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24th September 2012

Dear James

WWU response to Ofgem's RIIO GD1 Initial Proposals

This response to the Ofgem Initial Proposals is in two parts. Part 1 is our Executive Summary and provides our response to the "overall Ofgem approach" as requested within the RIIO-GD1 Initial Proposals Overview document. Part 2 contains our responses to each of the detailed questions contained in Initial Proposals supplementary documents. We also submit independent reports as appendices to this response in support of our arguments.

Part 1 - Executive Summary

RIIO clearly represents a different process for setting price control allowances going forward. For its part, WWU has been fully engaged throughout the RIIO process and actively participated in the industry workshops. We fully support the underlying RIIO principles. We believe our leading performance since 2005 on key areas such as customer service, safety and efficiency improvement position us well as an upper quartile operator in our sector. Our clear objective is to ensure a RIIO-GD1 settlement that is applied consistently across all networks and one that allows us to continue to deliver for our stakeholders.

In support of this, WWU submitted a comprehensive business plan, which was significantly influenced by the results of our stakeholder engagement process. We are pleased to see that many areas of Ofgem's Initial Proposals support our plan; however there are some areas that give cause for concern - particularly in the context of continuing to provide a safe and reliable network to consumers.

There is much debate taking place at present about the future of gas in the context of a future low carbon environment. Within this debate however, it is generally agreed by politicians and industry experts alike that gas should and will continue to play a key part in the energy mix for many years to come - to ensure reliability and affordability of energy to consumers and industry alike. In this regard, we are concerned that Ofgem's proposals are not taking a sufficiently longer term view of the investment required to ensure the safety and reliability of gas networks as an important source of energy going forward.

We recognise there are many areas where the Initial Proposals broadly reflect our plan and the associated benefits to consumers, and we welcome this. Whilst we agree with the principles underpinning the Initial Proposals, a number of key areas need to be addressed to ensure we are able to continue to run a safe and reliable gas network.

The key areas of particular concern are:

1. **Inconsistent treatment of WWU** - Workloads and subsequent cost allowances that have been disallowed for WWU which appear inconsistent with the treatment of other networks and which would compromise network safety and reliability.

2. **Inconsistent treatment of adjustments** - for example we see no justification for capping the Sparcity factor when the newly introduced Urbanity factor is not capped.

3. **Level of incentives** - Whilst we are fully in favour of incentivising improved performance by gas networks, we believe the levels of incentivisation and penalties proposed by Ofgem are in some areas unrealistic, and do not represent an adequate incentive.

4. **Financing our Business** - The ability to properly and adequately finance our business.

5. **The RIIO GD1 Uncertainty Mechanisms**- The level of cost risk exposes us to a level of uncertainty that is not consistent with GDPCR1, or the principles of RIIO GD1.

The remainder of this Executive Summary discusses the specific impact of the Initial Proposals on WWU, and the amendments that should be made in the Final Proposals.

In headline terms, the Initial Proposals expose WWU to an unacceptable level of risk - the proposed reduction in our planned totex expenditure by 25%[1] would have a significant impact on our ability to efficiently deliver a safe and reliable gas distribution network.

Whilst we accept some of the Ofgem challenges within the Initial Proposals and are working with Ofgem to deal with the errors and inconsistencies we are concerned that there still remains a significant and unacceptable reduction to our allowances.

1. Inconsistent treatment of WWU

We recognise there are many areas where the Initial Proposals broadly reflect our plan and the associated benefits to consumers, and we welcome this. We also recognise there are a number of areas where Ofgem has challenged the WWU submission and Ofgem has provided evidence to support their conclusions. However, there are a number of areas where there are significant disallowances, which if not addressed could result in significant safety and reliability risks for our customers and consumers. The key areas of concern are as follows:

[1] Note: There are a number of Ofgem recognised arithmetic errors that have a material impact on WWU that we must resolve ahead of Final Proposals. We also require a rework of the WWU upfront IQI to ensure we are not penalised for the Ofgem errors and inconsistency.

- **Mandated Tier 1 Replacement** - associated 2“ steel rail replacement. We understand from Ofgem there has been an error in the process that has resulted in the omission of this work. We supplied Ofgem with the workload and cost requirement and understand this will be corrected. If this work were not to be funded there would be a material safety issue for WWU.

- **Tier 2 Replacement workload** - We provided Ofgem with a comprehensive cost benefit analysis, with sensitivities as part of our RIIO-GD1 business plan submission. Despite this, almost all of the WWU Tier 2 Cost analysis Mains and associated Services were disallowed. This is not consistent with the treatment of other networks. We have provided updated cost benefit analysis to Ofgem which they have acknowledged, and anticipate the Final Proposals reflecting the appropriate workload and cost adjustments.

- **Pipelines expenditure** - Ofgem has disallowed the entire pipelines workload from the WWU business plan submission. This represents an unacceptable level of increased risk to WWU, and one which we have been informed will also be unacceptable to HSE. We believe such expenditure is justified, and that WWU's circumstances are unique, in that:

  - The Wales pipeline infrastructure was installed much earlier than all other networks. The result is a leakage rate that is 5.5 times higher than the rest of the networks - with 60% of all the leaks & faults recorded in the UKOPA database occurring on the Wales pipelines,

  - Our submission outlined a range of different interventions beyond outright replacement - which represent best value, and least whole life cost, to consumers to ensure the safety of these assets, and

  - We recently commissioned a further independent report relating to this critical asset area, which concludes that pipeline remedial activity is essential. Since the publication of the Initial Proposals we have provided Ofgem with updated analysis and further breakdown of workload, to ensure that the WWU proposals are reviewed in the light of this further information.

- **Vehicle Replacement** - Ofgem stated within the Initial Proposals[2] that vehicle expenditure is cyclical and that they have considered the capital spend on vehicles over the five years of GDPCR1, including the actual spend in the first three available years (2008/9 to 2010/11) to derive forward looking allowances. We agree that vehicle expenditure is cyclical. However, WWU replaced a significant proportion of its fleet six years ago as a matter of necessity due to previous underinvestment and has since only replaced vehicles on an “as required” basis. The Ofgem methodology has therefore missed a significant part of the WWU expenditure, and as a result WWU has by far the highest disallowance[3] (£15.4m for the 8 year RIIO GD1 period). We have subsequently provided Ofgem with the required cyclical expenditure to ensure consistent treatment with other networks who may have replaced their vehicles within the Ofgem review period.

[2] Paragraph 7.25 page 50 RIIO GD1 Initial Proposals – Supporting document – Cost efficiency
[3] Paragraph 7.25 page 50 RIIO GD1 Initial Proposals – Supporting document – Cost efficiency

2. Inconsistent treatment of adjustments

We recognise the inclusion of the sparcity and the new Urbanity adjustments to recognise the different geographic and topographical conditions that networks operate within. However we see no justification for these allowances being treated differently. Ofgem has capped the sparcity factor at the levels allowed in GDPCR1 and limited its impact to the emergency & repair activities only. However, as with the urbanity factor, sparcity clearly impacts other Opex activities such as maintenance - as well as Repex and Capex costs. The full cost of sparcity should also be allowed as Ofgem has chosen to do with urbanity.

3. Level of incentives

WWU has been a leading sector performer in reducing leakage by a total of 16% during GDPCR1 and has delivered leading customer performance. Against this background, the Ofgem proposals will not deliver the outperformance range suggested. In particular;

- **The environmental emissions incentive mechanism.** We support the continuation of an environmental emissions incentive and the introduction of a roller mechanism to equalise incentives over the entire RIIO-GD1 period. However, we are disappointed that the WWU proposal for a "simple" roller, with no end of period unintended consequences, was not reflected in the Ofgem proposals. We have noted the alternative National Grid proposal that aims to "reduce" the end of period consequences, but we still favour a simple roller.

  We would still urge Ofgem to reflect our mechanism in the Final Proposals. It is fair and transparent, and it does not contain any risks for consumers or networks when compared to the Ofgem or National Grid proposals.

  We also recommend that Ofgem removes the sharing mechanism. There is a clear lack of outperformance opportunity and therefore this adjustment is required to provide an increased incentive in this area.

- **The leakage baseline targets.** Although WWU has been a top performer during GDPCR1, the Ofgem proposed targets for RIIO-GD1 present a significant challenge to us. Our evidence strongly suggests that there is very little outperformance opportunity and we appear to have been penalised for our performance during GDPCR1.

- **Customer Service incentive.** WWU is well recognised as the frontier network on customer service. However, even if we maintain our current frontier service levels, analysis suggests we would fall significantly short of the Ofgem proposed upper range of outperformance - which does not reflect a realistic incentive for ourselves or other networks. We propose that the targets are reviewed to provide a realistic and achievable incentive.

4. Financing our business

In our response to the Initial Proposals, we have considered the appropriateness of the overall proposed allowed return and its constituent elements. WWU have conducted our own detailed analysis which disagrees with Ofgem's view that the financeability package is adequate. WWU is basing this conclusion on consideration of:

- the appropriateness of the overall WACC and the individual components in the context of relative risk
- the Return on Regulatory Equity (RORE) measure as used by Ofgem
- calculation of key credit metrics and stress testing, and
- the exposure to movements in the debt index, due to the implementation of debt indexation.

Our specific comments are outlined below.

4.1 Overall WACC

The proposed WACC for RIIO-GD1 is lower than all recent historical precedents which suggests that Ofgem consider the relative cashflow risk for gas distribution is lower than all other regulated sectors and lower than the assessment made for GDPCR1. However, WWU do not support the assessment of relative risk that Ofgem have developed and consider that inappropriate conclusions have been drawn. In particular Ofgem have placed an undue level of reliance on scale of investment (and specifically the Capex/RAV ratio) and not placed enough weighting on other key factors such as the increased length of the price control period, the higher operational gearing of gas distribution and the introduction of debt indexation.

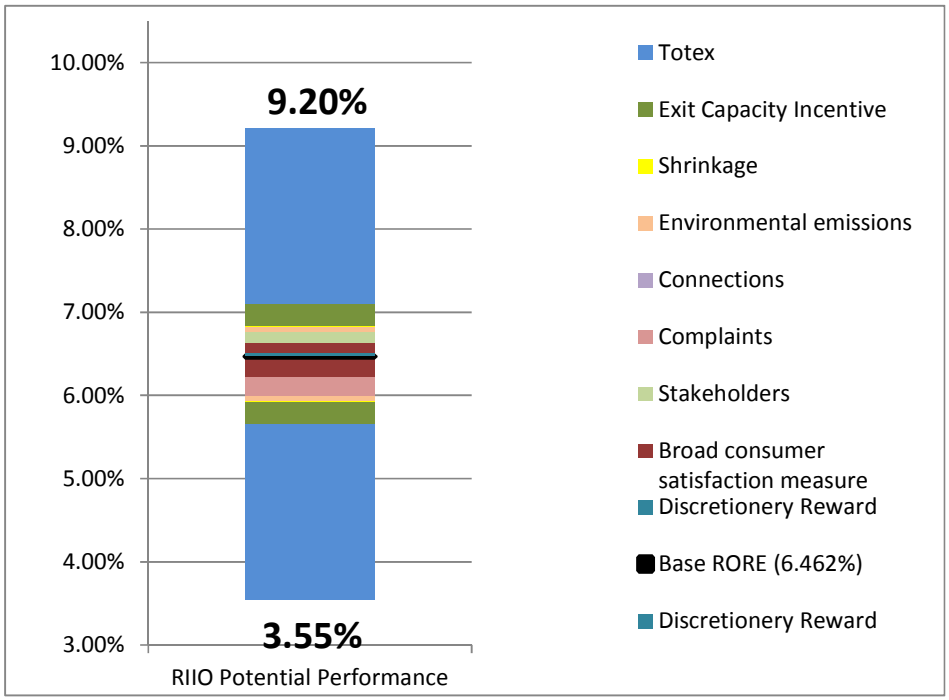
WWU are supportive of the CAPM parameter estimates used by Ofgem when calculating the cost of equity (a Risk Free Rate of 2% and an Equity Risk Premium of 5.25%). However, the overall WACC is deflated by Ofgem's assessment of relative risk. WWU is firmly of the view that neither the reduction in equity beta to 0.9, nor the increase in notional gearing to 65% are justified by the risk assessment or the analysis presented by Ofgem - and based on this evidence these parameters should not be changed from the levels set in GDPCR 1 of 1.0 and 62.5% respectively.

Our justification for this position is set out in our answers to the detailed questions in the Finance and Uncertainty section of this response and further augmented by a report from Oxera jointly commissioned by the ENA entitled 'RIIO-T1 and GD1 Initial Proposals – Financial Issues' which is attached as Appendix 1.

