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Dear Joanna

Gas Distribution Price Control Review – Initial Consultation

Thank you for the opportunity to comment on the Gas Distribution Price Control Review (GDPCR) Initial Consultation. This response is on behalf of Scotia Gas Network's (SGN) two licensees, Southern Gas Networks and Scotland Gas Networks. We have attached in the Appendix to this letter our detailed comment on the issues raised in the consultation document, set out as suggested in line with the tables in Appendix 2 of the document.

Overall, SGN supports the objectives and process for the review both for the one-year control and for the main control. There are many issues to be considered in the review, some of which will be complex. The timetable for the one-year control is therefore tight, and we agree that it would not be efficient to duplicate consideration of any issue. As a consequence, we would urge Ofgem to focus in the one-year control on the issues which are key for 2007/08. In our view, these are:

- Establishing that historic capex was efficient and confirming the Regulated Asset Value (RAV) at March 2006;

- A full review of pensions costs needs to be carried out alongside the Transmission Price Control Review (TPCR). Following that, arrangements need to be put in place to allow recovery of the excess costs above those allowed in the current price control period and funding of pension scheme deficits. These could both be recovered through the main control review (subject to recovery from 2008 of interim financing costs) but at the very least the increased ongoing normal pensions costs need to be recognised in setting allowances from 2007/08.

- Removing DNs' exposure, through the costs of procuring shrinkage gas, to gas price fluctuations over which they have little control, including:

    - An increased allowance for 2007/08; and/or,
    - An incentive mechanism going forward from 2007/08 which reduces the exposure to price risk. We believe it is feasible to introduce such a mechanism as part of the one-year review; and
    - Capping for 2006/07 of the exposure to excess costs above those allowed. We would also still wish Ofgem to consider as part of the main review, the recovery of excess costs for years prior to 2006/07.

- Adopting a cost of capital, on a pre-tax basis, consistent with electricity distribution, with a full review of the cost of capital and tax at the main review.

We see no reason why each of these issues cannot be addressed within the context of a simple, roll-over one-year control, with no need for a full review of operating costs or a detailed assessment of future upward pressure of such costs.

We recognise Ofgem's desire to avoid if possible, licence re-drafting in the one-year control. However, we do believe that it will be necessary see re-set as part of the review for the one-year control, a number of the unit rates and other parameters within the repex mechanism, including increased allowances for connections, services associated with mains replacement and risers.

This would logically leave for the main review the remaining pensions and shrinkage issues referred to above, and other issues including:

- Assessing opex efficiency, including understanding each DN's actual costs;

- Reviewing forecast capex;

- Reviewing the effectiveness of the repex incentive, including whether it is still appropriate;

- Considering the potential for other new incentive mechanisms;

- Setting the cost of capital and modelling of tax; and

- Financing issues, including the balance between repex and asset lives for regulatory depreciation.

Our key reason for proposing that consideration of the cost of capital is part of the main review is due to the implications of moving to a post-tax cost of capital i.e. arriving at a tax allowance will take time given the links to for example, the assumptions made on repex. It is for this reason that SGN proposes retaining a pre-tax cost of capital for the one-year control. Moving to a post-tax methodology can then be more fully considered as part of the main review.

Finally, there are areas of overlap with other projects which have a large bearing on the GDPCR and in our view therefore need to be considered early in the process, these include:

- Exit Reform;

- SOMSA; and

- Independent Undertakings.

We hope that our comments on the Initial Consultation are of help. If would like to discuss further any of our points made, please call.

Yours sincerely

Rob McDonald
Director of Regulation

Appendix

<u>Scotia Gas Networks</u>

<u>Response to the Gas Distribution Price Control Review – Initial Consultation</u>

Detailed comments:

1. <u>Issues for early decision:</u>

<u>Para</u>.

2.24 **Related projects**

- *Are there any other projects which Ofgem should take into account in the context of the Gas Distribution Price Control Review (GDPCR)?*

There are several other projects which impact on GDPCR. We discuss each of these in more detail below, however in summary we agree that the key related projects are:

- o The Transmission Price Control Review (TPCR). The review of pensions and capex overspends will establish principles which are of significant relevance to DNs;
- o The regulatory treatment of xoserve, which could lead to major industry change;
- o The regulatory treatment of Independent Undertakings. In our view, due to DTI policy that GB-customers should fund the excess cost of these networks, it would be sensible to consider this issue alongside the TPCR; and
- o NTS Exit reform and DN Interruptions reform. These reforms could have a large impact on DN costs and risks, for example on the requirement for diurnal storage, and therefore it is essential that GDPCR is flexible to any proposals.

In addition, we would add (and again we discuss each of these further below):

- o The SOMSA arrangements whereby National Grid provide operational control systems to DNs. DNs need to make early commercial decisions if they are to exit from SOMSA contracts at the earliest opportunity and bring control systems in-house. Therefore, the regulatory treatment of the transitional costs needs discussion early in the GDPCR process;
- o Reducing fuel poverty, for example extending gas networks into rural areas; and
- o Security of supply and the economic outlook for gas in the long term, given rising prices and increasing gas imports.

