Workshop 2 – 3rd October

General opening comments / Comments on NGM Context Presentation

The following questions/points were raised:

1. Point was made at start of the Workshop that the comment from Steve Rowe (Ofgem) at the launch meeting regarding the influence that this process for Domestic might have on the regulation of the I&C market had resulted in a heightened awareness by the I&C parties that they needed to actively participate in this process. This point was a key driver in a number of issues that were raised during the workshop. Points made regarding RAV based on this concern were:
    a. Only appropriate as a regulatory instrument to determine regulated income streams.
    b. Know there is a delta between RAV as determined previously and carried forward; and current value of assets (in domestic and I&C). If any of this difference goes into I&C portion of RAV and this was used to regulate I&C tariffs in any form, this would further inhibit effective competition in this sector.
    c. If this delta all (including the delta attributable to I&C) went into domestic portion of RAV - this would be inappropriate for setting the domestic regulated income.
    d. Need to determine the most appropriate way of establishing the domestic portion of the RAV and not use the I&C portion for anything.
2. Point was raised by several attendees that more detail regarding the impact of each RAV approach would be very useful. Some considered that NGM needed to be more transparent and open regarding the detail of the model e.g. commercial bodies provide full accounts.
3. Need to consider the impact of the MSAs on the appropriateness of the RAV as a basis. Does it not push any delta between MSA and competitive commercial price into the regulated tariffs? Point made was that NGM could undercut in the MSAs and balance in the regulated tariffs.
4. The question was raised regarding what would happen if all the Big 6 signed MSA contracts at some point during the roll-out. Regulated tariff pool to balance model would then be very small.

RAV Assessment & Allocation (5 Methodology Discussion)

The following questions/points were raised:

1. Initially point was made that to assess options would not be appropriate due to:
    a. Short timescales unable to model/Analyse
    b. No figures provided to assess options.
2. Question asked of Ofgem regarding the rationale/drivers for such a short timescales.
3. Linked to initial concern regarding influence of this process on the I&C market, the question was posed for Ofgem regarding the appropriateness of using RAV here.
4. Concern expressed over the use of RAV as the basis of any regulation in the I&C sector:
    a. Only appropriate as a regulatory instrument to determine regulated income streams
    b. Now there is a delta between RAV as determined previously and carried forward and the current value of assets (in domestic and I&C) - and if any of this goes into I&C

portion of RAV and this was used to regulate I&C tariffs in any way, this would further inhibit effective competition in this sector. If this delta all went into domestic portion of RAV - this would be inappropriate as well for setting the domestic regulated income. Need to determine the most appropriate way of establishing the domestic portion of the RAV and not use the I&C portion for anything (I&C participants view).

5. RAV split methodology discussion – It was accepted that the issue of whether this process would influence the competitive nature of the I&C market would potentially change the comments regarding each option. The following points were made:
    a. Methodology 1 implies an "As is" approach and therefore not appropriate.
    b. Methodology 2 was seen as having merit since it would accurately demonstrate the value of both the I&C and Domestic business. Points made were:
        i. Not connected back to RAV then analysis would show correct value of the business.
        ii. What is the depreciated replacement cost of a like for likereplacement of all the meters across the whole business. This includes the logistics in doing this activity as well.
        iii. Agreed that I&C replacement costs could have a high degree of subjectivity due to the complexity and practicalities of doing it.
    c. Methodology 3: Similar to 2 but with the legacy (2002) figures rolled forward. Viewed as being more achievable than Methodology 2.
    d. Methodology 4 was viewed as not appropriate as it was measuring the I&C market, but then leaving any "unknown" in the domestic market.
    e. A new Methodology was proposed (Methodology 6) that in effect was the reverse of Methodology 4. The domestic sector replacement value was assessed and the remaining RAV sits with I&C. This was accepted as a possible approach since probably easier to undertake, but it would be useful only if the derived net I&C RAV was not used to regulate this market in any way.
6. Methodology 5 – follows a more economic approach for valuing a (I&C) business but leaves all differences between RAV carried forward and current value of assets in domestic RAV.
7. Group 2 in breakout session suggested a variant on Methodology 6 – this being the reverse of Methodology 5. The income associated with the domestic sector being assessed (possibly based just on MSA contracts) – and this being used to set the domestic RAV.

