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Dear Joanna

Capacity outputs incentive for GDPCR – October Update Consultation

Further to your letter dated 23 October on the above, we have set out below our comments on the proposed capacity outputs incentive that would apply to the Gas Distribution Networks (GDNs) from 1st October 2011 to 30 March 2013. Overall, we welcome Ofgem's updated proposals and in particular the continued inclusion of a capex reopener mechanism.

Notwithstanding the above, we have provided feedback on each aspect of the proposed incentive scheme below which we hope you will find useful. In certain circumstances, we have also taken the opportunity to clarify our understanding of the proposals given that the arrangements set out in Ofgem's letter are still at a relatively high level (and we would welcome an early comment from Ofgem where our understanding is not correct).

Interruptions

Since the publication of the updated proposals, we welcome Ofgem's recognition that, in some circumstances, where a GDN is unable to contract for generic interruptible capacity then incremental NTS flat capacity on its own would be an insufficient substitute and investment would be necessary. Accordingly, based upon the principle that the GDNs are to make the most efficient trade offs between procuring interruption and investing in its own network, we agree with Ofgem's revised proposal to base the interruption incentive upon the discounted total reinforcement investment costs required to support *all* interruptibles as firm, not just that associated with projects necessary to remove locational constraints. We also agree that it would

seem appropriate to discount these investment costs over a 45 year period using an appropriate cost of capital to derive an annual interruption incentive allowance.

Table One in Appendix One of Ofgem's consultation letter provides estimates of the investment costs necessary to support all customers as firm and have been based on information provided by PB Power in their October Capex/Repex update report. As recognised by Ofgem in the letter and in our subsequent telephone conversations with the GDPCR team, these incentive allowances will need to be reviewed and updated to reflect the final capex allowances determined as part of the final GDPCR proposals. This requirement is particularly highlighted by the inconsistency between the proposed incentive allowance set out in Table One of Ofgem's consultation letter and the capex allowances (in particular capex associated with storage projects) in the Updated proposals for Scotland.

We also note that the figures in Table One are given in 05/06 prices and do not include the Real Price Effects (RPEs). Therefore, in addition to the adjustments referred to above, it will be necessary to ensure that the final interruption incentive allowance is indexed to reflect the year in which they apply and are further adjusted to include the RPEs consistent with the assumptions Ofgem make elsewhere in setting allowances.

Turning now to the proposed incentive parameters. We note that Ofgem has moved away from its previously proposed cap and collar and instead favours a 50% sharing factor. While we understand the rationale for Ofgem's revised approach, we are conscious that this is a new, as yet, untried incentive that exposes the GDNs to significant new risk. We therefore firmly believe that if Ofgem is to pursue the 50% sharing factor, the proposals for a capex reopener become increasingly critical.

Flat Capacity

The basis of Ofgem's proposed flat capacity incentive is that the GDNs would procure interruptible capacity using their interruption allowances if, by doing so, they would save on their NTS flat capacity target. However, we note that Ofgem is proposing to set the NTS offtake capacity target based on all loads, *except the NSLs*, being firm. By adopting this approach there is a risk that if the NSLs do not offer interruption the GDNs could be exposed to increased NTS flat capacity requirements over which they have no control. Discussions with Ofgem since the publication of the capacity update consultation letter would suggest that, in this scenario, the GDNs would have, in all likelihood, approached Ofgem for a capex reopener for the investment to overcome the locational constraints and that this process would also have addressed any shortfall in the NTS offtake capacity incentive target. However, we remain concerned that circumstances may arise whereby a capex reopener is not applied and which would leave the GDNs exposed. Therefore, while, we agree with Ofgem that the GDN's exposure under this incentive should be subject to a cap/collar as well as the proposed 50% sharing factor, in our view, the cap/collar should be no more than the GDN's current exposure, including the same absolute maximum exposure of £5m.

We note that the proposed incentive target is set at an LDZ level and not disaggregated into LDZ exit zone which, in our view, is appropriate. While the target will be set in volume terms, there is a requirement to convert it to financial terms which has not been covered by Ofgem's proposals. In our view, the relevant price to apply will need to reflect the capacity booking arrangements. That is, if the current OCS arrangements prevail, the price would be the NTS exit capacity charge at that time the capacity is used. However, this may need to be reviewed in the event that commercial NTS exit capacity arrangements associated with Mod 116V are implemented given the added complexity of a price differential between the capacity charge at the time it is booked compared with that which applies at the time of use.

It appears that the flat capacity targets have been set using a standard CV. In our response to Ofgem's updated proposals, we supported Ofgem's view that the target could be reopened in the event that actual CVs varied. We continue to support this view.

Finally, Ofgem has not mentioned how any actual costs that the GDNs would pay to the NTS for flat capacity would be treated should the charging model envisaged by Ofgem during the discussion on NTS exit reform be implemented. Under this model, the GDNs pay the NTS for its flat capacity not shippers. Currently, the licence drafting shows this payment (albeit is currently fixed at zero) as being a pass-through. We would expect this arrangement to continue.

