

RIIO|GD1

Response to Initial Proposals Impact Assessment

National Grid
Gas Distribution

September 2012

Impact Assessment

The following responses address the questions raised within Ofgem's RIIO-GD1 Initial Proposals 'Supporting Document - Impact Assessment'.

Question: We would welcome stakeholder views on the assessment in this document and whether this represents an appropriate analysis of the impacts and risks that could be observed through implementation of the RIIO-GD1 initial proposals.

Overall Process / Impact Assessment

- 1.1 NGGD has been very supportive of the RIIO framework, embracing the principles that networks should be more transparent about the choices and commitments we make for consumers, ensuring that stakeholders' views are considered and acted upon and considering the longer term consequences of investments made on behalf of customers today and in the future. Ofgem have praised the fact that all networks have responded to this challenge positively and pulled together plans which sought to meet these well justified criteria.
- 1.2 It is therefore particularly disappointing that we have seen a set of Initial Proposals which differ so significantly from the well justified plans that we submitted for our networks through this extensive stakeholder discussions and process.
- 1.3 Ofgem suggest in their Impact Assessment (IA) that the manner in which GDNs have adopted the RIIO principles indicates that there is agreement that the framework is broadly appropriate, and provides the right level of risk and reward. We would suggest however, that the level of risk and reward, and any benefits from this new regime are not linked to the principles developed for the RIIO model but are dependent on the way these principles are interpreted and applied in practice. This is also recognised by Ofgem in paragraph 3.18 of the IA as a potential risk in interpreting and applying certain elements of the regime.
- 1.4 We believe that there are a number of elements in Ofgem's approach and interpretation that need further discussion before the full impacts, risks and rewards can be fully understood and acted upon. These have been summarised in our Executive Summary to our response to Ofgem's Initial Proposals and set out in detail in our responses to the specific consultation questions.
- 1.5 In a number of areas such as benchmarking, ongoing efficiency and real price effects, Initial Proposals is the first time we have had opportunity to see Ofgem's precise methodology. It is clear from our analysis that the proposals have not been sense checked and were published with a number of errors of calculation. We fully expect these errors to be corrected by Final Proposals (December 2012). In areas such as their financeability assessment, we are still unable to understand Ofgem's analysis and how they are satisfied it meets their policy intent.

- 1.6 In other areas (such as Ofgem's approach to investment appraisal) the approach taken in Initial Proposals has been predicated on a set of high level assumptions on the future uncertainty of the gas network, the potential for ground breaking innovations and availability of additional asset health data. These issues have been discussed between the networks, Ofgem and stakeholders throughout this process. We believe the adopted approach neither recognises the dialogue we have had with our stakeholders' views on how to balance the short and long term priorities around managing future uncertainties, nor reflects the sophisticated and well developed asset management approaches applied to determine the minimum total cost approach to meeting their requirements.
- 1.7 There are a number of other concerns with the overall process followed to reach Initial Proposals:
- Ofgem appear not to have fully considered the evidence we have provided, e.g. why we are exposed to higher costs and delivery risks due to the complexity of our London network.
 - There is a lack of transparency in the reasoning behind Ofgem's policy decisions. In areas such as their financeability assessment and cost benefit modelling, we are still unable to understand the analysis and how Ofgem are satisfied it meets their policy intent.
 - In addition, the Initial Proposals were published with a number of acknowledged errors of calculation and further analysis by the GDN's has increased that number four-fold.
- 1.8 Our response to Ofgem's IA reflects these concerns over the robustness of the assessment that has been carried out to determine its Initial Proposals. Comments directly related to Ofgem's IA headings are summarised below.

Impacts on Consumers

Delivery of network services at value for money for consumers

- 1.9 We disagree with Ofgem's assertion that "*We consider that our proposed investment will allow the GDNs to maintain the high standards of security on their networks (including complying with Health and Safety Executive (HSE) legislation*". As outlined in our response to Question 3 in the Cost Assessment chapter, we note that Ofgem's technical assessments for repex have not taken due account of our statutory obligations in relation to Tier 1 condition mains including small diameter steel, the HSE mandated Tier 1 taper and the disallowance of all vital asset integrity condition workloads (steel, asbestos and other non standard materials). This evidence was set out within the evidence we have provided in our plan.
- 1.10 We would also expect to see that Ofgem had given consideration of the fact that there are material differences in network workloads, specifically for repex despite a common cost benefit methodology and common requirement to comply with Pipeline Safety Regulations. The result that customers receive different service levels in

safety, reliability and efficiency across the networks should also be considered in this impact assessment.

