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Dear Joanna,

### **Response to the Gas Distribution Price Control Review – Third Consultation Document**

Thank you for the opportunity to comment on Ofgem's Third Consultation Document in the Gas Distribution Price Control Review (GDPCR). Our main points are summarised below. Our detailed and other comments are set out in Appendix 1, following the form of the questions raised in the consultation document. We are happy for this response to be published on Ofgem's website, with the exception of Appendix 2 which we regard as commercially confidential.

The review for the one year control addressed to a number of policy issues, for example shrinkage costs and pensions. However there are outstanding areas from the review for the one year control which still require further work, these include regional costs and new and additional cost pressures.

Also in relation to the cost of capital, while we understand the reasons for a simple roll-over of the current figure in the one-year control, in the longer-term we would regard 4.38% post-tax real as insufficient to attract the required equity investment. Nor does it, in our view, reflect the inherent risks of gas distribution. We believe that this will be a key issue in the main review.

There are many other issues raised in the Third Consultation paper. We have set out below the key issues for SGN.

- Revenue driver – We support removing the volume driver, and suggest replacing it with one based on the number of customers. This would provide a more stable and predictable revenue stream while still incentivising the efficient utilisation of the network;

- Uncertain costs – We agree that a reopener may be necessary to deal with costs which will arise under the Traffic Management Act and Transport (Scotland) Act. We would also add congestion charges to this mechanism. However, when the re-opener mechanism was introduced in the electricity distribution price control review, it was expected that the general introduction of schemes under TMA would not be until well into the price control period. With regard to the gas distribution price control review, the general introduction is imminent, likely even in 2007/08. It is therefore our view that a specific term should also be included in the price control formula, and that setting of allowances should take place no later than in electricity.

We also welcome the recognition of our concerns about the potential loss of meter work carried out for other MAMs. In addition, of particular concern to SGN is that the additional regional costs incurred, in particular for operating in and around London and for operating the independent undertakings in Scotland, need recognition. We would urge Ofgem to also consider in this price control review the longer term implications of the ageing workforce and replacing potential skills shortages, and putting in place appropriate funding schemes;

- Quality incentives – We support in principle Option 2 – Rationalising and updating the outputs and standards of performance arrangements, with some modification. For example we do not support replacing OS2 with a Guaranteed Standard nor OS5 with a licence condition;
- Balanced Scorecard - Overall, we support introducing incentives where DNs can earn additional reward for out performance. We would also expect annual reconciliation of these schemes rather than logging up to the next price control review.

We therefore support the concept of a Balanced Scorecard package of measures to compare performance between DNs. In due course this could be incentivised with rewards for out performance, in the same way as IIP in electricity distribution. The attraction of the Balanced Scorecard approach is that DNs overall revenue exposure can be more easily capped. We believe this could also be expanded to include other outputs such as longer term performance measures, the accuracy of pipeline records and offtake and interruption incentives;

- Riser replacement – We welcome Ofgem’s recognition of the significant issues surrounding the funding of riser replacement. In our view a proactive riser replacement programme is needed. We would support further industry discussion on adopting alternative arrangements to that of pipe replacement;
- Capex rolling incentive and Information Quality Incentive (IQI) – We fully support the “strong” capex roller together with the Information Quality Incentive;
- Opex rolling incentive – We do not agree with the conclusion in the consultation document that there does not appear to be a strong case for

implementing the opex rolling incentive. The advantages are in our view clearly set out, for example removing “periodicity”. There would appear to be an opportunity now in gas distribution to address all of Ofgem’s concerns with such a mechanism and we therefore support in principle the introduction of an opex roller;

- Mains replacement incentive – On balance we support retaining the existing mechanism subject to a number of modifications including incorporating additional bands for larger diameter replacement, a separate mechanism for riser replacement, and making the sharing of under/over spends symmetrical;
- Offtake capacity and DN interruptions incentives – We are very concerned about the increasingly complex incentives being proposed for exit and interruption. We consider that given the lack of experience and data about the capacity trade-offs Ofgem should adopt a relatively simple incentive, as exists now, with a cost pass through supplemented by a target and caps and collars. This would not preclude a more ambitious and detailed scheme at a later date;
- Innovation Funding Incentive (IFI) – We believe that there is a compelling case for the incentivising of R&D, perhaps through a joint approach such as the IFI introduced into electricity distribution;
- Financial issues – We cannot envisage a circumstance where it would be appropriate to disallow any increase in tax allowances due to changes in accounting standards. We also believe that rolling forward tax losses between pre- and post-tax price control regimes is inconsistent. With regard to financeability, regardless of our own views on the appropriate financial ratios, we are constrained by the ratios used by the ratings agencies. Such ratios should be examined with respect to each financial year within a price control period. We see no compelling reason to change from the current practise of expensing 50% of repex. If more were to be capitalised, the deterioration in cash flows would need to be addressed in other ways;
- Network extensions – We welcome the introduction of an incentive scheme to facilitate extending gas networks into fuel poverty areas. At this stage we would provisionally support Option 3b combined with Option 6. However, we believe that Option 6 may need some modification i.e. the economic test alone may not always provide sufficient incentive for network extensions;
- Corporate Social Responsibility – We would support a scheme which rewards GDNs’ good performance in the overall interaction with the community, for example wider communication and awareness campaigns;
- Scottish Independent Undertakings – We do not believe that it is appropriate that customers located in areas where independent systems are located should bear the excess costs associated with these systems. Spreading costs across GB customers via transmission charges would be more in line with DTI policy. This would also be consistent with arrangements that have been put in place in electricity distribution in respect of assistance for areas with high

distribution costs. We also have a number of other issues related to the independent undertakings which we address in confidential Appendix 2 to this letter.

Finally, we continue to support the transparent process that has been adopted by Ofgem during the GDPCR to date and look forward to continuing to work with Ofgem in taking the remaining outstanding issues forward in the review. If you have any questions regarding our response please call.

Yours sincerely,

Rob McDonald  
Director of Regulation

Scotia Gas Networks plc

**Response to the Gas Distribution Price Control Review – Third Consultation Document**

**CHAPTER TWO**

**Question 1: Do you agree with our initial view on which services could be given excluded treatment? Are there any additional services that we have not considered?**

SGN agree with Ofgem’s initial view on which services could be given excluded treatment as set out in table 2.1. We have commented on the changes to the current treatment of some of these services below.

We agree with Ofgem that payment claims associated with last resort supply should not be treated as an excluded service but rather become a pass-through item. This would be consistent with our view that aspects of a GDN’s expenditure over which it has no direct control should be classified as pass through items.

