Decision

ofgem
Making a positive difference
for energy consumers

Decision on the closeout methodologies for RIIO-GD1

Subject	**RIIO-GD1 closeout**
Publication date:	14 April 2022
Contact	Jon Sharvill, Senior Manager
Team:	RIIO Gas Operations
Telephone	020 3263 9623
Email:	Jon.Sharvill@ofgem.gov.uk

The RIIO-GD1 price control ran from 1 April 2013 to 31 March 2021. This document provides the detail of the methodologies that will be used to deal with uncertain costs within the price control and assessment of the delivery of outputs against specified targets. These methodologies will be included in the RIIO-GD2 Price Control Financial Handbook.

We consulted on the draft methodologies on 14 January 2022. This document sets out our methodology decisions following this consultation. We have published the non-confidential consultation responses alongside this document.

Contents

Executive summary

The previous price control for gas distribution (RIIO-GD1) ran from 1 April 2013 until 31 Mar 2021. The RIIO-GD1 licence (the 'GD1 licence') makes provision in relation to several areas which, due to their uncertain nature, could only be settled once all costs and actual RIIO-GD1 performance is known. This means that some elements of the price control need to be subject to "closeout" once the price control has ended. To closeout the RIIO-GD1 price control, the following need to be addressed:

- Financial methodologies
- Iron mains risk reduction programme (Repex)
- Fuel Poor Network Extension Scheme (FPNES)
- Capacity Utilisation
- Reliability (Interruptions)
- Shrinkage and Environmental Emissions Incentives
- Tax Clawback (WWU)
- Disposals

This document provides a summary of each area of the price control where a closeout methodology was required, a summary of the consultation responses, a description of any changes made to the closeout methodologies since the consultation and the finalised closeout methodologies. The final closeout methodologies will be included in the RIIO-GD2 Price Control Financial Handbook (PCFH).

Related documents

Consultation on the methodologies to closeout RIIO-GD1
https://www.ofgem.gov.uk/publications/consultation-closeout-methodologies-riio-gd1

RIIO-GD1 Strategy Decision
https://www.ofgem.gov.uk/publications/decision-strategy-next-gas-distribution-price-control-riio-gd1

RIIO-GD1 Final Proposals
https://www.ofgem.gov.uk/publications/riio-gd1-final-proposals-overview

Supplementary documents to the RIIO-GD1 Final Proposals
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/3_riiogd1_fp_finance_and_uncertainty_0.pdf
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/2_riiogd1_fp_outputsincentives_dec12_0.pdf

Price Control Financial Handbook
riio-gd1-price-control-financial-handbook_0.pdf (ofgem.gov.uk)

RIIO-2 Final Determinations Transmission and Gas Distribution Network Companies
www.ofgem.gov.uk/publications/riio-2-final-determinations-transmission-and-gas-distribution-network-companies-and-electricity-system-operator

1. Background and overview

Background

1.1. The RIIO-GD1 price control sets the outputs that the gas distribution networks (GDNs) must deliver, and the revenues that they are allowed to collect from customers, between 1 April 2013 and 31 Mar 2021.

1.2. Within RIIO-GD1 there are several areas of expenditure that require information about actual efficient costs incurred, revenue received and the extent to which outputs have been delivered before RIIO-GD1 can be fully closed out. These are compared with the costs, revenues etc. that were assumed in RIIO-GD1 Final Proposals ("Final Proposals")[1] to determine the value of any adjustment required for closeout.

1.3. We have not included closeout of the Network Output Measures (NOMs) in this Decision; NOMs are being consulted on separately due to their cross-sector scope.

1.4. Table 1 gives a brief description of the areas of the price control that are subject to a closeout process.

Table 1: Cost areas for GD1 closeout

Area	Description	Chapter
Iron mains replacement programme (Repex)	Assessment required at closeout to determine whether GDNs have delivered the primary safety output.	3
FPNES	Assessment required at closeout and mechanism to enable allowance adjustment for any under or over-delivery in RIIO-GD1 to be implemented.	4
Capacity utilisation	Assessment required at closeout to determine whether the GDNs have met their capacity utilisation targets.	5
Interruptions	Review of GDNs' RIIO-1 performance against reliability output targets required.	6
Shrinkage and Environmental incentives	Assessment is required to determine performance against shrinkage and environmental emission targets and calculate rewards/penalties.	7
Tax clawback (WWU only)	Values to be trued-up through the GD1 legacy PCFM.	8
Disposals	Values to be trued-up through the GD1 legacy PCFM.	9

[1] And following any subsequent re-opener Decisions

NOMs	Consulted on separately due to cross-sector scope with separate decision to follow.	N/A

RIIO-GD1 closeout

1.5. On 14 January 2022 we consulted on our proposed methodologies for closeout of each of the elements of the price control in Table 1.[2] The finalised methodologies detailed in this Decision document will be incorporated into the PCFH. We will consult on amendments to the Price Control Financial Model (PCFM)[3] and final revenue adjustments ahead of the November 2022 Annual Iteration Process (AIP).

1.6. Our Decision on the RIIO-GD1 closeout methodologies includes: mechanisms that "true up" and reconcile actual expenditure against services provided by the GDN; output mechanisms which enable us to recover funds from GDNs if they have not delivered the outputs they were funded to deliver; mechanisms which deal with over or underspend against fixed allowances; and mechanisms that deal with over or under-delivery against output targets.

1.7. We have based the methodologies on the approach and principles that we described in the RIIO-GD1 Strategy Decision and Final Proposals, and as implemented in the GD1 Licence, relevant supplementary documents, and the PCFH.

Purpose of this document

1.8. This document sets out the background to the elements of the RIIO-GD1 price control that need to be closed out, detail of any changes we have made to the methodologies following the consultation, and our Decision on the finalised RIIO-GD1 closeout methodologies.