- 1.11 Ofgem state: “*Our Initial Proposals set out a decline in investment expenditure in all areas*” as appropriate given the risk of stranded investment as the UK moves towards a low carbon economy.” We believe this is overly simplistic and potentially detrimental to customers both today and in the future. As we state in our response to Outputs, Incentives and Innovation Chapter 6 question 1, we believe investments should be considered on a case by case basis. Consideration should be made with regard to changes in legislative and commercial environment, asset lives and investment cycles and opportunity to trade off opex and capex. Our response to Cost Efficiency question responses to Chapter 7 outlines specifically why we disagree with Ofgem’s assessments in LTS Capex - Diversion, Security, Vehicles and IS Capex.
- 1.12 Ofgem outline the impact on network charges and on customers’ bills. Firstly, to understand the full impacts this needs to be demonstrated on a per network basis, as opposed to an industry average. The average impact on customer bills of £5 put forward by Ofgem does not show the range of impacts on customers of which is between -£4 to +£14 dependent upon network. The scale of these differences is not visible to customers or explained by the Initial Proposals relative assessment. Ofgem’s Impact Assessment requires further work in this area.
- 1.13 Secondly, the inclusion of IFRS tax change masks the significant underlying reduction in customer bills which, combined with our concerns over the scale of the cost efficiency challenge and the levels of output disallowance resulting from Ofgem’s investment appraisal approach, should receive full debate.

Focus on longer term

- 1.14 We agree with Ofgem that elements of the RIIO framework, including the eight year control and outputs regime, have encouraged networks to focus on longer term impact. We believe the impact on future consumers of the Initial Proposals requires further consideration by Ofgem. Given the materiality of output disallowances in some areas of Ofgem’s Initial Proposals, we would welcome an assessment by Ofgem on the impact on future consumers of bearing a higher proportion of this spend at a time when average use of the gas networks is potentially declining.
- 1.15 It can be seen from Ofgem’s assessment that additional risk will be carried forward into RIIO-GD2 (20% less mains risk removed would be completed in RIIO-GD1 under the Initial Proposals). There would also be a consequent reduction in the associated benefits from mains replacement such as carbon emissions from leakage reduction which will be lost.
- 1.16 Given our Tier 1 replacement activity has been reduced, the number of unplanned interruptions will be higher. Therefore it is likely that more customers will be see disruption from these interruptions and again into the future when the main will need to be replaced prior to 2032.

Innovation

- 1.17 Ofgem highlight the significant role that networks will play in delivering the government's low carbon targets and suggest that to achieve this transition, network companies "*will need to innovate at an unprecedented rate*". Yet in response to this challenge Ofgem are proposing underlying reductions in customer bills at the same time as holding back on allowing any network the full innovation allowance. We do not see how this will drive long term value for customers and deliver a sustainable energy sector.

Financeability

- 1.18 Ofgem's aspiration is to strike an appropriate balance in the context of networks' investment programmes, the financial package and uncertainty mechanisms. However, we believe that Ofgem's analysis is incomplete and does not allow this balance to be struck. Similarly, we do not believe that it makes appropriate consideration of the additional risks and working conditions encountered by our London network.

Greater opportunities for stakeholder involvement in the price control

- 1.19 Ofgem state that: "*there have been greater opportunities for consumers to engage in the price control process and influence these RIIO-GD1 Initial Proposals. This has helped to ensure that the price control better reflects their needs and therefore delivers in line with their expectations.*"
- 1.20 Networks have placed a much higher emphasis on stakeholder and customer engagement, and our stakeholders' and customers' requirements have been reflected in our Business Plan. As a consequence of this, we are concerned that stakeholders have in many instances not felt it necessary to respond directly to Ofgem's own consultations. This has led to Ofgem giving more weight to the very small number of responses received which, does not reflect the breadth and depth of discussions that networks have had.
- 1.21 While this increased engagement has given Ofgem greater confidence in networks' plans, it is not clear from the disallowances how Ofgem have actually taken this engagement on board in assessing the plans. We requested to see any feedback Ofgem had received from their Consumer Challenge Group whom all the networks met with during the plan development process. Ofgem have declined to release that information.
- 1.22 Throughout our engagement, we have tested with customers and stakeholders what they are prepared to pay to have the level of output they require delivered. Through our customer focus groups, customers confirmed a willingness to pay of between 3 and 10% more than current prices (based on a distribution element of £122 p.a.) with the two key output areas being safety and reliability, followed by environmental and social outputs.
- 1.23 Through our stakeholder workshops, various options have been costed and views sought throughout the stages of engagement. Views were sought on the overall

package put forward in our Business Plan with stakeholders (who are ultimately customers) providing support for the proposals. Stakeholders confirmed that the impact on customers' bills was "*as would be expected*". We have not seen any Ofgem analysis of customers' willingness to pay underpinning their Initial Proposals. This would have been an important piece of information to how short term and long term customer interests have been balanced.

Impacts on Competition

- 1.24 We have no specific comments on this part of the assessment.

