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Dear James,

RIIO-GD1: Initial Proposals

Scotia Gas Networks welcomes the opportunity to respond to the above consultation.

We are fully supportive of the RIIO framework. In November 2011, we published well justified business plans after extensive stakeholder engagement. Following constructive feedback from Ofgem and further stakeholder engagement, we published a revised business plan (covering both our networks) in April 2012. That business plan was predicated on providing value for money for all of our stakeholders whilst ensuring we continue to maintain a safe and reliable network; one that will ensure flexibility as we move to a low carbon economy. It focused on incentives, innovation & outputs, with a financial package designed to allow our shareholders to earn appropriate returns; but importantly only if the business delivers the outputs we have agreed with our customers.

The Initial Proposals, with its extremely tight financial package, significant reductions in our proposed total expenditure and little in the way of incentives, is not focused on delivering sustainable energy networks. It appears to us to be focused very much on the short term, which cannot be in the interest of either current or future customers.

Safety is at the core of what we do and this is reflected in our track record in meeting our emergency standards, even during extreme weather conditions. Our business plan set out expenditure on emergency services and capital investment to maintain the health of our network such that we could continue to provide a safe and reliable service to our customers, now and in the future. We strongly believe that the proposed cuts in these areas will have a detrimental effect on our ability to meet customers' expectations and should be reconsidered.

Our response to the Initial Proposals is attached. It comprises an executive summary, our response to the key strategic issues raised in the overview document and answers to the questions posed by Ofgem in its various supporting documents.

Please contact me if you have questions on any aspect of our response.

Yours sincerely,

Malcolm J. Burns
Senior Regulation Manager

Executive Summary

	Key areas of Initial Proposals	Our Recommendations
1	Incentives & innovation Carbon monoxide awareness Facilitating connection of green gas IQI mechanism Network innovation allowance	Incorporate incentives to facilitate the move to a low carbon economy Strengthen incentives by not subjecting to IQI Increase allocation to spur high levels of innovation to help deliver sustainable networks
2	Cost efficiency Benchmarking - Cost drivers & regional factors Emergency Services funding	Adopt practical improvements supported by a critique from Frontier Economics Make adjustments to ensure quality of service is not compromised
3	Totex Transmission projects < £0.5m Repex tier 2/3 CBA Robustness of asset health data Capacity investment in Scotland	Make adjustments based on: further evidence of need evidence of ‘hotspots’ on networks base level and trigger mechanism further evidence of need
4	Finance & pensions Level of allowed return, relative risk and weak credit metrics Inconsistent approach to funding of efficient pension costs	Move to BBB iBoxx index with, as a minimum, no increase in notional gearing from GDPCR1 levels Proposed options to ensure funding fully reflects efficient deficit <u>and</u> ongoing contributions
5	Uncertainty Smart Meters Streetworks Scottish Independent Undertakings	Incorporate a flexible trigger mechanism and more realistic base allowance. Make clearer definitions of scope Enduring solution will require capital investment and hence a re-opener

Ofgem states that ‘(t)he RIIO model (Revenue = Incentives + Innovation + Outputs) is designed to build on the success of the previous RPI-X regime, but better meets the investment and innovation challenge by placing much more emphasis on incentives to drive the innovation needed to deliver a sustainable energy network at value for money to existing and future consumers.’

As they stand, the RIIO-GD1 Initial Proposals fail to deliver this aim, particularly around incentives and innovation. Our networks are an invaluable asset, there is a strong likelihood that alternative or ‘green’ sources of gas will be used in the medium to long term; and in the longer term our infrastructure could even be used to transport hydrogen. We are therefore particularly disappointed that our proposals for promoting the connection of green gas on to the network and raising awareness of the dangers of carbon monoxide (CO) have not been taken forward.

Both initiatives have the support of a broad range of our stakeholders. We do believe that concerns around measurability and setting of baselines can be overcome for CO₂; and that our green gas proposal aligns well with Ofgem's priority of contributing to curbing climate change.

We strongly support the incentive benefits of the Information Quality Incentive (IQI) that encourages companies to produce more accurate forecasts and we welcome clarification that its sharing factor is post-tax. However, applying IQI to incentives is not symmetric and this reduces the opportunity to outperform on an already weak package. A simple policy decision that no incentive should be subject to IQI would be a major step forward.

On innovation, a 1% Network Innovation Allowance (NIA) would provide the stimulus to deliver Ofgem's plausible out-performance targets and help to deliver sustainable energy networks. We are therefore disappointed that the NIA is to be set at between 0.5% & 0.6% of allowed revenue for Gas Distribution Networks (GDNs).

With regard to cost efficiency, we are supportive of top down benchmarking as part of the 'tool box' used to assess relative efficiency. However, we continue to have concerns over the use of disaggregated (bottom up) benchmarking and will provide a confidential paper by Frontier Economics which suggests some practical improvements in cost drivers as well as strengthening the regional adjustments, in particular in respect of labour. The approach to regional factor adjustments has not applied the evidence we provided in a consistent manner, resulting in an unjustified understatement which we require to be corrected prior to Final Proposals.

We believe that the current proposals to adjust for the effects on GDN emergency costs as metering contracts reduce are fundamentally flawed. It is crucial that Ofgem recognises all experience in assessing a reasonable level of costs, including the experience of the three GDNs which have met the licence conditions under all operating conditions as well as adjusting the operating costs of those networks that failed to meet license conditions in place to safeguard consumer safety.

Whilst we note that Ofgem has been correcting errors identified in the cost allowance work, there are still many points of policy over which we disagree and which must be addressed before Final Proposals. For example, holder governors are not simply part of our gas holder removal programme. In addition, as requested, we have provided further information on transmission projects less than £0.5 m in value (in a confidential annex) and will be providing further confidential information on our repex Tier 2/3 cost benefit analysis shortly. We would expect this additional information to be considered prior to Final Proposals. Furthermore, whilst we understand that our initially disallowed Tier 1 condition repex has been added back, if there is to be a further assessment of these costs we must have the opportunity to review and comment on that assessment prior to Final Proposals.

On capex, given Ofgem's concerns over the robustness of asset health data, we do need clarity on what is expected from us and have the ability to trigger a re-opener as soon as the assets require replacement, supported by the appropriate trigger and evidence. We have also provided additional evidence in support of our capacity investment requirements in Scotland that confirm the need for an upfront allowance for three projects and a trigger mechanism for the other identified project.

In addition to our comments above, we also expect Ofgem to apply a consistent approach to setting allowances and outputs across GDNs.

On finance, the allowed return and the financeability metrics fall short of what we believe to be Ofgem's previously stated objectives and obligations for RIIO. We maintain the view that the allowed return needs to be set in the context of the overall package, taking account of the level of cost allowances and the incentive package. Notwithstanding our concerns over Totex and the weak incentive package, the achievement of appropriate returns for Ofgem's plausible upside scenarios cannot be achieved without our proposed changes to cost of debt funding and notional gearing. The Energy Network Association has commissioned Oxera to provide a critique of Ofgem's proposed WACC. We fully support this work. In addition, we note recent Rating Agency publications on the Initial Proposals and urge Ofgem to address their issues when setting final allowances.

With regard to uncertainty and the smart meter roll-out programme, tying the uncertainty mechanism to the 2015 re-opener window could mean that we are left exposed to c. £200 m of cashflow impact until 2019, potentially compounded by asset health and SIUs. This is unacceptable and we need a flexible trigger that allows us to bring forward costs for assessment whenever the 1% trigger is forecast to be breached throughout GD1. There also remains uncertainty over the scope of this mechanism which must be clarified. We have similar cashflow and funding concerns with the proposed streetworks uncertainty mechanism. In addition, given the cumulative risk of such mechanisms we are proposing an overall cumulative cap of 1% of Allowed Revenue.

We also have concerns over funding for the Scottish Independent Undertakings (SIUs) during GD1. We have provided revised costs based on the required interim solution and have submitted a confidential annex on the options for an enduring solution that will require a re-opener in 2015 or sooner.

If the above concerns are addressed then we believe that the Final Proposals will provide a balanced package that provides us with the opportunity to meet reasonable return expectations whilst providing customers with value for money and the service they expect from us.

Introduction

GD1 is the first gas distribution price control review to reflect the new 'RIIO' regulatory framework where Revenue = Incentives + Innovation + Outputs. We are fully supportive of this framework. In particular, we believe that enhanced stakeholder engagement, outputs-led regulation with a strong incentive package and a greater focus on innovation will ensure that the gas distribution networks (GDNs) are well placed to deliver a sustainable energy network at value for money to their customers.

Our RIIO-GD1 business plan submission is predicated on incentives, innovation & outputs, with a financial package designed to allow reasonable returns, including double digit real returns on regulated equity, if the business delivers the outputs we have committed to. The plan delivers value for money for all our stakeholders whilst ensuring we continue to maintain a safe and reliable network. However, Ofgem's Initial Proposals recommend significant cuts to a Totex package that we have kept flat in real terms; an assessment of cost efficiency that we and our consultants (Frontier Economics) believe has material weaknesses; a very tight financial package with equity, debt funding and notional gearing all squeezed; and a weak incentive & innovation package that is unlikely to facilitate the transition to a low carbon economy.

If the Final Proposals are to provide a safe and reliable network for our current and future customers, deliver value for money and meet our stakeholders' reasonable return expectations, then the following areas must be addressed.

Incentives & innovation

Incentives

We are disappointed that our proposals for promoting the connection of green gas on to the network and raising awareness of the dangers of carbon monoxide (CO) have not been taken forward. Both initiatives have the support of a broad range of our stakeholders. For example, at consumer focus group sessions, when we explained our proposals for raising CO awareness and the cost involved there was general agreement that it was a good value initiative and that it would be beneficial.

We believe that concerns around measurability and setting of baselines can be overcome for CO and would urge Ofgem to drive this forward through the Customer & Social Issues Working Group (CSIWG). In addition, we consider that our green gas proposal aligns well with Ofgem's stated priority of contributing to curbing climate change and will be a valuable addition to the current proposals around biomethane information provision as well as providing opportunity for the emerging hydrogen initiatives.

We attach our proposals in each area for completeness and would welcome further discussion with Ofgem and other stakeholders. We would urge Ofgem to work with industry and implement these incentives for RIIO-GD1; experience has shown that such incentives will develop over time, will change behaviour and bring positive benefits to customers, e.g. such as the development of the electricity distribution quality of service incentive.

Innovation

We have led the GB gas industry on innovation in areas such as biomethane injection, self isolation & restoration, industry procedures for major loss of supply and spraying lining of mains. We are committed to developing innovative solutions to operating and maintaining our networks and are sending details of our Network Innovation Allowance (NIA) proposals under separate, confidential, cover.

If innovation is to deliver sustainable energy networks and provide the stimulus to deliver Ofgem's plausible out-performance targets, this needs to be set at the maximum 1%, not just for us, but for all GDNs.

Given that the NIA is on a 'use it or lose it' basis, setting it to 1% across the board will not mean any additional risk for customers; but it will mean that all GDNs have a strong incentive to trial and test innovative products that could reduce cost, improve efficiency and help to deliver sustainable networks.

With regard to the Network Innovation Competition (NIC), we need to ensure the GDNs can apply innovation to deliver sustainable networks; therefore our preference is to run the NIC and raise the required funds from the winning licensees' customers.

Application of the IQI Mechanism

We welcome the post-tax application of the IQI incentive rate. However, we disagree with Ofgem's proposal to run certain incentives (e.g. leakage) through IQI. Applying IQI to incentives is not symmetric and significantly reduces the opportunity to outperform what we believe is already a weak incentive package. Further, not all activities to improve performance above an incentive baseline need be based on capital investment and hence there is no overriding reason to apply IQI to out-performance, e.g. flexible design of repex projects. A simple policy decision that no incentive should be subject to IQI would be a major step forward.

Cost efficiency

Comparative efficiency analysis

Whilst we are supportive of the use of benchmarking as part of the comparative efficiency analysis 'tool kit', we are concerned that mechanistic regression models are being relied on too much. We engaged independent experts, Frontier Economics, to review Ofgem's comparative analysis work.

Frontier's analysis has given rise to material concerns with the bottom-up benchmarking arising from Ofgem's choice of costs drivers. This then permeates through the mid-level and top-down benchmarking. Frontier's key findings are:

- Inappropriate selection of some key cost drivers. In particular the use of customer numbers and not PREs, the exclusive use of reports without reference to repairs and the inflexibility of MEAV;
- The absence of quality, service outputs and standards from the cost driver selection and the modelling process. This Frontier believes creates significant gaps in the assessment process and detrimentally affects the validity of the conclusions reached;

- Weak or improper incentives through the choice of volume cost drivers. Where a company is assessed on only the volume of workload delivered then there is the risk that it is incentivised only to maximise volume and create economies of scale; and
- Complications in setting appropriate drivers for most Capex activities. The issues of ‘lumpy’ investment profiles and the potential for GDNs to be on different points in the investment cycle cast doubt on the strict application of capex results in setting allowances.