Responses to the RIIO-GD1 closeout consultation

[2] Consultation on the closeout methodologies for RIIO-GD1 | Ofgem
[3] RIIO-GD2 Price Control Financial Model for the Annual Iteration Process November 2021 | Ofgem

1.9. We received 5 responses to our consultation; four from the GDNs and one from an industry body, which we have carefully considered when reaching our Decision on the RIIO-GD1 closeout methodologies.

1.10. A summary of the responses to the specific consultation questions is provided in the relevant chapters of this document, and we have published the non-confidential responses on our website alongside this decision.

Next steps

1.11. We will implement the closeout methodologies and make any necessary revenue adjustments as part of the November 2022 AIP. Further details are in Chapter 11.

Your feedback

1.12. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this decision document. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned decisions?
6. Any further comments?

Please send any general feedback comments to Jon.Sharvill@ofgem.gov.uk.

2. Financial methodologies

This section describes the process which the Authority will follow in determining any revisions to the licensees' RIIO-2 RAV balances and revenue for the GD2 Price Control Period.

Background

2.1. To close out the Gas Distribution Price Control Review 4 (GDPCR4), i.e., the price control that preceded RIIO-1, the RIIO-1 model contained "legacy" adjustments to Regulated Asset Value (LRAV) and revenue (LAR) in the 2013/14 regulatory year. For the GDNs, the LAR value was spread over the 8 years of RIIO-1.

2.2. In contrast, the RIIO-GD1 licence introduced mechanisms that automatically true up revenue for outturn data on an annual basis. Therefore, the RIIO-GD2 Price Control Financial Model (RIIO-GD2 PCFM) does not need the same catch-all legacy terms used for GDPCR4 closeout. Instead, the RIIO-GD2 LAR term is the sum of the pre-existing true-up mechanisms introduced in RIIO-1 (see Part A of Special Condition 7.1 for the list).

2.3. Rather than make a one-off adjustment to RAV at the start of RIIO-2, we now import the final RIIO-1 values into the RIIO-GD2 PCFM; this reflects the historical adjustments more transparently. Accordingly, the LRAV term has been repurposed to refer to the "outturn" (or ex-post) RAV additions in RIIO-1, rather than a one-off adjustment.

2.4. The LAR in RIIO-2 is the sum of existing true-up mechanisms, which have been extended into RIIO-2 to cover the closeout of RIIO-1.

2.5. One component of the RIIO-GD2 LAR term is "LMOD", which is calculated by the RIIO-1 Legacy PCFM on an annual basis. The LMOD term calculates an appropriate revenue adjustment for a future year, given a set of changes in historical years. MOD has been calculated annually as part of the AIP, and we continue to calculate it for the first two years of RIIO-2 (as it reflects changes on a two-year lagged basis).

2.6. In the typical RIIO-1 process, the MOD term only reflects changes to pre-defined "variable values", and other values remain fixed through the price control. However, in the context of RIIO-GD1 closeout, we have decided to broaden the scope of values which may be modified or to add new calculations, if required, and then to extend the function of the

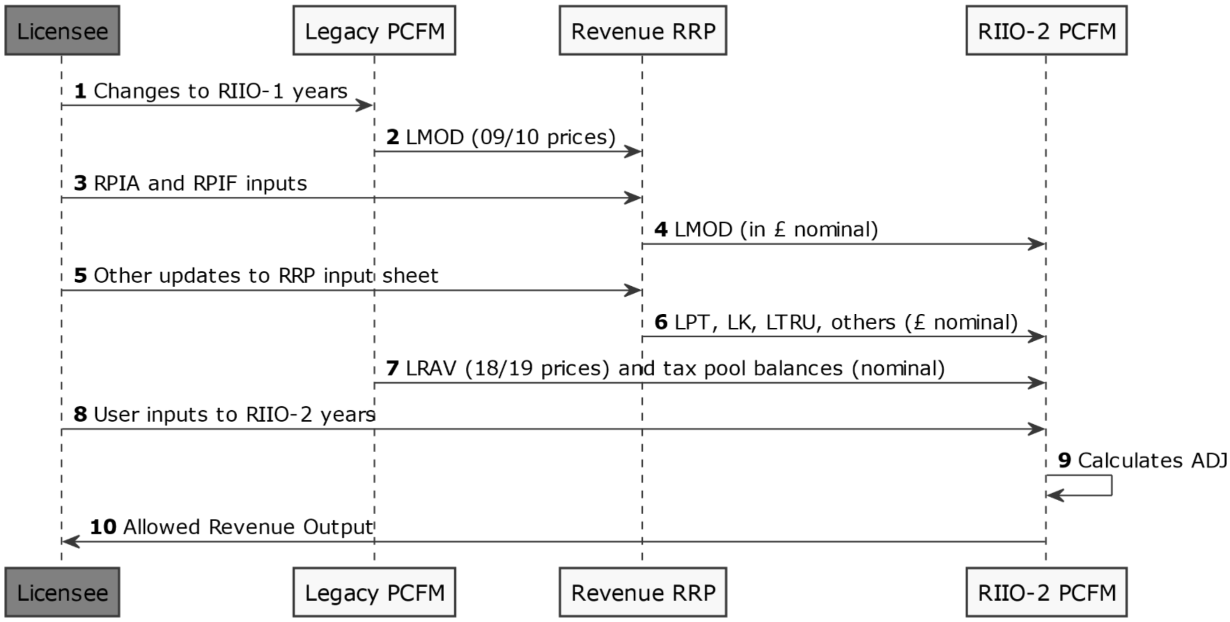
MOD term to capture the effect of RIIO-GD1 closeout. We describe this closeout model as the GD1 Legacy PCFM. The steps of this process are as follows.

- In calculating adjustments, we will apply the methodologies set out in this decision document.
- Through Legacy PCFM working groups, and ultimately a statutory consultation on the GD2 Price Control Financial Handbook, Ofgem will propose specific implementations of these methodologies in the GD1 Legacy PCFM.
- The GD1 Legacy PCFM is now not a licence instrument, but a regulatory tool to provide the inputs to the RIIO-2 values, specifically the LMOD term

2.7. For illustration, Figure 1 is a sequence diagram, showing how the GD1 Legacy PCFM, the extended GD1 Revenue Regulatory Reporting Pack (Revenue RRP), and RIIO-GD2 PCFM interact and produce an allowed revenue value for the next regulatory year. Figure 1 should be read from top to bottom (the steps are numbered), while the arrows show where components come from and feed into. Each step is briefly summarised below.

