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Dear Kieran,

Response to the Leakage and shrinkage baselines for GDPCR 2008-13 – October Update Consultation

You have invited views on the issues raised in the Leakage and shrinkage baselines for GDPCR 2008-13 – October Update Consultation. Our views are summarised below.

We continue to support the introduction of Ofgem's scheme to target the reduction of harmful environmental emissions caused by shrinkage gas. Furthermore we agree that such a scheme should use penalties and rewards as a means of incentivising GDN's to reduce their shrinkage volumes.

As a new and innovative scheme it is vitally important that the starting point (baseline) from which actual performance is measured is an equitable one - which avoids windfall gains and losses being made over the next Price Control Period.

We believe that the consultation letter has partly addressed our concerns over the setting of the baselines that we outlined in our response to the Update Proposals. However, the following measures still need to be addressed to ensure the GDN's have equitable baselines;

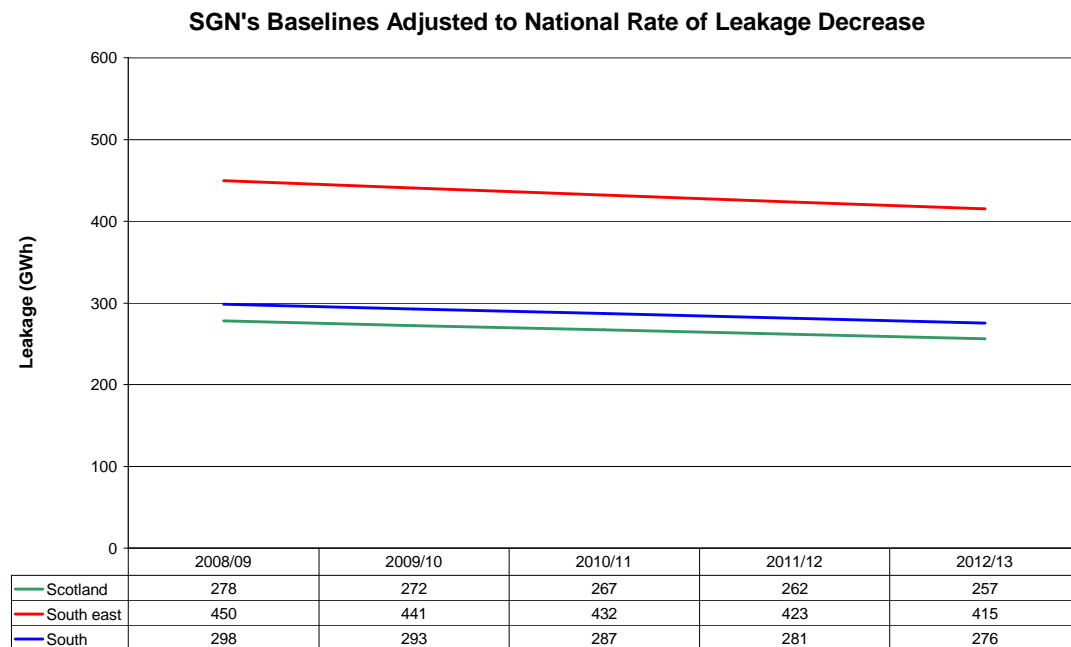
1. There needs to be equity in the decrease of GDN's' leakage baselines over the next PCR

The average decrease in GDN's' leakage volumes from 2007/08 to 2012/13 is 9.5%. We are fully supportive of the principle that there should be an incentive mechanism that has this target as a minimum, and also rewards investment that causes further reductions in the emissions of greenhouse gases.

However this average decrease is based on specific GDN target reductions ranging from 6-14%. With a target at the top end of this range, we are expected to decrease our emissions in excess of twice the rate as some other. We are not aware of any reason why such a range should exist and we therefore do not believe this provides an equitable incentive across GDN's to decrease leakage emissions.

Therefore we propose that each GDN is targeted with an overall reduction of 9.5% across its LDZs, thereby maintaining an overall minimum target of 9.5% across all GDN's - but allowing an equitable incentive for GDN's to further reduce their leakage emissions.

Thus we propose amending SGN's leakage baselines (from the figures in Table 1 of the consultation) to the national proposed rate of leakage decrease over the next PCR – as follows;



