



Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Tel: 01738 456400

29 August 2006

Joanna Whittington
Director of Gas Transportation
Ofgem
9 Millbank
London
SW1P 3GE

Dear Joanna,

Response to the Gas Distribution Price Control Review – Second Consultation Document

Thank you for the opportunity to comment on Ofgem's Second Consultation Document in the Gas Distribution Price Control Review (GDPCR). Our main points are summarised in this covering letter, and focus in particular on the one year control. Our detailed, and other, comments are set out in the Appendix to this letter, following the form of the questions raised in the consultation document.

We support the transparent process that has been adopted by Ofgem during the GDPCR to date and look forward to continuing to work with Ofgem towards an acceptable price control.

Our main points arising from the consultation document are as follows:

- We agree that due to the time constraint the review of the one year control should be kept as simple as possible, while ensuring that licensees are not unfairly disadvantaged from the simple roll-over process;
- A prime concern in the one-year control is the rolling forward of the regulatory asset value (RAV) and the recovery of capital and non-mains replacement overspends. We continue to believe that all of the overspend should qualify for "pot 3" funding and that the return and depreciation funding for prior year investment should be funded in full in 2007/08. However, we also believe that, at the very least, any overspend classified as "pot 2" should be included in the RAV at 1st April 2007, rather than the balance of five years from when the investment was made;
- Cost of capital – We would support retaining a pre-tax approach for the one year control to leave this complex area for the main price control given its interaction with areas such as increased repex capitalisation;

- There has been significant upward pressure on the costs of procuring shrinkage gas due to the increase in gas prices. This is beyond the control of the GDNs, and it is not appropriate for GDNs to be fully exposed to the risk of changes in the price of gas. We therefore welcome Ofgem's proposals for a new mechanism to incentivise shrinkage and we believe that option 1a is most likely to achieve the relevant objectives;
- Pensions – We support the adoption of the principles established in DPCR4. We agree that the same principles should be applied to pension cost recovery as applied in the electricity distribution review. This means that the one year control will need to reflect increased employee contribution costs and deficit repair payments. Provided the rest of the price control package is reasonable, it may be appropriate for Ofgem to commit to recovery of these costs, but for actual funding to occur in the main control. In addition, we believe that the one-year review will need to address the issue of over provision of pension costs by licensees between 2002 and 2007, compared to the assumption underpinning the price control. We consider that these adjustments, consistent with previously declared Ofgem policy, should accrue to each DN licensee;
- Other operating expenditure – We believe that the most straightforward approach would be for Ofgem to use the agreed 05/06 costs, net of atypical items, as a baseline for setting allowances, with no explicit efficiency assumption. This would unwind the anomalies in the existing allowances as a result of the NG allocation model and return to customers savings made in the last four years (as would be the case if a full review were being undertaken). The lack of a forward-looking efficiency assumption would (arguably) offset consideration of future cost increases in 2007/08;
- Repex – We welcome the commitment to update the parameters in the mains incentive mechanism. We would also support expanding the scope to include splitting the >12” diameter band to reflect the wide range of unit costs in this category and a mechanism to enable the recovery of riser costs; and
- Volume Driver - As part of the one year review we believe that it will be necessary to update the baseline volumes in the price control formula. If this is not the case, GDNs will receive gains or losses depending on changes in volumes relative to the baseline volumes presently enshrined in the formula (which were originally set in 2001 and are now out of date). This adjustment would only require small changes to the overall formula and, as a consequence, would not require excessive effort for the purposes of the one-year review.

I hope that our comments are helpful. If you have any questions please call.

Yours sincerely,

Rob McDonald
Director of Regulation

Scotia Gas Networks plc**Response to the Gas Distribution Price Control Review – Second Consultation Document****CHAPTER TWO****Question 1: Should Ofgem retain the form, structure and scope of the current price control during the one year control?**

We agree that due to the time constraints the review of the one year control should be kept as simple as possible, while ensuring that licensees are not unfairly disadvantaged from the simple roll-over process. To that end, we support the retention of the form, structure and scope of the current price control for the one-year review, with some updating of allowances. In particular, it will be necessary to make changes to reflect the actual and projected RAV to 07/08 (including the 07/08 capex forecasts), as well as pension costs and reform of the present shrinkage arrangements. This approach to the one year review will also mean that it will not be necessary to revisit these issues in the main review (i.e. work will not be repeated).

