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Our Reference:

Your Reference:

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Dear Rachel,

Consultation on strategy for the next distribution price control: RIIO-GD1

Scotia Gas Networks (SGN) welcomes the opportunity to comment on Ofgem's consultation on strategy for the next distribution price control.

Our response to the consultation is attached. The response comprises an executive summary and detailed commentary on the key strategic issues raised in the consultation. As such, it also covers the key questions from the RIIO-GD1 overview paper. Our intention is to respond to the questions raised in the various supplementary papers over the course of next week.

Please do not hesitate to contact me if you have any questions on any aspect of our response.

Yours sincerely,

Malcolm J. Burns
Senior Regulation Manager

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Executive Summary

Expectation for RIIO-GD1

In order to meet investor expectations and maintain investor confidence in the sector, our expectation as an efficient operator of two gas networks is to be able to earn at least 5% post tax real returns, including out-performance potential; and to ensure we have the ability to secure dividends. We therefore expect the overall package to provide not only predictability and stability to investors but to also be cash neutral compared to existing arrangements throughout the eight-year price control period.

From an operational perspective, incentives are a key part of the RIIO philosophy (Revenue = **Incentives** + Innovation + Outputs) and we expect to be provided with the opportunity to out-perform across a range of incentives; whilst if we under-perform we accept that, in certain circumstances, penalties should apply i.e. we are generally supportive of symmetrical incentives.

As it stands, the package defers a significant level of cashflows into future periods and could halve returns to investors. Ofgem's low case cost of capital will require large equity injections; and even at the high end will still remove the potential to pay dividends without increased borrowings and unacceptable weakening of credit ratios. The overall package therefore fails to deliver either a sustainable financing case or an appropriate range of incentives to meet our investors' expectations.

Key financial issues

We need a settlement that is attractive to investors (existing, as well as new long term ones), that encourages efficient treasury policy and provides a predictable dividend stream. Notional gearing must consider the cashflow profile and overall the financial package should not weaken existing credit metrics.

To achieve this, the cost of equity needs to be above the top end of the proposed RIIO range; the cost of debt must be such that it reflects the long term financing obligations of the business and encourages the right behaviours. In addition, front-end loaded depreciation profiles are required for both existing and future assets and asset lives may also need to be reviewed.

Key operational issues

We are fully supportive of the overall objectives of the RIIO framework and agree that change is required to incentivise the Gas Distribution Networks (GDNs) to play a full role in meeting government environmental targets as we move to a green economy. The existing incentive mechanisms on shrinkage, exit & interruptions and environmental emissions have worked well; they have provided the GDNs with the opportunity to outperform whilst ensuring penalties exist for failing to deliver agreed targets. Going forward under the new RIIO regime, and even with a cost of equity at the top end of the Ofgem range (7.2%), the proposed incentive package will not allow an efficient GDN to earn above 5% post tax, real returns on the cost of capital.

Some minor changes are required to the existing incentive package to ensure it remains fit-for-purpose; and there is further scope to develop parts of the package in RIIO-GD1 e.g. the interruptions incentive. These matters are being discussed in the various Ofgem-led working groups. Going forward, new incentives are required to ensure efficient GDNs are able to deliver the outputs that stakeholders value and to provide an opportunity for them to out-perform the base cost of capital. For example, the review of the replacement programme must ensure that safety remains uncompromised; but we believe that a greater focus on a risk based output measure could provide further incentives to deliver a more efficient outcome. In addition, in light of growing metering competition, whilst it is essential that the emergency services should be fully funded, we believe there is potential to develop incentives in this area. On both of these issues, we are keen to consult further with our stakeholders.

Innovation is a key part of RIIO and we welcome the proposed innovation stimulus initiative. We believe that the scope of the stimulus must be sufficiently wide to ensure GDNs are able to fully contribute to a low carbon energy sector.

To ensure that efficient GDNs are appropriately rewarded, benchmarking and allowance setting must take into account the different regional factors that impact Scotland, London and the wider South East.