4.2 RORE Analysis

As part of our assessment of the appropriateness of the allowed return we have used the Return on Regulatory Equity (RORE) measure, as used by Ofgem. Our analysis has focused on whether the current package would allow an appropriate return to be earned. Specifically, we have considered whether WWU would be able to achieve '*double-digit returns for exceptional performance'* as per the Initial Proposals, or *'low-teen returns for a better network'* as per the Ofgem City Briefing in July.

WWU have made a number of amendments to the original Ofgem table to reflect errors or inconsistencies in Ofgem's analysis, and also our realistic view of the maximum achievable outcome on the various incentive mechanisms. Our revised RORE table is shown below:



Following these amendments, the revised achievable range based on the current Initial Proposals package for WWU is between 9.2% and 3.55%.

As an illustration of the gap using the amended WWU calculations, the IQI rate would need to increase from 61.8% to 82% in order for a 10% return to be achieved. Whilst it may be considered inappropriate to increase the IQI rate to 82%, we would certainly advocate a higher figure of 70% - coupled with changes to other elements of the financing package that we discuss below.

In order for double digit returns to be at all achievable, Ofgem should consider the full range of options to make the available return in line with the commitment in the Initial Proposals, including:

- Increasing the cost of equity,
- Retaining the notional gearing at the levels consistent with GDPCR1
- Re-calibrating specific incentive arrangements for the environmental emissions and customer service incentives
- Increase the IQI rate to 70%

We would also emphasize that the above analysis assumes no impact in respect of debt indexation and the ability of networks to match that index. As discussed below, there is a significant risk to this assumption from the methodology as currently drafted in the Initial Proposals.

4.3 Key Credit Metrics and Stress Testing

We have conducted our own detailed analysis of the credit metrics arising from the Initial Proposals and we do not share the conclusion that the financeability package as currently proposed is adequate.

Further, the ratios derived from the Initial Proposals give limited scope to cope with unforeseen under-performance in any given year, the impact of currently unidentified future events, or protection against incurring costs that would only be recovered in subsequent years. This issue is of particular significance given the current suite of uncertainty mechanisms set out in the Initial Proposals, and the potential significant delay in cost recovery as set out in Section 5.

4.4 Debt Indexation

We note that Ofgem have rejected the proposals in our April 2012 plan for an explicit allowance for debt costs and inflation risk premium in excess of the iBoxx index, and a collar mechanism in order to protect networks and gas consumers against the volatility to earnings and customer bills that might arise from extreme variations to the debt index in the future.

The view expressed by Ofgem is that under the RIIO-GD1 debt indexation proposals, debt issuance costs are assumed to be funded through network companies continuing to achieve lower issuance yields relative to the iBoxx corporate index. WWU have consistently argued that this relationship is not statistically valid and hence should not form the basis of a regulatory settlement. We note that both Oxera and Ofgem's own consultants (FTI) have demonstrated that the recent evidence suggests that the difference to the iBoxx index has narrowed. In addition, the weight of utilities in the iBoxx index has increased since the RIIO – GD1 strategy decisions were published, hence rendering outperformance (to cover these costs) harder to achieve. WWU continue to hold the view that an explicit allowance for fees and inflation risk premium of 35bps is appropriate to ensure that efficiently raised debt can be financed.

In respect of our proposal for a collar mechanism; within our detailed response we have set out calculations which clearly demonstrate the exposure that remains under a sustained period of a falling debt index. The analysis we have presented is supported by Oxera who conclude that '*the fundamental characteristics for WWU, such as the relatively small size of its asset base and near-zero projected asset growth, mean that debt indexation increases, rather than reduces, the risk of error in the cost of debt. This appears to contradict the intention of the RIIO model'.*

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5. The RIIO-GD1 Uncertainty mechanisms

WWU are pleased that Ofgem has recognised some of the key additional uncertainties Networks will face during RIIO-GD1, namely the impact of Smart Metering and customer driven large connections.

However, the Initial Proposals still place an increased and unacceptable level of risk on Networks compared with GDPCR1, for which we are not being adequately compensated. The key points that need to be addressed are summarised below:

- Our analysis indicates that WWU could be required to fund additional and uncontrollable costs of 10% of our annual totex allowance. This significant exposure arises because there is no recognition of the cumulative impact of the six re-opener categories in any one year. We propose an overall cap of the aggregate exposure of 3% of Totex. Without this cap, networks will not be funded for necessary and efficient expenditure.

- Where networks are mandated to carry out work which is not funded ex-ante, there should be no threshold test, as necessary and efficient expenditure must be funded. A prime example of this is the requirement of networks to comply with the Department of Energy and Climate Change (DECC) instructions to ensure security of national infrastructure. The Ofgem proposals recognise the requirement for the expenditure, but the use of a threshold on this activity would mean that the vast majority of expenditure required by DECC would not be funded. A further example is Smart metering.

- We welcome the inclusion of the Innovation rollout mechanism within RIIO-GD1. However the amended Ofgem proposals to restrict re-openers to two windows and apply a threshold will become a disincentive to the use of such funding by third parties. Innovation with third parties must be encouraged within the package, and therefore there should be an annual re-opener mechanism with no threshold penalty for networks or third parties.

Summary

We recognise there are many areas where the Initial Proposals broadly reflect our plan and the associated benefits to consumers, and we welcome this. Whilst we agree with the principles underpinning the Initial Proposals, this executive summary has sought to outline the issues which need to be addressed in the Final Proposals.

Given the issues encountered during the Initial Proposals we recommend that Ofgem implements a process for the Final Proposals that allows for the correction of material arithmetical errors to avoid the requirement for a Competition Commission referral to adjust for such errors, where agreed between the GDN and Ofgem. There would be time during late December 2012 and early January 2013 for this to take place ahead of decisions required by Networks to accept or reject the Ofgem Final Proposals.

Yours sincerely

Steve Edwards
Head of Regulation and Commercial

Part 2 – WWU's response to the questions set out in the Initial Proposals

This Part 2 covers detailed responses to the three Initial Proposal supplementary documents:

- Cost Efficiency
- Outputs, Incentives & efficiency
- Finance and Uncertainty

Supporting document – Cost efficiency

CHAPTER: 1 Overview of cost assessment methodology

Question 1: Do you consider our overall approach to cost assessment appropriate, and if not what changes would you propose?

We welcome the transparency in the Ofgem overall approach and also recognise that where Ofgem has used regression modelling, they have generally used appropriate modelling techniques.

Our main concern with the overall approach is limited to three key areas:

1. Replacement allowances,
2. Capital integrity allowances, and
3. The inconsistent treatment of "sparcity" and "urbanity".

1. Replacement allowances

All networks have submitted RIIO-GD1 business plans that reflect the new three tier approach. However, there is a key inconsistency in the Ofgem approach that has a material detrimental impact on WWU:

- Ofgem has generated tier 1 allowances using regression modelling.
- Ofgem has not used regression modelling for tier 2 and tier 3 allowances.

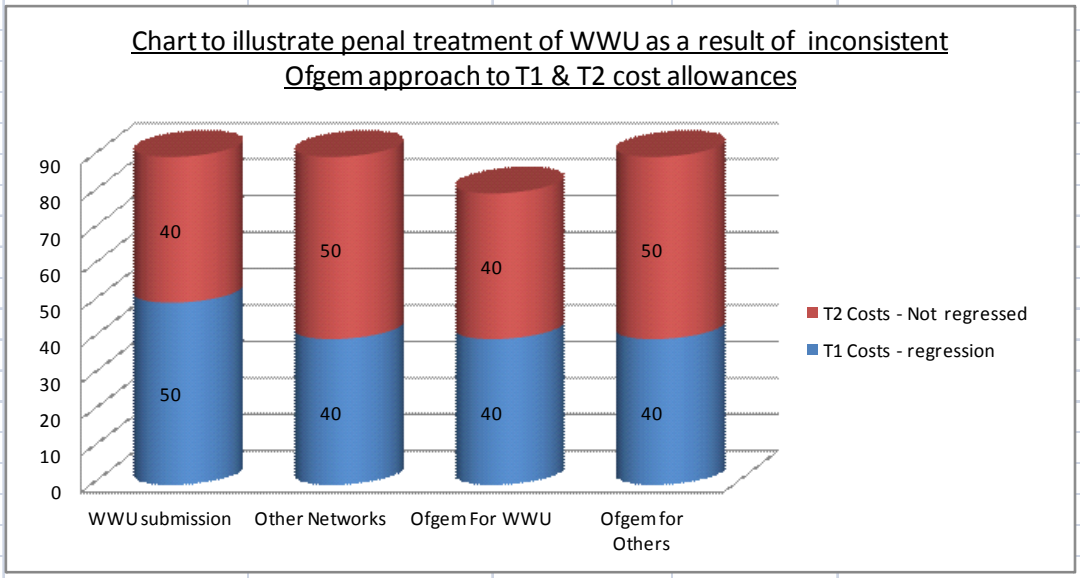
The key issue for WWU is that we have more granular information than most other networks and have submitted our proposals for all of repex using this detailed analysis of costs for each of the three tiers.

In broad terms, we have identified and submitted a higher proportion of costs within Tier 1 relative to the rest of the industry and a lower proportion of costs within Tier 2 and Tier 3. This is due to our more granular level of reporting and the methodology used to attribute support costs to the Repex activity. In particular, WWU has acknowledged in its business plan submission that the cost of planning, digitising, work recording and supervising is independent of the diameter of the Repex project concerned. It takes as long to work record a 2km 300mm Repex project as it does a 2km 35mm Repex project. In reporting Repex costs in its business plan, WWU has adopted this reporting approach.

Overall Ofgem recognise that the "total WWU repex costs" are upper quartile in its historic regression analysis. But Ofgem's overall RIIO-GD1 repex efficiency challenge on WWU is disproportionate to this relative position.

Ofgem has used regression in setting the Tier 1 cost allowance and this has resulted in a significant reduction in our Tier 1 cost allowance compared with our estimated costs due to our more granular cost reporting. Ofgem has not used regression for tier 2 and 3 costs and there is no recognition of the relative efficiency we have in Tier 2 and 3 costs when compared with the other GDNs.

Therefore WWU has suffered a disproportionate reduction in overall replacement costs that are not reflective of our overall efficiency. This can be illustrated by the chart below:



£m (indicative)	WWU submission	Other Networks	Ofgem For WWU	Ofgem for Others
T1 Costs - regression	50	40	40	40
T2 Costs - Not regressed	40	50	40	50
Total Repex	90	90	80	90

As can be seen, two networks, which are equally as efficient (both completing the same amount of work for the same overall cost ~ £90m, but who record their costs slightly differently dependent on the granularity of cost data which they have) will have different outcome allowances due to the inconsistent approach to Tier 1 and Tier 2 price setting.

We will provide Ofgem a revised split of costs for WWU that better reflects the less granular information for the sector and ask Ofgem to assess the totals for repex on a consistent basis.

Alternative solutions would be for Ofgem to:

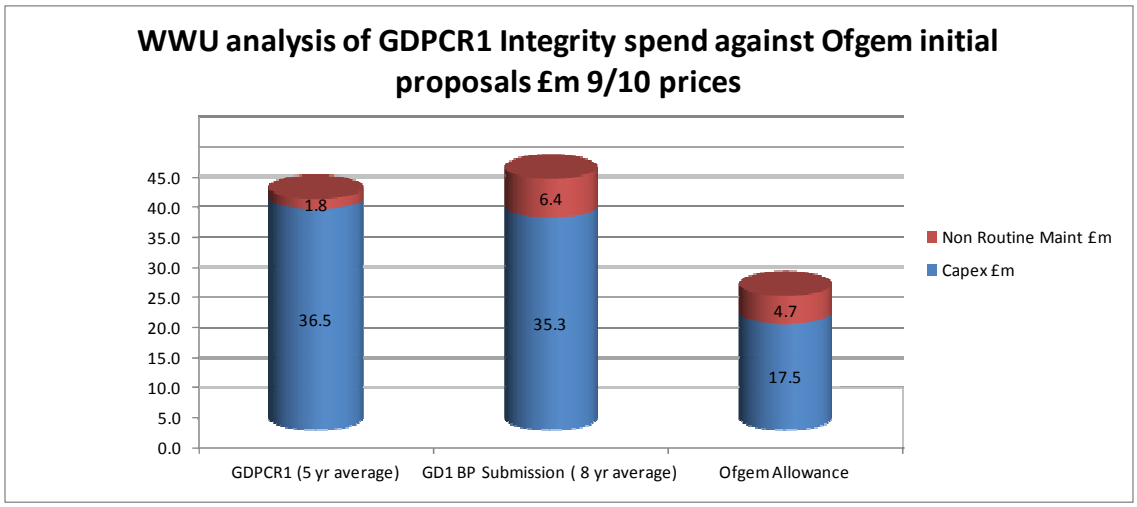
- either make a pre regression adjustment to WWU T1 costs, or
- use the equivalent regression modelling for Tier 2 and set Tier 2 allowances on a consistent basis to Tier 1.

This would also result in a more consistent approach across all networks.

