the outcomes envisaged by the proposals.

Weakening of the financeability test

We have always regarded the financeability test as a key tool in ensuring that any price control has appropriately balanced the need of licensees for funding against the consumers' and stakeholders' concern for value for money.

A number of fundamental "building blocks" of a price control require careful judgement and are susceptible to estimation error. A failure to meet "investment grade" financeability tests should be seen as a structural weakness in the settlement (by proposing a significant period of negative cashflow, for example) or an indication of estimation error within the proposed price control, most likely around assuming a weighted average cost of capital (WACC) that is too low.

The proposed longer term view of financeability will permit a failure of investment grade financeability tests in the short term (potentially over the proposed price control period) provided these tests are met over the longer term. The comfort of a "cross-check" of price control assumptions for estimation and other error is therefore lost. This would occur for successive price controls if in each instance licensees only meet the revised financeability test through assumptions about long term metrics beyond the individual price control.

Assumed indifference of investors to timing of NPV neutral cash flows

Oxera's report "What is the impact of financeability on the cost of capital and gearing capacity?" (May 2010), discusses the research of Brennan & Xia which concludes that the timing of cash flows is significant in an investor's assessment of risk. Consequently, the premium required by investors for deferred cash flows dictates they cannot be assessed on an NPV neutral basis. Oxera estimates that deferral of cashflows could increase cost of capital by an order of magnitude of 60bps.

This is consistent with our concerns:

- Deferring cashflows in an individual price control would result in equity investors bearing reduced distributions or having to make further additional equity investment in the licensee (e.g. to fund necessary capital investment) in anticipation of "NPV neutral future returns" in subsequent price controls. This sacrifice would be exacerbated during periods of high capital investment and intensity. A risk premium is necessary to attempt to compensate for the uncertainty of the "regulatory commitment"; to what extent will: a) cashflows continue to be deferred in successive price controls, and b) further equity funding be required?

  The required equity injection could be substantial – not even sufficient to match notional gearing assumed in the financeability model, but to repair interest cover ratios that even this financeability model is showing are insufficient to meet investment grade ratio criteria in the short and medium term.

  Consequently, both existing and potential future investors would be exposed to a greater level of uncertainty as to when they would expect to recoup their investment, yet alone achieve their required return thereon. This will have a destabilising impact on the sector

- This issue is more pronounced for private companies, who comprise a significant proportion of energy networks, where existing investors will have more regard to liquidity risk. It is a relatively simple process for individual equity investors in listed companies to choose between participating in a rights issue or selling their stake if a licensee requires further equity investment. The ability and willingness of a private company shareholder who has already made an investment in the licensee to contribute further equity will be dependent on that shareholder's financial circumstances and competing opportunities for its capital, compounded by the illiquid nature of its investment. New investors would have similar concerns regarding the timing of the return on investment and as such, would be less inclined to invest. This could result in existing shareholders being even more exposed to such risk as they are unable to exit or mitigate the additional demands of their investment.

- We do not think the arguments provided by the economic consultants that Ofgem have commissioned ("The CEPA paper on Cashflow profiles and the Allowed WACC") provides the evidence to support their contention that the risks associated with 'time-inconsistent' behaviour by regulators can be mitigated. At the start of paragraph 12.42 Ofgem acknowledges there is an argument that increasing the duration of cash flows may increase the cost of capital and we firmly believe the evidence provided by Oxera fully supports this case.

Annual adjustment to the Cost of Debt

The use of an index to adjust cost of debt has been considered and rejected by Ofgem in the past. We are surprised that Ofgem still recommends this despite the recent Competition Commission ruling on Bristol Water.

- To date, Ofgem's and Ofwat's position has been that companies and shareholders are responsible for their funding decisions.
- In its provisional findings, the Competition Commission recently considered whether regulators should set required return "equal to some concept of long term average cost of capital rather than the expected cost of capital for the specific price cap period" (Bristol Water Plc Provisional Findings June 2010 Para 9.7). It concluded this approach was not consistent with its terms of reference, and risked either setting the return below that required to secure the company's ability to finance its functions, or above that necessary to the detriment of consumers.
- Setting WACC using an index for debt will lead companies to avoid the risk of underperforming against the allowed cost of debt by profiling their debt to match the index. This may not result in efficient financing decisions in the interests of consumers. The statement in para 12.24 that networks will have comfort that "efficient cost of debt will be funded in the future" is only correct if the relevant future debt is not greater than 10% of notional gearing in each year. If Ofgem's proposed 10 year trailing average cost of debt for investment grade companies is used:
    - There is an implicit affirmation by the regulator that a 10 year average debt profile is appropriate and efficient for networks
    - Network Companies will need to refinance 1/10 of their debt each year to align with the index. This is unlikely to be efficient due to:
        - Ongoing transaction costs

