



Mr R McDonald
Director of Regulation
Scotland Gas Networks
St Lawrence House
Station Approach
Horley
Surrey
RH6 9HJ

*Promoting choice and value for
all gas and electricity customers*

Your Ref:
Our Ref:
Direct Dial: 020 7901 7292
Email: steve.brown@ofgem.gov.uk

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Dear Rob

Notice of Authority Decision and Reasons

Notice of decision on the application of Scotland Gas Networks to re-open the current Gas Distribution price control to accommodate proposed allowances under the capital expenditure interruption reform re-opener set out in the 2008-2013 Gas Distribution Price Control Review Final Proposals

1. Introduction

1.1. Scotland Gas Networks ("SGN") applied to provide capital expenditure funding for reinforcing SGN's system to accommodate the change of certain Interruptible customers to Firm status from October 2011 under Interruption Reform.

1.2. This letter summarises the background to SGN's application, the Authority's decision and reasons for that decision and its consideration of the financial impacts of SGN's capital expenditure interruption reform re-opener and associated issues.

2. Background

2.1. The Gas Distribution Networks ("GDNs") have a licence obligation to develop and maintain their pipe-line system to enable them to meet peak aggregate daily demand on their networks which is likely to be exceeded only 1 year out of 20 years. 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 National Transmission System ("NTS").

2.2. The GDNs currently have interruption arrangements with certain large interruptible customers that enable GDNs to require those customers to reduce or cease their offtake of gas at high demand levels in return for a discount on their transportation charges. In March 2007 Ofgem directed UNC Mod 90 'Revised DN interruption arrangements'¹ for implementation from 1 April 2008.

2.3. The revised DN interruption arrangements changed the way that interruptible capacity rights are allocated. Rather than allowing eligible customers to determine their firm or interruptible status at only one year's notice, the reformed arrangements allow GDNs to offer interruptible capacity solely in the locations and volumes they require via annual auctions with three year lead times.

¹ <http://www.gasgovernance.com/NR/rdonlyres/234B945D-7E4F-4AB3-BE35-957459D9CD28/15807/UNC900ofgemFinaldecisionletter1.pdf>

2.4. Following this reform of interruptions arrangements, GDPCR allowed for the possibility of a capital expenditure re-opener in 2008/09 to pay for network reinforcement that was required if a GDN was unable to procure sufficient interruptible capacity at an economic price (relative to the expected costs of providing firm capacity) after the first year of the auction process.

2.5. The auctions were held in June and October 2008 and resulted in few of the existing interruptible customers retaining 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. Subsequently only SGN requested an allowance for additional capital expenditure to reinforce their network because they were unable to obtain suitable bids for interruptible contracts from customers.

2.6. The 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. The other GDNs have therefore either successfully secured interruptible contracts with customers or have found that with the reductions in demand, network reinforcement is not required.

3. Summary of Scotland Gas Networks' application

3.1. The information supporting SGN's initial application stated that they had five interruption zones which depended on interruptible contracts with customers to avoid the necessity of reinforcement. During the tenders and contact with shippers and customers in 2008, there were no bids in three of the zones and insufficiently economic bids in the others to avoid reinforcement². National Grid then increased the amount of storage available to SGNs from the NTS which enabled the proposed projects in zone 5 to be deferred until the next price control period.

3.2. SGN's re-opener application dated 1 December 2008 was for four construction projects in four zones within Scotland LDZ, at a forecast cost of **£28.5m**.

3.3. We reviewed the application and assessed SGN's investment plans. We appointed consultants IPA to examine in detail SGN's submission for additional reinforcement in the four zones both in terms of the need for the reinforcement and the proposed capital costs.

3.4. IPA agreed that in principle there is a need for reinforcement in each zone but they challenged SGN's costs, load assessment and engineering assumptions. We agreed with their proposal that significant reductions could be made to the capital expenditure application. In particular we agreed with the view of IPA that the upward pressure on pipe costs that were forecast by the GDNs in the GDPCR as a potential risk over the price control period has not materialised. We therefore considered the base unit cost ranges assumed in GDPCR were still relevant to these projects. We also considered that some of the assumptions could be amended further, leading to even lower costs.

