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Dear Joanna

Gas Distribution Price Control Review - Initial Proposals for the One Year Control

Scotia Gas Networks plc (SGN) is pleased to set out below its views on Ofgem's Initial Proposals for the One Year Control. Our detailed comments have been set out in the Appendix to this letter. Overall, SGN believes that there is still some way to go in improving proposed allowances for its two networks, Scotland Gas Networks and Southern Gas Networks, before Ofgem's proposals could be acceptable to SGN. Our key concerns are summarised below.

- **Operating cost allowances.** SGN supports the principle of a simple "roll-over" review for the one year control. However:
  - The use of 2004/05 actual costs in setting operating cost allowances (opex) for 2007/08 is not robust. In particular, throughout 2004/05 the DNs were all in NG's ownership and we do not believe that NG's model for allocating costs across the DNs was appropriate;
  - The 2005/06 costs used are forecasts provided by DNs before the end of the financial year, which need to be updated to reflect actual costs as reported in the Regulatory Accounts;
  - An average of 2005/06 actual costs and 2006/07 forecast costs would be a more equitable solution, in the spirit of a simple roll-forward of the price control;
  - Allowances for the recovery of pensions deficits need to be updated to reflect the latest actuarial valuations;
  - In Scotland Gas Networks' case, the allowance for LNG storage has been omitted; and
  - The 2.5% opex efficiency assumption is at odds with the cost pressures DNs are facing and takes no account of the cost to deliver, or the time lag in achieving, efficiency savings. It should therefore be removed from the calculation.
- **Treatment of RAV roll-forward.** SGN has continuing concerns both with the principles proposed to roll forward the RAV for the capex overspends and with application of the proposed methodology. In particular:
  - It is apparent that the policy position applying between 2003 and 2006 is uncertain. In our view, the Ofgem March 2004 letter created an expectation of retrospective funding of efficient overspend (i.e. inclusion in Pot 3). That letter did not merely reassert that the rolling five year incentive mechanism was

“switched on” (i.e. Pot 2), as would probably have been the case, if that was the policy intent;

- Ofgem’s consultant’s found no evidence of inefficient spend, and customers have clearly benefited from the investment;
- The disallowance of capex from the RAV is therefore, in our view, a disproportionate penalty for inaccurate forecasting; and
- There is a significant risk of creating perverse incentives going forward to defer investment rather than risk disallowance and to over-forecast.

We have suggested to Ofgem an alternative solution for dealing with the overspends, by allowing capex into the RAV from 1 April 2007 rather than five years after being incurred. This would go some way towards addressing our concerns above and would be consistent with the approach Ofgem have taken in the electricity and gas transmission reviews.

This suggestion notwithstanding, SGN also has some issues with the application of the RAV roll-forward methodology, these include:

- Efficient price variances on customer-driven work should be capable of inclusion in Pot 3;
  - The disallowance of costs deemed as under-charging of customers for connections is part of a much wider debate needed on connections policy and is therefore in our view an issue for the main review; and
  - The disallowance of Related Party Margins on net capex has not been consulted on and needs proper debate. This is a fundamental policy shift and should be subject to full consultation in the Main Review.
- **Allowed returns.** In our view, the proposed cost of capital of 4.38% (post-tax real) is insufficient to attract equity investment in network businesses. We understand that in the spirit of rolling forward a one-year control, Ofgem have simply taken the post-tax figure implicit in the current price control. We understand the logic for this, but it is equally clear that DNs should not be penalised for the one-year roll-over process. Clearly, a thorough review of DNs’ returns is still needed in the main review, reflecting the high risk nature of the businesses. In the meantime, we continue to strongly support retaining a pre-tax cost of capital approach for the one year control or adopting a post-tax approach consistent with the 4.8% we believe that Ofgem should adopt in the transmission price review. We believe that this approach would also be consistent with the ability of DNs to finance their activities.
  - **Pensions.** We support the application of the same policy principles to pension cost recovery as applied in the electricity price review. To that end, we have recently provided Ofgem with the latest actuarial valuations, which we believe should be reflected in the final proposals.
  - **Shrinkage.** We welcome Ofgem’s suggested approach to incentivising shrinkage costs. We believe that this approach would represent a more proportionate set of incentives and we have commented in the attached on some of the detailed factors that will need to be taken into account in finalising this mechanism.

