Angus McIntosh
Scotia Gas Networks
Axis House
5 Lonehead Drive
Newbridge, Edinburgh
EH28 8TG

Direct Dial: 020 7901 1851
Email: dora.guzeleva@ofgem.gov.uk

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Dear Angus,

Decision to approve changes to Scotia Gas Network's Gas Network Innovation Competition project – Opening up the Gas Market

This letter contains our[1] decision to approve the change request for Scotia Gas Networks (SGN) Gas Network Innovation Competition (Gas NIC) project, Opening up the Gas Market (the Project).

We have approved this change because we think it is in the best interests of customers and consistent with our principal objective under the Gas Act 1986 and our general statutory duties. The change will allow the project to continue to deliver value for money to customers.

Background

On 19 December 2013, we issued a Project Direction[2] to SGN. The Project Direction contains the terms to be complied with by the Project as conditions of it being funded under the Gas NIC.

Part of the Project involves injecting gas which is not currently compliant with the requirements of the Gas Safety Management Regulations 1996 (GS(M)R) into the Oban network for one year. SGN will have to contract with a shipper to secure the supply of LNG, which is purposely non-compliant with GS(M)R, from Europe to the network in Oban for one year.

Change request

In July 2014, SGN requested us to approve a transfer of funds between cost categories in the Project budget to cover additional costs to secure the LNG contracts. Following a detailed procurement process, SGN found that the overall cost of the shipping contract would be significantly higher than the initial amount allocated (a revised cost of £260,000 compared with an original budget of £15,000).

The breakdown of the overall cost of the LNG purchase is made up by a management fee and a balancing fee. We understand that in the full submission, SGN accounted for the balancing fee only, calculating this figure based on its estimate of the potential worst case

[1] The terms "the Authority", "Ofgem", "we", "us" and "our" are used interchangeably in this letter. The Authority is the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.
[2] Terms not defined in this document shall have the meaning given to them in the Gas NIC Governance Document.

difference between the cost of gas at Zeebrugge and the GB National Balancing Point for 2,000 tonnes of LNG for one year.[3] As a result of work completed to date, SGN has now calculated that the cost of the LNG contract will be approximately £260,000, with this difference driven by the management fee. SGN states that it had no accurate way of predicting the management fee without reaching an advanced stage of contract negotiations with the potential shippers.

During the testing phases of the Project SGN will be replacing any non-compliant appliances. The cost of appliance replacements is covered by the 'Equipment' cost category, with £575,000 allocated within the category for this. SGN now anticipates that, based on the results from the Stage 1 testing in the Project, the appliance replacement costs will be much lower than budgeted for and these savings could be transferred to cover the LNG contract costs. SGN asked for an approval of a proposed transfer of £245,000 of the appliance replacement fund currently within the 'Equipment' cost category into the 'Payments to Users' cost category to cover the additional cost of the LNG contracts.

We were concerned about allowing SGN to transfer funds from the appliance replacement category because SGN stated in its Full Submission that "*the substantial costs for the project arise from the appliance testing and replacement. Therefore SGN, in collaboration with Kiwa, has estimated a worst case scenario for appliance replacement, i.e. % of the appliances in Oban will need [to be] replaced. If we need to replace less appliances than what we have budgeted for, then SGN will return to Ofgem the difference in monies requested."* We were not convinced that savings from the appliance replacement money should be transferred and spent on another part of the project since these savings were planned to go back to customers. In response to our concern, SGN said that based on the initial appliance survey and laboratory testing results there is likely to still be a significant sum of money returned to customers irrespective of the LNG contract costs.

Decision

Following further questions to and discussions with SGN, on 25 February 2015 SGN submitted the final version of the change request. We have decided to approve this request based on the updated change request. The updated change request seeks an amendment to the funding arrangements set out in the Project Direction and seeks permission for SGN to itself fund the cost of the LNG shipping contract until such time that Stage 3 of the project is complete.[4] If Stage 3 of the project is successfully completed, SGN will be able to recover these funds from the Project Bank Account. If Stage 3 is not completed successfully, SGN will bear the cost of the LNG shipping contract. No change to the overall project budget is required. SGN accepts this option would also mean that two Successful Delivery Reward Criteria (SDRCs numbers 9.1 and 9.4)[5] cannot be met, potentially reducing the reward available under the Successful Delivery Reward mechanism.

We consider this change is in the best interest of customers as it will allow the project to continue and achieve its objectives. There is no increase in the total cost of the project, the GB cost benefit case is unchanged and the micro cost benefit case remains positive (£956,616 per annum).

We are satisfied that the risks to customers associated with this change have been mitigated. SGN is demonstrating its commitment to the project by funding the cost of the LNG shipping contract at its own risk until the one-year trial is completed, thus reducing the risk to the GB gas consumer of funding this change but not seeing the results of the full trials. Furthermore, National Grid has taken the decision to close the Avonmouth facility earlier than anticipated by SGN (in 2016), which could present a risk to the security of supply to the Statutory Independent Undertakings (SIUs, which include Oban), in the near

[3] The National Balancing Point (NBP) is a virtual trading location for the sale and purchase and exchange of UK natural gas.
[4] Stage 3 involves SGN injecting non-GS(M)R specification gas into the Oban network for a period of one year.
[5] SDRC 9.1 relates to arranging the supply chain and shipping arrangements for LNG and SDRC 9.4 covers testing of all affected appliances in Oban.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

term.[6] In a letter we received from SGN on 23 January 2015 it said that *"availability of results from the one year trial in 2016 may lead to improved security of supply and reduced costs by informing the case for wider roll out of the solution in the other mainland SIUs, as well as Oban."*

In accordance with Section 15 of the Project Direction, we hereby amend Annex 1 to the Project Direction in the manner set out in the Schedule to this letter. By approving this change we are not making an evaluation of SGN's overall management of the project.

This letter constitutes notice of reasons for our decision pursuant to section 38A of the Gas Act 1986.

Yours sincerely,

Dora Guzeleva
Head of Networks Policy: Local Grids
For and on behalf of the Authority

[6] The Avonmouth facility is the only GS(M)R complaint LNG storage and tanker loading facility in GB and is currently used by SGN in transporting LNG to the SIUs.

Appendix 1 – Amendment to the Project Direction Annex 1: Project Budget

ANNEX 1: PROJECT BUDGET

Cost Category	**Cost (£)**
Labour	£266,000
Equipment	~~£1,123,000~~£878,000
Contractors	£471,000
IT	£0
IPR	£0
Travel & Expenses	£12,000
Payments to Users	~~£15,000~~£260,000
Contingency	£0
Decommissioning	£0
Other	£235,000
Total	**£2,122,000**