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Graham Craig
Utility Regulator
Queens House
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26 April 2018

Dear Craig,

<u>WTL Facilitating Pre-Construction Financing</u>

Please find attached our response to the Utility Regulators proposed modification of the Gas Conveyance Licence held by West Transmission Limited under Article 14(2) of the Gas Order.

We would like to express our support for the proposal of put forward by West Transmission Limited to seek early financing and will continue to play an active role to facilitate this.

In the table below we have attached our observations on the proposed licence modifications and we would be happy to discuss them with you further.

Yours sincerely,

David Handley
Head of Regulation
SGN

Gas to the West – Response to Authority consultation on proposed changes to WTL's licence by SGN

Background

1. The Authority has amended WTL's HP Licence to enable West Transmission Limited (**WTL**) to obtain financing in advance of construction of the HP Pipeline.

2. On 28 March 2018, the Authority launched a consultation in relation to the proposed modifications.

3. Scotia Gas Networks (**SGN**) has an interest in the proposed HP Licence modifications and sets out its formal response to the proposed modifications below.

4. Save where stated otherwise, defined terms are as used in the HP Licence.

Summary of key comments/ questions on consultation

1. The HP Licence is very helpful, but SGN have seen a model provided by WTL and would like the assurance that this is the same model the Authority recognises. This way, all of us can coalesce around the same numbers. For example, the consultation document in the text suggests there will be no return relating to capital after 21 months after the First Operational Commencement Date. However, the Capitalised Interest appears to apply a return equivalent to the Base Return from the First Operational Commencement Date up to the Cut-Off Date. SGN needs to understand what return the Authority intends to apply to the capital incurred, as SGN believes that it should receive a return on capital spent, regardless of whether the capital was spent before or after 21 months following the First Operational Commencement Date. This would be the same position as in the original HP Licence and would enable SGN to recover some of the financing costs incurred in relation to that capital.

2. ***Fixed and Capped Sums*** – It is unclear why these concepts are needed in Part 4, as well as Part 6 (the latter of which is supposed to be switched on in light of the new financing model). There also appears to be no limit on the use of these concepts and no need for consultation with WTL. It could be further clarified how they operate with the pain/gain mechanism (although this is clearer now that they are determined at the same time as the Verified Controllable Capital Forecast (VFCE), meaning that the verified and actual figures considered in the pain/gain mechanism should be the same). In addition, we would argue that the principle that any deviation from the sums incurred has to be justified on gas pipeline engineering and cost control principles should also extend to Fixed Sums/ Capped Sums. We have been told these sums relate to two specific sums in the VFCE, the SGN margin and project management costs. SGN will require a letter of comfort to offer reassurance on this point.

3. ***Capitalised Interest*** – An amendment appears to be required to the formula to prevent it cancelling itself out.

4. ***Grant*** – The new grant wording in Part 6 requires further clarification. In particular: (i) why the new title Grant Funding is used instead of Grants Received, while reference is still made to grant monies received; (ii) why new wording has been added in the m=p element of the formula.

5. ***Change of Law*** – The definition could be wider (e.g. what happens if there is a change in the interpretation rather than the wording of a law).

6. ***Amendment of Verified Controllable Capital Forecast*** - This clause needs to deal with more likely scenarios, for example: (a) at the Cut-Off Date, work is ongoing on a project, but just not completed; (b) there has been an exchange of one activity for another at a different price point; and (c) steps x and y (say with a landowner) will have been considered at the time, but then circumstances will have altered so that some steps or some different ones may have happened. The current language is too absolute to cater for that and should be amended accordingly. Please see Appendix 1 for our suggested alternative drafting.

Detailed analysis of the HP Licence modifications

	Reference	Description	Summary of provision	Comment
1.	**Part 4** **4.1.3**	Eligible Pass-Through Costs	The opening wording has been adjusted to say: Eligible Pass-Through Costs means, "in respect of any Gas Year following the First Operational Commencement Date, the sum of such costs as <u>the Authority determines</u> have been incurred by the Licensee during that Gas Year in relation to:..*[categories are listed]*"	While we assume that this has been added for clarity (the consultation document notes that the underlying policy has not changed), we note that it could be interpreted as giving the Authority additional scope to reject relevant costs and suggest that this is clarified.
2.	**Part 4** **4.2.2** and **4.2.3** (please also note **4.2.1(f)**)	Fixed Sum and Capped Sum concepts and Actions taken before Part 4 comes into effect (impact on Verified Controllable Capital Expenditure Forecast and Actual Controllable Capital Expenditure)	Under 4.2.2, the Authority may determine that the Controllable Capital Expenditure associated with specified activities or categories of activity is to be subject to the application of a Fixed Sum or Capped Sum. A Fixed Sum shall apply regardless of the actual expenditure incurred. If a Capped Sum applies, WTL will be able to recover the lower of the	We would note that: (a) 4.2.2 and 4.2.3 raise the prospect that WTL might not recover the whole amount incurred. The draft text does not clearly restrict the categories which the Authority may fix or cap, or otherwise define the scope of these concepts (at 4.2.1(f) or elsewhere); (b) there is a lack of clarity as to how the Fixed/Capped Sums interact with

