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23rd May 2025

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Dear Michael,

Wales & West Utilities (WWU) response to the proposal to modify the standard and special conditions of the Gas Transporter, Electricity Distribution and Electricity Transmission licence and the Price Control Financial Instruments (PCFIs) for RIIO-GD2, RIIO-GT2, RIIO-ED2 and RIIO-ET2

Thank you for the opportunity to respond to this consultation. WWU is a gas transporter and a regional gas distribution network ("**GDN/s**"), serving 2.6 million supply points in Wales and south-west England. This response is not confidential and may be published by Ofgem.

We comment on the proposals that impact our licence or PCFM. Our response on the proposed modifications to Special Condition 9.7 comprises most of the response and we respectfully request that our points are given due consideration, recognising that some aspects may require consultation with Ofgem colleagues outside the Regulatory Finance team.

Proposed changes to the WWU licence

Modification to Special Condition 5.4 Vulnerability and carbon monoxide allowance (VCMt) in the GD licences

WWU supports this change that allows unused company specific allowances to be used for collaborative projects.

We suggest that wording for the description of $VCMCLE_i$ and the $\sum VCMCLE_k$ should read "... total expenditure **by the licensee...**". We assume this was the intention and this is how all parties read it; the formulae would not be sensible without this assumed reading; however, making this clear would be sensible and avoid any questions arising at the end of GD2.

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Modification to Special Condition 9.7 Directly Remunerated Services of the Gas Transporter Licence

Ofgem are proposing to amend SpC 9.7.2 and SpC9.7.4 to reverse their effect as follows:

9.7.2 The effect of this condition is that revenue derived by the licensee from the provision of Directly Remunerated Services is ~~excluded~~ **reflected from** ~~in~~ the calculation of Calculated Revenue.

Part A: Licensee's obligation to ~~exclude~~ **account for** Directly Remunerated Services

9.7.4 The licensee must ~~exclude~~ **account for** revenue derived from Directly Remunerated Services ~~in its~~ ~~from~~ Calculated Revenue.

The proposed changes have not been justified and are not appropriate, this needs a comprehensive review with the involvement of appropriate Ofgem colleagues. It also fails to consider the potential consequences of this proposed change on the provision of non-statutory services by licensees and the effect on competition and customer service.

WWU will cooperate with a properly carried out review but will oppose poorly thought out and poorly justified changes. We have carried out a significant amount of work in this area and attach two annexes to this response; these are referenced in the relevant sections below:

Annex 1: Extracts from the GD1 licence date February 2020

Annex 2: WWU's views on DRS categories in Part C of SpC 9.7

WWU opposes this change for the following two reasons:

- 1) No reason or justification given for changing the licence
 - a. It does not justify why competitively provided services should be subject to price regulation that was intended to apply just to regulated monopoly services;
 - b. it fails to consider the possible consequential impacts on customers of licensees' decisions to provide or not provide certain services should any changes be made;
 - c. it fails to consider how the costs are treated and consequently will result in networks incurring unrecoverable costs;
 - d. the presence of the DRS term in SpC2.1 of the GD2 licence is due to the fact that it was included in the equivalent condition in the GD1 licence; **however**, in that licence DRS meant Discretionary Reward Scheme. The renaming of Excluded Services to Directly Remunerated Services in GD2 and the failure to remove the DRSt term that related to Discretionary Reward Scheme from what became SpC2.1 has led to the apparent conflict between SpC2.1 and SpC 9.7. It is clear that the way to resolve this is to remove the DRS term from SpC2.1 **not** to amend SpC9.7.2 and SpC9.7.4.
- 2) The proposed modification fails to address existing inconsistencies in SpC9.7 of the GD licence, if the proposed change is made it is vital that the licence clearly and unambiguously defines what comprises Directly Remunerated Services.

We address these in turn below.

1) *No reason or justification given for changing the licence*

The reason stated in the consultation is “The current GD2 PCFM does not correctly capture Directly Remunerated Services (DRS) as outlined in Part E of Special condition 2.1 Revenue Restriction (ARt) (SpC 2.1) of the Gas Transporter Licence”

This states that that the PCFM is inconsistent with the licence, but the consultation gives **no** justification for changing the licence.

The effect states “These proposed adjustments would provide more clarity by ensuring alignment of the Licence and GD2 PCFM, thereby enabling the Revenue tab of the GD2 PCFM to account for Directly Remunerated Services in accordance with Part E of SpC 2.1 of the Gas Transporter Licence.”

This does not mention that SpC9.7.4 purposefully states that DRS revenue shall not be included in the calculation of calculated revenue and fails to consider why that clause exists, we discuss this point below. The logical sequence is that SpC9.7 determines what is in DRS that in turn feeds into the PCFM and the PCFM then delivers a value that is used in accordance with SpC 2.1. The Ofgem argument is getting very close to asserting that the PCFM determines what should be in the licence. The Ofgem regulatory finance team seems to have taken the view that SpC9.7.2 and 9.7.4 are wrong without considering the reason why they exist on a sector specific basis.