We will provide Frontier’s report under separate cover.

Regional factors

We have provided considerable justification in support of a number of regional cost adjustments. This has included the considered opinion of expert consultants and the reference to a wide range and depth of information from third parties. The approach to regional factor adjustments has not applied the evidence we provided in a consistent manner. This has resulted in an understatement of the necessary adjustment.

Regional labour price index

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Urbanity

We have supported Ofgem’s research into the very significant gap in GDN costs between London and Southern and the rest of the UK. We welcome acceptance of our research showing that the relative productivity gap is due to the interaction of a dense urban environment and gas network operations. We have discussed with Ofgem methods of weighting the impact at the GDN level, in order to extrapolate this local effect to the average GDN cost adjustment in a straightforward way. Our primary concern is that the method adopted must be consistent; we have provided Ofgem with the appropriate, necessary adjustments and expect these to be incorporated in full for Final Proposals.

Total cost allowances

Operating expenditure

We believe that the current proposals to adjust for various elements of opex, primarily the effects on GDN emergency costs as metering contracts reduce, are fundamentally flawed. The following key issues remain and must be addressed prior to final proposals:

Cost assessment model

The cost assessment process must consider the total future emergency service cost, which comprises the efficient productive cost of delivery plus the efficient level of unproductive time. It is this cost which should be benchmarked through the costs assessment process. The remaining associated cost represents the residual labour resources created by the seasonal impact on workload which have been effectively absorbed into other GDN activities or displaced.

To ensure that the quality of service is not compromised for this key core activity, Ofgem needs to change the focus of its assessment and concentrate on the reasonable total costs of an emergency service.

Adjustments to modelling

Total emergency cost should be based on, firstly, the three GDNs which have delivered the licence conditions under all operating conditions and, secondly, the experience of the single GDN which has operated with minimal meterwork. It is crucial that all experience is recognised and that service standards are incorporated into the process wherever possible. We have shared these proposals with Ofgem and the other GDNs in our paper on emergency funding.

Other opex concerns

In addition to our concerns over the assessment of our emergency costs we believe that the proposals for the SIUs were misunderstood in the Initial Proposals. We discuss this further as part of our commentary on uncertainty mechanisms below and will also provide Ofgem with more explanation of the medium term operating costs for these vital assets.

We also believe that the Business Support assessment needs to be revisited. The SSE group analysis is inappropriate for SGN and the assessment needs to represent the SGN group structure with appropriate SGN group metrics where costs are assessed at a gross level.

Replacement expenditure

Tier 1 condition mains

We have proposed to decommission 54km and 41km of tier 1 band pipes in Scotland and Southern respectively based upon their asset condition. This requirement is robustly supported by cost benefit analysis (CBA) for this failing asset category. This investment was omitted from Initial Proposals but following discussions with Ofgem it has been re-instated. It is essential that the full investment is maintained in the Final Proposals.

Tier 2/3 iron mains

We believe that our April business plan was well justified and that the CBA models were appropriate. However, following further discussion with Ofgem, we have reviewed the methodology of applying the CBA model across the remaining assets, focussing upon particular networks with known condition issues (i.e. hotspots). We believe that this assessment results in a clear justification for material levels of tier 2 & 3 workload.

Capital expenditure

Asset integrity – general

The use of a base allowance derived from historic spend, coupled with a mid-period review will not provide the innovation stimulus or flexibility of investment strategy that an eight year price control under RIIO was intended to give.

Asset integrity – <£0.5m transmission projects

For our business plan submission, we undertook a comprehensive review of all our transmission assets, and fully assessed our investment requirements over GD1 to ensure a safe and reliable network. This assessment has included a site by site detailed review of asset condition and performance, and the full population of the health and criticality indices, together with cost benefit analysis. The proposals were endorsed by a third party engineering consultancy. Following Initial Proposals, we have reviewed the list of <£0.5m projects to establish the assets that are at the end of life and require funding in the Final Proposals, and those that could be undertaken subject to a suitable trigger mechanism. We have included a confidential appendix the listing projects that require funding, with the necessary justification.

Asset Integrity – Governor Refurbishment

We strongly believe it is inappropriate to base our allowances for governor replacement on what another GDN is proposing. The allowance must reflect the health and criticality of *our* assets and be based on our detailed assessment of condition and obsolescence; the governors will need to be *replaced* not *refurbished*.

In our April business plan, we proposed a fault trigger mechanism, applying the industry standard on reliability-centred maintenance for these assets. We continue to believe that such a fault based trigger mechanism is required, rather than a mid period review, to ensure the continued safe operation of our assets.

Asset Integrity – District Governors on Holder Sites

In our April business plan, we submitted proposals to replace 30 Donkin holder station regulators. These act in the same way as district governors, but are on the holder site. These holders have been identified separately primarily due to their size and diameter range, they will continue to be required following removal of the gas holders and will therefore need to be replaced i.e. the funding for their replacement should not be removed simply because the gas holders are being demolished.

Capacity Transmission Reinforcement (Scotland)

In our April business plan, we identified the need for investment around four transmission pipeline reinforcements. These investments are required to meet known localised load growth, primarily to support the distilling industry and the expiry of their interruptible contracts, thus returning these customers to ‘firm’ loads.

Our business plan highlighted that the interruption auctions we have undertaken in the last few years have proved unsuccessful and that the required load to negate reinforcement is not available. Therefore, the investment to carry out reinforcement is essential. We have surveyed our customers to establish the likelihood of connecting, and have concluded that three of the projects will require capital allowances in the final proposals but the fourth can be deferred and triggered at a later date, by continuing with the current trigger mechanism.

Finance & pensions

The financial package

In our view, the financial package in the Initial Proposals does not meet the objectives previously set out by Ofgem to deliver appropriate RORE ranges, fund efficient cost of debt and provide comfortable investment grade credit metrics. We have based this conclusion on an assessment of the individual components (cost of equity, debt and notional gearing); the impact the proposals have on financeability; and how the returns sit in the context of the overall package.

Assessment of the overall package

The allowed WACC in the Initial Proposals needs to be assessed as part of an overall package on incentives and efficiencies. The significant cuts in Totex from our April Business Plan submission, together with a weak incentive package, gives no mitigation to the proposed WACC; we have been squeezed on all areas of the package. This can be seen when applying plausible upsides for Totex and incentives, where returns are well below the targets previously set out by Ofgem and also the expectations of our shareholders.

Individual components of the allowed return

The Energy Networks Association has commissioned Oxera to report on the financial issues raised in the Initial Proposals and this report has been sent to Ofgem as part of the consultation responses. The report concludes:

- Taking the proposed values for the return on equity and gearing together, Ofgem's proposals for RIIO-GD1 imply a significant reduction in asset beta from GDPCR1. This appears to be justified mainly on the relative scale of investment in RIIO- GD1. Notwithstanding the noticeable limitations in this particular relative risk analysis, the significant reduction in asset beta is not consistent with a full assessment of the range of risk factors, several of which suggest that risk has in fact increased over time;
- The Initial Proposals imply significant differences in asset betas between sectors that do not appear consistent with a full assessment of the range of risk factors. Again, the GDNs appear to have either a cost of equity assumption that is too low or a gearing assumption that is too high;
- A lower gearing assumption for the GDNs is an option of increasing the implied asset beta; and
- The cost of debt index does not achieve the goal of eliminating all risk of differences between the fixed allowance and the actual cost of debt. In fact, for GDNs the index is likely to be more risky than a fixed allowance. These concerns can be addressed through reflecting the risk in the allowed return (either on equity or debt).

Financeability

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We have reviewed various publications made by the Rating Agencies since Ofgem's Initial Proposals. Standard & Poor's (S&P) published an article on 25 July entitled 'How Ofgem's Latest RIIO Proposals Could Increase Credit Risk For National Grid And Gas Networks In England And Wales'. Fitch Ratings have also released a statement following the review of one of the Gas Networks on 27 July where reference was made to the Initial Proposals. In both of these documents, S&P and Fitch raise important points on the business and financial risk profiles of the Networks, including cashflow volatility and the potential impact on credit metrics.

We urge Ofgem to ensure appropriate dialogue is had with all stakeholders to ensure that the concerns raised on the Initial Proposals are appropriately dealt with in setting final allowances.

Given these concerns, the requirements set out in our April Business Plan to have a BBB iBoxx index still holds. In addition, given the conclusions third parties and ourselves have drawn relating to the increases to both business and financial risk, there appears no justification to raise notional gearing from its current level of 62.5%.

Asset lives and RAV

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Pensions

It is essential that the Final Proposals maintain the pension principles set in 2010 regarding funding of efficient pension costs. We have concerns that the Initial Proposals do not fully achieve this due to some inconsistencies in the efficiency true ups and the funding methodology for GD1.

In assessing efficiency, Ofgem must recognise that due to various factors (such as maturity of the scheme) and different (but legitimate) approaches to managing risk, individual assumptions may be different. In taking an integrated approach to scheme funding, Trustees bring together advice on investment, covenant and actuarial strands to inform a complete financial management plan.

Our scheme funding target, coupled with a suitable investment strategy strikes an appropriate balance between the opportunity to pay all member benefits and the range of adverse outcomes. Provided we can continue to demonstrate this, our total contributions should continue to be funded in full. Looking at individual assumptions in isolation, such as investment returns, could

drive a focus on a more aggressive exposure to growth assets which does not fit with our considered approach to risk which should be welcomed by consumers.

Therefore, based on an overall efficient funding plan, we would expect to see our full contributions, whether deficit payments or future service costs funded in full.

Allowed Revenues

The initial proposals show that the allowed revenues in GD1 for our networks show an increase on current levels. Whilst this is factually correct, this increase is driven by two new items: NTS exit charges and the impact of changes in tax due to IFRS adoption. Both of these are not a direct control of actions taken by the networks between price controls and the underlying position is actually showing a decrease on GDPCR1. This distinction must be made clear in the Final Proposals.

Uncertainty

Smart meters

Restricting the recovery of the efficiently incurred GDN costs during the roll-out of smart meters to the two standard re-opener windows will mean that the GDNs will be left exposed to significant costs between the re-opener windows. For SGN this could be of the order of £200 m. Whilst the re-opener windows are intended to allow the efficient costs either already incurred or likely to be incurred the timing of the proposed roll-out (as well as the very real risk of delay) will mean that we are unlikely to have even one year of activity to base our forecast of future costs upon. What is required is a more flexible trigger arrangement that allows a GDN to apply for a re-opener at any time that it can show its efficiently incurred costs will breach the threshold.

Streetworks

We have similar concerns over the scope and funding of the proposed streetworks uncertainty mechanism.

Scottish Independent Undertakings

We also have concerns over funding for the Scottish Independent Undertakings (SIUs) during GD1. We have provided revised costs based on the required interim solution and have submitted a confidential annex on the options for a long term solution that will require a re-opener in 2015.

Other key concerns with the Initial Proposals

Real price effects and ongoing efficiency

Real price effects are a notoriously difficult area to forecast. Ofgem has received a number of independent assessments, as well as carrying out its own review. From our perspective, utility labour forces are tied to medium term wage settlements. Given this, and the uncertainty around RPEs, we would suggest that a more pragmatic approach be adopted in this difficult area; one that adopts the mid-point between the varying experts' views e.g. a Totex RPE of c. 0.75%.

Regarding ongoing efficiency, we note that Ofgem's assessment is not significantly different from the independent analysis carried out for us by First Economics. However, we have argued for some important exceptions in our business plan submission where it is not appropriate to apply ongoing efficiency adjustments. These include the emergency service (where the challenges facing that service are well documented), business services (where we have delivered the full de-merger savings) and London (where we have put forward specific productivity challenges ourselves). We recommend that Ofgem consider these exceptions further.

Outputs

We are generally supportive of the RIIO-GD1 proposed outputs and have been involved in the various working groups as they have been developed and refined. We have provided detailed commentary on each of the outputs in response to the questions raised in the 'outputs, incentives and innovation' supporting document.

With regard to the customer service outputs, we would suggest that the maximum reward and penalty for connections defined in the Initial Proposals is changed to match the methodology for Emergency/Repair and Planned work. For complaints, we agree with the weightings for each complaint measure in the metric except the element for Energy Ombudsman referrals found against the GDN. The measure in its current format can result in a totally disproportionate penalty and therefore drive inappropriate behaviours to avoid complaints being referred to the Ombudsman. Our preferred option would be to take this element out of the complaints metric and report on a reputational basis.

With regard to safety outputs, we fully support the cost benefit approach based on a 24 year payback. However, we do not agree with the outcomes Ofgem has proposed for our networks. We expand on this in our response to Cost Efficiency Chapter 8: Replacement Expenditure.