We also believe that emergency services provided to iGTs should continue to be treated as excluded services. However, we believe that the drafting of Standard Special Condition E4 may need to be amended to accurately reflect this since, currently, only those emergency services associated with a major loss of supply, and as directed by Ofgem pursuant to Standard Special Condition A41, are classified as excluded services and does not therefore include all of the emergency services provided to the iGTs.

We continue to believe that connections activities should remain as excluded services rather than bringing them within the ordinary price control. As we explained in our response to the second GDPCR consultation, we see no particular reason or advantage from changing the current arrangements. It would also be complex administratively, particularly in relation to capturing the volume uncertainty within the price control formula. In addition, it would be inconsistent with the policy adopted for equivalent arrangements in electricity.

We agree that Metering Services associated with GDNs’ own metering obligations, and those it provides to other meter asset managers (MAMs), should be treated as an excluded service rather than as an exemption from the de minimis cap. Similarly, we agree that the other services provided by the GDNs to other GDNs and to the NTS operator, should be treated as excluded services since they are related activities of the licensee. Ofgem has suggested that, in order to facilitate metering services being an excluded service going forward, it is ‘not necessary’ to include metering services in the definition of excluded services as these are already excluded from the definition of transportation business. However, we have a concern that that specific exclusion prevents them from being an excluded service of the transportation business. In the event that there is a move to a ‘core services plus user pays’ regime for the funding of Xoserve, we agree that it would be appropriate to include this as an excluded service. We discuss the funding of Xoserve later in this response.

Finally, Ofgem has asked whether there are any other activities that should be treated as excluded services. GDNs are being encouraged to provide other gas-related activities and we therefore believe that there should be scope for these also to be included as excluded services. For example, the provision of carbon monoxide detectors. As drafted, we believe paragraph 4.(a) of Special Condition 4E would enable the Authority to approve this activity as an excluded service, however, we believe that there would be merit to include it specifically to avoid further individual approvals in this manner.

**Question 2: Should domestic one-off connections be treated as excluded services or ordinary price controlled services?**

As we have indicated above, SGN sees no particular reason or advantage from changing the current treatment of connections as an excluded service. In particular, we see significant practical difficulties in setting allowances for connections given the uncertainty about volumes and average connections costs.

**Question 3: Have we correctly identified the range of items that could be treated as pass through items? Should these items be treated as pass through items?**

We believe that it is appropriate to continue to treat licence fees and rates as pass-through items. We understand the rationale behind Ofgem's proposal to potentially expose GDNs to some increased rates costs following the conclusion of the next rating review. However, if Ofgem is to pursue this approach we believe the presumption should be that rates are full cost pass through items from 2010/11 (i.e. for the full price control period), unless Ofgem specifically directs otherwise following completion of the next rates review.

In paragraph 2.17 Ofgem also considers whether NTS charges for pension deficit costs relating to non-active scheme members should also be subject to cost pass-through treatment. In our view, this principle has already been established as part of the one year control and it was our understanding that it would be retained for the main price control. We would welcome Ofgem's assurance that this is the case and that Ofgem is not now considering alternative arrangements in this respect. Furthermore, as we have already indicated in our response to Qu.1 above, we believe it would be appropriate to treat claims associated with last resort supply as pass-through items.

As part of the discussions on the proposed GDN interruption and NTS exit capacity incentive scheme arrangements, Ofgem has considered a number of alternatives some of which include a pass-through of actual costs of purchasing GDN interruption and NTS exit capacity (both flat and flexibility capacity). In our view, many of the charges to which the GDNs will be exposed in this context are out of their immediate control. For example, there is a likelihood that the GDNs will have to agree to contract for NTS exit capacity ahead of the charge being known. In addition, the proposed new GDN interruption regime enables shippers/customers to determine the price that GDNs will be required to pay for interruptible services. We therefore believe that the actual costs that GDNs pay for NTS exit capacity and (depending on the form of incentive, possibly GDN interruption rights) should be treated as pass-through items.

**Question 4: Is there any reason why we should change our position on cost indices?**

SGN continue to support the retention of the RPI price index. Real price effects including wage, contractor and material costs should be allowed for in the upfront cost allowances and efficiency targets.

**Question 5: Is there any reason why we should change our position on re-openers?**

SGN support Ofgem's view that there should be a specific re-opener where it is known that a change, which will have a significant impact on the GDNs, is likely to occur in the next price control period, but where the specifics are not known prior to the price control being set. For example, we agree with Ofgem that if the details of the Traffic Management Act (TMA) and Transport (Scotland) Act are not clarified prior to the implementation of the next price control, a specific re-opener on this issue would be required. We would also add congestion charging and changes to mapping backgrounds (PAI) to this list.

However, when the re-opener mechanism was introduced in the electricity distribution price control review, it was expected that the general introduction of schemes under TMA would not be until well into the price control period. With regard to the gas distribution price control review, the general introduction is imminent, likely even in 2007/08. The impact will also be greater in gas distribution where all of the network is underground and more often involves digging up roads. It is therefore our view that a specific term should be included for this in the price control formula, rather than logging up, and that setting of allowances should take place no later than in electricity.

We also believe, that there should be a mechanism for dealing with other, as yet unknown, events and that this should include a reference to relevant change of law. In adopting this approach, we believe that it would be necessary for the GDN to demonstrate that the change in law has an impact on costs greater than a pre-determined threshold. We believe this would provide the comfort to Ofgem that a generic re-opener of this kind would not lead to inappropriate applications by a GDN to re-open the price control settlement. This approach would be consistent with the income adjusting event that is available to the GDN to, in effect, re-open other aspects of the price control.

**Question 6: Should we introduce a two-tier correction mechanism for over and under recovery of allowed revenue, consistent with the arrangements that apply in electricity distribution?**

SGN certainly believe that the existing application of asymmetric interest rates is inappropriate and we would therefore welcome a move to a symmetric approach. We note that in electricity an over or under recovery of less than 2% attracts an interest rate of +/- 1.5% above base rate; an over recovery of more than 2% attracts a penal interest rate of 3% above base rate; while an under recovery of more than 2% only allows the GDN to apply the base rate. While we understand the incentive properties of the two-tier correction mechanism we do not support its direct application in gas.

The GDNs' licence obligations currently restrict their ability to adjust their charges more than once a year without the consent of Ofgem. Furthermore, unlike electricity

where the charges are set to coincide with the price control year, in gas charges are set to apply from October to coincide with the gas year. This arrangement inevitably exposes the GDNs to greater over/under recoveries for which we do not believe they should be penalised.

