Scotia Gas Networks plc **APPENDIX**

Response to the Gas Distribution Price Control Review – Initial Proposals Document

CHAPTER 1: Introduction

There are no specific questions in this chapter.

CHAPTER 2: Form, structure and scope of the price control.

Revenue driver. We agree with Ofgem's initial proposal to remove the volume driver from the price control. This would be consistent with the one year control and, in our view, better reflects the underlying costs of the GDNs. We also support Ofgem's initial proposal not to include a connections related revenue driver. However, we are disappointed that Ofgem has not proposed the introduction of a revenue driver that is based upon the number of customers since, in our view, this would give the GDNs an incentive to increase the number of connected customers and therefore increase the efficient utilisation of their networks.

Scope of Price Control. We support Ofgem's proposal to treat as pass through items the costs in relation to investigating theft of gas and payment claims associated with last resort supply. Likewise, in the event that there is a move to a "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.

We welcome Ofgem's initial proposals to maintain the existing approach to treat the costs associated with the provision or modification of connections as excluded revenue rather than bringing these costs within the ordinary price control. Their treatment as an excluded service is simple to administer and accommodates the considerable volume uncertainty.

In paragraph 2.9 Ofgem refers to the various services that are provided by the GDNs to the NTS and those provided by NGG GDN to the other GDNs, including the provision of the national emergency phone number. Currently the revenue received by the service provider is consented to be exempt from the de minimis cap. Ofgem intends to give further consideration to the appropriate treatment of those services that will not fall away with time as and when the consents expire but, at this stage, does not propose to treat them as excluded services. In our view, each activity associated with these services are legitimate GDN transportation activities, albeit they are being provided as a service to another party. While the current consents that exclude them from the de minimis cap essentially treat the revenue in the same way as if they were an excluded service, we would be concerned if there was any suggestion that *without* the consent they could considered a de minimis activity. For those services that are likely to be enduring, the ongoing requirement for a de minimis exemption consent creates potential risk to the GDNs and is unduly onerous on both Ofgem and the GDNs. We continue to believe, therefore, that to the extent that the services continue to be provided, they should be treated as an excluded service.

Irrespective of how the revenue associated with the provision of these services is treated, we do believe that where a service is being provided as, essentially a monopoly service (i.e. the national emergency phone number), there should be transparency in the charges that are levied by NGG GDN on the other GDNs. Most importantly, these charges should be *fully* reflected in the receiving GDN's allowed revenue. Failure in this respect places the sold GDNs at a disadvantage when compared to NGG GDN which is providing the monopoly service.

In addition to the above inter-GDN/NTS services, there are other services that are being provided by the GDNs to iGTs and suppliers which are likely to endure for the medium term and are which are subject to the consents described above. For example, post-emergency metering services and emergency services to iGTs. In our view, both of these activities are legitimate transportation activities and should therefore be categorised as an excluded service in the relevant licence condition (we believe the iGT emergency services is not currently explicitly included as an excluded service).

Turning now to Ofgem's initial proposals for the treatment of business rates. Ofgem has proposed an ex ante allowance that is based on the present level of rates, with a mechanism in the licences to allow companies to recover the difference between their out-turn costs and the allowance. However, Ofgem

has proposed that the adjustment mechanism will be automatically “turned off” from 2010/11 and only “turned on” again if the companies can prove to Ofgem that they have “engaged efficiently” with the relevant rating agencies during the rating revaluation. While we recognise Ofgem’s rationale to incentivise the GDNs’ participation in the revaluation exercise, we continue to believe that the presumption of a rates pass though should be maintained within the licence and therefore, the adjustment mechanism should apply for the whole price control period but subject to a possible direction by Ofgem to turn it off after 2010/2011.

Price indices. We agree with Ofgem’s proposal to retain the use of the RPI price index and not to link any cost allowances to alternative costs indices, apart from gas shrinkage. Real price effects including wage, contractor and material costs should be allowed for in the upfront cost allowances and efficiency targets discussed later in this response.

Dealing with uncertainty, new obligations and costs. For the reasons outlined in the initial proposals document, we support Ofgem’s continued approach to include specific reopeners in the licence drafting for the impact on the GDNs of the Traffic Management Act 2004, the Transport (Scotland) Act 2005 and tax changes that could occur within the price control period. However, as set out in our response to Ofgem’s third GDPCR consultation document, we also believe that Ofgem should include a further reopener to deal with other, yet unknown, events including change to relevant laws where the impact is demonstrably above a certain, predefined, threshold.