2. Capital integrity allowances

Ofgem has stated that it is their intention to broadly allow RIIO-GD1 integrity allowances that reflect current expenditure levels. We fully accept that justification is required for RIIO-GD1 allowances and we have provided all the required detail to Ofgem which includes independent supporting information.

However, it appears that Ofgem has allowed an insufficient integrity related allowance within RIIO-GD1 for WWU as indicated in the chart below.



In summary:

- The WWU average actual spend through GDPCR1 on integrity Capex and Non Routine Maintenance is circa £40m per annum. 95% of spend is on capital solutions,
- The Proposed Ofgem allowance for RIIO-GD1 is circa £22m. The allowance is approximately 60% of the WWU GDPCR1 spend for WWU, despite assets getting older and deteriorating, and
- The WWU RIIO-GD1 business plan has introduced a significant shift from Capex solutions to Opex solutions that provide best option for consumers and clearly help reduce the risk of stranding. Our proposal is 85% Capex and 15% Opex – hence the increase in Non routine Maintenance within an overall total which is aligned to the GDPCR1 spend.

We have discussed this particular issue with Ofgem and we understand that Ofgem is now reviewing with an aim to amend the proposed allowances to ensure consistent treatment across the networks.

The chart clearly shows that WWU has not asked for a significant increase in integrity related spend in RIIO-GD1 over GDPCR1. We have however, introduced more Opex based solutions into our planning, reducing the future risk of asset stranding to the benefit of current consumers.

Therefore we ask Ofgem to review the overall WWU allowance in this area to reflect the WWU efficient GDPCR1 spend (and indeed the allowance) in the RIIO-GD1 period, and allow us to incorporate the Opex solution to avoid future stranding.

3. Sparcity and Urbanity

We welcome the inclusion of the Sparcity and Urbanity adjustments that aim to recognise the different geographic conditions that networks operate within. Our only request is to apply sparcity and urbanity in a consistent basis. Ofgem has capped the Sparcity factor and limited its impact to the emergency & repair activities only. As with the urbanity adjustments, sparcity clearly impacts other Opex activities such as maintenance as well as Repex and Capex costs. We provided our evidence to Ofgem and stakeholders within our business plan submission that supported the cost of sparcity within the WWU network geography of circa £7m. Many of the arguments used by Ofgem to support an "uncapped" urbanity adjustment apply equally to sparcity.

Therefore we recommend Ofgem review the sparcity proposals to reflect the true cost of sparcity within the WWU region (of some £7m per annum). This will ensure consistency in approach across sparcity and urbanity.

CHAPTER: 2 Regional adjustments, RPEs and ongoing efficiency

Question 1: Do you consider our approach for regional adjustments and company specific factors is appropriate, and if not what changes would you propose?

We have examined the new adjustments proposed within the Ofgem modelling and the majority of these adjustments appear to be broadly consistent and reflective of those used in other regulated sectors.

However, we have concerns with the unjustified inconsistent treatment of sparcity compared to urbanity. Urbanity is an uncapped adjustment, whereas sparcity is capped. We have covered the detailed arguments in the response above.

Question 2: Do you agree with our assumptions for real price effects and ongoing efficiency?

Ofgem's approach to real price effects and efficiency improvements is broadly in line with WWU's. However, we have concern that Ofgem has assumed that further efficiency improvements are introduced during the term of GDPCR1 and rolled through into RIIO-GD1. We consider that these assumed efficiency improvements should only be considered for the eight year RIIO-GD1 period.

Ofgem state that they use longer term data to avoid short term impacts. We support this principle. WWU has concerns that the assumptions for wages do not reflect this principle. The wages RPES include negative RPE assumptions for certain years reducing the nominal increases down to near zero increases which are not achievable in the short term. We would therefore request that Ofgem revisits these short term assumptions.

CHAPTER: 3 Total expenditure and total opex, capex and repex analysis

Question 1: Do you consider our approach to totex is appropriate, and if not what changes would you propose?

WWU considers Ofgem's overall approach to Totex to be appropriate, although we have made some comments on some specifics. We also comment on the individual elements of the cost allowances in our detailed responses below.

We are pleased to note Ofgem has confirmed that the costs associated with achieving outperformance, such as severance, are shared with consumers during the RIIO-GD1 period as are the resultant benefits (a change from GDPCR1).

We note that our ongoing dialogue with Ofgem on certain elements of the proposed allowances, and we don't replicate those here.

CHAPTER: 4 Assessment of costs excluded from regression analysis

Question 1: Do you agree with the costs we have excluded from regression analysis and the methodology we have proposed?

WWU agrees that certain costs should be excluded from the regression analysis. These are generally costs, or areas of spend, that are not incurred in sufficient volumes to make a unit cost comparison across GDNs appropriate (once adjusted for regional variations).

Following review it is apparent that certain back office costs, such as IT, have merely been rolled forward from current (GDPCR1) costs with some uplift for changes in activity that is expected to occur between GDPCR1 and RIIO-GD1. However, it appears that insufficient increases in allowances have been made for these changes.

An example is IT costs, which during RIIO-GD1 will increase by the in sourcing by the GDNs of the Systems Operations activity previously carried out jointly by the GDNs and picked up in Work Management (SOMSA costs from NGG). These external IT costs, charged by NGG to the GDNs, have been removed from the future Systems Operations costs within Work Management in the Business Plan Data Template that have been subject to regression by Ofgem. However, the corresponding required increase in IT cost, given that each GDN will now incur their own IT support costs for this activity, have not been factored into the allowances proposed in the Initial Proposals in full.

Similar adjustments are required for other incremental costs which the GDNs will necessarily incur during the RIIO-GD1 period, including the costs associated with auto enrolment for pensions, etc.

In addition, where costs have been excluded from regression, the allowance has generally been set by reference to either an external benchmark or by reference to the upper quartile GDN performance. In the majority of cases, Ofgem has selected the most challenging of these two benchmarks against which to set allowances, and generally this is the external benchmark (usually Hackett). There is a risk that the activities included within this external benchmark do not align with those undertaken by the GDNs and therefore the allowed cost is too low.

An example is finance, audit and regulation. These are activities which we have built post network sale in 2005 and are considered efficient. However against the external Hackett benchmark all GDNs finance, audit and regulation costs are deemed inefficient. We would question whether, for example, the Hackett benchmark adequately includes allowance for the regulation activity element of the cost, especially given the view from Ofgem, which we share, that RIIO-GD1 will increase the cost of regulatory compliance compared with the current GDPCR regime.

Further examples exist in Property Management, where the Hackett benchmark may not adequately address the geographic spread of the GDNs activities.

We would recommend that Ofgem sets allowance by reference to an average of the two benchmarks to deal with any inaccuracies in the benchmark level.

Question 2: Do you agree with our proposals for smart metering?

We do not agree with the Ofgem proposals for Smart Metering.

We are pleased to note Ofgem recognises that Networks will play a key role in the Government mandated Smart Meter rollout. There has been a significant amount of stakeholder engagement and evidence specifically provided by WWU to DECC and Ofgem and we are disappointed that the Ofgem proposals largely recommend a re-opener mechanism.

Ofgem state[4] that the GDNs proposals reduce the networks incentive to minimise the volume of work. This statement suggests that Ofgem does not fully understand the detailed interaction that has taken place between Networks, Shippers, DECC and other industry participants to develop a framework to promote a successful rollout for the consumers. The networks fully understand that this is a mandated "Supplier" led rollout but the collective work clearly acknowledges there will be an impact on the networks and that industry will require network support.

We therefore ask Ofgem to review the detail of their proposal to better align to the requirements of the Smart Meter forums. In particular, as this is government mandated work, the GDNs should be recompensed for all costs which they incur, and not just those costs which exceed a trigger.

In summary, the ex-ante allowance proposed by Ofgem is set well below the levels requested and evidenced by the networks. Networks will require a significantly higher up front allowance and the removal of the threshold test on efficient network costs incurred.

Question 3: Do you agree with our proposals for loss of meterwork?

We do not agree with the Ofgem proposals for loss of meterwork.

WWU's RIIO-GD1 business plan proposed an alternative solution that would provide efficient funding for the emergency services and appropriate risk sharing between networks and customers. We are pleased that Ofgem has recognised the issue but disappointed that the Ofgem proposals have rejected our view.

It is critical that Ofgem provide sufficient funding to allow efficient networks to comply with their key emergency license obligations and therefore continue to ensure safety of supply during RIIO-GD1.

CHAPTER: 5 Overview of bottom-up assessment

Question 1: Do you consider our approach to bottom-up assessment is appropriate, and if not what changes would you propose?

In general we agree with Ofgem's approach of using bottom up analysis, combined with top down analysis, to derive cost allowances. We provide our detailed responses to each specific area in the relevant questions below.

[4] Para 8.49 page 58 Ofgem Initial Proposals Supporting Document Finance and Uncertainty

CHAPTER: 6 Operating expenditure

Question 1: Do you agree with the assessment we have carried out and the results proposed for opex?

In general we agree with Ofgem's approach to Opex. However, we have raised a number of supplementary questions with Ofgem to further clarify the approach and ensure appropriate allowances are given. In particular these address the errors identified by both the GDNs and Ofgem in the workbooks supporting the allowances as set out in the Initial Proposals.

CHAPTER: 7 Capital expenditure

Question 1: Do you agree with the assessment we have carried out and the results proposed for Capex?

Whilst we agree with the majority of the assessment carried out by Ofgem, we do not support the results proposed for certain Capex areas and have explained in various other sections of this response our concerns with:

1. Integrity Capex (see below), and
2. Capital Vehicle allowances.

We are engaged with Ofgem on these key issues and we require Ofgem to adjust the workloads and costs within the Final Proposals to reflect the appropriate level of allowance.

Question 2: 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?

We support the approach for allowing costs in line with historical levels for investment where supporting evidence is lacking. However, our view is that as part of our well justified business plan, we have submitted appropriate supporting information.

Where Ofgem has concluded that we have not submitted sufficient supporting information, the allowances set out in the Initial Proposals for WWU do not follow Ofgem's stated approach (particularly for asset integrity spend and vehicle replacement) of allowing costs in line with historic levels.

The lack of Capex integrity allowance and vehicle replacement allowance for WWU is set out on page 13 of this document above.

CHAPTER: 8 Replacement expenditure

Question 1: Do you agree with the assessment we have carried out and the results proposed for repex?

We do not agree with the results proposed for repex and we continue to have detailed discussions with Ofgem on some key material omissions. We have already demonstrated the following key issues within other sections of this response:

- Missing Tier 1 mandatory and condition workloads
- Lack of Tier 2 cost benefit workloads
- Overall approach to setting replacement cost allowances

In addition WWU's business plan included replacement of poor condition services identified through postcode analysis or on site inspection. Ofgem disallowed 42,000 of these only allowing 6000. This does not enable WWU to comply with the HSE enforcement policy 'HSE/ENF/SPC186 – steel services'. WWU forecast replacement of 17,900 as a minimum to afford compliance.

Question 2: Do you agree with our approach for the assessment of tier 1 repex costs?

We do not agree with the results proposed for tier 1 repex costs and we continue to have detailed discussions with Ofgem on some key material omissions. The key issues are:

- An omission of mandated steel rail workloads,
- An omission of condition workloads, and
- An inconsistent approach to proposed unit cost allowances between Tier 1 and Tier 2.

For further details, please see our response on page 10 of this response

Question 3: Do you agree with our approach for the assessment of tier 2 and tier 3 repex costs

We do not agree with the results proposed for the Tier 2 and Tier 3 repex costs and we continue to have detailed discussions with Ofgem on some key material omissions. The key issues are:

- An omission of WWU cost benefit workloads that pass the Ofgem assumptions, and
- An inconsistent approach to proposed unit cost allowances between Tier 1 and Tier 2.

A review of Table 8.4: "T2 mains and service unit cost allowances for 2014 (£m 2009/10 prices)" within the "RIIO-GD1: Initial Proposals – Supporting document – Cost efficiency" highlights the apparent inconsistency of cost allowances for tier 2 between GDNs.

CHAPTER: 9 Combining the elements of our cost assessment and applying the IQI

Question 1: 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?

