

Scotia Gas Networks plc

**Detailed Response to Gas Distribution Price Control Review – Update Proposals.**

Our comments are set out below following the format of the questions raised in the Update Proposals document.

**CHAPTER: One - Introduction.**

There are no specific questions in this chapter.

**CHAPTER: Two – Form, structure and scope of the price control.**

There are no specific questions in this chapter. However, we have the following comments to make.

Scope of the price control. With reference to excluded services, consistent with the Initial Proposals, Ofgem continues to believe that the inter-transporter services that the GDNs receive or provide should be subject to individual consents for exclusion from the de-minimis cap rather than bringing them within the umbrella of excluded services. While we continue to believe that this is necessary, nevertheless, we would request that Ofgem provide assurances that these consents will continue for as long as they are deemed necessary. We note that requests for extensions to some of the existing consents for the current financial year have yet to be granted by Ofgem. As Ofgem will appreciate, this creates uncertainty and we would therefore suggest that a mechanism be introduced that grants an automatic extension to an exclusion from the de-minimis cap unless otherwise directed by Ofgem within 2 months of receiving the request.

We also note that Ofgem has proposed that the provision of emergency services to IGTs remains an excluded service, and we support this. However, these services are not explicitly provided for in the relevant licence condition and therefore, we believe that paragraph 3(b) of Special Condition E4 be extended to include these services (and similar services provided to private networks) as well as those provided under Standard Special Condition A41 (which specifically relates to arrangements in respect of a major loss of supply and which ordinarily therefore, does not cover the IGT contracts).

We welcome Ofgem's proposal to increase its regulatory supervision of the emergency call handling arrangements provided by NGG. However, given the monopoly position NGG enjoys for the provision of this service we do not agree that it should be treated as an excluded service, rather we believe the charges should be price controlled, included as part of NGG's allowed revenue and be a pass-through item in our IDN licences.

Dealing with uncertainty, new obligations and costs. We do not believe that a simple 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.

DNs have also 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.

As we discuss later in this response, there is significant uncertainty about when interruption and exit reform will come in. In our view, 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.

## **CHAPTER: Three – Operating expenditure analysis.**

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

While we welcome the revised workload assumptions and the revised maintenance analysis, which we argued for, we have the following key concerns:

Regional 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 this also is a major factor in explaining the remaining gap between us on repx allowances v. forecasts.

In addition, we also welcome the recognition of the £1m sparsity allowance in Scotland. We have put forward evidence that the impact of sparsity in remote areas of Scotland costs the DN between £1.5m and £1.9m, primarily in the emergency process and believe that the allowance should be within this range.

Methodology changes. We strongly object to basing indirect opex allowances 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 grossly unfair and unjustifiable. It also reflects a fundamental misunderstanding of the SSE/ SGN contract. To be clear:

- The term "marginal costing" is a misnomer. The "umbrella" and other MSAs represent to a large extent the fixed costs. It is our firmly held view that this is an appropriate contract, that there is no hint of cross-subsidy and that this model is an option available to all DNs through their ownership groups;
- The "marginal" costing approach really only applies where SSE has available capacity. For example, at a recent meeting with Ofgem we discussed stores capacity. SSE has recently moved the central stores to a larger site, in part to provide more accommodation for SGN. SGN contributed to the acquisition of this site and purchased its own racking;
- IS costs, which are the biggest element of indirect costs, are on a packaged service basis. In addition, SGN purchases its own hardware;
- Indeed, in the examples of stores and IS above, SGN employs the personnel directly while SSE provides the management;
- The MSAs for SSE services were introduced for a transitional basis at DN sales. They will be reviewed in 2008 and there is no guarantee that SSE will wish to continue to provide services on this charging basis;
- 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 are to persist in claiming that the SSE/ SGN contract is unrepresentative, then SGN should be removed from the benchmarking process and allowances raised accordingly.

