



Gas and electricity licensees,
consumer groups, and
any other interested parties

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value for all customers*

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Dear colleague

Open letter consultation on proposed allowances for Scotia Gas Networks following an application under the capex interruption reform reopener set out in Gas Distribution Price Control Review Final Proposals

1. Introduction

- 1.1. The gas distribution price control review (GDPCR)¹ completed in December 2007 set the revenue allowances for the eight gas distribution networks (GDNs) for 2008 to 2013.
- 1.2. Following reform of the GDNs' arrangements for procuring interruptibility from customers, GDPCR allowed for the possibility of a reopener in 2008/09 to pay for network reinforcement where necessary following the results of the first year of the interruptions tender process. Of the eight GDNs, only Scotland Gas Networks has applied for a reopener. Scotland Gas Networks' reopener claim is for four construction projects, at a forecast cost of £28.5m.
- 1.3. We have reviewed Scotland Gas Network's application and taken advice from independent engineering consultants. We are minded to reopen the Gas Distribution Price Control to allow the reinforcement in two out of the four zones at a cost of £16.30m.

2. Background

- 2.1. GDNs have a licence obligation to develop and maintain their pipe-line system to enable them to meet gas demand on their networks in the event of a 1 in 20 peak demand day(s). GDNs meet this standard through a combination of investment in their own network, procuring interruption services on their own network, and booking flat and flex exit capacity from the NTS.
- 2.2. The GDNs currently have interruption arrangements with certain large customers that enable the GDN to require these interruptible customers to reduce or cease their offtake of gas at high demand levels in return for a discount on their transportation charges. Based on 1 April 2006 GDN transportation charges, the total value of the capacity charges discount received by interruptible customers across all distribution networks was in the region of £40m per annum.

¹ <http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/final%20proposals.pdf>

- 2.3. In March 2007 Ofgem directed Mod 90 'Revised DN interruption arrangements'² for implementation from 1 April 2008. The reformed DN interruption arrangements changed the way that interruptible capacity rights are allocated. Instead of large customers determining their own interruptible status at one year's notice, the reformed arrangements allow GDNs to offer interruptible capacity solely in the locations and volumes they require via annual tenders with three year lead times.
- 2.4. Following this reform of interruptions arrangements, GDPCR allowed for the possibility of a capex reopener in 2008/09 to pay for network reinforcement that was required in the event a GDN was unable to procure sufficient interruptible capacity at an economical price, following the results of the first year of the tender process. We accepted that the GDNs could not feasibly gauge the overall response of currently interruptible customers going firm and hence be able to fully estimate the reinforcement requirements ahead of completion of the price control. Additionally, it was identified that if the reforms resulted in less available interruptible capacity, then the need to provide increased transportation or storage capacity was likely to require bringing forward, or in some cases upsizing, capex projects already identified through the GDPCR process.
- 2.5. The first round of auctions was completed in June 2008. Following this round of auctions all four GDN owners indicated that they were still considering applying for a capex reopener. Following discussions with GDNs and shippers, it was clear that there was potential benefit to be had from holding an ad hoc round of auctions, as permitted under the Uniform Network Code (UNC) in order to allow customers to recalibrate their bids, where these had been uneconomic, or had not matched the GDNs' requirements. As a result, we stated that we would not assess any reopener applications until after GDNs had held ad hoc auctions in October 2008. This timescale allowed the GDNs to take into account the latest demand forecast information when submitting any reopener application.
- 2.6. The outcome of the tenders held in June and October 2008 was that few of the existing interruptible customers retained their interruptible status from October 2011. In autumn 2008 all GDNs reviewed their capital expenditure requirements in light of the first year of the tender process and subsequently only Scotland Gas Networks have requested an allowance for additional capital expenditure.
- 2.7. All other GDNs stated that given the forecast reduction in peak demand over the price control period and the increase in availability of a flexible offtake profile from the NTS they had decided not to apply for additional revenue allowances. On one hand they may have successfully secured sufficient interruptible contracts with customers, such that, along with the reduction in forecast demand, reinforcement is not required. On the other hand they may have some reinforcement requirements as a result of the auctions, but have decided that they would be better off bearing the capital cost (which would be subject to the GDPCR capex incentive, so that they would ultimately recover between 64 and 67 per cent of the cost) and retaining their full interruptions incentive allowance (see para 5.1), which we had stated we could reduce for companies who applied for a reopener. This is a legitimate trade-off of incentive mechanisms.
- 2.8. We signalled to the GDNs in GDPCR final proposals and during the discussions last year at the time of the auctions that we did not expect to grant any further revenue allowances in future years, since it was the first round of auctions that was likely to trigger material incremental reinforcement requirements.