We do not agree with how Ofgem has applied the IQI for RIIO-GD1. The following key points need to be addressed ahead of the Final Proposals:

- The entire IQI package should better reflect the improved quality of the network business plans and the industry attempt to set allowances to achieve required outputs for the first time. The current matrix is significantly more penal to networks than that used in GDPCR1 and DPCR5,

- The proposed IQI range set out in the Initial Proposals should be increased to a range of circa 65% to 70%. This would increase incentivisation within RIIO as opposed to maintaining the existing cost incentive levels,

- Ofgem has acknowledged there have been significant cost issues within the Initial Proposals. The final upfront IQI adjustments for networks need to be updated to reflect the correction of the agreed errors and inconsistencies,

- The WWU analysis of RORE (as set out in the executive summary) doesn't provide the potential double digit return for exceptional performance that Ofgem state and is well short of the "low teens" return which Ofgem has stated an efficiently run GDN can obtain. This can be partly corrected through increasing the IQI sharing range during the RIIO-GD1 period, such that the GDN retains a greater proportion of any outperformance during the RIIO-GD1 period, and

- Table 9.2 of the Ofgem Initial Proposals Supporting document – Cost Efficiency appears to indicate that Ofgem has used comparative historic efficiency within the calculations that generate the IQI scores. We accept that past and forecast costs should be used for setting upper quartile and cost allowances but we understand that the IQI scores should be generated using "forecast" data. Therefore Ofgem should recalculate the IQI scores using forecast data only. The result would be a closer alignment of the Ofgem forecast and Network forecast of costs. The result would be an improvement of Network IQI scores but this would better reflect the aims of the IQI.

RIIO-GD1: Supporting document – Outputs, incentives and innovation

CHAPTER: 2 Environmental outputs

Question 1: 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.

Whilst this question is aimed at connectees, WWU believe that information provision should be responsive, useful and practicable. WWU has previous proposed a three stage process:

1. Provision of access to GDN plans, especially at HP, IP and MP, to enable developers to understand the zones of opportunity to make a connection.
2. A 'land enquiry' style, short turn around, entry enquiry process.
3. Detailed enquiry – in response to detailed proposals, such as potential flow rates, a response including budget costs and feasibility, would be provided.

WWU would be please to discuss such a process and its funding.

Question 2: 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?

(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?

(a) We proposed a simple roller mechanism as part of our business plan submission. We note the NGG proposal that aims to reduce the complexity and unintended consequences of the Ofgem proposals but we still support a simple annual roller mechanism. The Ofgem proposals have the potential for unintended consequences with potential retrospective adjustments to allowances.

(b) We do not support a rolling incentive on the commodity cost. We cannot control the commodity cost. The current pass through of the day ahead Heren price remaining appropriate to the GDNs.

Question 3: Do you have any comments on our proposed shrinkage and losses output levels?

WWU has delivered an industry leading performance on leakage reduction during GDPCR1. We have also led significant improvement to the leakage model.

The RIIO-GD1 baseline proposals for WWU represent a significant challenge and provide limited scope for outperformance. The challenge to WWU seems disproportionate to that given to the other GDNs and would appear to penalise WWU for its performance during GDPCR1.

CHAPTER: 3 Customer service

Question 1: 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).

We agree with the proposed weightings and the fact that they are equally distributed across each of the three categories. The target scores have been established through the Gas Network trials and take into consideration the new questions which were developed to measure site tidiness and reinstatement. We also agree with the principles of setting fixed maximum penalty and reward targets.

The maximum reward scores are extremely challenging and do not reflect the already high levels of customer service being delivered by some of the gas networks. To move from upper quartile to achieve the maximum reward score, GDN's are required to improve performance by circa 20% for connections and planned interruptions and 12% for unplanned interruptions. The result of this is the maximum incentive of 0.5% of revenues, which in WWU's case is £1.6m pa, is, in reality, unachievable.

WWU is the industry leader in Customer Satisfaction and based on the survey scores we achieved in 2011/12, adopting the same principles as those included in the Initial Proposals, we would have been awarded £480k for the Customer Survey element. This implies that the financial incentive for each 0.05 improvement in score above upper quartile is set too low.

We also believe that it is essential that all GDN's use the same service provider to facilitate the customer satisfaction surveys; this would deliver economies of scale in terms of costs and will ensure a consistent approach is taken for all GDN's. Alternatively, a robust independent audit process needs to be introduced on an annual basis to ensure the different providers and GDN's are following the correct procedures.

Question 1: We would welcome views on our proposed approach to the broad measure, namely:

(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)

With the exception of the Ombudsman element we are satisfied with the proposed weightings for the other complaint elements. Whilst the Ombudsman complaints weighting has been reduced from 20% to 10% it is still disproportionate and the impact of having one case ruled against us would result in us being penalised £160k. As Ofgem is not minded to introduce exemptions for this element, in the extreme, a decision to award a customer an additional good will payment of £50 could result in us being penalised £160k.

The proposal also fails to recognise volume drivers in this category. Perversely, a GDN having 4 complaints referred to the Ombudsman and one case ruled against them would be penalised £40k whereas a GDN receiving one complaint and having that one ruled against them would be penalised £160k.

This doesn't support the principles of best practice and penalises GDN's for having low Ombudsman complaint volumes; which may encourage GDN's to pay off complaints to avoid cases being sent to the Ombudsman or in the extreme could result in GDN's referring more complaints to the ombudsman to increase their volumes.

We should be encouraged to minimise the volumes of Ombudsman complaints on an annual basis and the financial cost per case alone should be sufficient disincentive to ensure these cases are dealt with appropriately. We don't believe it was ever the Ombudsman's intention to penalise GDN's in such an extortionate financial manner.

We would prefer that Ombudsman complaints be removed from the complaints metric but continue to be monitored to ensure that this important category is managed efficiently. Alternatively, we would encourage Ofgem to reconsider the GDN's proposals for potential exemptions, address the volume driver issue, and remove any future amendments to the value of goodwill payments from cases ruled against the GDN's.

Question 1: We would welcome views on our proposed approach to the broad measure, namely:

(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)

Whilst we have some sympathy with NGN's view to apply more importance to Customer Satisfaction and less to stakeholder engagement, we believe that the equal weighting for the different elements of the broad measure is fair and will encourage GDN's to treat each one with equal importance.

WWU are relying on our employees to drive our stakeholder engagement programme and do not plan to employ a 'Cottage Industry' of staff to drive this initiative, we have not included any incremental costs in our business plan submission for these activities. We are keen to ensure that this is recognised and reflected in any discretionary reward process.

We have some reservations about the reward process for the stakeholder element and have a view that it is hard to foresee a position where GDN's are awarded up to £1.6m per annum by an independent panel for their stakeholder engagement activities. The Discretionary Reward Scheme process ("DRS") has taken 3 years to establish and for GDN's to achieve the maximum incentives available, if the stakeholder panel adopts the same approach as currently, will be difficult.

We welcome an early view of the work that is taking place with the DNO's along with any lessons learned and best practices.

CHAPTER: 4 Social outputs

Question 1: We would welcome your views on the proposed number of fuel poor connections (see Table 4.1).

The Initial Proposals are consistent with the volumes of connections WWU submitted in our business plan. WWU will commit to making every effort to achieve the volume of connections forecast each year, and we assume that it will be allowable to over perform in some years and under achieve in others.

We are pleased that Ofgem has listened to the inputs from the GDNs regarding the limitation on the number of connections that arises due to the lack of funding towards heating systems from other sources.

We welcome the opportunity for a review of the scheme in 2014 by which time the Green Deal and ECO (Energy Company Obligations) schemes are expected to be implemented and their impact understood.

We are currently working to establish a forum for all interested parties to understand each others roles within Wales and to form a strategy to tackle fuel switching to alleviate fuel poverty. We will use the learning from this exercise and apply to our South West network. Should this review amend the GDN Fuel poor Network Extension scheme, or external circumstances change, and it becomes clear that the number of fuel poor connections will exceed those in the Initial Proposals; we would like confirmation that these costs will be accepted automatically.

Question 2: We would welcome your views on our proposed approach to CO issues including setting an output measure based on improving CO awareness.

We are happy for an output measure to be developed to measure the effectiveness of our CO campaigns and we will work with the industry to develop a common methodology and core question set. However, we believe there may be some GDN specific supplementary questions and measures to monitor an increase in awareness. This is in order to reflect the diverse nature of projects tackling CO awareness across the networks.

We are concerned and surprised that Ofgem are proposing to provide funding of £2.26m for NGGD to enable them to make home visits to customers to provide information on the risks associated with CO; the distribution of 105,000 CO alarms to vulnerable groups and the update of detection equipment. We challenge this funding as the home visits should be included in their core costs as they will be carried out during FCO emergency service personnel downtime and the funding of the CO alarms should be covered by the DRS mechanism.

WWU didn't include any costs in our business plan submission for these activities and consistent with the outputs document we had assumed we would utilise our current personnel to raise awareness and recover any incremental costs associated with the purchase of CO alarms through the DRS mechanism.

Ofgem need to ensure the funding proposals are consistent for all GDN's and either remove the NGGD funding or, alternatively, fund all GDN's.

CHAPTER: 6 Safety outputs

Question 1: 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?

When considering the longer term strategy for the network our evaluation is that using DECC's guidance, gas utilisation is still the most cost effective outcome when considering alternatives such as heat pumps. We see no credible scenario where a 24 year payback should be used. We do accept gas usage may decline over time but the result will be a network potentially operated at lower pressures but with assets still very much required to operate safety and efficiently. A reducing benefit

has been utilised as a result in our business plan. We believe a 45 year payback period is appropriate.

With regard to the investment appraisal guidance, we broadly support the principles outlined but would make the following observations:

- Individual asset level CBA has been very challenging due to the number of variables and the number of assets (over 100,000). However, WWU has made good progress in achieving this goal and has submitted this back to Ofgem.
- WWU welcome Ofgem's calculation of deterioration rates, but believe that applying an efficiency challenge to them is mathematically unsound [and not supported by engineering knowledge/judgement].
- WWU would welcome confirmation from Ofgem of our approach and all the variables we have utilised.

Question 2: Do you agree with our proposed outputs levels in relation to risk removed (MPRS), and associated secondary deliverables (see also Appendix 7)?

WWU's forecast risk at the start of RIIO-GD1 and the risk to be removed by the end RIIO-GD1 is set out in parts B1 Outputs and C1 Main & Services of our Business Plan. These are not the numbers used by Ofgem in the Initial Proposals. This is detailed in the table below:

	Starting risk level (Incidents per annum)	Proposed Risk removed (Incidents per annum)	Risk removed
Ofgem	0.14	0.113	80.3%
WWU (C1 paper)	0.215	0.104	48.3%

WWU agree with the proposed output levels for secondary outputs based on the Initial Proposals workload. These will however require re-forecasting following agreement on repex workload.

Question 3: Do you agree with our proposals in relation to the other primary safety outputs?

WWU agree with the other primary outputs with the following comments:

I. **Repair Risk Score**. The suggestion is to base the target on the level experienced in 2012/13. Due to the impact of weather on this measure WWU do not deem it appropriate to forecast using a single year of data. We hold repair risk data back to 2010 and propose we take (risk x time) for an average repair since this time and multiply this by our forecast repairs for each year of RIIO-GD1. An alternative would be to derive a weather normalised figure and WWU would be prepared to assist in preparing such analysis.

II. **Major Accident Hazard**. The cuts to integrity allowance proposed in the Initial proposals would not enable this output to be sustained in WWU.

Question 4: Do you agree with our proposed approach to measuring performance in relation to safety risk (see Appendix 10)?

The arrangements for carry-over and catch-up appear to be logical.

CHAPTER: 7 Reliability outputs

Question 1: Do you agree with our proposed reliability outputs, and secondary deliverables?

- WWU do not agree with the reduction in unplanned interruptions given the large reduction in allowances for Capex and Repex service investment. Even with the Ofgem proposed revision in deterioration rates the reduction in unplanned interruptions is not credible

- WWU will resubmit health and risk metrics based on Initial Proposal workloads. We do have a concern that due to large reduction in Capex/Repex allowances the general health and risk of our asset population will deteriorate which is not in line with the requirements of stakeholders

- We support the approach and target output levels of the other primary and secondary measures in this category

- Ofgem has proposed a metering accuracy target beyond that proposed in the WWU business plan. No funding was proposed by WWU to maintain the 0.1% performance proposed by Ofgem.

Question 2: 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)?

Yes in principle, however further details and discussions are required in this area:

I. Asset health is a complex calculation with a large number of variables affecting assets and should be conducted at component level for complex assets such as Pressure Reduction Installations. Ofgem has recognised that WWU has been at the forefront of the development of Health Indices for gas assets and WWU has identified the factors that determine the health of a wide range of assets. WWU has shared this learning with Ofgem and others and would be pleased to use this as the basis of a consistent methodology across the sector.

II. Risk indices are dependent on calculating the consequence of failure and the operating costs of an asset. It will be important to develop consistent values if comparisons are to be performed or utilised for reporting purposes.

CHAPTER: 8 Encouraging innovation

Question 1: We welcome your views on the proposed level of funding for the licensees' NIA, based on the quality and content of their innovation strategies.

To provide a framework that maximises the opportunities for third parties to work with networks, we consider that Ofgem should provide a blanket 1% allowance to all networks. There is no risk to consumers to this approach whereas the current Ofgem proposals limit the opportunities for third parties.

All networks provided good insights into the areas they wish to explore and we would encourage Ofgem to move to a blanket 1% allowance.

