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Joanna Whittington
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Dear Joanna,

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

You have invited views on the issues raised in the GDPCR – Initial Proposals document. Our overall views and key concerns are summarised in this covering letter, and our detailed comments are set out in the Appendix to this letter.

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 towards an acceptable price control.

There are some developments in the Initial Proposals which we would welcome, including:

- Volume driver- We welcome confirmation that the volume driver is to be removed, for the reasons set out in the paper, although we do believe that some consideration should be given to a customer-related driver;
- Dealing with uncertain costs – We agree with the proposed re-openers for costs arising under the Traffic Management Act (and Transport (Scotland) Act, and for changes to tax treatment;
- Pensions – We welcome the commitment not to change the pensions principles already applied in previous reviews; and
- Opex roller – 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, overall we are very disappointed in the allowances set out in the Initial Proposals for our two networks, Southern Gas Networks and Scotland Gas Networks, which would be unacceptable to us. Our key concerns are set out below.

- 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 Deloitte which supports our view, and have submitted this separately under confidential cover.

In addition, we are pleased 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.

- Real price increases. We also believe that Ofgem have significantly underestimated future labour costs, both direct labour and contractor labour. The Deloitte report referred to above also considered real price increases and concluded that direct labour costs might be expected to rise at 1.4% to 1.9% per annum above RPI, with contract labour rising 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. We have factored these numbers into the re-submission of our repex and capex forecasts.
- Repex allowances. Ofgem have disallowed £389m of our repex forecasts. While much of the difference can be explained by Ofgem's underestimation of regional factors and real price increases (referred to above) and unrealistic productivity assumptions (which we comment on below), we believe that the methodology used to benchmark unit costs is flawed.

As a simple sense check, SGN's 2006/07 actual repex in 2006/07 was £114m for 567km of abandoned mains. By contrast, Ofgem's proposed allowance for 2012/13 allowance is £117m for 788km abandoned. **Ofgem's allowance therefore represents a 3% increase in total costs for a 40% step up in workload.** This is clearly unrealistic considering that repex is largely mechanical, with the majority of costs driven by external market rates, that techniques are fairly standard and that, given that until recently all DNs were under common ownership, we do not believe that there are major efficiency gaps between DNs.

We have asked Ofgem for further discussions on the benchmarking methodology used, and in particular the relationship between abandonment ratios and the unit costs used in the regressions, which we believe significantly disadvantages our networks.

In setting opex allowances, Ofgem recognised the benchmarking inadequacies by applying an uplift to the bottom-up approach, to be consistent with the top-down analysis. We believe that there is a strong case for a similar adjustment for repex.

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.

- 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. In addition, we also believe as commented on above, that Ofgem have significantly understated real price effects.

In addition, 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.

Finally, we are also 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 meterwork contracts with National Grid Metering, and the time it would take to find replacement work. We note that the Initial Proposals ask whether Emergency Service operatives should carry CO monitoring equipment and carry out CO monitoring tests. While we recognise that the industry needs to look at this issue, we have serious doubts about this, for example potential liabilities and significant costs, and also believe that this could be to the detriment of Emergency Service response times. As a consequence, we regard it as vital that an alternative mechanism is found to address the funding of emergency service cover through the price control.

- Capex allowances. The Initial Proposals do not reflect our views of LTS storage projects required. We have submitted further information on our assumptions going forward on NTS flex availability and in support of our forecast project specific costs, and hope to resolve outstanding differences. As you will appreciate, in the review for the One Year control our Bathgate to Carfin project was found to be both necessary and efficient, but was allocated to Pot 2 because Ofgem's consultants' view was that this should have been foreseeable. It should therefore be clear why we are keen to obtain agreement to our forecasts.

In addition, the impact of Exit and Interruption reform remains uncertain. A clear mechanism to fund any additional investment is needed.

- Cost of capital. 4.2% post-tax real is too low to attract equity, given regulatory precedent (transmission 4.4%, electricity distribution 4.8%, water 5.1% and c. £500m of investment to be funded by equity over PCR03). There

is also empirical evidence supporting higher equity returns for gas transportation than for transmission. We also believe that the proposed cost of equity does not reflect the relative risk of gas transportation compared with electricity/ water.

It is our view that 4.6% to 4.8% is supportable on the basis of risk differentials/ return expectations.

- Financeability. Ofgem's 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). However, Fitch for example rate PMICR below 1.2 times as below investment grade. To put this in context, to maintain our current BBB rating we would require a significant 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 is required.

- Related Party Margins. We have serious concerns about the impact on incentives of Ofgem's criteria for removing related party margins. We have written separately, and have several times requested discussions, on this issue.
- Other.
 - Information Quality Incentive - While we support the IQI, we see no justification for disallowing the 5% uplift which was allowed in DPCR4 for electricity distribution. 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;
 - Innovation Funding Incentive - We 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 – 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.

In summary, we believe that the Initial Proposals do not represent a balanced package and in particular it appears to us that the underlying assumptions are always at the most detrimental extreme of any range. We would therefore urge Ofgem to reconsider this position in the Update Proposals.

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

Yours sincerely

Rob McDonald
Director of Regulation