Furthermore, the proposed reform of the NTS exit and GDN interruption arrangements will mean that in the future the GDNs will be exposed to potentially far greater fluctuations in allowed revenue (and therefore charges). Under both reforms, the GDNs control of their actual costs is more restricted due to the auction mechanism for purchasing the NTS exit capacity products, and the associated NTS adjustment mechanisms that are required to overcome NTS over/under recovery resulting from the auction process. In addition, the market based proposal for procuring GDN interruption rights will inevitably mean that GDNs have less immediate control over their revenue.

Given the above, we believe that there are more factors to be considered when considering the introduction of a two-tier correction mechanism in gas, when compared to electricity. Certainly, if this approach were to be adopted in gas, the under/over recovery threshold that attracts the symmetric lower interest rate should be greater than 2%, due to the inherently less predictable charging influences in gas compared to that in electricity. Furthermore, the more penal interests rates associated with the two-tier approach should be symmetrical. Finally, Ofgem should consider removing the charge restrictions to enable the GDNs to change their charges in April and October.

**Question 7: Should we calculate the GDN's' allowed revenues in a way that creates a smooth revenue profile over the course of the price control period?**

We see no reason why a smooth profile of allowed revenues over the price control period is necessary. There are many factors which will affect the variability of charges. However, the revenue profile should take account of the cost profile to avoid any large discrepancies between GDNs' costs and allowed revenues that would have to be corrected by a p0 adjustment at the next PCR.

**OTHER ISSUES**

**Meter work**

We also welcome Ofgem's recognition of our stranded opex concerns around meter work for other MAMs. However, we do not agree that under the suggested benefit sharing mechanism the incentive of the GDNs would be reduced. In our view, the incentive would still remain to utilise the emergency service workforce efficiently, because the general incentive to reduce operating costs across the business would remain.

**De minimis activities**

In our view the cap on de minimis activities is no longer required. This was introduced as part of the financial ringfence of networks. However, with the advent of the special administrator scheme for networks we believe that this could now be removed.

Notwithstanding this, SGN have already indicated that we support the proposal that would treat the new service agreements that were entered into, at the time of the GDN sales between NGG and the GDNs, as excluded services rather than exemptions to the de minimis activities for as long as the service is provided. We also see no reason to introduce transitional arrangements for the System Operation Managed Service Agreements. While the service continues to be provided it would be treated as an excluded service. As and when the service is terminated it would simply no longer apply.

## **Revenue Drivers**

In the GDPCR second consultation document Ofgem sought views on whether other forms of revenue driver would be more appropriate than the current volume based one. In response to that consultation SGN suggested that the current volume based revenue driver should be replaced with one based on the number of customers as this would provide a more stable and predictable allowed revenue stream, and because it would not be sensitive to weather induced changes in volumes in the way that the present volume-based driver is. It would give the GDNs an incentive to increase the number of connected customers and therefore increase the efficient utilisation of their networks.

## **CHAPTER THREE**

### **Question 1: Is our proposed approach to setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?**

SGN support focusing the analysis on GDNs' forecast costs based upon its policies and procedures. Our concerns regarding benchmarking are the same as those for opex, as set out in Qu.2 below.

We see no reason to change the treatment of non-operational capex. Furthermore, we also consider that expensing non-operational capex would not reflect the benefit to future customers of such spend (which can be variable) and would put upward pressure on present prices.

### **Question 2: Is our proposed approach to setting opex allowances for 2008-09 to 2012-13 appropriate?**

Although we support benchmarking between GDNs in principle, and believe it will be a useful tool at the next review, in our view benchmarking of historic costs will provide relatively little value in this review. As we have set out in previous responses, we do not believe that 2004/05 or 2005/06 are typical years, and even 2006/07 costs will still reflect the amount of change which is going on in the industry, and will still not fully reflect the impact of the new management teams. We would urge Ofgem instead to concentrate on reviewing and understanding each GDN's cost forecasts.

Similarly benchmarking and in particular bottom-up benchmarking risks, by 'cherry-picking' the lowest unit costs at too detailed a level, creating a 'virtual GDN' that cannot exist in practise.

We are also not convinced that Total Factor Productivity analysis adds significant value, in our experience it is too subjective. It should also be noted that productivity improvements in the economy as a whole are already reflected in RPI, which is already factored into GDNs' allowed revenue through the price control.

It is also important to SGN that account is taken of regional cost pressures. For example, the additional costs of operating in and around London where this issue has already been recognised in electricity distribution price controls, and the cost of independent undertakings in Scotland (we discuss this in more detail later in this response). We have provided more analysis in separate submissions to Ofgem and their consultants.

GDNs are expecting considerable upward pressure on costs and most of these have been set out in the BPQs. However, there are other currently uncertain costs which we have excluded from the BPQs. Some of these have been recognised by Ofgem including costs which may arise under the Traffic Management Act and the Transport (Scotland) Act, but also others which need addressing including congestion charging and changes to mapping backgrounds (PAI).

Finally, an important issue for consideration is the ageing workforce in the gas industry and the long term replacement of skills as they are lost. Our BPQ for the coming price control includes plans to address the skills challenges presented by the work programmes and operational requirements in the coming period. However, along with the other GDNs, we are concerned that looking beyond the next price control period there are potential shortfalls in the availability of people with the skills needed to both deliver the projected workload volumes and to find innovative and effective solutions to the changing operational demands placed upon the network.

In the long term these skills shortages could impact our capacity to both renew and effectively operate the network. In the same way that we have argued elsewhere in this response that R&D expenditure needs incentivising, we would also argue, in this case, that there is a risk that a five year price control period does not adequately incentivise a network monopoly to invest in longer term skills development. In our view, expenditure needs to be allowed for this in the coming price control, although we may not see the benefit until the following price control period. We believe that there is an opportunity in this price control review for the industry to work together with Ofgem to address this issue.

### **Question 3: Is our proposed approach to updating the GDN's' RAV to 1 April 2008 appropriate?**

SGN believe this approach is appropriate and welcome the clarification letter from Ofgem, dated 20<sup>th</sup> December 2006, on the RAV roll forward approach for 2007/08.

## **OTHER ISSUES**

### **GTMS replacement and SOMSA exit costs**

SGN believe that GTMS replacement is fully justified, driven by system obsolescence. The joint approach taken by the GDNs on this replacement project is an innovative

solution to an industry-wide issue, which will ensure a more efficient solution when compared to the prospect of each GDN independently replacing its own system.