If you have any questions or would like to discuss further any of the issues raised in this response, please call.

Yours sincerely

Rob McDonald  
**Director of Regulation**

## Scotia Gas Networks plc

### Gas Distribution Price Control Review

#### Response to One Year Control Initial Proposals

The comments set out below refer to the questions as set out in Appendix 1 of the Initial Proposals document.

#### Chapter 2: Operating expenditure

**Question 1:** *Is Ofgem's approach for determining an opex allowance for 2007-08 appropriate? Are the resulting allowances appropriate?*

SGN supports the principle of a simple "roll-over" review for the one year control. However, we have a major concern over the absolute cost allowances and the relative fairness of the opex allowances for Southern Gas Networks compared to the other DNs and we have met with Ofgem on this. Our specific concerns are set out below and once corrected would go some way towards closing the gap between SGN's submitted BPQ and Ofgem's proposed allowance:

- The use of 2004/05 actual costs in setting operating cost allowances (opex) for 2007/08 is not robust, for example:
  - NGG allocations are inaccurate, using an outdated transaction model;
  - 2004/05 was an unusual year, in that it was in our view an atypically low cost year. For example, the level overheads allocated to excluded services/Meterwork means that opex does not accurately reflect the direct costs incurred;
  - NG submitted the numbers and these cannot be verified by SGN.

We therefore firmly believe that 2004/05 costs should not be used for setting future allowances and certainly not for the sold DNs. Instead we believe an average of 2005/06 actual costs and 2006/07 forecast costs would be a more equitable solution and would more accurately reflect expected costs in 2007/08.

- In addition there are a number of other adjustments that are required:
  - The 2005/06 costs used are forecasts provided by DNs before the end of the financial year, which need to be updated to reflect actual costs as reported in the Regulatory Accounts;
  - Allowances for the recovery of pensions deficits need to be updated to reflect the latest actuarial valuations;
  - In Scotland Gas Networks' case, the allowance for LNG storage has been omitted;
  - The 2.5% opex efficiency assumption is at odds with the cost pressures DNs are facing and takes no account of the cost to deliver, or the time lag in achieving, efficiency savings. We therefore consider that this assumption should be removed.

If 2004/05 costs are to be used, there are a number of mathematical adjustments that need to be made to SGN's networks and we have written separately to Ofgem on this.

We welcome the proposed reopener for costs arising under the Traffic Management Act.

We also welcome the updating of the pass-through costs element in the 2007/08 price control i.e. licence fees and business rates, and the roll forward of existing arrangements for third party damage and water ingress.

**Question 2:** *Is Ofgem's proposed approach to setting pensions allowance for 2007-08 appropriate?*

We broadly welcome the application of Ofgem's previously declared policy on pensions and the resultant allowances, subject to updating for the latest actuarial valuations as noted above.

There are also errors to be corrected for both SGN's networks and as stated above we have written to Ofgem separately on this.

***Shrinkage related questions (see Appendix 9)***

***Question 3: Is Ofgem's assessment of the costs and benefits associated with the three options for setting shrinkage allowances, as set out in the impact assessment, reasonable?***

SGN agree with Ofgem's assessment of the costs and benefits associated with the three options for setting shrinkage allowances. In particular we welcome the emphasis given to the risk associated with highly volatile gas prices and throughput volume variation.

GDNs are currently exposed to these risks and yet have no control over them. This is not consistent with the low risk profile allowed for in the GDN's regulated rate of return on their capital investment.

Finally we note that the RIA refers to a reduction in volatility in returns arising from movements in shrinkage prices justifying a reduction in DNs' equity premium in the allowed cost of capital. We would point out that the price volatility experienced over recent years has happened after the cost of capital was set for the current price control and was not foreseen, therefore could not have been reflected in the allowed cost of capital.

***Question 4: Do you support Ofgem's proposed approach to setting shrinkage allowances (i.e. Option 1a)?***

We welcome the proposal to remove gas price risk from DNs. We broadly support Option 1a but in our view this does not go far enough and still exposes DNs to significant within-month price risk. We discuss this further in our response to Question 5 below.

Firstly under Option 1a, in comparison to Option 1b, GDNs will, at the start of a regulatory year, be able to set budgets for allowed costs based on year ahead gas prices and DS7 volume forecasts. This allows efficient financial planning at the start of a regulatory year – and during the year as projections of allowed costs are adjusted as actual market index prices are known.