Uplift on bottom-up allowances. We welcome the change to the uplift from the bottom up approach to the top down approach (i.e. to upper quartile). We continue to support the top down approach to benchmarking at this review, as it reduces the risk of "cherry picking". The use of the upper quartile recognises the fact that there is no certainty that the unexplained differences in the top down regression are down to efficiency but will also result from the very real comparative data problems at this review. The alternative would be to allow glidepath, however Ofgem's stated preference is to use the upper quartile approach. Therefore in our view, to be consistent, the uplift has to be to the upper quartile of the top down approach not to the frontier.

Real price effects and productivity growth. The GDN's have collectively submitted analysis from First Economics that shows successfully that it would be wrong to expect the industry to

go on reducing opex in real terms indefinitely (i.e. to out-perform the rate of productivity improvement and input price control exhibited by the firms whose goods and services appear in the basket). We believe that Ofgem's frontier shift assumption is not well supported and not likely to describe very accurately the underlying trend in the GDN's costs. Two recommendations are put forward by First Economics:-

- A reduction to the 1.4% productivity assumption to a lower number that is equally well supported by First Economics: and,
- A separate allowance for the costs to deliver productivity savings. In our view, there is a difference between the efficiency savings needed to catch up to the frontier, and shifting the frontier itself. In a competitive market, the costs of the latter would be passed on to customers.

First Economics state that they have not seen any convincing evidence from Ofgem (including the Reckon report referred to by Ofgem in the Update Proposals) to contradict their conclusions.

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 and we have written separately on this.

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 chosen a conservative assumption for RPEs with an aggressive assumption for productivity).

#### Other Cost Allowances

We have responded in detail to the consultant reports on direct and indirect opex and believe there remains some understatement of cost pressures in particular, insurance claims, core training and emergency call handling.

**Question 2:** *Do you agree with our approach to the additional operating cost items included in these proposals covering the areas where our work was incomplete at initial proposals?*

We welcome the recognition of the very real issue of an ageing workforce and associated training and apprentice costs, although we are submitting, through EU Skills, a revised case taking on board Ofgem's comments, but which supports a higher allowance.

We also welcome the recognition of environmental decontamination and waste management issues. As we have said above, we believe that any increase in waste management costs as a result of changes to the classification of waste as hazardous should be a re-opener.

We have commented on regional cost allowances above. We note that there are a few other cost pressures which we have flagged to Ofgem, but which still need to be addressed.

#### **Other:**

Carbon monoxide (CO). We recognise, and support, the intent in the proposal that Emergency Service Personnel carry and use carbon monoxide measuring equipment (i.e. that "CO in air" readings are taken as opposed for the current visual inspections). We would note, though, that such a policy would clearly bring additional costs of equipping and training staff, and more FCOs would be required given that the duration of the average emergency visit would be extended.

However, we would not support extending CO monitoring for example to flue gas analysis of appliances as this would bring significant additional costs and potential liabilities.

Pensions. We welcome the statement that Ofgem's policy on pensions is unchanged since the Initial Proposals. We acknowledge that the treatment of potential surpluses is to be revisited after the price control review.

## **CHAPTER: Four – Capital and replacement expenditure analysis.**

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

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:

Local Transmission System & Storage Capex. 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;

Mains reinforcement. 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 have written separately on this issue.

Other operational and non-operational capex. We do not believe the capex/ opex trade-off issue is material in the context of five year price control review.

Mains and services. 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. As we have said above, 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. As we have also said above, 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.

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.

Riser replacement in multiple occupancy building. We welcome the recognition of our risers issue. Our re-submitted forecasts were significantly reduced to reflect a ramping up of the riser programme from current levels, over the period of the price control. We would therefore support an allowance based on our forecast, operating through the capex roller, not as suggested in the Update Proposals half way between our and PB Power's views.

Information quality incentive. Our concerns can be summed up simply as, for example, a company that is neutral in terms of additional reward/ penalty i.e. forecasts at 120% of Ofgem's "efficient base" is still only allowed 105% of that "base". Given the considerable uncertainty over cost pressures e.g. RPEs discussed above, that is simply too big an exposure to potential overspends. We believe that Ofgem should therefore apply the 5% additional uplift to allowances in common with DPCR4.