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        - Deal size – 6.25% of RAV (1/10th of notional gearing of 62.5%) will not meet bond issue "liquidity" criteria of approximately £200m unless RAV is £3.2bn for each Licensee.
        - Networks have an established long term capital markets funding structure already in place and would not be possible to restructure the debt profile in the shorter term without incurring significant cost.
    - Networks would need to address the credit rating agencies' debt maturity profile criteria, which are often incorporated into existing debt covenants, of no more than 40% of debt by RAV maturing within a single five year price control period. If an eight year price control were adopted then debt maturities would need to be reassessed - requiring Networks to balance covenant compliance and credit rating against the risk of unfunded debt costs.
- Ofgem's proposed historical, mechanistic approach to setting and annually updating the cost of debt is not appropriate:
    - WACC needs to be based on the expected future cost of capital in the ensuing price control, not a rear window view. The cost of debt should also reflect this
    - No headroom for volatility, market shocks/disruptions. This is currently exacerbated as market participants widely recognise we are in a prolonged period of economic uncertainty and market volatility.

Regulatory depreciation

We note that Ofgem intend to commence a full review of economic life in 2010 as part of the transmission and gas distribution price controls. We welcome a swift and pragmatic assessment of economic life which will end speculation over Ofgem's intentions given its previous indications questioning the economic life of gas distribution assets.

We believe the current approach to regulatory depreciation is appropriate and are comfortable with regulatory depreciation being set in accordance with the estimated economic life of the asset. We are not aware of any current available information for gas distribution that would require a departure from the existing methodology, which assumes a weighted average economic life for the combined components of the transportation asset of 45 years. The current methodology is transparent and the straight line basis is a well accepted methodology.
Shorter depreciable lives increase costs to current consumers and increases "cliff face" risk; whereas longer lives reduce current cashflows, impacting financial ratios. The regulatory framework needs to encourage investment as capital investment is incurred upfront - longer lives adversely impact on cashflows, debt serviceability, equity returns and hence, investment appetite.

Current studies suggest that under all credible energy scenarios gas will remain a significant source of energy for domestic and commercial properties for the foreseeable future. The recent Department of Energy and Climate Change "Pathways to 2050" work acknowledges the current uncertainty over nuclear and renewables take up and calls for further evidence. The number of domestic gas consumers in WWU's operations area continues to grow with approximately 15,000 new connections every year. In addition, the "Fuel Poverty Scheme" is enabling consumers of higher cost energy (electricity and heating oil) to reduce energy costs by connecting to a proximate gas supply. This all supports the continued reliance on gas in the UK for the foreseeable future.

Regulatory depreciation - Transitional arrangements

We believe that as companies have already raised significant debt to date under the current regulatory depreciation principles, that the current depreciation rate should continue to be applied to the existing RAV.

Capitalisation rates

Generally, capitalisation principles should align costs with consumer benefits. If consumers receive immediate benefits from a network activity, then it is reasonable that they should fund that activity in the current period. If the benefit is received over a longer period of time, then costs should be attributed over an appropriate period.

Ofgem's City Briefing of July 26th 2010 (slide 44) gave an indication of future views on the treatment of repex (replacement) cost as "likely to be treated as capex." We note that replacement expenditure is treated as a revenue cost under both UK GAAP and for taxation by HMRC following the Special Commissioner's ruling on the point. The replacement programme within gas distribution is unique and benefits current and future consumers. We believe the current 50/50 capitalisation policy is appropriate and reflects a fair balance between current and future consumers.

An increase in the proportion of "slow" funding would increase regulatory uncertainty. Investors and networks would be more reliant on the regulator setting WACC appropriately in future price controls. Consequently, we do not agree with Ofgem's view expressed in its January 2010 consultation document that investors should be indifferent as to the speed of money. Any change in "fast" or "slow" funding proportions would need to ensure sufficiency of cashflows to maintain ratios and financeability.

<u>Eight Year Price Control</u>

We believe five year price controls are appropriate and see no justifiable reason to depart from established practice. Our response to Ofgem's May 2010 working paper highlighted our concerns that an eight year review period could add further uncertainty and risk. We note that Para 5.4 of *RPI-X@20: Implementing Sustainable Regulation* supporting paper states that other stakeholders also had concerns. Any change to the price control period should be based on "better regulation".