3.3 - 3.7 **Objectives and framework**

- *For the purposes of setting GDPCR, what should Ofgem consider to be the outputs of a GDN?*

For discussion, we would suggest that the outputs of a DN include:

- Price - providing an economic and efficient network;

- Safety – of employees, customers and the general public;

- Capacity – for third parties wanting to connect to and use the network;

- Quality of service – in providing connections to the network and responding to supply interruptions and customer contacts;

- Asset integrity – long-term reliability and resilience of the network; and

- Recognition of environmental and social responsibilities.

- *What services offered by GDNs are valued by consumers and what aspects of GDNs' activities give rise to concerns?*

Clearly customers value an economic, safe and reliable network, also efficiency in any dealings they have with the DNs.

We agree that better measurement and reporting of quality of service outputs can incentivise improved performance. In our view, an efficient DN needs this in any case for its own management purposes, and to this end SGN is actively working with Ofgem to further improve reporting systems.

However, we do not believe that an incentive regime that replicates the quality of supply arrangements in electricity is appropriate, as the nature of supply interruptions in gas is different (i.e. the majority of interruptions are planned and tend to be of longer duration). It is for consideration whether expansion of the customer survey would be preferable.

We do however believe that there is a need to rationalise the Overall, Guaranteed and Connections Standards, to make them more focused and less confusing to customers. We discuss this further under Outputs below.

- *Are the objectives for the review proposed by Ofgem appropriate?*

Overall, SGN supports the objectives and process for the review both for the one-year control and for the main control. There are many issues to be considered in the review, some of which will be complex. The timetable for the one-year control is tight, and we agree that it would not be efficient to duplicate consideration of any issue. We would therefore urge Ofgem to focus in the one-year control on the issues which are key for 2007/08. In our view these are:

- Establishing that historic capex was efficient and confirming the Regulated Asset Value (RAV) at March 2006;

- A full review of pensions costs needs to be carried out alongside the Transmission Price Control Review (TPCR). Following that, arrangements need to be put in place to allow recovery of the excess costs above those allowed in the current price control period and funding of pension scheme deficits. These could both be recovered through the main control review (subject to recovery from 2008 of interim financing costs) but at the very least the increased ongoing normal pensions costs need to be recognised in setting allowances from 2007/08.

- Removing DNs' exposure, through the costs of procuring shrinkage gas, to gas price fluctuations over which they have little control, including:

    - An increased allowance for 2007/08; and/or,

  - An incentive mechanism going forward from 2007/08 which reduces the exposure to price risk. We believe it is feasible to introduce such a mechanism as part of the one-year review; and
  - Capping for 2006/07 of the excess costs above those allowed. We would still wish Ofgem to consider as part of the main review, the recovery of excess costs for years prior to 2006/07.

- Re-setting the allowed cost of capital at a level consistent with electricity distribution companies, against which gas DNOs have to compete for funding.

We see no reason why each of these issues cannot be addressed within the context of a simple, roll-over one-year control, with no need for a full review of opex allowances.

We recognise Ofgem's desire to avoid if possible, licence re-drafting in the one-year control. However, we would also wish to see re-set as part of the review for the one-year control, a number of the unit rates and other parameters within the repex mechanism, including increased allowances for services associated with mains replacement and risers.

This would logically leave for the main review the remaining pensions and shrinkage issues referred to above, and other issues including:

- Assessing opex efficiency, including understanding each DN's actual costs;
- Reviewing forecast capex;
- Reviewing the effectiveness of the repex incentive, including whether it is still appropriate;
- Considering the potential for other new incentive mechanisms;
- A full review of the cost of capital and modelling of tax; and
- Financing issues, including the balance between repex and asset lives for regulatory depreciation.

6.87 - 6.92 **xoserve**

- *Are the current funding arrangements for xoserve satisfactory and if not, should change be limited to refinements on the status quo or more substantial reform?*

The Initial Consultation suggests that it may be appropriate to give shippers greater influence over the range and quality of services provided by xoserve. It also cautions that any major change will be a significant project, impacting also on the UNC and SPAA. Ofgem also note that xoserve's price control should not fund its commercial activities.

We have some fundamental concerns with the funding of xoserve. Essentially, xoserve's function is to facilitate competition in supply. To support this xoserve is currently proposing significant capital expenditure to replace existing systems. This in turn raises questions about how xoserve is funded, through the DNs, especially given that suppliers are the main beneficiaries. The effect is that under the current arrangements, unless DNs recover their costs in full and are protected from "cost creep", their incentive is to resist such change.

A fundamental review of xoserve will take time. Therefore, in the context of the one-year control we would wish to see a relatively simple roll-forward of the current arrangements. However, given for example that the number of Network Code changes does not seem to be falling, also that in practice we question how much control a DN has over xoserve costs given that National Grid has a majority on the xoserve Board and that the majority of xoserve costs are NG contractual costs which have not been actively market tested, we would support a more in-depth review. Therefore, we consider that moving to a position whereby xoserve has it's own licence and/or price control, together with a "user pays" model, has merit and should be considered as part of the main review.

7.2 - 7.4 **Process**

- *Should Ofgem conduct its consultation process in a different way to the process outlined in Chapter 7?*

SGN supports the well-proven price control review process proposed, including consultation documents, seminars, bi-lateral meetings and Authority committee meetings.

We also believe that the Ofgem Working Group is a very useful forum for understanding individual views. However, we would comment that any sub-groups which may be set up should be time-limited and also that control is exercised to avoid duplication of work between groups.