SGN's view of the key strategic issues for RIIO-GD1

Financial issues

Capitalisation policy and asset lives

Ofgem's proposals in this area have serious adverse implications for SGN's short / medium cashflow. The increased level of Repex capitalisation defers a substantial amount of cash into later price controls. However, leaving asset lives unchanged and only front end loading depreciation on new assets advances a relatively small amount of cash during GD1, leaving a significantly worse cashflow position compared to existing arrangements, removing the potential for dividends and threatening our ability to finance investment. This is a material regulatory change which significantly increases risk

Our investors seek to earn a stable, predictable equity cash return that is indexed to inflation; dividends are therefore important. Due to the significant deferral of cashflow during GD1, the only means of paying a dividend would be through a significant increase in indebtedness. However, this would result in higher interest charges and as a consequence weaken our credit metrics below acceptable levels. This position would be further compounded if the cost of equity is set anywhere below Ofgem's high end of it range, requiring a significant equity injection to maintain credit ratings.

It is not clear why there needs to be a change in the current capitalisation policy for Repex and the consequential deferral of cashflows. We understand that the rationale for funding 50% upfront was that current customers were benefiting from improved safety as well as future customers. Not withstanding this, the RIIO proposals have not taken into account the concept of 'Grandfathering' regulatory arrangements, i.e. that regulators should not change the regulatory (financial) parameters, in a way that disadvantages shareholders. However, if this is implemented, in order to preserve cash neutrality, our calculation demonstrates that it would be appropriate to front end load depreciation on all assets and reduce asset lives to 30 years. We believe our alternative proposals provide a sustainable long term solution and that transitional arrangements are wholly inappropriate and would only store up cashflow problems for the future.

Not withstanding the Financeability concerns outlined above, deferral of cash flow is transferring too great a cost to future customers at a time when Ofgem are recognising future uncertainty in its decision to front end load depreciation on new investment.

Cost of equity

We believe the RIIO cost of equity range of 4% - 7.2% is too low at both the bottom and top end of the range. Firstly, at the top end of the range, 7% is low by international standards with, for example, two recent US determinations showing a much greater allowed return. Recent regulatory precedents in the UK do not support this range; in 2009, the electricity industry was given 6.7% and the water industry 7.0%. There is no evidence to suggest that much has changed in the last twelve months to support any significant shift below these precedents. Finally, we believe the equity risk in GDNs has increased under RIIO with the deferral of cashflows, debt indexation and a little outperformance potential.

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Secondly, at the bottom end of the range, Ofgem has relied on the mathematical CAPM to estimate its initial cost of equity range without taking account the reality of return expectations and risk that exists in the sector. The model also puts emphasis on recent evidence which has clearly been distorted by the credit crisis; longer run historical returns do not support the lower end of Ofgem's range. Not withstanding this, we believe there is evidence on each of the individual CAPM parameters to suggest that the bottom end of Ofgem's range is too low.

The ENA will be submitting a paper on this area as part of the response to the Ofgem's December consultation which we support. Based on the additional evidence they have presented, it can be concluded that a range of 6.3% to 7.5% is credible.

As outlined above, we believe that the setting of an appropriate cost of equity should not be based solely on the evidence from CAPM and should reflect the overall risk profile of the RIIO package. Firstly, the promise of NPV neutral returns rather than stable cashflows (which the full capitalisation of repex implies) exposes investors to significant regulatory and political uncertainty and risks. Investors should not have to wait more than 8 years to be compensated for the risk. There is a real danger of destabilizing the investor base in listed and private infrastructure. Secondly, an important part of the RIIO package is the opportunity for good performing companies to earn additional returns through incentives. However, the package put forward at present falls well short of providing an acceptable level. Unless this imbalance is addressed, a much higher cost of equity will be required.

With a large investment requirement needed across the gas networks, this is not the time to be setting returns at record lows with the backdrop of materially deferring cash flow and having a weak package of incentives. It is crucial to ensure that the allowed cost of equity is sufficient to attract and retain the necessary equity investment to deliver the objectives of RIIO.

Cost of debt

We believe the mechanism for calculating the cost of debt is insufficient to meet our financing requirements and have continually supported the retention of the existing arrangement whereby cost of debt is set taking into account historical trends but also making an assessing the future costs. The use of an inappropriate index will encourage companies to hedge the index rather than manage financing risk. If an index is to be imposed, addressing several key practical issues outlined below should provide a more realistic index which we believe currently understates our cost of debt - this is supported by some regulatory and market precedents.