## **CHAPTER FOUR**

### **Question 1: Do you support the proposed changes to the quality of service outputs?**

SGN do not support *Option 1 – Do nothing*. Quality of service is a key value for SGN and we have committed significant resource since acquiring our networks into establishing systems to reliably capture data and monitor performance. We agree with Ofgem that the accuracy of data submitted and standards of performance have improved, particularly in the area of connections.

We do however believe that the current package of guaranteed, overall and connections standards is unduly complex and needs refining. We therefore support *Option 2 – Rationalising and updating the outputs and standards of performance arrangements and improving measurement*.

#### **Overall Standards**

Under Option 2, we support in principle the removal, and replacement where appropriate, of the Overall Standards provided there is no significant additional reporting burden on GDNs. We comment on each in turn below:

**OS1 – Telephone calls.** Currently this standard provides limited incentives on individual GDNs as it is a common measure for all 8 GDNs. However, we believe that the speed of telephone response is a valid and useful measure of customer service. We would not support including the performance level within SSC A8, the licence condition that requires GDNs to provide a single continuously manned telephone service, as under the current arrangements we do not see how this would improve customer protection. However, we would urge Ofgem to consider allowing GDNs to take this in-house and provide their own telephone service in due course. This could then be incentivised through a comparative incentive scheme, as we understand is the case in electricity distribution.

**OS2 – Notification of planned interruptions.** We support removal of this overall standard, however we do not support its replacement by a guaranteed standard. We have well established processes and systems to manage the replacement programme for customer notifications and a change from an OS to a GS would necessitate significant changes to these. For example we do not hold customer names and contact details, therefore correspondence is addressed to ‘The Occupier’ and some are discarded. We would therefore question the robustness of such a guaranteed standard. For instance how would a GDN (or Ofgem) verify a customer’s claim that he/she had not received a notification. Customer satisfaction with interruptions is already the prime focus of the quarterly customer survey, and in our view this is the right approach. It is also for consideration whether the survey results could be part of a broader quality of service incentives package.

**OS3 – Notification during unplanned interruptions.** We are already pro-active in this area, for example we have a single customer service centre and our own 24/7 dispatch centres to handle customer enquiries following unplanned interruptions. We agree with the comments set out in the consultation document regarding the difficulties in measuring performance against this standard and support Ofgem’s view that this overall standard, and the associated reporting burden, should be removed and that performance should be assessed through the customer satisfaction survey.

**OS4 – Complaints.** In our view this overall standard incorrectly focuses simply on the time taken to make a response rather than the quality of that response or reducing the number of complaints. We have already driven significant reductions in the number of complaints received. We would support removal of this overall standard, for the reasons set out in the document, and its like for like replacement by a guaranteed standard. This would then incentivise reducing the number of complaints, as well as the time taken to respond.

**OS 5 – Attending emergencies.** Response times for attending emergencies is a key performance measure and is ingrained into our safety ethos, and built into our existing and new IT systems. These are monitored on a daily, weekly and monthly basis. Primarily this is a safety standard and not a customer service issue, and we do not think that it is appropriate to incentivise safety through either standards of performance or licence conditions. The consultation document also raises the lack of clarity around this standard. Therefore we would support its removal as an overall standard and would oppose its inclusion as a licence condition.

#### Guaranteed Standards

We agree that there appears no significant reason to change GS1 – Supply Restoration or GS2 – Reinstatement at this time.

**GS3 – Alternative heating and cooking facilities.** We agree that it is difficult in practise to report against this standard. Providing alternative facilities is something we would always consider as good customer service in the event of unplanned interruptions. We would therefore support removing this standard and the associated reporting requirement. If it were instead to be included as a provision of the licence, we would not support this requirement extending beyond customers on the PSR. However, this does not mean that we would not continue to do so depending on the circumstances of each event.

#### Connections Guaranteed Standards

We would support continuing with the current connections guaranteed standards. Systems have been built to report against these standards within defined timescales and reporting templates. These standards are now well understood by those in the business working to them.

#### Measurement improvements

The consultation document suggests that improvements are required to the accuracy and reliability of data in relation to the number and duration of interruptions. It should be

borne in mind that the incidence of unplanned interruptions in gas distribution is infrequent when compared to electricity distribution, therefore any reporting requirements should be proportionate and probably related to the duration of interruptions only. However, we believe it would be adequate for this to be added to the quarterly survey where customer satisfaction with interruptions is already assessed.

#### Amending the scope of the customer satisfaction survey

We would support increasing the scope of the survey where it leads to the removal of guaranteed or overall standards, as discussed above, and provided that the costs are taken into account in the price control.

#### Balanced Scorecard approach

We would support, in principle, a balanced scorecard approach to comparisons between GDNs on the quality of service delivered. We would see this also including other incentives such as the accuracy of pipeline records, longer term performance measures and offtake and interruption incentives. In due course, this could be incentivised with rewards for out-performance as with the IIP scheme in electricity distribution.

However, we recognise Ofgem's concerns about having robust measurement systems in place before financial incentives could be included, although where there are doubts these areas could be included in such a scheme initially with zero weights attached to them. The attraction of a balanced scorecard approach, as opposed to several separate incentives, is that our overall revenue exposure can be more easily capped. An alternative to zero weights would be to initially have a lower overall cap on revenue exposed. We would welcome early discussion on the potential for such a scheme.

#### **Question 2: Do you support the proposed changes to third party damage and water ingress proposals?**

SGN agree that, while GDNs are not in direct control of the number and nature of such incidents, incentives should;

- encourage working with the wider community to reduce the overall levels of such incidents;
- ensure that customers are reconnected as quickly as possible;
- provide protection for IGTs.

The initial opex allowances need to be set carefully in this area, not only to ensure they are at an efficient level, but also that they should reflect historical levels and recent trends.

Exposure caps need to be set based on the drivers for such incidents, and we believe that a percentage of allowed revenue provides a more appropriate cap than a blanket cap for all GDNs, better reflecting the relative size of GDNs. The rationale for exposure to 5% of payments above such a cap has not been explained and in our view all payments above the cap should be passed through.

We therefore have no objection in principle to Option 2, provided that the comments

made above are addressed.

**Question 3: Do you support our proposals for improving the accuracy of pipeline records?**

We have responded to this question below, under Question 8, Chapter 5.