Certain other simple adjustments will also be necessary in the one year review in relation to volumes distributed and the parameters of the repex mechanism, with more substantive reform of the volume driver and the repex incentive mechanism delayed until the main review.

Question 2: Should Ofgem introduce a new revenue driver other than the volume driver and, if so, what variable should it be linked to?

We agree that the 35% variability of allowed revenue to changes in throughput does not reflect changes in underlying costs and needs reviewing. The present circa 65% variability of collected revenue to changes in throughput compounds this effect, with the net result that GDNs' revenues are significantly exposed to changes in volumes while their underlying costs are largely fixed. The variability of collected revenue is being considered as part of the review of the structure of gas distribution charges with a view to fixing a larger proportion of collected revenue, and we support this.

With regard to the volume driver(s) in the price control, the key point is that it should reflect GDNs' underlying costs and changes in underlying costs. In our view, this would be better reflected by linking revenue to the number of customers. The consultation document also asks whether other drivers should be considered, such as the number of connections and/or load growth. It is unlikely that the volume driver could adequately capture the complexities of different mixes of connections or load growth schemes. In our view, these are better dealt with through robust capital expenditure incentives.

In any event, we agree that further work is required on the nature and form of any revenue driver as part of the main review, rather than the one year control. However, as part of the one year review it will be necessary to update the baseline volumes in the price control formula. If this is not the case, GDNs will receive gains or losses

depending on changes in volumes relative to the baseline volumes presently enshrined in the formula (which were originally set in 2001 and are now out of date). This adjustment would only require small changes to the overall formula and, as a consequence, would not require excessive effort for the purposes of the one year review.

Question 3: What revenue and/or costs should be treated as excluded/de minimis/pass through? What principles should be used to classify revenues and/or costs as excluded/de minimis/pass through?

There are certain costs which are beyond GDNs' control, or are not controllable within the price control period, and have traditionally been treated as pass-through costs in network price controls. These include licence fees and prescribed rates, and we see no reason to change the treatment of these costs.

There are certain other costs that are not within the price control but are for a 'permitted purpose' i.e. for the licensee's transportation, metering or meter reading businesses. This includes connections work. These costs are presently treated as excluded services largely due to the unpredictability in the volume of work and because the costs are not separated from price controlled work. We continue to believe that the provision of these services should be allowed to earn a reasonable margin, otherwise there is no incentive to efficient service provision.

We also note that Ofgem is considering as part of its review of competition in connections bringing the provision of domestic one-off connections within the price control. We see no need at this stage to change the treatment of connection costs as the underlying reasons for treating them as excluded services have not changed, and they are still regulated directly by Ofgem (through approval of the charging methodology and the determination of disputes). Including connections in the price control would also be inconsistent with the electricity sector, where the recent electricity distribution price review concluded that connections should remain outside of the price control.

Finally, there are activities carried out by the regulated resource but which are not for a 'permitted purpose'. These are classed as 'de minimis' activities and the total level of such activities is capped in the licence. However, these currently include a range of services which the GDNs and NTS provide to each other such as emergency arrangements, metering work and SOMSA services. The DN network sales has confused the treatment of some of these activities and they are currently treated as de minimis activities rather than excluded services, with a derogation to exclude them from the de minimis cap. In our view, these are legitimate activities of the licensed business and should be treated as excluded services. This could easily be achieved by clarification of the definition of 'permitted purpose' to include any gas network activity in the UK.

Question 4: Should Ofgem link some or all of allowed revenues to a price index other than RPI?

As noted above, the price control should reflect GDNs' underlying costs, and changes in such costs. A major part of our cost increases, particularly capital and replacement

expenditure are not likely to be closely correlated with RPI. This is in a large part due to the demand for limited resources, particularly due to substantial investment programmes in the other utilities and other major infrastructure projects such as Terminal 5, the Channel Tunnel Link and now the 2012 Olympics. In our view, the construction output price index more closely reflects underlying cost increases and will continue to do so.

However, there are concerns that rival indices may be less stable than RPI. As a consequence, rather than link the price control to the construction price output index or even a basket of indices, we believe it would be more appropriate to capture such cost increases in price control allowances or as efficient additions to the RAV through a robust incentive mechanism.

In light of this, we would support retention of RPI as the price control index.

Question 5: Should Ofgem specify certain issues that could be the subject of a reopener and, if so, which issues?

