RIIO|GD1

Response to Initial Proposals

Executive Summary

National Grid
Gas Distribution

September 2012

Redactions in documents

We welcome full and public debate on any aspect of our consultation response from all stakeholders. However, the conclusions we have reached and documented in our response are informed to a significant degree by data that has been shared by Ofgem on the companies' respective business plans. This data is not fully in the public domain and the other companies have not consented to publication of this at this stage. Ofgem are working to ensure that this data is released such that our full consultation response can be shared and we will publish in full when we have that direction from Ofgem.

Executive Summary

1 NGGD has been very supportive of the principles of Ofgem's RIIO framework, in ensuring that networks are far more transparent about the choices we make and the commitments we will deliver on behalf of consumers, whilst listening and responding to the needs of our stakeholders. We welcomed the opportunity to work with Ofgem in delivering a plan for RIIO-GD1 that is both aligned to these principles.

2 Having reviewed Ofgem's Initial Proposals, we are concerned that there are material issues and errors in Ofgem's approach to setting allowances. We will work with Ofgem through this response and over the coming months to the Final Proposals (December 2012) towards our shared goal of a RIIO-GD1 package that offers a fair and transparent deal to customers across all networks, and that appropriately balances value for money for our customers and fair returns for our investors.

3 The Initial Proposals appear to be driven more by limiting short term expenditure and customer bills, rather than considering the longer term value for money for delivering outputs. Ofgem quote an average £5 increase in customer bills by the end of RIIO-GD1, but this headline number contains an IFRS tax change for which there is still significant uncertainty over timing. With the removal of IFRS impacts, Ofgem are proposing large underlying reductions in customer bills and significant disparity in impacts between networks. We would question whether this is reasonable given our stakeholders clear priorities for us to continue to maintain critical safety and reliability levels on our network and the work undertaken on common industry approaches.

Structure of our response

4 Our response to this consultation is in two parts:

- This Executive Summary.
- Our detailed response to the specific questions that Ofgem have raised in their consultation.

In addition, we have provided specific information in correspondence with Ofgem's team through supplementary questions and working level meetings (which is not attached in this document).

5 This summary provides an overview of our main areas of concern with Ofgem's Initial Proposals. Further detail on all of these points can be found in the response to the specific consultation questions. This is not an exhaustive list of the changes we believe need to be made and our detailed response contains a number of other issues and comments with regard to the proposed framework.

1. Ofgem's approach to assessing our replacement and asset integrity expenditure

HSE framework Tiers 2 and 3 iron mains approach

1.1 Our Business Plan proposed a 13% reduction in iron mains replacement levels under the HSE framework from today, giving a £1 billion saving to customers. Under the new 3 Tier framework, we proposed to spend £67m p.a. in the Tiers 2 and 3 justified on the basis of delivering reduced risk, improved reliability and minimising leakage from our network. We had stakeholder support for our proposals, including HSE. We considered both short and long-term value to customers, ensuring we balanced the financial demand on today's customers with the need for managing risk and developing a low cost gas network that will play a vital role in the UK's future energy mix. We worked with Ofgem closely and we believed our cost benefit approach was aligned to Ofgem's common industry methodology.

1.2 Ofgem's approach, however, has disallowed 93% of our proposed Tier 2 and 3 programme, cutting our risk removed and leakage commitments by 20% on the basis of long term uncertainty over gas network use and the introduction of a hurdle of short term payback for any investment to be allowed. In addition to all Low Pressure replacement being disallowed in these tiers, only certain schemes (with positive payback) in our London Medium Pressure strategy have been allowed. No consideration has been given of the overall programme delivery efficiency and engineering rationale which were inherent in the original design of our programme.

1.3 We are concerned that payback on Ofgem's cost benefit modelling is highly sensitive to assumptions made. Ofgem's methodology results in different safety and reliability outcomes for customers across networks (for example NGN) where Tiers 2 and 3 cost benefit plans have been allowed in full. Given the similar nature of the networks, we would like to work with Ofgem to ensure that the common methodology produces consistent outcomes for customers across the country.

Condition mains replacement

1.4 Our Business Plan proposed 1,352 km of poor condition small steel mains and other mains outside of the HSE 3 Tier framework to be replaced. All of this expenditure has been disallowed in Ofgem's Initial Proposals on the basis that it has not been cost benefit justified. This is a vital safety and integrity driven programme required to meet our statutory obligations of operating a safe and reliable network. There are also material differences in allowed workloads across the GDNs. NGGD would like to work with Ofgem to ensure we have sufficient funding to meet our statutory safety and reliability requirements and that customers in our networks are afforded the same outcomes as those in other networks.

