Gas distribution networks, other regulated networks, consumer groups, shippers/suppliers, other interested parties

Promoting choice and value for all gas and electricity customers

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Dear Colleague

RIIO-GD1: Decision on fast-track process

This letter sets out our initial assessment of gas distribution networks' (GDNs) business plan submissions for the next price control review (RIIO-GD1). The letter sets out our proposed level of regulatory scrutiny for each of the companies' plans, and provides reasons for our earlier decision not to retain any gas distribution network (GDN) within the RIIO-GD1 fast-track process.[1] We provide more detail on our assessment in a supporting annex entitled 'Initial assessment of RIIO-GD1 business plans'.[2]

We would welcome views on any aspect of our initial assessment. We will consider views as part of our assessment of the plans the companies are due to submit to us on 27 April 2012. Please submit any written comments to RIIO.GD1@ofgem.gov.uk, by **Friday 30 March 2012**. Unless clearly marked as confidential, responses will be published on our website.

Background

In October 2010 we introduced RIIO (Revenue = Incentives + Innovation + Outputs), our new approach to regulating gas and electricity network companies. RIIO is designed to realise significant benefits for consumers including by providing network companies with strong incentives to submit high quality business plans. The better plans, along with greater clarity on the outputs which companies are expected to deliver for customers, and strong incentives to improve performance, will help realise the government's objectives to decarbonise the energy sector, and result in greater value-for-money for consumers than under our previous price control framework.

A key principle of the new framework is that companies' business plans should reflect enhanced stakeholder engagement. To incentivise companies to submit high quality plans we have stated that we will subject companies' plans to different levels of regulatory scrutiny according to the quality of the plan (proportionate treatment), and potentially agree price limits early for very high quality plans (referred to as fast-tracking). Proportionate treatment provides benefits in terms of enabling us to focus our resources where they can deliver most value for consumers. Fast-tracking provides strong incentives

[1] See:Ofgem (3 February 2012) RIIO-GD1: Decision on fast-track process http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/120203_fast_track_decision_letter.pdf
[2] See http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/120217_GDN_initial_assessment_annex_FINAL.pdf

for the companies by allowing them to conclude their price control ahead of the standard timetable.

In March 2011, we set out our strategy for RIIO-GD1.[3] This set out decisions on the key aspects of the regulatory framework, including the outputs that the gas distribution companies need to deliver and associated incentives, mechanisms to address uncertainty during the price control and the key elements of the financial framework. It also set out what we expected to see in a well-justified business plan and the criteria against which we would assess the plans.

In June 2012 we announced a delay to the GDNs' business plan submissions to 30 November 2011 to allow them to reflect a change to the Health and Safety Executive (HSE) policy on iron mains replacement (or repex).[4] In this decision, we stated that given the compressed time available for the RIIO-GD1 fast-track process (eg relative to RIIO-T1) we would require GDNs to achieve a very high-hurdle for their plans to be considered for fast-tracking.

The GDNs submitted their business plans to us on 30 November 2011, and we invited stakeholder feedback on their published plans.[5]

Our assessment of companies' plans

The companies' plans are much higher quality relative to previous price control submissions, and the plans were informed by a much greater degree of stakeholder engagement. In general, the GDNs have demonstrated strong commitment to the implementation of the new RIIO framework, and as we set out below, we consider there are key areas in each individual plan that we can broadly agree to (ie where we expect to apply lighter-touch regulation).

However, we also consider that there are material issues with all GDNs' plans that would be difficult to resolve in the consumer interest within the restricted RIIO-GD1 fast-track timetable (i.e. by the end of April 2012), notably in relation to asset investment plans and overall costs. We decided that the consumer interest would be better served by resolving such issues on an industry-wide basis, and over a longer time-frame than afforded by the fast-track process. We therefore decided that no GDN should be retained within the fast-track process. We set out this decision in a letter on 3 February 2012.[6]

Our views on the quality of GDNs' plans were informed by the views of the Consumer Challenge Group (CCG), our internal advisory panel on consumer, social and environmental issues, as well as stakeholders' views.[7] The CCG and Authority members met with each of the GDNs during our assessment process.