In contrast, under Option 1b, the allowed costs are dependent on the performance of other GDNs, which is not known until the end of the financial year, and would result in 7 out of the 8 DNs earning less than their cost of capital. However the above does assume that the mechanism adopted for Option 1a is similar to that referenced in our response to Question 5 below.

Secondly, Option 1a allows for the variations in GDN demand profiles. There is, approximately, a 5% range in the average price paid by GDNs - due to the relative shapes of their yearly shrinkage profiles. This is based on SGN's analysis using uniform procurement strategy and shrinkage volumes for all GDNs.

Assuming the mechanism adopted for Option 1a is similar to that referenced in our response to Question 5 below – GDNs can buy their volumes at a monthly index, and thus the relative shape of their yearly shrinkage profiles is incorporated in the allowed costs. In contrast, under Option 1b, the benchmark of the lowest (or average) cost of gas paid over the year does not take this relative yearly profile into account. As a consequence we support Option 1a, subject to the points below in relation to the choice of index.

***Question 5: In the event that Ofgem adopts Option 1a for shrinkage, which market index (or indices) should GDNs' shrinkage allowances be linked to?***

SGN believes that Heren Prices should be used as the main market index as these are recognised industry-wide. However, this is a private index and provision needs to be made for the possibility that the index becomes unavailable.

Furthermore we believe that the mechanism for Option 1a should not simply be based on a year ahead index - as this would not be reflective of market trends within the year. Therefore there would be a high risk that shrinkage allowances would be based on a price that is either too high or low, i.e. the mechanism would not be an efficient one.

Instead we recommend monthly price indices are used to encourage procurement to be made across the year, and thus allowances would reflect the actual market trends for the year. Additionally day ahead price indices would be used to take into account the price variation risk that GDNs would be exposed to within month. This price risk is on the often significant volume variations between DS7 shrinkage forecasts, available when procuring month ahead (or further), and actual shrinkage volumes.

The price risk is due to the likely scenarios of either having to buy extra gas within month at high prices (during periods of high demand) or sell shrinkage gas at low prices (during periods of low demand). The losses incurred would be for the price variation between month ahead and day ahead prices, for the difference in volume between DS7 forecast shrinkage volumes and actual shrinkage volumes.

SGN's mechanism for Option 1a is set out in full in the attachment to this response.

**Question 6:** *In the event that Ofgem adopts Option 1b for shrinkage, should allowances be based on shrinkage costs incurred by the average GDN or lowest cost GDN?*

We do not support Option 1b. It is also clear that 7 out the 8 DNs would under this Option, other things being equal, earn less than the regulated cost of capital. However, if it were adopted allowances should clearly be based on shrinkage costs incurred by the average DN. To base them on the lowest cost DN would severely weaken incentives as only the best performing GDN is not penalised (but not rewarded either).

Additionally SGN believe that if Option 1b was adopted the methodology should be adapted to give each GDN a demand weighted price as an allowance. This would allow for the variations in GDNs' demands profiles. This issue is explained further in our response to Question 4 which highlights how Option 1b does not currently take demand variation into account.

**Question 7:** *Should Ofgem remove throughput-related shrinkage volume risk from GDNs?*

SGN believe that Ofgem should remove throughput related shrinkage volume risk from GDNs as they have no direct control over this risk, in the same way that they have no control over gas price risk.

### **Chapter 3: Capital and Replacement Expenditure**

**Question 1:** *Do you agree with our proposals regarding expenditure that we should treat as wasteful and unnecessary?*

**Question 2:** *Do you agree with our proposals regarding expenditure that we should treat as efficient overspend and, in particular, expenditure that should be subject to a reopener?*

SGN has continuing concerns both with the principles proposed to roll forward the RAV for the capex overspends and with the application of the proposed methodology. Our concerns with the principles are as follows:

- It is apparent that the policy position applying between 2002 and 2006 is uncertain. In our view, the Ofgem March 2004 letter created an expectation of retrospective funding of efficient overspend. The letter states that "[where] this spending can be clearly shown as providing significant benefits to customers, such as in terms of being essential for security of supply, Ofgem would consider allowing the licensee to recover the regulatory