Rate of Return

The following questions/points were raised:

Network Rate as a base

1. This approach was suitable when first used but the market has moved on.
2. More appropriate approach might be based on market assessment of cost of capital for a metering business with a declining asset base (or similar entity) who is exiting a market.
3. Could ask a finance consultant house to give a suitable RoR for such a metering business (excluding risk of displacement time differences which is dealt via reopener).
4. If there was a Reopener in 2018 and it identified an over or under recovery to 2018:
    a. How would this be dealt with?

   b. The set of meters left in the period 2018-2020 is not going to be the set enjoying / suffering the under/over recovery in the period 2014-2018? This was viewed as not being fair.
   c. What if all of Big 6 on an MSA contract by then, such that only a very small number of meters were left on a regulated tariff to equalise over period 2018-2020.
   d. Is there an intention for some form of a claw back / rebate with the difficulties that this might present?
   e. If it looked like there was under recovery in period 2014-2018 as displacement was slower than expected, this could incentivise even faster displacement or move to MSA contracts so that party was not left in the regulated set that would be equalise. Reverse applies if there was over recovery.
   f. Might be useful if the reopener was on a % complete trigger rather than a time line?
5. Need to think through the impact of MSA on all of this. RAV / RoR / reopener etc.
6. How is all of this relevant to the setting of regulated tariff cap for non NGM GNs?

Risk Premium

The following questions/points were raised:

1. View was that 0.75% wasbased on a very dubious basis. Risk of different displacement timescales managed via the reopener. Therefore shouldn't be included in any risk premium. If it was it should arguably be negative given the displacement rate is almost certainly going to be slower than the DECC lower bound profile.
2. Reopener in 2018 could potentially result in large price swings.

Derivation of Tariff Caps and revenue requirements equation.

The following questions/points were raised:

1. Cross subsidy Issue: PPM is priced below the market rate and parties have been exploiting this with the result that the obligations holders (GDNs) could make a loss if their portfolio is weighted more to PPM. This issue could be made worse if the DCC does not have the prepayment infrastructure in place for SMART and more traditional PPMs are requested from the GDNs. Some relevant points are:
   a. Links back to asset transfer. GDNs that in this position could be seen as a distressed seller and not get a fair price for the assets.
   b. DECC should be informed of this issue, regarding SMART.
   c. Increased PPM rental charges would hit the poorest in society.
2. An overall revenue cap can affect other areas of the business due to the 6 box approach and how it is balanced in this approach.
3. As well as CDM/PPM split the age profile of assets is different between NG and other GDNs.
4. Question: why use DCM rentals only in the 6 box equation when cross subsidy exists?

Appendix - Group session RAV Allocation Methodologies

Group1

Option1	
Pros	**Cons**
• If I&C out it would be useful approach.	• Doesn't give right answer if I&C in
• Consistent with current arrangements	• No route to see if I&C is appropriate.
	• Couldn't explain to customer
	• Not transparent (Split rolled forward)
Option 2 (has to be transparent) – Option 4 variant on this	
Pros	**Cons**
• Does link to real world (ignoring RAV split aspect)	• Subjective/Practicalities of doing
• Can explain to customer	• Who does the assessment impacts the view of the outcome (competence issue)
• Info made public – useful to market.	• Energy Assets have done many of these already
• Would promote competition.	• Cost of doing
• Ask questions about correctness of RAV.	
• Cost of doing – transparency.	
Option 3	
Pros	**Cons**
• Have info for this one.	• If you are going to do why not do 2?
• Asks questions about the correctness of RAV.	• No view if good/bad approach.
Option 5	
Pro	**Con**
• Follows more economic approach •	• Impact on portfolios that are different.
	• Not consistent with Ofgem strategy on I&C competition.

Methodology 2,4,6 – Approach how to apportion RAV seem to have merit.