Non Routine Maintenance Programme (NRMP)

1.5 Our plan proposed the deployment of new techniques that emerged from IFI projects to better maintain, understand and monitor the health of our critical LTS assets. Operating expenditure for enhanced maintenance will avoid more expensive capital costs of replacement. Ofgem have removed significant parts Non Routine Maintenance expenditure in NGGD's plan through benchmarking efficient levels of maintenance operating costs, without recognising this was a step change from ongoing levels to deliver asset integrity outputs. We would like Ofgem to appraise this evidence and ensure that we are funded to deliver these outputs.

2. Ofgem's approach to assessing cost efficiency and setting allowances

Setting efficient levels of baseline costs across the industry

2.1 Ofgem's approach in Initial Proposals to setting an efficient benchmark forecast level of costs over RIIO-GD1 approach has altered substantially from a central principle of RIIO that greater emphasis should be placed on methods that look at total costs and their movement over time in order to reflect different management strategies (e.g. operating cost solutions as opposed to capex).

2.2 Ofgem's methodology averages two bottom-up assessments of costs with two top-down, diluting the emphasis on total cost. Calculating allowances using a bottom up approach means Ofgem risk 'cherry-picking' the lowest costs at individual activity level and combining these to set artificially low allowances. Ofgem's approach contains some correction for this, however nearly half of the costs at an activity level are set with reference to technical assessments which contain inconsistencies and poor logic, and have no such correction. Ofgem also need to ensure common assumptions in top down and bottom up methodologies (Tier 2 and 3 replacement work in London and for our riser work are not included in the top down benchmarking costs but are in the bottom up).

2.3 NGGD believes base-line cost efficient allowances should be set using 100% Totex approaches, to avoid the 'cherry-picking' bias in the bottom-up approach and properly reflect trade-offs between capital and operating costs.

Eight year plan benchmarking

2.4 Ofgem are setting allowances with an equal weighting on three historic years and the first two years of the plan. In a changing world, history is a weaker predictor of future network requirements and therefore future expenditure. We have acknowledged an efficiency gap to the frontier network and presented a plan to close that gap by 2014/15. Our networks are at the efficiency frontier for the remaining six years of the plan period. Our plan maps through the benefits of these efficiency gap closures and of expenditure on renewing and replacing our assets through to lower ongoing operating costs.

2.5 NGGD forecast a decrease of 7-15% in direct opex for RIIO-GD1 compared to historic expenditure whilst other networks are forecasting increases. We have the lowest deterioration rates of all GDNs in our iron mains networks, and are forecasting reductions in Public Reported Escapes driving our emergency workforce costs of between 5 and 12% (excluding London) compared to other networks forecasting increases of between 2 and 5%.

2.6 We recognise that normalising all plans to ensure assumptions are consistent, and thereby eight year benchmarking models are statistically robust, is a challenge. However we feel it is premature for Ofgem to abandon this principle. Whilst we recognise that data issues will make comparisons more challenging, we do not believe forecast plan benchmarking should have been excluded from the analysis.

2.7 We would like to ensure that NGGD's allowances and IQI are being set in reference to an assessment that recognises these long run efficiencies, given they drive higher customer benefits over the long term rather than low unit costs in the short term.

Roll forward of baseline year

2.8 Ofgem's methodology rolls forward from an assessment of efficient base-year costs. We are concerned that Ofgem's approach understates the likelihood of key cost drivers - in particular labour - to rise over and above the level of inflation by selecting projected pay awards from a forecast that is dampened by the impact of a public sector pay freeze. In the short term, 2012/13 to 2013/14 it is not safe to assume that private sector pay awards are the same as the public sector. We agree with Ofgem's approach to the long run average. We are also concerned that Ofgem's efficiency challenge departs very recent regulatory precedence including the Competition Commission and in some aspects, the views of the OECD.

2.9 NGGD would like to ensure Ofgem's approach sets a realistic and achievable eight year efficient benchmark.

Disparity in results of cost efficiency benchmarking for NGGD

2.10 Our analysis on cost efficiency disallowances for NGGD has highlighted areas which we would question:

- Top down and bottom up models produce very different results for National Grid's networks compared to the GDNs (who are relatively neutral to the different methods). For example, West Midlands is the frontier network on the top down future plan benchmarking approach, and yet receives a cost disallowance associated with being the 5th most efficient of the 8 networks (and 14% inefficient) under the bottom up assessment for the equivalent period. Moving to a 100% totex assessment over the full eight year plan period, even with the errors and inconsistencies we see in Ofgem's detailed methodology, would improve the efficient assessment of NGGD's costs by around £90m p.a.
- NGGD have identified a number of inconsistencies and errors in how the Initial Proposals benchmarking methodology has been applied (e.g. technical assessments and bottom up and top down benchmarking consolidation) which amount to £150m p.a. for NGGD.

2.11 As requested in the Initial Proposals, NGGD has provided additional evidence for costs associated with Streetworks and Diversions.