Regarding the use of external consultants, we would urge Ofgem to develop their expertise and understanding "in-house" wherever possible. Where consultants are appointed, the quality and funding should be consistent with the outputs required.

7.5 - 7.8 **Use of impact assessments**

- *How should Ofgem incorporate Impact Assessments into the price control process?*

Although we agree that the Final Regulatory Impact Assessment (RIA) in the electricity distribution price control review (DPCR4) represented a useful alternative means of presenting information, we question the value of an overall RIA in a process like a price control review. In particular, we would not wish to see resources diverted from price control issues. There is merit in our view to restricting RIAs, as suggested in the Initial Consultation, to important new initiatives. These should be supported by Appendices which set out the cost/benefits of different policy options.

7.9 - 7.11 **Timetable**

- *Is the timetable shown on page 66 appropriate and are there any issues that the draft timetable does not sufficiently take into account?*

We have already commented above on the timetable as regards the split of issues between the review for the one-year control and the main review.

There are also areas of overlap with other projects which have a large bearing on the GDPCR and in our view therefore need to be considered early in the process and linked to the GDPCR timetable. These include:

- Exit Reform – for example, how should DNs take into account in their capex submissions their requirements for diurnal storage?;

- SOMSA – we discuss this further below; and

- Independent Undertakings – we also discuss this further below.

Additionally, the timetable for the review is essentially a two year project, with the review for the one-year control leading into the main review. There is much to be done and it will be vital to keep to the timetable. It is therefore to all parties benefit to spread the workload as evenly as possible, and the proposed timetable tries to do this. It is also efficient that any issue is reviewed once only wherever possible, to avoid duplication and uncertainty. Therefore we would caution Ofgem against trying to do too much in the one-year control, hence our comments above that the focus should be on a thorough review of a limited number of issues e.g. historic capex, pensions and shrinkage.

The Initial Consultation also suggests starting collection of data early because of expected difficulties with historic data. While we support this in principle, it will help if the detailed review of opex costs and efficiency is carried out as part of the main review. We understand that one of Ofgem's intended work areas for the one-year control is historic capex. A detailed review of opex costs, and in particular the Activity analysis, will be complex and to request detailed historic opex costs as part of the BPQ for the one-year control, risks diverting time and resources from the consideration of capex.

The consultation states that it is intended to review a substantive amount of 2006/07 data, due to 2005/06 being an exceptional year and not reflecting the impact of the new management teams. 2006/07 will be the first full year of operation under new ownership but is still likely to be an atypical year given the ongoing work on establishing systems. As a consequence, while 2006/07 will be an important data set, we believe that comparisons across DNs in that year will be difficult.

With regard to the collection of data through the BPQ, we support the conclusions of the Assessment of the DPCR4 Review Process. In particular, we agree with respondents' view that much of the data collected was not used. Therefore we would encourage Ofgem, when issuing the BPQ to focus on the purpose for which the information is going to be used.

Finally, we support the development of the Cost Reporting Framework and an early start on legal drafting.

2. <u>Issues for initial views:</u>

Chapter 4 **Principles for the conduct of the review**

- *Are the proposed principles for the conduct of the review appropriate?*

The general principles set out in Chapter 4 of the Initial Consultation seem sensible. However, we have some comments on how these principles will be applied in the one-year control and the main control.

<u>RAV roll-forward</u> - Ofgem propose to adjust the RAV:

- for actual January 2001 to March 2005. However, given that Ofgem will have 2005/06 outturns, we see no reason why the RAV could not be updated to March 2006;

- for the projection of capex to 31 March 2008. We are strongly of the view that this should be on the basis of DNs' current projections and not the forecasts submitted at the last price control review, since the latter are known to differ from actual and expected spend.

Rolling capex incentive - Although we support in principle the use of a rolling capex incentive going forward, and we discuss this further below, it is of concern that Ofgem also intends to apply a capex roller retrospectively "in line with its March 2004 open letter". This letter introduced the concept of three categories or "Pots" of expenditure. Historically capex has either been treated as "Pot 3" i.e. efficient and therefore included in the RAV, or "Pot 1" i.e. inefficient and not allowable, although we are not aware of examples in previous price control reviews where this has been the decision. A capex roller introduces the concept of "Pot 2" i.e. expenditure which is efficient but which is not allowable until five years after the expenditure occurred. In the meantime, companies may have to bear the financing and depreciation costs.

The open letter was not consulted on or agreed (although it did provide helpful guidance ahead of the DN sales). Indeed, it stated that "… it will be appropriate to consult widely …". Therefore, in our view, Ofgem cannot simply state in the Initial Consultation that a retrospective capex roller is in place. Our belief is that historic capex is either efficient and allowable in the RAV from the date of expenditure (i.e. "Pot 3"), otherwise inefficient and not allowable (i.e. "Pot 1"). Clearly, we believe that all of SGNs expenditure during the current price control period is efficient and should therefore be included in the RAV as "Pot 3".

Repex – The Initial Consultation claims that variations between April 2002 and March 2007 are captured by the repex mechanism. In general this is true, but as noted above we would wish to see as part of the review for the one-year control, re-setting of some of the unit rate and other parameters within the repex mechanism (e.g. connections allowances, services and risers).