It is essential that any proposed changes to the workloads set out in our April 2012 business plan are correctly reflected in an adjustment to these output measures. In particular, any reduction in proactive pipe risk management activity will have a direct impact on the replacement outputs as well as a consequential impact on the repair residual risk score which will increase as a consequence of reducing the repex workload.

Furthermore, we are seeking a level playing field in other areas, in particular, a consistent requirement on all networks in terms of performance against the 12 hour repair standard.

With regard to the reliability outputs, we fully support the approach to measuring asset performance through a system of asset health assessment. Ofgem is already aware of the detailed on-site assessments of our assets that we have undertaken. This enables us to fully and accurately assess the health of our assets, especially offtakes, pressure reduction stations and governors. The data has been validated and entered into a fully functional reporting system. As a result, we are already using this information to prioritise replacement and refurbishment of our assets including inspection, remediation and painting programmes.

We have further developed the reporting system to model asset life through RIIO-GD1. The system is also sufficiently flexible to reflect changes to the asset at the time that they occur. Our reporting also considers complex systems such as offtakes and pressure reducing stations by assessing sub-systems. The total system is then categorised through a process of weighted averages of the relevant sub-systems.

Responses to Ofgem specific questions

Initial Proposals: Cost Efficiency

Chapter 1. Overview of cost assessment methodology

Question 1: Do you consider our overall approach to cost assessment appropriate, and if not what changes would you propose?

A Toolkit for RIIO

We acknowledge the scale and complexity of effectively assessing the combined GDN RIIO business plan proposals. Whilst the separation of the distribution networks has enabled the development of comparative analysis, it has also brought divergent business models, investment priorities and, in response to our customers requirements, a localised agenda. The assessment process must be able to adapt to these desired developments.

If the cost assessment response is not also suitably adaptable and responsive then it risks not achieving its primary objective, the identification of an equitable allowance for each GDN.

As a model for regulating large network businesses, RIIO brings the potential for many valuable characteristics to the regulation of UK network operators; a platform on which to innovate for the coming decades; real choices in investment decisions; a focus on what customers value. Many of these produce outputs which are inherently difficult to measure and track but remain of great value to our stakeholders and UK plc. In determining the relative merits of GDN proposals these outputs must take a central role, otherwise the conclusions of a cost assessment process will revert to a one dimensional measure of cost efficiency.

We do not believe that the costs assessment mechanisms have incorporated the key components of adaptability and responsiveness to the variety of business proposals. Further more, there is little evidence that the crucial elements of safety, service standards, quality and stakeholder value form part of the assessment process, particularly the quantitative approach used. A conclusion of our independent experts, Frontier, is that the concept of value outweighs the basic cost of an activity is missing from the process and that this is a fundamental omission. Without this additional dimension the assessment process does not maximise the benefit potential for stakeholders promised by the RIIO concept.

Tools in the cost assessment kit

Quantitative assessment

We believe that the initial proposals signal a return to the traditional assessment of GDN costs by mechanistic regression models. The use of econometric models in a RIIO assessment process is appropriate only where the specification incorporates all dimensions; outputs, quality of service, Stakeholder requirements and cost efficiency.

There are elements of the overall cost assessment approach which have attempted, with varying success, to incorporate the tangible and intangible outputs. The obvious direct links between measurable primary and secondary outputs have resulted in adjustments to Totex proposals where the target changes. Therefore it is positive that changes to replacement activity have been mirrored in a change to the safety output.

However, none of the quantitative assessments incorporate anything more than the volume drivers. The richer measures for service standard and quality have not been incorporated into the models. This resulted in some significant omissions in the assessment process. For example, while the Repex T1 regression measures efficiency of output, e.g. lay, it fails to incorporate the richer benefit of risk removed, e.g. abandonment. In this example the RIIO approach would be to find the most efficient method of removing risk; simply benchmarking on the lowest cost lay method overlooks the benefits from better network design, innovative risk removal techniques etc.

Similar omissions exist in recognising and rewarding companies which:

- achieve consistent emergency service standards
- deliver a more rapid repair service
- remove more mains risk per meter lay
- have higher customer satisfaction outcomes
- effectively manage opex – capex trade offs
- understand and manage the condition of their assets

Qualitative assessment

A material proportion of the Totex allowance at activity level is set following qualitative assessment. We believe qualitative assessment, if undertaken correctly, can achieve a balanced outcome. It can incorporate many of the less tangible outputs associated with expenditure proposals and is flexible enough to react to individual customer and company requirements.

The qualitative approach as outlined in the Initial Proposals document does not appear to consistently deliver a balanced qualitative output. As we note elsewhere in our consultation response the absence of a published report from the independent expert consultants advising Ofgem prevents us from reviewing the interpretation of our RIIO proposals and the rationale for the conclusions reached. This prevents us from being able to respond to some areas of the initial proposals in a constructive way as the issues are not always immediately evident.

This is evident in the analysis and proposals for activities such as the Holder demolition and governor renewal programmes. Here there have been significant reductions in cost per unit but the derivation and evidence supporting such conclusions is lacking.

Proposed Changes

We have provided the analysis, conclusions and recommendations from an independent review of Ofgem's benchmarking approach undertaken by Frontier Economics. They have identified a number of concerns and from this have suggested some changes which will improve the effectiveness of the cost assessment process. We support these conclusions but recognise that in some areas the recommendations will assist the development of future price controls and ongoing benchmarking. There however remain some simple changes which will resolve many of these issues and improve the overall cost assessment approach. These are:

- Use PREs as the emergency cost driver. This explanatory variable is the only measure which fully recognises the scale of the emergency service a GDN must provide.
- Adjust total emergency costs for under resourced networks in all years of cost assessment. As demonstrated in our supporting papers the financial adjustment to expenditure for below standard performance should be equivalent to the additional resources necessary to guarantee delivery.

- Use a weighted CSV for the repair cost assessment. Recognising that there remain issues in the use of either Reports and Repairs as explanatory variables. Given the large impact on cost assessment of either cost driver we propose the use of a CSV, 50% reports, 50% repairs.
- Labour Input prices. Incorporate an eight GDN contract labour input price adjustment reflecting the material differential in regional wages outside London and the South East.
- Urbanity. Use of consistent productivity impacts with consistent weighting methodology ensures the appropriate adjustment for Southern GDN costs. This has been indicated in supporting documentation provided during the IP consultation period. This weighted average adjustment should be a minimum of 5% for Southern GDN.

Chapter 2. Regional adjustments, RPEs and ongoing efficiency

Question 1: Do you consider our approach for regional adjustments and company specific factors is appropriate, and if not what changes would you propose?

We believe we have provided considerable justification in support of a number of regional cost adjustments, which has yet to be disproved. This has included the considered opinion of expert consultants and the reference to a wide range and depth of information from third parties. The approach to regional factor adjustments does not appear to have considered all the evidence submitted.

Regional labour price index

SECTION REDACTED – COMMERCIALY SENSITIVE INFORMATION

Sparsity

In our November business plan we supplied empirical evidence and set out the criteria by which the principle effects of Sparsity on GDN activities might be identified, evaluated and then removed from the cost assessment process. Core to this proposal is that Sparsity in a gas network is not the inverse of population density but instead relates to the availability of productive work. Such conditions arise when standards, particularly response times, prevent the absorption of unproductive time through labour mobility. For example, you cannot move emergency resources out of a one hour response zone when workload is low without compromising the network's ability to meet its emergency licence standards (SSC D10). A similar condition exists within repair.

We believe the simple process of identifying similar such areas across GDNs would enable a targeted adjustment for Sparsity to be applied to those networks affected.

Urbanity

We have supported Ofgem's research into the very significant gap in relative GDN costs between London and the Southern and the rest of the UK. Our research showing that the relative productivity gap is due to the interaction of a dense urban environment and gas network operations has been accepted by Ofgem. We have had an ongoing dialogue with Ofgem to propose methods of weighting the impact at the GDN level, in order to extrapolate this local effect to the average GDN cost adjustment in a straightforward way. Our primary concern is that the method adopted must be consistent. We propose that Ofgem complete and incorporate our Urbanity proposals in full.

Weather

In our November plan we provided evidence of the enduring seasonal cost impact in Scotland GDN. Clearly the average weather trends in the UK are materially more costly in Scotland GDN than the rest of the UK. To date we have not received any specific feedback on our evidence. We strongly encourage Ofgem to give serious consideration to the evidence, and implications on Scotland GDN's cost base.

Question 2: Do you agree with our assumptions for real price effects and ongoing efficiency?

Real price effects

It is clear that our independent consultants' assessment of RPEs differs from Ofgem's analysis in a number of areas. For example, we note that the 2011/12 labour RPE is based on actual real earnings growth for the private sector and that Ofgem's short-term forecast for 2012/13 & 2013/14 draws on the HM Treasury consensus forecast for average earnings growth for the whole economy. Average earnings for the economy as a whole needs to be considered alongside output in the utilities sector, as shown in the Oxford Economics report 'Input cost forecasts' submitted as part of our November 2011 business plan.

RPEs are a notoriously difficult area to forecast. Given that Ofgem has received a number of independent assessments, as well as carrying out its own review, we would suggest that a more pragmatic approach be adopted in this difficult area; one that adopts the mid-point between the varying expert views e.g. a Totex RPE of 0.75%.

In addition, it is worth noting that application of RPEs suggest that GDNs can adopt market prices for labour contracts. This appears to contradict the statement by Ofgem that GDNs are still tied to a common salary scale and cannot flex to any great extent from this. If they can, then the 8 GDN labour factors also apply to GDN direct labour. Please refer to the Deloitte report 'Direct and Contract labour regional factors for RIIO-GD1' submitted as part of our November 2011 Business Plan.

Ongoing efficiency

We note that Ofgem's assessment of ongoing efficiency is not significantly different from the independent analysis carried out for us by Frontier Economics.

However, we have argued for some important exceptions in our Business Plan where it is not appropriate to apply ongoing efficiency adjustments. These include the emergency service (where the challenges facing that service are well documented) business services (where we have delivered the full de-merger savings) and London (where we have put forward specific productivity challenges ourselves). We recommend that Ofgem consider these exceptions further.

Chapter 3. Total expenditure and total opex, capex and repex analysis

Question 1: Do you consider our approach to totex is appropriate, and if not what changes would you propose?

We have commissioned a report by industry experts Frontier Economics to evaluate Ofgem's quantitative approach to cost assessment outlined in the initial proposals of July 2012. The key findings of this analysis are discussed in our response to the questions raised in Chapter 5 below.

Chapter 4. Assessment of costs excluded from regression analysis

Question 1: Do you agree with the costs we have excluded from regression analysis and the methodology we have proposed?

We broadly agree that the costs excluded from the regression analysis are atypical or represent a material difference in expenditure level across GDNs due to third party actions or legislation.

While we recognise that streetworks must be removed from regression analysis we have been concerned that appropriate recognition of the income adjusting event submission on behalf of Scotland Gas Networks has been dismissed and no ex-ante allowance has been set. We believe the initial judgement on the 2011 claim under the T(S)A was due to a limited understanding of how to interpret the Scotland specific legislation and not due to any rejection of costs incurred.

Exclusion of the SIUs as an atypical cost exclusive to Scotland GDN remains a key principle.

Question 2: Do you agree with our proposals for smart metering?

We proposed the development of a revenue driver to allow for the additional network issues workload generated as the national programme rolls out during GD1. This provided the balance between certainties of funding for GDNs and represented the strongest incentive on network operators to minimise the ongoing cost and in turn share the performance benefits with customers.

Whilst we accept that the issues or the network operator response are not sufficiently developed to permit a revenue driver we feel it important that the proposals for smart metering through upfront allowance and uncertainty mechanism fully recognises the material impact this programme will have on GDN activities. We have therefore sought ongoing engagement with Ofgem and DECC to work towards a comprehensive uncertainty mechanism and ensure we are prepared to support this national programme.

Building upon the proposals of our April business plan we have completed a second, extensive survey across both of our network footprints to identify the likely issues faced by GDNs. This study has then been reviewed and analysed, with the likely GDN response to identified issues quantified in incremental levels of core workload; e.g. service replacement, ECV alterations. Our conclusions from the second survey are consistent with the first and suggest a total GDN exposure of c. £200 m during GD1.

Based on this we recommend that Ofgem adopt our proposals for a more flexible incentive trigger early in the smart metering programme. This accommodates the potential impact on GDN costs of delays in the roll out or changes in experienced issue volumes as suppliers move from the foundation and learning stages to mass installation. Our proposals will be the subject of a comprehensive report submitted to Ofgem during October 2012. We urge the conclusions and recommendations within this to be incorporated into the final proposals to ensure a successful programme.