Impacts on Sustainable Development

- 1.25 We are supportive of an outputs led regime but, as with our comments above, the customer benefits they will drive are dependent on the way the RIIO principles are interpreted and applied in practice.
- 1.26 We do not believe that the adjustments to outputs being proposed by Ofgem will meet one of the key drivers of RIIO - to encourage networks to play a full role in facilitating the transition to a sustainable energy sector. Some of these points have been discussed above.
- 1.27 Under Ofgem's Initial Proposals, and their assumption around the uncertainty of future gas flows, we are at risk of exposing our customers in the future to higher costs. Our plan had already proposed a significant reduction in replacement and asset integrity expenditure. Further cuts are unsustainable both in allowing us to meet our statutory requirements underpinning safety and reliability of the network (customers' top two stated priorities) and in balancing the short term costs and requirements of customers with the longer term. A key risk identified by Ofgem (table 3.4) was the need to consider the needs of existing and future consumers, and this has not been fully assessed.

Impacts on Health and Safety

- 1.28 The safety of the network is our stakeholders' and our own number one priority. As such Ofgem must enable us to adequately fund sufficient replacement to maintain/reduce risk and to meet our statutory safety and reliability requirements.
- 1.29 We set out in our main response how Ofgem's workload disallowances create specific risks in this area. Our analysis shows that the proposed replacement workload volumes would see 27% less risk removed from our networks over RIIO-GD1 than our plan. This is equivalent to not doing any replacement on one network for the period hence is a significant change to the outputs customers will receive. These outputs are being delayed on the basis of the 24 year payback period Ofgem have used to determine allowances for items not covered by the mandatory parts of the HSE's Three Tier Framework. We set out in our main consultation response why we believe this is not a good long term outcome for customers.
- 1.30 In addition, the benchmarking approach taken to the emergency resources, if not corrected, will put at risk the 2.1m carbon monoxide (CO) awareness visits that we committed to as part of the plan. This formed a key part of our efforts to improve the

awareness of CO and improve the safety of our customers. This output impact does not appear to have been assessed by Ofgem in its analysis.

Potential Risks

Potential non-delivery of the primary outputs

1.31 We have set out in our main response where, notwithstanding our views on the proposed workload reductions, we believe Initial Proposals have not proposed consistent primary output targets with the allowances given. These essentially relate to volumes associated with:

- Annual repair risk management
- Shrinkage and leakage
- Mains risk removed
- CO Awareness visits

Over / Under Estimation of allowance

1.32 We do not believe Ofgem have applied a robust assessment to sense check whether the Initial Proposals provide a fair allowance for the outputs being committed to. We set out in detail our views on this in the main response to the Cost Efficiency section of the consultation. Our analysis suggests that the Initial Proposals create a significant risk of under-estimation of allowances both at an industry level (through the creation of unrealistic notionally efficient network) and at a network company level (where we have demonstrated that allowances are unduly reduced for National Grid networks).

1.33 This section of the Impact Assessment does not highlight the risk that if allowances are not sufficient, then this puts output delivery significantly at risk. In addition, if allowances are not fair across the network companies then customers in some network areas may receive better outputs and services than in others. Given the clear discrepancies we have identified in the relative allowances for similar sized networks, we believe there is a real risk that NNGD's customers are unfairly disadvantaged.

Potential Regulatory Risk

1.34 We do not believe Ofgem have properly assessed the risks of their financeability response. They have not been transparent in the Initial Proposals about how they have assessed financeability (particularly in not showing their cash flow risk analysis modelling on determining and testing credit metric ratios).

1.35 Our assessment is that the Initial Proposals do not meet financeability metrics to maintain investment grade credit ratings. In addition, the unprecedented reduction in the proposed cost of equity of 0.55% (from 7.25 to 6.7%) and the range of plausible returns being offered through the combination of Ofgem's approach to setting cost allowances and the incentive mechanisms on offer provides a return range much reduced from GDPCR1 and other regulatory precedents such as DPCR5. This brings the significant risk that investors will be deterred from investing in gas distribution,

ultimately impacting in increased bills for customers. We do not see the evidence that Ofgem have robustly assessed that the returns they propose in the Initial Proposals are sufficiently reflective of the relative risks that investors face in funding gas distribution networks.

Anticipating the needs of future consumers

- 1.36 As set out above, there is limited evidence that the Initial Proposals have assessed the impact of workload disallowances on future customers' bills and the outputs they will receive. It was expected that the RIIO framework would place more weight on this aspect, in reality the Initial Proposals look similar to an RPI-X type approach to balancing existing and future customer needs.

Potential risk of interpretation and application of elements of the regime

- 1.37 We agree that the benefits of the RIIO regime are determined by how the principles are applied rather than the principles in themselves.
- 1.38 Where Ofgem have followed this policy intent of the RIIO principles, we have supported their conclusions, however there are a number of areas where the Initial Proposals' methodology appears to be moving away from the expected principles of RIIO (most notably in its proposed benchmarking approach to determining allowances). In some areas Ofgem's own analysis falls short of the same threshold of reflecting stakeholder views, justifying the analysis and conclusions that have been reached and properly balancing the needs of customers' needs in the short and long term.
- 1.39 This brings the risk that the benefits of the principles set out in the RIIO framework have not been translated in practice in terms of ensuring regulatory allowances and financing provisions are sufficient to ensure outputs can be delivered efficiently to customers over the long term.