2.12 We would like to work with Ofgem to address these areas and ensure our allowances fully reflect the efficient cost of delivering our output commitments.

Reflecting the higher cost of working in London

2.13 Our plan contained considerable evidence supporting the additional cost of working in London. Ofgem have acknowledged that working in London reduces productivity for repex but not for emergency and repair activities, which are very similar. For repex, Ofgem's Initial Proposals reference an SGN study which showed a 15-20% impact and, as a result, use 15% as the basis for our London network adjustment. However, the elements of our networks within inner and outer London are 20% more densely populated than those of SGN. Our analysis shows 20% is a more appropriate adjustment for repex.

2.14 The evidence in our plan for additional productivity factors for emergency and repair has not been considered by Ofgem. In fact our repair activity in London is deemed by Ofgem to have the easiest operating environment in the country (based on being more urban). Our allowance is actually reduced through only applying a penal sparsity adjustment.

2.15 Partially as a result of these inadequate adjustments, our London network continues to be assessed as an outlier on all methods of assessment. We run a common operating model with unified processes and support functions across all its networks, and yet, for example, our repair activity assessment shows our networks ranked 1, 2, 3 and 8.

2.16 We would like Ofgem to consider the evidence in our plan that our London network should have a productivity loss adjustment of 20% for repex, and similar adjustments for emergency and repair activities. Our analysis on productivity impacts shows that London allowances should be improved by around £10m p.a. Correct adjustment to allowances would largely remove the inaccurately implied efficiency gap.

Consistency of plan allowances between networks

2.17 Standing back from the detail, a simple comparison of £ allowed against measures of network scale / complexity [redacted] show that NGGD's allowances for each network (including London) are around 20% lower [redacted] on a like-for-like basis.

[redacted]

[redacted]

2.18 Our analysis shows this disparity can be explained by the factors we have outlined above. We would like to see significant changes to the cost assessment methodology such that it recognises total cost efficiency, is applied in a logical, consistent and error free way, and results in a spread of allowances across networks that is reasonable and fair to customers. We are committed to working with Ofgem to address these issues between now and Final Proposals.

3. Ofgem's financial proposals

Headroom against credit metrics in determining financeability

3.1 Ofgem assert the financial package allows our networks to maintain an investment grade rating. We have been unable to validate this directly as Ofgem have withheld their evidence to support this. We have attempted to replicate Ofgem's analysis and we believe their approach has a number of shortcomings (for example Ofgem appear to have incorrectly reflected index linked debt in the calculation of credit metrics).

3.2 Ofgem should be targeting credit metrics which are consistent with the rating assumed by the cost of debt index, this is the border of a BBB and A rating. Our assessment of Ofgem's analysis shows that our networks fail to meet this target in all years of RIIO-GD1.

3.3 We are concerned the financial package is set at a level where there is no, or very little headroom if actual cashflows are lower than forecast. This is a material concern because i) Ofgem have modelled metrics on their view of efficient spend, not allowances, as their base case (even though allowances specifically cover the eventuality that Ofgem may have set too demanding a target for efficient costs) ii) the aggressive efficiency targets and limited scope we have to manage spend to allowances given the clear output commitments; iii) the impact on timing and size of future cash flows arising from the actual operation of uncertainty mechanisms; and iv) impact of risks that fall outside uncertainty mechanisms e.g. RPI, actual debt costs vs. index etc.

3.4 We would like to work with Ofgem to ensure our networks have sufficient headroom against credit ratings in order that we can continue to secure low financing costs for our customers.

WACC, gearing and return range

3.5 NGGD proposed a cost of equity of 7.2% and gearing at 60% (55% London). We evidenced this by analysis of cash flow risk through Monte Carlo analysis, regulatory precedents, CAPM and other economic models, and investor feedback. We concluded a higher risk of RIIO-GD1 compared to the current control although the operation of uncertainty mechanisms we proposed managed this risk back down to similar levels of today.

3.6 Ofgem's approach to assessing the cost of equity is based on a qualitative assessment of relative risk which we believe is incomplete. This approach therefore does not justify the large drop (16%) in asset beta vs. GDPCR1. The resulting framework leaves scale of investment (as measured by capex to RAV) as the primary driver of risk but it understates the detailed features of the regulatory framework (such as the size of the cost sharing factors) under which networks are bearing significant additional risk on behalf of consumers.

3.7 Ofgem appear to have arrived at 65% gearing by targeting a consistent RoRE range across the RIIO controls. We believe the gearing assessment needs to balance levels of gearing against credit metrics and transitional measures. Furthermore, this assessment does not appear to consider the feedback from this approach to the equity returns - which under conventional theory would increase to compensate for the increased leverage.

