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Dear Joanna

GDPCR – Updated Proposals Document

You have invited views on the issues raised in the GDPCR – Updated 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 Update Proposals which we welcome, including:

- The change to the uplift from the bottom-up benchmarking approach to the top-down approach (i.e. to upper quartile);
- The revised approach for maintenance opex, which we have argued for, also the additional workload allowed for PREs and repairs;
- The regional costs associated with sparsity in Scotland and working in London, although we still believe these are understated;
- The recognition of the very real issue of apprentice and training costs and environmental remediation costs, although we believe there is a case for a re-opener for hazardous waste; and
- The introduction of the Innovation Funding Incentive, although we believe that restricting this to sustainability initiatives risks limiting other potentially valuable initiatives (e.g. in relation to CO monitoring).

However, overall we remain disappointed in the allowances set out in the Update Proposals for our two networks, Southern Gas Networks and Scotland Gas Networks, which we would regard as inadequate. Our key concerns are set out below.

Repex

The gap between us on repex is still substantial. We believe this breaks down as follows [pre-IQI uplift]: £118m starting point/ regression methodology (including regional factors); £79m Real Price Effects (RPEs); and £15m in relation to steel replacement.

Our main concern is that we still cannot understand why the output from the regression methodology is so different to our real costs. This is illustrated by the sense check we presented at the Authority meeting (i.e. in Southern DN a 32% step up in workload for a 12% increase in allowances by the end of the period). This equates to an unprecedented and unrealistic reduction in unit costs required in the first year of the price control of around 13%. We suspect that a key part of this is explained by an understatement of regional factors. We also believe that the regression methodology punishes us for having a more efficient abandonment ratio. In any event, since RPEs are moving costs in the opposite direction, we do not believe that the allowances and implied unit cost reductions are credible.

Regional data for labour costs. While we welcome the fact that Ofgem recognise the London regional effect, we believe that our Deloitte's report was also compelling in the case for a South East regional adjustment in addition to a London effect. In our view, as well as impacting on opex, this is also a major factor in explaining the remaining gap between us on repex allowances v. forecasts.

Real Price Effects. The Update Proposals refer to our Deloitte's report and an apparent inconsistency with Deloitte's 2006 report for the Office of Government Commerce. Deloitte have told us that these reports are not on a like for like basis. We have written separately on this, but we have still to receive feedback from Ofgem.

Overall, we are concerned that, when looking at allowances for RPEs together with the ongoing productivity assumptions, and cost to deliver, this is not a balanced package (i.e. Ofgem have combined an aggressive assumption for high productivity alongside a conservative assumption for RPEs).

Steel. We are disappointed that Ofgem are not persuaded to make a full allowance for our steel replacement proposals, on the basis that other DNs have not made similar requests. We believe that we still need a steel policy and have made a good case as to why our proposal represents the more efficient longer term solution for customers. We would, however emphasise that if in the end no allowance is made, we would not expect to be penalised through the IQI.

Repex Incentive Cap. We strongly support the proposed removal of the overall repex incentive cap, given the inherent uncertainties. While this in part mitigates some of the issues above, it is nonetheless still vital that Ofgem get the allowed unit costs right.

Cost of capital

We continue to believe that Ofgem's assumption of 4.2% post-tax real for the cost of capital would be insufficient to attract equity into network businesses, particularly given the scale of the investment challenge facing the industry. It would also be out of step with other relevant national and international precedents. In our view, the relevant question is what has changed since the transmission review, including the relative risk of the businesses. We firmly believe that movements in the debt markets since the transmission review and the relative risk of the gas distribution businesses all point to a cost of capital 20-30bps higher than allowed for National Grid in the transmission review (and noting that the effective cost of capital for Scottish Hydro in that review was 4.6%+).

Capex

We have a number of concerns about the capex proposals (although we recognise that many aspects of the allowances are still under consideration). In particular:

- We have provided the latest market-tested tender prices in support of our LTS major projects (Barton Stacey-Stoneham Lane and Farningham Phase 2). However, we note that Ofgem have not fully taken these into account in setting allowances, preferring to use their consultant's model which is based on out of date information. We note from the Update Proposals that latest tender information is being used for other DNs. We also note that the output of the latest OCS process supports our view of storage project requirements. We would welcome further discussions with Ofgem on this;
- We are extremely concerned about the major reduction in allowed reinforcement costs following the assessment of 2006/07 outturns. We believe this is being based on an atypical year. We also believe Ofgem have made an incorrect assumption in the regression methodology and we have written separately on this; and
- We do not believe the capex/ opex trade-off issue is material in the context of a five year price control review.

Shrinkage. While we support the proposed incentive in principle, we believe there are significant issues to be resolved around setting the baseline leakage volume before this would represent a symmetrical incentive. As presented in the Update Proposals, we believe that our networks are exposed to significant downside with little or no potential for beating the incentive, which we would regard as unacceptable.

Meterwork. We welcome Ofgem's recognition of the funding issue of front line staff following the anticipated loss of meter work. We are also supportive of the structure of the suggested incentive. However, we believe that the amount of protection offered by the scheme is insufficient and in particular, we believe that the unit costs per lost job should also include stranded overheads.

Benchmarking of indirect costs. We strongly object to basing allowances for other DNs on the second best GDN ("to mitigate SSE marginal cost service"), while SGN's allowances remain based on the upper quartile. In our view, this is unjustifiable. It also reflects a fundamental misunderstanding of the SSE/ SGN contract. If the other DNs' allowances are to be based on the "second best" GDN then so should the allowances for SGN's two networks. To do otherwise is at odds with the equitable treatment of all DNs through the benchmarking process. Alternatively, if Ofgem have fundamental concerns about the SSE contract costs they should be removed from the benchmark altogether and allowances for all raised accordingly.

Capacity output incentives. There is significant uncertainty about when interruption and exit reform will come in. In our view, therefore, the incentives are not on the critical path for this price control review. However, we do consider it vital that any additional capex that is triggered by a move to firm access would need to be fully recoverable. Given the inherent uncertainty about how much this could be, we believe that either a specific capex re-opener or logging-up mechanism is required in regard of interruption reform.

Other re-openers. DNs have raised significant concerns about potential large increases in Landfill Tax which may arise as a result of changes to the definition of hazardous waste. Due to the uncertainty over these potential costs, we believe there is a strong case for including this as a potential re-opener alongside TMA and other tax rules.

In addition, we do not believe that a simple a re-opener for TMA costs is sufficient. In our view, an ex ante allowance is also required given that costs will start to be incurred from 1 April 2008, and these costs will be significant. Pass-through of permit costs should also be considered.

Emergency service standard. We strongly believe that there should be exemptions to the emergency service standard for exceptional circumstances e.g. major incidents, severe weather and industrial action.

In summary, we believe that the Update Proposals still do not represent a balanced package and in particular it appears to us that the underlying assumptions are always at the most aggressive end of the plausible range. Taken together, this results in an overall revenue allowance that will in many areas lead to significant underperformance and is overall inadequate to meet required operational performance and investment plans. We would therefore urge Ofgem to reconsider this position.

I hope the comments above are helpful, if you would like to discuss any of these issues further please call.

Yours sincerely

Rob McDonald
Director of Regulation