A further area of change that could impose significant additional costs on the GDNs within the price control period is that associated with industry change particularly through the UNC modification process. This could impact the GDNs’ own, direct costs as well as those incurred by xoserve. We address this point later in the response.

Finally, Ofgem has acknowledged that there is uncertainty over the impact of exit and interruption reform on the GDNs’ capital investment plans. Ofgem has provided a summary of these reforms in chapter 6 and has said that it will progress capacity output incentives associated with the reforms in due course. We will of course participate fully in that discussion at the time. However, at this stage it is important to stress that the principle should be established that the GDNs should not be penalised under the IQI incentive proposal if capex outturn is greater than expected due to these reforms and that any additional, efficiently incurred capex should be fully funded. The price control will therefore need either a re-opener mechanism to address this or alternatively a robust scheme for “logging-up” investment (on an approved basis). In either case, any such investment must be capable of “pot 3” funding.

Question 1*: Do you think that a wider deadband on the revenue recovery correction mechanism is appropriate in gas distribution?*

As we set out in our response to Ofgem’s third GDPCR consultation document, we support the move to a symmetrical application of interest rates in the event of an over or under recovery of allowed revenue. However, we do believe that there needs to be a wider deadband on the revenue recovery correction mechanism in gas when compared to that in electricity for the following reasons:

- The GDNs are restricted from adjusting their charges more than once a year without Ofgem’s consent;
- The GDNs’ charges are set to coincide with the gas year and not the price control year against which the GDNs’ performance in this respect is judged;
- Even with the removal of revenue drivers, GDNs’ allowed revenue will continue to be influenced by weather to a greater degree than that in electricity;
- The implementation of NTS exit reform and DN interruption reform will mean that GDNs are exposed to actual costs over which they have no direct control;
- A further implication of NTS exit reform is that the GDNs will be subject to the impact of the NTS revenue adjustment mechanisms that are required as a result of the NTS recovering much of its allowed revenue through auction mechanisms; and
- The introduction of more incentive based regulation (particularly in respect of NTS exit reform and DN interruption reform) introduces further scope for under/over recovery.

Together, the above issues mean that the GDNs are/will be exposed to a much greater potential for over/under recovery than the electricity distribution network operators for which we do not believe they should be unduly penalised. We therefore believe that a higher deadband should be introduced; at the very least the penal interest rates associated with the two-tier approach should be symmetrical.

Finally, we continue to believe that Ofgem should consider removing the charge restrictions to enable the GDNs to change their charges more frequently than they can under the current regime.

CHAPTER 3: Operating expenditure analysis.

***Question 1**: Do you agree with our approach for setting opex allowances and the proposed allowances we have derived using that approach?*

Opex allowances. Ofgem's proposed allowances for operating costs going forward are, in our view, insufficient. This is partly as a result of unrealistic and flawed productivity assumptions. The DNs commissioned a report from First Economics, and we welcome Ofgem's continued consideration of this report, which we believe robustly critiques the Europe Economics/ Ofgem work and concludes that rather than Ofgem's assumption of a frontier shift downwards of 1.6% p.a., instead supports our view that DNs' costs will rise on an above-RPI trend. They also point out a flaw in Ofgem's methodology.

Related Party Margins.

SGN insourced the delivery of new connections and part of our contracting resource during 2006. The prime driver for this decision was to improve customer service, safety and to gain more control over workload delivery in key areas such as replacement work. We have concerns over the treatment of potential margins generated by these businesses, both in 2006/7 and during the main price control period.

We believe that the 2006/07 margins should not be removed from the DN's costs for a number of reasons:

- There is no capex roller facility is in place to recover any of these margins which essentially removes all efficiency savings incurred;
- This penalises SGN for the quick exit from Fulcrum contract, which was initiated to improve on historic poor customer service; and
- Rates charged by these businesses to the DN are market tested and governed by arms-length SLAs between the DNs, SGN Connections and SGN Contracting.

Ongoing – we have concerns over the approach proposed by Ofgem and believe there has been insufficient dialogue to date. Our specific concerns are:

- Where rates are market tested, we believe our forecasts are robust as the related party is taking on board both the incentive to become more efficient and the risk of losing money;
- Removing margins risks incentivising DNs to outsource rather than seek the most efficient solution. In our view, incentives need to be put in place to reward efficient insourcing which should go beyond the levels in the capex roller; and
- Under our model, our rates are market-tested and the strong ratchet effect ensures that consumers in the short term will still pay the same irrespective of our decision to insource/ outsource, and in the longer-term benefit as the market will quickly correct as we will continue to source a proportion of work from external contractors.

