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24th September 2012

James Grayburn
Ofgem
9 Millbank
London
SW19 3GE

RIIO-GD1: Initial Proposals

Dear James,

Please find attached NGN's detailed response to the Initial Proposals for the RIIO-GD1 price review. I summarise below the key messages from our response which I would be happy to take you through in more detail if that would be helpful.

The Initial Proposals represent an extremely challenging potential outcome containing the lowest ever cost of capital set by Ofgem against the background of significant cuts to our business plan coupled with demanding productivity targets. As the frontier gas distribution company NGN will seek to meet the challenges that have been set but we consider the Initial Proposals do not correctly balance the interests of all stakeholders. In particular, we are concerned about the lack of incentives in the Initial Proposals from the perspective of a frontier company and the ability to earn double digit RORE returns.

NGN has consistently benchmarked as the most efficient GDN since 2005 under a variety of benchmarking techniques and cost drivers. The newly developed benchmarking approach for RIIO-GD1 has again confirmed NGN as the frontier performer consistent with the results from GDPCR1. Additionally our business plan has demonstrated industry leading approaches in layout and transparency, release of data into the public domain, use of cost benefit analysis, adoption of the new iron mains replacement policy and the granularity and depth of asset health assessment.

Our performance has created significant value for customers across the industry through continually extending the efficiency frontier. Setting the right incentives for such behaviour is a critical component of incentive regulation and to achieve this, the differentials between the best and worst performing GDNs must be meaningful. NGN has received the highest IQI frontier reward (1.38%) and efficiency sharing factor (64%) in recognition of our frontier performance. However, these parameters are not significantly different enough from other GDNs to be meaningful. The differential is less than 0.4% of RORE or c£3m per annum which reduces to c£1.5m when compared to industry average performance. On the efficiency incentive rate the differential is only 2%. These are notably less than the equivalent differentials during the last electricity distribution price control where the most efficient DNO had a nearly 3% RORE differential and a 6% difference in the IQI efficiency rate.

The Initial Proposals contain the lowest ever cost of capital set by Ofgem at a time of significant financial uncertainty. When this is combined with the limited frontier rewards and small range of incentive mechanisms for the new price control the overall impact is a potential RORE return that even for NGN maximising its future performance is less than double digit. This does not deliver the "I" in RIIO and reduces our ability to attract equity investment when compared to other energy and infrastructure investment. To address this and maintain the correct incentive framework the IQI parameters for NGN should be set at 2.5% frontier reward and 70% efficiency sharing factor in Final Proposals.

Even with these adjustments the overall level of potential RORE is still significantly below previous regulatory settlements and Ofgem needs to reconsider the proposed cost of equity in this context and in light of the additional analysis presented in the Oxera report submitted on behalf of all the gas distribution companies. We believe this necessitates an upward movement in the cost of capital in Final Proposals.

The revenue profiling in Initial Proposals creates issues for NGN by creating large negative cash flows in specific years and will potentially cause NGN significant financing issues and credit rating negativity in those years. Our response sets out an alternative profile which provides a smoother net cash position that would be more acceptable to credit rating agencies and importantly has no impact on average customer bills over the RIIO-GD1 period.

Our responses to each of the detailed questions in the consultation are set out in the attached appendices. Please do not hesitate to myself or Gareth Mills if you wish to discuss any aspect of our response.

Yours sincerely

Stephen Parker
Regulation Director

<u>Appendix 1</u>
<u>Response to Detailed Questions on Cost Efficiency</u>

Q1 - Do you consider our overall approach to cost assessment appropriate, and if not what changes would you propose?

Response: Yes NGN broadly believes the approach taken is appropriate. NGN has consistently supported Ofgem's intentions to create a wider basket of approaches and methodologies to assess the relative efficiency of the GDNs over the RIIO-GD1 period. This included the use of both historic and forecast benchmarks assessed using both Top-Down and Bottom-Up approaches.

This general level of support for Ofgem's approach is based on the difficulties associated with any form of detailed, statistical comparative assessment and the inability to fully capture the fundamental differences between organisations. This places limitations on what can be inferred from any single model/approach about the relative efficiency of individual organisations. Ofgem's approach has the ability to overcome some of the issues associated with a more limited approach to comparative analysis.

However, Ofgem's extended approach to comparative efficiency assessment has highlighted a number of issues which need to be carefully considered:

- **Complexity & Transparency** – the volume of detailed analysis required to support Ofgem's approach significantly adds to the complexity of the regulatory process. It is neither easy or straightforward to see how Ofgem have arrived at final allowances for individual GDNs. The transparency of the wide regulatory process is impacted significantly by this approach.

- **Subjective Assessment** – Ofgem have repeatedly stated that their proposed approach to comparative assessment would not look to simply translate the results of the statistical benchmarking directly into allowances. Instead a more holistic approach would be taken that sought to combine this with an assessment of, in particular, the delivery key primary and secondary outputs and other factors such as the degree of transparency of company business plans. It is not clear that this wider assessment has been incorporated into Ofgem's analysis.

- **Period of Assessment** – Ofgem have limited their assessment to three years of historic expenditure and two years of GDNs forecasts for RIIO-GD1. The rationale for this being that these are the most 'robust' figures on which to carry out their assessment. However, this approach specifically excludes the impact of clear strategies that may have been adopted that deliver enhanced outputs alongside further cost efficiencies over the full RIIO-GD1 period.

  A specific example is NGN's Tier 1 Repex strategy where a programme with higher unit costs was submitted that would enable NGN to deliver significant wider efficiencies and a lower Totex in beyond the early years of RIIO-GD1. In particular the decision by Ofgem to only consider the first two years of forecasts within its efficiency analysis ignores the more dynamic approach taken by NGN whereby higher costs in early years of the plan deliver longer term benefits and minimise Totex not just within a single year but across the whole eight year period of RIIO-GD1.