Firstly, regarding precedents, if applied today, Ofgem indicate the proposals provide a cost of debt of 3.1%, though trends could reduce this figure to 2.8% by the start of GD1. The electricity determination in Dec 2009 was 3.6% when the Bloomberg indices yielded 3.2%. There is no justification for the elimination of the 40 bps premium to the Bloomberg index. The index is also punitive relative to the 3.60% allowed by both Ofwat in 2009 and NATS in 2010.

Secondly, there remain several practical issues that we believe understates our true cost of debt. The Index does not incorporate at least 50 bps of additional costs i.e. new issue premium (10 bps), the credit spread payable on index linked debt (20 – 40 bps), bank liquidity or contingent equity to support a business of this scale (20bps) and legal, rating agency, listing and other fees (10 bps).

Furthermore, some of the parameters need further consideration. For example, the length of maturity at 10 years does not recognise the fact that infrastructure investors prefer to finance

long life assets with long life debt to align risks with recovery over 45 years. SGN was funded in 2005 with circa 15 year debt and we believe 15 to 20 year tenor for gas industry is more appropriate. Shortening financing tenor introduces additional refinancing risk.

In relation to the proposed 10 year trailing average period, Ofgem's December 2007 decision states "3.55% appropriately balanced the spot rates for the cost of debt, the ten year trailing average and the long term averages". We believe the GDNs are penalized by having a ten year trailing versus a long term average of the cost of debt and this penalty will increase in the future as higher rates from early 2000s roll off. The Index will be unduly influenced by the impact of the recent credit crisis and desire of central banks to maintain low real interest rates

The choice of corporate index needs to address the fact that Bloomberg indices include bonds guaranteed by insurers previously rated AAA. This guarantee distorted bond pricing until the 2008 credit crisis began, causing a bias to lower credit spreads and therefore the index does not provide for the recovery of fees paid by GDNs to insurers for the AAA guarantee.

As in previous price controls, the allowed cost of debt must take into account an assessment of future costs as well as historical trends. Therefore, the index also needs to include a mechanism to manage uncertainty and 'shocks'. For example, it needs to cater for future step changes in banking and bond investor regulation.

In summary, the indexation methodology introduces more risk as it is more difficult to finance against a moving target than a fixed target and represents a material shift in methodology. It also ignores at least 50 bps of associated costs and has some practical issues relating to the parameters used in the index. The increased risk of having an index should be reflected in the cost of equity and specific improvements to the practical issues identified above should be incorporated.

Taxation

Whilst we support the use of a small threshold for a trigger to re-open tax issues, the GDNs should not be exposed to any 'dead band' that is introduced within the trigger. Material changes to levels of tax are highly likely to be outside the GDNs control and as such they should not benefit or be penalised for this amount.

Therefore, we propose that a mechanism similar to the tax re-opener in the current price control with a cumulative or annual trigger where all of the re-opener amounts are recoverable. We would suggest 0.33% of base revenue, similar to the trigger in DPCR5.

Given we propose a fully recoverable re-opener for tax (subject to a suitable trigger) we believe it is sensible to use existing parameters for the current assumptions for tax modelling and would also support the default use of UK GAAP.

Any re-opener amount should be adjusted for in allowed revenue as soon as practicably possible to minimise the impact on short term cashflows.

Pensions

We are broadly supportive of the retention of the existing six pension principles. Notwithstanding this, we have raised concerns via an ENA response about the Ernst & Young

methodology for calculating the established / incremental deficit both in terms of accuracy and cost and proposed alternatives to solve these concerns.

We agree that any true ups from the current price control should be recovered on an NPV neutral basis over eight years providing other cashflow issues raised earlier in this response are adequately addressed.

Outputs and incentives

We continue to be fully supportive of outputs-led regulation and the development of appropriate primary output measures. We have been actively engaged in all of the Ofgem working groups but are disappointed that GDNs views have not always been taken onboard. For example, proposals around the broad environmental measure, discussed below, merit further consideration.

Many of the proposed outputs still require development. We would expect Ofgem's proposals to be informed through stakeholder engagement and we would expect to discuss all key proposed outputs with our stakeholders to ensure they are focused on what current and future customers require, drive the correct behaviour and provide value for money.