The consultation document suggests that licensees can apply to disapply the price control in the event of exogenous price shocks. This is indeed true, however we do not believe that a complete price control ‘re-opener’ is appropriate where for example there is a change of law or where it is currently known that costs will be incurred but the impact is not currently known. In the latter case, prime examples are the Traffic Management Act and the Transport (Scotland) Act, where it is not possible to predict the take-up of road charging schemes or the level at which charges will be set, but it is certain there will be a major impact. We believe it is appropriate therefore to include a specific ‘re-opener’ in the licence to provide for this, such as was introduced into electricity distribution licences in DPCR4, and we welcome the confirmation in the price control document that Ofgem are proposing to do this.

More widely, there is a significant risk of further changes in legislation during a price control period. These have included in the current period for example tightening of the Working Time Directive and the Working at Height Regulations. These and others will lead to changes in working practices and increased operating costs as well as increased training costs. We therefore believe that a mechanism for dealing with uncertainty should also include a reference to relevant change of law (possibly subject to a materiality threshold), as well as specifically the Traffic Management Act. In the absence of a mechanism for ‘dealing with uncertainty’/changes in law, it will be important that these costs are not only reflected in allowances but also captured in the RAV as efficient expenditure.

CHAPTER THREE

One year control issues

Question 1: Is our approach to carrying out ex-post assessments of historical efficiency appropriate?

We have written separately to Ofgem about the PBPower/Rune draft reports on the efficiency of historic capex. We note that, in our view, little evidence was found of inefficiency.

Against this background, we are concerned about the matrix set out in the consultation document for allocating expenditure to particular “pots” for the purposes of cost recovery. We recognise that this is not straightforward, but we believe that the guidance issued by Ofgem as part of the gas network sales process set out a clear expectation that the rolling capex mechanism was not *automatically* in application (and if Ofgem policy was that the rolling mechanism applied, this raises the question of why publish the extra guidance at all). We do not therefore believe that “pot 3” cost recovery should be limited to the narrow criteria of “work that was timely and justified by a new external driver”. In our view, a policy which applied pot 3 funding to all efficiently incurred investment would be consistent with Ofgem’s previous guidance and would provide appropriate incentives going forward.

Such an approach would not, in our view, represent a “reopening” of the previous price control, but simply form part of the normal ex-post assessment of actually incurred capex one would see as part of the price review process. By contrast, disallowing GDNs from recovering the value of past efficient investments could increase perceptions of regulatory risk and deter otherwise efficient future investments.

We also note that “pot 2” recovery involves licensees bearing the costs for a full five years rather than for the interim period to the next price review. This seems particularly inequitable given the obvious uncertainty about the incentive regime that applied during the present price control period (and that uncertainty is evidenced by the apparent need for Ofgem to develop a brand new set of criteria). As a consequence, we believe that at the very least consideration should also be given to putting pot 2 investment into the RAV at 1st April 2007 rather than waiting for the balance of five years from the date that the investment was made. As we understand it, this is also the approach that has been applied by Ofgem to the overspend in the transmission price control review.

Finally, we believe that the return and depreciation due on pot 3 investments prior to 07/08 should be recoverable in full in the one-year review (i.e. the retrospective recovery of financing costs should be allowed in full in the one year review).

Question 2: Is our proposed regulatory treatment of our conclusions on efficiency appropriate, transparent and practical?

See our comments above in relation to the RAV for the period from April 2002 to March 2007.

For the period January 2001 to March 2002, we support the principle of allocating any positive additions to the RAV by size of DN, but we have yet to see any definitive quantification of the adjustment. We note that it will be inappropriate to apply an overall efficiency assumption to this as it will include RAV originally in other price controls as well as investment differences between actual and forecast, for example

offtakes originally in the NTS TO price control and data loggers in the Metering price control.

Question 3: Is our initial view on how to set capital and replacement expenditure allowances for 2007-08 appropriate?

We believe that capex and repex allowances for 07/08 should be based on the forecasts supplied by the GDNs, subject to the normal review processes by Ofgem and their consultants. We would be firmly opposed to a process based on adjustments to the historic capex program, when the GDNs were under different management and given that uncertainty clearly exists as to the basis on which the last price review was set.

We welcome the commitment to update the parameters in the mains incentive mechanism. We would also support expanding the scope to include splitting the >12” diameter band to reflect the wide range of unit costs in this category and a mechanism to enable the recovery of riser costs. Riser replacement is unlike normal replacement activity and therefore needs to be incentivised differently. In particular, it is for consideration whether there should be the option to remove gas from high rise buildings in some circumstances, although we recognise that it would be necessary to consider the wider policy implications, for example on fuel poverty.

