SGN
Axis House
5 Lonehead Drive
Edinburgh
EH28 8TG

Paul Harland
Regulation Manager
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ER

10 February 2015

Dear Paul,

Discussion Document on Overall Approach to the Price Control for Northern Ireland's Gas Distribution Networks GD17

This response to the above discussion document is submitted on behalf of Scotia Gas Networks Northern Ireland Ltd (SGN NI), the preferred bidder for the Gas to the West (GttW) Low Pressure Licence. SGN NI is a wholly owned subsidiary of Scotia Gas Networks (SGN). SGN was formed in 2005 and is currently the second largest gas distribution company in the UK, operating over 74,000km of gas mains and services to meet the needs of 5.8 million customers in Scotland and the south and south-east of England. SGN's primary aim is to provide a safe, reliable and efficient gas supply, in line with its vision to be the leading operator of gas networks in the UK. It has significant experience of operating under a robust regulatory framework in GB and the new RIIO framework introduced by Ofgem in 2010 (Revenue = Incentives + Innovation + Outputs). SGN NI has drawn on this experience in formulating its strategy for GttW and this response to the above discussion document, whilst being mindful of the different regulatory drivers in Northern Ireland and different market conditions.

In particular we are supportive of proposals to build on learning elsewhere, where relevant, in relation to benchmarking, customer service, innovation and incentives while remaining focused on the priorities in NI. We also believe proposals for GD17 should be proportionate and cost effective given the relatively small consumer base and developing market. We are also keen to ensure any proposed changes relating to financeability remain appropriate for the NI market and retain the key elements on which our bid for GttW was based. We would not expect to see any material or detrimental change under GD17 and expect to see key parameters such as form and duration of control, WACC etc. set out in the Licence consultation issued in December 2015 retained.

As you will appreciate our business strategy for GttW continues to develop and will be taken forward following Grant of Licence. However, as preferred bidder we have provided initial views on each of the key areas covered in the GD17 discussion document below. We look forward to work with the Regulator, other GDNs and stakeholders to develop our thinking further, with a view to providing more detailed plans and proposals as part of a formal Business Plan submission.

Objectives for GD17

We understand there is no plan to change the principal objective under GD17, as such the focus will continue to be promoting the development of an efficient, economic and coordinated gas industry in Northern Ireland. SGN NI fully supports this approach across all Licensed Areas but particularly GttW.

We note the Regulator is also keen to ensure value for money. Given the focus on high levels of capital investment associated with developing long life assets we believe the focus should be on long term efficiency. Given the relatively low customer base in NI and the GttW Licensed Area initially it will also be important to ensure allowances are set to recover costs within an appropriate timeframe with a reasonable return, while ensuring charges remain affordable for consumers. With this in mind we support proposals to take a longer term and more holistic view when developing Business Plans.
We also support proposals to give greater consideration to customer service, wider incentives and innovation. We believe there are many lessons that can be learned from GB experiences across gas and electricity on this front. Further details are set out below.

Duration of Price Control
SGN NI supports proposals to move to a 5 or 6 year price control period. We believe this strikes a reasonable balance, allowing GDNs to plan and invest over a time horizon with sufficient certainty to drive greater efficiency while avoiding the need for a disproportionate number of re-openers and uncertainty mechanisms. We believe a 5 or 6 year framework would also provide a more stable and predictable framework for GDNs, consumers and other stakeholders. There is also considerable experience in GB of price controls spanning similar horizons. We do not see a need for a shorter duration price control for GttW. We are keen to ensure all GDN price controls in NI are aligned.

We also support proposals to align the NI price control periods to make greater use of learning emerging in GB from the RIIO frameworks to the extent it may be relevant for NI, particularly in relation to benchmarking.

We are mindful that the GttW Low Pressure Licence is drafted on the basis the next price control would take effect on 1 January 2018, a year after other GDNs. As such we expect the first price control period for GttW to last 5 years, while other GDNs would last 6 years so that all will come to an end at the same time.

Benchmarking
In general terms we are supportive of proposals to benchmark costs, services and performance. Benchmarking is widely recognised as good regulatory practice. However it is vital that benchmarking reflects the different market conditions in NI and maturity of the 3 Licensed Areas. Phoenix has been in operation since 1996 and currently has a market base of around 171,000 customers, concentrated around the Belfast city area. Whereas Firmus has been in operation since 2005 and has a customer base of around 20,000, spread across the 10 towns area, which includes a more rural customer base. The GttW Licensed Area covers 7 Districts which in the first 10 years of operation are targeting around 13,000 properties passed (or capable of being connected). Appropriate adjustments should be recognised to reflect the fact that each network will be at a very different stage of development, operating in different markets with different customer bases. This will impact on costs, services and efficiency.