In particular, we are concerned about the treatment of services replaced as part of the mains replacement programme. The open letter of 4 October 2004 stated that any variances from allowances would be treated as capex, and presumably subject to the capex roller. However, we are concerned that the Initial Consultation states that this may be reviewed (unlike the capex roller) and we need early clarification on what is intended. We are strongly of the opinion that this expenditure was non-discretionary and therefore is "Pot 3".

As noted above, we believe that a full review of the effectiveness of the repex mechanism is appropriate for the main review.

Shared assets – Ofgem state that it may be appropriate to make a downward adjustment to DNs' RAVs for shared assets, but with a compensating increase in allowed revenue. This issue is relatively small, however if re-visited could be complex given all the issues that were involved in separating DN price controls and "sculpting" RAVs. The RAV does not reflect physical assets and any adjustment would simply be a transfer between IDNs and National Grid. We do not believe there is any benefit to customers from re-visiting the Shared Assets issue.

Non-operational capex – It is appropriate in our view to allocate non-operational capex to the RAV. Such expenditure, for example whether on information systems, furniture, transport or buildings, will all have different economic lives all of which exceed five years (i.e. the traditional period of a price control). Therefore, to treat this in the same way as opex, by giving an allowance each year for the period of the control, gives no certainty about recovery of overall costs.

5.10 – 5.14 **Setting the one year control – capital and repex**

- *What is the appropriate scope of the work on capital and replacement expenditure and what techniques should Ofgem seek to use in assessing capital and replacement expenditure.*

Ofgem intend to look for any evidence of inefficiency in capex/repex over the period January 2001 to March 2007, and outputs delivered. Given the complexity of the capex spends and the data issues about the allocation of cost allowances we believe that a bottom-up analysis is preferable to a variance analysis. To try to compare actual expenditure and outputs with the projections at the last review (e.g. changes in outputs and unit costs), will be difficult given the uncertainty over the breakdown of the allowances between DNs.

We also do not believe there is value in re-visiting the RAVs for the period January 2001 to March 2002. National Grid would have to provide the information, and in any case this will be confused by the issues involved in separating the price controls and "sculpting" RAVs. To the extent that there is a material difference between the forecast closing RAV at the end of the last price control period and the outturn position, this should be a matter of bi-lateral discussion between NGG and Ofgem. In the interests of regulatory certainty there should be no adjustment to the DN RAVs.

In grouping costs for review, a split between LTS & Reinforcement, connections (net of contributions), non-mains replacement and other capex seems appropriate. Projects are best reviewed by carrying out a detailed assessment of a sample of projects, especially where large projects may cover more than one category of expenditure and splitting the costs may be subjective.

The review for the one-year control also needs to establish principles about how capex will be assessed as efficient or not, especially if a capex roller is to be introduced going forward. In principle we believe that customer-driven capex, investment to meet security of supply and replacement are non-discretionary and deliver significant customer benefits. Such expenditure should in our view be allowable in the RAV from the date incurred i.e. "Pot 3".

5.17 – 5.26 **Setting the one year control – operating expenditure**

- *What is the appropriate scope of work on operating costs for the one year control?*

We believe that the tight timetable for the one-year control means that the review has to be kept as simple as possible, proportionate to a one year control, but that there are two key issues which need to be addressed: pensions and shrinkage allowances.

- *What approach should Ofgem use to set the operating costs allowance for 200708?*

Due to the significant excess of current pensions and shrinkage costs over the current allowance, SGN would wish to see for these costs which are to a significant extent outwith DNs direct control, addressed in the one-year review. In particular, we believe that Ofgem should set an allowance in 2007/08 for expected costs of shrinkage and pensions in 2007/08 with other costs allowed at current levels. A roll-forward of actual 2006/07 costs would go some way toward this but would still expose DNs to risk, especially in regard to shrinkage. Indeed, we could not accept a roll-forward of the current price control allowance.

While we note Ofgem's points about forward-looking efficiency assumptions, it is also evident that there are many areas that are producing an upward pressure on operating costs over and above the pensions and shrinkage costs. We have discussed these issues with Ofgem separately. In our view, if Ofgem attempt to assess actual costs going forward, it will also need to take into account these additional pressures. Given the tight timetable we believe that this points to a simple roll-forward of actual costs in 2005/06, plus the adjustments for pensions and shrinkage noted above, and followed by a full review in 2007/08.

- *What approach should Ofgem adopt for shrinkage for 2007-08?*

Shrinkage is the gas lost in the system, primarily through leakage. Allowances for shrinkage in the current price control were fixed in £m terms, based on volumes (with an improvement assumption built in) and an assumption on gas prices. Gas prices are currently three to four times higher than at the time of the review, and significantly more volatile. These price rises were not expected, and are unlikely to fall back, given that gas reserves are finite and the increasing reliance on imports.

We believe that it is vital in the context of the one-year control, to adjust the shrinkage allowance for 2007/08 to reflect the increase in gas prices and also review the incentive to procure shrinkage gas efficiently. The DNs have already suggested a number of alternative incentive mechanisms, and we will be writing to Ofgem shortly with further thoughts on our suggested mechanism.

We also believe that there is a case for recovery of the overspends in the current price control period. Shrinkage allowances in the current price control are fixed, based on gas prices at the time of the last review. The major and sustained rise in gas prices, over which DNs have little control, has exposed them to major excess costs which in any other circumstances would have triggered a request to re-open or disapply from the price control. We therefore believe that these excess costs should be capable of recovery.