  Extending the analysis to consider some of these effects in the later years of RIIO-GD1 alongside the necessary subjective assessment to account for any deterioration in data accuracy will better reflect Ofgem's stated approach to both comparative assessment and the Totex approach embedded within the RIIO principles.

Q2 - Do you consider our approach for regional adjustments and company specific factors is appropriate, and if not what changes would you propose?

Response: It is clear that there are differences in key areas of individual GDN's activities that reflect the differing operating environments that each company faces in its specific area. The key areas of difference however are sparsity/urbanity and the regional cost of operating in London. We therefore agree with Ofgem's focus on these two areas within their benchmarking analysis.

We do not have any specific issues with the approach taken to the adjustments for those networks operating in the urban environment of London and the relative higher cost bases that these two networks face when compared to the rest of the country. However, there is no evidence to suggest that there are significant differences between the remaining six networks in this area.

The impact of urbanity/sparsity is far less of a relative issue but is instead a direct function of the geographical spread of the population served by the gas network and in particular the additional costs faced by GDNs who have to retain additional resource to provide services to more remote communities. There are three key issues with the approach Ofgem has taken to measurement of sparsity within its analysis:

- The analysis carried out by Ofgem focuses on the relative sparsity of the local authority areas that fall within each of the GDN's total geographical area. However, crucially it does not reflect the presence of a low pressure gas networks in that area hence potentially including areas within the calculation that are not relevant to the assessment and overstating the relative level of sparsity.

- As outlined above the key driver of additional costs in this area is in fact the proximity of sparsely populated areas of the network to more densely populated areas. Sparse areas of population can be served without additional costs to the network if they are situated close enough to higher density areas. Again Ofgem's analysis makes no attempt to identify this true driver of additional costs across networks.

- The financial impact of sparsity on networks is calculated with reference to an estimate that was made at GDPCR1. It is not clear that this estimate of the cost impact across GDNs is based upon any robust basis for inclusion in the wider efficiency analysis. Notwithstanding the issues raised above, this estimate has the potential to undermine any accuracy that may exist in the underlying measurement of sparsity.

Q3 - Do you agree with our assumptions for real price effects and ongoing efficiency?

Response: The assumptions for real price effects and ongoing productivity represent a very challenging set of proposals for the RIIO-GD1 period. There are several features of the analysis used to derive them which we do not agree with and are at odds with the evidence we have provided in our business plan. However, we recognise there is always a degree of subjectivity when forecasting such data and we are prepared to accept the assumptions set out subject to other issues outlined in this response being rectified.

Q4 - Do you consider our approach to totex is appropriate, and if not what changes would you propose?

Response: NGN are strong supporters of the philosophy underlying Ofgem's move to a wider Totex within the regulatory framework. This is reflected in the approach NGN set out within its business plan with its approach to Total Network Management and the consideration of a wide range of options that maximise the delivery of outputs whilst minimising total expenditure.

It is not clear in the approach taken by Ofgem that full consideration has been given to the trade-offs between categories of expenditure that have been made within NGN's plan. In particular the decision by Ofgem to only consider the first two years of forecasts within its efficiency analysis ignores the more dynamic approach taken by NGN whereby higher costs in early years of the plan deliver longer term benefits and minimise Totex not just within a single year but across the whole eight year period of RIIO-GD1.

Whilst recognising some of the issues that using longer term forecasts imply for Ofgem's statistical approach, this does not preclude its inclusion within the analysis or the inclusion of a more subjective assessment as indicated in Ofgem's proposed strategy in this area.

Q5 - Do you agree with the costs we have excluded from regression analysis and the methodology we have proposed?

Response: NGN have no issues with the stated approach taken to the categories of costs excluded from the regression analysis. The general approach provides a robust and consistent basis for carrying out the detailed benchmarking analysis.

For the loss of meter work adjustment, Ofgem have excluded only those additional/stranded costs associated with our Emergency activity and not those associated with Repex. For consistency, the necessary adjustment needs to be made in the benchmarking analysis for Repex.

Q6 - Do you agree with our proposals for smart metering?

Response: NGN have been working closely with other GDNs to identify potential issues that will impact on the GDNs as a result of the Smart Metering Implementation Programme (SMIP). As a member of the ENA, we have helped to produce a Hierarchy of Gas Issues, which lists the identified issues, and categorises them based on importance. However, we recognise that, although the identified issues may be consistent between the GDNs, there is a disparity in the forecast impacts included in company business plans.

Given the difficulty to quantify the exact impact that the SMIP will have on the GDNs, Ofgem's proposals regarding an additional ex-ante allowance and an uncertainty mechanism for future costs is an appropriate way forward. However, we continue to believe that the additional allowance should include some allowance for future operating costs not just set up costs.

Q7 - Do you agree with our proposals for loss of meter work?

Response: Our business plan set out in detail the impact on NGN from the loss of metering contracts in 2008. The plan set out the measures we implemented to minimise the impact and make efficient use of any stranded labour. We believe these represent an efficient benchmark that can be used for the other GDNs.

However, the calculations set out in the Initial Proposals do not recognise the additional costs that we have incurred in our Repex activity by using emergency staff to undertake purge and relight work so as to maximise their productive time. These costs need to be reflected in the cost efficiency benchmarking of NGN and the calibration of allowances for other GDNs.

Q8 - Do you consider our approach to bottom-up assessment is appropriate, and if not what changes would you propose?

Response: As previously indicated, the broader approach to the benchmarking of efficiency across GDNs is supported by NGN. The inclusion of Bottom-Up and Top Down assessments of both historic and forecast expenditure removes any bias and specific issues that may exist with a less comprehensive approach.