Treatment of property disposals. We disagree with Ofgem's proposal to apply the standard rolling incentive mechanism to land disposals i.e. disallow from the RAV after five years the gross disposal proceeds, net of direct costs of disposal and net of directly associated remediation costs. This completely ignores the considerable risks which the DNs are bearing over the value of these sites:

- The added value by a third party or a related party is at no additional cost to customers. Customers have not funded any costs associated with planning, design, development, sales and marketing of the property which contributed to its added value;
- Customers have not taken any risks associated with property marketing and development; and,
- Customers would not have expected networks to have generated such added values, as networks neither have the skills and competencies, nor the capacity to take property risks.

We therefore strongly believe that the RAV should only be adjusted, through the capex roller, on the basis of the commercial value of the land pre-development.

## **CHAPTER: Five – Quality of service arrangements.**

**Question 1:** *Do you agree with our updated proposals for the quality of service arrangements?*

We are broadly supportive of the proposals for the quality of service arrangements, and we acknowledge that some of the detail is still being discussed through the working group.

Emergency service standard. However, we have a serious concern which we would highlight, with regard to the change of the one hour emergency response standard from an overall standard to an absolute standard within this licence condition. Events happen which are out of DNs control which can impact on the ability to meet this standard, for example major incidents, severe weather and industrial action. We strongly support the exclusion of such events from the measure of response to gas emergencies, as we understand to be the case in electricity distribution. Without such exemption for major incidents we believe that there is a disincentive to cooperate or provide resource to other DNs in major incidents, for fear of

adverse impact on this standard. We also believe that, by excluding major incidents, this will add to the transparency of how DNs perform in such events.

We have provided further feedback on Ofgem's proposals for the quality of service arrangements in our response to the Initial Licence Drafting Consultation and through the Quality of Service working group.

#### Private and sub-deduct Networks.

We would re-iterate that without adequate information about the scope and state of sub-deduct networks, there would be unacceptable financial risks in adopting them. Experience has demonstrated that there are very few sites that would meet the standards and criteria that would enable adoption without significant remedial works.

As well as the quality of assets issue, there will be other matters to consider collectively or on a case by case basis before adoption can be considered:

- Legislation and UNC modification;
- Additional installations such as boosters/ compressors;
- Reinforcement costs (systems may be designed at lower pressures than our existing assets);
- Records management;
- Metering issues;
- Resources to replace/ reinforce;
- Funding for upfront and ongoing works;
- Safety issues and potential conflicts with safety case requirements; and,
- Design consultancy and load evaluation.

The following is our response to Ofgem's specific questions:

- **The capability/willingness of DNs to conduct a survey.** SGN has always stated that it would work positively with Ofgem to develop a framework for the resolution of this issue;
- **The practicalities and challenges involved.** In terms of completing the survey, the resource capability for achieving this is not currently available within SGN. The exact number of locations within SGN is not known, however it is estimated that there are at least 1000 site assessments to be carried out. The assessment would require competent engineers, at a minimum level of Technical Officer, with detailed knowledge of network integrity standards. SGN's capabilities in this area are currently fully utilised, and we are aware that the limitation of skilled resource is an industry issue. A coordinated programme of recruitment and training would therefore be required.

Other practicalities and challenges have previously been highlighted but would also include site access, willingness for third parties to cooperate and legal responsibilities for third parties to support the programme.

- **The timeframe required.** On the basis of surveying 1000 sites, allowing one year for recruiting and training, and assuming that one site could be fully surveyed and assessed by one person in two weeks we could assume that 11 FTEs could complete the surveys within around 5 years, allowing some contingency for additional sites. In addition to this, some time would be required for economic assessment and project planning by existing planning teams.

An impact assessment would be required once surveys had been completed to determine the effect on the replacement and upgrade programme of any remediation works required.

- **An estimate of the costs involved per network.** For the survey, based on the above resource and support costs, we would estimate around £500k per annum until survey completion

The costs of the remedial works cannot be known until the survey is complete but any remedial works would need to be cost pass through, and funding arrangements would need to be clear.

- **Alternative methods of resolving this situation.** The alternative to SGN completing the survey would be for the onus to be placed on the site owners to complete the surveys based on industry standards agreed in advance and compile and submit site specific remediation programmes for GDN approval as part of an adoption submission process.