Question 4: Which of our options is most appropriate for setting the operating expenditure allowance for 2007-08?

We support the separate treatment of shrinkage and pensions. For the remainder of operating costs, we believe that the most appropriate option would be to base future allowances on the 05/06 outturn, subject in the case of SGN to a few adjustments in relation to atypical items.

We would be particularly opposed to the roll forward of present opex allowances for 2006/07 as this would exacerbate the known errors in NG’s transaction model which was used to split the LDZ price controls. We believe that rolling forward the existing allowances would be inconsistent with the outcome that would have arisen had a full five-year price control been implemented. Such an approach would also not return to customers any savings made before 2005/06.

Whichever approach is adopted, we note that Ofgem also intend to consider a forward-looking efficiency assumption. We are particularly concerned about the suggestion of rolling forward the efficiency assumption implicit in the current price control. We do not believe that this is appropriate without a full consideration of the upward cost pressures being faced by GDNs in 2007/08. It will also be necessary to provide an allowance for GDNs to achieve any efficiency savings assumed by Ofgem up front for 07/08 (bearing in mind that such savings usually require a cost to deliver equivalent to one year or more of the anticipated savings). Finally, any setting of a forward-looking efficiency assessment would require a robust assessment of regional factors, as they apply to each DN.

For all of these reasons, we believe that the most straightforward approach would be for Ofgem to use the agreed 05/06 costs, net of atypical items, as a baseline for setting

allowances, with no explicit efficiency assumption. This would unwind the anomalies in the existing allowances as a result of the NG allocation model and return to customers savings made in the last four years (as would be the case if a full review were being undertaken). The lack of a forward-looking efficiency assumption would (arguably) offset consideration of future cost increases in 2007/08.

Main control issues

Question 5: Is our proposed approach for setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?

We broadly agree with the approach outlined by Ofgem for assessing investment in the main review. We believe that consideration should also be given to supplementing the assessment of GDN forecasts with an information quality incentive, in common with the approach taken in the recent electricity distribution review.

With regard to Asset Management Systems, SGN support a mechanism where good practice is recognised and rewarded and incentives put in place to invest in effective asset management processes.

Question 6: Is our proposed approach for setting operating expenditure allowances for 2008-09 to 2012-13 appropriate?

As Ofgem recognise in the consultation paper, there will be limited data available on which to undertake a robust benchmarking exercise in the 2008 review. Indeed, since the base year for much of the work on the main review will be 05/06 (with limited time available for review of 06/07 numbers before the final proposals), any comparison will simply reflect the different circumstances across DNs, rather than genuine variations in efficiency. It may, however, be possible to benchmark support costs (IS and HR) against other utilities such as electricity distribution.

In any event, by 2012 the separate DNs should be sufficiently established to allow benchmarking across companies, using similar techniques as have been used in the electricity sector (although recognising that there are fewer comparators).

Question 7: How should we deal with the uncertainty surrounding the level of costs associated with the Traffic Management Act?

As stated above, we support Ofgem's proposal for a specific dealing with uncertainty mechanism to be included in the price control consistent with the approach adopted as part of DPCR4. The alternative approach of setting an ex ante allowance will be difficult given the uncertainty about the exact level of costs.

Question 8: What are your views on our principles for assessing GTMS replacement costs, SOMSA exit and ongoing system operation costs?

The consultation document sets out clearly the principles to be applied. A process now needs to be established to collect the information required to distinguish between costs which are lost economies of scale/separation costs and efficient GTMS replacement costs.

We note that ongoing aggregate operating costs will be capped at current NGG level. However, in applying this principle the costs of additional functionality will also need to be taken into account.

CHAPTER FOUR

One year control issues

Question 1: Is Ofgem's initial view on how to update the mains replacement incentive mechanism for 2007-08 appropriate?

We welcome the confirmation that the assessment of the efficient unit costs of mains replacement and real price effects will be used to update the parameters of the mains replacement mechanism for the one year control.

Question 2: Is Ofgem's initial view on rolling incentives during the one year control appropriate?

SGN supports in principle the introduction of a capex roller from 1 April 2007. However, it is not yet clear what the distinction is between Option 1 (extend the existing approach for an additional year) and Option 2 (apply the agreed method for the main control to the one year control). In any event, we believe that Ofgem should commit to applying the capex roller for 07/08 and the duration of the main price control period. If clearly stated in advance this will provide strong incentives for capex efficiency, which will hopefully avoid a repetition of some of the issues that have arisen in the present review.