Real price increases. We also believe that Ofgem have significantly underestimated future labour costs, both direct labour and contractor labour. We commissioned external consultants, Deloittes, to report on this and have submitted their report under separate confidential cover.

Direct Labour – The Deloittes report supports our view that Ofgem's real price increase assumption RPE of 1% is understated and that direct labour costs might be expected to rise at up to 1.9% p.a. above RPI. In our view, Ofgem has placed too much emphasis on recent developments and insufficient emphasis on forecasts. Forecasts are likely to be more appropriate than backward looking historical data to derive inputs for the forthcoming regulatory control period. HM Treasury Forecasts for the UK economy and the NGG commissioned Hay report both suggest real growth rates in the region of 1.6%, compared to Ofgem's assumption of 1%. Similarly Deloittes report for the Office of Government Commerce concludes that wages for skilled workers will still increase on average by 3.9% per annum during the next 10 years. With inflation estimated to be in the range 2.0%-2.5%, this implies a real price effect for skilled construction labour of around 1.4-1.9% for the period of 2005-2015.

Contractors – The work undertaken by Deloittes also confirms the assumptions made in our forecasts, and that the 2% real increase proposed by Ofgem is significantly understated, that contractor labour costs might be expected to rise at 3.2% p.a. above RPI nationally, 3.9% p.a. above RPI in the rest of the South East and in London at 4.5% p.a. above RPI. In addition, using the methodology adopted by Ofgem, and applying to the latest data set, the real growth rate derived from EC Harris is significantly understated. There is also clear evidence using EC Harris that there is a differential in London and the South East.

Regional factors. We remain of the view that Ofgem's analysis significantly understates the additional costs of operating in London and the South East. We have commissioned a report from Deloittes which supports our view, and have submitted this separately under confidential cover.

Direct labour – Based on Ofgem's methodology in determining a regional factor for direct labour, an assumption has been made as to the amount of work that takes place within the M25 and the proportion of work management activities that needs to be close to this work. This has produced a regional factor of 1.066 assuming only 40% of work management activities need to be where the work is undertaken and that 30% of South's work is within London. Analysis by SGN and supported by Deloittes (and updated for 2006/7 costs) shows that at least 60% of work management activities are required where the work is undertaken and 33% of work is within London. In addition, we also have externally supported evidence that due to the close links between the labour markets in London and the South East, an uplift is also required for the remaining part of our South East LDZ. This gives a regional factor of 1.10 – 1.115 (depending on further work to be undertaken on the proportion of work management activities that are located in London/ South East).

Contract Labour – we have not seen any robust information supporting Ofgem's assumptions of a regional factor of 1.09 for Southern Gas Networks. We believe that a significant proportion of the gap between ourselves and Ofgem on replacement expenditure cannot be readily explained (after taking into account differing RPE views and known challenges to the regression methodology). Given that replacement is fairly mechanical and contract structures are fairly standard, we believe there is no significant difference in efficiency between DNs. The unexplained gap can only be down to further regional factors not taken into account and ask that Ofgem provide more transparency on how their conclusions have been reached (we comment further on repex below).

In addition, we welcome the fact that Ofgem is still considering additional allowances for operating in dispersed rural areas, in particular the costs of meeting the one hour emergency response standard in Scotland. We have submitted separately further analysis of these additional costs.

Pensions – We welcome the commitment not to change the pensions principles already applied in previous reviews.

Question 2*: Do you agree with the proposals to uplift allowances derived from disaggregated benchmarking so that they are consistent with the power of a top down approach?*

In previous reviews, Ofgem has used the upper quartile of the regression analysis of actual costs as the benchmark. In GDPCR, through the bottom-up approach, the quartile benchmark of "virtual" costs is used, producing unrealistic targets through implied "cherry-picking". Therefore, while we support the principle of, and the reasons for, applying an uplift to the bottom-up benchmarking analysis to be

consistent with the top-down approach, there is no logic to the uplift being constrained to the frontier of the top-down approach. The uplift must be applied to the upper quartile of the top-down analysis or, for example, even the frontier company is not rewarded.

Question 3*: Do you agree that GDNs' Emergency Service Personnel should be required to carry and use carbon monoxide measuring equipment during gas emergency investigations?*

We are very concerned that Ofgem is yet to propose an acceptable allowance for the costs of the Emergency Service, given the uncertainty surrounding the continuation of meter work contracts with National Grid Metering, and the time it would take to find replacement work.