Question 2: 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?

To provide opportunity for third parties, the NIC should be run from 2013/14 and funds raised from winning licensees. Ofgem should take guidance from the cross industry innovation workgroup.

Supporting Document – Finance and uncertainty

Initial Proposals Responses – Finance and Uncertainty

Chapter 2 - Asset Lives and RAV

Q1 Do you agree with the 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?

It is clearly of benefit to ensure that revenues and returns remain stable and hence WWU are comfortable with the approach of using the backlog depreciation to smooth revenues. We note however that in the case of WWU no sculpting has been applied in the Initial Proposals.

Chapter 3 - Allowed Return

Covering Note:

Our assessment of the Initial Proposals in Chapter 3 is augmented by two Papers prepared by Oxera

1) A report jointly commissioned by the Energy Networks Association (ENA), entitled 'RIIO-T1 and GD1 Initial Proposals – Financial Issues' which is attached as **Finance and Uncertainty – Appendix 1**.

2) A report commissioned by WWU entitled 'RIIO-GD1 Initial Proposals: options to reduce risk under debt indexation – Note Prepared for Wales & West Utilities'. This report is attached as **Finance and Uncertainty – Appendix 2.**

These two reports are contained within Section 3 and constitute part of our formal response to the Initial Proposals and should be considered in conjunction with the comments made below.

Q2 Do you have any comments on our relative risk assessment?

We note the principle introduced by Ofgem as part of RIIO-GD1 that the (base) allowed return for network companies should reflect their exposure to cashflow risk. It is therefore implicit in the WACC comparison that the relative cashflow risk for gas distribution is considered by Ofgem to be lower than recent precedent for all other regulated sectors and lower than the assessment made for gas distribution in GDPCR1.

WWU accept that if there is robust evidence of material differences in business risk – either across time or between sectors – then setting different allowed returns for individual companies/sectors would be appropriate. However, WWU do not support the assessment of relative risk that Ofgem has developed and consider that inappropriate conclusions have been drawn for two reasons:

a) The factors that Ofgem has considered in assessing relative risk are not complete.

b) The evidence from the consideration of those factors which Ofgem has included is either incomplete, or is given an inappropriate weighting in the overall risk assessment. In particular Ofgem has placed an undue level of reliance on scale of investment (and specifically the Capex/RAV ratio) and not placed enough weighting on other key factors such as the increased length of the price control period, the higher operational gearing of gas distribution and the introduction of debt indexation.

In light of these omissions, it is essential that Ofgem reconsider the relative risk assessment as part of the Final Proposals for RIIO-GD1 and ensure that the relative risk between sectors and price control periods is properly reflected in allowed returns.

Detailed Considerations

The three main areas considered by Ofgem in arriving at their conclusion are the scale of investment, the incentive rate and the length of the price control period. A detailed critique of the relative risk analysis has been carried out by Oxera as part of the report jointly commissioned by the Energy Networks Association (ENA). This report, entitled 'RIIO-T1 and GD1 Initial Proposals – Financial Issues', is attached as **Finance and Uncertainty – Appendix 1**.

WWU support the approach suggested by Oxera that assessing relative risk is most reliable and transparent when undertaken at the level of the asset beta, focussing on the risk characteristics of a company's assets independently from the financial risks that arise from capital structure choices.
The relative asset betas implied by the Initial Proposals are as per the following table:

Table 2.3 Asset betas Implied by the Initial Proposals

	SHETL and SPTL	NGET	NGGT	GDN's (Industry)
Asset Beta (RIIO)	0.43	0.38	0.34	0.32
Asset Beta (Previous Control)	0.40	0.40	0.40	0.38

Source: Oxera

The above table implies that the asset betas for gas distribution are assumed to be about 15% lower than GDPCR1. Additionally, there is a material variation in the asset beta across sectors and this variation is greater than in previous price controls. For example, the implied asset beta for the GDN's in RIIO-GD1 is 26% lower than the fast tracked electricity networks (SHETL and SPTL).

WWU do not support the assessment of relative risk that Ofgem has developed and consider that inappropriate conclusions have been drawn. Also, we have been by advised by Ofgem that there is no reliance on any Monte Carlo modelling of risk between sectors. Such analysis could have further informed an objective comparison and refuted the conclusions detailed in the table above.

The three key factors impacting relative risk as identified by Ofgem, our concerns with their methodology and the additional factors that WWU has considered are discussed below:

a) Scale of Investment

We consider that, in the Initial Proposals, Ofgem has overly relied on a single metric – the Capex/RAV ratio – to justify significant differentials between the asset betas of different sectors.

Within section 3.12 of the Initial Proposals Ofgem highlight that 'this approach is consistent with the considerations of the major rating agencies'. However, as highlighted by Oxera, the scale and complexity of investment only accounts for 4% of the overall credit score in Moody's methodology published in 2009 on 'Regulated Electric and Gas Networks' and hence Ofgem are placing undue emphasis on this specific metric.

We recognise that the overall Capex/RAV ratio for gas distribution has fallen from approximately 9% in GDPCR1 to approximately 7% in RIIO-GD1. However, Oxera conclude that 'Overall, the differences in asset beta across time and across companies appear large in the context of relatively small differences in the Capex to RAV ratios' and 'even if the Capex to RAV ratio is the most relevant metric of business risk, an analysis of the underlying data suggests that the material differences in the asset beta implied in the Initial Proposals are not fully supported by the evidence presented'.

When considering the scale of investment, we consider that Ofgem do not give the appropriate emphasis to the higher operational gearing in gas distribution– by which we mean a GDN's relatively small RAV relative to ongoing operating costs – as driving differences in relative risk. This was considered an important factor in GDPCR1 by both WWU and Ofgem and we note that Ofgem's analysis was vindicated by the attention that the Competition Commission gave to RAV-to-opex ratios in their 2010 Bristol Water inquiry. The table below demonstrates that WWU's returns remain more sensitive to a given percentage variation in opex and therefore implies that WWU has a higher beta than the Transmission Operators.

	NGET *(2012/13)*	**NGG** *(2012/13)*	**WWU** *(Ave 2013-21)*
Controllable Opex	198	63	82
Average RAV	8,528	3,996	1,574
Opex/RAV	2%	2%	5.2%

In conclusion, WWU do not agree with the comment in 3.11 of the Initial Proposals – Finance and Uncertainty that describes the scale of investment and specifically the capex to RAV ratio 'as the most significant differentiator of risk, affecting both the asset beta (and therefore the cost of equity) and the appropriate level of notional gearing.' In order for an appropriately balanced assessment of relative risk to be achieved, additional significance should be given to the other factors outlined below.

b) Length of Price Control Period

The move to an eight-year price control period exposes a company to greater risk than the previous five-year price control periods. As a consequence, we do not support the conclusion drawn by Ofgem in Section 3.25 of the Initial Proposals that 'the move to eight-year price control has a neutral impact on cash flow risk'.

In our November business plan, WWU provided detailed analysis and developed a detailed model used to objectively assess whether the proposed RIIO 8-year price control framework provides WWU with a higher or lower risk profile than the current GDPCR1 5-year framework. The outputs of this modelling demonstrated that the RIIO framework creates additional risk to shareholders, which would equate to a required 44bps uplift to cost of equity. As Ofgem has acknowledged in Section 3.21 of the Initial Proposals 'the assumptions that underpin a price control are more likely to prove incorrect further into the future'.

WWU do not believe that this additional risk can be appropriately dealt with via uncertainty mechanisms and hence a residual increase in the relative risk will remain, which should be funded through allowed return. The Initial Proposals do not include any explicit analysis demonstrating that the uncertainty mechanisms proposed by the networks are sufficient to mitigate the increased risk from a longer price control. Indeed, as we discuss in our responses to the questions from Chapter 8 – Dealing with Uncertainty, the current proposed uncertainty mechanisms leave networks exposed to significant residual cashflow risk.

The impact of a longer price control is further analysed by Oxera in Appendix 1**.** WWU support the overall conclusion reached which was that '*A longer price control will increase the variance of costs relative to regulatory allowances and hence increase business risk'.*

c) Incentive Rate

Under RIIO-GD1, Ofgem has set the totex incentive rate to give broadly the same outcome as the effective weighted incentive rate (of opex, repex and capex) for GDPCR1. Therefore, the basis of setting these rates would assume that the asset beta should also be broadly unchanged when compared to GDPCR1. However, as discussed previously the implied asset beta in the Initial Proposals is 15% lower than GDPCR1, which would imply that Ofgem has placed less significance on this factor. As noted by Oxera, '*Analysing changes in business risk as a result of changes in the incentive rate is an important step in the relative risk assessment. There are no compelling reasons to place less weight on this factor, compared, for example, to the scale of investment'.*

In addition, the comparison of the efficiency incentive rates across sectors does not support the variation in the proposed asset beta assumptions. The average efficiency incentive rate for the GDN's is considerably higher than for transmission (63% compared to 46%), yet the asset beta is lower. This is a significant disconnect, which unfairly penalises gas distribution and results in an inappropriately low relative WACC, which in the longer term will impact relative investment.

Other Factors – Debt Indexation

The other primary factor that influences relative risk compared to GDPCR1 is the implementation of debt indexation. WWU has consistently argued that contrary to the view held by Ofgem, the introduction of debt indexation materially **increases** risk compared to GDPCR1 for WWU and that absent any additional protection (e.g. through a collar mechanism) or uplift to the index, this should result in a higher cost of equity.

We discuss the impact of debt indexation more fully in response to question 3 below. In the context of relative risk, we conclude that in order for WWU to be appropriately treated under RIIO, for the Final Proposals it is important that Ofgem reflect in their methodology the conclusion drawn by Oxera below:

'it is important that the residual uncertainty in the cost of debt is reflected either in the allowed return or through a mechanism to avoid undue exposure to risk. An example of this would be a cap and a floor'

Q3 Do you agree with our proposed elements of the allowed return?

The proposed WACC for RIIO-GD1 is lower than all recent historical precedent. It is therefore implicit in the WACC comparison that the relative cashflow risk for gas distribution is considered by Ofgem to be lower than all recent precedent in other sectors. However, WWU do not support the assessment of relative risk that Ofgem has developed and consider that inappropriate conclusions have been drawn. In particular Ofgem has placed an undue level of reliance on scale of investment (and specifically the Capex/RAV ratio) and not placed enough weighting on other key factors such as the increased length of the price control period, the higher operational gearing of gas distribution compared to other regulated utilities and the introduction of debt indexation.

WWU is supportive of the CAPM parameter estimates used by Ofgem when calculating the cost of equity (a Risk Free Rate of 2% and an Equity Risk Premium of 5.25%). However, the overall WACC is deflated by the assessment of relative risk. WWU is firmly of the view that neither the reduction in equity beta to 0.9 or the increase in notional gearing to 65%, are justified by the risk assessment or the analysis presented by Ofgem and that based on this evidence these parameters should remain at the levels set in GDPCR 1 of 1.0 and 62.5% respectively.

3.1 Detailed Considerations

In our response to this question we consider the appropriateness of the overall proposed allowed return and its constituent elements. Inherent in this critique is a consideration of the adequacy of the financeability assessment carried out by Ofgem. It is therefore disappointing, that unlike previous price controls, Ofgem has not provided their credit metric calculations to networks and have only released very limited sensitivity analysis that it has used to underpin their financeability assessment. WWU has conducted its own detailed analysis and we do not share the conclusion that the financeability package that is currently proposed in the Initial Proposals is sufficient. WWU are basing this conclusion on consideration of:

- the appropriateness of the overall WACC and the individual components (including our exposure to movements in the debt index).
- reference to the range of outcomes under the Return on Regulatory Equity (RORE) measure as used by Ofgem.
- calculation of key credit metrics and stress testing.
- our exposure to movements in the debt index, due to the implementation of debt indexation

3.2 Overall WACC

A summary of the overall WACC determinations from recent regulatory settlements and proposals is as set out in the following table:

	TPCR4 Transmission (Dec 06)	GDPCR1 Gas Distribution (Dec 07)	DPCR5 Electricity Distribution (Dec 09)	TIIO-T1 SPTL+SHTL (Apr 12) *Fast Tracked*	RIIO-T1 NGET (Electricity Transmission) (Jul 12) *Non-Fast Tracked*	RIIO-T1 NGG (Gas Transmission) (Jul 12) *Non-Fast Tracked*	RIIO-GD1 Gas Distribution (Jul 12) *Non-Fast Tracked*
Cost of Debt	3.8%	3.6%	3.6%	3.0%	3.0%	3.0%	3.0%
Cost of Equity	7.0%	7.3%	6.7%	7.0%	7.0%	6.8%	6.7%
Gearing	60.0%	62.5%	65.0%	55.0%	60.0%	62.5%	65.0%
Vanilla WACC	**5.1%**	**4.9%**	**4.7%**	**4.8%**	**4.6%**	**4.4%**	**4.3%**

Note: The WACC outcomes under RIIO incorporate an assumed index value of 3.03%. The actual cost of debt will vary in accordance with the methodology set out by Ofgem for calculating the iBoxx 10 year trailing average.