Bottom-Up analysis has a tendency towards overestimating the efficiency achievable by GDNs. An efficient GDN at the aggregated level will need to be the most efficient in every area of its operations. It also cannot fully take account of the trade-offs taken by companies to achieve an overall efficient Totex package. However, these issues are negated to an extent by the wider basket of approaches taken by Ofgem and could be further strengthened by considering a longer time period for the forecast expenditure either on a detailed or subjective basis.

Q9 - Do you agree with the assessment we have carried out and the results proposed for opex?

Response: With the exception of two specific issues the assessment carried out and the results proposed look challenging but fair.

- Repair Costs

The first issue relates to the adjustments to the repair activity. We agree with the basic premise that the volume of external condition reports should reduce over time as the volume of metallic mains and the services on the network reduce. However, the straight line adjustments applied do not recognise three factors:

  - There are fixed costs associated with the repair activity. The modelling used to set repair allowances assumes all costs are variable. We will always have to maintain a capability to carry out repairs across our network region to meet Safety Case and other statutory requirements even when there are relatively small levels of ongoing repairs.

  - The unit cost adjustments applied use a single consolidated unit cost for a repair rather than separate mains and service repair costs. This therefore assumes that a consistent ratio of mains and services repairs is maintained throughout the period. The workload forecasts assume service repair volumes will decline at a faster rate than mains repair volumes. As mains repairs cost significantly more than service repairs the single consolidated unit cost will therefore increase over time. This has not been reflected in the allowance calculation.

  - It is not possible to recover all costs associated with repairs caused by third party interference. It is not possible in many cases to identify the specific party responsible. In addition, where a customer damages a service pipe under Schedule 2B paragraph 17 of the Gas Act the transporter can only recover the cost where the work was made necessary by any intentional act or culpable negligence of the customer. This is a high burden of proof that cannot be met in many cases.

- Business Support Costs

Ofgem's separate analysis of Business Support Costs is the only area where the results presented appear counter-intuitive with the least efficient company (NG) receiving significantly higher allowances than the more efficient companies (NGN & SGN). There are two specific issues with the IT analysis for NGN which may be driving this outcome and should therefore be corrected:

  - The benchmarking of IT costs is based on the number of end users. The estimated number of end users for NGN shows a markedly different ratio of employees to end users compared to all other GDNs as shown in the table below.

	National Grid	NGN	SSE	WWU
End users	10618	1075	8479	1825
Employees	7605	1070	4962	1363
Ratio of employees to	1:1.4	1:1	1:1.7	1:1.3

end users				

We have provided data on the correct number of end users which is broadly in line with the ratios for NG and WWU and this needs to be reflected in the calculations for Final Proposals.

- The analysis has focussed almost exclusively on the base year on 2010/11 to carry out the analysis. Whilst this is a reasonable starting assumption for the analysis without any refinement this approach also assumes that business support costs will be in this steady state for the RIIO-GD1 period. This is clearly not the case and Ofgem have not recognised the additional cost that NGN will face during RIIO-GD1 that was not present in 2010/11. In particular, the benchmarking needs to take into account that IT costs from 2011/12 includes the full costs of IT support (£0.8m) for our Control Centre in Sunderland, which went fully live in 2011. Previously these costs were included in the overall System Control New Service Agreement (NSA) charged to us by National Grid. Until 2011/12 this NSA was recorded in the Cost Reporting Submission in entirety under System Control, not IT. So historical benchmarking for IT will exclude this forward looking cost.

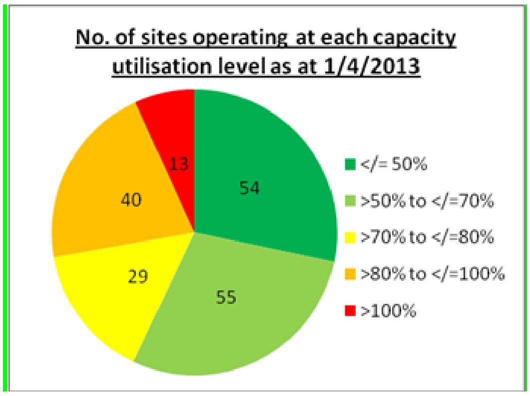
Q10 - Do you agree with the assessment we have carried out and the results proposed for Capex?

Response: We agree with the majority of the principals of the assessment and accept the efficiency challenges which we will have to meet in certain areas of our Capex. However, there are three areas where workload adjustments have been made where we will incur expenditure in RIIO-GD1 driven by factors outside our direct control which need to be corrected.

- PRI Capacity Upgrading

The whole of our forecast work on PRI capacity upgrades (£12.9m) has been disallowed on the basis that our peak day demand is forecast to reduce by 3% over the RIIO-GD1 plan period. However, this expenditure is not driven by our future forecast peak day demand but by an event that occurred during the GDPCR1 which resulted in a c10% overall increase in peak hour flow at our NTS offtake sites.

Towards the end of GDPCR1, UNC modification 90 (Interruption Reform 11/12) had a significant impact on peak hour flow by moving all interruptible loads to be supplied as firm demands at peak 1 in 20 winter conditions. This resulted in a significant number of sites operating at 100% capacity during peak winter conditions. Throughout GDPCR1 period we have therefore been undertaking work at various sites to make these critical assets compliant in terms of integrity and capacity within our overall financial and manpower constraints. However, we have not yet completed all this work and the forecast position as at 1 April 2013 is shown below:



The work we have carried out to date and that included in our RIIO-GD1 business plan is the minimum necessary to make the site compliant. In addition to Interruption, Offtake Reform introduced this year places contractual obligations dictating the changes in offtake flow rates for flex (storage) and flat. It also limits ability to shift flows between offtakes. NGN has not been limited by NTS by flex or flat but changing flows between offtakes options is now limited placing more emphasis to ensure all offtakes and PRI's are fully compliant in terms of capacity utilisation. This is Capex work we need to complete and should be allowed.