Directly Remunerated Services relate solely to the Licensed Activity of the licensee (see below for the definition of DRS in Special Condition 9.7 and the definition of Licensed Activity). Licensed Activity is a subset of the licensee’s transportation business that is itself a subset of the licensee’s permitted activity defined in Standard Special Condition A36. Prior to GD2, what is now Directly Remunerated Services were known as Excluded Services. That is, they were excluded from calculations relating to formula revenue (revenue from Shippers for the Supply of Distribution Network Services). In our view this is the correct position and the current wording in the licence supports this position and is consistent with the wording of the GD1 licence condition (SpC 4C. Services treated as Excluded Services). All parties acknowledge that the Supply of Distribution Network Services is a monopoly activity and requires regulation and the current licence supports this, that is revenue from the Supply of Distribution Network Services is regulated but DRS revenue is not.

SpC9.7.7 states that DRS are services provided as part of its Licensed Activity but not already remunerated by either Network Charges or returned royalty income under SpC7.7.

Licensed Activity means the activities of the licensee connected with the development, administration, maintenance and operation of the Distribution Network and with the Supply of Distribution Network Services.

The other main activity that falls under the definition of Directly Remunerated Services is “the activities of the licensee connected with the development, administration, maintenance and operation of the Distribution Network”. “Maintenance and operation” does not produce revenue and hence is not relevant for DRS. “Development and administration” includes activities such as new connections to the Distribution Network or alterations to existing assets. Four points are relevant.

a) Both connections and much of alterations such as service alterations are open to competition and the general principle is that services that are open to competition do not need to be regulated as competition will ensure that prices are cost reflective.

b) Considering service alterations for example, these are done for the benefit of the individual customer for example to enable a house extension, they do not provide benefits to other customers who are not affected whether or not the service alteration occurs or not and the service alteration does not have any impact on the work required to ensure that the network operates safely and efficiently. Including the revenue from service alterations as part of formula revenue, means that revenue that can be recovered from Shipper is reduced yet the licensee still has to do the same amount of work to operate its network safely and efficiently to provide Supply of Distribution Network Services. There is therefore no logic for including revenue from these service alterations and similar activities in formula revenue (calculated revenue) calculations and to do so produces a perverse incentive to networks to minimise the number they do. This potentially means that networks could withdraw from providing service alterations thereby reducing customer choice and competition with likely detrimental impacts on customers.

c) Including DRS revenue as part of allowed revenue, fails to take into account how costs of connections and alterations activities are treated; for example, for any connection work where a profit is made, this benefit is already shared with customers through the Totex sharing mechanism. Customers do already benefit from the use of network resources to provide these services because the cost of the resources used to provide them is removed from cost allocated to the core regulated business so customers do not pay for them. Without the provision of these services then there would be more unproductive time as these resources are required at peak times to deal with escapes for example. Therefore, the argument that customers do not benefit from networks providing connections and alteration services is incorrect, in fact the opposite is true. It is also worth highlighting business plans submitted in December 2024 would need to be reviewed and potentially re-submitted if these changes were applied given assumptions made around DRS activities.

d) The presence of the DRS term in SpC2.1 is due to the fact that there was a DRS term in the equivalent GD1 licence SpC 1B; however, in that condition DRS related to Discretionary Reward Scheme. This should have been removed from the GD2 licence; however, it was not. The coincident renaming of Excluded Services to Directly Remunerated Services in GD2 which has the same abbreviation as Discretionary Reward Scheme has led to the incorrect belief that Directly Remunerated Services revenue should be included in SpC2.1. SpC9.7 in the GD2 licence is exactly the same as the SpC4C Services treated as Excluded Services in the GD1 licence apart from the name change. There is also no definition of DRS_t in SpC9.7 which would be expected if the revenue was to be included in SpC2.1. The GD1 licence also contained a definition of Discretionary Reward Scheme in SpC 1A Definitions; however, this was removed from the GD2 licence and there is no corresponding definition of Directly Remunerated Services in the GD2 licence SpC 1.1 Interpretation and Definitions. The clear intent was not to change the treatment of Excluded Services / Directly Remunerated Services between GD1 and GD2 and therefore the clear conclusion is that the DRS_t term in SpC2.1 should be removed as there was no intent to have DRS revenue included in calculated revenue. We provide extracts from the GD1 licence in Annex 1.

2) *The proposed modification fails to address existing inconsistencies in the GD licence*

Information provided in the Regulatory Reporting Pack relating to DRS has previously been provided for information only. We have been aware for some time of the inconsistencies in the current drafting; however, given that the information had no material impact on revenue we have focussed on other matters. WWU has asked for clarification on a number of occasions in RRP workgroups.

Starting with the definition of DRS in SpC9.7.7 and 9.7.8

9.7.7 The general principle is that a service provided by the licensee as part of its Licensed Activity is to be treated as a Directly Remunerated Service if and to the extent that the service is not already remunerated under any of the charges listed in paragraph 9.7.8.

9.7.8 The charges referred to in paragraph 9.7.7 are:

- (a) Network Charges; and
- (b) charges arising from any activity carried out under the provisions of Special Condition 7.7 (RIIO GD-1 network innovation competition) which results in Returned Royalty Income for the licensee.