As is clearly demonstrated, the proposed WACC for RIIO-GD1 is lower than all recent historical regulatory precedent. In our response to question 2 above, we discuss the relative risk assessment that underpins the WACC assessment. Within our response to this question we focus specifically on the individual components to WACC and the assumptions adopted by Ofgem to determine the appropriate values.

3.3 Cost of Equity

As with previous price controls, we support the typical two-stage approach to determining the appropriate cost of equity:

- using the Capital Asset Pricing Model (CAPM), taking into account the relative risk
- sense-checking against alternative approaches, information from transactions and regulatory precedent

Our comments on the key components - Risk Free Rate (RFR) and the Equity Risk Premium (ERP) are discussed below. We have already set out in Question 2our concerns over the value of the beta being applied. We also comment below on a small error in the calculation made by Ofgem.

3.3.1 Risk Free Rate

The RFR in the Initial Proposals is set at 2%. It is recognised that the RFR is in excess of current market estimates, but we regard this as essential protection consistent with a long term regulatory view. We support the view taken by Ofgem's consultants FTI in their report 'Cost of Capital Study for the RIIO-T1 and GD1 Price Controls' Section 4.21:

'It is unclear how yields will change in the future, which means that there is a material risk that a parameter estimate based on current market data (which may place undue weight on low/negative real returns that may not persist in the future) could turn out to inappropriately restrict the allowed returns to the network companies over the price control period'.

In Appendix 1, Oxera further comment that *'the application of the CAPM to current capital market data is unusually difficult'.*

The factors that contribute to this difficulty include:

- the aftermath of the most severe financial crisis in recent decades, with capital markets continuing to go through periods of high volatility
- impact of monetary policy and specifically Quantitative Easing
- increased uncertainty around economic fundamentals, such as output and inflation
- worldwide fiscal uncertainty, particularly in the eurozone

We therefore support the conclusions drawn by Ofgem that the 2% RFR is reasonable.

3.3.2 Equity Risk Premium

We support the comments made by Oxera that '*based on forward-looking measures of the ERP an allowance higher than 5.25% could be supported*', noting that recent Bank of England estimates have trended upwards and stabilised at about 7% in the last 18 months.

The allowance of 5.25% is lower than current market estimates and Ofgem has given limited justification in the Initial Proposals as to why this is appropriate. However, WWU support the conclusion made by Oxera in Appendix 1 that '*consistent with the overall approach of taking a longer-term view and a risk-free rate allowance that is set above spot yields, an allowance of 5.25% is appropriate'*.

3.3.3 Calculation Error

We note the cost of equity used by Ofgem in the Initial Proposals of 6.7%. However, re-performing the calculation using the parameters as published by Ofgem gives a cost of equity of 6.725%. The impact of this error is that the allowed return over the 8 year RIIO-GD1 period is incorrectly reduced by £1.1m.

3.3.4 Cost of Equity Conclusions

Whilst WWU could support the individual parameter estimates of RFR and ERP in the round, as we have discussed in question 2, we consider that the overall cost of equity at 6.7% is set at too low a level, due to the inappropriate assessment of cashflow risk reducing the beta component of CAPM. If the equity beta were to remain at 0.9 it would be necessary to increase the ERP to derive an appropriate cost of equity that is comparable to other sectors. WWU continue to assert that an appropriate cost of equity for gas distribution would be higher than the 6.7% currently proposed.

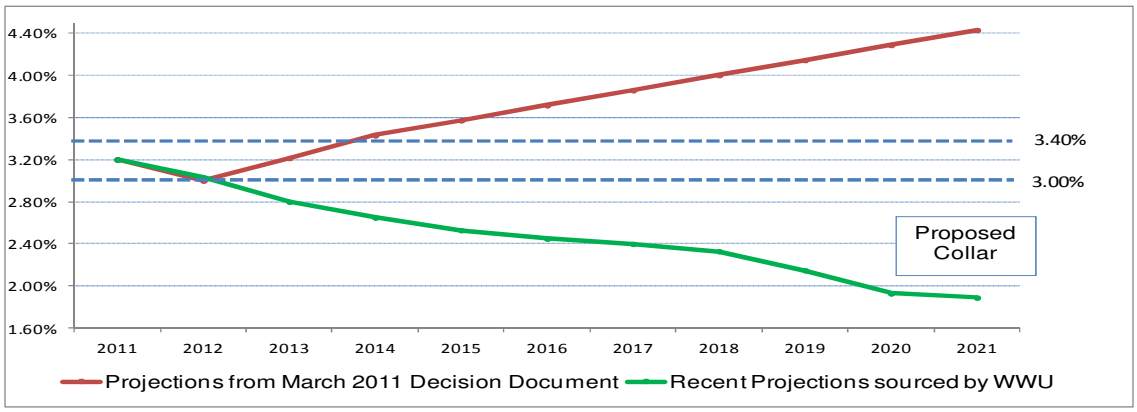
3.4 Cost of Debt (Collar + Fee uplift)

3.4.1 Background

A major uncontrollable risk to networks arises from the potential for significant variations to the debt index, which has been evidenced by recent history. At the point of originally submitting our business plan in November 2011, the trailing average index assumption was 3.20%, as requested by Ofgem, and was used as the modelling assumption for future years. However, as per the data published by Ofgem in January 2012 the trailing average had fallen to 3.03% at 31 December 2011 and continues to trend downwards.

As an illustration of the issue, WWU has previously presented the graph below to the GEMA board

Projected 10 year trailing average cost of debt allowance during the RIIO-GD1 Period



Notes

1) Downward sloping forward curve was produced by a leading UK bank in early 2012 and assumes:10 year trailing average of IBOXX indices deflated by 10 year breakeven inflation,20 year swap forward curve (average duration of iBoxx indices is c19 years) and Credit spread of 165bps. Ofgem projections are per the March 2011 Decision Document, which included the expectation that rates would rise quickly from historic lows.
2) Index midpoint of 3.2% excludes the required additional 0.35% uplift for inflation risk premium and other necessary financing costs, which are not covered by the index.

As highlighted to Ofgem in our November plan, WWU cannot react to this change in the index due to:

- The significant proportion of embedded debt - Of the £1.365bn of bonds currently in issue £1.05bn (77%) will still be in place at the end of the RIIO-GD1 period and hence not influenced by subsequent debt index movements

- WWU are unable to issue debt each year due to the size constraints in the capital markets. Only issues in excess of the benchmark size (£250m-£300m) are included in the index and attract the appropriate liquidity from investors. WWU are only likely to issue 2-3 times during the RIIO-GD1 period due to our RAV remaining relatively flat in real terms.

As a consequence any fall in the index has a direct impact on both equity returns and credit metrics.

The risk to WWU is further exacerbated by the potential for further significant falls in the index during the RIIO-GD1 period. The projections above show the index falling below 2% prior to the end of the RIIO-GD1 period. As with all economic forecasts, there are clearly a range of potential outcomes, but there is a significant pro-cyclical risk from debt indexation.

Conversely, with a rising index a network could be making 'excess' profits at the expense of the gas consumer, who in turn, at a time of prolonged high interest rates, will also incur higher gas costs due to the same economic factors.

3.4.2 Proposed Transitional Mechanism

In order to address the above risks, in its April 2012 business plan submission WWU proposed a transitional mechanism that would provide appropriate protection to the network and the gas consumer in equal measure.

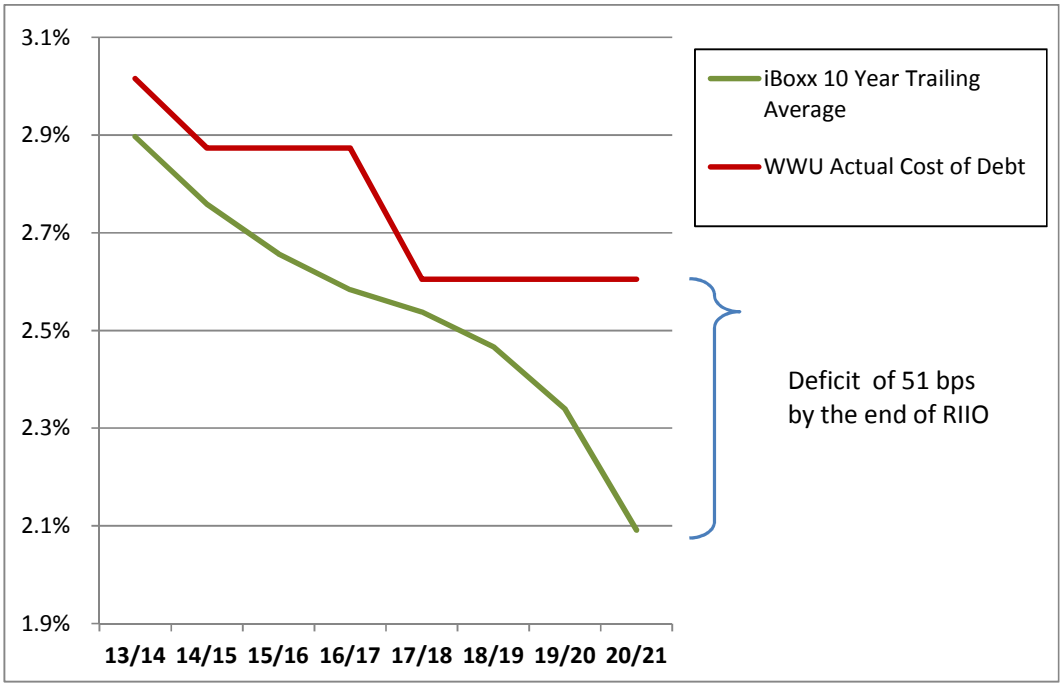
An appropriate transitional mechanism would be to implement a collar and thereby set a cap and a floor on the range of potential trailing average values. The benefit of a collar is that it would provide a degree of certainty of returns and allowed revenues, within a range providing protection to networks and gas consumers from economic uncertainties and hence would be consistent with a lower allowed cost of equity, whilst still encouraging networks to behave efficiently.

Our proposal for the mid-point for the collar was the allowed cost of debt under GDPCR1 of 3.55%. The proposed range of the collar was 20bps either side of this mid-point and hence gave a range of potential outcomes for the cost of debt trailing average (including the required uplift for inflation risk premium and other financing costs) of 3.35% to 3.75%.

3.4.3 Ofgem Response in the Initial Proposals

In section 3.43, Ofgem state that they further tested the robustness of the cost of debt index. The Initial Proposals state *'We modelled the index and each company's actual cost of debt from its regulatory reporting pack for 2010-11 under several scenarios in which the market cost of debt rises, falls or remains constant'.*

WWU requested the above analysis and identified that an incorrect cost of debt had been used by Ofgem, as it failed to take account of either the hedging arrangements held by WWU or any fees or other necessary financing costs, which are an integral part of the cost of debt. WWU has updated the Ofgem analysis to reflect our actual cost of debt (including hedging arrangements) and the summary of the output is shown in the following graph:



The above analysis is simply a replication of the Ofgem modelling used to assess the sensitivity to a falling index. The above analysis assumes a future annual index value of 2% and that all future debt is issued in line with the index (before fees and other necessary financing costs). It is worth noting that the cost of debt curve for WWU contains a number of limiting assumptions and excludes:

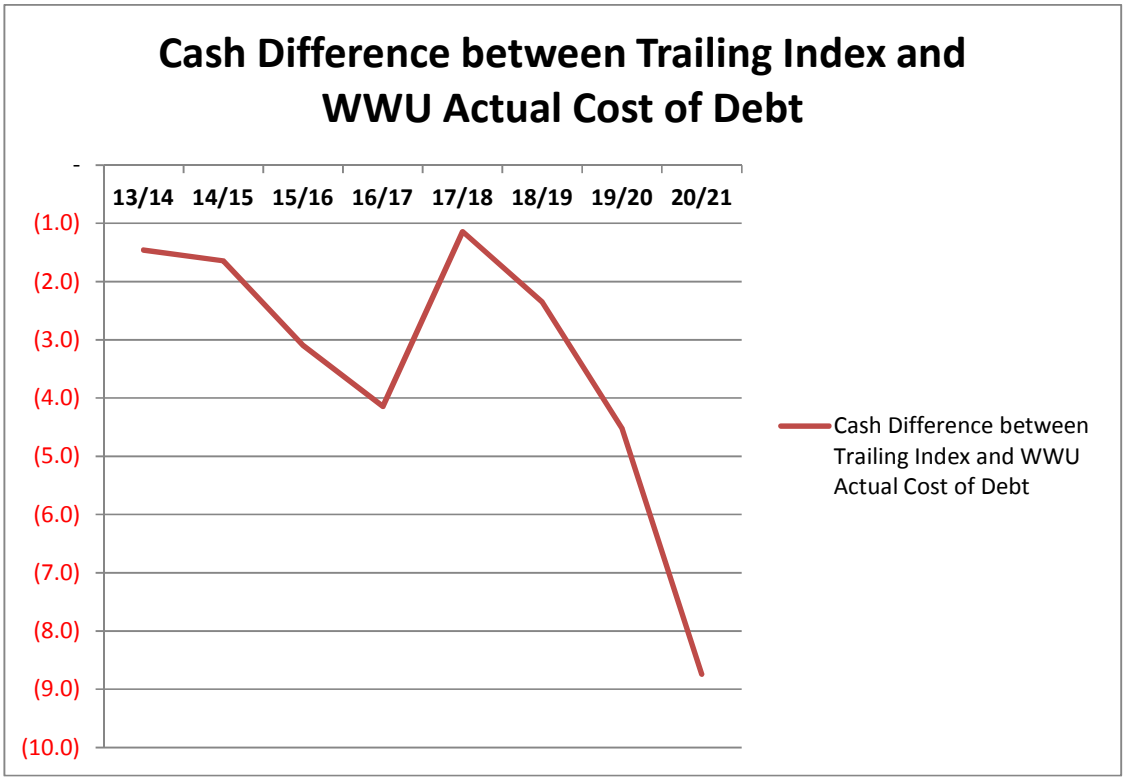
- Any bank debt, liquidity or hedging costs, or any cost of carry from liquidity pre-funding
- Any fees associated with raising debt (issue costs) or ongoing costs (e.g. Rating Agency)

Under the current proposals, all of the above costs are required to be funded by the cost of debt allowance.