## **CHAPTER: Six – Incentives.**

**Question 1:** *Do you agree with our view that an opex rolling incentive is not appropriate?*

We support in principle the concept of an opex roller, for the same reasons as apply to capex. However, given that Ofgem's proposed opex targets are very challenging, the risk of overspend means that we would not support a symmetric opex roller in this price control.

**Question 2:** *Is our approach to capping the expenditure under the mains and services incentive appropriate?*

We welcome the removal of the incentive cap, as in our view this would have been inconsistent with the intent of the IQI. We agree with Ofgem's proposed approach to set the cap at the aggregate of the five year forecast of expenditure but with any overspend that has not already been accounted for through the mains and services incentive being subject to the capex rolling incentive.

**Question 3:** *Is our approach to allocating domestic purge and relight costs to services costs appropriate?*

We agree with Ofgem's approach for allocation of purge and relight costs to each of the separate service cost areas. In our submissions we have provided Ofgem with disaggregated P&R costs in each area of service spend.

### **Capacity Outputs Incentive**

We agree with Ofgem that there is considerable uncertainty surrounding the capacity arrangements that will apply from 1 October 2011. As Ofgem has identified, the outcome of the first round of interruption auctions may trigger significant additional capital expenditure by the GDNs and the NTS offtake arrangements that are integral to setting any capacity output incentive are, as yet, undefined.

We are also concerned that there is very little time for detailed discussion of Ofgem's proposed incentive scheme and associated targets if they are to be finalised and included in Ofgem's final proposals document in December. Indeed, based on our experience of setting the offtake incentives so far, there remains a considerable amount of detailed discussion and analysis to be carried out before the GDNs could be in a position to agree to Ofgem's proposed incentive arrangements and any proposed targets. As a consequence, we believe that Ofgem should consider progressing the capacity output incentive proposals in two parts. First, a price control re-opening mechanism that should be progressed for inclusion in the GDPCR final proposals in December to address potential capex that may result from the interruptions arrangements. This would leave a second tranche of work to progress separately the proposed incentive mechanism and associated targets for inclusion prior to the first round of auctions. We believe that this would be the most pragmatic approach to achieving a robust incentive scheme without jeopardising the wider GDPCR timetable.

**Question 4:** *Do you agree with our approach to the capacity outputs incentive? What are the issues raised by incentivising or not NTS flex capacity?*

As we understand it, Ofgem has proposed that the funding for generic interruption would be provided by savings made by the GDN from its NTS flat capacity target. As now, the target would be calculated by taking the volume of NTS flat capacity required by the GDN at each offtake point for the relevant year (assuming all non-NSL loads are firm) and applying the relevant year's NTS capacity charge. However, in setting the GDN's target allowance in this way, a number of factors have not been taken into consideration.

1. Most importantly, Ofgem's proposal for the generic interruption requirements is based on the assumption that a GDN's NTS exit flat capacity is the only issue that needs to be considered in the context of a GDN's interruption volume. However, whilst there is a relationship between non-NSL interruption and NTS flat capacity, no account has been taken of the impact on a GDN's own investment requirements. For example, if the volume of gas at the GDN offtake point increases, there is a likelihood that the GDN's offtake assets will need to be reinforced/upgraded.
2. Furthermore, as Ofgem is aware, the GDNs have not invested in their networks to accommodate the existing interruptible loads becoming firm. Whilst ordinarily some additional load may be accommodated for a period of time, a step increase would significantly advance a GDN's general reinforcement investment programme.

Therefore, although Ofgem's incentive proposal provides a certain level of funding for the purchase of interruption, it does not provide a funding mechanism for consequential expenditure on the GDN's network to ensure ongoing resilience where "insufficient" interruption is procured. This issue must be addressed and, in our view, the simplest mechanism for doing so would be to extend the proposed price control re-opener to include **all** investment associated with the new arrangements rather than restricting it to NSL-related investment.