² <http://www.gasgovernance.com/NR/rdonlyres/234B945D-7E4F-4AB3-BE35-957459D9CD28/15807/UNC900fgemFinaldecisionletter1.pdf>

3. Application Summary

3.1. The information supporting Scotland Gas Networks' application stated that they have five interruption zones which originally required reinforcement unless they could conclude interruptible contracts with customers. Despite the two rounds of tenders and extensive contact with shippers and customers in 2008, there were no bids in three of the zones where avoidance of reinforcement is dependent on the continuing interruptibility of individual network sensitive load and insufficient economic bids in the others to avoid reinforcement³. However, since then National Grid has increased the amount of storage available to Scotland Gas Networks from the NTS which has facilitated the proposed projects in zone 5 being deferred until the next price control period.

4. Ofgem's view - Capex assessment

- 4.1. We have carried out a review of Scotland Gas Networks' application as we would have done had we been in a position to assess their investment plans during the price control review. Our consultants IPA reviewed Scotland Gas Networks' submission for additional reinforcement in these four zones in terms of both the need for the reinforcement and the proposed capital costs.
- 4.2. Subject to certain assumptions IPA agreed in principle with the need for the reinforcement in each zone, but they have challenged Scotia on their cost estimates and other assumptions and consider that sufficient reinforcement to meet the 1 in 20 obligation could be made for a significantly reduced cost. Additionally we consider that some of those assumptions can be challenged further, leading to still lower costs. These issues are discussed in paragraphs 4.7 to 4.9.
- 4.3. Table 4.1, presents the proposed projects and associated costs as estimated by IPA and Scotland Gas Networks, and our view on proposed allowances.
- 4.4. Having reviewed both Scotland Gas Networks' application and our consultant's report we are minded to agree with our consultants on their suggestions for how the work Scotland Gas Networks propose could be carried out more efficiently. We also consider that Scotland Gas Networks could do more to explore ways of avoiding the need for reinforcement in zones 2 and 3.
- 4.5. Our proposal would result in a reduction of 43% of Scotland Gas Networks' claim. We have shared the consultant's report with Scotland Gas Networks and received a response in which they substantiate their position and defend their proposed costs indicating they are based on recent feasibility studies.
- 4.6. In particular we agree with the view of IPA that the upward pressure on pipe costs forecast by the GDNs in the GDPCR as a potential risk over the price control period has not materialised. Hence we consider the base unit cost ranges assumed in GDPCR are still relevant to these projects, once updated for inflation. IPA have reviewed these costs against a range of projects recently completed or proposed for construction in Scotland GDN to support their unit cost assessment. The impact of the unit cost adjustment for LTS projects proposed by IPA is £5.6m across zones 1 and 4.

³ Customers re-designated as firm following interruptible capacity auctions are exempt from the application of the economic test and hence any contribution.

Table 4.1: Summary of GDN, consultant and Ofgem reopener proposals [£m, 2008/09 prices]

	All costs £m [08/09 prices]	SGN Proposed	IPA recommendation	Ofgem proposed allowance
Zone 1	Project proposal	LTS: 15.14km x 300mm 69 bar steel pipeline	<i>Project specifics as per SGN submission</i>	<i>Project specifics as per SGN submission</i>
	Forecast cost	13.20	10.60	10.60
Zone 2	Project proposal	MP: 2.72km x 355mm PE	MP: up to 2.185km x 355mm PE	No reinforcement proposed/Discussions with customer recommended
	Forecast cost	1.06	up to £0.91m	0.00
Zone 3	Project proposal	IP: 6.62km x 355mm HDPE	Further review proposed	No reinforcement proposed/Discussions with customer recommended
	Forecast cost	4.00	n/a	0.00
Zone 4	Project proposal	LTS: 11.4km x 250mm 19 bar steel pipeline	LTS: 9.0km x 250mm	LTS: 9.0km x 250mm
	Forecast cost	10.20	5.70	5.70
	Total Cost	28.46	up to 17.21	16.30

- 4.7. IPA proposed two options for zone 4 dependent on a review of the connections arrangements with one current interruptible customer going firm. IPA confirmed a minimum of 3km x 250mm pipeline at a cost of £1.90m was required for the connection which would result in a lower pressure being provided to the customer at the point of connection. An additional 6km x 250mm at a cost of £3.80m would be required to maintain the customer's current pressure arrangements. Scotland Gas Networks' project proposal included an additional length of 2.4km at a cost of £1.5m due to a proposal they have received from a customer for site redevelopment. We do not consider this additional length should be funded through the reopener.
- 4.8. In zones 2 and 3 the nominated maximum hourly quantity (SHQ) of the customers concerned is far higher than their recent maximum value. If the recent maximum values are used for network planning rather than nominated SHQ then no reinforcement is required in zone 3 and reinforcement in zone 2 will be reduced by at least 0.54km. Scotland Gas Networks say that they need to plan the network to meet their contractual obligation to supply the nominated load in order to ensure security of supply.
- 4.9. Where SHQ is the investment driver we are of the view that Scotland Gas Networks should be able to challenge users to nominate an accurate SHQ. Outside of this reopener process, an increase in a customer's nominated SHQ that triggered network reinforcement would be at that particular customer's expense. If the UNC does not currently allow GDNs to challenge nominated SHQ then GDNs should look at proposing changes to the UNC. In the meantime we propose that Scotland Gas Networks should explore the possibility of reaching a commercial agreement with customers to encourage them not to overstate their SHQ. Therefore we are proposing to disallow all the proposed investment for zones 2 and 3, reducing Scotland Gas Networks' re-opener request by £5.1m.