Table 1 sets out a summary of our assessment of GDNs' plans. In this Table:

- Green denotes aspects of companies' plans that are broadly acceptable to us
- Amber denotes areas where we require more information before we can form a view
- Red denotes aspects of companies' plans which are not acceptable to us

[3] See: Ofgem (March 2012) Decision on strategy for the next gas distribution price control - RIIO-GD1 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=312&refer=Networks/GasDistr/RIIO-GD1/ConRes
[4] The original timetable was based on a submission of plans on 30th July 2012. See; http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=322&refer=Networks/GasDistr/RIIO-GD1/ConRes
[5] See: Ofgem (December 2011) RIIO-GD1: Gas Distribution Networks' (GDNs) business plans - publication and next steps http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=325&refer=Networks/GasDistr/RIIO-GD1/ConRes
[6] See footnote
[7] See Annex 1 of supplementary annex for a summary of stakeholders' views.

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Table 1: Summary of assessment of GDNs' plans

Category	Sub-category	NGGD	NGN	SGN	WWU
Process					
Outputs					
Cost efficiency	*Strategy*				
	Efficient delivery				
Financial arrangements	*Financeability*				
	Technical accounting				
Uncertainty					

Overview of companies' plans

National Grid Gas Distribution (NGGD)

NGGD submitted a comprehensive business plan which contained a clear and structured framework for dealing with many of the key business plan issues, eg in relation to uncertainty, cost efficiency, and their financing requirements. We also consider that their stakeholder engagement process was robust.

NGGD has proposed an iron mains asset plan which responds to a greater degree than other GDNs' plans to the new HSE repex policy. NGGD's programme for tier 1 iron mains is based on cost-benefit analysis (CBA) and delivers benefits in relation to a wide set of factors, eg publicly reported escapes, repairs and environmental risks as well as safety risks. [8] The proposals indicate that mains replacement will lead to a material corresponding reduction in emergency, repair and leakage volumes. NGGD has also provided detailed CBA analysis to support their proposed investment levels in tiers 2 and 3.[9] NGGD has also developed a capex strategy which includes a material reduction in load and non-load related expenditure relative to GDPCR1. Of the set of GDNs, our initial assessment indicates that NGGD's asset investment strategy is the most developed.

However, there are still material issues that we need to resolve with NGGD's asset investment plan, notably in relation to: understanding NGGD's cost benefit analysis (CBA) supporting non-mandatory iron mains work and investment other asset classes; the London repex strategy; reinforcement and connection costs in London; and, how to deal with uncertainty over the future use of gas networks, and asset health data, in determining the asset plan.

NGGD has submitted a business plan based on closing the efficiency gap with other GDNs, where the analysis is based on changes to the econometric models we published in our March strategy decision. We have concerns that NGGD's proposals do not close the acknowledged efficiency gap. However, we need to undertake further analysis on comparative efficiency modelling before drawing definitive conclusions. NGGD has submitted high real price effects (relative to other GDNs) which we do not consider are well-evidenced.

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8 Under its new policy, the HSE has identified three tiers of mains Tier 1 (iron mains less than or equal to 8″ nominal diameter) ; tier 2 (iron mains greater than 8″ and less than 18″ nominal diameter); and, tier 3 (iron mains equal to or greater than 18″ nominal diameter). The new policy provides GDNs with greater flexibility in relation to the prioritisation of mains replaced subject to specific rules for each tier. For example, for a description of NGN's approach to the new repex policy, see: http://www.northerngasnetworks.co.uk/documents/a10.pdf

9 For the definition of tier 2 and 3, see footnote .

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NGGD submitted a comprehensive analysis of their required financing arrangements. However, we do not consider that their proposals are efficient in relation to the cost of equity (7.2% real post-tax) or proposed level of gearing (53%).

NGGD has also discussed a change to our uncertainty mechanism to deal with street works costs which we need to discuss with them.

Overall, we decided not to retain NGGD within the fast-track process given the number of issues that we would need to resolve in the compressed timetable, as set out above**.**

Northern Gas Networks (NGN)

NGN submitted a detailed business plan which fulfilled our key content criteria, and was consistent with the policy decisions we set out in our March strategy decision. The plan is also supported by a clear stakeholder engagement process. Overall, we consider that their process for constructing their plan was robust.

However, we have concerns with NGN's asset investment strategy which we need to resolve in the next stage of our assessment. The primary areas of further work will be in relation to NGN's approach to repex, where, contrary to our expectations, their proposed workload is on a par with historic levels. We also need to discuss other material aspects of their asset plan in relation to steel mains, and reinforcement costs. In common with other GDNs, we also need to consider in more detail NGN's CBA modelling supporting their asset investment plans.