3. Notwithstanding the above point, we think there is a timing issue associated with calculating the target and when the GDN will need to make its decision on whether to buy interruption. That is, next year the GDNs will need to assess whether or not they accept tenders for interruptible capacity for gas years 2011/12 and beyond. If our understanding of Ofgem's model is correct, the GDN's decision will be based upon the cost of interruption that has been offered compared to the cost of NTS flat capacity. However, the cost of NTS flat capacity will not be known until three years after the decision has been made. Clearly, the extent to which this issue is a problem will depend on the variability of NTS charges and is something that we believe needs to be explored in more detail.
4. Finally, consideration must be given to whether there is a direct correlation between the value a shipper/end user places on interruption and the NTS exit flat capacity charge. Currently, DN interruptible sites do not pay either NTS or GDN capacity charges. Whereas the proposed budget a GDN will have for interruption is based on NTS capacity charges only. We therefore believe that there is a risk that shippers/end users may not be as willing to offer interruption at a price that is "economic" to the GDNs when compared against to the proposed allowance. To the extent that this materialises, the gap in Ofgem's funding issue in respect of additional reinforcement identified in point one above becomes more exaggerated.

Turning to Ofgem's proposal for NSL interruption. We believe that Ofgem's approach to provide a target based upon the discounted project cost of making NSLs firm is appropriate providing that the proposed capex re-opener is progressed.

We understand Ofgem's rationale for a 100% sharing factor however, given the uncertainty associated with the enduring regime we think that it would be more appropriate to retain the current 7.5% cap/collar rather than moving to 10% as proposed. We also believe that the

income adjusting event threshold should be retained at the £1m figure associated with the regime up to October 2011.

Given the great uncertainty surrounding the flex product in the enduring regime and additional complexity associated with the product and any incentive scheme that should apply to it, we agree with Ofgem's view that it would be more pragmatic to monitor flex over the eighteen month period of the price control with a view to addressing a potential incentive in the GDPCR that will apply beyond 2013.

**Question 5:** *Should the volume targets for the flat capacity incentive vary with changes in the calorific value (CV) of gas ?*

As a matter of principle, we do not believe that factors over which the GDNs have no control should influence the risk/reward in any incentive scheme. Accordingly, we believe that the volume targets for flat capacity incentive should vary with changes in the calorific value (CV) of gas.

**Question 6:** *Is it appropriate to allow a price control re-opener (subject to certain criteria) for any capex spend that may be required following the interruption auctions?*

We very much welcome Ofgem's consideration of a capex re-opener. Given the uncertainty associated with the volume and location of interruption available to the GDNs beyond September 2011 and the impact a shortfall of interruption will have on a GDN's capex expenditure, it is critical that a price control re-opener is included as part of the price control arrangements. However, we also are firmly of the view that the proposed re-opener should not only relate to capex associated with accommodating network sensitive loads (NSLs) becoming firm, it should also apply to consequential investment that is required in the event that insufficient generic interruption is procured through the tender process. In conjunction with addressing additional investment requirements, it will be necessary to ensure that the re-opener mechanism also caters for corresponding adjustments to a GDN's NTS exit capacity requirements that may result from NSL customers becoming firm. However, it will also be necessary to factor in the deemed increase in NTS offtake requirements if all loads were firm.

Finally, it will be important to ensure that the re-opening mechanism is not limited to addressing issues associated with the outcome of the first interruption capacity auctions. It is likely that interruptible capacity may only be offered for a one year duration meaning that the outcome of subsequent auction processes could also result in consequential investment on the network being necessary and therefore the reopening mechanism must remain in place until the end of the 2008-2013 price control.

**Question 7:** *Is it appropriate to have an adjustment mechanism for the treatment of emergency services costs arising from the loss of metering? If so do you agree with our approach and methodology for the parameters?*

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. In addition, it does not seem logical to have such a disparity in unit costs across DNs. We therefore urge Ofgem to reconsider the parameters in the proposed incentive scheme.

Notwithstanding the above, we believe it is important that there is clarification in respect of the revenue treatment of any "filler" work associated with this incentive scheme. In our view, consistent with the treatment of the meter work to which the incentive relates and to ensure that the proposed incentive is not undermined, it will be important to ensure that revenue associated with any new "filler" contracts for the FCOs (irrespective of their nature) should be treated as excluded services and not counted against the de minimis cap.

