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30 August 2013

Dear Paul,

Consultation on Ofgem's proposal to modify Gas Distribution Special Conditions

We welcome Ofgem's continued commitment to correct and update Network Licence Conditions and supporting Financial Handbook. These iterations continue to highlight the need for further updates, ensuring consistency and quality across this area. Throughout this and all future review processes we will continue to play an active part and are happy to provide a range of comments on the proposed modifications to our current Special Conditions.

In the comments which follow we outline a number of concerns or issues identified within the proposed modification to the GD1 Gas Distribution Special Conditions as indicated in Ofgem's Notice under s23(2) Gas Act 1986 (24th July 2013).

Our response links the proposed changes set out in Appendix 1 to the Authority's Notice with the tracked changes in the GD1 Price Control Financial Handbook, appendix 4, and highlights any inconsistencies with the latest Legacy Workbooks, issued 30th July 2013.

Where the intent and meaning contained within the GD1 Price Control Financial Handbook does not appear to have been replicated in the treatment of legacy adjustments within the respective workbook it is essential to discuss these issues further with Ofgem to ensure a satisfactory resolution. In particular we believe there is a pressing requirement to resolve the treatment of Tax adjustments as an industry group working closely with Ofgem. We believe the issues created by some of the adjustments made prior to the commencement of GD1, in particular the adjustment to Regulatory Tax Losses in respect of Pension True up calculations, remain very material and can be best resolved by further dialogue.

SGN's representation on the proposed licence modifications

1. **Additional component terms for legacy price control adjustments – IFIAR and IAEAR**
   We are supportive of the inclusion of the two additional terms, IFIAR and IAEAR, within Licence condition 3A as appropriate mechanisms to adjust for know errors in GDPCR1 allowances and legacy Income Adjusting Event determinations.

   In reviewing the new Financial Handbook section 10, Part 8, 10.117-10.122, in conjunction with the latest Legacy Workbooks, issued 30th July 2013, we have identified a number of issues as outlined below:
   - IAEAR – Legacy Workbook: in the calculation of the IAEAR variable only 50% of the incentivised repex element has been included in the total revenue adjustment. This should reflect 50% of the total Repex determination, including non-incentivised repex. The Financial Handbook, 10.122 (c), appears to be correct in defining that 50% of the step 1 total repex costs are collated on the IAEAR tab.
   - IAEAR / CAR – the Financial Handbook correctly indicates that the IAE allowance adjustment for capex will be collated on the CAR worksheet. It is also correct to collate the IAE allowance adjustment for the non-incentivised repex element on the CAR worksheet. This has been done in the Legacy Workbook but is not reflected in the Financial Handbook, section 10.122 (C).
   - IAEAR / CRAV – the Financial Handbook correctly indicates that 50% of the IAE allowance adjustment for repex should be collated on the CRAV worksheet. The Legacy Workbook only draws 50% of the incentivised IAE allowance determination through to the CRAV worksheet. This should be 50% of total repex.

2. **Existing component terms for legacy price control adjustments**
   The following inconsistencies were noted between the intent of the Licence Conditions, the Financial Handbook and the Legacy Workbook.
   - Financial Handbook, 10.20. The current version refers to the one year price control for 2006-07 and the GDCPR1 price control 2007-2013. The dates included are not consistent with the one year price control 2007-08 and GDPCR1, 2008-2013.
   - TAR – In the latest Legacy Workbook for Southern the Notional Gearing has been set at 60%. This should be corrected and be consistent with the Scotland gearing of 62.5%.
   - CAR – We are pleased to note our earlier comments suggesting the inclusion of IAE allowances into the CAR calculation were adopted in this version of the model and Financial Handbook. However this is only appropriate in the calculation of the 'Desired RAV additions gain' (RAV performance post incentive) element. In calculating the 'Depreciation and Revenue earned' on the RAV difference in GDPCR1 the calculation should be based on the base revenues as set out in GDPCR1 and not the IAE adjusted base revenues. A GDN will not have collected depreciation and allowed return on the IAE proportion and therefore it is inappropriate to adjust the Capex incentive scheme adjustments for this. The Financial Handbook methodology should also be amended to reflect an adjustment to base allowances for the RAV additions gain but not for the Depreciation and Revenue earned'.
   - CAR – Financial Handbook section 10.77. We believe the bullet which currently reads; 'outturn repex expenditure' should be amended to 'outturn non-incentivised repex expenditure'.