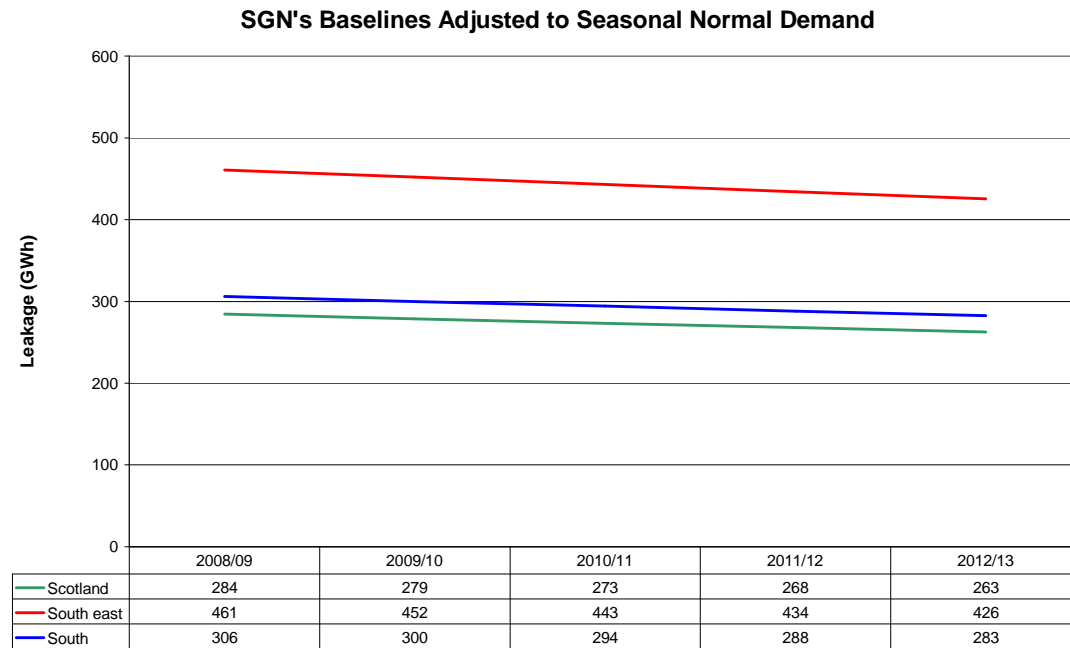
2. SGN's baselines need to be adjusted so that they are based on seasonal normal temperatures

As previously stated in correspondence with Ofgem, our baselines are understated as the starting point of our forecast was based on a very mild year (2006). There is a direct link between annual demand, average system pressure (ASP) and leakage volume. For example, during a mild winter ASPs would not be set as high as they would need to be in the colder conditions of a 'seasonal normal' winter to maintain security of supply, thus causing lower leakage volumes as compared to a 'seasonal normal' winter.

SGN's baselines are projected from the 2007/08 leakage return. This leakage return used average system pressure from a very mild year (calendar year 2006) which experienced demand 10% below seasonal normal levels. Analysis that we have previously submitted empirically proved that SGN's leakage baselines are understated

and that the South and South east baselines need to be increased by 2.5%, and the Scotland baseline by 2.4%, to allow an equitable baseline based on seasonal normal temperatures.

The leakage baselines set out below are based on what we consider to be a more realistic starting position - based on average system pressures under seasonal normal temperatures, and the national rate of leakage decrease;



3. Model methodology changes need to be reflected in an amended baseline

Any improvements or corrections to the leakage model used by GDN's, during the next PCR, need to be reflected in an amended leakage baseline. Otherwise GDN's will experience windfall gains or losses which are not at all linked to the management of leakage levels in their networks.

Also a standard model needs to be issued so there is clarity and transparency in the methodology used in the leakage calculations and the consequent amendments that need to be made to GDN's' baselines.

Thus it should be noted that we welcome the use of 2006/07 LDZ specific actual calorific values (CV) in the calculation of leakage baselines and future leakage volume forecasts. This is because adjusting the CV used in leakage volume calculations over the next PCR would introduce unnecessary complication in terms of the necessary adjustments to baselines, without significant improvements in accuracy in terms of reflecting the environmental impact of methane gas emissions.

Finally we believe that the shrinkage baseline will need to be reviewed if there is a change in the methodology in calculating the Own Use Gas and Theft of Gas Factors – so that GDN's are not exposed to uncontrollable windfall gains or losses. However we do question whether Own Use Gas and Theft of Gas factors should be included under this particular environmental mechanism. This is because the nature of these

shrinkage elements is that the vast majority of the gas is burnt, and thus they have much less of an impact on the environment than directly leaking methane into the atmosphere.

4. SGN's baselines need to be amended for workload adjustments

SGN's baselines are consistent with the Capital and Replacement forecasts submitted in our BPQ's - as requested by Ofgem. Therefore final baselines will need to be adjusted for any subsequent changes that Ofgem may introduce in the Final Proposals.

5. Rolling Incentive Mechanism

We believe that introducing a rolling incentive mechanism would maximise the environmental benefits of such a scheme as would be incentivised to make leakage reduction investments throughout the PCR period. Due to the requirement for a sufficient 'pay-back period' from relevant investments, we believe that the lack of a rolling incentive would provide perverse incentives which would raise the issue of periodicity of expenditure.

Summary

SGN are fully in support of the introduction of a mechanism that reduces environmental emissions caused by shrinkage gas. Introducing the measures set out above would ensure a robust baseline and incentive mechanism for GDN's, giving a substantial and equitable reduction in shrinkage over the next PCR.

Yours sincerely

Rob McDonald
Director of Regulation