**Other:**

Innovation Funding Incentive. We welcome Ofgem's proposal to introduce a new incentive to fund innovation. Our previous responses have clearly demonstrated the benefits to customers associated with such a scheme, particularly in the light of the experience from the introduction of a similar scheme in DNO Price Controls. We would however make the following suggestions in the operation of such a scheme:

- We believe that the application of a Sustainable Development umbrella to the scheme should not be allowed to restrict the benefits to a narrow field of application. We believe that an emphasis on the clear demonstration of benefit to customers in the long term is adequate in meeting a Sustainable Development agenda; and,
- The Good Practice Guide developed by DNOs is adequate in meeting the needs of Gas Distribution. We propose that GDNs' adopt this document rather than develop a new one.

**CHAPTER: Seven – Sustainable development.**

**Question 1:** *Is it appropriate to roll forward the existing shrinkage incentive and if so do you consider the leakage volumes appropriate?*

We support the roll forward of the existing shrinkage incentive which provides the GDN's protection against price risk, which is not within our control, with realistic leakage volume targets.

However, we have some significant concerns about the leakage volumes proposed (even after they have been reissued). We believe that the baseline leakage volumes should be set to provide symmetric incentives on the GDN regarding leakage reduction. Currently, the methodology used by Ofgem produces targets that are well below our latest forecasts and we believe this is due to the 'extrapolation' of the 2006/7 position. This position used by Ofgem is driven by the application of leakage factors to the actual demand in 2006/7, which was an extremely mild winter, rather than to the seasonally normalised leakage volumes produced by the leakage model which are higher.

**Question 2:** *Is the gas reference price formula appropriate?*

We welcome the move away from the three month ahead price and would suggest that the within day price should be used as the reference price.

**Question 3:** *Should Ofgem establish a new incentive to target harmful environmental emissions?*

We fully support the introduction of an incentive to target harmful emissions that is:

- Symmetric (i.e. has an appropriate baseline forecast)
- Uses output from a robust leakage model
- Applies appropriate costs of carbon
- Has caps and collars that reflect the fact that this is a new untested incentive that is being introduced
- Does not penalise on parameters which are outside the control of SGN, such as CV and gas demand.

The proposed scheme does not achieve these objectives. We would therefore urge Ofgem to reconsider the scheme parameters as well as a mechanism to flex those parameters in response to changes in variables outside of DNs' control (mainly demand and CV).

**Question 4:** *Do you support the design of the environmental incentive and its parameters?*

We firmly believe that there should be certainty in the shadow carbon price used in the incentive scheme, for the duration of the price control. Otherwise, DNs' investment decisions may be distorted. Provided that our concerns about the scheme parameters are addressed, we would have no objections to the adoption of the shadow price suggested in the Update Proposals.

**Question 5:** *Are the strength and baselines for the incentive appropriate?*

The shadow cost of carbon provides strong incentives on GDN's to reduce leakage and therefore it is vital that the baselines are set appropriately with a robust leakage model underpinning the actual leakage reported.

**Question 6:** *Are the cap and collar arrangements appropriate?*

Given the uncertainty around the application of this incentive as raised previously in this section, we believe it is vital that a relatively tight cap and collar exists in the first five years of application to ensure that GDN's are not penalised or receive windfall gains due to outcomes that differ significantly from expectations. The parameters put forward seem appropriate and we believe that the cap and collar arrangements should also be applied to the cost of shrinkage gas.

**Question 7:** *Is it appropriate to introduce a mechanism to address periodicity of investment?*

The lag between actions taken and the resulting reduction in leakage could be measured in years. The financial payback is also usually over a number of years, extending overall leakage reduction benefits well over a single price control period. For the incentive mechanism to be effective therefore it is essential to have a rolling mechanism to allow DN's to receive benefits from actions taken. Without a rolling mechanism there would be a disincentive to take actions towards the end of a price control period. We would suggest the rolling incentive period to be in excess of 5 years, and linked closely to the life cycle of investments, to allow full recovery of benefits to be taken into account in investment decisions.