Our Emergency Service, by its very nature as a 24/7 service with 1 hour response times, has significant levels of unproductive time, as we have to resource to peak winter levels. Due to the flexible nature of the meter work scheduling, common competencies with emergency engineers, system synergies and the ability to drop work quickly to answer an emergency call, this work provides an ideal filler for the unproductive time. Historically, this work has provided substantial workload which has utilised £17m of this unproductive time.

However, our meter work is heavily reliant on National Grid Metering (NGM), who own the bulk of gas meters, and in turn with their continued appointment as meter operator by shippers. We have already seen contracts with National Grid terminated, and NGM going out to tender for meter work. This is an issue for all DNs and is a consequence of metering competition. With the additional pressure from shippers to ensure meter appointments are kept, we believe that there is a high likelihood that we will lose the remaining contracts with NGM when they expire in June 2008. This will result in less flexibility than we previously had and will inevitably lead to a more dedicated workforce and more unproductive time in the Emergency process.

Finding alternative filler work will not happen overnight and filler work needs to be flexible in order to ensure that resources remain in the right location and can be easily diverted at short notice.

Ofgem have initiated an investigation into whether emergency engineers can carry out additional CO monitoring on visits to customer premises, and we have responded separately on this. While we welcome an industry debate on tackling this important issue, we have serious concerns about potential liabilities and additional costs, and we believe that much work is needed to develop a working solution. In addition, we do not believe that CO monitoring will materially address the existing unproductive time issue as it is likely to at the very least double the time required to be spent in customer premises which will in turn require additional peak resources. We consider that these additional costs woule be substantial and this proposal would significantly worsen, rather than help, the unproductive time issue.

CHAPTER 4: Capital and replacement expenditure analysis.

Question 1*: Do you agree with our approach for setting capex allowances and the proposed allowances we have derived using that approach?*

<u>Capex allowances</u>. The Initial Proposals include a significant reduction in our LTS & Storage forecasts submitted. We strongly dispute the reductions for the following reasons.

Timing. In the Initial Proposals, a number of storage projects have been deferred outside of the next price control period on grounds that the balance of storage required and storage available within the network does not merit planned investment in line with SGN's timing assumptions. However, this view appears to be largely based on the assumption that levels of NTS diurnal storage will be maintained throughout the control period. We have had further discussions with Ofgem and with NTS and expect that our re-submission will largely close the gap between us and Ofgem.

Unit Cost Assessment. Where projects have been allowed within the period, adjustments have been made to the required level of investment based on an assessment of historical unit costs for pipelines. We disagree with this assessment, and believe that the sample of projects used is incorrect as it includes both pipeline and storage projects. It is well documented that these two types of project give rise to disparate unit costs due to the fundamental differences in design and operational requirements.

The inclusion of pipeline projects artificially and incorrectly lowers the historic unit cost. A sample containing only storage pipelines would provide a more accurate assessment. Notwithstanding the use of an incorrect sample, we are also concerned that recent changes to steel material costs and tendered labour costs in this sector have been far in excess of RPI or general inflationary pressures in the construction industry. The use of historical data to derive and extrapolate future unit costs is clearly unreliable being heavily weighted to historical costs that bear no resemblance to current market conditions. We have provided Ofgem with project specific costing based on tendered market prices as part of the BPQ update process.

Reform of Exit and Interruptions Regime. We would reiterate our concern that the proposals for the reform of Exit and Interruptions Regime (UNC Modifications 116 and 90) introduce a high level of uncertainty around network investment in LTS, and that the interaction with the price control proposals has not been taken into account so far. We understand that Ofgem are reviewing the LTS capex requirement and to that end have sought further information from networks on the likely impact on investment in this area. We expect that the updated proposals would provide clarity on investment allowances and associated capacity incentives. We remain of the view that in the light of increased complexity associated with these reforms, a simple mechanism for recovery of additional investment costs should be adopted.

Question 2*: Do you agree with our approach for setting repex allowances and the proposed allowances we have derived using that approach?*

We consider that the regression analysis deriving allowances is not sufficiently robust on its own. Repex is primarily driven by statutory requirements, performed mainly by contractors with market-tested rates and utilising relatively standard practices. It is inconceivable to us that the significant efficiency gaps that are indicated by the regression analysis performed on 2005/06 actuals, are real so soon after Network sales,. In simple terms, Ofgem's repex allowance infers an unprecedented Year 1 efficiency improvement for Southern Gas Networks of 22%.