3.5. The contractual UNC Supply Point Hourly Quantities (SHQs) of customers can be significantly higher than their recent maximum peak hourly loads. If the recent maximum peak hourly values (rather than contractual UNC SHQ) were used by SGN for network planning, then no reinforcement was required in zone 3 and reinforcement in zone 2 would be reduced by at least 0.54km. However, since SGN said that in order to ensure security of supply their network planning had to incorporate their contractual obligation to meet the UNC SHQ load, we considered it appropriate to recommend to SGN that they engage with relevant customers to see whether they really required the SHQs or whether recent maximum peak hourly loads better reflected their capacity needs.

² Customers re-designated as firm following interruptible capacity auctions are exempt from the application of the economic test and hence any contribution.

4. Initial Proposals

4.1. Following our review of SGN's application and our consultant's report, on 9 June 2009 we consulted³ widely on our initial view that we were minded to re-open the SGN's GDPC to allow the reinforcement in two out of the four zones at a cost of **£16.30m**.

4.2. The consultation sought comments on:

- our methodology of assessment of the re-opener,
- whether GDNs should look to review their current charging arrangements and consider whether they are fully cost reflective where a customer's SHQs require them to incur additional costs when providing firm capacity,
- any other issues Ofgem should consider in reviewing SGN's proposal.

4.3. The following table, Table 1, presents the original proposed projects and associated costs as submitted by IPA and SGN, and our minded to position on proposed allowances.

Table 1: Summary of GDN, consultant and Ofgem initial re-opener proposals

	[08/09 prices]	Scotland Gas Networks Proposed	IPA recommendation	Ofgem Original view
Zone 1	Project proposal	LTS: 15.14km x 300mm 69 bar steel pipeline	<i>Project specifics as per Scotland Gas Networks submission</i>	<i>Project specifics as per Scotland Gas Networks submission</i>
	Forecast cost	£13.20m	£10.60m	£10.60m
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	£1.06m	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	£4.00m	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	£10.20m	£5.70m	£5.70m
	Total Cost	£28.46m	up to £17.21m	£16.30m

Operating Expenditure Allowance

4.4. As part of GDPCR Final Proposals, we implemented an interruption incentive covering the period 1 October 2011 to 31 March 2013 to incentivise the GDNs to contract for interruption up to the point at which it became more efficient to reinforce their networks to support the conversion of those customers to firm. The interruption incentive was based on the annuitised cost of the investment required to support all interruptible customers as firm. Since SGN applied for a re-opener and a number of their previously interruptible loads

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<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=GDPCR%20Interruption%20reopener%20open%20letter%20consultation.pdf&refer=Networks/GasDistr/GDPCR7-13>

have chosen to become firm, it is appropriate to reset this incentive. We indicated our intention to do this in GDPCR Final Proposals⁴.

4.5. SGN was set an annuitised value of investment of £2.8m (05/06 prices) based on their case that the total capital expenditure cost of network reinforcement due to all interruptibles going firm would be £52.0m (05/06 prices). The £52.0m investment value was based on the forecast project costs submitted by SGN at the time of the price control. In our consultation, we therefore proposed that the interruptions incentive allowances be adjusted by comparing SGN's capital expenditure forecast submitted for the GDPCR with SGN's interruptible capital expenditure investment proposal.

5. Consultation responses

5.1. We received five non-confidential and two confidential/part confidential responses to the consultation.

5.2. A high level summary of the responses is set out below and Ofgem's views are set out at part 6 of this letter.

5.3. Two respondents supported closer examination and focus on whether customers' existing SHQs were representative of their peak hourly demand, while three other respondents did not consider this to be appropriate action.

5.4. One respondent agreed with Ofgem's conclusions on costs and two respondents supported GDNs exploring ways to agree commercial solutions to revise customers' network access rights, while another respondent considered such commercial contact between GDN and consumer to be unacceptable.