Environment

We welcome the development of a broad environmental measure and the intention to create an enabling regulatory environment that ensures GDNs are able to play a full role in delivering a low carbon energy sector. We do not, however, believe that reporting the capacity of bio-methane connected to the network is as a suitable primary measure. Ofgem has noted that such an output measure is not sufficiently controllable by GDNs and it is therefore not appropriate to set targets or attach financial rewards / penalties. For exactly these reasons, it is inappropriate to publish an annual league table; whether the incentive is financial or reputational, if it is outside a GDNs control it is inappropriate. It may be appropriate to report and monitor at UK level for information purposes to monitor progress on distributed gas. However, an alternative broad environmental measure that captures and reports on how effectively GDNs promoted and facilitated the connection of distributed gas may be more applicable. We would welcome further discussion of this alterative in the working group.

With regard to information provision for distributed gas, whilst we agree that GDNs should produce common, simple, accessible and reliable set of guidelines to help customers wishing to connect bio-methane plants to the networks, we do not believe that a new licence condition is required. Furthermore, the level of information required will be determined by the customers knowledge and understanding of the industry.

Shrinkage and Environmental Emissions Incentive (EEI)

We fully support the continuation of the shrinkage and EEI mechanisms for RIIO-GD1 and welcome the proposal to adopt the DECC's non-traded value of carbon for the EEI to bring this into line with government policy.

We believe that a volume based cap and collar on the EEI continues to be required to reflect ongoing uncertainty. We do not believe that a cap and collar arrangement is required or would function effectively for the shrinkage allowance mechanism.

We note Ofgem's current position not to adopt a rolling incentive mechanism for shrinkage and EEI. In our view, whilst extrapolating leakage performance out to 2029 may be difficult, it is important that the GDNs are able to realise the benefits from investment or improved network management over an extended price control period. We believe that the working group should therefore focus on developing a common methodology for extrapolating shrinkage performance past 2021.

With regard to the use of actual shrinkage data instead of modelled data, whilst we recognise that benefits could accrue from using actual data we do not believe that robust data will become available until the end of the next price control period i.e. 2020/2021. In our view a licence condition to collect actual shrinkage data is not appropriate at this stage. What is required is an agreement as part of the price control package for GDNs to assess the quality and accuracy of data from smart meters during RIIO-GD1 with a view to using this for shrinkage / EEI purposes in RIIO-GD2 onwards. If GDNs have an obligation to assess the quality of such data it will be essential that they are provided with access to that data.

Customer services

We are generally supportive of the development of a broad measure of customer service across the three broad areas of customer satisfaction, complaints handling and understanding & responding to stakeholders.

However, we do believe that negative only incentives are appropriate. In our view any mechanism should be suitably calibrated to allow symmetrical incentive properties. Hence, with regard to customer satisfaction, we do not support the proposals to penalise any GDN not in the upper quartile on its complaints performance. In our view, an incentive mechanism on complaints should allow for the opportunity to outperform from a base level. In developing such a metric it will be important to ensure that regional differences in customer perception are taken into account.

Whilst we note Ofgem's view that GDNs will not be exposed to excess financial risk with a complaints incentive in addition to the guaranteed standards, it will mean that GDNs are subject to 'double penalties' which is clearly inappropriate. In our view any, symmetrical, complaints measure should supersede the current guaranteed standard.

We support the inclusion of stakeholder engagement in the broad measure of customer satisfaction along with the asymmetric incentive mechanism. However, we do not believe that the stakeholder engagement element of the broader measure replaces the current discretionary reward scheme (DRS); we believe that it complements it. The aim of the DRS is to encourage and drive performance in areas that cannot be easily measured or incentivised through more mechanistic regimes. The scheme covers initiatives such as environment, social and safety and has provided positive benefit across all of these areas in GDPCR1; and we believe it can continue to provide benefit in these areas in RIIO-GD1.

xoserve

As noted in the consultation document, xoserve provides regulatory services to the industry, split between core services and user pays services. There is potentially significant changes to the scope and nature of these services in the future (due to the advent of smart meters as well as the proposed replacement of many of xoserve's core systems). Ofgem's proposed review of

xoserve's governance and ownership arrangements is therefore timely. Given the relatively small proportion of funding that xoserve represents as a total of industry revenues, we agree that this review can be carried out on a separate timescale to the main review.

In our view, xoserve has provided reliable, efficient services to-date. We understand that there has been some concern about the quality of service provided under the user pays service; we believe that xoserve is addressing these concerns in its response to the December consultation.

Going forward, we believe that a governance and funding framework similar to that currently in place is likely to provide the most economic and efficient service to the industry.