We believe there is sufficient doubt regarding the benchmarking due to a number of potentially distorting factors such as:-

- Differing contract rates that may be due to levels of contract rate exclusions (particularly higher due to working in the London area);
- Potential to offer higher levels of insertion, mains laid and size of projects, that are more likely to be driven by relative positions on the risk reduction curve and choice over abandonment ratios rather than underlying efficiency – these factors may influence the contract rates that could be offered to contractors;
- Movements in workload throughout the period where regression slopes remain constant at the position set by the 2005/6 analysis;
- Application of regional factors, as discussed above, which are highly subjective and not supported by sufficiently robust indices; and
- Choice of mains laid rather than abandonment as a volume variable where DN's have significantly different main abandoned to laid ratios.

We believe a combination of the above is adversely impacting on networks, particularly Southern.

In addition to considering these factors we would also urge Ofgem to apply an uplift to the benchmarking to at least bring the target unit cost to the quartile or actual cost used.

We conclude that Ofgem should take note of the external analysis provided on real price increases, incorporate the actual starting position for 2006/07 actuals (which we believe should address our concerns on regional factors) and provide a credible top down sense check.

Finally, with regard to repex workload, we continue to propose a proactive approach to steel replacement, as the efficient solution to avoid a cliff-face/ step increase in the future to comply with longer-term HSE requirements on risk removal. We also welcome the industry dialogue proposed by Ofgem to proactively address the issue of riser replacement and alternative solutions.

CHAPTER 5: Outputs

Question 1*: Do you support our proposals for changes to the outputs and quality of service arrangements?*

Overall, we support Option 2 – Rationalising and updating the outputs and standards of performance arrangements and improving measurement, subject to our comments set out below.

Overall Standards of Performance (OSOP). While we agree with the proposal to revoke the OSOPs, we have some concerns with the detailed proposals to migrate these obligations to licence conditions or guaranteed standards of performance (GSOP).

OS1 – Telephone calls. It is proposed to migrate this OSOP to a licence condition. NGG operate this service on a national basis on behalf of all the DNs. NGG cannot disaggregate performance by DN, therefore any target contained within the licence condition has to be a national target.

OS2 – Advance notice of planned interruptions. We do not agree with Ofgem's proposals to replace OS2 with a guaranteed standard. Firstly, OS2 currently does not require the specific date of the interruption to be notified, and we are concerned that as a guaranteed standard DNs will be expected to give specific dates five days in advance. This will restrict operational efficiency and in our view will be a backward move from the current service provided, whereby we contact customers in a range of ways e.g. by letter, telephone or door to door calls, especially for safety reasons.

New systems will be required to support this standard, for example to be able to confirm that individual customers have been sent the required notification. We are also concerned as to how DNs prove that a customer received the letter. For example, we do not hold customers names and contact details and letters addressed to "The Occupier" are frequently discarded. . We constantly review best practise, and are currently looking at branding to encourage customers to take notice of written notifications, but DNs will inevitably be exposed to a level of incorrect claims under the guaranteed standard.

We also do not support the two stage approach suggested, which could provide for an earlier notification one month in advance followed by written notification five days before the interruption. It is our experience that the initial written notice is important, and that is what OS2 measures. We see no reason to change this, and believe that this can be adequately monitored through the customer satisfaction survey.

Finally, OS2 sets a 95% compliance target. Replacing it with a guaranteed standard implies a 100% target, or else the DN has to make compensation payments. As a minimum, we would expect an allowance to be given in the price control for such increases in costs, in addition to an allowance for incorrect claims and the costs of system changes.

OS5 – Gas emergencies. We support moving OS5 – attending 97% of gas emergencies within 1 [or 2] hours, to the outputs monitoring condition SSC D9. However, we would expect the 97% target to remain an annual target, to allow for monthly/ seasonal variations, even though it may be subject to quarterly reporting.

Guaranteed standards of performance.

Compensation payments for third party and water ingress interruptions. We see no reason, or logic, for exposing DNs to the remaining 5% of any payments in excess of the threshold amount "to ensure that [DNs] are appropriately incentivised to restore consumers' supply quickly in all instances". This is, in our view, completely unnecessary as DNs are driven by customer pressure to reconnect customers as soon as possible.