*depreciation and or return from the year the expenditure is incurred*". In our view this indicated that efficient and necessary investment (which we believe covers all of the overspend) would qualify – subject to normal efficiency tests - for inclusion in Pot 3. By contrast, the letter did not merely reassert that the rolling five year incentive mechanism was switched on (i.e. Pot 2), but which is effectively Ofgem's present policy;

- Ofgem's consultant's found no evidence of inefficient spend, and customers have clearly benefited from the investment;
- The disallowance of capex from the RAV is in our view a disproportionate penalty for inaccurate forecasting. This equates to a fine of over £300m for the industry (equivalent to £70m for SGN), when compared to, for example, fines for breach of other statutory regulatory requirements. It would also, for example, be greater than 10% of turnover (c. £60m for SGN) in the context of a major Competition Act breach;
- There is a significant risk of creating perverse incentives going forward to defer investment rather than risk disallowance, and to over-forecast.

We have suggested to Ofgem an alternative solution for dealing with the overspends, by allowing capex into the RAV from 1 April 2007 rather than after five years after being incurred. This would go some way towards addressing our concerns above and would, for example:

- Recognise the ambiguity about the incentive arrangements;
- Deliver a more equitable sharing of the pain;
- Only penalise DNs in this price control period, not the next one; and,
- Be consistent with the view that the five year rolling incentive did not apply.

SGN also has some issues with the detailed application of the RAV roll-forward methodology, and these include:

- Efficient price variances on customer-driven work should be capable of inclusion in Pot 3;
- The disallowance of costs deemed as under-charging of customers for connections is part of a much wider debate needed on connections policy and is therefore in our view an issue for the main review;
- The disallowance of Related Party Margins on net capex has not been consulted on and needs proper debate:
  - Ofgem accept that margins are allowable in arms-length third party contracts e.g. Northern Gas Networks/United Utilities;
  - Risks encouraging DNs to always use third party contractors rather than seek the most efficient solution;
  - Is effectively a pass-through of connections costs and does not incentivise efficiency.

This is a fundamental policy shift and should be subject to full consultation in the Main Review.

We also have outstanding concerns on the way in which specific elements of capex have been treated for both of SGN's networks and we have written to Ofgem separately on this.

**Question 3:** *Do you agree with our proposed adjustments to the RAVs to reflect expenditure incurred between 1 January 2001 and 31 March 2002?*

The retrospective application to the previous price control period of the efficiency conclusions from the review of expenditure in the current period, in effect extends the capex roller, which is already under dispute, back a further 15 months to 1 January 2001. This is retrospective regulation and is totally unjustified.

**Question 4:** *Is our proposed approach for determining capex and repex allowances for 2007-08 appropriate? Are the resulting allowances appropriate?*

We broadly agree with Ofgem's repex and capex allowances for 2007/08. However, we have concerns about the proposed glidepath on unit costs for both connections and repex. The benchmark levels are not in our view sustainable and need proper review for the main control.

We also welcome the broad acceptance of our forecasts for LTS projects and gas risers. However, there is a need to develop an appropriate mechanism going forward for dealing with gas risers as the current mechanism neither allows sufficiently for the costs of these often complex projects, nor does it allow for the wide mix in scope of schemes. There is also an urgent need to consider the option of removing gas from high rise buildings where the cost of riser replacement is uneconomic, although we recognise that this is part of a much wider debate including fuel poverty concerns. We have written to Ofgem separately on this subject.

**Question 5:** *Is our proposed update of the mains replacement incentive mechanism for 2007-08 appropriate?*

As we have said above we do not believe that the benchmarks used to set glidepaths for replex are sustainable and these need proper review for the main control.

#### **Chapter 4: Financial issues**

**Question 1:** *Do you agree with our proposed approach to calculating the cost of capital to apply for 2007-08?*

In our view, the proposed cost of capital of 4.38% (post-tax real) is insufficient to incentivise extra investment in gas networks in the long term. Clearly the outcome of the debate on the appropriate cost of capital taking place as part of the Transmission Price Control Review will influence the Gas Distribution Price Control Review. However, a thorough review of DN's returns is still needed in the Main Review, reflecting the high risk nature of the businesses.