- LTS Diversion

Our business plan included an assumption that we would be required to carry out a major non-rechargeable LTS diversion at some point during the eight years of the RIIO-GD1 period. We believe this is a reasonable supposition, however, whilst we are aware of several potential instances where this may occur our business plan did not set out a specific project. Because of this uncertainty over the need for such a project the amount (£4.4m) has been disallowed from Initial Proposals.

We are becoming increasingly aware that one of these potential instances will now crystallise into a major project. Over the past three years (and not confined to the winter period), there has been a disturbing increase in flooding in the North of NGN's patch in both the North East and the Cumbria area. Over the last few months there have again been flooding problems in the latter location and we have recently completed a further inspection of an affected LTS pipeline.

Within this area, NGN has a 150nb single source HP pipeline (Saughtreegate to Penrith), which provides the sole supply to Penrith and surrounding areas. The pipeline is located close to the river bank and crosses the River Eden. On several occasions we have undertaken protective measures on the River Eden where the river bank has been eroding and placing the High Pressure Pipeline at risk of failure. These include:

- 2007/8 following on from an IGE TD1 survey, remedial work was completed by pinning sand bags to the bedrock.
- 2009 following on from survey/ inspection work some Sand Bags lost down-stream resulting in the pipeline being undercut and spanning by approx 6m.
- 2009/10 further remedial work was completed to secure the protection on the high pressure pipeline.
- In 2011/12 inspection following torrential rainfall concluded that further sections of the pipeline are exposed requiring remediation.

11,300 customers are supplied from this section of single source pipeline. Failure of this pipeline would have catastrophic impacts to customers. If failure coincided with severe weather conditions further problems would be encountered. Emergency diversion work could take several weeks to complete and this would put the well being of older customers at risk and place more stress on the relevant Local Authorities and other emergency services. The risk to end users presented by the failure of this pipeline is too high not to undertake remedial action.

NGN has sufficient information to believe that the flooding in the area is increasing and that the pipeline will require diverting within RIIO-GD1 period. A 2.8km section of 150nb 19 bar HP pipeline will likely require diverting using live gas flow stopping operations and heavy wall pipe to ensure security of supply to our customers. NGN believe these funds (£4.4m) should be allowed in full.

- Security Upgrade at Pannal

The Initial Proposals contain an uncertainty mechanism to cover enhanced physical site security. NGN's has a single site under its direct control that has been categorised by Centre for Protection of National Infrastructure (CPNI) as a category 3 site. As such it requires appropriate security measures recommended by the Government security services to ensure the site is adequately protected against terror threats that could impact on the Networks Customers.

The site was identified by CPNI following the national categorisation of all locations in the UK critical to National Infrastructure. As part of this process, the CPNI visits site annually. This visit has resulted in a recommendation to upgrade security and counter terrorism measures significantly, including the design and build of an Alarm Receiving Centre (ARC) to monitor site-specific alarms and threats.

Pannal is one of NGN's major offtakes sites, supplying over 250,000 customers and as such requires security measures to reflect its criticality and to reduce the risk of terror threats. The site currently experiences a number of intruders (latest August 2012) which cause extensive damage to our assets, with telemetry & site control buildings being damaged by intruders. We are seeing an increasing the risk of failure to supply to our customers due to this interference with equipment. As such we are in the stages of advanced planning for a major project commencing during 2013-14 to improve the security of the site in line with CPNI requirements. It is very clear that the project is not uncertain as to whether it will go ahead and therefore should be included in the ex-ante funding.

Q11 - Do you agree with our approach for allowing costs in line with historical levels for investment where supporting evidence is lacking or not sufficiently supported by CBA?

Response: Yes. Using historical cost levels for investments where increased investment is currently lacking supporting evidence or is currently not sufficiently supported by CBA is the right approach.

Q12 - Do you agree with the assessment we have carried out and the results proposed for repex?

Response: NGN broadly agrees with the principles and methodologies that Ofgem has adopted when assessing Repex. However, we believe there two areas which need to be corrected:

- NGN's Business Plan also included for a small amount of under-recovery of costs associated with Rechargeable Diversions. This is based on legislative requirement under NRSWA to provide an 18% discount on fully-loaded costs for diversions driven by qualifying street and road works. NGN's under-recovery is based on a conservative estimate that 50% of rechargeable diversions will be driven by qualifying works, and would seek to be allowed for this unavoidable net cost.

- Ofgem has proposed to disallow much of the submitted workload and cost associated with "Bulk relays and services other work" on the basis that no cost benefit analysis (CBA) has been provided to justify a bulk service replacement programme. However, NGN has included no such programme in our business plan. The definition of what is covered by this other category is not clear and we acknowledge that the volumes we have reported both historically and included in our business plan significantly exceed that of some other GDNs. We believe this is a classification issue and that other GDNs report some of these work types elsewhere. As our forecast volumes reflect the volume of work we have done historically they should be allowed in full.

Q13 - Do you agree with our approach for the assessment of tier 1 repex costs?

Response: NGN supports Ofgem's approach for assessing Tier 1 Repex costs.

Q14 - Do you agree with our approach for the assessment of tier 2 and tier 3 repex costs?

Response: NGN supports Ofgem's approach to Tier 2 and Tier 3 Repex costs.

Q15 - Do you agree with how we have applied IQI, and if not what would you propose to change? Do you agree with our approach to combining elements of the cost analysis?

Response: NGN has consistently benchmarked as the most efficient GDN since 2005 under a variety of benchmarking techniques and cost drivers. The newly developed benchmarking approach for RIIO-GD1 has again confirmed NGN as the frontier performer consistent with the results from GDPCR1. Additionally our business plan has demonstrated industry leading approaches in layout and transparency, release of data into the public domain, use of CBA, adoption of the new iron mains replacement policy and the granularity and depth of asset health assessment.