GS3 – Alternative heating and cooking facilities. We do not support the extension of this standard to include, in addition to priority customers, all customers who request it. This could easily extend to all customers interrupted, and there would be significant practical difficulties. For example we do not carry unlimited stocks of equipment and there would need to be a definition of the requirement e.g. one heater per house? We believe that Ofgem's proposal is unworkable and that the original proposal to remove GS3 and replace it with a licence condition would better meet Ofgem's concerns, especially given that customers are satisfied with the way in which DNs currently perform to/ exceed this standard.

Question 2*: Do you support our proposals for improving the accuracy of pipelines records?*

The additional output reporting requirement proposed seems a sensible and proportionate approach. We agree that financial incentivising may lead to perverse incentives and, bearing in mind the "legacy" issues not within DNs direct control, therefore would not be robust.

Question 3*: Is Ofgem's proposed approach to setting allowances for the outputs and quality of service arrangements for 2008-13 appropriate?*

We have commented above on the need to provide allowances for the replacement for OS2. We also believe that GS3, in its proposed form, should reflect the increased costs likely to arise.

CHAPTER 6: Incentives.

Question 1*: Are the proposals for the capex rolling incentive and IQI appropriate?*

We continue to support the proposals for the capex rolling incentive. However, while we also support the IQI in principle, we have concerns about the way it is being applied. Firstly, we see no justification for disallowing the 5% uplift which was allowed in DPCR4 for electricity distribution. The Initial Proposals claim that the 5% uplift in DPCR4 was because the IQI was based on the consultants' base case assumptions and that the same reasons do not apply in GDPCR where DNs' forecasts it is claimed have been taken more into account. We fail to see this, given that no DN appears to be close to the 100% "consistent with consultants" position. The model is essentially asymmetric in its incentive properties, with DNs facing significantly more downside risk than upside potential. For example, even to be reward/ penalty neutral, DNs would still be exposed to a 15% overspend if their forecasts turned out to right compared with Ofgem's assessment.

Question 2*: Is it appropriate to implement an opex rolling incentive?*

We agree that this should be considered further, since the data issues that have manifested in previous reviews are not relevant to gas distribution. However, it should not be at the expense of other incentives such as the Innovation Funding Incentive.

Other

Innovation Funding Incentive (IFI). We continue to support IFI, and see strong potential in areas such as smart metering, leakage reduction, CO monitoring, small-scale LNG in remote [fuel deprived] areas and bio-methane transportation;

Skills replacement. We, in common with the other DNs, are concerned about the emerging issue of our ageing workforce and how to address the significant cliff-face in recruitment and skills replacement. We believe that allowances need to be included in the coming price control to start to address this issue, and welcome Ofgem's continued discussions in this area.

CHAPTER 7: Sustainable development.

Question 1*: Do you agree with our assessment of the risks, costs and benefits attributable to the options for facilitating network extensions (Appendix 14)?*

We agree in principle with Ofgem's assessment of the options detailed in the Initial Proposals.

Question 2*: Do you agree with our initial proposal (i.e. Option 3 complemented by a discretionary reward scheme)?*

Our preference continues to be for Option 3b i.e. a specific incentive for network extensions, linked to an output measure. We suggest an appropriate measure to be the number of all schemes initiated in each year, whether they meet the Economic Test or not. Such an incentive, in our view, would still provide for other innovative methods that can be developed for gas supplies to the fuel poor, outside of the economic range of gas networks.

Question 3*: Do you consider our proposed method to implement Option 6 appropriate (i.e. through GDNs' connection charging statements)?*

We continue to support the conclusions for Option 6 (amended Economic Test), complemented by Option 3 (incentive scheme)

Question 4*: Do you consider the Government's Index of Multiple Deprivation to be an appropriate index to identify which fuel poor non-gas communities qualify for special treatment for gas network extensions? If not, what do you recommend?*

This seems a sensible approach.

Question 5*: Do you support our proposals for the introduction of a Discretionary Reward Scheme for GDNs and its format given the larger reward?*

We support the introduction of a Discretionary Reward Scheme to recognise best practice in service to customers, for example in CO poisoning awareness. However, the Initial Proposals are too prescriptive in the areas it will cover and risks restricting the innovative nature of such a scheme.

CHAPTER 8: Other issues.

Question 1*: Do you agree with our proposed approach to the funding of xoserve?*

We repeat our major concern with the current arrangements for the funding of xoserve, in that transporters have to bear the risk that there may be changes to the core industry systems mid-price control, which result in additional costs. 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.

