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Dear Hannah

This letter introduces National Grid Gas Distribution's response to Ofgem's Initial Proposals for the RIIO-GD1 control. It should be read alongside:

1. An Executive Summary (appended to this letter) which highlights the key themes;
2. Our detailed response to the specific questions that Ofgem have raised in the consultation;
3. Specific detailed information and issues that we have raised in correspondence with Ofgem's team through supplementary questions and at working level meetings.

Having reviewed the Initial Proposals, we are concerned there are a number of material issues that require attention in Ofgem's approach to setting allowances and in the financial package for RIIO-GD1. Our issues are summarised under three broad themes:

1. Workload/Customer Output Disallowances

The Initial Proposals reduce the Outputs we had committed to customers on mains risk removal and leakage reduction by 20% compared to April Business Plan. This equates to a reduction from our plan of £149m p.a. on our mains replacement programme. Our response to the Initial Proposals outlines that the proposed allowances fail to fund work required under our statutory duties, and that the results of Ofgem's cost benefit approach to investment appraisal leads to inconsistent outcomes across networks and hence inconsistent outcomes for customers.

2. Cost Efficiency Assessment

We are concerned that the Initial Proposals set an unrealistic industry benchmark for efficiency improvements, by assuming networks will be able to absorb external cost rises through delivery of further efficiencies over and above those set out in our plans.

We are also concerned that Ofgem's relative efficiency methodology significantly understates NGGD's efficiency and continues to understate the additional cost of operating in central London.

There are high-level outcomes of the Initial Proposals which need further explanation. For example:

- The material disparity between the results of our networks' efficiency ranking between top-down approach and bottom up (e.g. West Midlands network is deemed the most efficient on a Totex approach and receives a 14% disallowance on the bottom-up approach).

- NGGD is required to deliver a similar set of outputs to the other GDNs with significantly less (c.20%) levels of funding (whatever normalisation approach is chosen).
- The London network is judged inefficient on almost all assessments even when our other networks lead; this in spite of the fact that all our networks are managed under a common operating model.

Our analysis has identified a number of areas where the cost assessment methodology could be improved, which would fully close the difference between Ofgem's Initial Proposals and our plan.

3. Proposed financial package

We believe that Ofgem's analysis of the relative risk of networks is incomplete. It produces a financial package that does not adequately reflect the risk that networks face, or allow an acceptable range of plausible returns.

It has been difficult for us to review Ofgem's financeability assessment, as Ofgem have not provided either the detailed analysis that has been performed, or the details of its financial stress-testing. When we attempt to reproduce Ofgem's calculations from the proposed allowances and proposed financial structure, and make corrections, our networks fail to achieve appropriate credit metrics in all years of RIIO-GD1 (and our London network by a significant margin). It remains unclear how Ofgem have assessed the network specific financial evidence we put forward for our London network in our April 2012 Business Plan.

We set out more detail on each of these three themes in our Executive Summary, and in the detailed response to the consultation questions.

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 in the Final Proposals, as below:

- 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.

We look forward to working with Ofgem over the coming months to Final Proposals on all of these areas to ensure that we have 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.

Yours sincerely



Helen Campbell