1. Ofgem or the licensee will input changes to RIIO-1 values in the GD1 Legacy PCFM.
2. The GD1 Legacy PCFM is used to calculate LMOD value(s), which is then input into the Revenue RRP.
3. Inflation assumptions are input by the licensee into the Revenue RRP.
4. The Revenue RRP provides the LMOD value in £m nominal and is then input to the RIIO-2 PCFM.
5. Other inputs to the Revenue RRP are filled in by the licensee.
6. The remaining legacy values are input to the RIIO-2 PCFM, completing the 'LAR' input block for the corresponding year.
7. Legacy RAV additions are input from the GD1 Legacy PCFM to the RIIO-2 PCFM, after being converted to 18/19 prices.
8. The licensee updates all other variable values in the RIIO-2 PCFM.
9. The RIIO-2 model calculates the ADJ term for the following year.
10. The RIIO-2 model provides the licensee an Allowed Revenue value for the following year.

Figure 1: Sequence Diagram of the RIIO-2 AIP with Legacy Adjustments



Methodology proposed at consultation

2.8. We proposed to implement closeout methodologies via the GD1 Legacy PCFM by revising "yellow box" (non-variable) values as well as variable values or modifying the GD1 Legacy PCFM as necessary.

2.9. We proposed to implement the GD1 closeout methodologies in the November 2022 AIP, noting that corrections can be made in subsequent AIPs as necessary.

2.10. We proposed that rather than the cumulative impact of all changes being included in the next MOD value, the impact of the November 2022 AIP legacy adjustment is smoothed over the remaining three years of RIIO-2 by dividing the LMOD value by three.

Consultation responses

2.11. We received four responses to this consultation question. Three GDNs supported the principle of the proposed methodology, while one GDN posed a question in relation to the status of the RIIO-GD1 licence which we have answered in paragraph 2.23.

2.12. One GDN requested that where formulae are being amended that Ofgem puts assurance processes in place to ensure the closeout terms work as intended, while another GDN stated that, where modifications are proposed (para 2.11), Ofgem must undertake statutory consultations in respect of those modifications.

2.13. A GDN requested that networks have flexibility in how adjustments are apportioned across the remaining years of RIIO-GD2 to try and best achieve a smoothed bill impact for customers.

2.14. A GDN highlighted that as LMOD will be adjusted based on RPI there will need to be a mechanism to true up to actual RPI in RIIO-GD3 and this item will not be fully closed out until then.

2.15. SGN highlighted 2022/23 tariffs that it had fed through an adjustment, the origin of which was an NTS booking capacity oversight, which it was unable to change at the time and generated an increased NTS incentive reward in 2020/21.

2.16. One GDN questioned Ofgem's ability to make modifications to the GD1 Licence and give effect to the proposed methodology on the basis that the GT1 Licence no longer exists and, therefore, all former GD1 licence conditions have already been deleted and replaced.

Closeout methodology Decision

2.17. Our Decision is to implement the approach to financial methodologies that we consulted on and to do so through the GD1 Legacy PCFM in the November AIP. We consider this approach to be transparent, straightforward and proportionate for both the GDNs and consumers.

2.18. We will engage with the GDNs through the GD1 Legacy PCFM working groups to agree on the specific adjustments needed to the yellow box and blue box variable values in the GD1 Legacy PCFM and the updates required to the Revenue RRP. Following this working group engagement, we will consult on the modified GD1 Legacy PCFM and legacy Revenue RRP.

2.19. We acknowledge the request that GDNs have flexibility in how they apportion adjustments in order to smooth the bill impact on consumers. Our decision is that the default position for closeout adjustments is to spread them out over the remaining three years of RIIO-GD2, because we think this is the most appropriate balance between current and future consumers, whilst minimising any impact on bills. However, it is possible that during the implementation of closeout, Ofgem may be persuaded that a different time period should be used if there is a compelling reason to do so.

2.20. Regarding the issue described in paragraph 2.14, we agree that a LMOD value in 2025/26 should be inflated by a forecast of RPI, and that there is currently no mechanism to true up this value as it is separate from the rest of RIIO-GD2 Allowed Revenues (and was trued up via the TRU term in RIIO-GD1).

2.21. We have decided that we want to avoid a lengthy extension of the TRU term, and to decide the exact implementation of the RPI true-up through working groups. One way to address this is to make an ex-post revision to the nominal LMOD value in 2025/26, and that the correction would flow through the K correction factor in RIIO-GD3. The reason for this is to avoid extending a complicated reference to RIIO-1 licence conditions for multiple price controls, while we can achieve the required true-up in another way.

2.22. In relation to the point raised by a GDN in paragraph (2.16), we are not retroactively modifying any licences or licence instruments. We are only modifying *current* instruments, which are used to calculate *current* values of Allowed Revenue. However, in doing this, we are looking back in time (as many mechanisms do) to calculate the necessary closeout adjustments to current revenue.[4]

2.23. To this end, we are using the RIIO-1 Legacy PCFM and existing RIIO-1 reporting packs as tools to calculate the correct true-up. We consider this is an appropriate approach as they contain the full history of data from the RIIO-GD1 price control and using them as legacy calculation models would ensure that we calculate adjustments in a way that is transparent and correct.

2.24. Paragraph 2.13 in the consultation document posits that we could modify the PCFH to implement the closeout methodologies, which would require a statutory consultation.

2.25. Regarding SGN's exit capacity booking issue highlighted in paragraph 2.15 above, we have decided that the RIIO-GD1 closeout mechanism will be used to return these funds. We will engage with SGN at the GD1 Legacy PCFM working groups to agree revised PCFM values and ensure the increased incentive revenue received by SGN is returned to consumers.

