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Our Reference:

Your Reference:

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Dear Rachel,

Open letter consultation on the gas distribution price control review (GDPCR2) – the way forward

Scotia Gas Networks welcomes the opportunity to respond to Ofgem's open letter consultation on GDPCR2. As you are aware, we have generally been supportive of the proposed amendments to the regulatory framework in the RPI-X@20 recommendations. In particular, well justified business plans, enhanced stakeholder engagement, outputs-led regulation and a greater focus on innovation represent, we believe, timely and sensible developments to the GB regulatory regime given the challenges that we are now facing. We note the tight timetable for implementing the RPI-X@20 recommendations into the GDPCR2 programme but we will, of course, take an active role to help ensure that key milestones are met.

At this stage in the price review process, the key areas for focus that we have identified are the replacement expenditure programme, the impact of smart metering on the Emergency services workforce and the development of output measures and related incentives. We provide below, detailed comments on these key areas, along with our comments on other issues highlighted in the open letter or of concern to us.

In summary, we welcome the review of repex and reiterate our commitment to finding innovative solutions to reducing the risk inherent in legacy cast iron mains. With regard to Emergency services, we are concerned that the loss of meter fill-in work for our Emergency workforce will be lost. Ofgem will therefore need to ensure that our statutory and licence obligations in this area are fully funded going forward. With regard to the development of output measures, we have taken an active role in the working groups and are generally supportive of the work done to-date. We do, however, have concern that the development of too many secondary measures could stifle the opportunity to innovate.

Key issues for the review

Replacement expenditure (repex)

We welcome the Health & Safety Executive (HSE) review of the 30/30 iron mains risk programme and look forward to working with all interested parties to develop a future programme of work that continues to enable us to satisfy our statutory responsibilities whilst taking due account of the practicability of delivering that programme.

We note the aim to conclude this review in time for submission of the business plans in July 2011. However, this is a very tight timetable and we agree that the GDPCR2 timetable may need to be reviewed if it is not possible to conclude the HSE review as planned.

Given that this review has only just started, our recently submitted high level forecasts have maintained the *status quo* for distribution mains and services, with some sensitivity analysis identified around this base case. This does not preclude the assessment of new, innovative approaches to repex delivery going forward.

Indeed, we have been proactive with the HSE to-date, developing a 3-year programme for mains replacement along with introducing an element of condition monitoring and developing the secondary minimum thresholds. Going forward, we are exploring options which might shift the focus to a condition based approach in the medium term. We are still developing our proposals in this area and will keep Ofgem fully apprised of our work in this area.

Capital Expenditure (capex)

Demand forecasts

We note Ofgem's concern about the accuracy of the GDNs' demand forecasts. We have been proactive in this area and have undertaken independent analysis that has enabled us to develop flexible models for sensitivity analysis around our demand forecasts.

However, future capex is not dominated by demand growth, it is about asset integrity and infrastructure support. We have highlighted this in our recent high level forecasts and will provide further information as we develop our full business plans.

Network extensions

We believe that the network extension programme has been a resounding success and should be continued through GDPCR2. Our goal in GDPCR1 has been to connect 10,000 fuel poor customers and we are well on the way to achieving this: to date we have received over 6,250 acceptances and completed nearly 3,500 connections. As a result of this programme we have worked with Local Authorities and Suppliers to support various fuel poor and energy saving initiatives.

Scottish independent Undertakings

National Grid has informed us of the potential closure of its Liquefied Natural Gas facility at Glenmavis in 2015. Whilst we are looking at a number of alternatives, the closure will mean significant capital expenditure for us.

Excluding this one-off costs, our forecast average capex for GDPCR2 is broadly in line with GDPCR1.

Operating Expenditure

Emergency services

The smart meter roll-out programme is a crucial part of the Government's carbon reduction initiatives. It is a programme that we fully support. However, we anticipate that Suppliers will wish to take control of the roll out with their own workforce. This will mean that the majority of meter work, which provides fill-in work for our Emergency workforce, will be lost. However the Gas Distribution Network operators (GDNs) must, of course, continue to be able to recover all of the costs of meeting their statutory and licence obligations. Given this, Ofgem need to address how we fully fund the Emergency service going forward.