5. Ofgem's view - Opex assessment

- 5.1. As part of final proposals we implemented an interruption incentive covering the period 1 October to 31 March 2013. The mechanism was deemed to incentivise the GDNs to contract for interruption up to the point at which it became more efficient to reinforce their networks to make customers firm.
- 5.2. The interruption incentive was based on the annuitised cost of the investment required to support all interruptible customers as firm, and since Scotland Gas Networks have now applied for a reopener, and hence a number of their previously interruptible loads have gone firm, it is appropriate to reset this incentive. We indicated our intention to do this in final proposals⁴.
- 5.3. Scotland Gas Networks was set an annuitised value of investment of £2.8m (05/06 prices) based on the price control analysis that indicated at the time, in addition to the allowances given for the baseline case, the total capex cost of all interruptibles going firm would be £52.0m (05/06 prices).
- 5.4. The £52.0m is based on the forecast project costs submitted by Scotland Gas Networks at the time of the price control and since this was not challenged by our consultants we deem it appropriate to adjust the opex allowances by comparing Scotland Gas Networks' capex forecast submitted at the price control with the revised value of £28.4m (08/09 prices) submitted under the reopener. The effect of this adjustment is to reduce the incentive value from £2.8m to £1.4m per annum⁵.
- 5.5. As stated in GDPCR Final Proposals the interruption incentive is subject to 50% sharing factors to protect customers from any windfall gains by the GDNs. This means that GDNs will only keep half of any savings they make from interruption contracts that cost them less than the annuitized value of investment. The sharing factor is not constrained by a cap or collar.

6. Financial Impact of Ofgem proposals

- 6.1. Table 6.1 sets out the financial impact of Scotland Gas Networks reopener application and the impact of our current recommendations on allowed revenue.

Table 6.1: Financial impact of reopener proposals (£m, 2005/06 prices)

£m [2005-06 prices]	2008-09	2009-10	2010-11	2011-12	2012-13	5 yr avg
Price Control Allowed Revenue	194.65	197.19	201.84	205.79	207.86	201.47
Revised Ofgem proposal						
Additional revenue	-	0.00	0.05	0.43	1.05	0.31
Interruptions incentive (Opex)						
Final Proposals	-	-	-	1.4	2.8	
Revised Ofgem proposal	-	-	-	0.7	1.4	

⁴ "In the event that an application for a capex reopener was permitted we would expect to make a proportionate adjustment to the size of the interruption and flat capacity incentive targets." – GDPCR final proposals, p79

⁵ The revised interruption incentive allowance is based on the additional capex requirement that has not been applied for under the reopener to cover the remaining potential interruption payments in SGN. The value of this incentive would now be: $2.8/52 * (52 - (28.4/1.109)) = £1.4m$ per annum

- 6.2. Scotland Gas Networks' reopener claim of £28.4m would result in an increase of £2.51m (0.25 per cent) to allowed revenue over the price control period, because the assets have a 45 year life under our regulatory treatment of capital expenditure and so only a small proportion of the cost (plus financing costs) are recovered in the current price control. The Ofgem proposal would result in an increase of £1.53m (0.15 per cent) to the allowed revenue over the control period. This will be substantially offset by the reduction in interruptions incentive from £4.2m to £2.1m in the last two years of the price control, although 50 per cent of any unused amount will be returned to customers in any case, but the increase in RAV results in revenue streams in future price control periods.
- 6.3. The impact of our current recommendation is an increased cost to Scotland customers of 22 pence per domestic customer per year across the remainder of the price control period (4 years). Based on average customer charges of £85.77 as at 1 Apr 07 the increase is approximately 0.26 per cent.

Next Steps

We would welcome the views of any interested parties in relation to the issues raised in this proposal. Any comments on this proposal should be made by 7 July 2009.

In particular we would welcome respondents' views on the following questions:

Do respondents agree with our methodology for assessment of the reopener?

Is there any reason why a GDN should not look to propose changes to the UNC which provides them the opportunity to challenge nominated SHQs?

Are there any other issues Ofgem should be considering in reviewing SGN's proposal?

Responses should be sent to Paul.Branston@ofgem.gov.uk. If you have any queries in relation to the issues raised in this letter please do not hesitate to contact Paul Branston on 020 7901 7105.

Yours faithfully,



Steve Smith

Managing Director – Networks

Signed on behalf of the Authority and authorised for that purpose by the Authority