At the very least, we believe that Ofgem should consider capping DNs' exposure in 2006/07 to further gas price rises, given the scale of these costs and risks to the DNs.

- *Should Ofgem apply the principles relating to pensions costs to GDNs as part of the one year control or the main review?*

We believe that it is sensible to carry out a full review of pensions alongside the National Grid pensions review (i.e. alongside TPCR), as IDNs have significant financial interests in the National Grid/ TPCR pensions review.

We agree that the same broad principles as established in DPCR4 should be applied in GDPCR, including:

- Recovery of current period (2002-2007) excess costs for DNs, including a return from the time these costs were incurred;
- DN deficit repair over average service life;
- Increased allowances for 2007/08 onwards;
- Need to include costs of Pensions Fund Levy. SGN is in discussion with the Pensions Regulator to minimise these costs; and
- A "true-ing" up mechanism for the next price control period.

5.28 – 5.29 6.56 – 6.58 **Setting the one year control – incentives**

- *Should rolling incentives be applied for capital, replacement and operating expenditure for the one year control?*

SGN supports the use of rolling incentives going forward. The capex roller when combined with the sliding scale mechanism as applied in DPCR4 should in our view ensure capex spends close to forecast. We discuss this in more detail below under the sliding scale mechanism.

An opex roller going forward represents a strong efficiency incentive and we believe is vital for the next price control period, especially for 2007/08 (the one-year control), to avoid perceived periodicity problems. If the Cost Reporting Framework is put in place as proposed before the start of the next price control period, there is no reason in our view why a forward looking opex roller could not be considered for 2007-2013. There is a wealth of academic evidence to support opex rollers, including Ofgem's own report from Frontier Economics.

However, we are concerned about the retrospective application of the capex and opex rollers to the current price control period. Retrospective regulation undermines the fundamental principle of the predictability of regulation and a minimum cost of capital.

We have already commented on the capex roller above. However, Ofgem is also considering whether to apply an opex roller with effect from 1 April 2003. We would be firmly opposed to this, since it was not highlighted in advance and would therefore undermine incentives going forward. We also note that historically, opex rollers have only applied to underspends (i.e. they are asymmetric), reflecting the nature of operating costs.

We would also question how a retrospective opex roller would work, given that increased pensions and shrinkage costs which are outwith a DNs control. There may also be no consistency between DNs due to the high level methodology used to split Transco's price control between the DNs, which in our view led to some DNs having tighter price controls than others. A retrospective opex roller would exacerbate such differences and reward/penalise DNs simply as a result of the allocation of opex allowances rather than genuine relative efficiency.

As we discuss elsewhere, we agree with Ofgem's proposal to update the parameters of the repex mechanism for 2007/08 but leave a more detailed assessment for the main review.

5.31 – 5.38 **Setting the one year control financial issues**

- *What issues need to be considered when providing a cost of capital allowance for the one year control?*

We note that Ofgem intend to adopt a post-tax approach going forward and provide separately for tax, following a detailed study of relevant theory and data during 2006 which we understand will be available for the Final Proposals for the one-year control. However, we would caution against this for the one-year control. Switching to a post-tax cost of capital will involve careful modelling of tax. Tax is impacted by repex, the switch to IFRS, the Inland Revenue and assumptions made on gearing in setting the allowed cost of capital. Therefore we would urge Ofgem to retain a pre-tax cost of capital for 2007/08, and consider a post-tax cost of capital as part of the main review. This would also be consistent with keeping the one-year control as simple as possible.

We believe that gas DNs are inherently more risky business than electricity DNOs, given the volatile nature of gas. We therefore believe that, at the very least, the 6.9% pre-tax cost of capital applied recently in DPCR4 is a reasonable assumption for the one-year control. In particular, we would see no justification for applying a lower cost of capital given that gas DNs have to compete with electricity DNOs for capital. Applying the 6.9% assumption for the one-year roll-over would be straightforward and would allow a fuller review as part of the main price control.

- *What issues need to be considered when providing a tax allowance for the one year control?*

If it is decided to adopt a post-tax approach with an explicit tax allowance for the one-year control, it will be important to maintain incentives (i.e. reward those companies that manage their tax affairs efficiently). For this reason we do not support pass-through of actual corporation tax.

Instead, we support the arrangements developed for DPCR4 (i.e provide an ex-ante tax allowance of expected company-specific tax costs). In this regard, Ofgem should note that there is no historical tax information for the DNs other than the opening capital allowance balances at DN sales.

- *What analysis should Ofgem perform in relation to financeability and financial modelling for the one year control?*

The financial model developed as part of DPCR4 was a comprehensive model, and a very useful piece of work, but it was not for the “lay reader” and required a lot of “maintenance”. We would support developing a simpler model, based on rationalising the DPCR4 model, for GDPCR.

Setting the main control

6.6 – 6.15 **Structure of the price control**

- *Should Ofgem consider setting GDPCR for a period other than five years?*

We support the continued application of the RPI-X methodology, which in our view provides strong efficiency incentives.

We also see no reason at this stage to depart from a five year price control period i.e. apply the main price control for 5 years from April 2008. We believe that five years represents an appropriate balance between efficiency incentives and risks to Ofgem and companies of changing circumstances.