[4] To implement the FPNES methodology we will need to adjust PCFM input values before calculating the LAR term

3. Iron mains risk reduction programme (Repex)

This section details our Decision on the methodology and process we will follow to close out the RIIO-GD1 Iron Mains Risk Reduction Programme.

Background

3.1. The iron mains risk reduction programme (IMRRP), or 'repex' programme, is an HSE initiative to decommission c.72,000km of iron mains by 2032 as part of an ongoing programme to increase safety on the gas distribution networks.

3.2. Final Proposals set the GDNs' allowances to achieve the Primary Output relating to safety by reducing risk on their networks from between 40-60% relative to the 2013 baseline[5], with the HSE also imposing a statutory obligation on the GDNs in relation to the delivery of iron mains replacement workloads.

Methodology proposed at consultation

3.3. As all GDNs had already met/exceeded their risk reduction targets for RIIO-GD1 and therefore delivered the Primary Output for repex we did not propose any revenue adjustment nor revision of RIIO-GD2 targets in respect of RIIO-GD1 repex performance.

3.4. We proposed that any over or underspend against allowances will be treated as totex and subject to the RIIO-GD1 Totex Incentive Mechanism (TIM) sharing factor.

Consultation responses

3.5. We received four responses to this consultation question. All GDNs supported the proposed methodology to close out the RIIO-GD1 repex programme.

3.6. However, one GDN queried why the RIIO-GD1 NOMs consultation could not have been brought forward from May to align with this consultation, noting that its consultation

[5] RIIO-GD1 Final Proposal, overview, para 2.8

responses are predicated upon there being no change to the minded-to position on NOMs which was circulated to the networks in November 2021.

Closeout methodology Decision

3.7. Ofgem will implement the methodology proposed in the RIIO-GD1 closeout consultation without modification. The GDNs all met their Primary Output for safety, and the licence made no provision for any further revenue adjustments beyond application of the RIIO-GD1 TIM.

3.8. We acknowledge the point raised by a GDN that responses to this consultation are predicated upon there being no change to the minded-to NOMs position shared with the GDNs in November 2021. Due to NOMs being a cross-sector policy area we did not want to consult formally on its closeout until our position has been finalised for all sectors, not just gas distribution.

3.9. However, we considered it appropriate to consult on the methodologies to close out the rest of RIIO-GD1 in January 2022 rather than delaying the consultation until the cross-sector NOMs position had been finalised and consulting at the same time. We will take into consideration the outcome of this consultation process when closing out NOMs.

4. Fuel Poor Network Extension Scheme (FPNES)

This section details our Decision on the methodology and process we will follow to close out the RIIO-GD1 Fuel Poor Network Extension Scheme.

Background

4.1. The Fuel Poor Network Extension Scheme (FPNES) is a scheme delivered by the GDNs in partnership with other organisations, to help tackle fuel poverty by supporting off-grid, fuel poor households to connect to the gas network.

4.2. RIIO-GD1 Final Proposals provided baseline funding for the GDNs to deliver 77,450 connections to fuel poor customers collectively, constituting the GDNs primary social output. Following a review of the scheme in 2015[6], the GDNs' target was increased to 91,203 connections.

Methodology proposed at consultation

4.3. Ofgem proposed to make allowance adjustments in respect of over- or under-delivery against RIIO-GD1 FPNES targets through the Legacy PCFM. We proposed to do this by adjusting the 'IAEFP' (Uncertain costs – fuel poor network extensions) PCFM Variable Value in the Legacy PCFM so that allowances reflect actual RIIO-GD1 performance, then re-running the Legacy PCFM to calculate revised LMOD and LRAV variable values which feed into the RIIO-GD2 PCFM as per the process described in Chapter 2 of this document.

4.4. We proposed that, due to Covid-19 impacting the GDNs' ability to deliver forecast workload volumes in RIIO-GD1 as well as changes to FPNES eligibility criteria following the 2017 FPNES Decision[7], we would not consider any under-delivery against targets to be *unjustified* and thus liable for a financial penalty as predicated under Special Condition 7.12 of the GT2 Licence.

[6] Fuel Poor Network Extension Scheme final decision document | Ofgem
[7] Decision to change the criteria for the Fuel Poor Network Extension Scheme, p1

4.5. We also proposed that all connections in excess of the GDNs' targets that met the scheme eligibility criteria be considered *justified* and eligible for a financial reward of 2.5% of the efficient cost of the over-delivery, as per Special Condition 7.12.

4.6. We proposed that to closeout FPNES in RIIO-GD1 we would calculate any over- or under-delivery against the connection target and then multiply that by each GDNs' average outturn unit cost, calculated by dividing total incurred costs by total connections made for each network. This figure would then be divided by 8 and then applied to each year's PCFM input to the IAEFP term.

4.7. We acknowledged that this methodology is a departure from that provided for in Special Condition 4J of the GD1 Licence and proposed to implement the methodology under the process set out in paragraph 8.2 of the Price Control Financial Handbook. This would therefore not require any modification to either the GD1 or GD2 Licences.

Consultation responses

4.8. We received four responses to this consultation question. All GDNs agreed with the proposed approach to make legacy adjustments for both over- and under-delivery against connection targets rather than carrying any under-delivery over into RIIO-GD2.

4.9. While agreeing with the proposal to smooth any over-delivery over the 8 years of RIIO-GD1, one GDN proposed that, as FPNES targets would have been met if it were not for the impact of Covid-19, legacy adjustments for under-delivery should only be applied to 2020/21, where the pandemic impacted operations.

4.10. Another GDN disagreed with our proposal to base the allowance adjustment on actual average GD1 outturn unit costs for each GDN, and instead proposed that it should be based on average allowed unit costs, which reflect the actual allowances that require recovering. It further added that basing adjustments on outturn costs would mean more value is recovered than allowances actually awarded and proposed instead that the unit costs used in the 2015 FPNES Decision are used, and the adjustment made in the variable value in the Legacy PCFM.