We also need to address the difficulty of making sound statistical comparisons given the limited number of data points and different underlying conditions. As a result we expect there will be a number of atypical events, special regional and company specific factors that will need to be taken into account. This makes a "top-down" approach extremely challenging if not unreliable.

We note proposals to widen benchmarking to include GB GDNs and other Utilities. While this will potentially provide additional data points for regression analysis, care needs to be taken regarding the appropriateness of such comparators and the extent to which specific adjustments will need to be made as the GB market has a number of significant differences:

- The GB gas market serves over 20m gas consumers. This drives very different investment strategies and different efficiencies;

- The GB gas market is a mature market - full competition has existed since the late 1990's;
- Network activities and capital expenditure in GB is focused on maintenance, replacement and reinforcement not network development. This means appropriate comparators may not be available.
- Given the different level of maturity and larger customer base there is a very different focus and approach to issues such as customer service, stakeholder engagement and incentives.

There are also wider socio and economic considerations that need to be factored in to any comparison e.g. related to different contractor rates, wage scales etc.

In conclusion, we believe a bottom-up approach is likely to be more robust as this gives greater opportunity to consider market and company specific factors. Given the capital intensity of the NI market, a TOTEX, top-down approach is unlikely to be as relevant as in GB where the cost base is more balanced across Capex, Repex and Opex categories. We are happy to work with the Regulator to develop thinking in this area further. It is essential that the overall approach includes sufficient comparable data points to ensure benchmarking is reliable and robust.

Cost (and Performance) Reporting

We believe robust and consistent cost reporting is an essential element of benchmarking. We are mindful that RIGs reporting is essentially backward looking and for GD17 there will be limited historic information available as this was only introduced in NI in June 2015. Therefore, we believe greater consideration should be given to forward looking forecasts and supporting evidence for benchmarking purposes, particularly for GttW as this new project will be competitively tendered and will have information regarding current market rates.

We believe RIGs reporting will also have an essential role to play throughout the price control process, allowing Licensees and the Regulator to monitor costs and performance within price control periods. As such it is important that future RIGs reporting requirements mirror priorities for GD17, the output and incentive regime. We are keen to work with other GDNs and the Regulator to ensure cost reporting is fit for purpose. In particular we are keen to ensure costs and associated allowances are recorded against relevant conveyance categories to help drive efficient outcomes and ensure cost reflective charging arrangements are developed and maintained. Associated with this we believe there is a need to develop and agree reporting templates early in the GD17 process and associated GD17 financial models.

Output Based Regulation

This is a key part of the RIIO framework. We are fully supportive of output based regulation which links allowances with clearly defined outputs and identified drivers. We look forward to working with you, giving careful consideration to company specific factors in setting outputs as they will vary given the different stage of network development, degree of market maturity and characteristics of each Licensed Area.

For GttW we believe primary outputs should be those currently set in the Low Pressure Licence i.e. focused on the Licensee installing and bringing into operation the low pressure pipe-line and meeting targets set against the Development Plan for the number of premises readily capable of being connected. We believe wider considerations should also be given to customer service, emergency services etc. which are also relevant and could be developed further.

Incentives

We believe a strong incentive regime is a key part of output based regulation as it helps drive efficiency and delivery of outputs. With this in mind we believe further consideration should be given to ensure strong incentives are in place to reward good where GDNs deliver outputs.

To reinforce the need for strong incentives to maintain focus on developing the network we believe further consideration should also be given to developing incentives focused on the following areas of activity:

- Providing a timely and accurate connections service;
- Handling customer enquiries and complaints in a timely, honest and professional manner;
- Maintaining a safe and reliable network;
- Ensuring GDNS play their part in delivering a low carbon economy and wider environmental benefits e.g. minimising shrinkage and helping reduce consumer greenhouse gas emissions;
- Developing robust stakeholder engagement programmes; and
- Improving customer satisfaction.

Under the connection framework we believe further consideration should be given to Fuel Poor initiatives similar to those introduced in GB. We believe they have been particularly successful and similar opportunities exist in NI. We believe this can be done in a cost effective way. We are happy to work with the Regulator to develop thinking in all areas over coming months.

Form of Price Control and Profiling Allowances

We note plans set out in the discussion document to consider moving to a revenue control for GDNs in NI. We note the GttW Low Pressure Licence operates under a volume incentive control and states this would first be reviewed after 5 years of operation. Given the proposed duration of the GD17 price control for GttW we suggest any changes should not be considered until at least the next price control period. This is essential to ensure incentives exist to develop the network and maximise connections / volume of gas transported.