Initial Proposals provided an upfront allowance of £0.30 per meter, this is insufficient. In our April business plan we suggested ex-ante funding levels and recognised that these initial allowances were unlikely to be sufficient for the range of set up costs anticipated. These costs include the adjustments to our work management and dispatch systems to accommodate the

secondary flows of smart metering issue workload, alternations to the data links between SGN and the DCC, training and resource development to enable provision of business as usual service during periods of peak winter workloads and many other changes to our business model to accommodate the condensed programme volumes. We believe that a flexible uncertainty mechanism which enables GDNs to recover all efficiently incurred additional costs, both workload volumes and fixed set up costs will provide us with the necessary certainty to plan for GD1.

Our concerns about the proposed uncertainty mechanism are discussed further in our response to Question 18 on the finance and uncertainty supporting document.

Question 3: Do you agree with our proposals for loss of meterwork?

We believe that the current proposals to adjust for the effects on GDN emergency costs as metering contracts reduce are fundamentally flawed. The following key issues remain and must be addressed prior to final proposals.

Cost assessment model

The cost assessment process must consider the total future emergency service cost which comprises the efficient productive cost of delivery plus the efficient level of unproductive time. It is this cost which should be benchmarked through the costs assessment process.

The remaining associated cost represents the residual labour resources created by the seasonal impact on workload which have been effectively absorbed into other GDN activities or displaced.

We strongly propose the industry cease to discuss and assess emergency and loss of meterwork costs separately. These elements are co-dependent factors in assessing the reasonable costs required to deliver a consistent and effective emergency. To ensure that the quality of service is not compromise for this key core activity Ofgem needs to change the focus of its assessment and concentrate on the reasonable total costs of an emergency service.

Adjustments to modelling

As we have proposed to Ofgem total emergency cost should be based on, firstly, the experience of the single GDN which has operated with minimal meterwork and, secondly, the three GDNs which have delivered the licence conditions under all operating conditions. It is crucial that all experience is recognised. As discussed in the general comments on cost assessment it is essential that service standards are incorporated into the process wherever possible and reflect the value placed upon the output.

We also propose that where upward cost adjustments are required to ensure standards are met that:

- The cost adjustment must pass a reasonableness test. We have demonstrated that to meet the winter conditions of 2010/11 an upward cost adjustment of £2.7m for Northern Gas Networks and an average £1.2m for NGGD GDNs would be reasonable and credible.
- The adjustment must be applied to all years, historic and forecast, to reflect the need to engage these resources each and every year in order to accommodate the recurrence of comparable conditions.

Avoid the temptation to cherry pick

Ofgem's current modelling approach is to benchmark the level of stranded labour costs (referred to as loss of metering impact) separately from the residual productive emergency costs. This automatically introduces a 'cherry picking' bias where the lowest unproductive and productive proposals will form the frontier for the industry. Such a result is inconsistent as improvements in efficiency of delivery with a constant total emergency base necessarily increase the stranded labour element.

For this reason we propose that emergency costs be analysed at a total level.

Adjustment for remaining metering contracts

By setting an efficient total emergency cost first a GDN's business plan proposal can then be adjusted downward for the level of metering they forecast will remain into the early years of GD1. All GDNs continue to have a strong incentive through the IQI sharing mechanism to maximise any future opportunities to secure income generating contracts to absorb emergency resources. To the extent that they achieve this the benefits will be shared with consumers.

Chapter 5. Overview of bottom-up assessment

Question 1: Do you consider our approach to bottom-up assessment is appropriate, and if not what changes would you propose?

We have commissioned a report by industry experts Frontier Economics to evaluate Ofgem's approach to all aspects of cost assessment outlined in the initial proposals of July 2012. Their key findings are noted below:

- Inappropriate selection of some key cost drivers. In particular the use of customer numbers and not PREs, the exclusive use of reports without reference to repairs and the inflexibility of MEAV
- The absence of quality, service outputs and standards from the cost driver selection and the modelling process. This they believe creates significant gaps in the assessment process and detrimentally affects the validity of the conclusions reached
- Weak or improper incentives through the choice of volume cost drivers. Where a company is assessed on only the volume of workload delivered then there is the risk that it is incentivised only to maximise volume and create economies of scale
- Complications in setting appropriate drivers for most Capex activities. The issues of 'lumpy' investment profiles and the potential for GDNs to be on different points in the investment cycle cast doubt on the strict application of capex results in setting allowances

We have encouraged Ofgem to make some key changes which will improve the assessment process. These are as follows:

- The cost driver for the emergency service must reflect the full workload that a GDN will be compelled to resource for, i.e. total PREs and not customer numbers. The current proposal to use customer numbers as a proxy places an impossible measure upon GDNs which receive proportionally significantly higher numbers of PREs per customer than others
- Ofgem should consider creating a combined CSV for repair activity incorporating both reports and repairs. This will go some way to mitigate the potential benefits and flaws in both measures

- With reference to the conclusions on regional factors Ofgem should recognise the full adjustments for Urbanity and GDN labour indices and remove the distortion created by the current Sparsity proposal

We also believe that Ofgem should consider further the consequence of assessing activities such as Maintenance and Capex without incorporating appropriate cost drivers representing factors such as condition. Failing to incorporate such explanatory variables and exclusively using MEAV results in the roll forward of historic maintenance allowances at the industry upper quartile. This essentially disregards the RIIO concept of Totex. Whether higher maintenance costs represent a better value Totex decision to maximise the economic value of assets by deferring investment expenditure is effectively not considered.

The qualitative approach to cost assessment has failed to justify the conclusions reached in some key areas as discussed in our response to chapter 1, question 1. In holder demolition allowances the dismissal of our justification supporting the additional engineering costs which will impact some sites has not been qualified nor any evidence presented to demonstrate alternative solutions to the issues identified. Consequently the unit allowance for the removal of an individual holder has been set unrealistically low and may result in the deferral of more expensive sites to GD2. We propose that Ofgem recognise the specific engineering issues identified; their material impact of the cost of demolition; and provide sufficient allowance within the Final Proposals.

A further example is the cut in cost allowance for governor refurbishment. The assessment process has concluded that approximately 50% of the governor population can be refurbished and not renewed. With the absence of an independent report from Ofgem's expert consultants the conclusions reached and the supporting justification are not available to determine how the comparative GDN condition data enabled the intervention proposal of one GDN group, NGGD, to be applied to the other groups.

This also impacts the unit cost assessment. Unless it is demonstrated that the relative condition of the governor assets is consistent across GDNs it is inappropriate to allow the same unit cost for their refurbishment. The proposed allowances of £8k and £12k for outer and inner London areas provides for little more than increased maintenance. This will fail to address the condition issues identified in our business plan proposals. We believe that in the absence of a rationale for applying unit allowances from NGGD to other GDNs the original proposals set out in our April business plan should remain.

Chapter 6. Operating expenditure

Question 1: Do you agree with the assessment we have carried out and the results proposed for opex?

We believe the initial proposals for the Scottish Independent Undertakings are insufficient and fail to address the complex nature of this issue. This is developed further in our response to question 22 of chapter 8.

Business Support

In addition to the comments provided in response to the cost assessment process questions above we believe the analysis and proposals for business support costs are inappropriate in the initial proposals. We have identified three key areas of concern with the approach taken and the allowances proposed.

These are as follows:

- **Group assessment of costs.** Assessment of cost efficiency has been undertaken using the concept of a ‘SSE Group’ of 5 companies comprising; one SSE transmission, two SSE electricity distribution and two SGN gas distribution entities. This approach is wholly inappropriate. SGN is a joint venture between three share holders with no single holding exceeding 50%. Some corporate services are procured by SGN from SSE but this represents a minority of total business support costs and the flow of costs is only in one direction. We strongly recommend Ofgem remove the collective assessment of costs and address the efficiency of SGN as an independent group.
- **Appropriate benchmarking metrics.** When considering SGN business support costs at gross level it is essential that the benchmarking metrics used represent the SGN group of companies across which the costs are shared. Ofgem has used only the regulated entities and therefore materially underestimated the efficiency of the historical and forecast cost base. We have provided SGN group metrics to enable this to be corrected and urge Ofgem to make these improvements prior to final proposals.
- **Proportionality.** In submitting our business support proposals for GD1 we have been guided by Ofgem’s strategy for RIIO. A key component of this is the identification and application of the principle of proportionality in cost justification. We consider that providing external justification for approximately 50% of the business support cost forecast focusing on the material areas of expenditure is in keeping with the original RIIO concept. The remaining items are of low relative expenditure. We do not believe the mechanistic assessment of justification across GDNs is appropriate across all of business support and are surprised by the relative reward. We suggest Ofgem review the appropriateness of this approach and recognise that our balanced approach is a response to the guidance given.

Emergency service

We consider the proposed allowances for the emergency service to be insufficient to deliver our licence obligations in a future without metering filler work. In our response on the cost assessment process we have highlighted the concerns we have on the use of an appropriate cost driver. Further to this we believe the single, one year adjustment in 2010/11 for those networks falling below licence standards **does not represent the reasonable additional expenditure necessary** to deliver the 97% threshold. We have provided to Ofgem a suggested derivation of an **appropriate upward adjustment** and proposed the rationale for ensuring the resourcing requirements are reflected in all years. In addition we have demonstrated that separate assessment of the base emergency and the ‘stranded’ labour proportion of total costs leads to cherry picking a proposal which may not exist in reality. Both costs must be considered together in setting final allowances.

Repairs

We recognise that in response to the decisions on replacement mains workload the output measure and associated funding of repair activity should adjust. However we do not support Ofgem’s conclusions on mains deterioration rates through GD1 nor the application of these revised drivers to the dependent repair workloads and allowances. While the calculation of the revised deterioration rates for metallic mains have been provided there has been no supplementary justification for why the range of deterioration rates has been constrained to the lowest 25th percentile.

Ofgem's approach has been to adjust for external factors and the variability in the starting failure rates within the historic sample period. Once these adjustments were made we do not believe there is any justification for further adjustments to the deterioration range across GDNs. Ofgem's secondary amendment is to constrain the maximum deterioration range across GDNs to the lowest 25th percentile of the highest recorded deterioration rate. This is an inappropriate and unnecessary adjustment. Once the trend in historic failures has been smoothed the resulting implied deterioration rates for GD1 should not be reduced unless Ofgem believe there are other exogenous factors which will come into play in the future. In the absence of any further evidence that linear deterioration trends will change there is no justification to constrain GDN failure rates through GD1. We recommend Ofgem revise the application of calculated deterioration to GD1 workloads and reflect this is output measures and allowances.

We also have identified the inconsistent application of reports as a cost driver in the cost assessment process. GDNs have indicated that there is a range of issues with the use and reporting of mains and service condition reports and repairs. This issue has not been resolved to date as the potential for differences lies in both the reports and repairs as follows:

- Reports. GDN practice can be to record additional reports associated with an ongoing external public reported escape as an when they are identified in the general proximity survey. This will essentially reduce the repair / report ratio.
- Repairs. A GDN may elect to undertake adjacent repairs where identified during survey to avoid returning to site at a later date and record these as part of the originating report. This will essentially increase the repair / report ratio.

Both approaches have merits and reflect a GDN's process in attending and remediating mains and service escape events. Given the differences it is therefore not appropriate to use only one metric as it necessarily favours one business model over an other even though both may be equally justified. We recommend, as supported by Frontier Economics, that this potential inconsistency is recognised and a CSV is derived based on equal weighting of both metrics.

Ongoing efficiency

As noted in our response to question 2 of chapter 2 the application of ongoing frontier efficiency shift to certain elements of Totex is inappropriate. One such area is business support costs (indirect costs). The external evidence provided in our November submission identified the delivery of the demerger savings anticipated across the GDNs. Further to these it is inappropriate to expect the overheads of the business to continue to contract at the 1% annual improvement proposed by Ofgem. Given the additional demands on GDNs through reporting outputs, targeting improvements in customer service and the complexity of managing Totex investment decisions a greater demand will be made of support functions in GD1. This in turn limits the potential to reduce the associated cost base.

The application of ongoing efficiency to emergency costs is also inappropriate. The allowances should reflect the efficient total cost of delivering an emergency service, resourced to respond to the range of operating environments. The industry recognises this is in essence a fixed cost. Therefore to expect GDNs to improve labour efficiency through GD1 is to anticipate that the unproductive time embedded within these allowances will increase.

We recommend that the frontier shift of 1% is removed from Business Support and emergency allowances.

Chapter 7. Capital expenditure

Question 1: Do you agree with the assessment we have carried out and the results proposed for Capex?

Our review of the initial proposals has identified a number of key areas where disallowances have been applied through Ofgem's assessment which should not have been applied. These are:

- 1) Capacity Transmission Reinforcement in Scotland
- 2) Asset Integrity
 - a. Less than £0.5m projects on the transmission system;
 - b. Disallowance of district regulators on holder sites, commonly referred to holder governors; and
 - c. £8k allowance for 50% of proposed district regulator investment
- 3) Scottish Independent Undertakings (SIUs)

Capacity Transmission Reinforcement (Scotland)

In our April business plan we proposed £25.63m of investment for four transmission pipeline reinforcements due to known localised load growth, primarily from the distilling industry.