The above contain a number of defined terms that require examination.

Licensed Activity means the activities of the licensee connected with the development, administration, maintenance and operation of the Distribution Network and with the Supply of Distribution Network Services.

It is important to realise that Licensed Activity is only part of the transportation business of the licensee and that is only one of the four business activities permitted by Standard Special Condition A36.

Supply Of Distribution Network Services means the undertaking and performance for gain or reward of engagements:

- (a) in connection with the conveyance of gas through the Transportation System;
- (b) for the prevention of the escape of gas which has been taken off the Transportation System; and
- (c) relating to the acquisition of capacity rights, gas or gas derivatives for the purpose of:
 - (i) the balancing of the Transportation System through the acquisition or disposal of gas to replace gas lost from the Transportation System; and
 - (ii) facilitating constraint management.

In plain English, Supply of Distribution Network Services is the provision of transportation services to Shippers as detailed in the Uniform Network Code. The other part of Licensed Activity relates to “the activities of the licensee connected with the development, administration, maintenance and operation of the Distribution Network” which includes things like connections to the system, alterations and other similar activities.

Distribution Network has the meaning given to that term in Standard Special Condition A3 (Definitions and Interpretation).

“**distribution network**” means a gas distribution network as defined with reference to the aggregate of its constituent local distribution zones (as defined in the Uniform Network Code (“LDZs”)) in accordance with the table set out below:

Distribution Network	LDZ
East of England	East Midlands, Eastern
London	North Thames
North West	North West
West Midlands	West Midlands
Northern	Northern, North East
Scotland	Scotland
Southern	South East, Southern
Wales and West	Wales North, Wales South, South West

This states that Distribution Network is the licensee's network only (and does not include other distribution networks for example, IGTs).

The definition of DRS is therefore that is a subset of Licensed Activity that is not remunerated by Network Charges or Returned Royalty Income.

Network Charges means charges made or levied, or to be made or levied, on any person by the licensee for the provision of services as part of its Licensed Activity.

In this context this is somewhat circular and tells us that DRS are any services provided as part of the licensee Licensed Activities that are not remunerated. There is a question as to whether "remunerated" means fully remunerated. If "remunerated" means fully remunerated, DRS is only those services where the remuneration does not fully cover costs. This does not make sense. Therefore, our view is that remuneration includes payments that do not necessarily fully cover costs. This means that DRS are those services for which the licensee receives some revenue but that it may not cover its costs, hence DRS revenue for these services will be less than cost. Since at least some revenue is received for what are listed as DRS 1, 2 and 3 in the licence, these actually fall outside the definition of DRS. This is consistent with the current treatment of these services through Totex described earlier in this response. In Annex 2: WWU's views on DRS categories in Part C of SpC 9.7 - we provide a detailed view of which service lines currently listed as DRS in the licence should continue to be listed and comment on how the costs for DRS 1,2,3 are currently treated.

Proposed way forward

Ofgem's proposed licence changes cannot progress as drafted, there is good evidence that the inclusion of the DRS term in SpC2.1 was due to drafting errors and the unfortunate use of one abbreviation to mean two different things between GD1 and GD2. If Ofgem wants to change the principle upon which network regulation is based then it needs a proper debate in the context of the setting of price controls that considers the principle behind regulation of licensees' revenue and costs as well as the potential for consequential impacts on licensees' decisions to provide or not provide certain services should any changes be made. Therefore, no changes should be made to the GD2 licence or PCFM in this respect and any proposals addressed as part of GD3 licence drafting and PCFM development. Noting the prior comment on the potential change to the GD3 business plan.

Comments on changes to the PCFM

1) Modification to the non-variant allowances in the GD2 PCFM

Ofgem states "We intend propose to make corrections to the non-variant allowances (row 8 to 14) within the company specific input tabs of the GD2-PCFM."

WWU notes and agrees with the proposed updates to non-variant allowances in the GD2 PCFM.

2) *Modification to the GD2 PCFM for DRS*

Ofgem states “We propose modifying the formulae in row 158 (AP158:AT158) - Identified directly remunerated services costs (as used in revenue calculation) - in the Input tab of the GD2 PCFM to get data from row 152 (AP152:AT152) - Identified directly remunerated services costs - within the same tab”

WWU opposes this change for the reasons outlined in detail in the “Modification to Special Condition 9.7 Directly Remunerated Services of the Gas Transporter Licence” section above. There should be no changes made to the GD2 PCFM until DRS has been discussed in detail on a principles basis at industry level to ensure consistent interpretation and application.

GD2 Price Control Financial Handbook (PCFH)

We note that no changes are proposed to the GD2 PCFH this year. We request clear guidance to be provided by Ofgem relating to how the price setting process will work for the 2026/27 regulatory year absent an Annual Iteration Process noting that GDN’s have an obligation to set a 150-day indicative notice and 90-day final notice of charges ahead of the upcoming regulatory year.

Yours sincerely,



Richard Pomroy
Regulation Manager
Wales & West Utilities

Attachments

Annex 1: Extracts from the GD1 licence date February 2020

Annex 2: WWU’s views on DRS categories in Part C of SpC 9.7