			sum actually incurred or the capped sum. Under 4.2.3, the Authority can make a determination regarding a Fixed Sum or Capped Sum before Part 4 comes into effect and it shall be treated as if made under Part 4. Under 4.2.1(f), the Authority may make amendments to the Total Controllable Capital Expenditure figure if (amongst other things) it is necessary to give effect to a Fixed Sum or Capped Sum. In such circumstances, the Authority does not have to justify their amendments on the basis of "established gas pipeline engineering and cost control principles".	pain/gain (although this is now determined at the same time as the Verified Controllable Capital Expenditure Forecast, so it appears that it will mean that the verified and actual amounts should be the same, so no pain/gain should apply). Should the pain/gain mechanism come into effect before any cap is imposed? It is worth further clarifying how the concepts fit into the Allowed Capital Expenditure Formula at 4.5.6; (c) capped sums (assuming these relate to design and project management) should still be subject to "established gas pipeline engineering and cost control principles"; The key point in relation to Fixed/ Capped Sums is that they should relate solely to contingency and project management costs. SGN will require a letter of comfort to offer reassurance on this point
3.	**Part 4** **4.5.7**	Capitalised Interest	Formula for capitalised interest, including CEm (the Actual Capital Expenditure in month m).	We would suggest that '-CEm' should be replaced with '+CEm' in the second term of the formula (otherwise it cancels itself out).
4.	**Part 4** **4.5.8**	Grant	The wording of 4.5.8 is consistent with the wording in the current licence, referring to the present value at FOCD of grants received.	We note that this wording lacks clarity (i.e. what/when is a grant received), although we note the amendments to the equivalent grant

				wording in Part 6 which aim to give some clarity. We note that the consultation document suggests that the wording at 4.5.8 should refer to where this month is before the FOCD (as in the new Part 6 below), but the actual text does not appear to reflect this.
5.	**Part 4** **4.7.4**	Definition of 'Controllable Operating…'	The title cuts off half way through.	The following wording should be reinstated in the title: "…Expenditure and Uncontrollable Operating Expenditure."
6.	**Part 6** **Definition**	Cut –Off Date Pre-determined Cut-Off Date 30 months after the First Operational Commencement Date.	The 'Cut-Off Date' means the date which falls 30 Months after the First Operational Commencement Date.	We support a set cut-off date and this update reflects earlier comments.
7.	**Part 6** **6.2.1**	Provisional estimate at 21 months Provisional estimate by the regulator 21 months after the First Operational Commencement Date	Under 6.2.1(d), the Authority is required to submit to WTL figures for the 'Provisional Controllable Capital Expenditure' and 'Provisional Uncontrollable Capital Expenditure' 'by a date which falls no later than 21 months after the First Operational Commencement Date'. The Provisional Controllable Capital Expenditure is 'the sum of (A) the Authority's assessment, having regard to the information available to it, of the expenditure incurred by the Licensee prior to that date that will constitute part of the Actual Controllable Capital Expenditure in accordance with paragraph (e); and	We note that: (a) the interaction between provisions 6.1.2(d) and (e) could be clarified further. In particular, the reference in (d) to 'in accordance with paragraph (e)' might more accurately refer to 6.2.1(e) to (h), which together govern what the actual sums agreed to will be; (b) 6.2.1 (d) (ii) - the language is too absolute in this and following clauses. "…will be…" is a very high bar and we consider everyone would be better served if this said "is likely to be";