- *Should the current volume-based revenue driver be retained? Should it be modified? Should Ofgem introduce any other form of revenue driver?*

The volume driver is intended to reflect changes in costs arising from changes in demand. Under the current control 65% of allowed revenues are fixed and 35% is variable on throughput. Conversely, current charging structures are such that actual revenues are 65% variable and 35% fixed. This variability exposes DNs’ revenue to significant risk from changes in weather.

We therefore support in principle Ofgem's proposal to move to a charging structure based more on capacity, which should remove much of the variability in actual revenue.

With regard to allowed revenue, the 65/35 split already recognises that gas demand is more variable to weather than say in electricity distribution, where there is a 50/50 volume driver split. However, we do agree that the extent to which this reflects costs needs to be assessed as part of the main review. However, if Ofgem intend a thorough review of operating costs and forward looking efficiency as part of the one-year review, then it would be vital to include the extent to which current revenue drivers reflect costs as part of that assessment.

- *Is the pass-through mechanism that applies under the current price control review still appropriate?*

The pass-through mechanism currently applies to prescribed network rates and Ofgem licence fees. In our view a pass-through mechanism is still appropriate for such costs, which are not in DNs' direct control.

- *Should any other costs be subject to the pass-through mechanism?*

In DPCR4 pensions costs were also treated as a quasi-pass through cost, where an ex ante allowance was given and "trued-up" to actual costs. This would also seem an appropriate mechanism in gas distribution.

Most controllable costs are allowed for within the main price control. However, there are some significant cost areas which are known but where the impact is variable (e.g. tax and shrinkage). In DPCR4 tax was allowed as an ex ante allowance, thereby maintaining incentives to manage tax affairs efficiently. Shrinkage however and in our view, is suited to its own incentive mechanism, and we have suggested a mechanism to Ofgem based on the average of DNs costs.

There are a number of other potentially significant new costs which are currently uncertain as to their timing and size, for example costs arising from the Traffic Management Act (TMA). Ofgem's preliminary view is that it is not appropriate to introduce formal mechanisms to deal with uncertainty associated with potential new costs arising between price control reviews. In DPCR4 a mechanism for dealing with uncertainty was introduced, relating in particular to the TMA and to new obligations arising under the Electricity Supply, Quality and Continuity Regulations (ESQCR). TMA is also an issue for DNs and we would expect this mechanism to be extended to gas.

- *Are any changes required to the correction mechanism that applies under the current price control?*

We see no reason why the mechanism for rolling forward under/over recoveries at the end of the price control period needs to be changed.

The Initial Consultation states that prices that remain stable are more likely to benefit customers than charges that fluctuate and infers that revenues which might cause such variability (e.g. incentives mechanisms), are logged up and recovered at the next price control. This would significantly undermine the incentive properties of such mechanisms. Incentive mechanisms exist in electricity distribution and gas transmission and cause variability in prices year on year, but we are not aware of concerns from suppliers or customers. We would therefore be firmly opposed to any suggestion that revenue due under incentive schemes should be "logged up" to the next price review.

6.16 – 6.22 **Scope of the price control**

- *Is the scope of the current price control appropriate for GDPCR?*

We agree the proposed scope of the price control, which would cover:

- o All distribution charges (other than charges for excluded services); and
- o Connections, to the extent that they are provided free under statute/licence (where funded by customers these are treated as an excluded service).

Ofgem also intend that the GDPCR will not consider metering charges as these were removed from the price control in 2002. However, in our view it is appropriate to consider the removal of the "last resort" metering obligation from DNs, and hence the caps on metering charges will no longer be required in DN price controls (though it would clearly be retained by NGG). The DNs do not own meters, for example the IDNs did not acquire meters as part of the DN sales process, as these were retained by National Grid Metering (NGM). SGN is not a meter operator, and to become a Meter Operator would involve significant costs in establishing the required systems. The "last resort" obligation has to therefore be sub-contracted by the DNs. In our view, the obligation to provide metering services therefore lies clearly with NGM.

- *Which services provided by GDNs should be considered to be excluded services?*

Excluded services currently include:

- o Connections and construction for third parties;
- o O&M for third parties including emergency services;
- o Provision of operational consultancy to third parties;
- o Provision of services to other members of the same corporate group; and
- o Miscellaneous (including the provision of training and information services, and sales of electricity, to third parties).

We are not at present seeking to change these. However, there are also a number of services provided to National Grid, including work carried out for NGM, which are currently regarded as de minimis activities but are excluded by derogation from the de minimis cap. We believe that these contracts are better defined as excluded services.

6.59 – 6.64 **Sliding scale incentives**

- *Should Ofgem adopt a sliding scale mechanism similar to that used in DPCR4 to encourage more realistic BPQ submissions?*

We support the use of the sliding scale incentive developed as part of DPCR4, to encourage companies to forecast accurately. Under this scheme, companies effectively choose between a lower allowance with higher incentive rates, or a higher allowance but relatively smaller reward for underspending. Companies that choose the lower allowance receive a small amount of additional reward. Combined with a capex roller this mechanism should ensure companies forecast capex accurately and spend close to forecast to make maximum returns, otherwise they would have been better off submitting a different forecast. A forward-looking capex sliding scale mechanism could therefore have strong incentive properties during the next price control period.