While we support in principle a "user-pays" approach as a route to overcoming our concerns, we are concerned that there is still some way to go before Ofgem's current proposals adequately address our original concerns, given the additional cost and risks of the new arrangements and uncertainty over governance arrangements.

Question 2*: How should we address any benefits arising to xoserve from redundancy created from the replacement of UK Link?*

It is our understanding that there will be no built-in redundancy in the replacement of UK-Link.

Question 3*: Do you agree with our approach of modifying SSC A15 to facilitate governance arrangements for user-pays?*

Our fundamental concern with the proposed arrangements are in relation to governance, which has yet to be finalised. Transporters will clearly be prepared to pay towards changes which they raise, however they should not be exposed to additional costs of system changes initiated by users, otherwise the new arrangements are no more acceptable than those they replace. The governance arrangements are key to this and must be consistent with the way in which xoserve is funded through the DNs i.e. DNs should still receive an allowance for residual costs to which they are exposed.

Question 4*: Do you think that the existing arrangements are adequate to ensure enforcement of the range of services and outputs delivered by xoserve in light of these proposals?*

We believe current arrangements are working well. GDNs are aware of their obligations to deliver these services.

CHAPTER 9: Financial issues.

Question 1*: What are your views on the factors relevant to our consideration of cost of capital?*

Cost of capital

- Whilst we appreciate that the cost of capital analysis set out in the Initial Proposals is likely to be adjusted prior to the Final Proposals, we wish to emphasise our strongly held view that the initial proposal of 4.22% (post-tax, real) is significantly below the level required to provide a robust financial basis for the gas distribution business. In order to explain our reasoning, we have set out below our views on the Cost of Debt and Cost of Equity, and combined these to propose what we regard to be a viable cost of capital for the business.

Cost of debt

Debt capital market conditions have changed materially during the past 9 months, with both risk free rates and credit spreads now substantially higher. This trend seems set to continue.

Risk free rate

- We note Ofgem's reference to the cost of debt proposed by the CAA as part of the price control for landing charges at Heathrow and Gatwick. On the matter of the risk free rate, we would echo the concerns voiced by EDF Energy in their submission of 27 April '07 to the Competition Commission. In this submission, and backed by detailed analysis by NERA, it is argued that the CAA's proposals understate the risk free rate by at least 50bps, with the understatement being attributed to arbitrary interpretation of evidence, methodological inconsistencies and biases in the use of UK Gilt Yields. We would endorse these points.
- We also believe that the analysis carried out by Oxera, as detailed in their 19 September '06 report, "the cost of capital of the gas DNs", should be factored in. Oxera focus on the issues of mean reversion in the risk free rate and the critical nature of regulatory commitment and how this would be undermined by a significant and unjustified reduction in the applied risk free rate.
- With nominal gilt yields now between 80 and 100 basis points higher than they were in November 2006, we are of the opinion that an increase of 50 bps on the 2.5% risk free rate applied in the TPCR should be considered to be the minimum acceptable level for the purposes of this review.

Debt premium

- Debt premia have been markedly low for a prolonged period of time. There are however now clear signs that this favourable situation will not continue, with credit spreads now moving sharply higher. Continuing concerns over sub-prime lending in the US are likely to further exacerbate conditions in the UK debt markets. We are of the opinion that an increase of 15 bps on the 1.25% debt premium allowed for in the TPCR should be considered to be the minimum acceptable level for the purposes of this review.
- Our views on the debt premium are supported by Oxera's report of 19 September '06 which notes that spreads are historically low and recommends that weight is given to longer-term historical averages, citing the Bank of England's warnings regarding the tightness of recent spreads on corporate debt. Oxera also find that the credit quality of the gas distribution sector is below that of the UK water sector with key risks being those of fuel switching, exposure to catastrophic risk, the impact of weather conditions and the relative immaturity of the sector.

- We would add to this list of significant risks the potential for stranded costs which is higher for the gas sector than the water sector, and has the effect of limiting the potential tenor of debt finance for gas, as compared to water.

Indexing

- On the issue of indexing the cost of debt to a market rate benchmark so as to achieve a cost of debt that would vary both within and between price control periods, we would refer to our response to the February '06 consultation paper, "Financing Networks: A discussion paper". In that consultation, we were asked to consider whether regulators should assume that a proportion of debt is index-linked – this would be the effect of assuming an indexed cost of debt. In our response, we questioned the appropriateness of regulators effectively constraining the options of management in pursuing an efficient capital structure. We remain firmly of the opinion that such decisions should be for management, with regulators focusing on maintaining and improving regulatory certainty, as Ofgem highlight in the Initial Proposals.
- The Centrica / CEPA proposal to operate an adjustment mechanism to protect against adverse movements in the cost of debt during a price control is interesting, but in our opinion is overly complex and would be problematic to operate in practice. We also believe that it is an unnecessary measure which would effectively remove the incentive for DNs to secure appropriate long term financing when market conditions are favourable.