4.11. Two GDNs agreed that as under-delivery was due to the Covid impact, it is right that no additional penalty is imposed in respect of this.

4.12. SGN responded that it would not make a claim for allowances for over-delivery in the Scotland network as part of the agreement made in its Voluntary Contribution in November 2017[8].

Closeout methodology Decision

4.13. Following careful consideration of the consultation responses we are making a change to the methodology that was consulted on.

Over-delivery

4.14. Where a GDN has outperformed its RIIO-GD1 FPNES targets we are implementing the methodology as per the consultation. All over-delivery that met the prevailing eligibility criteria will be considered justified and a reward of 2.5% of the efficient costs of delivering the work will be provided, consistent with Special Condition 7.12.

4.15. We will also make an upward revenue adjustment based on each GDN's average RIIO-GD1 outturn unit cost multiplied by the volume of over-delivery, as consulted on. This represents a consistent policy with Final Proposals and is a straightforward approach to close out a low materiality policy area.

4.16. We welcome the commitment SGN made in 2017 not to pursue an allowance adjustment in respect of over-delivery against targets in its Scotland network and will not make any closeout adjustment in respect of the Scotland GDN's RIIO-GD1 performance.

Under-delivery

4.17. Where a GDN has underperformed its RIIO-GD1 FPNES targets, we are changing the methodology that we proposed for calculation of the allowance adjustment. We consulted on basing the adjustment on the outturn average unit cost per GDN. However, we agree with the consultation response that it would be inappropriate to claw back allowances at a different rate to that at which they were set during RIIO-GD1 for a given output target.

[8] SGN Voluntary Contribution statement

4.18. This means that, for GDNs that had their connection targets adjusted by the 2015 FPNES Decision we will use the 2015 unit cost, while for GDNs that did not have targets adjusted in 2015 we will use the unit cost determined at Final Proposals.

4.19. We recognise that this creates an inconsistency between revenue adjustments for over-delivery and under-delivery. The 2015 policy intention is clear that the upward allowance adjustments should be based on the *efficient* cost of over-delivery while the 2015 policy intention was to carry-forward under-delivery into RIIO-GD2.[9] In this particular instance, given the low materiality of the change and differing policy treatment we consider it reasonable to make revenue adjustments for over- and under-delivery on a different unit cost basis for the reasons set out in paragraphs 4.17 to 4.18 above.

4.20. We acknowledge the point that Covid impacted delivery in the final year of RIIO-GD1 and the suggestion that any allowance adjustment for under-delivery should therefore be made in 2020/21. However, to minimise any consumer bill impact and for consistency with the treatment of over-delivery, we still consider it pragmatic to smooth the allowance adjustment across all 8 years of RIIO-GD1 and are not changing our consultation position.

[9] Fuel Poor Network Extension Scheme final decision document, p21, para 4.3-4.4

5. Capacity Utilisation

This section details our Decision on the methodology and process we will follow to close out the RIIO-GD1 capacity utilisation output.

Background

5.1. In RIIO-GD1 the GDNs were required to provide sufficient capacity on the network to ensure that they were able to meet the highest daily demand that is likely to be experienced in one winter in every twenty years (the '1 in 20' standard).

5.2. In the RIIO-1 Strategy Decision and Final Proposals we stated that we would assess the GDNs' performance by way of an ex-post review of asset utilisation against the target utilisation index, using asset utilisation/ capacity charts. This was the secondary deliverable that we said would inform our assessment of whether the GDNs had met the primary output of delivering the '1 in 20' standard.

5.3. However, changes to the NOMs Methodology during RIIO-GD1[10] mean that asset utilisation is now embedded in the monetised risk values derived through application of the NOMs Methodology, and therefore we considered that separate application of the capacity utilisation output is now not necessary and could lead to double counting of adjustments to allowed revenue.

Methodology proposed at consultation

5.4. We proposed to depart from the closeout approach set out at RIIO-GD1 Final Proposals and included in Special Condition 4H of the GD1 Licence, and instead combine the closeout of the Network Outputs relating to the Network Capacity Measure with closeout of Network Outputs relating to the network asset health, criticality, and risk measures.

[10] The Methodology for Network Output Measures common to all DN Operators approved by the Authority under Sp 4G, and published on Ofgem's website on 15 December 2015: https://www.ofgem.gov.uk/publications/gas-network-output-measures-methodology-decision

5.5. By integrating capacity into both the monetised risk targets and monetised risk outputs, the assessment of over- or under-delivery conducted as part of the NOMs Closeout accounts for capacity utilisation. Therefore, we did not consider there to be a requirement to propose a discrete closeout methodology for the capacity utilisation output.

5.6. To give effect to the above we proposed to modify Special Condition 4H of the GD1 Licence to remove the following provisions:

- Part B (4H.6) – Network Outputs relating to the Network Capacity Measure
- Part D (Table 2) – Treatment of under or over-delivery of Network Outputs relating to the Network Capacity Measure

Consultation responses

5.7. We received five responses to this consultation question. Three GDNs supported the proposed methodology, one GDN stated it was not commenting until publication of the separate NOMs GD1 closeout consultation in May 2022, and an industry body raised concerns about assessing the capacity utilisation output on a different basis to the basis on which it was set.

5.8. While supporting the proposed methodology, one GDN queried why the consultation on RIIO-GD1 NOMs closeout could not have been brought forward to align with this consultation, stating that its consultation response is predicated on there being no change to the NOMs position circulated to the networks in November 2021.

5.9. Another GDN queried how Ofgem will modify the provisions currently in the GD1 Licence for a discrete capacity utilisation assessment on the basis that the GD1 Licence no longer exists and the provisions within it have been deleted and replaced.

5.10. An industry body noted that it has previously raised concerns about the rebasing of targets for the Network Outputs relating to asset health and assessing performance on those rebased targets, noting that it is not in consumers' interests for capacity utilisation as well to be assessed on a different basis to the basis on which allowances were set. It also highlighted that stakeholders were not made aware of this issue when the asset health targets were rebased.