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- MRAV – We note that in the Legacy Workbooks for Southern and Scotland GDNs the MRAV incentivised repex allowance, excluding IAEAR adjustments are set to £0m per annum during GDPCR1. In the latest iteration of the workbook the Actual incentivised repex workload is to be input. The GDPCR1 Incentivised Repex allowance has not bee populated in the MRAV tab of the workbook and therefore if, as directed by the blue cells the total annual workload adjusted incentivised Repex for either 2012/13 or the cumulative GDPCR1 value are entered into this section of the calculation the movement in GDN RAV will be a very material number. We do not believe this is in keeping with the process outlined in the Financial Handbook, section10.86 (C). To correct this total incentivised GDPCR1 repex allowance, including IAE determinations, should be compared to the actual workload adjusted repex allowance, adjusted for IAE determinations. The difference, where actual is greater than allowance, should be deducted from the opening RAV post IQI.
- FRAV / FAR – In reviewing the Legacy Workbooks provided we note that the adjustment to RAV in relation to additional customer discounts for community schemes has not been included in the calculation of the Fuel Poor RAV additions. This information has been provided in section 3.17 of our annual RRP returns and, in accordance with 10.56 of the Financial Handbook, should for part of the GD1 opening RAV adjustment. We would ask this is addressed prior to the 2013/14 legacy adjustment process.
- FRAV – In the Legacy Workbooks, issued 30th July 2013, we note that the calculation of FRAV is dependent on comparing the post 2012/13 actual Fuel Poor, including additional customer discounts, incurred with any adjustments made to the financial model at Final Proposals. However the current formula (FRAV cell AG33) simply duplicates the adjusted Fuel Poor RAV and therefore the FRAV calculation (line 35) can not return any other value than £0. We would ask this is addressed prior to the 2013/14 legacy adjustment process.
- IFIAR – In the Legacy Workbooks, issued 30th July 2013, we note that the Eligible IFI expenditure for 2012/13 (IFIEt) is not shown in blue as a variable to be updated for actual expenditure incurred and reported. We would ask this is addressed prior to the 2013/14 legacy adjustment process.

3. Proposed amendments to Financial Handbook

Chapter 3 - Pensions

- We have previously indicated that the principles and calculations for adjustments to Pension allowances laid out in this section of the Financial Handbook appear consistent with our understanding of the correct methodologies. In doing so we have also highlighted that the inclusion of Corporate Tax adjustments within the process appears to be an unnecessary step in the calculation.
- In the latest amended version of the Financial Handbook we are encouraged to note that in tables 3.2 and 3.3, sections 1-9, references to Corporation Tax have been removed. However we also note that an overarching reference to necessary adjustments for Corporation Tax has been inserted in step 10 of these tables.
- We believe that the adjustment of revenue for Pension allowances, independent of whether this is an over or under recovery and regardless of whether the entity currently pays tax or not, should be made excluding Corporation Tax.
- Given this is a complex and material issue and as the logic for making Corporation Tax adjustments impacts a number of other areas in the Financial Handbook we

would seek to work with Ofgem to resolve this issue in the short term with any necessary amendments being made to the Financial Handbook at that time.

4. Proposed amendments to Special Conditions

- In addition to the comments made in respect of the amendments to the Financial Handbook and Legacy Workbook models the following represents comments on the proposed amendments outlined in Appendix 1 to the Notice.
- 1D, Appendix 2 – NTS Exit Capacity Cost Adjustment. The indicated amendment of the term NTSTVEv,t in the table header to NTSTVgv,t would appear to amend the term to a form which is not recognised nor defined in Special Condition 1D.1 through 1D.20. The definitions and use of variables in the condition should remain consistent with their reference in a supporting appendix.
- 1F.14. Revenue adjustments for performance in respect of gas Shrinkage and environmental emissions. The proposed amendments replacing MWh with GWh should require a multiplication of Carbon values of 1,000 and not 100 as indicated. This would otherwise significantly distort the magnitude of the total Leakage incentive adjustment.

Should you have any further questions on our response please do not hesitate to contact me at michael.ferguson@sgn.co.uk

Yours sincerely,

Michael Ferguson
Regulation Manager, Finance

cc. Mick Watson
cc. Joanna Campbell