			(B) the Authority's assessment, having regard to the information available to it, of the expenditure which it is satisfied will be incurred by the Licensee on and from that date but prior to the Cut-Off Date, and which will constitute part of the Actual Controllable Capital Expenditure in accordance with paragraph (e)..." Equivalent provisions apply in relation to Provisional Uncontrollable Capital Expenditure. Then, under 6.2.1 (e), WTL submits evidence of sums actually incurred. The Authority audits this and, by no later than the Cut-Off Date, either approves it or says if it requires amendment. If the Total Controllable Capital Expenditure does require amendment, the Authority's reasons must be based on 'established high pressure gas pipeline engineering and cost control principles', save where the amendment relates to the application of any Fixed Sum or Capped Sum. The Total Uncontrollable Capital Expenditure can be amended if costs were incurred outside of the accepted categories. The Actual Controllable Capital Expenditure may be found to be less that the Provisional Controllable Capital Expenditure in certain circumstances (if the Authority issues a notice varying the Verified Controllable Capital Forecast, in which case the Authority may (after	(c) it should be clarified how the 28 day consultation period under 6.2.1(g) interacts with the 30 month Cut-Off Date. Is the whole audit and assessment process intended to be completed before the 30 month Cut-Off Date? This could be a particular concern if these need to be receipted and paid invoices rather than incurred costs (as there could be a significant time lag associated with chasing smaller suppliers).

			consultation with the Licensee) determine the Actual Controllable Capital Expenditure at such level as it considers to be appropriate to take account of that fact). The Actual Uncontrollable Capital Expenditure shall not be less than the provisional estimate. (6.2.1(f) to (h))	
8.	**Part 6** **6.2.1(i)**	Amendment of determination of Verified Controllable Capital Forecast Authority can amend its determination of the Verified Controllable Capital Forecast to take account of capital expenditure included in the original forecast, but not actually incurred prior to the Cut-Off Date. If such expenditure then occurs, it will be an Eligible Pass-Through Cost (and will be part of WTL's Actual Required Revenue in a Gas Year).	Under 6.2.1(i), the Authority may, following an audit, by notice to the Licensee, vary the Verified Controllable Capital Forecast in a manner that reduces the Verified Controllable Capital Forecast by such an amount as in the opinion of the Authority: (a) relates to costs associated with activities that were taken into account by the Authority both in the Verified Controllable Capital Forecast and in determining the Provisional Controllable Capital Expenditure, in each case as being activities remaining to be carried out by (or on behalf of) WTL after the date of that approval or determination; (b) (1) the activities have not been carried out/ costs not incurred, (2) no other activities of substantially equivalent effect have been carried out and the costs associated with such other activities have not been incurred, (3) no alternative steps have been taken which have the effect (without any adverse consequences) of avoiding the need to carry any such activities as are referred	We would note that the draft talks about "no other activities", "no" alternative steps having been taken and without "any" adverse consequences. In reality, this clause needs to deal with more likely scenarios. The first is at the Cut Off Date there has been an exchange of one activity for another at a different price point. Or for example, steps x and y (say with a landowner) will have been considered at the time, but then circumstances will have altered so that some steps or some different ones may have happened. The second is that following further diligence not all steps have been undertaken because it has been determined that these steps are not required. For example, if it was originally envisaged that a fence required 100 rivets, but during construction, because of more efficient ways of working, it became apparent that 75 rivets was sufficient. The additional 25 rivets would not be included in the fence, and under the current drafting that could potentially been classed as the work being

			to in sub-paragraphs (1) and (2), and the costs associated with such alternative steps have not been incurred; (c) if any of the activities are subsequently undertaken and the costs incurred, these will be recoverable as Eligible Pass-Through Costs (the amended definition of 'Eligible Pass-Through Costs' allows for this.) WTL is to be given the opportunity to comment on any proposed amendment.	incomplete. We think it would serve everyone better to have those concepts included. The current language is too absolute to cater for that and should be amended accordingly. Please see Appendix 1 of this document for our proposed alternative wording for 6.2.1(i).
9.	**Part 6** **6.2.2** (please also see **6.2.1(g)**)	Fixed Sums and Capped Sums	Under 6.2.2, at the same time as approving/ determining the Verified Controllable Capital Expenditure Forecast, the Authority may determine that the Controllable Capital Expenditure associated with specific activities is to be subject to a Fixed Sum (whatever the cost) or a Capped Sum (with the lower of the cap or the sum incurred being recognised). The Fixed Sum and Capped Sum are also relevant for the determination of the Actual Controllable Capital Expenditure. Under 6.2.1(g)(ii), the Authority may make amendments to the Total Controllable Capital Expenditure figure if (amongst other things) it is necessary to give effect to a Fixed Sum or Capped Sum. In such circumstances, the Authority does not have to justify their amendments on the basis of "established high	We would comment that: (a) as under Part 4, there do not appear to be any clear parameters regarding the circumstances in which the Authority can make such determinations or definitions beyond references at 6.1.2 to the substantive provisions (although we understand the Fixed Sum is designed specifically to deal with the SGN £10.8m and the Capped amounts PM costs. Is that the case?) In addition, there does not appear to be a clear consultation process with WTL as to what Fixed/Capped Sums would be. This opens up the possibility that WTL may not be able to recoup its full costs in relation to various heads of loss. The Fixed/ Capped Sum concepts should only be exercisable in specific circumstances and not generally; (b) it needs to be clarified that Fixed and