Our performance has created significant value for customers across the industry through continually extending the efficiency frontier. Setting the right incentives for such behaviour is a critical component of incentive regulation and to achieve this, the differentials between the best and worst performing GDNs must be meaningful. NGN has received the highest IQI frontier reward (1.38%) and efficiency sharing factor (64%) in recognition of our frontier performance. However, these parameters are not significantly different enough from other GDNs to be meaningful. The differential is less than 0.4% of RORE or c£3m per annum which reduces to c£1.5m when compared to industry average performance. On the efficiency incentive rate the differential is only 2%. These are notably less than the equivalent differentials during the last electricity distribution price control where the most efficient DNO had a nearly 3% RORE differential and a 6% difference in the IQI efficiency rate.

The Initial Proposals contain the lowest ever cost of capital set by Ofgem at a time of significant financial uncertainty. When this is combined with the limited frontier rewards and small range of incentive mechanisms for the new price control the overall impact is a potential RORE return that even for NGN maximising its future performance is less than double digit. This does not deliver the "I" in RIIO and reduces our ability to attract equity investment when compared to other energy and infrastructure investment. To address this and maintain the correct incentive framework the IQI parameters for NGN should be set at 2.5% frontier reward and 70% efficiency sharing factor in Final Proposals.

To maintain the incentive framework the IQI parameters should be revised to increase the frontier reward to 2.5% for the most efficient GDN (NGN) and the efficiency incentive rate should be extended to 70%.

Appendix 2

Response to Detailed Questions on Outputs, Incentives & Innovation

Q16 - Biomethane information provision: We would welcome respondents' views on whether our proposed information provision draft licence condition meets the needs of potential biomethane/entry connectees.

Response: We believe this does meet the requirements of entry connectees.

Q17 - EEI/ shrinkage incentive:
(a) Should we introduce option A or option B (or an alternative) in relation to the rolling incentive mechanisms for the EEI?

Response: We agree with Option B and whilst we appreciate the potential for year on year pricing volatility, if the proposed lag of rewards & penalties is implemented, as set out in the Ofgem 'pricing volatility consultation', this issue will be addressed.

(b) Should we also adopt a rolling incentive mechanism in relation to the commodity cost element of gas transport losses, ie in addition to the EEI?

Response: Yes we support this proposal.

Q18 - Do you have any comments on our proposed shrinkage and losses output levels?

Response: We have no comments on the proposed shrinkage and losses output levels.

Q19 - We would welcome views on our proposed approach to the broad measure, namely:

(a) Customer survey: Our proposed weightings for different customer interactions, and scores associated with maximum penalty, target and maximum reward (see table 3.3).

Response: We do not see any basis for increasing the already very challenging connection targets and reward/penalty triggers simply for rounding purposes. A 0.1 movement in these targets is very significant. The targets should be set consistent with Table 3.3.
The targets and associated reward and penalty triggers for planned and unplanned interruptions are very challenging but acceptable.

(b) Complaints metric: Our proposed weightings for each complaint element (incl. whether or not to include Energy Ombudsman findings within the metric), and score associated with target and maximum penalty (See table 3.4).

Response: Consistent with representations we have made previously we do not consider that the number of Ombudsman complaints upheld as a percentage of the total number of Ombudsman complaint decisions is a meaningful indicator of customer service performance. This is particularly where extremely low numbers of complaints reach the Ombudsman as is the case with GDNs.

The outcome of retaining the current approach with a volume driver on Ombudsman complaints is potentially perverse and sends the wrong message to GDNs, for example: one case which if ruled against GDN = 100% penalty of £200k, whereas 10 cases with one against attracts 10% penalty of £20K.

We are disappointed that Ofgem has not accepted the proposal to treat findings where the Ombudsman decision is equivalent or less than the company's own complaint resolution had offered the customer as decisions not upheld against the company. This would truly reflect a ruling against a company.

(c) Overall revenue weightings: we welcome views on one GDN's proposed changes to the weightings of the different elements of the broad measure revenue (see table 3.5)

We believe our proposal puts the focus on the most important element of customer service.

Q20 - We would welcome your views on the proposed number of fuel poor connections (see Table 4.1).

The proposed volumes are consistent with our views.

Q21 - We would welcome your views on our proposed approach to CO issues including setting an output measure based on improving CO awareness.

Response: NGN welcome your approach to CO awareness and that of sharing results from each GDN for the benefit of our customer. The flexible approach taken in delivering outputs will enable NGN to meet the needs of our stakeholders and customers. One key advantage of your approach is it allows the GDNs to continually look at innovative ways to deliver CO awareness programmes.

If we are to be assessed against a definitive set of output measures, then these should be clearly defined taking the proposed flexible approach into account.

Overall, NGN agree with your approach as it allows us to address our stakeholder requirements whilst importantly continually learning from others.

Q22 - Do you agree with our proposed approach to assessing non mandatory investment in relation to tier 2 and 3 iron mains, eg based on a 24 year payback period, and consistent with our earlier investment appraisal guidance?

Response: NGN's Business Plan included large elements of expenditure that were fully justified using the published guidance to assessing the validity of the proposed investment. All of NGN's CBA modelling used a payback period of 16 years to address any uncertainty with long term investment being required beyond this period.

This approach was therefore more aggressive than that proposed by Ofgem and resulted in a smaller investment programme than would be justified using Ofgem's approach using 24 years. We strongly believe a period of between 16 and 24 years is an appropriate timescale to consider non-mandatory investment decisions.

Q23 - Do you agree with our proposed outputs levels in relation to risk removed (MPRS), and associated secondary deliverables (see also Appendix 7)?

Response: NGN agrees with Ofgem's proposed primary and secondary output deliverable of the amount of MPRS risk removed (subject to comments in our response to question 25), occurrences of Gas in Buildings, occurrences of mains fractures / corrosion failures and length of main abandoned.