Social obligations

As noted on previous occasions to Ofgem, we believe that the fuel poor network extensions scheme has been a huge success story for GDPCR1. We believe it is still the most appropriate way to assist the fuel poor for RIIO-GD1. Furthermore, we do not believe there is any evidence that the current incentive mechanism is overly complicated or is over-rewarding GDNs for carrying out the activity. Neither of the alternatives considered in the December consultation paper improve upon the existing initiative; option 2 is a simple 'pass-through' and option 1 does not provide any greater (or simpler) incentive on the GDNs to connect the fuel poor.

With regard to carbon monoxide, we have welcomed the discussions around promoting gas safety and intend to seek our stakeholders' views on initiatives such as providing CO detection devices via our first call operatives. However, as discussed previously, there are legal issues around the provision of such devices that must be addressed first. It will not be possible to develop output measures or incentive mechanisms until the liability and funding issues are addressed. We also believe further discussion is required regarding what is a suitable role for a GDN in this area and what our obligations they should bear, bearing in mind the wide range of parties with an involvement or interest in this area.

Connections

We welcome Ofgem's acceptance of effective competition in the various connections market segments. We believe that the significant loss of market share in a number of segments demonstrates the presence of successful competition. To that end would, we encourage the removal of these services from the Guaranteed Standards regime.

Given that there is full competition in a significant number of market segments, GDNs should continue to be allowed to earn an unregulated margin in these areas. We do not believe there is any segment that warrants the imposition of a regulated margin.

Our experience of the connections standards leads us to believe that there is not a material issue with the service we currently provide. Nevertheless we will continue to seek initiatives to improve our services. The growth in market competition combined with our existing results would suggest that further new standards are not required. This includes the proposed extension of guaranteed standards into the distributed gas activity. We already have a proven commitment to the development of this market and will continue to focus on providing the most effective service to all potential entrants.

Safety & reliability

Safety and Reliability is core to the operation of gas transportation assets. We have been pro active in the safety and reliability working group, and fully support the principles of output based measures for safety and reliability of the networks.

With respect to mains replacements, we are encouraged by the primary output being risk reduction, and the continued work of the group to develop smart measures with a transparent and equitable funding mechanism. We would also highlight that at this stage the proposed revenue drivers for mains risk removal do not encompass all the replacement outputs achieved by us such as removal of steel. In this area we will seek to clarify the specific arrangements for funding these key elements of our replacement programme in building a holistic approach.
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Many of the other primary outputs have no incentive mechanism. Whilst we accept that incentives around some safety output measure may not be appropriate, it is important that the working group continues to explore the opportunity to incentivise across as broad a range of outputs as practical.

Asset risk management

We support the principle of a holistic approach to the management of risk across the full range of network assets. As part of Ofgem's working groups we have been central to developments to date and intend to play an active part going forward. Within the working groups we have highlighted that attainment of this broad measure will entail the gathering and evaluation of significant volumes of data in conjunction with testing and review of the mechanism for assessing asset risk. It is proposed in the consultation document that where data relating to asset health and criticality already exist or can be acquired readily this will result in determining outputs targets against which cost baselines can be assessed. We support this process, but advise caution in the application of a methodology which is yet undeveloped and untested. We are currently finalising our asset health strategy as part of RIIO-GD1 and will be submitting this to Ofgem in the near future.

Capacity outputs working group

We welcome the establishment of the capacity working group, which has only recently started to develop proposals around outputs and incentives in this area. We would caution Ofgem against developing complex new incentives in this area. We believe that the existing incentive mechanism, which has worked well during GDPCR1. Going forward, we would expect the working group to further enhance the demand side initiatives.

Low pressure gas holders

Following the Buncefield incident in 2005, there has been growing concern about the societal risk posed by low pressure gas holders. This predominately affects our Southern GDN and another two networks. Overall, we own 81 gas holders and we intend to develop and agree with the Health & Safety Executive (HSE) a risk-based programme for decommissioning these, commencing in 2013. This will form part of our business plan submission in July.