**Question 4: Is it appropriate to introduce network capacity output measures? If so what type of output measures are appropriate and what sort of rewards/penalties should the GDN's be exposed to?**

We have no objection in principle to Ofgem measuring the amount of capacity on the network, but we would have significant issues with moving beyond the existing 1:20 requirement for regulatory investment. In particular, Options 2 and 3 would result in Ofgem micro-managing investment of the network by selecting “appropriate” amounts and/or mix of capacity to be delivered. We do not understand why Ofgem would consider that regulators or their consultants are better placed to determine investment than the management of the companies.

We also do not understand the underlying rationale for such prescriptive regulation. There is also no suggestion that investment to deliver capacity is “remunerated twice”; capex is remunerated through the RAV and offtake capacity through the pass-through/incentive scheme.

It is our view that Option 1 is the most practical to implement and operate and is also consistent with, and underpinned by, GDN Licence and Safety Case obligations. Inputs to such a measurement regime are already available to Ofgem via the current reporting regime. This is (or can be) supplemented by assurance in the GDN asset management processes via PAS55 accreditation and/or a detailed process review at the time of the PCR (that is already a feature of this PCR). We would be firmly opposed to the other options put forward by Ofgem.

With regard to what sort of reward/penalties should the GDNs be exposed to, we would refer Ofgem to SGN's response to Questions 6 and 7 in Chapter 5.

## **OTHER ISSUES**

### **Riser replacement**

The consultation document correctly highlights the background to this issue and the difficulties being experienced in both inspecting and assessing the condition of risers. The document focuses on risers supplying high rise buildings only. GDNs have a duty, under the Pipelines Safety Regulations, to maintain all risers and similar issues and difficulties apply to risers and above ground pipes supplying other properties, albeit GDNs are currently focusing on high rise buildings where the risks are considered highest.

SGN are of the view that a proactive riser replacement programme is needed and should be funded. We do however support the view that the costs of pipe replacement to such properties can be disproportionately costly. As such we would support further industry

discussion, with a view to obtaining an agreement on a means and mechanism of adopting alternatives arrangements to that of pipe replacement.

The consultation document highlights building life expectancy as an issue that should be taken into account. This is an area, particularly involving local authority housing stock, where GDNs are experiencing difficulty. Many local authorities and other property owners have a desire to proactively demolish aging high rise buildings but are unable to confirm demolition programmes until funding is approved or until public consultation, on what can be a sensitive subject for their residents, has taken place and concluded. Although relationships with a number of property owners have improved, it is rare for a property owner to be able to provide significant forward notice of their plans even when it is known they wish to replace this housing stock.

### **Private Networks**

SGN would be pleased to discuss the adoption of private networks. The consultation document clearly identifies many of the concerns with the current process, however, there are a number of practical difficulties which would have to be overcome. For example, GDNs do not have full records of private networks and therefore the adoption process should include case by case technical and financial assessment.

Our experience with this type of work, suggests that there are very few sites that would meet the standards and criteria currently in place for our own assets. Site owners would typically need to be able to provide demonstrable confidence in the construction standards (materials, test certificates, maintenance/ repair history etc.), to allow the process of adoption to go further than an initial investigation. The result of this would typically be extensive ‘proving works’ or a programme of replacement work. Historically this has proved to be prohibitive to the progression of adoptions. Abortive costs of such evaluation must be considered at the outset.

We would also need to be clear on how adoption would be funded, for example, how opex and capex allowances would be set, and how the adoption of these networks would impact on the DNs’ customer service standards and targets changed. We would not be willing for such costs to be “logged up” given the uncertainty. As a consequence, we would require the up-front costs of assessing adoptions to be included in the initial allowances in the price control. We would also require a mechanism to increase revenue during the price control period to reflect the cost of adopted networks. This could either take the form of a revenue driver (which would be very complicated and could result in perverse incentives) or an excluded service. In addition, a mechanism would need to be found to remove the effect of adopted networks from the various incentive schemes (such as the capex roller, customer service standards etc.).

Against this background, we would be prepared to enter into discussions with Ofgem in order to try and develop a framework for facilitation of this type of request. At this stage, it is believed that the following issues would also need to be considered and addressed:

- legislation, including GSI&U Regulations and Pressure Systems Regulations;
- installations that currently include boosters/ compressors;

- reinforcement costs ( systems may be designed at lower pressures than SGN's assets);
- records management;
- metering issues (various);
- resourcing to carry out necessary works to achieve and adoptable standard (and the potential impact on the replacement programme);
- replacement costs;
- safety issues and potential conflicts with safety case requirements;
- the design consultancy/ load evaluation procedure.

### **Longer term performance measures**

We support Ofgem's view that GDNs should take appropriate steps to manage the long-term performance of the network. Considering the short-term nature of the PCR focus, we believe that GDNs' approach to asset stewardship and long-term risk management should be separately recognised and rewarded.

We acknowledge Ofgem's encouragement of GDNs to become PAS55 certified, and note industry participation in the development of the Asset Management Assessment Project which should allow Ofgem to conduct comparative assessment of GDNs' asset management practices with other networks and industries.

We strongly believe that the efforts by GDNs in achieving PAS55 certification should be recognised by including the costs of accreditation, and that GDNs should be incentivised to improve their position against the Ofgem Asset Management Assessment, and rewarded for improvements made.

## **CHAPTER FIVE**

### **Question 1: Have we identified all the issues for each of the incentives?**

SGN have no other comments apart from that we would support annual reconciliation of incentives rather than logging up to the next Price Control Review.

### **Question 2: Is it appropriate to better align capex and opex incentives?**

With the capex and opex rolling incentives as proposed, SGN believes there would be no further need to align these incentives, particularly given that the enhanced cost reporting framework will provide more transparency on the classification of costs. We would however, be firmly opposed to any suggestion that operating cost or capex incentives should be weakened in strength, as has happened in certain previous reviews.

### **Question 3: Do you agree with our initial view that a capex rolling incentive and information quality incentive should be implemented?**

As we have stated in previous responses, we fully support a capex rolling incentive together with an information quality incentive, for the reasons set out in the consultation document.

Clearly GDNs need to see the ‘incentive rate matrix’ for the information quality incentive. We note that Ofgem will allow GDNs to re-forecast following receipt of this matrix.

**Question 4: Given the issues raised is there a case for an opex rolling incentive?**

We do not agree with the conclusion in the consultation document that there does not appear to be a strong case for implementing the opex rolling incentive. The document itself, in our view, sets out clearly the advantages, for example removing ‘periodicity’. The concerns expressed about inefficiently increasing incentives on GDNs to capitalise opex costs, and gaming of the timing of efficiency savings, are not substantiated. There would appear to be an opportunity now in gas distribution, given the common history and capitalisation policies which have not yet changed from National Grid ownership and the probable introduction of the Regulatory Reporting Pack, to address such concerns.