In the context of the main review, we believe that consideration should be given to automating the capex roller in the price control formula. This would mean that adjustments to revenue to reward savings (or penalise overspend) of capex are made in the year following the saving (or overspend), instead of "logging up" or "logging down" adjustments for the next price control period.

With regard to an opex roller, the problem of periodicity in the current framework was recognised in Ofgem's previous reviews of network incentives. We therefore believe that there is a compelling argument for the introduction of a five-year (or longer) opex roller in the main review. Given that there are no issues in relation to deferral of opex (arguably unlike capex) and given the obvious practical difficulties with any alternative, we consider that the opex roller should be a one-way mechanism. As above, we believe that consideration should also be given to annual settlement of an opex roller scheme rather than "logging-up".

Question 3: How should Ofgem determine shrinkage allowances? Should Ofgem adopt one of the options presented in this chapter or a different option?

We welcome Ofgem's commitment to deal substantively with shrinkage costs as part of the one-year control, and strongly support the introduction of a shrinkage incentive mechanism from 1 April 2007.

We do not support Option 2 (equivalent to the treatment of losses in electricity distribution) at this stage as it is too complex, too soon until measurement problems are overcome and in our view adds nothing to Option 1.

We also consider that Option 1b (benchmarking of DNs average costs) will be difficult to apply in practice and leaves too many factors impacting on relative positions which are outwith DNs' direct control.

Therefore, of the options put forward we agree with Ofgem that Option 1a (reference to forward prices) is preferred. However, we believe there are refinements to be considered, particularly in relation to relative swings in price within month.

SGN's fuller assessment of the options is summarised in the following table.

Criteria	1a. Predefined index of market prices		1b. Benchmarking the GDNs' costs of procurement of shrinkage gas		2. Remove GDNs' responsibility for procurement
Price risk removed?	✓	GDNs can follow the efficient procurement strategy of month-ahead purchases (following the mechanism highlighted in appendix one) and not be exposed to uncontrollable price risk. Exposure to within-month price risk is under review.	✘	GDNs could procure more cheaply as compared to a market price index – but still be exposed to gas price risk as it has not performed as well as another GDN. Additionally 'poor performance' could be due to bad luck rather than bad judgement because of the highly volatile nature of the gas market.	✓ Gas not purchased by GDNs so no risk.
Volume risk removed?	✓	SGN are assuming the 'pass through' costs are based on final demand – and thus GDNs are not exposed to this uncontrollable risk.	✓	SGN are assuming the 'pass through' costs are based on final demand – and thus GDNs are not exposed to this risk.	✓ Gas not purchased by GDN so no risk.
Good performance rewarded	✓	If GDNs purchase shrinkage gas at a lower price than the allowance (based on the month ahead index) then they will be rewarded the difference, and will absorb the cost if they are less efficient.	?	If the benchmark is the lowest cost GDN then no GDN would be rewarded - as all, apart from the best performing, would be penalised.	✘ Gas not purchased by GDN so not able to out perform other GDNs.
Transparency and financial planning allowed?	✓	Projected allowed costs, based on DS7 forecasts and year ahead gas prices, allow realistic budgets to be set and efficient financial planning at the start of the year (and during the year as projections can be adjusted).	✘	Allowed costs are dependent on the performance of other GDNs, which is not known until the end of the financial year.	✓ Gas not purchased by GDN so not applicable.
Accounts for variations in GDN demand profiles?	✓	Allowed costs based on monthly price index – which allows for the 5%* range in average price paid by GDNs due to the relative shape of their yearly shrinkage profile.	✘	Some GDNs will have higher costs due to greater relative volumes in months of higher gas prices. This option does not take this into account.	✓ Gas not purchased by GDN so not applicable.

* Based on SGN analysis using uniform shrinkage volumes and procurement strategy across the year

Question 4: Should Ofgem carry out any further work on incentives as part of the one year control review, other than those set out in paragraphs 4.1 to 4.23?

We agree that the areas noted above should be the main focus for the one-year review.

Main control issues

Question 5: Should the interruptions and NTS offtake incentives on the GDNs be part of the overall RPI-X price control or separate incentives with caps, collars and sharing factors? How should the price risk for each of these incentives be addressed?