Please see our response to question 27 in relation to asset health and risk metrics.

Q24 - Do you agree with our proposals in relation to the other primary safety outputs?

Response: Yes we agree with these proposals.

Q25 - Do you agree with our proposed approach to measuring performance in relation to safety risk (see Appendix 10)?

Response: As improvement in safety is one of the key drivers for the Repex programme, it is imperative therefore that this is measured and reported. However, as both the MRPS risk model itself and the pipes contained within it are subject to dynamic changes, it is not possible to forecast accurately how the risk score of an individual pipe will vary through time. This provides significant challenges to the development of a robust forecast for the level of risk removed and also to its subsequent measurement.

We understand that Ofgem proposes that this metric will be applied using base scores as at 1st April 2013 and held static through the RIIO-GD1 period. Whilst we agree with this in principle, it is important that a full and common understanding exists between Ofgem and the GDNs as to how this will be defined and measured, and to ensure that this does not inadvertently drive wrong behaviours. NGN would welcome the opportunity to work with Ofgem and the other GDNs to deliver this clarity.

We have no concerns with the other safety outputs.

Q26 - Do you agree with our proposed reliability outputs, and secondary deliverables?

Response: We agree it is appropriate to update the asset health assessments to reflect the changes to the investment programme in the Initial Proposals and seek to get some consistency across the GDNs.

NGN is confident that the approach we have taken to developing Asset Health metrics at the individual component level for major installations is appropriate and welcome the statement in the Initial Proposals that this is the preferred approach. We will work closely with Ofgem and the other GDNs to bring a more comparable suite across the different companies.

Q27 - Do you agree with our proposed approach to measuring performance in relation to asset health and risk metrics, and asset load/capacity utilisation (see Appendix 10)?

Response: Yes we think the proposed approach is appropriate. There is still work to do on some of the underlying detail and questions as how any future changes (e.g. to changes asset health and criticality scoring mechanism) would be accommodated. Assessment of the trade off between asset classes is a complex area which will need further consideration over the RIIO-GD1 period.

Q28 - We welcome your views on the proposed level of funding for the licensees‘ NIA, based on the quality and content of their innovation strategies.

Response: We are disappointed that the differentiation between the default level, our high quality and detailed innovation strategy warrants no greater differentiation than 0.1%.

We are pleased that Ofgem recognise our strategy provided a thorough explanation of the challenges we face which was developed through a comprehensive engagement programme. NGN consulted with stakeholders on the specific areas on where we should focus. We also engaged with industry working groups and employees who provided a stream of issues and challenges. Without comprehensive stakeholder engagement we could not have been so thorough with our Business Plan.

Ofgem also recognised that NGN has clear governance and business processes in place to ensure customer money will be well spent. NGN recognises the need for a clear governance structure and set of regular, core activities allowing NGN to keep robust control of the expenditure and direction of innovation. The core activities, their purpose and frequency are detailed in our submission.

Transformational innovation is much more risky than incremental and involves changes to business models, cross industry and energy sector engagement, longer term and greater complexity. These stages require strong governance, flexibility and clarity or purpose to major industry leading changes that have a lasting legacy. An allowance of 0.1% above the default level may not allow us to undertake as much of this type of innovation as we believe would benefit customers.

Q29 - In relation to funding the NIC for 2013-14, do you support either option 1 (run the NIC and raise the required funds from the winning licensees' customers) or option 2 (no NIC, but roll-over funds to 2014-15). If NIC is delayed beyond 2013-14, what option would you support?

Response: NGN supports option 1 this would allow the NIC to commence within the first year, projects to be submitted, evaluated and started. We are keen to undertake a submission within 2013-14.

Appendix 3
Response to Detailed Questions on Finance and Uncertainty

Q30 - Do you agree with approach of using the profile for the release of backlog depreciation as a mechanism to smooth revenues and reduce their volatility through the RIIO-GD1 period?

Response: Yes we agree with the approach of using backlog depreciation to smooth allowed revenues across the price review period. However, the proposed revenue profile for NGN creates issues for us by creating large negative cash flows in specific years and will potentially cause NGN significant financing issues and credit rating negativity in those years. As set out in the presentation submitted to Ofgem on 24th September we propose an alternative profile which provides a smoother net cash position that would be more acceptable to credit rating agencies and is more closely aligned with movements in underlying expenditure forecast phasing.

Importantly this change has no impact on average customer bills over the RIIO-GD1 period. The key concern for our major customers is revenue predictability and not charging volatility per se. This proposal does not impact on predictability but will contribute directly to lower overall finance charges for NGN.

Q31 - Do you have any comments on our relative risk assessment?

Response: As set out more fully in the paper submitted by Oxera on behalf of the GDNs, the relative risk assessment does not support the implied differences in business risk, and in particular, the reductions relative to previous price controls. The following measures should be considered as ways to address the issues raised by this analysis:

- Increasing the equity beta and therefore the cost of equity such that the implied asset betas are not reduced relative to GDPCR1.
- Modify the equity beta to reduce the implied difference in the asset betas between the sectors, including the fast tracked electricity transmission networks.
- Setting gearing for GDNs no higher than the previous price control.

Q32 - Do you agree with our proposed elements of the allowed return?

Response: Consistent with our previous submissions and business plan we continue to have concerns that the indexation of the cost of debt will in practice increase risk rather than reduce risk. Further evidence to support this conclusion is set out in the Oxera paper. Therefore for Final Proposals it is important that the risk of error in the cost of debt is reflected either in the allowed return or through supplementing the debt index with an allowance for debt issuance and a mechanism to avoid undue exposure to risk.

Q33 - Do you agree with our approach to transition of the repex capitalisation rate from 50 per cent to 100 per cent in seven equal annual steps ("stepped approach")?