5.5. One respondent considered that it was inappropriate from a good governance perspective for Ofgem to recommend that SGN raise a UNC change proposal.

5.6. Another respondent considered that Ofgem could have done more to enable customers to assess earlier the level of GDN investment required to enable them to make informed commercial decisions when bidding for interruptible capacity rights.

5.7. SGNs response included a significantly revised SGN submission of **£25.76m** due to project changes in zone 3. They provided detail regarding the results of the cyclic validation of their zone 3 Network Analysis model following the 2008/09 winter. This showed that the relevant capital expenditure re-opener pipe network was physically more robust than the model had previously simulated it to be. In addition, they confirmed that the potential loads on the validated model had been updated and this had reduced load growth over the 5 year period.

5.8. As a result, SGN advised that in zone 3 they were able to reduce the proposed pipe length and hence reduce the estimated costs by £2.7m. In addition, they confirmed that their original zone 4 project proposal included 2.4km of pipe within the customers site, of which a minimum of 1.2km was necessary to reach the customer's existing point of connection. SGN stated that the proposed additional 1.2km of pipe was the most cost effective solution to maintaining total system pressures while also ensuring their ability to reach the customer's point of connection, when the customer's future site development plans are taken into account.

⁴ "In the event that an application for a capital expenditure re-opener 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

6. Authority Decision and Reasons

6.1. In the light of the consultation responses, SGN's revised proposals, and following further discussions with SGN, we re-examined how the proposed works could be carried out more efficiently. We have also re-considered our minded-to position regarding how SGN could do more to explore ways of avoiding the need for reinforcement in zones 2 and 3.

6.2. We originally recommended that SGN should explore the possibility of reaching a commercial agreement with customers to encourage them not to overstate their SHQ and on that basis that we were minded to disallow some of the proposed investment in zones 2 and 3. We have decided that, given SGN's substantially revised proposal for zone 3 and hence the low financial materiality of this issue in these particular circumstances, it would not be proportionate to disallow expenditure on this basis in this particular case.

6.3. However we consider that this has highlighted an issue that the GDNs need to consider and review. We are concerned that the existing charging and contractual arrangements may not place appropriate incentives on customers to declare accurate SHQs and this issue does not appear to have been adequately addressed through existing industry governance arrangements. If customers do not have appropriate incentives to consider the level of SHQ they require, this could lead to over investment in the pipeline system.

6.4. We understand the concern of one respondent that it would be inappropriate for us to recommend that SGN should raise a UNC proposal, but we are responsible for making sure that GDNs comply with their statutory and licence obligations. These include, amongst other things, the obligations to develop and maintain an economic and efficient pipeline system, keep their charging arrangements under review and to have in place cost-reflective charging arrangements.

6.5. We think the GDNs need to initiate a review of the issues raised in this process and consider what, if any, changes should be made so that customers face appropriate incentives to consider the level of SHQ they require. Our understanding of the current arrangements is that customers' capacity charges are broadly independent of their contractual SHQ, even if this requires the GDN to incur additional costs in meeting their SHQ requirements.

6.6. We think the GDNs need to review this situation. If they do not then we may conclude at subsequent reviews that either forecast or incurred capital expenditure was inefficient. We may disallow all (or part) of such expenditure where the GDN cannot demonstrate that their contractual and charging arrangements place appropriate incentives on customers to accurately declare their SHQ requirements.

6.7. We will be writing to the other GDNs to notify them of the Authority's views on this issue.

6.8. The Authority has considered the Licensee's request in accordance with its principal objective and general duties and carefully considered the consultation responses and all other relevant considerations.

6.9. The Authority considered that SGN's proposed engineering design specifications for the original zone 1, zone 2, zone 4 and the revised zone 3 project investments should be allowed but have re-assessed the costs of SGN's proposals.

6.10. The Authority has decided to allow SGN the allowances set out in Table 2 below.

6.11. The following table, Table 2, presents the revised proposed projects and associated costs as submitted by SGN, IPA's recommendations and the Authority's Decision on the capital expenditure allowances.