Given the significant level of costs associated with developing the network in initial years, we believe it is also essential that a profile adjustment is retained for GttW to ensure costs are recovered (with a reasonable rate of return) so that charges remain affordable to consumers. We would plan to set out further thoughts on this and potential impact on consumer charges in our Business Plan.

TOTEX Approach

A TOTEX approach is a key part of the RIIO framework introduced by Ofgem in GB in 2010. This allows Licensees to make trade-offs between capex and opex and provides flexibility to allow Licensees to deliver outputs in a more cost effective way. While this works well in GB there is significantly less opportunity to make trade-offs in NI where the focus is still on developing the network, particularly for GttW.

Uncertainties and Re-openers

In developing a Business Plan for GttW we will give careful consideration to key risks and uncertainties and associated requirements for uncertainty mechanisms and re-openers. As a minimum we would expect unforeseen and significant legislative, regulatory or government policy initiatives to be taken in to account and any materiality threshold to be set relative to individual Licensee costs in each individual area and allowances in each year. We note the GttW Licence already makes provision for material changes in volumes and operating costs and would expect to retain this approach.

We believe further consideration should be give to metering changes such as smart metering and Traffic Management costs. Further detail will be set out in our Business Plan.

Stakeholder Engagement
Stakeholder Engagement is another important element of the RIIO framework introduced in GB. It is designed to encourage network companies to put stakeholders at the heart of their decision making process, identifying priorities and ensuring value for money. We believe a framework should be developed for N, focusing on ensuring:

- Licensees consult their stakeholders at every stage of the planning and decision making progress and are able to demonstrate how stakeholder views have been taken into consideration;
- Licensees keep stakeholders informed of key developments and decisions;

Innovation
The innovation stimulus packages introduced in electricity and gas in GB under the RIIO framework is widely recognised as having delivered significant potential network benefits. Specific ring fenced funding is made available to Licensees to encourage a step change in approach to help find new more innovative and efficient ways of doing things with a view to reducing costs to consumers over the longer term. Given the long term nature of investments and potentially higher risk, it is widely recognised Licensees would otherwise not be able to fund such initiatives themselves. While we appreciate the differences in scale and market conditions in NI we believe there is still significant potential to develop similar arrangements or approaches in NI to help explore ways of improving efficiency, reduce cost and improve customer service. We believe further consideration should be given to such initiatives either directly through funding or through incentive arrangements under GD17.

Financeability
The discussion document sets out proposals to use a standard Capital Asset Pricing Model (CAPM) for assessing a suitable rate of return and plans to review how tax should be treated. It also sets out proposals to consider different rates of return on certain components of the Total Regulatory Value (TRV) to reflect different levels of risk. While we support the use of a CAPM model we would stress that it is important this takes into account the full range of risks involved in a particular business which will in turn impact on the cost of equity and the cost of debt. We are keen to work with the Regulator to develop a suitable approach. We also note a WACC was set through the application process for GttW. This was referenced in the recent Licence consultation document. We do not expect to see any departure from this under GD17.

In terms of general financeability and metrics such as gearing, debt to TRV ratios, debt indexation etc. we have no specific comments at this point but are keen to work with the Regulator in developing the approach for GD17 and understand some of the key consideration. We would expect metrics to be meaningful to investors and reflect the market conditions and risk in NI. Regulatory principles should not create financeability issues.

One of the key things that we are keen to establish under GD17, as previously discussed is the setting of an annual TRV throughout the price control period.

In relation to depreciation, we note both existing GDNs have different policies for depreciation rates and economic life and there are proposals to review this under GD17. Further detail is required to understand the key differences that currently exist and arguments for making any further changes. We would expect any change for GttW to place us in no worse a position than that assumed in the application process.

Conclusion
In summary SGN NI is generally supportive of proposals to build on learning elsewhere, particularly under the RIIO framework implemented in GB which places greater focus on benchmarking, output based regulation and strong incentives to deliver outputs. We believe there is additional opportunity to widen the regulatory

framework to consider additional incentives around customer service, stakeholder engagement and innovation but proposals for GD17 should be tailored to be proportionate and cost effective for Northern Ireland. They must also reflect the different costs, market conditions and customer base of each Licensee. Finally, any proposals relating to financeability must retain the key elements on which our bid for GttW was based.

We look forward to working with the Regulator, other GDNs and stakeholders to develop thinking in all key areas further.

Yours sincerely

Beverley Grubb
Regulation Manager