Response: We are pleased to see Ofgem's recognition of requirement for transitional arrangements to address the impact of the move to the capitalisation of Repex in RIIO-GD1 on financial ratios. As set out in our Business Plan there are a range of solutions available to address this issue that differ in their impact upon the company and customer bills in the short and longer term.

We believe that the appropriate mechanism is to adjust the Fast:Slow money split provide a neutral impact upon customers over the longer term. Ofgem's proposals follow this principle in applying stepped capitalisation rate from 50 per cent to 100 per cent in seven equal annual steps.

This single approach will impact the assessment of financeability of each GDN differently depending on their profile of investment expenditure over the period – particularly benefitting those with front-loaded investment programmes. Whilst agreeing with the overall approach to financeability as described in response to question 30 the proposed revenue profile needs to be adjusted to avoid potentially significant financing issues and credit rating negativity in individual years.

Q34 - Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?

Response: NGN believes that having a clear long term strategy for the management of pension scheme risk is the first step towards the efficient management of a pension scheme as, a successful long term "de-risking" strategy can deliver the following main benefits for consumers:

- reduce the risk of deficit increasing further;
- lower the volatility of future pension contributions;
- ensure that future generations of consumers will not be burdened with pension costs associated with the provision of services to previous generations of consumers; and
- reduced levels of management time and expense associated with managing pension scheme risk.

As a result of the above, taking into account that investment strategy is a trustee power, we agree that all network operators should demonstrate the benefit to consumers of any "de-risking" strategies or any other strategies which have been adopted.

However, there are a number of ways network operators could use to demonstrate how a particular strategy could protect future scheme funding and benefit consumers. As a result, in order that this is done consistently we would propose that the scope of GAD's review be widened so that they also review any long term strategy, whether implicit or explicit, that has been agreed for each pension scheme. We would suggest that Ofgem consults with all stakeholders regarding this as there are a number of factors which GAD will need to take into account in this type of review. For example, the general direction of travel in regulated and non-regulated companies; "de-risking" coupled with longer recovery periods; the appropriateness of investing in return seeking assets; the fact that any review would need to adopt a forward looking approach.

It should be noted that "de-risking" is simply one of the current phrases in pensions but there is nothing new involved and many of the techniques (e.g. buy out \ in, adopting appropriate investment strategies, liability management etc.) have been around and employed for years and many network operators have for some years already commenced "de-risking".

The current increased focus on "de-risking" is purely down to the current environment where deficits have increased significantly leading both employers and trustees to look at ways to reduce the volatility of the funding position and contribution requirements.

Q35 - Do you agree that the costs of contingent assets may be allowed if considered to be in consumers interests?

Response: Contingent assets are assets on which the pension scheme would have a claim if one or more specified future events (such as employer insolvency) occurred. Contingent assets do not represent an actual direct injection of cash into a scheme; this only occurs if the contingent asset is called upon.

Contingent assets are usually put in place for the following main purposes:

- to reduce the scheme's PPF levy; and / or

- as part of a Scheme's funding or recovery plan where they can, for example, be used to:
  - support the calculation of the technical provisions;
  - increase scheme security should future experience prove adverse;
  - support investment in return-seeking asset classes;
  - support long recovery plans where it becomes difficult to forecast the strength of the employer covenant; and
  - reflect the support of a wider group etc.

Given the above reasons for the use of contingent assets, as long a network operator can justify that implementing a contingent asset has been beneficial to consumers (e.g. through lower PPF levies, lower contributions, less volatile contributions, lower risk etc.) then, in our view, it would seem reasonable to expect customers to fund the implementation and ongoing costs associated with contingent assets.

Q36 - Do you agree with the thresholds for pension scheme administration costs and Pension Protection Fund levies set out in table 5.1?

Response: We agree with the proposed thresholds. Ofgem may want to consider reviewing these thresholds every three years as part of their reset and true up cycles as there may be a need to reduce / increase the thresholds if there are any changes which occur which are outside of company control. For example, the PPF may change their method for calculating PPF levies resulting in significant increases, legislative changes may result in increased administration costs etc.

Q37 - Do you agree with our amended treatment for modelling the cash flows of corporation tax payments?

Response: Yes we agree that it simplifies the modelling and is not material the revenue calculation.

Q38 - Do you agree with amending the timing of the revenue adjustment for tax clawback to be annually in line with the annual iteration process?

Response: Yes we have no issue with adjusting each year. It would be helpful to have all the calculations within the financial model. Arriving at the GDPCR1 clawback numbers / methodology took several iterations so would be helpful to have an agreed format / calculation as standard.

Q39 - Do you agree with our treatment of expenditure for tax modelling?

Response: Yes we have no issues moving to an industry standard average allocation.

Q40 - Do you have any views on the calculations and layout in the financial model?

Response: The current version is a big improvement on what we have previously used. It is a lot easier to follow and the structure of each sheet is clear.

For Final Proposals it would be helpful to have agreed definitions of financial ratios, these seem to have been taken out of the current version of the model.

One minor improvement that would help further and is quite simple to do is to hide the sheets that are not relevant – there is still a large number of sheets that are not relevant to a specific GDN (over 20) – a macro button could be added in the menu process that when you select for example "NGN" it hides all other sheets not relevant to NGN, making it a lot more user friendly and manageable to work with. Once RORE graphs and anything else is added for each company the number of sheets is going to increase even further.

Q41 - Should the financial model also capture, for presentational purposes only, the revenue from all incentive schemes?

Response: We are happy for this to be included, but would prefer it to be in line with how we do it now per our revenue reports i.e aggregate the total amount of incentives only not a breakdown of each incentive.

Q42 - We have set out three options to deal with the issues relating to SIU and legacy pensions arrangements. Which option do you prefer?