6.96 – 6.102 **SOMSA**

- *Should Ofgem respond to the new developments in relation to SOMSAs and if so how?*

SOMSA was a transitional arrangement to facilitate DN sales, whereby National Grid provide operational control systems to DNs. Ofgem and the DNs are aligned in their aim for earliest exit from SOMSA and bringing control systems in-house. As a consequence, DNs are currently exploring with National Grid the most efficient way to do this.

SGN has looked into developing its own systems. However, while we recognise Ofgem's view that separation costs will not be allowable in the price control, the current GTMS system will need replacing in the next price control period and the most efficient way may be to do both at the same time in a structured way. DNs need to make an early commercial decision on the way forward and therefore need early engagement with Ofgem on how costs are likely to be treated in the price control. To that end DNs have already initiated meetings with Ofgem.

On a final point, the current derogation for SOMSA expires at the end of March 2008 and will need extending to accommodate a structured exit from SOMSA.

3. <u>For information, other work to be carried out as part of the main review</u>

We have set out below our comments on the miscellaneous issues raised in the Initial Consultation.

<u>Capital and replacement expenditure</u>

In assessing DNs' capex and repex projections for 2008-2013, it will be important to understand each DN's internal asset management policies. as well as understanding the usual "bottom up" modelling of costs.

Ofgem intend that the main BPQ will ask for forecast information up to 2018. Given the uncertainty of forecasting this far ahead, we would suggest that this information will be of limited use. As a consequence, this should only be provided at a very high level for the purposes of identifying any potential "cliff faces" in antcipated expenditure.

<u>Operating expenditure</u>:

We believe that top-down benchmarking of total controllable operating costs (whether on 4 ownership groups or 8 DNs), will be of little value in this review. For example:

- 2004/05 may have consistent accounting policies but it was the same management team i.e. Transco. In addition, Ofgem would need to satisfy themselves about the consistency of the allocation of costs between DNs;

- 2005/06 will be an atypical year and will not reflect the impact of the new management teams; and

- 2006/07 will be the first full year of operation under new ownership but will still be an atypical year and can only realistically be used to test other analysis of costs.

Instead, it is our view that Ofgem should develop a good understanding of each DN's actual costs, working towards being able to benchmark DNs at the next price control review in 2012. To this end, we support the development of the Cost Reporting Framework.

In the meantime, the efficiency of actual costs can be tested by benchmarking a selection of individual activities using unit costs where appropriate drivers can be identified. However, we would caution against carrying out an activity-based analysis at a level that is too disaggregated. Our experience of disaggregated cost models is that they often just provide more opportunities for costs to be allocated differently across companies, which includes comparison. We would therefore urge Ofgem to limit any such comparisons to a high-level matrix with a full comparative analysis, using consistent data applied through the reporting process at the 2012 review.

We do not believe that external benchmarking (e.g. electricity DNOs), adds much value in efficiency exercises, due to the difficulty to obtaining comparative data on a like-for-like basis.

Ofgem welcomes views on whether a number of different techniques can be brought together by weighting. In our view, it is not likely that any agreement could be achieved on this, particularly the relative value or weight. Any such analysis therefore risks arbitrary outcomes at least in the context of the current review. Instead, we believe that Ofgem would obtain greater benefit from a thorough understanding of each DN's cost base.

All DNs will have reasons why their costs are higher than other DNs because of inherent and inherited differences in their networks. In past price control reviews it has been assumed that most of these will even out across companies. However, it has been recognised that there are special circumstances in relation to working in London and in the remote areas of Scotland. This needs to be recognised for SGN's two licensees and we will be costing these factors in our BPQ submission.

To summarise, rather than focusing on benchmarking for the one-year and indeed main review, Ofgem should set future allowances based on a starting point of each DN's actual costs in 2005/06 and 2006/07. To avoid the periodicity problem, particularly in 2007/08, Ofgem should supplement this by making it clear that any efficiencies in that year (and indeed throughout the 2008-2012 period) will be retained for future years using the opex roller mechanism.

In addition to this, there are a number of factors putting a significant upward pressure on DN operating costs. In brief, these include:

- Above RPI increase e.g. contractors charges and salaries. All utilities are competing for a limited contractor pool, with major investment programmes, and this puts pressure on contractor prices;

- Skills shortages;

- A developing "compensation culture";

- Rising insurance premiums;
- Network Code changes – linked to the issue of the treatment of xoserve funding discussed above;
- Working Time Regulations – will lead to the need for additional staff where we operate a 24 hour service e.g. emergencies;
- Occupational Health Regulations;
- Working at Height Regulations – every gas holder site needs to be upgraded.

In the context of the one-year review, we can understand that Ofgem will not wish to carry out an assessment of each of these costs. However, if Ofgem is not willing to simply roll forward the 2005/06 outturn costs (subject to adjustments for pensions and shrinkage costs) and instead wishes to assess prospects for future efficiency, then it will be vital for Ofgem to also assess in detail the impact of these and other cost pressures. As noted above, for the main review, Ofgem should in our view use the actual costs of each DN as the starting point, followed by the an assessment of future costs, including the factors outlined above. In this regard, incentives for future efficiency will be vital.

On a final point in relation to the assessing of efficient costs, we do not believe it is appropriate to remove related party margins from the calculation of future allowed revenue, unless it can be demonstrated that such margins are exessive or inefficient. Removal of all internal margins would distort the incentives on companies to seek the most efficient solution between sourcing in-house and outsourcing.