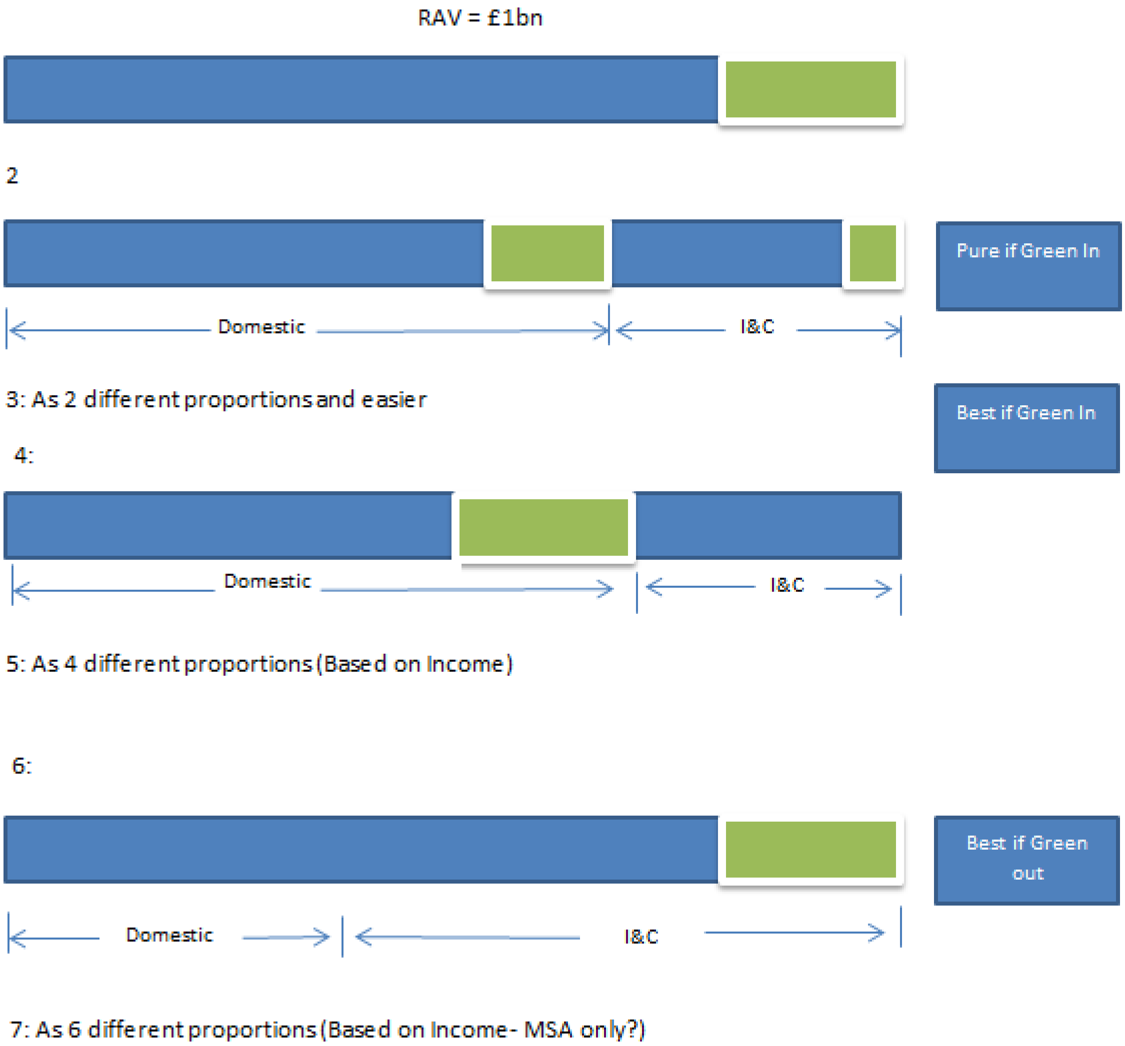
1. Methodology 2 – Better detail since both assessed. Still issue over regulation impact in I&C.
2. Methodology 6 (Reverse of 4)– Easier
3. Methodology 4 - better for I&C, but any delta then used in domestic price cap.

Issues

- Impact on other transporters if single tariff cap is applied.
- Methodology 4 – impact on other transporters.
- Point was made that the same level of work should be undertaken in this process as a financier would need to do in valuing the business.

Group 2

- Considered the principle of RAV as a regulatory tool for determining regulated income.
- Acknowledged that this is a common tool used worldwide in many regulated sectors.
- Also acknowledged that the RAV as determined initially and carried forward – can drift from the current value of the underlying assets.
- Modelled this effect for each of the options as below – with the RAV of approx. £1bn comprising the genuine value of the underlying assets (blue) and a difference compared to RAV as determined initially and carried forward (green – which could be +'ve, 0, or –'ve).



- None of the options considered appropriate as the basis of regulating I&C.
- Methodology 1 not considered appropriate.
- Methodology 2 considered the purest way of determining a domestic RAV - if RAV theory dictates that a regulated income should be obtained from any green above (difference between the RAV as established initially and carried forward, and current value of underlying assets). Acknowledge the non-trivial issues with determining the value of I&C assets in particular.
- Methodology 3 – considered the best way of achieving a methodology 2 like approach.

- Methodology 4& 5 – all the delta between RAV as established initially and carried forward, and the current value of underlying assets, is put in domestic – which is not appropriate.Methodology 5 alternative to 4 but drifts from the RAV theory which is based on asset value.
- Methodology 6 (domestic RAV determined from an assessment of the current value of these assets and the remainder attributed to I&C) - purest way of determining a domestic RAV - if RAV theory dictates that a regulated income should not be obtained from any green above (difference between the RAV as established initially and carried forward, and current value of underlying assets).
- Methodology 7 - (domestic RAV determined from an assessment of the income from the assets -probably using MSA contracts -and the remainder attributed to I&C) – alternative to 6 but drifts from the RAV theory which is based on asset value.