Response: Our opinion is that there is a difference between the arrangements created for the NTS pension (and SIU) costs and that proposed for the Network Innovation Competition which has created this legal issue. We believe the current arrangements could continue.

In policy terms (and following part of the GDN sales consultative exercise) Ofgem concluded that the historic element of the Lattice pension scheme costs should sit with the Gas Transmission aspect of the price control and therefore would comprise part of the costs that the NTS would need funding for from time to time as allowed revenue. This then facilitates the inclusion of such revenue items, after application of the NTS charging methodology, within the charges that Transmission make on the various parties under UNC. The UNC was then amended to include a charging item which relates to the pension deficit aspect of an amount that has previously been approved by Ofgem as being the correct amount. That sum is then recovered as a contractual charge due. In that sense Ofgem are not directing revenue to be paid they are simply confirming that costs are NTS costs are being recovered in the correct amount.

This is somewhat different from a scheme where Ofgem directs sums to be paid out of allowed revenue by one GDN to others and we agree that there is no express power in the Gas Act to do that. There are already precedents where secondary legislation has been put in place to allow this to happen, GSOS and the small business compensation scheme being two obvious examples. An example of where it is done through contract is the UNC liability regime, but this is really about the sharing of liabilities to Shippers.

Of the options outlined option 2 would be our preferred approach as it results in the least disruption to the companies affected.

Q43 - Repex: Do you agree with our proposed revenue driver for repex? Should the revenue driver apply to all above risk threshold tier 2 mains, or be limited to additional mains that breach the threshold during price control period, i.e. those where no funding was provided ex ante? Should services be included within the revenue driver?

Response: We think the mechanism should be limited to additional mains that breach the threshold during the price control period and should not include services. We currently would have significant system issues in reporting exactly the number of services associated with the replacement of specific mains lengths with scores above the rsk threshold.

Q44 - IRM: Do you agree with our proposal to restrict the reopeners for the roll-out of innovation to the two standard reopener windows, i.e. 2015-16 and 2018-19?

Response: Yes we agree with this proposal.

Q45 - Lane rental: Do you consider a revenue trigger to be appropriate for allowing additional costs related to the implementation of lane rental schemes? In particular do you have any views on how the unit cost of such schemes should be set?

Response: There is a great deal of uncertainty surrounding if, how or when lane rental schemes will impact NGN.

For any highway authority to implement a lane rental scheme they should firstly have implemented a permit scheme and have run this for a minimum of a year. As there are only four authorities we deal with who have currently implemented such a scheme, in theory they should not be considering a lane rental scheme until June 2013 and there would then be a period of consultation, cost analysis to be undertaken so it could be well into 2014 before any scheme would be implemented.

We are unable to comment with regard to the unit costs of such a scheme at this time as we would need an understanding of the works types involved, potential workloads etc. which we currently do not have.

Q46 - Mid-period review: Do you agree with our proposed approach to addressing any changes to the HSE iron mains policy at the mid-period review, and our proposed reopener in relation to asset integrity? Do you agree with our proposed materiality threshold of 5 per cent in relation to assessing changes to costs?

Response: NGN understands that HSE is intending to review the Pipeline Safety Regulations and will actively contribute to any consultation on this. If this results in a significant change in the way that the GDNs are required by HSE to replace or manage their mains populations which has an impact on their costs we support the proposal for an interim review and potential reset based on a 5% materiality threshold.

Should a review be undertaken, we would emphasise that our Business Plan has been set out based on a full 8-year RIIO period. If an interim review is carried out, the requirement for end-of-period assessment of the achievement of outputs would need to be assessed on a non-linear basis.

Additionally, the timing of any interim review should be considered, and sufficient time be allowed for development of a full understanding and re-modelling in line with any revised requirements from HSE, rather than the “4-year” period being the driver.

Q47 - Smart meters: Do you agree with our proposed approach to dealing with uncertain smart metering costs?

Response: NGN have been working closely with other GDNs to identify potential issues that will impact on the GDNs as a result of the Smart Metering Implementation Programme (SMIP). As a member of the ENA, we have helped to produce a Hierarchy of Gas Issues, which lists the identified issues, and categorises them based on importance. However, we recognise that, although the identified issues may be consistent between the GDNs, there is a disparity in the current numbers being forecast.

Given the difficulty to quantify the exact impact that the SMIP will have on the GDNs an uncertainty mechanism is the right approach. However, we continue to believe the ex-ante allowance should include some funding for the operational costs not just the initial set up costs.

Q48 - MOBs: Do you consider a volume driver to be appropriate for increasing revenues as a result of work conducted on assets related to medium rise multiple occupancy buildings (MOBs)? Please provide evidence of the unit cost assumptions that should be used?

Response: Yes. NGN believes that there is significant uncertainty regarding the workload requirements for medium rise multiple occupancy buildings, and would support the use of a volume driver to determine revenues.

Q49 - Connecting large loads: Do you consider that there should be reopener in relation to connecting large loads?

Response: Yes. We agree with the proposal set out in Initial Proposals to include a re-opener for new large loads (e.g. gas fired power stations) subject to a threshold value and where there is clear evidence that such a load will connect and pass the economic test.

Q50 - Xoserve: Do you agree with our proposals in relation to uncertainty with respect to Xoserve"s costs?

Response: Yes. We agree that the proposal to allow for review at any time following changes to the funding model for Xoserve.

Q51 - Scottish independent undertakings (SIUs): Do you agree with our proposals not to introduce an uncertainty mechanism in relation to supply to SIUs?

Not relevant to NGN.

Q52 - Do you have any other comments in relation to our approach to uncertainty mechanisms?

Response: It is our understanding that the re-opener mechanisms will apply when the cumulative costs post IQI exceed the threshold value rather than costs in an individual year exceeding the threshold. This policy position needs to be confirmed in the Final Proposals.