Proposed cost of debt

- We believe that the current market and other academic evidence would suggest a cost of debt of at least 4.4% (pre-tax, real) - being 3.00% risk free rate plus 1.40% debt premium.

Cost of Equity

- We note Ofgem's intention to continue with a range for the cost of equity of 6.5% to 7.5% and your intention to consider the relative risk of gas distribution as compared with transmission. As Ofgem are aware, the Gas DNOs commissioned Oxera to analyse the risk differential between different types of energy networks, with their findings being set out in their report of 27 April '07. Oxera found that gas distribution has the highest beta out of gas and electricity, distribution and transmission, with compelling evidence for gas distribution asset betas having a 20bps premium over gas transmission asset betas. On this basis, we would propose that the cost of equity applied for gas distribution is significantly above the 7.0% cost of equity applied in the TPCR.
- We have consistently advocated the use of the Dividend Growth Model ("DGM") as an important real world cross-check in the largely theoretical analysis of the cost of equity. For example, SSE has increased its dividend for 2006/7 by more than 18% on the prior year, and committed to delivering real dividend growth of at least 4% until at least 2009/10, with investors likely to be anticipating a degree of outperformance. Investors factor SSE's earnings from its investment in gas distribution in to their investment decisions and, as such, we have applied a real growth rate of 4% for dividends in the DGM. The recent share price range indicates that the observed cost of equity is c.8%.
- Recognising the regulated nature of gas distribution, we therefore believe that a cost of equity of at least 7.5% (pre-tax, real) can be supprted by the academic evidence.

Proposed Cost of Capital

- It is clear that gas distribution businesses will be competing with a large number of other utilities, both in the energy sector and beyond, for substantial amounts of capital to fund large-scale infrastructure investment. Capital providers, both debt and equity, therefore have a wide range of options on a pan-European and even global basis. This optionality applies equally to the gas DN owners, for whom any network investment must compete with alternative investments. Taking SSE as an example, SSE has a 3 year investment programme to March 2010 of c.£2bn, with substantial opportunities in generation and gas storage, for example – each of which would be expected to yield post-tax returns very significantly above the cost of capital Ofgem have proposed for gas distribution, on a risk adjusted basis. SGN's other shareholders have similarly diverse investment opportunities. To the extent that possible returns on investment in gas distribution fall short of those available elsewhere, DN owners and capital providers will have little option but to

pursue these other areas of growth that deliver the required levels of return. It is therefore vital that the allowed cost of capital, however derived, is sufficiently attractive to stimulate investment in gas distribution and we do not believe that the pre-tax, real level of 4.84% in the Initial Proposals will do this.

- Our conclusions on the components of the cost of capital are as follows (all pre-tax, real):

Cost of Debt	**4.40%** (being 3.00% risk free rate plus 1.40% debt premium)
Cost of Equity	**7.50%**
Gearing	**62.5%**

In conclusion, these components give a required Cost of Capital of **5.56%** (pre-tax, real), or **4.79%** (post-tax real).

Question 2*: Are the factors affecting financeability set out in Paragraph 9.36 the responsibility of shareholders or the regulator to address and how should they be addressed?*

Ofgem have stated that they would like DNs to be "comfortably investment grade". We understand Fitch's view to be that a PMICR below 1.2 times is below investment grade. However, the Initial Proposals have PMICR below 1.2 times for four years of the control for Scotland Gas Networks and for three years of the control for Southern Gas Networks.

Licensees have a licence obligation to maintain an investment grade credit rating (and Ofgem have a duty to ensure that licensees can finance their activities). To put this in context, to maintain our current BBB rating we would require a 40-60 basis points increase in the proposed cost of capital.

We also welcome the recognition in the Initial Proposals that Scotland Gas Network's RAV was artificially reduced, when the DN price controls were split, to minimise initial variations in charges between regions. This will take time to self-correct through asset replacement, therefore in our view a financing adjustment may be required in the interim.

CHAPTER 10: Overall impact of the proposals.

There are no specific questions in this chapter.

CHAPTER 11: Next steps.

Ther are no specific questions in this chapter.