- **The lack of evidence for change** - We have not seen any objective evidence that an eight year review period would yield a better regulatory outcome. The comments regarding the current alleged "short term focus" of network companies described in the supporting paper are not supported by analysis. Para 5.11 refers only to "a greater range of options that network companies might consider for efficiently delivering outputs during the period, even if only at the margins". We are not clear that the other stated benefit –

reduced administrative burden - will be achieved when interim reviews, of variable length and scope are required at year four.

The benefits of extension need to demonstrably outweigh stakeholders' concerns. The supporting paper attempts to manage these concerns, but we do not believe they are addressed:

- **Inability to provide necessary commitment** - as outlined above it will be extremely difficult, if not impossible, for a regulator to provide the "firm commitments" on the scope of any mid period review described in para 5.6. Consequently, networks will remain exposed to the risk of:

  - Scope creep
  - Political change
  - Asymmetric adjustments, where out-performance in one output / incentive area is not balanced with addressing adverse uncontrollable cost movements or exposures in another area.

  This is especially when a network needs to determine whether to accept an eight year price control and in the lead up to the mid period review, where there is little clarity regarding: a) what will be subject to review; and b) a network's remedy in the event of an unsatisfactory mid period review.

- **Uncertainty** - A five year control period in itself presents a number of areas of uncertainty; an eight year control would exacerbate this. Recent and foreshadowed developments in the energy sector will increase uncertainty compared to the previous decade. Whilst the need for further "uncertainty mechanisms" in an extended price control period, is recognised, Chapter 11 outlines Ofgem's view of the grounds for, and potential drawbacks of, uncertainty mechanisms. We are concerned that Ofgem's application of its "overarching principle" - that uncertainty mechanisms should be limited to instances where they would deliver value for money for consumers and protect the ability of networks to finance efficient delivery - will significantly reduce the scope of, and mechanisms to, address increased network risk.

- **Complexity** - Possible changes in required outputs along with the "uncertainty mechanisms", would increase the complexity of the regulatory regime. It would also result in an administrative burden on the networks and Ofgem which may undermine any efficiency incentive and objectives that the longer control period aims to achieve.

The current five year price control has been accepted by all stakeholders as providing an appropriate balance of incentive / risk. Given the many references to uncertainty regarding the outputs required to be delivered by energy networks over the next few decades, the alleged benefits of moving to an eight year control have not been demonstrated to outweigh stakeholder concerns.

<u>Greater role for third parties in delivery</u>

The list of conditions contained within the recommendations that need to be satisfied appear to rule out this option for gas distribution. Despite this, we do not believe "the option within the toolkit", coupled with the associated recommendations by Ofgem will add to regulatory commitment or enhance sustainable regulation.

The appropriateness of Ofgem as the economic regulator to run tenders

Ofgem is the independent economic regulator. We do not believe it is appropriate for Ofgem to run tender events. We think the role of Ofgem is to regulate and it should not extend to running tenders. We do not have any evidence that Ofgem has the experience and relevant skills to provide an efficient and effective tender service.

Ofgem's view of when they would consider giving third parties a greater role in delivery

The recommendations list three points within the regulatory process when Ofgem could give third parties a greater role in delivery

- During the comprehensive price control review
- At the mid-period review of output requirements
- If a network is persistently failing to deliver primary outputs

To conduct a price review within the evolutionary principles of network regulation the networks will be providing well justified business plans, engaging with stakeholders and defining outputs that will shape investment decisions. The threat of removing a section of the business plan will have significant consequences on the whole negotiation process and appears to be inconsistent with regulatory commitment.

Under an eight year price control review, the current proposal is to have a limited discussion on Outputs after four years. The agreement of the eight year settlement could be completely undermined by the introduction of third parties at this time. The recommendations do not sufficiently cover what process would be followed and this clearly adds risk to the Network businesses.

The principles of sustainable regulation include enhanced stakeholder engagement and incentivisation of outputs. The principles of sustainable regulation should be adequate to sufficiently penalise / motivate networks to address significant failings. Outside of the regulatory framework, network management teams and shareholders already have significant management and legal responsibilities that are sufficient to address failing performance.

Compensation for past investment provided

The introduction of third parties owning and delivering existing network obligations introduces a significant risk of retrospective disallowance of network funding. Given the list of conditions where Ofgem believe this mechanic – e.g.: "Significant scale" projects the funding issues could very significant to network viability.

In summary, we do not think the option of third party ownership and delivery within Gas Distribution is appropriate and we do not think Ofgem, the economic regulator, should be engaged in the tender processes. The option, coupled with the detailed recommendations in this area, add significant risk and uncertainty to the overall proposed framework.