We believe that appropriate incentives are vital to the success of this area of work and would therefore welcome future discussions to develop these. However, we have a number of concerns about the present offtake incentives, in particular the fact that the present form of incentive penalises “normal” and efficient procurement of offtake capacity in the ordinary course of business. For example, DNs’ are exposed to all of the risk of unanticipated demand growth triggering requirements for more offtake capacity. We regard this as unacceptable. The present incentive scheme is also excessively complicated and has already led to unintended consequences. In addition, we are concerned that the proposed incentive scheme for the interruption regime may lead to similar issues.

We therefore believe that consideration should be given to alternative incentive arrangements such as a basket of various quality of supply measures, with an overall cap and collar on exposure. This basket of measures could include a telephone customer survey, some of the existing Guaranteed and Overall Standards, other quality of supply standards as appropriate, as well as targets in relation to offtake and interruption. The overall basket of incentives could then be subject to a single cap and collar.

In our view, such an approach would be a proportionate incentive scheme, which would avoid the complexity and risk of unintended consequences associated with the alternatives. As a consequence, we believe that such an incentive scheme would sit alongside the RPI-X framework, in a similar manner as the IIP scheme in electricity distribution.

Whatever the form of the incentive scheme, clarity on the detail behind offtake and interruption reform is urgently required, if we are to be expected to capture the resultant investment in the BPQ for the main review. At the very least, we will reserve the right to revisit our investment plans until the offtake and interruption reforms are finalised as both of these could result in significant additional investment.

Question 6: Is it appropriate to adopt rolling incentives and an information quality incentive mechanism for capital expenditure for gas distribution? If so, what should be the features of the incentives?

As noted above, we support in principle the introduction of a capex roller in the main review. We also believe that consideration should be given to annual settlement of the

capex roller rather than logging up or down any adjustments to revenue until the next price control.

We also continue to support the introduction of an information quality incentive. This scheme was introduced in the electricity distribution review and provides strong incentives to forecast capex requirements accurately. It therefore complements the capex roller (which provides incentives to deliver the agreed investment program as efficiently as possible).

Question 7: Should the mains replacement incentive mechanism be carried forward in its current form, adjusted for particular factors such as service pipes, or abandoned in favour of a more generic incentive?

If the existing mechanism is retained, there are particular issues that need to be addressed e.g. large diameter mains and risers. However, we believe that the appropriateness of the mechanism should be reviewed and consideration given to treating repx as capex within the context of a capex roller.

Question 8: Is it appropriate to adopt rolling incentives for operating expenditure for gas distribution?

As noted above, we believe that an opex rolling incentive would be appropriate in gas distribution. The periodicity problem remains an issue with network regulation. In addition, Ofgem's proposals in relation to more standard regulatory reporting should remove the practical objections to the introduction of the opex roller.

Question 9: How can the quality of service arrangements be improved? In particular what are your views on the high level options proposed by Ofgem for the quality of service and outputs arrangements for 2008-2013?

In our view, various current and future incentives should be combined to form a basket of measures against which incentives are applied. This approach would avoid complexity, and prevent inappropriate behaviour resulting from opposing incentives. For example, as outlined above, we believe that there is scope to combine customer service standards, guaranteed standards, quality of supply and capacity and interruption targets, with appropriate weighting, into a single incentive scheme. This would be similar in design to the electricity IIP scheme, albeit targeting different measures of performance.

Question 10: What are the advantages and disadvantages of the different approaches to setting capacity outputs and providing appropriate incentives for efficient behaviour by the GDNs in the next price control?

SGN recognise that the incentive regimes for Offtake capacity bookings (for both the transition and enduring arrangements) and DN Interruption are at different stages of development by the various Industry Work Groups with the final proposals as yet, unknown. We believe that until these processes are fully developed, it is difficult to assess how each will interact and influence the decision making on the development of the networks and ensuring security of supply.

Nevertheless, as noted above, we believe that there is merit in a single incentive incorporating a number of measures of quality of supply, including offtake and interruption arrangements.

It is our view that the setting of appropriate incentives for capacity outputs will assist in driving the correct behaviour in developing the Networks in the most efficient and cost effective manner to ensure security of supply. An incentive for security of supply would minimise the regulatory intervention and oversight required during the price control period. If more than one incentive existed (flexibility from the NTS, level of Interruption per zone or level of investment in network per annum) it could lead to inefficient behaviour, as the UCAs and other parameters will over time contain inaccuracies.