Environmental issues

On the wider environmental front, we believe that the GDNs can positively contribute to the climate change agenda by lessening their own impact on the environment and by facilitating activities on their own networks that will positively help meet Government carbon targets, waste reduction targets etc. The development of an innovation stimulus package should provide the necessary incentive in this area. We intend to take an active part in the proposed innovation stimulus working group and look forward to developing initiatives and incentives not only around carbon but across the wider environmental issues such as waste reduction, recycling and land remediation.

Leakage

Leakage is a significant part of a GDN's carbon footprint and must continue to be addressed in GDPCR2 (and beyond). We believe that the existing incentive mechanism has worked well and has provided real benefits in carbon reduction. As such we believe that it should be retained for GDPCR2. Whilst the introduction of smart meters may eventually provide real-time information on leakage to GDNs, for GDPCR2 the existing modelled approach will need to be retained.

Bio-methane

We are also committed to exploring the most economic options for the injection of bio-methane into the distribution networks. We are currently working in partnership with third parties on an Innovation Funding Initiative for bio-methane and are keen to explore how work such as this could be taken forward during GDPCR2. We believe that charging arrangements and connection boundaries will need to be reviewed if the injection of bio-methane is to become a viable option.

Financial issues

Financeability

Ofgem is aware of our concerns over the financeability proposals in the RPI-X@20 recommendations. Whilst we do not wish to repeat all of our arguments, we do wish to reiterate our key concerns and our proposal of how to alleviate these for the GDNs.

We are firmly of the view that annual dividends are just as important to investors as long term security and returns. Indeed, our shareholders have expressed just this concern to Ofgem in response to the RPI-X@20 recommendations. We therefore have serious concerns with Ofgem's proposals to change how it assesses the depreciation and capitalisation policies of network licensees if these changes adversely impact on short term cashflows. If implemented, we believe that these proposals have the potential to increase the riskiness of network businesses and to seriously undermine investors' confidence in the sector.

Given this, we believe that Ofgem needs to deal with the concern that cashflow could be impaired by a making it clear that it would not expect any new depreciation or capitalisation policy to make the DNs worse off from a cash perspective. The various RPI-X@20 documents have hinted at this but we believe that the market requires clarity here.

Return on regulatory equity
We note Ofgem's intention to use the return on regulated equity (RORE) model for GDPCR2. We broadly support the use of RORE to calibrate the overall package and the level of out or under performance available to individual GDNs. However, it will be important not to lose sight of the need for a weighted average cost of capital (WACC) that encourages long term investment in the networks. We do not believe that the 4% post-tax real WACC recently applied in the electricity distribution network operators (DNOs) review is sufficient to encourage long-term investment in energy networks. We are aware that the electricity price control final proposals were accepted by all 'in the round', but many DNOs voiced similar concern over the WACC and the implications for long-term investment.

Pensions
With regard to pensions, following the recent comprehensive review of the sector's pension principles we now expect these to be embedded in the GDPCR2 settlement. We look forward to working with Ofgem on this implementation process. However, the recent proposals for separating historic and future deficit appear to us to be unworkable. They are more complex than the issue warrants, they are not proportionate to the problem and, in our view, they undermine the agreed pension principles.

Outputs-led regulation

We are fully supportive of the concept of outputs led regulation. The six categories of outputs appear to us to cover the key deliverables in a price control settlement. However, they do vary in importance and it will be important to ensure that the scope and significance of any associated incentive is appropriate. For example, care will need to be taken over how safety is incentivised.

Following the experience of developing output measures in the recent electricity distribution price control review (DPCR5), we are strongly of the view that output measures must be 'smart' i.e. specific, measurable, achievable, relevant and time bound. Furthermore, care must be taken to ensure that the output measures are as simple and straightforward as possible; complexity tends to result in unintended consequences. Also, given the challenges and uncertainty facing GDNs over the next price control period, it will be essential to ensure that any output measures have sufficient flexibility to adapt to changing circumstances and to drive the most efficient behaviour overall.