			pressure gas pipeline engineering and cost control principles".	Capped do not cut across pain/gain and only relate to the two categories mentioned above. It is important this is the case and SGN do require assurance on this. (Under 6.5.5 (allowed capital expenditure), pain/gain will apply to Actual Controllable Capital Expenditure against the Verified Controllable Capital Forecast. There now appears to be some clarity here, as the Fixed Costs/ Capped Costs decision is made at the same time as the determination of the Verified Controllable Capital Forecast, so the Authority will know how much to attribute to it and there should be no discrepancy between verified and actual costs. However, the intended application of these concepts still needs to be clarified. In particular (a) should the pain/gain mechanism come into effect before any cap is imposed?; (b) SGN would like further clarification on how the concepts fit into the Allowed Capital Expenditure Formula at 6.5.5; (c) fixed/capped sums should still be subject to "established high pressure gas pipeline engineering and cost control principles". On a minor point, we note that 6.2.2(a) refers to 'Verified Controllable Capital Expenditure Forecast', rather than 'Verified Controllable Capital Forecast'. This appears to just be a typographical error, but the Authority should confirm that there is not intended to be any

				difference in the concept. The key point in relation to Fixed/ Capped Sums is that they should relate solely to contingency and project management costs. SGN will require a letter of comfort to offer reassurance on this point
10.	**Part 6** **6.2.4**	Change of Law Restricted to the impact of changes to Capital Expenditure. The Authority will be permitted to amend its determination of Verified Controllable Capital Forecast.	The change of law provisions apply if the Authority determines, prior to the Cut-Off Date that: (i) there has been or will be a Relevant Change of Law; (ii) Controllable Capital Expenditure has been or will be (prior to that date) incurred as a direct consequence of the Relevant Change of Law and either (1) there is no provision in the Verified Controllable Capital Forecast or (2) as a result of the Relevant Change in Law, the cost is greater; (iii) having regard to all the circumstances, it is appropriate to amend the Verified Controllable Capital Forecast 'in order to ensure that the financial position and performance of the Licensee, acting efficiently, will be, so far as is reasonably practicable, the same as if the Relevant Change of Law had not taken place'. Where the paragraph applies, the Authority <u>may</u>, prior to the Cut-Off Date, determine that the Verified	We note that: (1) the definition of Relevant Change of Law may not be wide enough – for example, query whether it covers a change in interpretation of the law; (2) it appears from the consultation document as if, in other licences, the concept is not restricted to its effect on capital expenditure (so should it be restricted here?)

			Controllable Capital Forecast shall be amended and may, by direction, make consequential amendments to Part 6 by direction. The Authority can only apply the whole provision either on application by the Licensee or otherwise following consultation with the Licensee.	
11.	**Part 6** **6.5.4**	OAV OAV is key, as is supposed to equal the payment that WTL is permitted to make to SGN for the G2W network.	OAV = A + Base Return + Supplemental Return. A = Allowed Capital Expenditure (Verified Controllable Capital Forecast + Pain/Gain + Actual Uncontrollable Capital Expenditure) + Capitalised Interest – Grant Funding + Early Sectional Completion	We note the addition of the Base Return and Supplemental Return components. As noted above, the impact of the Fixed/ Capped components and the interaction with pain/gain could be made clearer.
12.	**Part 6** **6.5.6**	Capitalised Interest	Formula for capitalised interest, including CEm (the Actual Capital Expenditure in month m).	We would suggest that '-CEm' should be replaced with '+CEm' in the second term of the formula (otherwise it cancels itself out).
13.	**Part 6** **6.5.7**	Grant Funding	The grant wording in 6.5.7 is slightly different to its equivalent in Part 4, as follows: (a) title/ reference to Grant Funding (rather than Grants Received); (b) no reference to 'present' value of the grant at FOCD; (c) m=p has been amended to refer to: "the first month in which <u>an amount of </u>capital grant is received by the Licensee <u>where this month is</u>	We would note that: (a) it is unclear what the intention of the change of title denotes while the text still refers to 'the amount of capital grant actually received'; (b) it is unclear why the m=p wording has been amended in this way. This is stated at 5.36 of the consultation document to provide clarification that the first part of the funding formula relates to the scenarios where the first month in which an amount of