Our business plan highlighted that the interruption auctions we have undertaken, including ad-hoc, in the last few years have proved to be unsuccessful and that the required load to negate reinforcement is not available. Therefore, the investment to carry out reinforcement is required in the final proposals. In addition, we have surveyed our customers to establish the likelihood of connecting, and this has resulted in three of the projects requiring capital allowances in the Final Proposals and the fourth could be deferred, with WWU's the proposed large load trigger being applied at a later date.

The details of the projects are:

Project Name	Size	Pressure	Year	Cost (£m)
Moray	13.4km x 300mm	69bar pipeline	2014/15	
Logerait phase two	3.8km x 150mm	19bar pipeline	2018/19	Redacted -
Foudland	4.9km x 300mm	69bar pipeline	2015/16	Sensitive
Pathhead	6.3km x 300mm	19bar pipeline	2015/16	Information
Total				

We are now proposing an allowance of £20.17m in the final proposals and £5.46m subject to a large load re-opener, if the developments progress.

We still require on-going interruption allowance for the existing customers, which is £2.17m.

Asset Integrity – <£0.5m Transmission Projects

We have undertaken a comprehensive review of all our transmission assets, and fully have assessed our investment requirements over GD1 to ensure a safe and reliable network. This assessment has included a site by site detailed review of asset condition and performance, and the full population of the health and criticality indices, together with cost benefit analysis. The proposals were endorsed by a third party engineering consultancy.

The investment in these assets are required over GD1, and we have reviewed the list of below <£0.5m projects to establish the assets that are at the end of life and require funding in the final proposals, and those that could undertaken subject to a suitable trigger mechanism.

We have included in the appendix the list of projects that require funding in the final proposals and the justification. We are planning to modify the health and criticality indices to reflect the changes in allowances. We will shortly be in a position to share with you out latest analysis.

Asset Integrity – Governor Refurbishment

We strongly believe it is inappropriate to base our allowances for governor replacement on what another GDN is proposing and set an allowance based upon being able to refurbish a governor. From our assessment of condition and obsolescence the governors need to be replaced.

In our April plan, we proposed a fault trigger mechanism based upon the industry standard on reliability centred maintenance for these assets. This approach is well established and the data is robust and that governance is applied to fault reporting, which could be subject to audit and controls, like MRPS (mains risk prioritisation system) or LRMM (leakage reduction management tool).

We are seeking appropriate allowances for this work in the Final Proposals to undertake asset replacement to deliver safety and reliability together with a fault trigger mechanism for those assets that are not allowed. We have continued to develop our analysis in this area and will shortly be in a position to share our thoughts with Ofgem.

Asset Integrity – District Governors on Holder Sites

In our April business plan, we submitted proposals to replace 30 Donkin holder station regulators. This terminology has created some confusion and we can confirm that these regulators act in the same way as district governors, but are located on the holder site and have no relationship to the operation of the holder. These have been identified separately primarily due to their size and diameter range, they therefore require appropriate funding of £**Redacted**.

Scottish Independent Undertakings

The continued long term supply of gas to the SIUs requires capital investment and we have detailed three potential enduring solutions within the confidential appendix.

Question 2: Do you agree with our approach for allowing costs in line with historical levels for investment where supporting evidence is lacking or not sufficiently supported by CBA?

With respect to the gas network assets, we do not agree with the approach for allowing costs based upon historical levels. We have undertaken a comprehensive review of the distribution and transmission assets and proposed justified funding to ensure a safe and reliable network, supported by the completed suite of health and criticality indices and cost benefit analysis.

For these assets, an approach that looks back at historical levels is not appropriate; it needs to be forward looking to ensure that funding is appropriate for a safe and reliable network.

CHAPTER 8. Replacement Expenditure

Question 1: Do you agree with the assessment we have carried out and the results proposed for Repex?

We have fully embraced the new three tier approach, and this was reflected in our revised business plan submitted in April 2012, where we have reduced our investment proposals. However, we have four major areas of concern in the initial proposals, these are

- Tier 1 condition mains
- Tier 2 and 3 iron mains
- Unit rates for above threshold tier 2
- Gas Service Relays (following alteration and escape)

The first three of these areas are more fully explained in subsequent responses below.

In our response to the cost efficiency questions above, we have outlined the need for full recognition of company specific factors. This important adjustment to the Initial Proposals recognises the appropriate residual unexplained efficiency gaps. This then permits effective comparison of inter-GDN efficiency through quantitative and qualitative tools. The adjustments required are application of the consistent urbanity productivity gap and the recognition of eight GDN contractor labour indices.

Furthermore, we do not agree with your assessment of Gas Service Relays (following alteration and escape). The proposed workload reductions for service relays following an escape and alterations are insufficient to meet this reactive workload, and our historical trends, which have been consistent year on year, reflect our April business plan requirements. We continue to experience service failures, and we will require additional workload to cover off the loss of mains in tier 2 and 3 should those adjustments remain. Also, where alterations are customer driven, recent government planning changes may even result in a increase, although we have not built in this assumption and will bear that risk. Our April plan does reflect a declining workload in both of these activities that has been applied on a pro rata basis with the declining number of steel services (e.g. resulting from the mains renewal and service hot-spot programmes we have proposed).

Question 2: Do you agree with our approach for the assessment of tier 1 repex costs?

We believe there has been inconsistency in your assessment of Tier 1 mains where workload comparisons and subsequent adjustments have made having mixed decommissioning length (at-risk iron mains) with installation lay lengths (all Tier 1). We would also point out that the HSE three tier approach is applicable to iron mains located within 30m of a property and not other pipe assets. Your assessment appears to result in the disallowance of all Tier 1 condition mains that do not fall within the HSE 3-Tier policy.

Tier 1 condition mains

We have proposed 54km and 41km in Scotland and Southern respectively to decommission tier 1 band pipes based upon their asset condition. This proposal is 46km less than GDPCR1 investment, and our plan is robustly supported by cost benefit analysis for this continuing failing asset category. Therefore, this investment should be allowed in the final proposals.

Question 3: Do you agree with our approach for the assessment of tier 2 and tier 3 Repex costs?

Tier 2 & 3 iron mains

We believe that our April business plan was well justified and that the cost benefit analysis (CBA) models were appropriate. However, following further discussion with Ofgem, we have reviewed the methodology of applying the CBA model across the remaining assets, focussing upon particular networks with known condition issues (i.e. hotspots). We believe that this assessment results in a clear justification for the tier 2 & 3 workload submitted in our April 2012 plan, with a particular focus on the following areas of our network.

Unit rates for above threshold tier 2

The proposed unit costs for dynamic growth above the threshold in tier 2 are inadequate, and this becomes more evident when comparing your proposals with those for other networks and also against existing allowances for the 2012/ 13 period which are significantly higher. We believe this is partly related to the small volumes in our business plan not being fully representative of the full range of pipe diameters in Tier 2. We have therefore undertaken further detailed work to propose the following unit costs for both our networks:

Diameter Range	Proposed Rate (£/m)	
	Scotland	Southern
9"	Redacted commercially sensitive information	
10" to 12"		
13" to 17"		

These unit rates are based upon a normalisation of our last three RRP submissions which provide a more representative volume of work than the very small volumes incorporated into our April 2012 plan which were for the small number of pipes that currently exceed the risk threshold. The volume driver must recognise that a broad range of diameters within Tier 2 may exceed the risk-action threshold over the GD1 period.

Chapter 9. Combining the elements of our cost assessment and applying the IQI

Question 1: Do you agree with how we have applied IQI, and if not what would you propose to change? Do you agree with our approach to combining elements of the cost analysis?

We have concerns that the IQI mechanism is calibrated upon a notional company with all GDNs to the right of that. This implies that all GDNs are, to some degree or another, inefficient which we strongly contest and have seen no justification for. The concept of a notional company that combines the best outcomes from disaggregated benchmarking has been considered in previous price controls and the conclusion has always been that this approach is not robust.

We support the post-tax application of the IQI sharing rate and the exclusion of certain costs (as noted in para 9.11 of Initial Proposals - supporting document – cost efficiency). However, we disagree with Ofgem's proposal to run certain incentives (e.g. leakage) through IQI. Applying IQI to incentives significantly reduces the opportunity to outperform what we believe is already a weak incentive package. Further, not all activities to improve performance above an incentive baseline need be based on capital investment and hence there is no overriding reason to apply IQI to out-performance. A simple policy decision that no incentive should be subject to IQI would be a major step forward.

Initial Proposals: Finance and uncertainty

Chapter 2. Asset lives and RAV

Question 1: Do you agree with approach of using the profile for the release of backlog depreciation as a mechanism to smooth revenues and reduce their volatility through the RIIO-GD1 period?

In principle we agree with the profiling of the release of backlog depreciation, as the appropriate profiling can assist with addressing the important issues of reducing any spikes in revenue, and thus charging volatility, and smoothing the shape of credit metrics and cashflows over RIIO-GD1.

For the profiling of catch-up depreciation to be effective it needs to be done on a GDN specific basis. This is because the implementation of a generic profile will not address the specific nuances of individual GDN's revenue and credit metrics shaping requirements over an eight year period.

Additionally, the profiling needs to exclude IFRS revenues, as it remains very uncertain and out with our control.

Chapter 3. Allowed return

Question 2: Do you have any comments on our relative risk assessment?

One of the key principles in the RIIO approach is that the 'base allowed return for network companies should reflect their exposure to cashflow risk' (para 3.8, p 11, of the IP-FU), and Ofgem state that the GDNs have a lower cashflow risk than GDPCR (para 3.8, p 11, of the IP-FU). This perceived lower level of risk, is then used to justify the Initial Proposals (IPs) recommendations of 6.7% Cost of Equity and 65% Notional Gearing, as compared to 7.25% and 62.5% in GDPCR1. The lower Cost of Equity also includes a reduction in the equity beta from 1.0 to 0.9.

All of our analysis of Ofgem's key risk factors, detailed further below, points to a relative risk level in GD1 that will be at a minimum approximately the same as, or even higher than, in GDPCR1. However, the Ofgem-proposed 6.7% Cost of Equity and 65% Notional Gearing implies a 16% asset beta reduction from GDPCR1, as detailed on page 8 of Oxera's report 'RIIO-T1 and GD1 Initial Proposals – Financial Issues'. We strongly believe that the asset beta reduction is not based on a full assessment of the relative risk between GDPCR1 and GD1, and results in returns that are inconsistent with the risk that we will be expected to manage in GD1.

Analysis of Ofgem's Key Risk Factors

Scale of Investment

Ofgem regard "Scale of Investment" as the most significant differentiator of risk, stating that the decrease in the Capex to RAV ratio shows a decrease in the riskiness of an investment programme due to its declining scale. However it is doubtful that this would impact asset beta at all. As highlighted in CEPA's report 'RIIO-GD1: Cost of Equity – A Report for Centrica' (p34) Capex Risk in principle is diversifiable and thus a reduction in the Capex to RAV ratio does not imply a reduction in the systematic risk and the required Cost of Equity.

Notwithstanding this important point, the 16 % decrease in asset beta from GDPCR1 to RIIO-GD1 is not only disproportionate to the change in the Capex to RAV ratio from GDPCR1, but also to the relative movement in the asset betas and levels of investment for SPTL and SHETL. Finally, excluding Capex allowed as part of within-period determinations, which have low levels of risk as compared to ex ante unit and cost allowances, the Capex to RAV ratios across the UK gas transmission and distribution networks are relatively similar and do not suggest a material difference in business risk. The analysis behind these important factors, showing that scale of investment does not justify the significant reduction in allowed return for GDNs, can be found in section 3.2.1 of Oxera's report.

Incentive Rate

The GDN average post tax incentive rate has increased from 44% in GDPCR1 to 63% for RIIO-GD1, exposing them to a greater share of cost variances. This will cause a significant increase in risk between GDPCR1 and RIIO-GD1 and, furthermore, the incentive rate is considerably higher than for the fast tracked transmission companies and yet the GDN's asset beta is 26% lower.

We understand that Ofgem believe that the size of the Capex programme, relative to RAV, is a strong indicator of financial risk. However this needs to be considered in conjunction with the incentive rate. If one multiplies the incentive rate by the Capex to RAV ratio to derive a baseline theoretical financial risk, the risk exposure as a percentage of RAV increases significantly in GD1.

Increased Length of Price Control

The RIIO-GD1 price control covers an eight year period, compared to the five years in GDPCR1. A longer price control increases the risk that a network will under or over perform the regulatory assumptions, leading to a greater variance of outcomes relative to allowances, and thus leads to an increase in risk compared to the five year GDPCR1 period.