5.11. The industry body raised the concern that assessing performance on a different basis to the basis on which allowances were set could give rise to windfall gains or losses to the

GDNs, and that, as a sense check, Ofgem should undertake and publish performance assessments based on the capacity utilisation methodology included in the GT1 Licence.

5.12. The industry body also sought clarity on whether there is any overlap in terms of activities needed to satisfy the repex capacity utilisation and asset health outputs and, if so, it recommended that the closeout of repex is conducted at the same time as performance against the asset health and capacity utilisation output is assessed.

Closeout methodology Decision

5.13. We have decided to implement the methodology on which we consulted without modification and therefore capacity utilisation will be assessed as a contributing factor to the overall NOMs assessment, rather than assessed as a discrete output. We consider this approach to be most appropriate given the risk of double-counting any reward/penalty following the revision to the NOMs methodology during RIIO-GD1.

5.14. We recognise that the GT1 Licence is no longer in force; the consultation aimed to set out the proposed policy position, given the GT1 Licence makes explicit provision for a discrete closeout assessment and contains a methodology for doing so. In effect, to close out the capacity utilisation output in accordance with the consultation proposal this means that the discrete assessment[11] will not be undertaken and the closeout methodology[12] will not be applied, with no requirement for any licence modification.

5.15. We acknowledge that capacity utilisation is now being assessed on a different basis to that stated at Final Proposals. However, given the subsequent changes to the NOMs methodology and incorporation of capacity utilisation within that assessment, we consider that the change in approach is appropriate to avoid the risk of double counting any rewards/penalties.

5.16. We accept that stakeholders should have been made aware that capacity utilisation was a factor in the NOMs rebasing and acknowledge this oversight. However, the risk of double counting remains and this decision addresses that risk.

[11] As stipulated in Part B (4H.6) of Special Condition 4H
[12] As stipulated in Part D (Table 2) of Special Condition 4H

5.17. We acknowledge the industry body's concern that assessing performance on a different basis to the basis on which allowances were set could potentially give rise to windfall gains or losses accruing to the network companies. Our analysis of RIIO-GD1 data shows that the GDNs delivered all funded capacity outputs except for a small number of projects which were impacted by Covid-19. The GDNs have committed to delivering these projects in RIIO-GD2 without any additional allowances, and once project delivery has been confirmed in the 2022 RRPs we will be satisfied that all funded outputs have been delivered and no windfall gains or losses have occurred.

5.18. We accept that there is some overlap across the repex, asset health and capacity utilisation outputs. However, our assessments across all three mechanisms are aligned to avoid double funding or double rewarding any GDNs through the closeout of these mechanisms.

5.19. Regarding the timing of the RIIO-GD1 and NOMs closeout consultations, our minded-to decision, as communicated to GDNs in November 2021, has not changed. While no further action is required for GDNs our assessment of other sectors is ongoing. Our intention is to consult formally on the outcomes from our NOMS closeout assessment for all three (ET/GD/GT) sectors in April/May in accordance with the timelines set out in the RIIO-1 NOMs Incentive Methodology.

6. Reliability (Interruptions)

This section details our Decision on the methodology and process we will follow to close out the RIIO-GD1 reliability output.

Background

6.1. Maintaining low levels of unplanned interruptions is a key output requirement for customers. At RIIO-GD1 Final Proposals we set the GDNs target levels for both the number and duration of interruptions on the networks in order to meet the reliability (loss of supply) Primary Output. The aim of this output was to drive GDNs to reduce the impact of interruptions on consumers.

6.2. The output was reputational only and there is no provision in the licence for any reward or penalty, or upward/downward adjustment to the GDNs' revenues, in relation to its performance against the output

6.3. In March 2018[13], Ofgem amended the targets for both the number and duration of planned and unplanned interruptions, having identified defects in some of the GDNs' loss of supply targets in the RIIO-GD1 mid-period review (MPR).

6.4. In Final Proposals we stated that we would assess the GDNs' performance against the interruptions targets as part of the end of period review.

Methodology proposed at consultation

6.5. We proposed that GDNs submit performance data and commentary in the 2021 RRP submissions and, where any GDN has failed to meet its RIIO-GD1 targets, that it would be required to explain the reason for any underperformance in the RPP narrative document.

6.6. We proposed that Ofgem would publish the GDNs' performance in relation to the loss of supply Primary Output in the 2021 Annual Report.

[13] Decision on amendments to reliability targets for RIIO-GD1

Consultation responses

6.7. We received four responses to this consultation question. All GDNs supported the proposed methodology to close out the RIIO-GD1 reliability (interruptions) output.

Closeout methodology Decision

6.8. We will implement the methodology to close out the reliability output as consulted on without modification. This output will therefore closeout as per the provisions in the GD1 Licence and we do not consider it appropriate to make any revenue adjustments in regard to GDNs' reliability performance.

7. Shrinkage and Environmental Emissions Incentives

This section details our Decision on the methodology and process we will follow to close out the RIIO-GD1 Shrinkage and Environmental Emissions Incentives.

Background

7.1. Shrinkage refers to gas which is lost from the transportation network and is the dominant element of the GDNs' Business Carbon Footprint (BCF). Shrinkage is comprised of leakage from pipelines (95% of the gas loss), theft from the GDN networks (3% of the gas loss), and companies' own use (2% of gas loss). GDNs use a common leakage model to assess the leakage from each of their networks.

7.2. RIIO-GD1 included both a shrinkage allowance and an Environmental Emissions Incentive (EEI)[14]. These provided enhanced incentives to reduce gas transport losses and network emissions, based on over or underperformance against performance targets.

7.3. At RIIO-GD2 Draft Determinations, Ofgem acknowledged the potential Covid-related impact on shrinkage volumes and stated that '*if we decide that we need to change the way that final year performance under the RIIO-GD1 incentive is assessed, we may also need to change how the RIIO-GD2 targets are set. However, we would still expect to maintain the link between the two incentives*.'