			before the First Operational Commencement Date".	capital grant is received before the FOCD.
14.	**Part 6** **6.5.8**	Definition of 'Early Section'	"Early Section" is defined as: "a Section which has been constructed and: (a) in relation to which a gas supplier or gas shipper is able to book capacity, pursuant to the provisions of the Network Code, in respect of a date which is prior to the First Operational Commencement Date; or (b) which the Authority has otherwise, in a direction issued for that purpose, deemed to be operational with effect from a date prior to the First Operational Commencement Date, but such that that Section shall be treated as an Early Section for the purposes of this Part 6 only on and from the date applicable in accordance with paragraph (a) or (b) (as the case may be)."	We would propose deleting limb (b) of the definition.
15.	**Part 6** **6.10**	Shadow Price Control	6.10 relates to determined and actual Controllable Operating Expenditure. The provisions of Part 6 generally follow Part 4, save that it is clarified to have no impact on the calculation	We would query why this is now required in Part 6. Under Part 4 it is required as part of the Approved Surplus calculation. However, there is no Approved Surplus under Part 6, and the consultation document (at 5.90) notes that this is separate from the Actual Required Revenue and will have no impact on the regulatory regime, so

			of the Actual Required Revenue in condition 6.4.	this wording appears redundant.
16.	**Part 6 - general**	Use of 'high'.	N/A	The use of "high" in terms of pressure now appears inconsistently in the licence (e.g. the reference to "high pressure" gas pipeline engineering and cost control principles in Part 6, but no reference to "high pressure" in the equivalent wording in 4.2.1(f)). We suggest that this is clarified.

Appendix 1: Suggested drafting for 6.2.1(i)

6.2.1(i)

The Authority may, following audit pursuant to paragraph (f), and by no later than the date on which it has issued a notice to the Licensee under paragraph (g), by notice to the Licensee vary the Verified Controllable Capital Forecast approved or determined in accordance with paragraph (b) in a manner that reduces the Verified Controllable Capital Forecast by such amount as in the opinion of the Authority:

(i) relates to the costs associated with activities that were taken into account by the Authority both in:

(A) approving or determining the Verified Controllable Capital Forecast; and

(B) determining the Provisional Controllable Capital Expenditure,

in each case as being activities remaining to be carried out by (or on behalf of) the Licensee after the date of that approval or determination; and

(ii) ~~to~~reflects the extent that, by the date on which a notice under this paragraph is issued to the Licensee:

(A) the activities referred to in sub-paragraph (i) have not been carried out (and those activities subsequently need to be carried out) and the costs associated with them have not been incurred (and the costs associated with them will need to be incurred);

(B) no other ~~activies~~activities of substantially equivalent effect have been carried out and the costs associated with such other activities have not been incurred;

(C) no alternative steps have been taken which have the effect (without any significant adverse consequences) of avoiding the need (in whole or in part) to carry out any such activities as are referred to in sub-paragraphs (A) and (B), and the costs associated with such alternative steps have not been incurred~~; and~~,

provided that:

(iii) before issuing any such notice to the Licensee, the Authority shall have provided to the Licensee details of the proposed reduction in the Verified Controllable Capital Forecast and of the reasons for it, and given the Licensee an appropriate period (being not less than 28 days) to comment on them; and

(iv) to the extent that where, by any subsequent date, any of the activities or steps referred to in sub-~~paragraph~~paragraphs (i) and/or (ii) have been carried out or taken, and the costs associated with those activities or steps have been incurred, those costs will be recoverable by the Licensee as Capital Expenditure constituting Eligible Pass-Through Costs~~,~~.

~~provided that before issuing any such notice to the Licensee the Authority shall have provided to the Licensee details of the proposed reduction in the Verified Controllable Capital Forecast and of the reasons for it, and given the Licensee an appropriate period (being not less than 28 days) to comment on them~~

For the avoidance of doubt, if any alternative steps taken pursuant to paragraph 6.2.1(i)(ii)(C) incur costs higher than those attributed to the activities referred to in paragraph 6.2.1(i)(i), this shall not constitute a significant adverse consequence for the purposes of paragraph 6.2.1(i)(ii)(C).