We therefore support, in principle, the introduction of an opex roller and also support the principle of no negative incentive payments i.e. opex overspends would be carried forward and set against future opex underspends.

**Question 5: Do you agree with our proposals to retain the mains replacement incentive?**

The issues for SGN in the choice of an appropriate incentive depends on the following factors:-

- the extent to which we are exposed to cost pressures, e.g. contractor price inflation;
- the risks/ rewards and allowances present in the capex rolling incentive;
- the inclusion of additional matrix rates as GDNs move to larger diameter replacement;
- the treatment of riser replacement;
- the treatment of services;

On balance, we believe that the current arrangements (Option 1) should remain, but should incorporate additional bands for large diameter replacement. Risers should be dealt with outside of this mechanism with an appropriate allowance. Services, LTS and other repex should continue to be treated alongside capex.

However, we agree that the sharing levels of gains and losses should be reviewed. We believe that the sharing mechanism should be symmetrical with respect to overspends and underspends. In our view, it is appropriate that this should be 50:50 for both. This view is based on the fact that our ability to outperform on the repex incentive mechanism is lower than the capex roller, due to the fact that the repex incentive mechanism adjusts for volume variances, and therefore the incentive is restricted to price variances.

## Capacity output incentives

Ofgem has set out three possible ways forward for setting capacity output incentives for the period October 2011 to March 2013. Ofgem's proposals are based on the assumption that enduring offtake and interruption arrangements (as proposed by NGG's modification 116 and modification 90) are implemented. Our response to questions 6 and 7 below are therefore based on the same assumption.

In considering Ofgem's three proposed options it is vital to recognise that the gas industry is going through a period of significant change and therefore the complexity of any incentive mechanism and exposure to risks should be limited during this time. We believe the potential exists where incentives could be implemented that could have unforeseen consequences on the GDNs, NTS and possibly consumers. Due to these uncertainties, we would support Ofgem's view that the incentives during the next PCR period should be simplified to allow time for the industry to understand these complex relationships with a view to potentially developing a more targeted incentive that could be applied thereafter to the extent it is proved to be necessary.

It is also evident that under the proposed enduring regimes, the GDNs will be exposed to price risks over which it has not control, for example the cost of NTS flex capacity and potentially the cost of NTS flat capacity. We therefore believe that the price risks that are beyond the control of the GDN should be treated as pass through costs. Furthermore, under any incentive mechanism it will be important to ensure that the GDN is not exposed to other risk over which it has no control including for example variations in CV where they impact a GDN's capacity requirements (CV is controlled by the NTS) and if the delivery of incremental NTS capacity is late forcing the GDN to take alternative measures to ensure can meet its capacity requirements.

We agree with Ofgem that options one and two have a number of weaknesses associated with them and therefore at this stage we have focussed our response to questions 6 and 7 below based on Ofgem's preferred option 3.

### **Question 6: Is flexibility capacity the key incentive to focus on for the capacity outputs? Should we assume that the use of existing NTS flex capacity is the most efficient flexibility capacity product?**

SGN agree that flex capacity is an important output that should continue to be effectively managed by the GDNs to ensure that the most efficient method of providing flex capacity is identified and implemented. However, when considering an appropriate incentive mechanism, we do not believe that the distinct trade-offs that Ofgem has identified in its option three actually exist. Therefore, we believe the introduction of an incentive mechanism based upon these trade offs would be inappropriate and would, in our view, increase the risk of unforeseen consequences and/or disproportionate complexity.

Our view on the strength of the proposed flexibility trade-offs described by Ofgem under option three is based upon a number of key factors, including the following:

1. Under the enduring arrangements, NTS flex capacity is constrained by geographical restrictions placed on it at a National, Area and Zone level by NGG

(NTS). The allocation of NTS flex capacity is therefore based upon and limited by these geographical constraints and not solely on the basis of how economical NTS flex is to the GDN when compared to investing on its own network.

2. Future availability of NTS flex capacity is uncertain as NGG (NTS) have indicated that they will not invest in their system for flex capacity. In reality, this has always been the case with flex capacity being a by-product of new pipelines designed solely to provide flat capacity. The NTS has never constructed or enhanced the design of a pipeline for the provision of flex capacity. In our view the definition of flex capacity as a ‘product’ in its own right, in the context of network code developments, has led to some confusion in this area.
3. Although we recognise that flexibility can potentially be provided from the NTS or from the GDN’s own network, these interactions are not always based on a one-to-one ratio nor do they necessarily exist as alternatives at every offtake and in every scenario. That is, inter-changeability between NTS flex capacity and GDN flex capacity does not always exist. For example, where a GDN requires “embedded” flexibility at the extremity of its network NTS flex capacity ceases to be an option. This has been demonstrably the case in the South LDZ.
4. As we have indicated in point 2. above, flex capacity is not a bespoke, “stand alone” product. Rather the availability of flex capacity varies depending upon changing levels of flat capacity. Increased levels of flat capacity utilisation within the local or national systems will result in decreasing levels of flex capacity availability. This will become an increasingly important factor with the implementation of the interruptions reform.

The above factors attempt to show the complex interactions and dependencies associated with flex capacity which in our view makes the trade-off potentials between NTS flex and GDN flex very complicated. We therefore believe that this complexity means that flex capacity is not the key incentive to focus on for the capacity outputs.

We also believe that it is not possible to make an assumption that the use of existing NTS flex capacity is the most efficient flex capacity product. As we have explained above, in some circumstances NTS flex is not a viable option for the GDN and therefore it would be inappropriate to adopt this assumption. Furthermore, the geographical constraints associated with the product and the relative competition within any one zone for NTS flex will expose GDNs to widely different charges for the capacity product. We therefore do not believe that it would be appropriate or practical to base an incentive mechanism based upon a marginal price for a unit of incremental NTS flex capacity against which a GDN’s investment choices would be judged. Any link with such a price and a GDN’s investment cost would have to be so prescriptive so as to recognise all of these interactions that the benefit of the incentive would, we believe, be outweighed by the complexity and compliance cost. For these reasons we would be firmly opposed to an incentive scheme of this form.