In addition, where a Network is close to its incentive target for e.g. NTS Flex in a particular area, they could opt for investing in their network (as they are not close to the ceiling of this target) rather than incurring a penalty for taking more flexibility. Alternatively, they may prefer to invest and develop the network regardless of any targets, as the penalties they may incur could be less compared to the addition transportation income. We believe that, in contrast to our proposed “basket” of measures approach, more complex schemes that seek to reflect detailed cost trade-offs will result in perverse incentives, such as these examples.

We believe that it is important that incentives do not distort the objective of delivering the most efficient way of developing the Networks. The interaction/relationship between DN Interruption, NTS Offtake Capacity (OCS process) and investing in the local networks (as well as NTS Exit Incentive arrangements) need to be aligned. If the NTS Exit incentives are not developed in line with the DN incentives, this could introduce a degree of conflict between the two that may prevent the best solution for the industry being identified and delivered. We would therefore urge Ofgem to consider how the timetable for these two projects can be aligned.

In addition to the above, we would suggest that incentives on supply resilience be considered. Supply resilience is developing the networks to maintain supplies should third party damage or catastrophic failure of a key component occur at a strategic location (i.e. an Offtake or Pressure Reduction Installation). Historically, planning for Peak Day Demand did not consider resilience but concentrated on ensuring sufficient capacity was available in the Network to meet 1 in 20 Firm demand. We believe that DN's should be incentivised to develop a strategy of resilience, in conjunction with Offtake Capacity for 1 in 20 Firm demand, which will increase security of supply to consumers. However, this will require further work to develop measures of network resilience.

Question 11: Are there any other areas where outputs or output based incentives for GDNs should be developed including safety and the accuracy of gas pipeline records? If so, what should they be?

SGN believe safety issues should be dealt with primarily by the HSE. We also believe that any additional requirements with regard to line records would need to be funded through the price control.

Question 12: Does any aspect of the operation of a GDN require more investment in technical innovation than occurs at present?

We see no reason why an Innovation Funding Incentive as applied in electricity distribution should not be further developed for gas. The need for innovation is just as important in the gas sector as in distribution and the pressures to avoid such discretionary expenditure in the context of the short term RPI-X framework is just as pressing as for other networks. An opex roller mechanism, by extending the benefit period for rewarding investment to reduce costs might help with innovation in gas, but we still believe that an IFI scheme should be introduced as well.

Question 13: Should Ofgem consider any other form of incentive mechanism in the context of GDPCR?

The incentive package we have outlined above would, we believe, deliver a balanced set of arrangements for delivering efficient operation and improving service to customers. We have not identified any other areas of the DNs' operations that would require additional incentives.

CHAPTER FIVE

One year control issues

Question 1: Is Ofgem's approach of calculating a post-tax cost of capital and an ex ante tax allowance appropriate?

SGN does not support moving to a post-tax cost of capital for the one year control. Retaining a pre-tax approach would be consistent with a relatively simple roll-forward of the price control. By contrast, there are a number of complications with a post-tax approach that would require detailed consideration, which will be difficult in the limited time remaining for the one-year review. In particular, setting a company specific tax allowance is complex and would also need to reflect the implications of the Inland Revenue adopting changes to UK GAAP and IFRS.

In our view, it would be more appropriate to consider moving to a post-tax regime at the same time as deciding on the capitalisation policy for repex (which has tax implications). We therefore believe that a post-tax approach to the cost of capital should not be implemented until the main review. In the meantime, we also consider that pass-through of tax for the one-year control is not an attractive option because of its poor incentive properties.

For these reasons, we believe that a pre-tax approach should be adopted based on the same cost of capital as applied in electricity distribution (6.9%), with a more detailed consideration of the cost of capital and tax for gas distribution undertaken as part of the main review.

Question 2: What, if any, financial indicators should be used to assess financeability (also relevant for the main control)?

We believe that a basket of traditional financial ratios are appropriate including Funds from Operations (FFO), Post Maintenance Interest Coverage Ratio (PMICR) and Senior Debt to RAV.

Main control issues

Question 3: Should Ofgem use its traditional approach to calculate the cost of capital or should other approaches be considered?

We believe that Ofgem should have regard to a range of measures in calculating the cost of capital, not just the theoretical CAPM model. In this regard, we have attached our recent response made by SSE to the recent initial proposals in the Transmission review which sets out why we believe that a figure of 4.9% post-tax real is justified on the basis of the balance of market evidence. In our view, a similar figure would be justified for the higher risk activity of gas distribution.

Question 4: How should Ofgem approach the issue of the level of gearing to be used in the calculation of the tax allowance? Should Ofgem ensure that consumers share in any benefits arising from companies having higher actual gearing than the regulatory assumption?