Ofgem has stated that they disregarded the index linked hedging arrangements held by WWU in their assessment. However, the approach adopted by Ofgem is inconsistent with:

a) The assertions by Ofgem in Section 3.59 of the Initial Proposals that when considering financeability they have assumed that 25% of each network companies debt is index linked
b) The statement in Section 3.43 of the Initial Proposals by Ofgem that they have modelled each company's actual cost of debt from its regulatory reporting pack. By only using the bond coupons and not the associated hedges or additional financing costs, the analysis by Ofgem is incomplete and inaccurate and hence the conclusions are not reliable.

Our amended analysis clearly demonstrates the requirement for an index collar and re-asserts the conclusion that the index does not provide sufficient protection for networks. The following graph converts the Ofgem analysis into cash values. All amounts shown are £m:



As part of our response to the Initial Proposals, we asked Oxera to independently assess the Ofgem response to our conclusions. The paper produced by Oxera entitled 'RIIO-GD1 Initial Proposals: options to reduce risk under debt indexation – Note Prepared for Wales & West Utilities' is included with Section 3 of our response. The key headlines are that Oxera has also concluded that the proposed collar *'would lead to lower risk for WWU than the current proposals for the implementation of debt indexation, and would improve the financeability of the RIIO-GD1 proposals'*

3.4.4 Allowance for Inflation Risk Premium and Other Necessary Financing Costs

As per the discussion on the collar mechanism above, the rejection of our proposal for a specific allowance for other necessary financing costs is based on incomplete calculations that do not fully reflect the financing costs of an efficient network. WWU has consistently argued for the need for the index formula to give explicit recognition to the inflation-risk premium and other debt costs (including fees). The adjustments are 25bps and 10bps respectively.

In respect of the Inflation Risk Premium, we note the conclusion by Ofgem's own consultants – FTI Consulting, that *'The UK inflation breakeven rates used to discount the nominal cost of debt values appear likely to include an inflation risk premium'*. WWU therefore remain convinced that the evidence fully justifies the need for an uplift of 25bps for Inflation risk premium.

FTI consulting also noted the possibility of a liquidity risk premium on index linked bonds as compensation if this market were less liquid than the conventional bond market. However, FTI conclude that their analysis and research does not allow definite conclusion that the two factors offset.

In respect of an explicit allowance for fees, Ofgem has argued that utilities had typically been able to issue debt at lower yields than the iBoxx index and that this out-performance relative to the index should be sufficient to cover all costs associated with issuing debt and any new issue premia.

However, the Initial Proposals note that, more recently, this difference has narrowed substantially.

Based on the most recent data, the average difference since the start of 2010 is 19bps, compared to an average of 53bp over the history of the iBoxx index.

In addition, changes in the composition of the iBoxx index over time will affect the ability of the energy networks to issue debt below the index. Compared with the analysis presented in the RIIO-T1 and GD1 strategy document, utilities now make up a larger share of the two iBoxx indices used to set the allowed cost of debt. Since the strategy decision, the number of utilities bonds has increased significantly. Utilities currently account for 60% of the A index and 48% of the B index.

We note the conclusion by FTI Consulting that '*Recent data suggests that outperformance of the cost of debt index may have been diminished /removed. During 2010 and 2011, the ability of the network companies to issue debt below the index was lower than in previous periods'.* Although there may have been some recent evidence that the headroom has returned we further note the comment by FTI that '*There is significant uncertainty over the way in which market conditions will develop through to the Final Proposals and over the price control period'* . WWU continue to re-assert that any correlation between levels of index outperformance and levels of fees is nothing more than 'historical accident' and therefore not an appropriate basis on which to set a long-term regulatory framework.

Finally, WWU continue to re-assert that the current proposals disadvantage a smaller network and hence an infrequent issuer. Based on the capital programmes outlined in the Initial Proposals, WWU are only likely to be issuing on 2 or 3 occasions in the 8 year period. As such this equates to 2 or 3 out of c2000 index data points in RIIO-GD1. Even if WWU were to outperform on these spot occurrences, there is no statistical validity to an assertion that this would lead to outperformance of the index as a whole. It is therefore essential to take a more explicit approach to ensuring that efficient debt costs, including debt issuance costs, are recoverable regardless of the market conditions. A separate allowance would be the only appropriate means of achieving this.

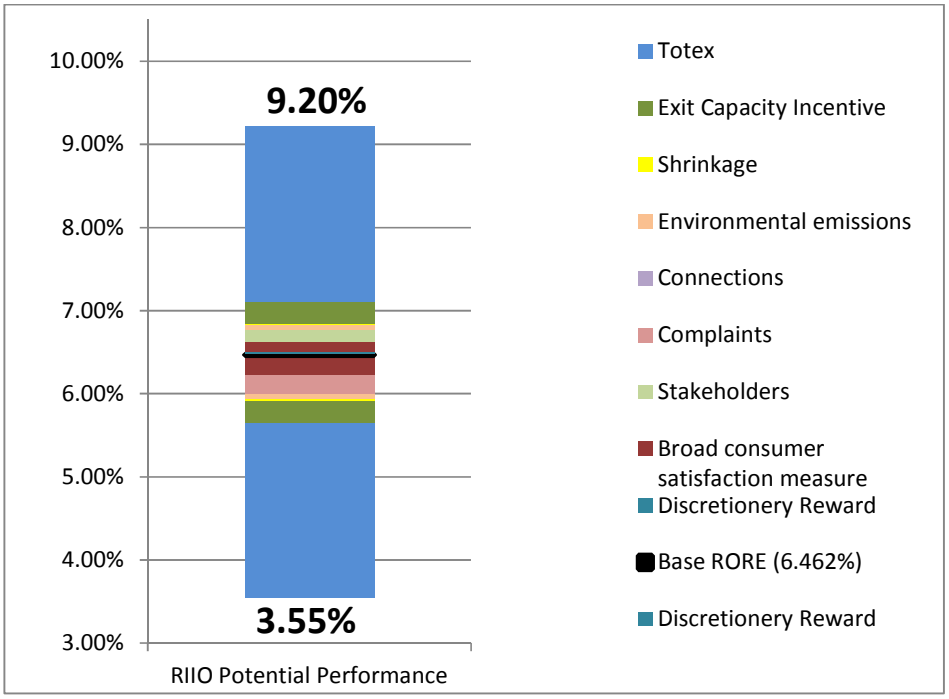
3.5 Proposed RORE Range

As part of our assessment of the appropriateness of the allowed return we have used the range of outcomes under the Return on Regulatory Equity (RORE) measure, as used by Ofgem. Our analysis has focussed on whether the current package would allow an appropriate return to be earned. Specifically, we have considered whether WWU would be able to achieve '*double-digit returns for exceptional performance'* as per the Initial Proposals or *'low-teen returns for a better network'* as per the Ofgem City Briefing in July.

The RORE calculations published by Ofgem as part of the Initial Proposals showed a range for WWU of between 9.75% and 4%. WWU has amended the Ofgem view to reflect:

- Errors or inconsistencies in the original Ofgem calculations
- The removal of the tax deadband and repex revenue driver. These are simply adjustment mechanisms not under the control of management and hence should not be considered as part of the potential return
- Our updated view as to the realistic achievable levels of incentive income (post IQI sharing) under the RIIO-GD1 package
- The TIM additional income of -0.76% of Totex as set for WWU in the Initial Proposals is treated as a definitive outcome rather than a potential outcome and hence reduces the Base RORE

Following these amendments, WWU presents below a revised calculation which shows the achievable range based on the current Initial Proposals package for WWU is reduced to a range of between 9.2% and 3.55%.



As an illustration of the gap using the amended WWU calculations, the IQI rate would need to increase from 61.8% to 82% in order for a 10% return to be achieved. Whilst it may be considered inappropriate to increase the IQI rate to 82%, we would certainly advocate a higher figure of70% - coupled with changes to other elements of the financing package that we discuss below.

In order for double-digit returns to be at all achievable, Ofgem should consider the full range of options to make the available return in line with the commitment in the Initial Proposals, including;

- Increasing the cost of equity,
- Retaining the notional gearing at the levels consistent with GDPCR1,

- Re-calibrating the proposed incentive arrangements,
- Increase the IQI rate to up to 70%.

We would also emphasise that the above analysis assumes no impact in respect of debt indexation and the ability of networks to match that index. As discussed below, there is a significant risk to this assumption from the methodology as currently drafted in the Initial Proposals.

3.5 Financial Modelling and credit metrics

3.5.1 Problems with the Ofgem Approach

Inflation Assumptions

We note that, within the Ofgem PCFM model, the inflation assumption is reduced during the RIIO-GD1 period from 3.3% to 2.5%. The impact of this assumption is that the model would show improving credit ratios in the later lower inflation years (this is due to the method that nominal interest is calculated from the real interest rate). WWU do not feel that this is an appropriate assumption and that an assessment of future credit metrics should not be distorted by a perception of future inflation. WWU has therefore used a static 3% inflation assumption in its modelling.

Interest Costs

As we discuss in section 3.4, there is a significant risk that the allowance for debt costs based on the index will lead to an under-recovery of efficiently incurred debt costs (including fees and other necessary financing costs). The analysis that Ofgem has historically presented, assumes that interest costs equal the allowance for the notional entity. Due to the significant risk arising from debt indexation, WWU has run a downside sensitivity on this assumption.

3.5.2 WWU Sensitivity Analysis

As per our previous submissions, we have focussed our financeability assessment on the Adjusted Interest Cover Ratio (also known as the Post Maintenance Interest Cover Ratio (PMICR)). We set out the reasoning for this approach on page 35 of our November plan submission.

The two key ratios that rating agencies will use for assessing a networks credit rating are the PMICR and the RAR% (which in the case of a notional entity equates to the notional gearing %). There are other ratios that a rating agency may consider, although each agency will focus on different criteria in their evaluations. However, the ability to pass a majority of other supporting ratios will not be of significance if the key criteria are not met.

The other primary purpose of credit ratios is that they determine the covenants that a company must meet with its lenders. Failure to comply with lending covenants will result in a company being unable to distribute to equity, and in extreme cases, defaulting on its borrowings. In addition to the two ratios discussed above WWU is also covenanted on the simple interest cover ratio (ICR). Hence, the RAR% (Debt/RAV), PMICR and ICR are the key ratios to be considered in a financeability assessment.

We have considered the credit metrics for the notional entity absent any incentive income or cost outperformance, which is consistent with the methodology that a rating agency would employ. The results of our modelling support our conclusion that the financeability package currently proposed in the Initial Proposals is not sufficient.

Chapter 4

Financeability, transition and return on regulatory equity

Q4 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')

The mechanism proposed by Ofgem is to apply a stepped transition for repex capitalisation, similar to the WWU approach. The transition would be from 50 per cent capitalisation in 2013/14 to 100 per cent in 2020/21 in equal incremental steps of 7.1 per cent each year. The proposal by Ofgem is broadly in line with our plan and hence we would support its implementation.

The transitional arrangement is essential to provide an appropriate balance of cash yield and RAV growth in respect of businesses like WWU who are not forecasting significant RAV growth and who are therefore essentially in steady state.