We therefore believe that there is a modified version of option three that should be considered. Under this proposal, the GDNs would be able to pass through the actual costs of NTS flex capacity. However, for the incentive aspect of the regime, rather as

they do now, the GDNs would forecast their target future volume requirements of NTS flex capacity. They would also forecast their capital expenditure to meet their forecast demand (and flexibility) requirements. A penalty/reward parameter that would be applied where the GDN booked more or less than the target forecast NTS flex capacity volume would also be agreed. If the GDN subsequently purchased more NTS flex capacity than they had forecast they would need, they would be exposed to a financial penalty calculated by multiplying the incremental volume by the incentive parameter. Where it was reduced the same calculation would be used to calculate the incentive reward. The risk/reward being capped at an agreed level.

**Question 7: Is it appropriate to assume that NTS and LTS flat capacity are complementary products? Should we incentivise tradeoffs between flat capacity and interruptible capacity?**

SGN agrees with the assumption that NTS and LTS flat capacity are complementary products and are not substitutes of each other. However, we believe that it will be very difficult, if not impossible, to accurately capture the trade offs between NTS/LTS capacity and interruption on the DNs. These are complex relationships - varying at each offtake point - and we consider that any incentive which tried to set a capacity "allowance" would risk distorting investment decisions. Indeed, until recently Ofgem/NGG have been designing business rules which treat offtake and LTS capacity as substitutes which underlines the limited understanding of the nature of the respective investments.

As with flex capacity, we would not therefore support a new incentive in this area which either tried to explicitly capture these trade-offs or simply set a lump sum allowance for capex/opex to cover both own investment costs and offtake capacity. We therefore believe that a passthrough of actually incurred costs of purchasing NTS flat capacity (and potentially interruption) should be introduced. This could be supplemented by a simple incentive similar to the electricity IIP scheme with a target level of efficient offtake capacity and interruption and appropriate caps and collars. This would not preclude the introduction of more ambitious schemes at a later date when more data and experience of the arrangements is available.

**Question 8: Should we incentivise accuracy of pipeline records? If so how could accuracy be measured and audited?**

We are not opposed to an incentive scheme going forward that rewards performance in this area. However, careful consideration needs to be given to the definition of accuracy and its application. Any incentive should not be about the inherent accuracy of records i.e. we would expect that any requirement to hold additional asset data (above that which the business currently requires) or being pro-active in identifying inaccuracies, would be funded through the price control. It should also be taken into consideration that pro-active checking of records will cause considerable disruption to customers.

Any incentive should therefore relate to reducing the time taken to update records. In our view, different targets would be necessary for updating records from the mains replacement activity, for new connections and for correcting existing records. It should also be borne in mind in any incentive, that we already bear the extra costs of connection to the network where our records turn out to be inaccurate.

### **Question 9: Is there a case for an innovation funding incentive?**

We fully support the introduction of an innovation funding incentive. We believe that investment in new technology, research and development and skills replacement is in the strong interest of customers.

The gas industry has not been correctly incentivised in the past, where the regulatory regime removes benefits at each price control review. Techniques cited by Ofgem in the consultation document as examples of innovation in mains replacement are, in reality, only marginal enhancements of existing techniques that were introduced in the previous decade. When compared to the benefits that have been realised with new techniques and technologies in other industries and other parts of the world, recent innovation in the gas industry is by comparison non-existent.

The lack of manufacturer and supplier willingness to introduce new techniques, materials and equipment, is also notable. Discussions with manufacturers and suppliers indicate high levels of frustration across the industry as a whole.

Finally, we believe that there is an excellent opportunity in this price control review, to introduce a mechanism similar to the Innovation Funding Incentive in electricity distribution. Also, there is potential for joint ventures to develop new technologies and skills development, with assisted or matched funding.

## **CHAPTER SIX**

### **Question 1: Should we allow for an ex post adjustment for changes in tax treatment for certain kinds of expenditure, as outlined in paragraphs 6.3 and 6.4?**

Repex is currently treated as opex for tax purposes i.e. full tax relief is allowed, whereas under IFRS repex is treated as capex. We agree that a move to IFRS, and any subsequent change in the timing of tax relief should be reflected in future tax allowances. However, we believe that such a change will be driven by complying with latest UK GAAP requirements, which are likely to be driven by the continuing convergence with IAS and IFRS accounting standard best practice, rather than companies voluntarily adopting IFRS. We therefore cannot envisage a circumstance where it would be appropriate for Ofgem to disallow any such increase in tax allowances.

We believe that the concept of rolling forward losses between pre- and post-tax price control regimes is inconsistent and should be reviewed.

### **Question 2: Which key ratios should we use as financeability indicators?**

We believe ongoing financeability should be a key factor when setting allowances. Regardless of our own views on the appropriateness of specific ratios, we are constrained by those ratios currently used by the ratings agencies, and therefore investors, to assess our financial health. Current ratios used by credit rating agencies of PMICR, FFO / Debt, FFO / Interest and Debt / RAV are therefore appropriate and

indicate the potential ability of GDNs to attract further investment.

Such ratios should be examined with respect to each year within a price control period to reflect the assessment that the ratings agencies will carry out.

**Question 3: How should we finance replacement expenditure, having regard to its impact on the overall financeability of the price control?**

We see no compelling reason to change the current arrangements that expense 50% of replacement expenditure. If there were to be a change whereby more repex is capitalized into the RAV, we would require the deterioration in cash flows to be addressed.

**Question 4: Should we change our depreciation rates for new assets in response to the changing mix of assets being capitalised?**

We accept that the mix of capex in the next price control period may indicate that the current 45 year depreciation on new investment may need to be reconsidered. As with repex financing, the maintenance of appropriate cash flows will be a key consideration in this regard.

## **CHAPTER SEVEN**

**Question 1: Which of the two forms of the network extensions incentive scheme should we adopt going forward?**

We continue to fully support the work being carried out to promote network extensions into fuel poverty areas, whilst simultaneously reducing carbon dioxide emissions. We believe that the development of the economic test, or an equivalent mechanism, is the best approach to promoting network extensions in an equitable and efficient manner.

However, we recognise that the economic test alone may not always provide sufficient stimulation for network extensions and will need to be coupled with a range of additional funding measures, including accessing government grants and further allowances through the price control review. In addition, At this stage in the development of the incentive schemes we believe that Option 3b would best incentivise the development of network extensions

Additionally, we believe that the extensive administration that will be required to coordinate any potential schemes (including gas infrastructure, internal pipework, appliances and fuel efficiency measures) will also require adequate funding, and it should be recognised that only a percentage of all the schemes developed are likely to be completed.