While increased levels of gearing may be capable of maintaining adequate financial ratios, it is important to retain incentives for equity injection as given the large capex/replex programmes projected for the DNs, debt finance may not always be available to fund investment. Increasing gearing also has the potential to increase the perceived business risk and the marginal cost of debt. We believe that to move to a gearing assumption nearer to the current actual levels of some DNs would simply incentivise all to move to that level and beyond. We therefore see no reason to move from a level c.57.5% as assumed in DPCR4.

Question 5: Are there any arguments for changing the depreciation rates used in the price control?

The main argument for changing depreciation rates is a financeability question e.g. to phase in “cliff-face” changes in revenue. This was, for example, used in electricity distribution because of the ending of vesting depreciation. The same reasons may not apply in gas, although this may depend in part on other assumptions in the price control (such as the capitalised proportion of repex). It will therefore be necessary to look at depreciation rates as part of the overall package of the main control to ensure that GDNs have adequate cashflows to finance operations.

Question 6: Is Ofgem’s initial view on the treatment of pensions, and, in particular the treatment of the GDNs’ pension deficits, appropriate?

We agree that the same principles should be applied to pension cost recovery as applied in the electricity distribution review. This means that the one year control will need to reflect increased employee contribution costs and deficit repair payments.

Provided the rest of the price control package is reasonable, it may be appropriate for Ofgem to commit to recovery of these costs, but for actual funding to occur in the main control. However, in common with the position in electricity distribution, we also believe that Ofgem should commit to a “true-up” mechanism for actual changes in pension costs after the price control is set for April 2007.

Finally, we believe that the one-year review will need to address the issue of over provision of pension costs by licensees between 2002 and 2007, compared to the assumption underpinning the price control. We consider that these adjustments, consistent with previously declared Ofgem policy, should accrue to each DN licensee in proportion to number of employees.

Question 7: Is Ofgem’s proposal on the mechanism for recharging NTS pension costs appropriate?

In our view, this mechanism is unnecessarily complicated and involves DNs in a pass-through of costs that have nothing to do with them. We see no reason why these cannot be recovered through exit charges, which would be simpler to implement. We also do not believe that this would result in material cross-subsidy between customers, particularly when compared to the adjustments that arose following the sculpting of the DNs’ collective RAV as part of the sales process.

Question 8: What should be the timing of allowances for under recoveries from the current price control and deficit repair costs?

As noted above, we consider that re-setting allowances for current contribution levels needs to be addressed in the one-year control. However, provided that the principles are established now for recovery of past under recoveries and deficit repair costs (and subject to the overall price control package being acceptable), we would not object to recovery being part of the main price control.

Question 9: How will the changes to pension law affect the price control?

We cannot fully anticipate how changes in pensions law will affect the price control at this stage but for example, we do anticipate that other related potential legislative changes such as the age discrimination Act may put upward pressure on funding. We are involved in industry discussions on these matters with the relevant regulatory authorities, but it is nonetheless clear that pension cost allowances will need to reflect compliance with latest pensions law.

CHAPTER SIX

Question 1: Are the three options for the funding of xoserve appropriate? Should we consider different options?

We support the option of user pays for incremental costs above a core package. This will provide a better framework going forward for managing industry change. In particular, it would provide greater flexibility for funding industry change that shippers and network companies agree is appropriate.

Question 2: Should Ofgem consider the outcome of an industry dialogue as part of its assessment of the funding required to replace UK-Link?

We believe all stakeholders should be involved in the assessment of the funding required to replace UK-Link.

Question 3: Which, if any, of the 5 options for facilitating network extensions should Ofgem consider in more detail?

We fully support an initiative to extend the gas network into fuel poverty areas and welcome the opportunity to engage in a fuller dialogue on this matter. It is our view that a range of complementary customer incentives will be required to support the costs of mains infrastructure, one-off service costs and internal pipework and appliances. This will almost certainly require a well coordinated multi agency response. There is some merit in all of the options included in the consultation, particularly options 4 and 5. However, we believe that further work is required to develop these options and we are happy to contribute to this debate.

Question 4: Should Ofgem introduce a licence condition that required NGG NTS to recover the excess costs associated with independent systems on behalf of GDNs?

We have written separately on the treatment of independent systems. We believe that such an obligation would better implement the DTI's policy requirements in relation to SIUs than the current arrangements, which suffer from, amongst other things, being overly complicated.