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Dear Hannah

RIIO GD1: Initial Proposals for Gas Distribution Networks (GDNs)

Thank you for the opportunity to respond to Ofgem's Initial Proposals for RIIO GD1. The document raises a number of important issues for ENA's Gas Distribution Network (GDN) members. Of course they will be responding individually but there are some collective views that we would like to set out in this letter.

Introduction

We believe that the gas networks have a long term future and are key assets in the transition to a low carbon economy. We note the reference to the Government's Heat Strategy published earlier this year in which future energy pathways with more weight given to electrification were presented. However, this strategy is far from a finalised statement of Government policy; rather it is intended to inform a debate. Therefore, we believe it is premature of Ofgem to be using this as a basis behind such a large scale disallowance of investment in renewing and replacing the networks' assets with a consequent large reduction in customer outputs, as seen in the investment appraisal approach in the IP.

The RIIO GD1 settlement has to equip the GDNs to meet the many new challenges they will face over the next review period. Currently, Ofgem's proposals fall considerably short of what is required.

All the networks recognise that the cost allowances within the Initial Proposals contained some material errors and whilst there has been good collaborative work to correct some of the basic arithmetical errors, it is very important that Ofgem continues to work with the companies in order to produce a comprehensive and robust settlement appropriate for the companies to work within for the next eight years, whilst helping to deliver a sustainable energy sector and do so in a way that delivers value for money for existing and future customers.

ENA has commissioned a report from Oxera on behalf of Gas and Electricity Transmission members and our Gas Distribution members in response to the Initial Proposals for RIIO T1 and RIIO GD1 respectively.

This report reviews how the principles for setting the allowed return have been applied in practice in the Initial Proposals, and to what extent the Proposals achieve the stated objectives of the RIIO framework and ensure that efficient financing costs are recoverable in RIIO GD1/T1. ENA will send this report to you and your team under separate cover today.

This letter is limited to three key issues that materiality impact all networks and we trust Ofgem will address these issues ahead of Final Proposals.

The specific issues are

- The Information Quality Incentive (IQI) matrix
- Outperformance Range
- Dealing with uncertainty

The Information Quality Incentive (IQI) matrix

Our members have some concerns about the calibration of the IQI matrix, which implies that the industry is inefficient, we would strongly challenge this. The GDNs have delivered savings to customers through improved efficiency over and above those envisaged at the time of network sales and have been proactive in seeking innovative solutions to drive more efficiency. Ofgem have presented no evidence to suggest that a further step change, as implied by Ofgem's cost efficiency assessment, is realistic or achievable against the backdrop of a mature industry. Given this, we would expect one or more of the GDNs to be at the efficiency frontier rather than calibrating the IQI around a notionally efficient company.

The IQI matrix proposed for RIIO GD1 appears to limit the outperformance opportunity and also over penalise gas distribution networks.

All networks have submitted stakeholder based, Output led plans to support the cost allowance for this first RIIO based settlement but Ofgem appear to have determined a notional benchmark out of step with this stakeholder led process and without recognition of the significant past and future efficiencies already embedded into the GDN plans.

Outperformance Range

Throughout the process of the price control, Ofgem's stated policy has been to create a framework which aligns customer and network interests to create an environment where network companies do the right things to create and share in increased customer value. The Return on Equity range presented by Ofgem in its March 2011 strategy document for RIIO-GD1 recognised that well run companies should be able to earn low double digit returns. However our members do not believe this is available with the current proposals given the significant cost disallowances, limited incentive opportunities and depressed financial package.. This is clearly not in customers' long term interests.

Dealing with Uncertainty

We welcome the Ofgem recognition of additional uncertainty mechanisms within the initial proposals based on robust evidence provided by the networks.

We are conscious there is still some significant work to finalise the precise workings of these mechanisms and to ensure the licence drafting is finalised and we look forward to supporting Ofgem in completing this.

One of the key areas is to finalise is the thresholds to apply to the mechanisms and the precise data requirements to evidence logged up and forecast costs to be considered in any re-opener windows.

Conclusion

All ENA's members fully support the RIIO principles and have delivered business plans that have been stakeholder led. The RIIO GD1 settlement has to equip the GDNs to meet the many new challenges they will face over the next review period. Currently, Ofgem's proposals fall considerably short of what is required. It will be very important therefore that Ofgem continues to work with the companies in order to produce a comprehensive and robust settlement appropriate for the companies to work within for the next eight years, whilst helping to deliver a sustainable energy sector and do so in a way that delivers value for money for existing and future customers.

Yours sincerely



David Smith

CEO, Energy Networks