Flex Capacity

We continue to agree with Ofgem's proposed approach not to set a specific flex capacity incentive. However, to the extent that concerns could arise surrounding the GDNs' NTS diurnal storage bookings, we would not object to there being some form of regulatory oversight in the event that our overall requirement for flex in any one of our networks increased from one year to the next by more than 10% as suggested.

Capex reopener

We agree with Ofgem's explanation that the requirement for investment may arise from the need to remove particular locational constraints, or the need to build increased transportation or storage capacity should insufficient interruption be available. Accordingly, we welcome Ofgem's proposal to include a capex reopener if a GDN is unable to contract for all of the interruptible capacity it requires in all of the locations they require it. Indeed, we believe that the inclusion of a capex reopener in this respect is essential.

Discussions with Ofgem following the publication of the update consultation letter have confirmed that subject to the proposed threshold, a GDN would be able to apply for a capex reopener if contracts for interruption were either greater than the cost associated with reinforcement at a network level or at a particular area/location within the network. That is, if the cost of interruption in a specific zone within the network was greater than the reinforcement costs to make all customers in that zone firm, the GDN could approach Ofgem for a capex reopener on the grounds that for that zone investment would be the more efficient option even if the GDN's total interruption

expenditure was within the total incentive allowance. Clearly we understand that should a reopener be allowed by Ofgem, the interruption incentive values would also be reopened. We welcome Ofgem's clarification on this point.

Our discussions with Ofgem have also clarified our understanding of the proposed treatment of any investment. As we would expect, any capex that has been agreed with Ofgem under a capex reopener would be fully funded from the point of expenditure. To put this into effect, we believe the simplest mechanism would be for the actual capex to be "logged up" and for retrospective funding to be applied at the start of the next price control (i.e. "pot 3"). However, as proposed, where the GDN does not apply for, or Ofgem does not allow a reopener (for whatever reason, including the reopener threshold not being met), the GDN's investment would be subject to the capex rolling incentive with the associated GDN funding implications for 5 years before it goes into the RAV. We do not believe that the application of the capex roller incentive is appropriate in these circumstances. Rather, assuming the incremental capex is deemed efficient by Ofgem, we believe the investment should be included in the GDN's RAV at the start of the next price control period. In our view, this would be more appropriate particularly since the interruption incentive savings to which Ofgem refers would help fund the investment would only apply for 18 months from October 2011 whereas the GDN's expenditure could be initiated as early as next summer. Under Ofgem's proposal, the GDN would be exposed to 5 years funding whereas the GDN would only have 18 months of incentive benefit to offset that cost.

Turning now to Ofgem's proposed reopener criteria.

We agree that it would be appropriate for there to be some criteria against which an application for a capex reopener would be assessed. In terms of efficiency, Ofgem has suggested that the GDN would need to be able to demonstrate that, taking the discounted cost of an investment over 45 years together with the reasonably foreseeable costs of any incremental NTS flat capacity necessary to support an increased load, interruptible offers which would have removed the need for the investment were not available in sufficient numbers or at sufficiently competitive prices to avoid the need for reinforcement. This seems reasonable.

Ofgem has also proposed that it would consider the extent to which the GDN had effectively marketed the interruptible product. The implementation of Mod 90 has associated with it requirements on the GDNs to release certain information to the community in respect of its interruption requirements both in terms of the interruption tender methodology statement and in the invitation to tender. We would therefore expect that Ofgem's criteria in this respect to have been met where the GDN has met the requirements of the UNC.

We understand the rationale of introducing a materiality threshold and Ofgem has proposed that any application for a capex reopener should be for recovery of costs greater than £1m per GDN. This threshold seems an appropriate balance if, as we believe it does, it means the aggregate investment cost to the GDNs resulting from insufficient/uneconomic offers of interruption being available would need to be more than £1m. The aggregation of costs is important as in those networks where there are a number individual and discrete locational constraints investments could be triggered

which individually could be less than £1m but in aggregate could be considerably more.

Income Adjusting Event

We agree that it would be more appropriate for the Income Adjusting Event (IAE) threshold to reflect the differing size of each of the GDN businesses rather than it being a same absolute value. However, we are concerned that using a threshold of 0.5% of allowed revenue significantly increases the exposure of some GDNs to over £2m which we do not believe is acceptable. We therefore believe that the IAE threshold should be set at the higher of 0.5% of allowed revenue or £1.5m.

To conclude therefore, we welcome Ofgem's updated proposals on the principles of the capacity outputs incentive as set out in the October letter subject to the points we have made in this letter.

We hope that you will find our comments helpful. Please give me a call if you would like to discuss any of the points we have made in more detail.

Yours sincerely

Rob McDonald
Director of Regulation.