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Ofgem
FAO: Michael Smith
10, South Colonnade
Canary Wharf
London, E14 4PU
Email: Michael.smith@ofgem.gov.uk

20th May 2025

Dear Mr Smith,

Re: 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 statutory consultation which proposes to modify the Standard and Special Conditions of our Gas Transporter licence and the PCFIs. Please note that we are only commenting on the three proposals outlined in this consultation which relate to the Gas Distribution (GD) sector.

We agree with the proposed modifications to the Vulnerability and Carbon Monoxide Allowance (VCMA) set out in Chapter 3 of the consultation document. The proposed changes introduce additional flexibility to accommodate individual or collaborative VCMA projects and bring closer alignment between Special Condition 5.4, the functionality of the PCFM and the intended purpose of the VCMA.

We also agree with the proposed modifications to be made to non-variant allowances in the GD2 Price Control Financial Model (PCFM), set out in Chapter 5. These modifications correct for errors in the calculations which we have raised and engaged with Ofgem on previously.

The third proposal which impacts the GD sector is the proposed modification to incorporate the impact of Directly Remunerated Services (DRS) into the determination of Calculated Revenue in the GD2 PCFM. To date, there has been a lack of clarity over the treatment of DRS in Calculated Revenue and the allocation of DRS in Regulatory Reporting, which has led to licensees reporting on DRS in different ways. To allow time for clarity and uniformity we do not believe that it is appropriate for changes to the treatment of DRS to be implemented until RIIO-3.

**we are
the network**

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In the RIIO-2 Sector Specific Methodology Decision (SSMD) Ofgem stated: *“We will consider treatment of DRS in light of operational practice to date and the information in company business plans. Where costs incurred differ from original forecasts, we will consider true-up methodologies if we believe it is in the consumer interest. We will also consider where regulatory reporting could be further improved to enhance understanding.”*¹ We are not aware whether Ofgem has undertaken the detailed DRS review to date, however, we have not been appropriately consulted on the “true-up methodologies” or the reporting guidance ambiguities.

Further, the RIIO-3 SSMD also stated: *“Ofgem will forecast the expected revenues and costs from the network company providing these services and reflect these when setting the allowances at the beginning of the price control. Where the actual revenue earned or cost incurred differs from original forecasts, in some cases, it may be appropriate to true-up this difference. The need for a true-up depends on the category of services and whether the costs and revenues are incentivised.”*² However, we are yet to see Ofgem’s analysis on the appropriateness of the “true-ups” or the engagement on DRS incentivisation.

We acknowledge that Ofgem raised concerns in relation to the mechanics of DRS treatment in PCFM last autumn. However, despite GDN requests, no comprehensive review of the matter has taken place to date. We would therefore suggest that before making any DRS formula changes to PCFM, Ofgem undertake a further round of engagement with GDNs to settle the points of principle mentioned above. We require absolute clarity on exactly how DRS should be reported on, incentivised and what revenue “true-up” methodology is appropriate in RIIO-GD2 and in RIIO-GD3. Once licensees have this clarity, it will be possible to understand the impact of the proposed change on Calculated Revenue and determine whether transitional arrangements are necessary to enable licensees to plan for the upcoming change. As a result of the engagement process, it would be useful for licensees to have sight of Ofgem’s impact assessment and evidence that the proposed change is in the consumer interest.

We also consider that there are further refinements required to Special Condition (SpC) 9.7. Paragraph 9.7.2 is proposed to be amended to: *“The effect of this condition is that revenue derived by the licensee from the provision of Directly Remunerated Services is reflected in the calculation of Calculated Revenue.”* This is not aligned with the formulae in the PCFM which adjusts for the margin (i.e. the profit or loss) rather than the revenue generated by DRS. If this change is implemented, despite the reservations expressed above, we would suggest that the wording of this Licence Condition more accurately reflects the calculations that are suggested in the PCFM and refers to DRS margin instead of DRS revenue.

Given there has not been a comprehensive review of DRS to date, and we are approaching the end of the GD2 regulatory period, we consider that it is appropriate to defer DRS-related Licence modifications to RIIO-GD3. In the meantime, further engagement with the Licensees can take place via the PCFM Development Working Group or in a different forum. This would allow for sufficient time to clarify the correct treatment of DRS and ensure that the resulting impact of the changes is fully understood and acceptable. It would also allow time for further refinement of SpC 9.7 to be undertaken in order to maintain that much-needed consistency between the PCFM and SpC 9.7 as mentioned above.

¹ Paragraph 7.76 of the RIIO-2 SSMD Finance Annex

² Paragraph 10.26 of the RIIO-3 SSMD Finance Annex

If you have any questions in relation to this response, please contact Dean Peason, Head of Regulation on depearson@northerngas.co.uk who will be able to assist your queries.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Greg Dodd'.

Greg Dodd | Regulation and Strategic Planning Director

Northern Gas Networks