Tools for cost assessment

Overall approach

We note the proposal to develop a toolkit approach to cost assessment. We would welcome further information on the proposal to develop a matrix analysis technique and to understand how this would feed into the overall cost assessment process. With regard to benchmarking historic and forecast costs we have previously raised several concerns with Ofgem. In summary these are:-

- appropriateness of drivers (for example, repairs rather than reports)
- totex – we believe this cost pool is too wide and has multiple drivers to support a regression in its own right
- adjustments for more atypical costs need to be made e.g. TMA costs, Non labour regional costs
- adjustments to costs where key outputs are not been delivered e.g. failure to deliver emergency standards
- we are also doing further work to refine labour and contractor regional costs which were not adequately provided for in GDPCR1
- maintenance – a wider basket of drivers is required to improve the poor correlation
- support service activities have proved difficult to benchmark through regression and we would support alternative techniques such as market testing in this area

With regard to replacement expenditure, we have put forward several suggestions for improvement including:-

- taking account of the unique project costs of high diameter replacement
- separating mains and services
- consider incorporating the abandonment to lay ratios into the driver

Benchmarking should be both bottom up and top down. In terms of historical benchmarking, we do not support Totex at the highest level and we should continue to separate totex into opex, capex and repex. However, providing appropriate drivers can be found for totex, we support the use of totex regressions for business plan forecasts but it should only be used as part of a much wider toolkit.

As a general point, we believe that as the working groups finalise development of outputs, Ofgem should consider whether some of the key outputs should be considered as additional or alternative drivers in some of the bottom up regressions where they are currently not being used.

Whilst we recognise the benefit of return on regulatory equity (RORE) within the toolkit for assessing performance, its use should not be over played. RORE looks at the value of out / under performance generated in a year compared to allowances and does not take into account the timing of cashflows relating to this amount. For example, in GDPCR1, a capex under spend will attract a 33% out-performance and return on equity in the year it is generated. However, it will take a number of years through the rolling capex incentive to recover this out-performance from a cash perspective. RORE for individual years can also be misleading where there are timing issues between allowances and expenditure due e.g., timing of large capex projects. Therefore, care needs to be taken when looking at RORE over a relatively short period of time.

We believe that regressions can give an alternative indication of efficiency, and credit metrics also pick up any financeability issues. Both should therefore be used alongside RORE.

Input price inflation and ongoing efficiency

This is a material area to the GDN's cost base going forward and we believe Ofgem should take into account independent and factual studies. We intend to produce evidence in our business plans to justify any assumptions made.

Regional factors

Our two licensed businesses operate in very different conditions. In Scotland regional factors such as the extreme weather experienced over the last three winters have profoundly impacted how we operate our business; as does the sparsity and geographical spread of our customer base. For Southern, operating across London and the South East, regional factors such as contractor and labour costs, urbanity and customer expectations impact upon our operations. It is essential that these regional factors are taken into consideration in any benchmarking exercise and when allowances are formulated.

Business plans, innovation and efficiency incentives

Form and structure of the price control

In order to promote further innovative ways of utilising regulated assets, we believe that work that is essentially carrying out core activities for other customers (e.g. maintenance of pipelines and emergency response for third parties) should be included in excluded services. This would leave much greater headroom in our de-minimis cap for innovation.

Business Plans

We are committed to developing well-justified business plans for both our licensed networks. We feel that the level of guidance provided by Ofgem to date has been constructive and useful in developing our thinking in this area.

We recognise there will be more robust definitions of the outputs and incentive packages in the March document. However, it is important that these are flexible enough to allow us to develop an overall package in our business plans that is acceptable to our stakeholders whilst delivering the required returns to our shareholders.

We believe there are areas of producing a well justified business plan that Ofgem will need to contribute to e.g. benchmarking data that individual GDN's will not have.

We support Ofgem's proportionate treatment provided the assessments are carried out appropriately. The assessment criteria seems sensible and to ensure the process is not too rigid, we would wish to see some subjectivity applied.

However, unless there is a step change in the financeability and incentives package in the March document, we will not be able to deliver a plan which is credible to our shareholders in terms of cash flow, returns and out-performance potential. Without such change, fast tracking is unlikely to hold any appeal to us.

Role of third parties

We agree that it is not practical for third parties to undertake and own the development where new projects are heavily integrated within our Networks. However, we do believe there exists opportunities to work in partnership with third parties in developing innovative solutions to meet the changing needs of the gas networks. We will seek out and work with appropriate partners as we develop our networks to meet the low-carbon challenge.