7.4. At RIIO-GD2 Final Determinations, Ofgem decided that the appropriate way to maintain this link, while mitigating Covid-19 adversely impacting on performance in the final year of the RIIO-GD1 incentive, was to change how we set the RIIO-GD2 performance target. Instead of the baseline target being based on the RIIO-GD1 outturn year 8 position, it would be based on the 3-year average performance on network pressure and levels of gas conditioning from 2017-2020. As a consequence, to preserve the link between the RIIO-GD1 incentive and RIIO-GD2 incentives, we stated that '*we will use these averages in the closeout of the RIIO-GD1 incentive'*.

Methodology proposed at consultation

[14] RIIO-GD1: Final Proposals – Supporting Document – Outputs, Incentives and Innovation (ofgem.gov.uk)

7.5. We identified two options that we considered meet the policy objective to maintain the link between the RIIO-GD1 and RIIO-GD2 incentives:

- Option A: The RIIO-GD1 2020-21 shrinkage outturn position is adjusted so that it is based on the average pressure and gas conditioning values recorded from 2017-18 to 2019-20, rather than the outturn position from Year 8 of RIIO-GD1. The RIIO-GD2 methodology remains as per the current licence mechanism.

- Option B: The RIIO-GD2 year 1 baseline value is adjusted so that it is based on the RIIO-GD1 Year 8 outturn position, rather than the average pressure and gas conditioning values recorded from 2017-18 to 2019-2020, as stated at Final Determinations, and as implemented in Special Condition 7.10. The RIIO-GD1 methodology remains as per the current licence mechanism.

Shrinkage

7.6. We stated that, as there was no observable Covid-19 impact on RIIO-GD1 Year 8 performance, we considered Option B to be the appropriate methodology to close out RIIO-GD1 as this is the approach as was intended prior to the Covid-19 pandemic. It also means that the incentive will be applied consistently across the whole of RIIO-GD1.

7.7. We proposed that to close out the Shrinkage incentive a mechanistic allowance adjustment is made using 2021 RRP data, applying the incentive formula detailed in Special Condition 7.10. This will then feed into the legacy adjustment term (LARt) detailed in Chapter 2 of this consultation.

7.8. We also stated that to give effect to our policy intention to preserve the link between the RIIO-GD1 and RIIO-GD2 incentive, we will need to undertake a statutory consultation to modify Special Condition 7.10 in the GD2 Licence, which we intend to engage with the GDNs on separately in 2022.

Environmental Emissions Incentive

7.9. We proposed to take the same approach to the EEI as we proposed for Shrinkage and treat RIIO-GD1 performance as per the methodology set out in Special Condition 1F.

7.10. As per the Shrinkage incentive, we proposed to consult later on modification of Special Condition 7.11 of the RIIO-GD2 licence in order to give effect to the Final

Determinations policy position to maintain the link between the RIIO-GD1 and RIIO-GD2 incentives.

Consultation responses

7.11. We received four responses to this consultation question. The GDNs generally agreed with the closeout element of Option B - that the RIIO-GD1 incentive schemes should be closed out using the methodology currently contained within the licence - however three GDNs disagreed that there was any requirement to adjust RIIO-GD2 baseline values to maintain continuity between the RIIO-GD1 and RIIO-GD2 incentives.

7.12. Two GDNs explicitly disagreed with Option A in its entirety, citing that making ex-post adjustments to incentive parameters is not part of the RIIO regime and positing that the incentive parameters have changed so much from RIIO-GD1 to RIIO-GD2 that they are now effectively different incentive mechanisms.

7.13. Two GDNs agreed that any changes to the RIIO-GD2 Shrinkage and Environmental Emissions Incentives should be consulted on separately to the RIIO-GD1 closeout process.

Closeout methodology Decision

7.14. After consideration of the consultation responses, we have decided to close out the Shrinkage and Environmental Emissions Incentives in line with the methodologies set out in Special Conditions 7.11 and 7.12 of the GD2 Licence.

7.15. This means that there will be no adjustments to either RIIO-GD1 targets (Option A as consulted on) or RIIO-GD2 targets (Option B as consulted on) as part of the closeout process. The RIIO-GD1 incentive schemes will therefore close out using the established mechanistic formulae in the licence.[15]

7.16. We are still considering the requirement to modify the RIIO-GD2 targets to give effect to the policy intent stated at Final Determinations, however we will engage on this as a separate RIIO-GD2 issue outside of RIIO-GD1 closeout, and we acknowledge all the points raised by the GDNs in their consultation responses.

[15] These are: Special Condition 7.10; Special Condition 7.11

8. Tax Clawback (WWU)

This section gives an update on the close out of RIIO-GD1 Tax Clawback for WWU.

8.1. In our GD1 Closeout methodology consultation, we set out the background to the tax clawback mechanism, discussed an issue relating to clawback for WWU that had arisen during RIIO-GD1 and sought views on two proposals for closing out the mechanism for WWU for the GD1 period. We also sought views on our proposal for closing out the mechanism for WWU during the pre-GD1 period.

8.2. We have decided to carve out the decision on tax clawback for the GD1 and pre-GD1 periods from this GD1 Closeout methodology decision as we need time to consider it further. We will publish our decision on the GD1 tax clawback values for WWU separately, in due course.

9. Disposals

This section details our Decision on the methodology and process we intend to follow to close out RIIO-GD1 disposals.

Background

9.1. When a licensee sells an asset that was originally funded by consumers, we think the proceeds of that asset sale should be passed to consumers.

9.2. In RIIO-GD1, our policy was to deduct the sale proceeds of disposals directly from the licensee's RAV balance five years after the disposal took place. This five-year lag between the asset disposal and the deduction of the sales proceeds from the closing RAV balance allowed GD licensees to continue to earn depreciation and a return on the original RAV balance for an extra five years after the disposal date. This provided a cashflow incentive for GD network companies to sell assets that were no longer used or needed.