In agreement with the FTI report for Ofgem 'Cost of Capital Study for the RIIO-T1 and GD1 Price Controls' (para 2.19 [p12]) we acknowledge uncertainty mechanisms and efficiency incentives partially offset the increases in risk, but do not fully mitigate the risks. Detailed analysis of the increase in risks due to a longer price control, the potential for asymmetric risk of cost shocks on the downside, and an explanation of why uncertainty mechanisms only partially mitigate the overall increase in risk, can be found in section 3.2.2 of the Oxera report.

Question 3: Do you agree with our proposed elements of the allowed return?

As detailed in our response to Question 2 above, the proposed RIIO-GD1 levels of Cost of Equity and Notional Gearing imply that the asset beta for GDNs will drop by 16% from GDPCR1, despite levels of relative risk remaining similar, if not indeed rising.

The allowed return proposed in our April Business plan addressed this mismatch. In analysing the RORE range, the allowed returns in the Initial Proposals can not deliver the lower double digit returns that Ofgem state are plausible from the proposed package.

In order to achieve Ofgem's stated plausible RORE range and an appropriate corresponding return on WACC, the following changes are required to the Initial Proposals package:

- An increase in the base allowed WACC (through a combination of increased Cost of Equity and/or Notional Gearing maintained at the GDPCR1 level of 62.5%)
- A widening of the incentives package
- Increases to the proposed totex allowances
- The adoption of a BBB Cost of Debt index allowance and a 30 bps uplift for the inflation risk premium allowance as proposed below.

Cost of Debt

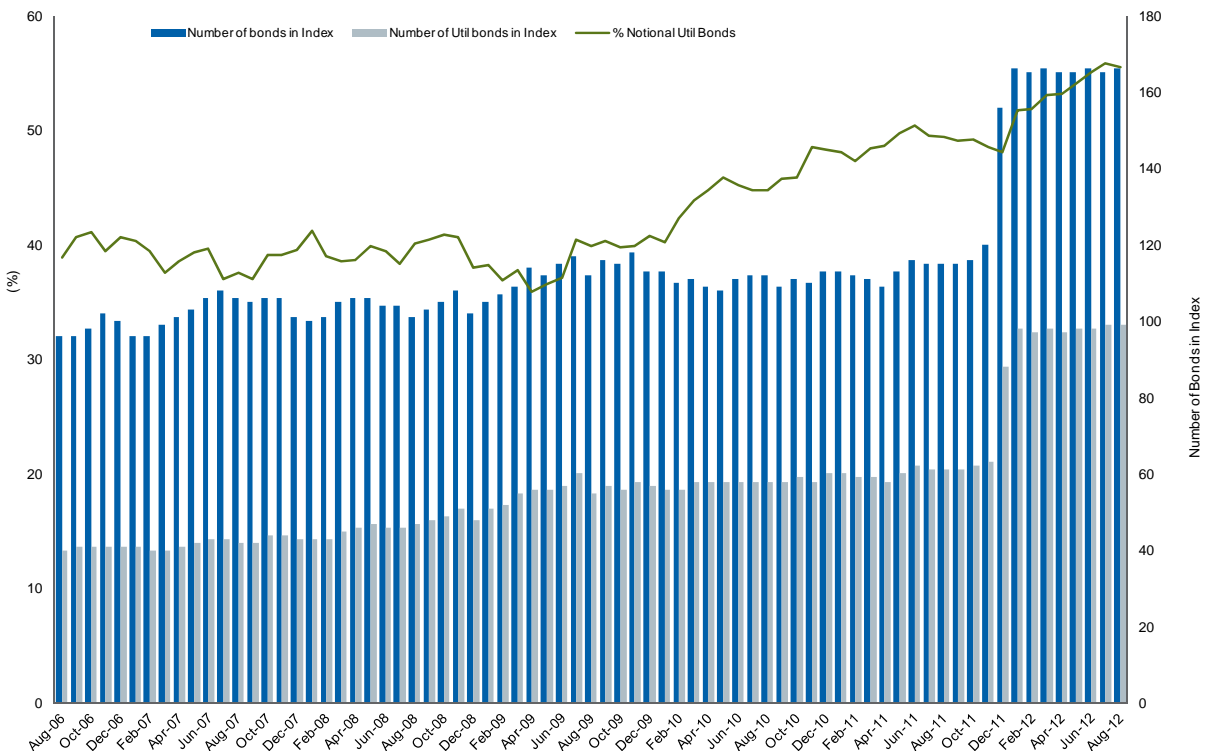
As detailed below, there are several risk factors which are likely to cause actual costs of debt to be significantly higher than what is 'allowed' by the trailing average. The adoption of a BBB index and a 30bps uplift for the impact of the inflation risk premium would mitigate some of these risks and also assist with RIIO GD1 financeability package delivering appropriate credit ratios.

The proposed Cost of Debt allowance of a ten year trailing average of the A/BBB IBoxx index in the Initial Proposals is a significant shift from the setting of a fixed Cost of Debt allowance that has been used in previous UK regulatory determinations. UK regulators, including Ofgem, have tended to set the fixed cost of debt allowance slightly above the central estimate of the efficient cost of debt for the price control period, after allowing for debt issuance costs (see section 4.1 of Oxera's report).

The adoption of a trailing average as the cost of debt allowance therefore leads to several risk factors which are likely to cause actual costs of debt to be significantly above those allowed by the trailing average:

1. **Embedded Costs Are Not Covered By the Index:** As detailed in para 8.49 (p 100) of the FTI report for Ofgem, 'recent low yields are extremely low by historical standards, and may not be representative of a normal economic cycle. Moreover, current low levels of growth may continue for longer than normally expected in the economic cycle. Consequently it is possible that the divergence between embedded and new debt costs will become more pronounced during the 2013/21 Price Controls'
2. **Inability to Match Index:** No company issues debt on an even and daily basis, and thus they are exposed to the risk that their issuance yields differ from the average of daily yields that go into the trailing average. Furthermore the low RAV growth of 1% for GDNs will significantly hamper their ability to reduce the mismatch between actual and allowed costs of debt. Section 4.1.2 of the Oxera report details the analysis behind this point. As pointed out in para 8.87 (p 105) of FTI's report to Ofgem issuing debt in such small sizes is likely to lead to a substantial increase in transaction costs. Therefore, due to the very low anticipated asset growth and small asset bases, a cost of debt allowance based on the iBoxx index is likely to continue to be a higher risk option than a fixed allowance.

3. **Mismatch of A/BBB index to SGN’s Notional Rating:** Assuming the concerns over the overall package raised in this response are addressed, the notional capital structure set for SGN will produce ratings that fall within the BBB thresholds. The cost of debt funding should be consistent with the notional capital structure and therefore should be based on a BBB iBoxx index. The ‘halo-effect’ referred to by Ofgem for utility companies, which enables them to issue bonds at a lower rate than the index, was arguably higher during the start of the financial crisis in 2008 and 2009 – but this effect is now diminishing. In addition this trend is also due to the fact that utilities are making up an increasing proportion of the iBoxx index – as detailed in the following graph;



Indeed FTI’s report to Ofgem in para 10.58, page 128, states ‘The network companies consider that outperformance of the index will be diminished if network companies become a larger part of the iBoxx index. We agree that if this effect was significantly large this would make outperformance of the index more difficult, and thus reduce the margin available to fund other costs of debt financing’;

4. **Solvency II:** This is an EU initiative requiring insurers to maintain higher levels of capital if they hold longer dated assets and / or assets with lower credit ratings, thereby reducing the risk of insurers defaulting on their payments or having an adverse market impact. Over time, Solvency II will increase the actual cost of debt relative to the index, since insurers will be less willing to purchase bonds with longer maturity, as recognised in para 9.19 (p115) of FTI’s report for Ofgem, thereby driving up their cost and making these bonds more difficult to issue.

- 5. Inflation Risk Premium:** Ofgem propose using forecasts of inflation to convert the A/BBB IBoxx ten year trailing average from a nominal to real rate, which is inherently risky due to the difficulties in forecasting inflation. As detailed in Appendix J of the April re-submissions of the Scotland and Southern Business Plans, we estimate the impact of the inflation risk premium to be 30bps, and this is supported by FTI’s report to Ofgem stating (para 11.23, p139) that ‘it seems likely that the inflation risk premium is larger than the liquidity premium.’

Given the above-noted risk factors, which will result in a significant mismatch between the allowed and actual cost of debt, we are proposing that the index conform to our actual BBB debt profile plus 30 bps uplift to account for the inflation risk premium.

Chapter 4. Financeability, transition and return on regulated equity

REDACTED SECTION – COMMERCIALY SENSITIVE INFORMATION

Question 4: Do you agree with our approach to transition of the repex capitalisation rate from 50 per cent to 100 per cent in seven equal annual steps (“stepped approach”)?

In order to maintain stability of cashflows we believe a flat repex capitalisation rate should be adopted.

Chapter 5. Pensions

Question 5: Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?

Our experience is that schemes (and their sponsors) already spend significant amounts of time and effort conducting exactly these exercises, to ensure that the appropriate level of risk is being taken. We agree with the statement and would encourage a risk-based assessment of schemes’ contribution and investment strategies. In fact, we believe that a more pertinent question would be to ask companies to justify why they are not taking steps to de-risk investment strategy. At the centre of this analysis is an objective assessment of the level of risk schemes are running. We believe it would be hugely beneficial if Ofgem were to take an active role in specifying the risk parameters it expects companies to work within. At present, Ofgem’s focus appears to be on

the selection of individual assumptions – which, of course, do not affect the ultimate cost of providing the benefits – when we believe the focus should be on the level of risk being run, as the level of risk is more likely to influence the amount consumers need to pay in future than any of the funding assumptions used.

To help develop this risk-based approach, we believe it would be helpful for Ofgem to specify their tolerance to risk. This could be defined in a number of ways but as an example, schemes could set their contributions and investment strategy such that there is a 95% chance that the funding deficit in 10 years' time should be less than £Xm (this could be defined as a fixed monetary amount, or as a percentage of RAV, or even £X per consumer).

Question 6. Do you agree that the costs of contingent assets may be allowed if considered to be in consumers interests?

Yes if deemed an appropriate option to the scheme.

Question 7. Do you agree with the thresholds for pension scheme administration costs and Pension Protection Fund levies set out in table 5.1?

We believe a threshold of £0.5m is appropriate based upon the level of allowance set for these items.

Chapter 6. Tax

Question 8: Do you agree with our amended treatment for modelling the cash flows of corporation tax payments?

We do not object to the change in treatment for modelling payment of corporation tax.

Question 9: Do you agree with amending the timing of the revenue adjustment for tax clawback to be annually in line with the annual iteration process?

We do not object to the tax clawback adjustment being calculated annually.

Question 10: Do you agree with our treatment of expenditure for tax modelling?

By applying generic attributions of capital expenditure to tax pools, the tax allowances do not reflect the diverse nature of the GDNs Capex plans, nor the timing of individual projects. Since the generic attribution has been determined on the basis of averaging the allocations within the April Business Plan submissions, and the content of the GDN plans have subsequently been amended by the Initial Proposals, the modelled allocations will be even further removed from the detail of the individual plans.

The treatment of demolition expenditure as an allowed cost against revenue will reduce the tax charge, and therefore the allowance, in the year of expenditure. This does not reflect the actual position, which is that demolition expenditure will be added to the special rate asset pool and only a small proportion will be available for offset against tax charges in the PCR period.

We believe that the GDNs will be adversely impacted by the timing of tax relief on the element of new connections funded by the customer after the implementation of IFRS. Contributions will be treated as turnover and charged to tax in the year in which they are received while the Capex

cost will be added for the relevant section of the service will be added to the special rate pool, thus resulting in an adverse cash flow to the Network.

Chapter 7. Allowed revenues, annual iteration and the financial handbook

The allowed revenue increases detailed on table 7.1 (p.42) of the IP (Finance and uncertainty) are incorrect, as the RIIO-GD1 revenues for the Scotland and Southern GDNs include the costs of NTS exit capacity payments, IFRS and SIUs – but these are not included in the 2012/13 figures.

Question 11: Do you have any views on the calculations and layout in the financial model?

We support the clearer layout and structure of calculations as compared to previous versions of the model, and the ongoing dialogue between Ofgem and the GDNs on model development. We must emphasise that a RIIO-GD1 specific model needs to be used for the GDNs and a full audit is needed before the Final Proposals.

Question 12: Should the financial model also capture, for presentational purposes only, the revenue from all incentive schemes?

We support the disclosure of appropriate data within the Financial Model, providing it adds value to all and is not commercially confidential.

Question 13: We have set out three options to deal with the issues relating to SIU and legacy pensions arrangements. Which option do you prefer?

We believe that every effort must be made to amend the Gas Act prior to 1 April 2013 in order to maintain the current arrangements. We understand that DECC are working towards this and would urge Ofgem to provide any assistance that is necessary.