In the meantime, we continue to strongly support retaining a pre-tax cost of capital approach for the one year control for the following additional reasons:

- This would be consistent with a simple roll-over of the current price control;
- Ofgem's financeability review of SGN's financial model at the time of the acquisition of the networks was based on a pre-tax assumption, with no "flagging" of a potential move to a post-tax approach;
- DNs should not be penalised by the one year review process;
- DNs have a licence obligation to maintain an investment grade credit rating and we consider that a cost of capital of 4.38% post-tax real challenges this going forward.

The Initial Proposals claim that the loss of the tax wedge referred to above is offset by the increases in allowances for shrinkage and pensions, we strongly refute this argument. The increased allowances for shrinkage and pensions merely reflect the increased costs in these areas, they do not have any impact on financial ratios.

**Question 2:** *Do you agree with our proposed approach to the treatment of tax?*

As noted above, we believe that Ofgem should retain a pre-tax approach to the cost of capital in the one year control, moving to post-tax in the main review. We believe that this will be consistent with a simple roll-over of the price control. By contrast, Ofgem's current proposals include a detailed review of tax, but a simple roll-forward of post-tax returns implicit in the current cost of capital. We believe that if Ofgem is to move earlier to a post-tax return, it should conduct a detailed review of the cost of capital as well as a detailed review of tax (rather than one of these but not the other). In our view such a detailed review of the cost of capital would indicate that a return of at least 4.8% post-tax real is appropriate. If Ofgem is to persist with the present approach, at the very least the calculation of tax allowances need to follow the regulatory accounting i.e. 50% expensed.

**Question 3:** *Do our initial proposals, taken in aggregate, represent a reasonable outcome that both protects the interests of consumers and ensures that GDNs are able to finance their activities during 2007-08?*

We have set out in detail above our views as to why the Initial Proposals do not represent a reasonable or fair outcome for SGN.

## **Chapter 5: Timetable and Process**

**Question 1:** *Are the high level licence drafting changes proposed in Appendix 10 appropriate? Should we consider any other licence drafting changes?*

We support the proposed process to develop the licence amendments through the joint Ofgem/DN working group. The licence conditions identified as requiring amendment seem appropriate and we have no further comment at this stage.

## **Other issues**

Ofgem is seeking views as part of the Transmission Price Control Review on the proposed regulatory treatment of NGG's use of affiliated LNG facilities. In particular, how funding of the LNG facilities should be provided going forward given its current role in providing Operating Margins and System Support to NGG NTS. On the grounds that Ofgem believes NGG NTS can procure these services from other sources, Ofgem has decided that it is not appropriate to fund the investment through the main TPCR. The above debate, therefore, is now focussed on how to set the regulated prices that NGG NTS is permitted to pay for the services in the event that a competitive market for the services does not materialise.

It would appear that the above debate has focussed only on the use of the facilities by NGG NTS. That is, to date, no mention has been made of the application of the regulated price to the use of the Glenmavis LNG facility by SGN to meet its obligations relating to the independent systems associated with that network. Therefore, any increase/removal of the regulated prices will have an immediate impact on SGN and its own price control review for 07/08 and beyond. While we believe it is desirable to reduce regulation where there is effective competition, it is clearly not appropriate where the service in question is in effect a monopoly. In our view, the Glenmavis LNG facility is a monopoly service provider for the LNG requirements associated with SGN's independent system obligations. We therefore believe that this factor should be taken into consideration when considering the regulatory treatment of these facilities going forward. If price controls are nonetheless removed from the Glenmavis LNG facility, it will be necessary to include a full cost pass through for this service in SGN's price control.

**Scotia Gas Networks**

**Shrinkage gas incentive - Proposed Mechanism**

*Market index set on March 1st for each month of following financial year*

- Monthly prices for the following financial year would be set based on published Heren Prices on March 1st
- Monthly Heren Prices only go six months out. Thus quarterly Heren Prices for September to March of the following financial year would be shaped into monthly prices using ICE Natural Gas futures prices – as published in the Heren Report.