With regard to secondary deliverables, whilst we support the principle we are concerned that this will result in micro-management by Ofgem. It will therefore be essential to ensure that the inclusion of any secondary deliverables is meaningful, adds value and avoids more intervention.

Providing for enhanced engagement

We are fully committed to the concept of enhanced stakeholder engagement and agree that any well justified business plan must show how stakeholders' views have been taken into account. We have published an initial consultation document that is seeking our stakeholders' views on what they wish to be consulted on. We are following this up with direct contact with groups of key customers. Going forward we intend to utilise a variety of media to reach out and engage with our stakeholders, including regional workshops and stakeholder seminars.

We are, of course, aware that stakeholders will hold different views and that a balance will be required to be made between these different views and our licence obligations to operate and maintain an economic and efficient system.

Business plans and proportionate treatment

We are fully supportive of the development of well justified business plans and welcome the guidance provided in the open letter. The guidance will be very useful to assist us as we develop our business plans over the coming months, engage with stakeholders and refine our forecasts as new information emerges.

Fast tracking

With regard to the proposed fast track process, whilst we continue to be fully supportive of the principle we are still unsure how it could be implemented in practice. We would welcome further clarity on this topic from Ofgem.

Key milestones and timetable

With regard to the key milestones outlined in the open letter, in general these appear to capture many of the key dates for the price review. However, we note that the GDN / Gas and Electricity Markets Authority (GEMA) meetings are missing and we would wish these to be agreed as soon as practicable.

We welcome the introduction of the price control review forum and look forward to active participation in this key stakeholder initiative.

The timetable itself is challenging. However, we will work proactively with Ofgem and all other stakeholders to ensure there no significant slippages to the programme.

Other issues

Carbon monoxide (CO)

As part of the GDPCR1 discretionary award scheme we have raised awareness of CO poisoning with universities and their student population and with fire and rescue services. We are supportive of developing further initiatives to help reduce CO poisoning further, but there are potential liability issues that will need to be addressed. We will continue to explore our thinking in this area as we develop our business plans.

Xoserve

We note Ofgem's concern over the quality of service and value for money provided by Xoserve. We will work with Xoserve, as one of their shareholders, to develop a model going forward that puts customer service at the forefront and recognises the potential changes in its role with the roll out of smart meters.

Traffic Management Act (TMA)

The roll out of TMA will continue through to GDPCR2. The full year impact of the roll out in London and Kent will only be realised during this financial year (2010/11), with further roll out across the region during the next twelve / eighteen months.

There is also a strong possibility that new resurfacing legislation will be introduced in Scotland from 2012, the costs of which will need to be factored into our business plan. It is uncertain whether this legislation will be introduced in England & Wales during GDPCR2.

Sub-deduct networks

We note the intention to identify the most appropriate way forward for sub-deduct networks as part of GDPCR2. We believe that it will be necessary to extend the current derogation beyond 1 March 2011 and understand that this is being considered by DECC. For the longer term, we do not believe that it is practical for GDNs to adopt these networks. In our view the only viable long term solution is to re-engineer the networks and metering points. Any costs incurred by the GDNs in carrying out full surveys to enable this re-engineering to take place must be fully funded.

Summary

We welcome the opportunity to comment on Ofgem’s view on the way forward for GDPCR2. We are fully supportive of the development of well justified business plans, enhanced stakeholder engagement, outputs-led regulation and a greater focus on innovation.

We welcome the HSE review of repex and look forward to investigating the most cost effective, innovative way of implementing the outcome of this review. We are currently exploring options which might shift the focus to a condition based approach in the medium term.

We have some concerns in two areas of the review at this stage. Firstly, the impact of smart meters will impact on the costs of our Emergency services. Ofgem will therefore need to ensure that this obligatory service is fully funded for GDPCR2 onwards. Secondly, the development of too many secondary measures could lead to Ofgem micro-managing our businesses, stifling the opportunity to innovate. We would urge Ofgem to focus on key primary outputs, developing associated incentives that are proportionate to the importance of each output measure.

Please contact me if you have any questions on the issues raised above.

Yours sincerely,

Malcolm J. Burns
Regulation Manager