3.8 The comparison of the package with other controls is only partially assessed. We consider it notable that there is no comparison of the overall RoRE ranges and IQI treatment to DPCR5 and we would note that the overall regulatory framework appears to pass much more risk to the gas distribution networks than DPCR5. There is also no reference to the recent Scottish transmission operator's package - where gearing was assessed at 55% - much lower than allowed to the gas distribution networks.

Relative risk of operating a London network

3.9 NGGD also provided evidence that operating a network in London was higher risk than other networks due to a number of factors including the more complex assets, the economic importance of assets in the capital and the greater cash exposure to future streetworks regulation. We reflected this in our financial proposals for London through a higher gearing, lower sharing factor and higher WACC. It is unclear whether Ofgem considered this evidence fully and why our well-reasoned case was apparently ignored. We would like to discuss this further with Ofgem prior to the Final Proposals.

RoRE range

3.10 NGGD believes the combination of a depressed cost of capital, large allowance cuts and limited incentives delivers a plausible return range which is significantly lower than both GDPCR1 and DPCR5, and well below Ofgem's stated policy intent in its RIIO-GD1 March 2011 Strategy document (which targeted upside 10% RoRE returns at 50% gearing).

3.11 The Initial Proposals show that the expected variation in returns on regulated equity lies in the range of around 4.8% to 9.7% average across our four networks for a gearing level of 65%. This analysis assumes that Ofgem's analysis of NGGD's efficient costs is about right. However, as we have explored above, we have concerns over Ofgem's methodology for setting allowances. If, as we expect, our actual costs are as evidenced in our plan, returns will be around 5% on average; in our London plan. This would result in a return below the cost of debt.

3.12 We would like to work with Ofgem to ensure we have a balanced financial package and incentive framework to align customers and networks long term interests.

4. Process for this review

4.1 We are disappointed with Ofgem's process for this review. Ofgem have set a high hurdle for network companies to produce quality, well evidenced business plans, but appear not to have held themselves to the same high standards in assessing and responding to our plan. Our concerns include:

- Ofgem have withheld evidence underpinning their key decisions including their assessment of our financeability, technical assessments and consultant's advice. This lack of transparency is contrary to the onus Ofgem have put on network companies to publish full and complete information and to fully evidence the positions we have taken.
- Where we are able to understand the basis of Ofgem's position, Ofgem's reasoning is often obscure and we see many instances where Ofgem appear not to have fully considered the evidence we have provided or taken a simplistic approach that does not pass simple sense checks.

- New policy has been revealed late in the day, such as the benchmarking approach, and cost benefit modelling approach, and often does not take on board the feedback we have given.
- Key RIIO principles appear to have been set aside such as IQI upfront reward for forecasting being set on first plan, and allowances set on forecast plan benchmarking.

4.2 The Initial Proposals have been published with a number of calculation errors in the models that are used to derive each network's allowances. These are material in nature, so far Ofgem have confirmed Initial Proposals allowances are understated by £251m across the industry, 2% of proposed expenditure over RIIO-GD1. There remain unanswered errors that we have raised. This, and the complexity of modelling, has made full analysis of the allowances challenging. We welcome Ofgem's current audit of the allowance models, and will continue to work with Ofgem to resolve any outstanding errors. A re-run of the Initial Proposals numbers with these errors corrected would aid understanding of the proposed allowances.

5. Further work before the Final Proposals

5.1 There is still significant work to undertake to finalise and develop the incentive and uncertainty mechanisms prior to the Final Proposals.

5.2 As Ofgem have indicated, there is considerable work required to update and align the Licence drafting and regulatory reporting with the RIIO framework. This is an ideal opportunity to ensure that the regulatory reporting is rationalised to align with the key output commitments and requirements for benchmarking and to ensure the optimal balance of accuracy and detail versus materiality. The GDNs are working on a proposed new Regulatory Instruction and Guidance document and licence condition which governs this to support this aim and will be working with Ofgem on this prior to the Final Proposals.

5.3 Since the submission of our April Business Plan, two Government initiatives have emerged which are likely to materially impact the risk and returns for our business during the RIIO-GD1 price control period. These new issues will need to be addressed:

- DECC's 'Consultation on a proposed new power for Ofgem to compel regulated energy businesses to provide redress to consumers' which materiality affects the level of performance risk which the business is exposed; and
- ONS's consultation to consider changes to the formulae used to construct the RPI - which is likely to rebalance a number of judgements Ofgem will have made on real price effects and returns in putting together its proposals.

5.4 We look forward to working with Ofgem over the coming weeks to ensure to develop the robustness of analysis which will underpin the Final Proposal allowances and to ensure such allowances balance risk appropriately between customers and NGGD, provide a fair allowance for our networks against other comparative network operator allowances and enable NGGD to meet its statutory requirements underpinning vital customer priorities of safety and reliability.