Innovation stimulus

Innovation is a key part of RIIO. We welcome the proposal for an innovation stimulus and have taken an active part in the working group that is helping Ofgem to develop its thinking in this area. In our view, the scope of the proposed innovation stimulus needs to be sufficiently wide to ensure the long term stability of the gas networks i.e. to promote a long term low carbon, sustainable future for the gas networks.

We believe that the level of funding for the gas distribution networks ought to be proportionally similar to that recently agreed for the electricity distribution networks. The Redpoint report has provided viable scenarios in which gas has a long term future. As such, the overall funding between gas and electricity (transmission and distribution) should be proportionate.

With regard to how network companies should be required to meet the costs of the innovation stimulus, we agree with the view of the working group that it should be via 'fast money', released on a milestone basis within each specific project.

The current innovation funding incentive (IFI) has been extremely successful during GDPCR1 and we welcome the proposal to continue with an innovation allowance for each GDN. In our view, the existing IFI funding mechanism has worked well, it is currently in place and we see no reason to depart from this for the replacement innovation allowance.

Efficiency incentives

We believe that the IQI mechanism is now well embedded in regulation and support its continued use. However, the way in which it is calibrated is vital to ensure the right incentives and rewards exist.

The current proposal does not adequately reflect what we consider to be appropriate incentives. Firstly, in GDPCR1, additional financial rewards were given where a company's forecasts were within 20% of Ofgem's assessment and in DPCR5, this was within 15%. We note, it is now proposed only to reward companies whose forecast come in under Ofgem's assessment. Given the inevitable legitimate differences in views of forecasts, we believe the threshold for additional financial reward should remain close to existing precedents.

The incentive strength range (the proportion of outperformance that is retained by GDNs or underperformance it is exposed to) seems appropriate and reflects a similar position to the weighted average sharing mechanisms in GDPCR1. However, the way in which outperformance is recovered by GDNs results in a significant deferral of cash recovery from the present position. We feel strongly that given the perceived intention to keep the over impact of the incentives similar to GDPCR1, more outperformance should be retained immediately rather than been deferred through the RAV.

The sharing principles set by the IQI mechanism is intended to apply to the majority of costs i.e. totex. However, Ofgem have raised the issue as to whether to continue to exclude business support costs and non-operational capex from totex. Most recently, in DPCR5, these cost have been excluded on the basis they are not asset related and are not impacted by the same choices which balancing of incentives in totex incentivised. We believe non asset related costs (including Business Support and non operational capex) should continue to attract a much stronger incentive to reduce costs in this area and should be 100% incentivised (maximum benefit retention / maximum exposure) with out / under performance returned immediately.

Uncertainty mechanisms

We note the potential uncertainty mechanisms that Ofgem consider could be appropriate for gas distribution, including some mechanisms considered appropriate for all sectors. We note the potential move to a 12-month period for RPI indexation. In principle we are supportive of a move to a 12-month average. We have no strong views on whether this should be the calendar year or the financial year. We do not believe that transitional arrangements are necessary for any such change.

We welcome the decision to continue the pass-through of Ofgem licence fees and business rates. We strongly disagree with Ofgem's concern that the business rates mechanism may not provide strong enough incentive on the companies; as previously discussed, the level of business rates already undergo a rigorous test to ensure value for money.

We also welcome the proposal for an uncertainty mechanism for potential changes in the connection charging boundary to promote bio-methane. However, we do not support a logging up mechanism as proposed by Ofgem. Such a position exposes GDNs to all funding risks should the market develop at an increasing rate over the eight-year price control period

An alternative, discussed at the environmental working group, is to set an *ex-ante* allowance of the expected efficient costs along with a re-opener mechanism to cover any additional costs not covered in the allowance. This is similar to the proposals for permitting schemes under the Traffic Management Act (discussed below). We believe this alternative should be implemented for RIIO-GD1.

Traffic Management Act (TMA) permitting schemes

We note the current proposal for a re-opener mechanism along the lines of electricity distribution for managing the uncertainty associated with permitting schemes under the TMA. The costs of such schemes (e.g. lane rental costs) are a significant issue for licensees who have networks around London and the South East. Furthermore, in Scotland, where there is a separate Transport Scotland Act, we are seeing similar issues regarding costs.