<u>Shrinkage</u>

We have commented on shrinkage above. We will be writing to Ofgem with further thoughts on how an incentive mechanism might be applied in time for the one-year control.

<u>Outputs</u>

In our view safety outputs are for the HSE rather than Ofgem/ the price control.

We have briefly commented on quality of service above. In summary:

- Outputs currently include the number and duration of interruptions, a customer survey and environmental measures;
- We support the continuing improvement in the accuracy and consistency of measurement, and we are working with Ofgem to this end;
- We do not think that an incentive scheme similar to that in electricity distribution is appropriate, due to differing nature of interruptions (i.e. there are fewer unplanned interruptions in gas, but they tend to affect more customers and are of longer duration);
- We believe there is a need to rationalise the Standards of Performance. For example, the Overall Standards could be removed or brought into the RIGs. There are also too many Connections Standards, these are confusing and could be rationalised with a much clearer focus. The Guaranteed Standards need reviewing as to whether they are meaningful and measurable; and

- o SGN would support the introduction of a Customer Reward Scheme per DPCR4 e.g. priority customers, corporate social responsibility.

Capacity

As the Initial Consultation notes, it is of course necessary to avoid duplication of reward through offtake incentives and the capital expenditure allowance. It is equally important to avoid reward being missed altogether. It is for this reason that Exit reform is integrally linked with the price control review. In this regard, we are concerned that this timetable for exit reform and the price control review business planning process are currently inconsistent. An early view of the proposals for exit reform is therefore required or alternatively a mechanism needs to be put in place to allow revisions of capex plans once exit reform is finalised.

We do however agree with the proposal to analyse the relationship between changes in capacity and costs. As part of this, it will be necessary to consider the extent to which the current revenue drivers in the price control framework are reflective of underlying costs.

Long-term network reliability

Correct interpretation of Asset Risk Management standards should avoid any need for additional indicators to avoid short-term incentives for efficiency and delivery of outputs leading to perverse incentives to neglect the longer term reliability of the network. We therefore see no need for any new initiative schemes or reporting in this area.

Cost reporting framework

As we have said above, we support the development of a set of tightly defined reporting requirements which build on the BPQ and reflect the basis on which the control is set in 2007-08.

Mains replacement

As noted above, there are several components of the repex mechanism which in our view need to be reviewed. For example:

- o An additional category is required for large diameter mains;
- o Replacement of services associated with mains replacement were not allowed for;
- o The actual costs of risers is more than the allowance, by a factor; and
- o Various unit rates do not reflect increases in contractor charges.

We would therefore support a relatively simple roll-forward of the repex mechanism for the one-year control, and believe this can be done while avoiding re-drafting of licence conditions (i.e. with some adjustment of unit rates and allowances for services and risers). We accept that to introduce an additional category for large diameter mains may need to be deferred to the main review.

In the main review, we would wish to see a full review of the effectiveness of the mechanism, including the sharing proportions with customers. The mechanism was introduced at a time when workloads were uncertain. Now that workloads are understood more fully, it is for consideration whether this mechanism is necessary or whether it could be dealt with in the same way as other capex.

The issue of expensing repex v. shorter regulatory asset lives needs also needs careful thought, taking into account the tax and financing issues.

Financeability and financial modelling

We continue to believe that the broad requirement to "maintaining an investment credit rating" remains the most appropriate approach. However, we look forward to reviewing Ofgem's forthcoming joint consultation with Ofwat on these more general financing issues.

Other issues

- Independent systems:

  Scotland Gas Networks has four LNG and one LPG Independent Undertaking. These local networks are not connected to the DN's transportation network, instead gas is transported by road or ship.

  Undertakings are in place on DNs and NTS to ensure that customers connected to independent systems pay no more than the average GB charge for gas transportation. These are interim arrangements expiring on 31 March 2008.

  These arrangements need to be correctly reflected in both TPCR and GDPCR, therefore there is a need for early consideration in the GDPCR timetable. We believe that a simpler mechanism for achieving the DTI's policy objection ought to be found. For example, there are a lot of parallels with the hydro-benefit replacement subsidy in electricity which is recovered from all uses of the transmission systems on a simple basis. In our view, a broadly similar mechanism should be introduced in gas for the SIUs, with the costs paid directly to the NTS.

- Connections:

  - DNs currently have an obligation to provide the first 10m of a new connection free of charge. However, Ofgem have suggested in the past a review of the 10m rule. Any review would clearly have an impact on BPQ submissions and clarification of the position is therefore required;

  - Since the onset of a competitive market in connections, there is pressure from IGTs, in particular, to improve the accuracy of the mains records maintained by DNs beyond that historically required. There could be significant costs involved, especially if such records were to become more of an asset database rather than a geographic record. This potential new costs will need to recognised in the price control allowance.

- The current water ingress arrangements need simplifying.

- There is a need to recognise environmental cost pressures, for example:

  - Decontamination costs;

  - Waste Regulations; and

  - Discharges from gasholders.

- Fuel poverty issues, such as extending rural networks will need careful thought.

- DNs are being pushed to provide more services for IGTs, including on the scope of emergency cover and metering. In our view, charges to IGTs should be cost reflective, which is not the current position. Our concerns are that firstly DN customers, and that cost recovery should include indirect costs e.g. sub-optimal work scheduling.