Challenge to Regulatory Decisions

Accept a Price Control or appeal to the Competition Commission

Given the complexity of price control reviews, and that historically, the full detail of the proposals have tended to only be made available upon release of the final proposals, we would welcome a mechanism by which the networks could discuss with Ofgem, and to the extent necessary, review aspects of the final proposals rather resorting to the rather extreme action in a full appeal to the Competition Commission. Escalation processes to address issues at various levels with options to escalate to an independent higher authority would seem a sensible option. We believe this would offer more constructive mechanisms to address any uncertainty or issues following the final proposals. This is particularly where networks seek clarity on specific issues rather than re-opening the entire price control which would take up considerable time, resources and could result in additional uncertainty for networks and their ability to raise finance in the meantime.

Further comments on other areas of the proposals are included in the appendix. We hope our continued engagement and feedback facilitates an improved regulatory outcome.

Yours sincerely

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Wales & West Utilities

Appendix

<u>Part 1 Price review process and role of stakeholders</u>

Price Control Process

A key tool for establishing the extent to which Networks are delivering "long term value for money" will be the success of the work currently being undertaken to identify outputs and related stakeholder engagement. This is a challenging process, with which all gas networks are engaged with Ofgem. Accepting this is the first time that we trying to implement the principles, early indications are that a lot of up front, co-ordinated effort is required from networks and Ofgem to ensure a successful regulatory process.

Fast Track process

WWU intend to demonstrate the behaviours that will encourage Ofgem to take a "proportionate" approach to WWU Price Control. However, WWU will need to carefully consider whether it is appropriate to agree the Price Control on an accelerated time-frame without safeguards which ensure that WWU would be not be disadvantaged compared to the Price Control proposals developed at the end of a full Price Control consultation period.

Stakeholder engagement

We welcome the additional guidance provided by the discussion of stakeholder engagement. We have begun our stakeholder engagement process but it is clear there needs to be appropriate, joint engagement with common parties on limited topic areas to avoid wasteful and unnecessary contact. It is also evident that Ofgem needs to play its role with networks to ensure efficient use of resource.

<u>Part 2 How the ex-ante Price Control would be set</u>

Setting Outputs & Incentives

We have begun the early work to develop Outputs. Our well justified business plans, the stakeholder engagement process, incentives and the remainder of the price control process requires that we deliver this key part of the process. The early indications are that there is a significant amount of network and Ofgem effort to ensure the delivery of this work in a timely manner.

We must ensure we maintain a clear link between Outputs, targets and business plan costs. We must also ensure that we can efficiently collect the data required and be able to compare network data. There is a concern of asymmetric treatment at the mid point review and we hope the regulatory commitment principles are adhered to.

As part of the Outputs work stream we must also ensure that incentives are appropriately developed. We agree the strength of any financial incentive should depend on the clarity of output, the reliability of the data and materiality of the output. Clearly, there is further work required to develop the appropriate incentives and establish whether it is appropriate to vary incentives by company.

Managing Uncertainty

We note that uncertainty mechanisms within the "RPI-X" have consistently included an adjustment for the effect of changing prices for Licensee expenditure and the inflation element of funding costs. We agree with Ofgem's analysis, concluding that Ofgem does not recognise a benefit in moving form the current RPI +/- Real Price Effect methodology to one based on CPI (particularly as all things being equal either index, when appropriately adjusted for real price effects, should arrive at the same answer).

We agree with Ofgem that the way in which regulatory regime allocates volume risk between customers and network companies is an important decision. We do not agree with Ofgem that there are a material proportion of costs that vary with volume. We have Licence conditions to ensure Transportation charges to end users are cost reflective and we have carried out significant analysis and stakeholder engagement to ensure our charging regimes that reflect our cost base. Ofgem must also be aware of potential volatility that volume risk placed on Networks could have on Shippers and consumers. We have been given clear guidance from Shippers that they require predictability and stability in charges.

Part 3: Other elements of Sustainable Network Regulation

Improving regulatory clarity

We welcome a number of statements in the consultation which improve clarity, being:

- Investment included in the RAV would not be at risk (so long as outputs are delivered) where an investment decision was considered to be efficient in the light of information available at the time (page 149)
- A commitment not to penalise companies for unsuccessful innovations (page 148).

The Sustainable regulatory framework will be wholly dependant on how these statements translate into actual regulatory commitment.

Innovation Stimulus Package

We would appreciate further guidance on how an innovation stimulus package will work. In particular, we are unclear of the commercial incentive for innovation projects to be carried out by a Network where

- only a proportion of the cost is funded,
- parties progressing innovation should be exposed to a level of risk associated with the project, and
- any benefits arising are disseminated (para 14.13 and 14.20)