**Question 2: Do you agree with our assessment of the risks, costs and benefits attributable to the options for facilitating network extensions (see Appendix 6)?**

We support the use of an economic test, coupled with an incentive promoting co-operative work to gain government funding. We believe that further details of the mechanism behind the various options are required to fully assess their respective risks,

costs and benefits. However, at this stage, we favour Option 6 as a basis for further development. This is because, referring to the matrix, we believe that, unlike Option 5, it has a positive effect on competition and is relatively simple to implement. It is not entirely clear how Option 5 would work, but we are concerned that the accounting arrangements would be complex.

**Question 3: Is our proposed methodology for quantifying the costs and benefits associated with the various options appropriate (see Appendix 6)?**

As per our response to Qu.2 above – we would like to have more information on the mechanism behind the various options to properly analyse the methodology for quantifying the costs and benefits associated it.

**Question 4: Is it appropriate to set an incentive scheme which recognises the initiatives that some companies undertake with respect to their corporate social responsibilities?**

We would support a scheme that rewards GDNs for good performance in this area. We would therefore support a similar mechanism for a discretionary reward scheme as was introduced in the last electricity distribution price control.

**Question 5: What other criteria should be included in a Corporate Social Responsibility incentive scheme for GDN's'?**

We do not believe that the example in the consultation document of network extensions and carbon monoxide (CO) detectors are appropriate for such a scheme although we still see the need for an incentive to fit CO detectors. In our view the criteria should be the overall interaction with the community through wider communication, awareness campaigns, school visits etc. Also the scheme could cover pro-active customer initiatives, such as the provision of on-line information.

## **OTHER ISSUES**

### **Shrinkage Factor**

We understand the issues in relation to leakage and methane emissions but it is not immediately clear to us what more can be done to address this by way of price control incentives. However, we would be happy to have further discussions on this.

## **CHAPTER EIGHT**

**Question 1: Do you agree with our assessment of the risks, costs and benefits attributable to the two options for the funding of Xoserve?**

Our major concern with the present arrangements for the funding of xoserve is that transporters have to bear the risk that there may be changes to the core industry systems mid-price control, which result in additional cost. Transporters cannot control such changes and hence face significant risk of additional system development cost that was not anticipated at the time the price control was set. There is also no incentive on shippers to reduce their cost burden on xoserve services, for example through restricting

new UNC modifications or reducing utilisation of existing services. One effect of this is to produce a tension between the network owners of xoserve and shippers about whether costly changes to the core industry systems should be made (even where from an industry perspective such changes might be efficient).

We would support a separate price control for xoserve but we understand that this might not be straightforward, in terms of separate licences etc.

We therefore broadly support the current industry dialogue aimed at introducing a new mechanism whereby the existing xoserve range of services is funded through allowances in the existing DN and NTS price controls and charged out to users in the present way (we believe that reform of changes to the present *charging* framework for xoserve - as opposed to the allowed revenue - are a separate matter, not related to the price control). However, any changes to the core service would be funded by users that would benefit from such changes. This would limit the risk exposure to network companies, avoid any perverse incentives for such companies to resist appropriate change and simultaneously focus incentives on shippers to only promote change that results in significant benefits (bearing in mind the costs).

We do have some further concerns with this approach which need addressing. For example, a user pays approach to the funding of xoserve activities may lead to a more focused approach by shippers to the raising of new process requests and the utilisation of current core xoserve services, and in turn direct costs towards the heaviest users. However, where shippers reduce their reliance on xoserve services, a smaller group may be left utilising such services which may have the impact of reducing service income and stranding xoserve investment.

Also, under the user pays option, changes would be required to the current governance arrangements to allow for all modification proposals to be defined in terms of how they were to be funded.

The user pays approach would also allow for the implementation of premium services where shippers would be prepared to pay for the additional benefits these services could bring. Costs associated with implementing these variable service standards to different users could increase with the complexity and administration involved in such a process.

**Question 2: If we adopt a core services plus user pays approach (Option 2), how should we define core services and user pays services?**

The criteria for a user pays service should be that:

1. The key stakeholders are users;
2. Users have discretion on whether to use the service;
3. The costs associated with the service is usage dependant.

Otherwise, current services provided by xoserve from regulated assets i.e. excluding other commercial services, should continue to be funded through the price control.

**Question 3: What costs/benefits would your organisation incur in the event that we adopt Option 2?**

An immediate benefit would be the reduced costs associated with the provision of new services associated with UNC modifications for the benefit of shippers. However, existing services re-defined under the user pays option could lead to reduced costs and stranding of xoserve investment.

Increased costs would be associated with the initial set up of the process and to establish the enduring management of the contractual framework.

**Question 4: What questions do we need to ask GT's, xoserve and shippers in order to accurately quantify the costs associated with Option 2?**

Shippers will need to indicate the nature and volume of potential new services that will be requested under the new arrangements, also the likely utilisation of existing services that may be reclassified as user pays.

**Question 5: In the event that the Secretary of State requires GDN's to put in place further alternative arrangements relating to independent systems, should the excess costs associated with independent systems be:**

- **Spread across all GB consumers via transmission charges, or**
- **Borne by customers located in gas distribution areas where independent systems are located (primarily Scotland)?**

We do not think that it is appropriate that customers located in gas distribution areas, where independent systems are located, should bear the excess costs associated with these systems. This arrangement makes these networks disproportionately more expensive than those networks with no independent systems. A situation that would clearly be exacerbated if the excess costs associated with the independent systems were to increase as expected in respect of the Glenmavis LNG costs. As Ofgem has identified, this issue is particularly acute for the Scottish GDN that supports five relatively large independent networks.

Indeed, we believe that spreading these costs across all GB consumers via transmission charges would be more attuned to the DTI Position Paper on Policy regarding the treatment of Independent Gas Networks issued at that time of the GDN sales. This policy determined that the consumers connected to the independent networks should be cross subsidised so that they should be charged no more than the average charge for conveyance to premises in GB. Furthermore, paragraph 3 of that Position Paper specifically referred to the cost of the cross subsidy 'to all GB consumer'. While the current alternative arrangements ensure that these consumers pay no more than the average GB price for the conveyance of gas, it does not ensure that GB customers provide the cross subsidy of the extra costs associated with these networks. Rather, the majority of the cross subsidy for conveyance of gas to these customers is provided by the other customers connected to the relevant GDN.

Spreading the excess costs of conveying gas to these consumers across GB consumers, via transmission charges, would also be consistent with arrangements that have been put in place in Electricity in respect of assistance for areas with high distribution costs.

Further discussion on the above issue is provided in confidential Appendix Two (attached). We have also raised a number of other issues related to the independent undertakings that we believe should be considered as part of the GDPCR in that attachment.

**APPENDIX TWO (CONFIDENTIAL)**