*Shrinkage forecast for GDNs set on March 1st – based on DS7*

- Just as Heren Price is an industry recognised index for the market cost of gas – DS7 is a recognised forecast for the shrinkage volumes for LDZs
- So the shrinkage volumes for the following year will be based on the latest DS7 forecast available on March 1st

*End of financial year adjustment made to the allowed revenue based on ‘actual’ month-ahead prices and GDN’s actual shrinkage volumes*

- Actual allowed shrinkage ‘pass through’ costs for each GDN would then be calculated on the basis of actual month-ahead prices (last trading day before month start) and actual shrinkage volumes
- The difference in costs from the forecasted shrinkage costs (based on year ahead monthly market price and shrinkage volume forecasts) would then be reconciled as an adjustment to the allowed revenue

**Methodology to Address GDN Exposure to Within Month Price Variation**

SGN proposes a further refinement to its proposed mechanism above, to address GDNs’ exposure to residual within-month price risk, for the difference between forecast (DS7) and actual volumes.

It is highly likely that GDNs would incur an additional cost from this residual price risk - due to the relationship between demand and prompt (within month) prices, as set out in the four possible scenarios below. Our refinement to our proposed mechanism takes into account the price variation from month-ahead to day-ahead prices.

We have included actual examples of how the refinement would have calculated the within month price variation in each scenario – based on actual daily data from Jul 05 to Jun 06.

**Scenario 1 – Demand decreases, prompt prices rise**

This scenario is not very common as prompt prices tend to decrease with a drop in demand (assuming SGN shrinkage variations reflected national demand);

E.g. 12/11/05

Volume differential (kWh) = Actual Shrinkage for day – DS7 monthly forecast/day  
 = 3,780,000 - 4,260,000  
 = -480,000

Price variation (p/kWh) = Day-ahead price – month-ahead price  
 = 2.03 – 1.52  
 = 0.51

Allowance for day = Volume differential \* Price variation  
 = -480,000 \* 0.51  
 = -£2,448

**Scenario 2 – Demand increases, prompt prices rise**

This scenario is common as prompt prices tend to rise with an increase in demand;

E.g. 25/11/05

$$\begin{aligned}\text{Volume differential (kWh)} &= 5,940,000 - 4,260,000 \\ &= 1,680,000\end{aligned}$$

$$\begin{aligned}\text{Price variation (p/kWh)} &= 4.50 - 1.52 \\ &= 2.98\end{aligned}$$

$$\begin{aligned}\text{Allowance for day} &= 1,680,000 * 2.98 \\ &= \text{£}50,064\end{aligned}$$

### **Scenario 3 – Demand increases, prompt prices fall**

This scenario is not very common as prompt prices tend to rise with an increase in demand;

E.g. 28/01/06

$$\begin{aligned}\text{Volume differential (kWh)} &= 5,900,000 - 5,400,000 \\ &= 500,000\end{aligned}$$

$$\begin{aligned}\text{Price variation (p/kWh)} &= 1.93 - 2.78 \\ &= -0.85\end{aligned}$$

$$\begin{aligned}\text{Allowance for day} &= 500,000 * -0.85 \\ &= -\text{£}4,250\end{aligned}$$

### **Scenario 4 – Demand decreases, prompt prices fall**

This scenario is common as prompt prices tend to fall with a decrease in demand;

E.g. 29/03/06

$$\begin{aligned}\text{Volume differential (kWh)} &= 3,820,000 - 4,620,000 \\ &= -800,000\end{aligned}$$

$$\begin{aligned}\text{Price variation (p/kWh)} &= 1.52 - 1.97 \\ &= -0.45\end{aligned}$$

$$\begin{aligned}\text{Allowance for day} &= -800,000 * -0.45 \\ &= \text{£}3,600\end{aligned}$$

The total adjustment to the allowance for Jul 05 to Jun 06, to the proposed mechanism in appendix one, would simply be calculated by summing the daily adjustments across the year – which would fall under one of the four scenarios above.

### **Summary of proposed mechanism for shrinkage gas incentive**

The below is a summary of the proposed mechanism for option 1a – including the refinement above to address GDNs' exposure to within month price exposure;

- 1. Initial Allowed Revenue**  
= DS7 Forecast \* Monthly Heren Prices @ 1<sup>st</sup> March
- 2. Actual Shrinkage Volume and Month end<sup>-1</sup> Price Allowance**  
= Actual shrinkage volumes \* Month end<sup>-1</sup> Heren Prices
- 3. Within Month Price Variation**  
= (Actual daily Shrinkage - DS7) \* (Day-ahead price – Monthly price)
- 4. Adjustment to Initial Allowed Revenue = (2. - 1.) + 3.**