Our comparative efficiency analysis shows that NGN is one of the most efficient GDNs. However, we have concerns in relation to the projected cost increases over the period relative to other companies' plans. The cost increase is in part explained by NGN's high real price effects (RPE) assumptions (net of on-going efficiency), which we do not consider to be justified, as well as material increases in condition-based expenditure. These issues constitute key areas for further work.

NGN has proposed the most efficient financial package of the set of GDNs. However, we consider that their proposed cost of equity of 7.2% (real post-tax), at the top-end of our range, has not been adequately justified.

Overall, we decided not to retain NGN within the fast-track process given the materiality of the issues that we would need to resolve, notably in relation to their asset investment strategy (eg in relation to repex volumes, including their approach to setting the tier 2 threshold, steel mains replacement, reinforcement). We also have concerns about NGN cost efficiency, notably in relation to their proposed RPEs net of on-going productivity assumptions, and the overall proposed increase in total costs relative to GDPCR1 of the order of 20 percent.

Scotia Gas Networks (SGN)

SGN provided a concise executive summary setting out their proposals. The main business plan also provides a clear guide to the structure of the plan, and sign-posting to the related appendices and independent reports. SGN has also set out a clear stakeholder engagement process they undertook in the development of their plans.

One primary concern we have is with SGN's asset investment plans. SGN do not appear to have exploited the opportunities offered by the new HSE repex policy, and contrary to our expectations, propose similar levels of replacement to GDPCR1. In addition, we note that

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they have not set out a tier 2 threshold (below which expenditure should be justified in CBA terms). They also propose an increase in their integrity based capex (eg compared with NGGD) which we need to understand in more detail. They also have the highest costs in relation to low pressure gasholders.

Our comparative efficiency analysis also shows SGN to be relatively high cost for a number of activities, particularly for Southern GDN. However, we recognise that further work is needed in this area to consider the appropriate cost drivers and company specific factors.

SGN's financial proposals depart from our policies in substantive areas, and more so than any other GDN. We do not consider that their proposals are well-justified, eg in relation to asset life (where they propose a 38 year asset life compared to our March decision of 45 years); their proposed 60 basis points (bps) uplift to the cost of debt index; and, cost of equity of 7.5% (real post-tax).

Overall, we decided not to retain SGN within the fast-track process given the number of issues that we would need to resolve in the compressed timetable, as set out above.

Wales and West Utilities (WWU)

WWU's business plan is comprehensive, has a clear structure, and clear sign-posting to guide the reader from the summary sections to the detailed analysis. We also consider that WWU undertook a robust stakeholder engagement process which underpins their plan.

In common with other GDNs, we have material concerns with WWU's asset investment plan, which will constitute the main area of work going-forward. For repex, we have concerns that WWU has not optimised their expenditure for tier 1 mains to exploit the greater flexibility offered by the HSE repex policy. We also need to understand in more detail WWU's proposed population-weighted approach to setting the tier 2 risk-threshold. WWU also proposes a high level of integrity based capex, when compared with NGGD.

By contrast, our current comparative efficiency analysis shows WWU to be relatively low cost in terms of efficient delivery. However, this analysis is at a relatively early stage and we need to carry out further work on the appropriate cost drivers and company specific factors.

In relation to financing proposals, we also do not consider that WWU's proposed cost of equity of 7.5% (real post tax) and their proposed uplift to the cost debt indexation of 35 bps are well-justified.

Overall, we decided not to retain WWU within the fast-track process given the material issues that would need to be resolved in relation to its capex and repex programme, as well as its cost of equity and debt indexation proposals.

Next steps

Our overall objective between now and the second business plan submission is to reach a common understanding with the industry on the key issues to enable GDNs to submit a plan in April which is acceptable to us, and which we could potentially adopt as the basis for our initial proposals document to be published in July 2012. The prospect for us adopting GDNs' revised plans (or elements of their revised plans) as the basis for our July initial proposals document should provide an incentive for GDNs to submit high quality plans.

In Chapter 3 of the supplementary annex to this paper, we set out the key common industry issues that we need to resolve. We will focus initially on those issues that are integral to ensuring companies' can submit a high-quality second business plan in April.

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We consider the priority issues are set of issues around repex, and GDN’s approach to cost-benefit analysis for all asset classes, and we have started a process of work to resolve these issues.

Regards

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