If this is not possible, whilst Option 1 would mean we incur significant cashflow issues, this would be preferable to setting a precedent that may not then be able to be unwound. Indeed, if Ofgem were to profile the catch-up depreciation to be more front-loaded this could provide the mitigation required.

Chapter 8. Dealing with uncertainty

Our comments on the individual uncertainty mechanism questions are provided below. However, given the cumulative risk of such mechanisms we believe that an overall cumulative cap of 1% of Allowed Revenue is necessary in addition to these mechanisms.

Question 14: Do you agree with our proposed revenue driver for Repex? Should the revenue driver apply to all above risk threshold tier 2 mains, or be limited to additional mains that breach the threshold during price control period, i.e. those where no funding was provided ex ante?

We believe that the industry agreed tier 2 risk threshold has established the workload in this category, and therefore it would be appropriate to include this within the ex-ante allowance along with the tier 1 mains.

The mains that escalate through the risk-action threshold during GD1, known as dynamic growth, should be funded through a unit cost mechanism based upon diameter band. It is important that we are funded to the right level of unit cost recognising that the volume and mix of diameters will grow in GD1 beyond the small and therefore unrepresentative Tier 2 (above threshold) volumes already identified in our April plan.

It is also important to note that the HSE enforcement policy requires Medium Pressure Ductile Iron that are within 30 metres to be decommissioned within the year of being identified. We recommend that this is captured via this process by treating such pipes as if they have exceeded the risk-action threshold thus being addressed by the volume driver.

Question 15 IRM: Do you agree with our proposal to restrict the reopeners for the roll-out of innovation to the two standard reopener windows, i.e. 2015-16 and 2018-19?

We do not believe that restricting the roll-out of innovation to the two re-opener windows is appropriate. The Innovation Roll-out Mechanism (IRM) is not an uncertainty; it will help the GDNs to deliver sustainable energy networks and should be allowed for on an annual basis.

Question 16 Lane rental: Do you consider a revenue trigger to be appropriate for allowing additional costs related to the implementation of lane rental schemes? In particular do you have any views on how the unit cost of such schemes should be set?

We welcome an appropriately structured uncertainty mechanism which enables GDNs to recover all efficient costs. However, the scope of the proposed streetworks mechanism must incorporate all aspects of future developments in highway legislation, roll-out of the current TMA/TSA legislation not covered by the GDPCR1 re-opener and the proposed material increases in Section 74 overrun charges.

Furthermore, we believe the mechanism needs to be flexible enough to respond to any changes in roll-out and the consequential financial risk this would pose to us. This could be addressed through either a more flexible trigger or an additional re-opener window at the mid-point review.

Question 17 Mid-period review: Do you agree with our proposed approach to addressing any changes to the HSE iron mains policy at the mid-period review, and our proposed reopener in relation to asset integrity? Do you agree with our proposed materiality threshold of 5 per cent in relation to assessing changes to costs?

Replacement Programme

We will comply with the new Health & Safety Executive (HSE) enforcement policy for the Iron Mains Reduction Programme, and will be submitting our proposed 8 year IMRP programme together with our revised management procedure for their approval prior to 31st March 2013. We are committed to working with Ofgem and HSE in progressing further work in relation to the IMRP and other pipe assets.

Asset Integrity

We do not agree that the mid point review is appropriate for asset integrity, that appropriate allowances should be set in the final proposals and that asset fault trigger mechanisms should be implemented, similar to the mechanism for dynamic growth on iron pipes in tier 2.

With respect to district governors, we proposed a fault trigger mechanism in our April business plan based upon the reliability centred maintenance system, which is well established across all gas networks for this range of assets.

For the transmission system, we have provided robust justification, evidence and cost benefit analysis, and require appropriate funding in our final proposals for the <£0.5m projects. This is covered in our response on chapter 7, Question 1 proposing a trigger mechanism to provide assurance that funding would be available to address increasing fault levels.

It is also important that the output measures are amended to reflect the changes in funding.

Question 18 *Smart meters*: Do you agree with our proposed approach to dealing with uncertain smart metering costs?

Restricting the recovery of the efficiently incurred GDN costs during the roll-out of smart meters to the two standard re-opener windows will mean that the GDNs will be left exposed to significant costs between the re-opener windows. For SGN this could be of the order of £200 m. (reference: SGN second Smart Metering study, which will be provided to Ofgem under separate cover – see below).

Whilst the re-opener windows are intended to allow the efficient costs either already incurred or likely to be incurred the timing of the proposed roll-out (as well as the very real risk of delay) will mean that we are unlikely to have even one year of activity to base our forecast of future costs upon. What is required is a more flexible trigger arrangement that allows a GDN to apply for a re-opener at any time that it can show its efficiently incurred costs will breach the threshold.

Since our April business plan submission we have carried out further survey work which verifies the initial survey findings that our costs will be material during GD1. We have discussed these findings with Ofgem staff and intend to follow-up with a more detailed paper on the latest survey in the next few weeks.

Question 19 *MOBs*: Do you consider a volume driver to be appropriate for increasing revenues as a result of work conducted on assets related to medium rise multiple occupancy buildings (MOBs)? Please provide evidence of the unit cost assumptions that should be used.

Our April 2012 plan set out baseline workloads for MOBs, split between emergency and planned work activities. These workloads reflected a mix of low, medium and high rise buildings, with work being driven by asset failure, leading to a gas emergency and also a risk based proactive approach utilising our risk assessment model on a top-down basis.

Extending the existing high rise surveys into the medium rise population will identify further work within the medium rise population that has not been recognised in our plan, and we agree that a volume driver is an appropriate mechanism for any incremental additional volumes.

In the business plan data templates, we identified costs for riser pipe installation in the 0-20m and 20-40m height bands. We believe these are a good reflection of the type of work required in medium rise buildings.

For reference, these are shown in the table below for the first year of our plan 2013/14 (at 09/10 prices, excluding RPEs and excluding productivity adjustments).

Height Band	£ per metre installed	
	Scotland	Southern
0m to 20m	Redacted: Commercially sensitive information	
20m to 40m		

These are pipe installation rates that have been developed based upon costs incurred for riser work that we have undertaken in previous years, thus normalising to some extent the extremely variable costs incurred for each individual riser.

However, the volume driver needs to reflect an output rather than an input and our April 2012 business plan proposed ‘number of risers where risk has been managed’ as an appropriate output. Based upon the analysis above, we propose the following rates per riser

Height Band	£ per riser managed	
	Scotland	Southern
0m to 20m	Redacted: Commercially sensitive information	
20m to 40m		

These rates reflect the differences in riser height and numbers of ECVs per riser in our two networks as well as the differences in other variables such as scaffolding and remediation costs.

Question 20: *Connecting large loads:* Do you consider that there should be a reopener in relation to connecting large loads?

Yes. It is important to recognise the risks associated with funding availability associated with connecting large loads. A change to allowed revenues from April 2016 and/or April 2019 is vital to ensure that funding is provided for connection of these types of load. There is no clear definition of Definition of large loads in the documentation but we would like this to include options for large consumption sites e.g. power stations, distilleries, large CHP loads / sensitive loads.

Question 21: *Xoserve:* Do you agree with our proposals in relation to uncertainty with respect to Xoserve’s costs?

In the event that the current funding / governance / ownership (FGO) review results in obligations being removed from the Transporters in relation to Xoserve provided activities it would seem appropriate that a mechanism exists to adjust the amount of funding that Transporters are permitted to collect in relation to Xoserve. Also, were the FGO review to result in no change to these arrangements and the current suite of services continued to be obligated onto Transporters to provide, then due to significant industry reform linked to smart metering / European changes that a mechanism would still be needed to re-open required Xoserve funding.

It may be the case that the FGO review results in no change as far as governance and ownership is concerned, however funding of Xoserve services is moved further into the Shipper funding arena (user Pays) then again an adjustment of the Transporter allowance may be appropriate.

Question 22: *Scottish independent undertakings (SIUs)*: Do you agree with our proposals not to introduce an uncertainty mechanism in relation to supply to SIUs?

No. We continue to believe that an uncertainty mechanism is the most appropriate way forward to address this matter.

Following closure of the Glenmavis facility, we are very concerned about the long term viability of the LNG plant owned by National Grid at Avonmouth, Bristol. As such, we are undertaking studies for an enduring solution for the supply to the SIUs.

In the interim, we will require appropriate operating costs to manage the SIUs and the supply chain from Avonmouth, prior to the introduction of an enduring solution. We will provide a 'SQ' response on this point. The safe and secure supply to our SIUs is essential and the interim solution includes provision of additional LNG storage at one of our sites near Glasgow, direct road tankering to this facility and also direct road tankering to our four SIUs from Avonmouth.

The enduring solution will require capital expenditure and on-going operating costs. We have narrowed the enduring solution down to three potential options which are discussed in more detail in the attached, confidential, annex.

Initial proposals: Outputs, incentives and innovation

Chapter 2. Environmental Outputs

We are disappointed that our proposals for promoting the connection of green gas on to the network and raising awareness of the dangers of carbon monoxide (CO) have not been taken forward. Both initiatives have the support of a broad range of our stakeholders. We believe that concerns around measurability and setting of baselines can be overcome for CO and would urge Ofgem to drive this forward through the CSIWG. In addition we consider that our green gas proposal aligns well with Ofgem's stated priority of contributing to curbing climate change and will be a valuable addition to the current proposals around biomethane information provision.

Our papers on these proposed incentives are attached.

Question 1: Biomethane information provision: We would welcome respondent's views on whether our proposed information provision draft licence condition meets the needs of potential biomethane/entry connectees.

In general we are in agreement that the proposed information provision draft licence condition will meet the needs of potential biomethane/entry connectees. The condition has been developed through discussion at industry work groups and it is important that this continues until the final versions of the documents are published under the direction and for the purposes of an annual review.

It is important that this condition be developed in a manner that does not introduce conflict and show undue preference for one category of customer relative to another. It is also important to recognise that the injection of biomethane into the gas network is at an early stage of development and the standardisation of costs and timescales may become more amenable as projects come on line.

These documents will provide connectees a high level overview of the biomethane/entry procedure and requirements and, along with a direct stimulus such as our proposals for a green gas incentive mechanism, will help lead to the development of the market for distributed gas.

Question 2: EEI/ shrinkage incentive:

(a) Should we introduce option A or option B (or an alternative) in relation to the rolling incentive mechanisms for the EEI?

(b) Should we also adopt a rolling incentive mechanism in relation to the commodity cost element of gas transport losses, ie in addition to the EEI?

(a) We are supportive of the strengthened incentive for continued improved leakage outputs that the incorporation of a roller mechanism delivers. This is an important component in ensuring that the gas customers of today can benefit from the innovative potential within all GDNs to improve their environment.

The two options proposed differ primarily in the timing of the cash flows resulting from any reward or penalty generated. We have a number of criteria which we believe are important in the final option adopted. These are as follows:

- The cumulative reward or penalty must be recognised in transportation prices during the GD1 period or in a single true up adjustment at the commencement of GD2. It is

inappropriate for customers to pay for environmental benefits achieved in GD1 out into GD2. It is also inappropriate for GDNs not to experience the impact of their GD1 actions within a similar period.

- Where possible the recovery of rewards or application of penalties should result in the least amount of price volatility possible. We feel the two options proposed both result in significant price adjustments at either the start or end of GD1. As part of the remaining discussions with Ofgem we intend to submit a mechanism which will enable GDNs to forecast the GD1 performance and recover annually, thus smoothing the effect through the period. This will incorporate a retrospective adjustment process to avoid price volatility. These proposals will be shared amongst all GDNs.
- The total rolling reward or penalty generated across GD1 through the EEI and shrinkage incentive should be derived from the applicable cost of carbon or baseline commodity unit price for 2021. This is necessary to preserve the incentive strength out across the whole period.

(b) It is entirely consistent that the commodity cost element of gas transportation losses should be incorporated within the roller mechanism. The rationale for continued incentive strength on the EEI component through a roller mechanism applies equally to the commodity targets. We support the consistent application of the roller mechanism across both facets of the narrow Environmental output measure.

Question 3: Do you have any comments on our proposed shrinkage and losses output levels?

We believe Ofgem has sought to adopt a consistent approach to matching EEI and shrinkage output targets with movements in the driving workload volumes, primarily mains replacement. The recent alterations to allowed mains workload does not permit us to make an absolute statement on the appropriateness of the proposed leakage targets as, to date, these have not been revised and provided to us for comment. However, we anticipate that if the consistency of approach continues the target output levels should be appropriate for GD1.

Chapter 3. Customer service

Question 1: We would welcome views on our proposed approach to the broad measure, namely:

(a) *Customer survey:* Our proposed weightings for different customer interactions, and scores associated with maximum penalty, target and maximum reward (see table 3.3).