It is worth noting that the net effect of the changes to capitalisation policies and asset lives broadly offset each other in respect of cashflows to equity over the RIIO-GD1 control and hence our support for this proposal is on the assumption that it is implemented in conjunction with the implementation of 45 year sum of digits depreciation for post-2002 additions.

It is clear that any returns from RIIO-GD2 onwards would be less certain and that this would exacerbate the increase in required returns associated with an increase in duration of cashflows.

CHAPTER: 5 Pensions

Question 5: 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?

WWU agrees that where GDNs are proposing a de-risking strategy for their pension fund, the future benefits should be clearly articulated. This is particularly important as de-risking may result in current consumers paying a greater portion of the pensions cost and future consumers paying a correspondingly lower proportion.

Question 6: Do you agree that the costs of contingent assets may be allowed if considered to be in consumers interests?

WWU agrees that the costs of securing contingent assets should be allowed where these are considered to be in the consumers' interest.

Question 7: Do you agree with the thresholds for pension scheme administration costs and Pension Protection Fund levies set out in table 5.1?

In setting allowances in this area, Ofgem should note that the future level of Pension Protection Fund levies are set by the PPF with reference to the expected failure rate of schemes in general and the amount that the PPF therefore expects to pay out. These are items outside of the GDNs control and are likely to increase with the current state of the economy.

Therefore Ofgem should give consideration to the future failure rate within DB schemes generally and fund the GDNs accordingly. This may need to be via an uncertainty mechanism or through an adjustment to allowances within RIIO-GD2 for any under or over recovery of these costs during RIIO-GD1.

Chapter 6

Taxation

Q8 Do you agree with our amended treatment for modelling the cash flows of corporation tax payments?

WWU and Ofgem have held detailed discussions on the modelling of cashflows and specifically the appropriate implementation of the tax clawback methodology. There are two specific points on the Initial Proposals that require addressing.

8.1 Inconsistency Between PCFM Tax Modelling and Revenue Table

Within table 6.1 of the Initial Proposals, WWU is given an initial tax allowance of £98.0m over the RIIO-GD1 period, whereas within the PCFM the comparable number is £105.8m. WWU is assuming that this is an error and as per the stated methodology the PCFM will be the basis of the final annual allowance given.

8.2 Basis of Inflation

The figure currently showing in the PCFM for Tax Losses Brought Forward is £200.4m. The supporting sheet for this figure is called *WWU Tax Clawback and Tax Losses Calculation*, which takes its inputs from the GDPCR model and from the actual interest data that we provided.

The original allowed losses are from the GDPCR model and they are quoted in nominal values to allow these figures to be compared with actuals and thus make the tax calculations. However, the nominal values quoted are the 05/06 figures from the GDPCR model converted to nominal based on the original forecast of inflation. However, the actual RPI has been quite different from that forecast in that model. If the figures are being compared to actuals which have been subject to actual inflation, the 05/06 need to be converted to nominal using actual RPI indices. Otherwise, the figures quoted are not nominal. If the correct, actual RPI, is applied, the modelled losses then increase in value.

The same also has to be applied to allowed interest within the figure – against which the nominal actual interest rate is going to be compared – uplifted using the actual indices rather than the old model indices. This produces an increase in the value of the interest allowances and thus the level of clawback is lower. This then combines with the increase in the value of the base losses to give a revised Regulated Loss carried forward into RIIO-GD1 of £190.2m.

It is therefore not appropriate to use a simplistic 'modelled' view of inflation as this overstates our opening tax losses by £10.2m.

Q9 Do you agree with amending the timing of the revenue adjustment for tax clawback to be annually in line with the annual iteration process?

We agree that an annual adjustment would be appropriate. This approach is consistent with annual cashflows to HMRC

Q10 Do you agree with our treatment of expenditure for tax modelling?

No comments from WWU

Chapter 7

Allowed Revenues, annual iteration and financial handbook?

Q11 Do you have any views on the calculations and layout in the financial model?

We recognise that there have been significant improvements to the financial model. We have some minor points as set out below.

1. **Input – Line 61** – The inflation forecast is obviously down as an input; but can Ofgem confirm that this will be updated annually as we will have actuals and an updated view of the future?

2. **Input – Cells E53 & E8** – We believe that it would be clearer to label these as the iBoxx 10 Year Trailing Average (Cost of Debt) to make it clear that this is not the rolling average and not the market cost of debt for the year in question. In addition, the exact date the iBoxx 10 Year Trailing Average is taken from needs to be specified.

3. **Input – Line 343** – Exactly what the figure on this line represents has not been clarified. If it is the GDPCR Capex Roller, then we are unable to reconcile the figure back to our records. Could we therefore have the supporting calculations of what has gone into this figure?

4. **Input** – This sheet contains entries for the allowances and then actuals (driven from the Blue Box) for all of Totex in recognition that that the actuals are unlikely to match the set allowance. The same uncertainty applies to non-controllable opex and it would appear sensible to keep the same format to avoid confusion. We would therefore suggest this small change and the inclusion of non-controllable Opex in the Blue Box.

5. **Input** – Can Ofgem clarify why an allowance set at the time of Final Proposals is not Non-Variant? Is the distinction that Non-Variant cannot be changed in the RIIO period; but Variant Allowances can? If that is the case; can the exact conditions under which an allowance can be altered or removed be clearly set out?

6. **Input – Lines 504, 506 & 508 –** Para 6.18 on page 37 of the *GD1 Finance Initial Proposals* document says that of opening Capital Allowance Pools are based on our forecast and will be reviewed against the actuals. Can it please be clarified how any true-up would be effected

7. **Input – Line 510 –** While table 6.2 on page 36 of the *GD1 Finance Initial Proposals* document states the regulated tax loss position to use is dependent on forecasts for the last year and thus the opening position will need to be trued up. What mechanism will be in place to achieve this?

8. **TIM –** Calculations for the TIM efficiency incentive do not appear to be in the model. The Incentive Rate (slope and intercept) are universal figures; and we would like to review the calculations.

9. **Return & RAV – Line 80 –** This post vesting net additions is supposed to be after disposals. However, there is no line for disposals in the Input sheet and thus nowhere to include the expected disposals that were identified in the Opening RAV spreadsheet calculation. These figures are therefore missing from the Model. Perhaps a different line for disposals for pre and post vesting assets would help avoid such an oversight.

10. **Fuel Poor – Lines 26 & 27 –** The values taken here are not the same as the ones on the Opening RAV Spreadsheet as they have been rounded. This is not in itself an issue; though the effect is proportionally larger as these were already small figures; however, it is inconsistent with the how all the other figures are taken. We would therefore recommend consistency and the exact figures from the agreed Opening RAV Spreadsheet be used.

11. **Depn GD – Lines 14 & 19 (also Input – Lines 375 & 377) –** These values have been changed from the Opening RAV Spreadsheet and we have no record of these changes. Could Ofgem therefore please re-issue the opening RAV spreadsheet calculation so we can agree the values?

12. **RAV Opening Spreadsheet** – We believe that there is also an error in cell M11 on the WWU Summary tab because it transfers in the Fuel Poor Expenditure Total as part of the net additions; but does not remove the accumulated depreciation on the Fuel Poor Expenses.

Q12 Should the financial model also capture, for presentational purposes only, the revenue from all incentive schemes?

Yes – It would be appropriate to ensure that all revenues are shown in the model

Q13 We have set out three options to deal with the issue relating to SIU and legacy pension arrangements. Which option do you prefer

No comments from WWU

CHAPTER: 8 Dealing with uncertainty

Questions 14: 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?

We support the application of a revenue driver to the total above risk threshold tier 2 mains. There are potential large variations that could impact consumers or networks within this population and therefore it is appropriate to apply a revenue driver to the entire tier 2 above threshold population.

Question 15: Innovation Rollout Mechanism: 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?

We do not agree that Ofgem should restrict the reopeners for the roll-out of innovation to the standard windows. In addition, we do not support the use of a threshold test for this expenditure.

We welcome the inclusion of the Innovation rollout mechanism within RIIO-GD1 but the amended Ofgem proposals to restrict re-openers to 2 windows and apply a threshold will disincentive use of such funding by 3rd parties. Innovation with 3rd parties must be encouraged within the package and therefore there should be an annual re-opener mechanism with no threshold penalty for networks or third parties.

Question 16: 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?

Networks should be funded for necessary and efficient expenditure. The networks are lobbying to minimise any lane rental costs with the relevant Government and local bodies but once decisions are made we must comply with their requirements. Therefore necessary and efficient lane rental costs should be funded. If a re-opener is the method of funding these costs, there should not be a threshold test applied. The use of a threshold imposes significant additional cost risks on networks which are not reflected in any other part of the RIIO-GD1 settlement.

Question 17: 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?

The mid point review should be restricted to a review of Outputs. We agree that a three stage approach would be sensible in relation to the review of the HSE Iron mains Policy. We do not agree with Ofgem's definition of the materiality test for the Iron Mains review. Five percent of annual allowed revenues is too high and represents a significant funding risk for the post mid point years of RIIO-GD1.

If there is no change to network revenues coupled with a £16m increase in total costs to deliver a revised mandated programme, networks will not be funded to carry out an unacceptable level mandated work. For WWU, the 5% materiality of Allowed Revenues translates into circa 30% of WWU Repex costs. This is clearly not sustainable. An alternative would be to set a materiality of Repex costs of 5%.

We support a re-opener to allow necessary and efficient expenditure of costs to deliver required outputs associated with network integrity. We do not support the restriction to a single window nor a 5% materiality threshold. Both these points place an unacceptable, material cost risk and cashflow risk on networks. Again, if expenditure is necessary and efficient, then it should be allowed in total as soon as reasonably practicable.

Question 18: Smart meters: Do you agree with our proposed approach to dealing with uncertain smart metering costs?

We refer Ofgem to our response to Supporting document ~ cost efficiency Chapter 4 question 2.

Question 19: 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?

We would broadly support a volume driver if the ex-ante costs and volumes cannot be forecasted at the time of Final Proposals. The Unit Cost that would be applicable to each medium rise MOB will vary considerably depending on the nature of that specific MOB. Therefore the Unit Cost allowance should reflect the efficient costs of each installation.

Question 20: Connecting large loads: Do you consider that there should be reopener in relation to connecting large loads?

We welcome the wider consultation on this uncertainty which was not covered in the previous Ofgem RIIO-GD1 strategy documents. We re-iterate the requirement for this mechanism.

- The inclusion of this mechanism would be a simple continuation of existing regulatory treatment. The non inclusion would be a significant increase in regulatory risk to networks
- The network has no control over the timing of customer generated requests
- Efficient and necessary network costs should be funded within the price control settlement
- Efficiency of costs is secured by use of established connection policies and associated tools – i.e the economic test
- Any large load connection may result in significant network costs
- We support the use of an uncertainty mechanism as opposed to an ex ante allowance given the uncertainty of costs.

Question 21: Xoserve: Do you agree with our proposals in relation to uncertainty with respect to Xoserve s costs?

We are aware of the Xoserve review and support the intended Ofgem approach. We need to ensure there is sufficient time and funding following any possible material change to allow Xoserve and the networks to reflect any changes in outputs and licence obligations.

Question 22: Scottish independent undertakings (SIUs): Do you agree with our proposals not to introduce an uncertainty mechanism in relation to supply to SIUs?

Whilst there is no impact on WWU, Networks should be funded for necessary and efficient costs. If the costs cannot be reasonably forecast at the Final Proposals for RIIO-GD1, then there should be a mechanism for networks to recover such costs.

Question 23: Do you have any other comments in relation to our approach to uncertainty mechanisms?

We are pleased that Ofgem has recognised some key additional uncertainties highlighted by WWU, namely the impact of Smart metering and the impact of customer driven large load connections. However, the Initial Proposals still place an increased and unacceptable level of risk on Networks.

- Our analysis indicates that WWU would be required to fund uncontrollable costs of at least 10% of our annual Totex allowance. This significant exposure arises as there is no recognition of the cumulative impact of the six re-opener categories in any one year. We propose an overall cap of the aggregate exposure of 3% of Totex in any one year. Without this cap, networks will not be funded for necessary and efficient expenditure.

- Where networks are **mandated** to carry out work which is not funded ex-ante, there should be no threshold test, as necessary and efficient expenditure must be funded. A prime example of this is the requirement of networks to comply with the Department of Energy and Climate Change (DECC) instructions to ensure security of national infrastructure. The Ofgem proposals recognise the requirement for the expenditure but the use of a threshold on this activity would mean that the vast majority of expenditure would not be funded as required by the Department of Energy and Climate change (DECC)

- We welcome the inclusion of the Innovation rollout mechanism within RIIO-GD1 but the amended Ofgem proposals to restrict re-openers to 2 windows and apply a threshold will disincentive use of such funding by 3rd parties. Innovation with 3rd parties must be encouraged within the package and therefore there should be an annual re-opener mechanism with no threshold penalty for networks or third parties