Methodology proposed at consultation

9.3. We proposed to apply the disposals policy that was set out in the RIIO-GD1 Price Control Financial Handbook[16] and deduct asset disposal proceeds from the closing RAV balance for any disposals that took place within the RIIO-GD1 price control period, with a five-year lag.

9.4. We proposed to true up the assumed disposal values (the "yellow box" values) within the PCFM to ensure that the appropriate values are deducted from the RAV with a five-year lag.

Consultation responses

9.5. All four GDNs agreed with the proposed methodology for closing out disposals, with one GDN requesting that the detailed mechanics of how any adjustments will be made,

[16] See RIIO-GD1 Price Control Financial Handbook at paragraph 6.19, here.

through both the legacy PCFM and RIIO-GD2 PCFM, are discussed and finalised at a sector level in advance of the November 2022 Annual Iteration Process.

Closeout methodology Decision

9.6. We will closeout RIIO-GD1 disposals by applying the methodology as consulted on. We consider it appropriate that the proceeds of asset sales should be returned to consumers and that the five-year lag policy should be implemented as originally proposed.

9.7. We agree with the GDNs' point in paragraph 9.5 above and intend to engage with the GDNs on the specific mechanics of the PCFM adjustment through a series of legacy PCFM working groups ahead of the November 2022 AIP.

10. Additional closeout issues

10.1. In addition to responding to the specific consultation questions, an industry body also raised a number of further points around the closeout process, which we address below.

Sharing factors, timing benefit and RIIO-GD2 allowances

10.2. The industry body stated that the network companies should not benefit financially by delivering outputs later than agreed and therefore the relevant sharing factors that should be applied are those that were set for RIIO-GD1. The TIM sharing factors were reduced from an average of 63% for RIIO-GD1 to an average of 49% for RIIO-GD2, therefore applying the RIIO-GD2 TIM sharing factors would result in the network companies benefiting financially because they are less exposed to over-spends.

10.3. The industry body also stated that any timing benefit that accrued to the GDNs because they received expenditure allowances before they were needed should be returned to consumers.

10.4. The industry body also requested that Ofgem confirm whether the GDNs received additional allowances as part of the RIIO-GD2 settlement to complete delivery of the outstanding outputs. Stating that, if so, those allowances should be returned to consumers to avoid consumers ‘double funding’ a portion of the outputs.

Ofgem response

10.5. For RIIO-GD1 projects that were impacted by Covid-19 and will not be delivered until RIIO-GD2, the GDNs have committed to delivering these projects without additional allowances and Ofgem confirms that no additional allowances were provided at RIIO-GD2 Final Determinations in respect of funded RIIO-GD1 work. Therefore, there is no risk of double-funding of any delayed RIIO-GD1 work.

10.6. We acknowledge the points raised around the different sharing factors and GDNs accruing any unearned benefit from RIIO-GD1 projects not completed until RIIO-GD2, however bespoke treatment of delayed projects is not built into the RIIO-GD2 framework.

10.7. While we accept the validity of the industry body’s response and intend to make provision to address these issues in RIIO-GD3, after careful consideration, we do not consider it appropriate to make any allowance adjustments in regard to project timing or differing sharing factors in RIIO-GD2 for the following reasons:

(1) There are only a small number of RIIO-GD1 projects that were not completed during the price control, the delayed work was largely due to the Covid-19 pandemic and the GDNs have not requested any RIIO-GD2 allowances to complete the work.

(2) The forecast expenditure to complete the remaining RIIO-GD1 projects is low, therefore any impact of applying different sharing factors for RIIO-GD2 expenditure is low, especially relative to the complexity of applying split TIMs within the PCFM (see below).

(3) The PCFM does not allow for different sharing factors for different projects and the TIM is applied at the totex level rather than the project level, therefore there is no mechanism under the existing framework whereby a sharing factor adjustment can be implemented.

(4) Our regulatory intent is to provide a transparent and stable ex ante framework for the GDNs to operate as per our Final Determinations Decisions. Given the low materiality of delayed RIIO-GD1 projects we do not consider it appropriate to adjust the RIIO-GD2 framework that has already been consulted on, agreed, and implemented.

(5) Some of the delayed projects relate to the Physical Security Upgrade Programme. GDNs did not receive any allowances to deliver this work in RIIO-GD1 as incurred costs were below the materiality threshold to trigger a re-opener therefore, even though consumers will contribute slightly more in RIIO-GD2 than they would otherwise have done had the project been completed in RIIO-GD1, in aggregate they are still paying less than the actual efficient cost of delivering the work.

(6) The delayed RIIO-GD1 projects have largely already been delivered, or are forecast to be completed early in RIIO-GD2, therefore any time value of money benefit will be immaterial.

10.8. Considering all of the points in paragraph (10.7) in the round, we do not consider it appropriate to make any allowance adjustments in respect of delayed RIIO-GD1 projects.

11. Next steps

11.1. Ofgem will engage with the GDNs as necessary to implement the closeout methodologies and effect any necessary revenue adjustments as part of the November 2022 AIP. Specifically:

- We will consult via working groups on which values or rows in the PCFM to modify to effect the closeout methodologies, and prepare a reconciliation workbook from the final published RIIO-GD1 PCFM (2019) to the final closeout GD1 Legacy PCFM.
- We will consult via working groups on modifications to the GD1 Legacy PCFM to allow the phasing of the LMOD term.
- We will describe the modifications and updates in the GD2 Price Control Financial Handbook, via statutory consultation.

11.2. The GDNs have already submitted their 2021 Regulatory Reporting Packs (RRPs). Ofgem expects that this information will be sufficient to enable it to undertake a robust assessment of the GDNs' RIIO-GD1 performance and determine the extent of any over- or under-performance against their targets. If any additional information is required Ofgem will engage with the GDNs and request this as necessary at the closeout implementation stage.

11.3. We will engage with the GDNs outside of the closeout process with regard to a licence modification to amend the parameters of the RIIO-GD2 Shrinkage and Environmental Emissions Incentives.