We are comfortable with equal weighting across the three measured customer interactions and the defined target and maximum penalty and rewards for Emergency/Repair and Planned work. We would challenge the maximum reward and penalty for Connections defined in the IP as 7.5 to 8.5 and suggest that this should be reduced to 7.4 – 8.4 matching the methodology for Emergency/Repair and Planned work.

(b) *Complaints metric:* Our proposed weightings for each complaint element (incl. whether or not to include Energy Ombudsman findings within the metric), and score associated with target and maximum penalty (See table 3.4).

We agree with the weightings for each complaint measure in the metric except the element for Energy Ombudsman referrals found against the GDN. As demonstrated at the latest CSIWG on 10 September, the measure in its current format can result in a totally disproportionate penalty and therefore drive inappropriate behaviours to avoid complaints being referred to the Ombudsman and potentially putting us at risk of hundreds of thousands of pounds worth of

penalty when the Ombudsman can only award up to £5k. Our preferred option would be take this element out of the complaints metric and report on a reputational basis. The 10% allocated should then be added to the outstanding complaints after Day 31 element of the metric.

(c) Overall revenue weightings: we welcome views on one GDN's proposed changes to the weightings of the different elements of the broad measure revenue (see table 3.5)

We agree with the Ofgem proposal to keep the weightings on 3 elements as +/-0.5% on Customer Satisfaction, -0.5% on complaints and +0.5% on Stakeholder Engagement.

Chapter 4. Social outputs

We are disappointed that Ofgem is not proposing to expand the Discretionary Reward Scheme (DRS) as suggested in our business plan submission. Our proposal will improve the overall incentive package whilst driving further innovation; essential in the drive towards sustainable networks. We would urge Ofgem to reconsider its current position.

Question 1: We would welcome your views on the proposed number of fuel poor connections (see Table 4.1).

We are confident that we will achieve our targets for connected customers, assuming that there are no fundamental changes the scheme rules / funding to any detrimental effect during the 2014 review. We also assume that government policy changes will not have any detrimental effect. CERT and CESP disappear at end of 2012 – ECO and Green Deal replace these but we're not sure how these will affect take up rates.

The Hills Fuel Poverty Report was published in March 2012 and it is expected that Government will go out to consultation over next few weeks. Professor Hills' report proposes a new way to define fuel poverty, separating the extent of the issue (the number of people affected) from its depth (how badly people are affected). In 2015 there will be further changes to the Scottish homes quality standard. Finally, we would also welcome Ofgem's continued support should we exceed the connections volumes anticipated.

Note

Table 4.1 shows that Scotland Gas Networks will connect 11000 customers and Southern Gas Networks will connect 6400 fuel poor customers. In fact, Southern Gas Networks proposes to connect 9000 fuel poor customers.

Table A3.6 of the RIIO-GD1: Initial Proposals – Supporting document – Cost efficiency document correctly references the Southern Gas Networks volume.

Ofgem Response for Clarification / information (Ref number GD1-SGNPh4-2) confirms that no adjustment to numbers has been made.

Question 2: We would welcome your views on our proposed approach to CO issues including setting an output measure based on improving CO awareness.

We have previously proposed an incentive mechanism around raising CO awareness, fully supported by our stakeholders. As noted above, we continue to believe this is the most appropriate way to change GDN behaviour and urge Ofgem to reconsider its initial proposal.

Chapter 6. Safety outputs

Question 1: Do you agree with our proposed approach to assessing non mandatory investment in relation to Tier 2 and Tier 3 iron mains, e.g. based on a 24 year payback period, and consistent with our earlier investment appraisal guidance.

We fully support the cost benefit approach based on a 24 year payback. We also believe that we have submitted cost benefit analyses that are consistent with Ofgem's appraisal guidance. However, we do not agree with the outcomes Ofgem has proposed for our networks. Please refer to our response to Cost Efficiency Chapter 8: Replacement Expenditure; Question 3 for our position on this. We intend to bring forward additional analysis based upon pipe condition hot-spots to support our original proposals

Question 2: Do you agree with our proposed output levels in relation to risk removed (MRPS), and associated secondary deliverables (see also Appendix 7)?

We agree that the primary and secondary outputs for iron pipe risk management are appropriate and will provide a reliable indicator of the benefits of investment.

We also agree that these primary and secondary outputs should be adjusted to reflect any proposed increase or decrease in iron risk management workload on a proportionate basis.

Question 3: Do you agree with our proposals in relation to the other primary safety outputs?

We agree that the broad range of outputs proposed as 'primary safety outputs' are appropriate and will provide a reliable indicator of the benefits of investment.

However, it is essential that any proposed changes to the workloads set out in our April 2012 plan are correctly reflected in an adjustment to these output measures. In particular, any reduction in proactive pipe risk management activity will have a consequential impact on the emergency residual risk score which will increase as a consequence of reducing workload.

Furthermore, we are seeking a level playing field in other areas, in particular, a consistent requirement on all networks in terms of performance against the 12 hour repair standard.

We will continue to work with all parties on the continuing development of the asset health outputs informed by asset reliability and criticality.

Question 4: Do you agree with our proposed approach to measuring performance in relation to safety risk (see Appendix 10)?

We agree that the two tier approach to assessing performance is appropriate and that the evaluation in Tier 1 is a suitable means of determining whether a GDN has achieved its target and whether further examination of the deliverables and costs is required in the case of over/under delivery. However, with typically high workflows crossing between financial years, experience shows that delivering an exact target on any given date is impractical and can have a tendency to drive inefficient behaviours. We therefore support a suitable 'dead-band' around each output value to reflect the potentially large volumes of work in progress in addition to the inherent uncertainties in the assessment methodology.

More specifically, in relation to ‘Safety Risk’ we agree that assessing risk reduction by reference back to individual pipe risk at the beginning of GD1 is the most pragmatic approach to mitigating the effects of dynamic growth. However, we have identified at least two areas where this approach penalises correct and appropriate pipe selection behaviours:

1. A pipe currently with zero risk score (>30m from property) is affected by new build encroachment resulting in a positive risk score that potentially places that pipe in the top 20% (mandatory). In this case no risk benefit would be assigned as the point of reference would be a zero risk score. However the correct decision has been made; and
2. A pipe with a very low risk score is subject to failure resulting in it being included within the top 20% thus becoming a mandatory intervention requirement but this decision not being properly reflected in the risk output measured.

Chapter 7. Reliability outputs

Question 1: Do you agree with our proposed reliability outputs, and secondary deliverables?

In general, we agree with the proposed reliability outputs, and secondary deliverables. Regarding the outputs relating to ‘loss of supply’, we recognise that the primary output for the number and duration of interruptions is similar to that monitored under the current regime. We endorse the disaggregation of the output by cause that allows the impact of third party actions and our own mains replacement techniques (no dig) to be properly identified and itemised. We also endorse the exclusion of large events, which recognises the low scale of interruptions under normal operating circumstances and the rare, but excessive impacts from incidents such as water ingress.

Regarding ‘asset health and risk metrics’ and asset utilisation / capacity charts’; please see our response to Question 2 below.

Regarding the outputs relating to ‘network reliability’; we generally support both secondary deliverables covering offtake meter errors and fault reporting.

We understand that the volume of any offtake meter errors will be normalised by the LDZ throughput. This ensures that the importance of larger offtakes is recognised and that these are managed accordingly. We do already recognise the importance of our offtakes and we do manage them according to their size and criticality to downstream supplies.

In many cases, when offtake meter errors are identified, they span more than one financial year (for example, between annual meter validations). As such, simple annual reporting covering a defined period may not be sufficient. Ofgem already recognises this and has indicated a more complex system of monitoring over the life of any error. However, it is not clear how more than one error on more than one offtake spanning different time periods and identified at different times may be treated. We would therefore appreciate an opportunity to further clarify the reporting arrangements for this deliverable to ensure we fully understand the process and can maximise the accuracy of our returns.

The secondary deliverables covering telemetered faults, where attendance is required within 2 hours, and faults identified during PSSR inspections that give rise to ‘imminent danger’ (A1) or are ‘significant’ (A2) are appropriate and reasonable. We have already updated our systems to monitor our own performance on this basis. Again, we would appreciate some clarification as to

how faults that remain open at year end are treated. We would propose the relevant duration is captured within the year reported.

Regarding the outputs relating to ‘records and data accuracy’, we support secondary deliverables relating to the capture of mains replacement records within 42 days. The number of third party reports highlighting inaccuracy in mains location is dependent upon the volume of work undertaken by external service providers and utilities and upon the quality of mains records inherited by ourselves and is therefore not immediately controllable. Instead, we currently monitor the time taken to correct such errors, which is within our gift. Nevertheless, we do understand the benefit of such a measure in highlighting data quality and we support such a measure providing no incentives are included.

Question 2: Do you agree with our proposed approach to measuring performance in relation to asset health and risk metrics, and asset load / capacity utilisation?

We fully support the approach to measuring asset performance through a system of health asset assessment. Ofgem is aware of the detailed on-site assessments of our assets that we have undertaken to enable us to fully and accurately assess the health of our assets, especially offtakes, pressure reduction stations and governors. This data has been validated and entered into a fully functional reporting system. As a result, we are already using the data to prioritise replacement and refurbishment of our assets including inspection, remediation and painting programmes.

We have further developed the reporting system to model asset life through RIIO GD1. The system is also sufficiently flexible to reflect changes to the asset at the time that they occur. Our systems also consider complex systems such as offtakes and pressure reducing stations by assessing sub-systems. The total system is then categorised through a process of weighted averages of the relevant sub-systems. The maturity and complexity of these systems will make it difficult for us to adapt our processes should Ofgem wish to consider alternate arrangements for the assessment of sub-systems or total systems into the future.

In delivering our obligations for gas supply at the 1:20 peak condition, we recognise that each element of our system is a link in the supply chain. We therefore intend to use the health metric as an indicator as to the content of our business plan.

We endorse the use of the criticality metric in calculating overall risk and we intend to utilise this metric as a means of prioritising our workloads.

The asset load/capacity utilisation output is supported, however £2m of PRS capacity upgrades have been disallowed and the output measure will have to be reviewed in light of this.

Chapter 8. Encouraging innovation

Question 1: We welcome your views on the proposed level of funding for the licensees’ NIA, based on the quality and content of their innovation strategies.

Since the Innovation Funding Incentive (IFI) was first introduced by Ofgem in 2007 we believe it has played a valuable role in promoting new, innovative projects and have used this fund to innovate in areas that deliver substantial technological advancement and environmental benefits, ultimately delivering value to the consumer.

It has taken time to establish structural and cultural change within our business, whilst developing working relationships with project partners, within the UK, Europe and the rest of the world. The IFI has stimulated innovation in gas distribution into a growing sector with an ever increasing diversity of project partners.

Our appetite for innovation has grown during the current price control period and we have led the gas industry in areas such as bio-methane injection and self isolation & restoration, and we are committed to developing innovative solutions to operating and maintaining our networks.

We have learned through the projects we have undertaken and the partnerships we have established, such that we are confident we are highly capable of delivering successful projects. Innovation is truly becoming 'business as usual' for us and we are now projecting expenditure above our current allowance and looking to continue this momentum into RIIO-GD1.

Having listened to the feedback from Ofgem, customers and other stakeholders in this area, we accept that our innovation strategy was not as clearly defined as it could have been in our business plan submissions. We intend to provide Ofgem with a breakdown of our target innovation areas and their value, planned future projects and their estimated cost up to 2015 under separate cover. This submission will be confidential as we have a number of confidentiality agreements associated with live and future projects. Within our proposals for NIA there is a clear focus on incremental innovation; more radical innovation projects will be developed for the Network Innovation Competition (NIC) as soon as it is able to start.

We believe this proposes a well balanced selection of target areas and projects allowing us to explore and develop new concepts, strategies, products and techniques, which, underpinned by our commitment to knowledge dissemination, will provide positive contributions to the challenges faced by the UK energy sector as a whole, both today and in the future.

If innovation is to deliver sustainable energy networks we believe that the NIA should be set at 1% for ourselves, and indeed for all GDNs. Given that the NIA is on a 'use it or lose it' basis setting it to 1% across the board will not mean any additional risk for customers; but it will mean that all GDNs have a strong incentive to trial and test innovative products that could reduce cost, improve efficiency and help to deliver sustainable networks.

Question 2: In relation to funding the NIC for 2013-14, do you support either option 1 (run the NIC and raise the required funds from the winning licensees' customers) or option 2 (no NIC, but roll-over funds to 2014-15). If NIC is delayed beyond 2013-14, what option would you support?

It is disappointing that the NIC cannot be run for gas as it will be for electricity in 2013/14. However, given where we are, and the need for the GDNs to apply innovation to deliver sustainable networks, our preference is for Option 1.

We believe that every effort must be made to ensure the correct funding of NIC post-2013/14. If any further delay becomes likely then we believe the overall funding of the NIC will have to be reviewed.