We are therefore supportive of the proposal to set an *ex-ante* allowance and for a re-opener mechanism to recover any additional costs not covered in the allowance. We are, however, concerned that a single re-opener window within an eight-year price control period may mean significant costs being logged up until the end of the price control period. We suggest that two re-opener windows are required; one to allow changes at April 2016 and one to allow further changes at April 2019. With regard to a materiality threshold, we agree that a threshold expressed in terms of allowed revenue may be more appropriate for these costs.

With regard to critical national infrastructure, we note the proposal to adopt the DPCR5 approach of a logging-up mechanism with a threshold for a re-opener. However, given that we are moving to an eight-year price control period, we would again suggest that two re-opener windows may be more appropriate for RIIO-GD1.

Emergency services and the loss of meterwork revenue driver

We note Ofgem's proposal to remove the current revenue driver for loss of meterwork. Whilst we are not fundamentally opposed to this proposal, we do not believe that an *ex-ante* allowance is an appropriate mechanism to fund the emergency services going forward.

The meter industry is undergoing significant change, with the accelerated roll-out of smart meters likely to be taking place during the next price control period. Metering competition puts at risk the ability for GDNs to utilise emergency services' downtime on traditional meterwork. We firmly believe that the efficient costs of the emergency services must be fully funded, and there are a number of options to do this. Whilst our preference is for full upfront funding, we are also considering a move to an outputs based, symmetrical incentive mechanism around a base standard. We intend to develop this proposal as part of our business plan submission.

Replacement programme

We welcome the proposal to focus on risk reduction for asset replacement and have discussed with the HSE our views on developing the current '30/30' iron mains programme to include other pipe assets such as risers, steel mains and services, adopting a holistic approach to risk reduction and ensuring protection under the Pipeline Safety Regulations. We agree with the proposals for a repex re-opener to protect from volume risk and for a specific re-opener for any changes required following the HSE review of the 30/30 repex programme.

The Scottish Independent Undertakings (SIUs)

Prior to submission of our high level business plans in September 2010, National Grid informed us of the likely closure of its liquefied natural gas (LNG) facility at Glenmavis. Since then, there have been a number of serious incidents at Glenmavis which have rendered it non-operational. We are working closely with National grid and Ofgem to ensure that the SIUs continue to have a secure and reliable supply of LNG in the short to medium term.

For the longer term, we are looking at a number of alternatives, all likely to require significant capital expenditure. We have advanced our assessment of these long-term options given the current problems with the Glenmavis facility.

Other Uncertainties

Whilst we agree that the current disapplication procedure is fit for purpose and does not require to be changed, we continue to believe that a specific re-opener mechanism is required for potential changes in legislation that could impact on the price control settlement. This is particularly important given the extended length of the price control periods.

We note Ofgem's intention to separately consult on its approach to sub-deducts through an industry open letter. We have previously expressed the view that it is not practical for GDNs to adopt these networks and that re-engineering the networks and meter points is the only viable long-term solution.

Summary

We are generally supportive of the RIIO framework and have worked with Ofgem and industry in developing outputs and incentives that will enable GDNs to take a full part in the move to a low-carbon energy sector. However, as it stands, the overall package fails to deliver either a sustainable financing case or an appropriate range of incentives to meet our investors' expectations.

Financial Issues

In order to meet investor expectations and maintain investor confidence in the sector, our expectation as an efficient operator is to be able to earn at least 5% post tax real returns, including out-performance potential; and to ensure we have the ability to secure dividends.

We therefore expect the overall package to provide not only predictability and stability to investors but to also be cash neutral compared to existing arrangements throughout the eight-year price control period.

Operational Issues

Incentives are essential in ensuring GDNs deliver. The existing incentive mechanisms on shrinkage, exit & interruptions and environmental emissions have worked well, albeit there is an opportunity to refine and develop some of them.

Going forward, new incentives are required to provide the opportunity for efficient GDNs to out-perform the base cost of capital. For example, a greater focus on a risk based output measure could provide further incentives and there is potential to develop incentives around provision of emergency services whilst ensuring full funding of the core service.

Innovation is also a key part of RIIO and we welcome the proposed innovation stimulus initiative. We believe that the scope of the stimulus must be sufficiently wide to ensure GDNs are able to fully contribute to the development of a low carbon energy sector.

To ensure that efficient GDNs are appropriately rewarded, benchmarking and allowance setting must take into account the different regional factors that impact Scotland, London and the wider South East.