Table 2: Summary of GDN and consultant proposals and the Authority's capital expenditure re-opener decision

	[08/09 prices]	Scotland Gas Networks Proposal	IPA recommendation	Authority Decision
Zone 1	Project proposal	LTS: 15.14km x 300mm 69 bar steel pipeline	LTS: 15.14km x 300mm 69 bar steel pipeline	LTS: 15.14km x 300mm 69 bar steel pipeline
	Forecast cost	£13.20m	£10.60m	£10.60m
Zone 2	Project proposal	MP: 2.72km x 355mm MDPE	MP: up to 2.185km x 355mm MDPE	MP: 2.72km x 355mm MDPE
	Forecast cost	£1.06m	up to £0.91m	£1.06m
Zone 3	Project proposal	(Revised proposal) IP: 2.1km x 355mm HDPE	Not reviewed by IPA	IP: 2.1km x 355mm HDPE
	Forecast cost	£1.3m	n/a	£1.19m
Zone 4	Project proposal	LTS: 11.4km x 250mm 19 bar steel pipeline	LTS: 9.0km x 250mm 19 bar steel pipeline	LTS: 11.4 km x 250mm 19 bar steel pipeline
	Forecast cost	£10.20m	£5.70m	£7.18m
	Total Cost	£25.76m		£20.03m

Operating Expenditure Allowance

6.12. In our consultation we proposed that the interruptions incentive allowances be adjusted by comparing SGN's capital expenditure forecast submitted for the GDPCR with SGN's interruptible capital expenditure investment proposal.

6.13. We have reviewed our position and now consider this approach could result in a reduction in the interruption incentive allowance while no corresponding capital expenditure may be allowed.

6.14. The Authority has therefore decided that the approved capital expenditure allowance of £20.03m should be used to adjust the interruptions incentive allowance.

6.15. The approved capital expenditure allowance of £20.03m when adjusted for Real Price effects (RPE) is £17.20m and when adjusted to 2005/06 prices is £15.51m.

6.16. The Authority's decision is that the net effect of the £15.1m adjustment will, from 1 October 2011, reduce SGN's interruptible incentive allowance from £2.8m to £1.96m per annum⁵.

6.17. Table 3 sets out the financial impact of the Authority's decision on SGN's Regulated asset Value (RAV) and allowed revenues.

⁵ The revised interruption incentive allowance is based on the additional identified capital expenditure requirement that has not been applied for under the re-opener to cover the remaining potential interruption payments to interruptible customers. The 2005/06 value of this incentive would be: $2.8 / 52 * (52 - 15.51) = £1.96m$ per annum

Table 3: Financial impact of Authority Decision (£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
Effect of Authority Decision:						
Incremental RAV	-	0.27	2.07	17.11	17.63	7.42
Additional revenue	-	0.01	0.06	0.50	1.22	0.36
Interruptions incentive (Opex)						Total
GDPCR Final Proposals	-	-	-	1.40	2.80	4.20
Authority Decision	-	-	-	0.98	1.96	2.94

6.18. The Authority's decision to allow a capital expenditure allowance of £20.03m will result in an increase of £1.79m (0.18 per cent) to SGN's allowed revenue over the remainder of the price control period. This will be substantially offset by the £1.26m reduction in SGN's interruptible incentive from £4.2m to £2.94m in the last 18 months of the price control.

6.19. 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 value of the interruption incentive. The remainder will be returned to customers. The increase in Regulated Asset Value will result in additional revenue streams in future price control periods.

6.20. The impact of the Authority's decision is an increased cost to Scotland customers of approximately 25 pence per domestic customer per year across the remainder of the price control period. Based on an average domestic customer charge of £85.77 as at 1 Apr 07, the increase is approximately 0.30 per cent.

This letter constitutes Notice pursuant to Section 38A of the Gas Act 1986

Yours sincerely



Steve Smith

Senior Partner, Local Grids & RPI@20

Signed on behalf of the Authority and authorised for that purpose