**Question 8:** *Are the leakage model and governance arrangements appropriate?*

The Leakage Model has been in use by the industry for a number of years, and although subject to periodical changes, has proved successful in the long term. We believe that the leakage model should be owned jointly by GDNs and maintained independently by a third party (subject to independent audits) to ensure consistent reporting of leakage. This approach has been adopted for the governance of mains risk models successfully.

Where the model requires updating, either as a result of data validation or updating the way the model actually calculates leakage, we would expect the baseline forecast to be reset to prevent windfall gains or losses.

## **CHAPTER: Eight – Other issues.**

There are no specific questions in this chapter.

## **CHAPTER: Nine – Financial issues.**

**Question 1:** *Does our risk analysis support a range for the cost of equity of 7.0 - 7.5 per cent?*

We have previously argued that DNs should be capable of achieving returns in excess of 5% post-tax real, including scope for outperformance. Against this background, we continue to believe that Ofgem's assumption of 4.2% post-tax real is insufficient to attract equity,

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%+).

In terms of the cost of equity, we note Ofgem's 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.

In addition, the impact of higher gearing assumed in Gas Distribution (62.5%) in itself would increase the cost of equity by over 30 basis points above Transmission to 7.3% (even if all other assumptions were held constant), as a consequence of the higher implied risk. As a result, even a small differential in business risk is sufficient to justify a cost of equity for gas distribution of 7.5% or more.

We have consistently advocated the use of the Dividend Growth Model ("DGM") as an important real world cross-check on 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 no lower than 7.5% (and arguably higher) can be supported by the academic evidence.

**Question 2:** *Is it appropriate to continue to maintain a consistent approach to cost of debt to that taken in TPCR?*

Once again, we believe that the relevant question is what has changed since the transmission review was completed last year. Given that borrowing costs have increased since that review and that the potential for stranded costs is higher for the gas sector than, for example, the water sector, this would point to a cost of debt, higher, not lower than applied in transmission.

This is also supported by recent market evidence. For example, taking a mid point in current debt premium for ten year A and BBB debt (over the relevant index linked gilts), we calculate that this produces a cost of debt in line with the transmission review. Any reduction would therefore not in our view be consistent with Ofgem's financing duty. We therefore see no reason for moving away from the cost of debt in the transmission review of 3.75% and indeed arguments for a higher relative figure in gas distribution.

Taking our answers to questions 1 and 2 together and following the recent review of airports, we believe that regulatory consistency, market evidence and the need to attract equity all point to a cost of capital in the range of 4.6-4.8%, post-tax real.

**Question 3:** *In the light of both the results of our risk analysis and the levels of actual gearing observed in the sector, is there a compelling reason to change our notional gearing assumption from 62.5 per cent?*

We understand Ofgem's reasons for not changing the current assumption of 62.5% for gas distribution. However, for consistency, Ofgem should either reduce the gearing assumption to 60% or increase the cost of equity to reflect the additional implied risk.

**Question 4:** *Is our approach to determining the GDNs' tax allowances appropriate ?*

We support the approach taken in determining the GDNs' tax allowances together with the re-opener for changes in tax treatment which has been discussed earlier.

**Question 5:** *Should we make a financeability adjustment in cases where a GDN fails to meet our target ratios because of its own actions, such as penalties incurred under incentive schemes ?*

We believe financeability adjustments should be appropriate where GDN's fail to meet their target ratios. We do not believe that Pot 2 disallowance or RAV sculpting explain the weak performance of some GDNs and in particular Scotland. Rather, we believe that this reflects the inadequate allowances proposed by Ofgem, including for the cost of capital. We would urge Ofgem to consider the various points made in this response, which we believe are underpinning the financeability concerns of some DNs.

To the extent that financeability remains an issue, adjustment options considered such as changing the proportion of repex expensed and depreciation lives can only be applied universally. Therefore, we consider the best way of addressing any remaining financeability shortfall is through a one off revenue adjustment for specific DNs only.

#### **CHAPTER: Ten – Overall impact of the proposals.**

There are no specific questions in this chapter.

#### **CHAPTER: Eleven – Next steps.**

There are no specific questions in this chapter.