

Gas Distribution Networks and
other interested parties

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Decision on amendments to the Shrinkage Allowance

Background

As part of the RIIO-GD1 Price Control we¹ provided a Shrinkage Allowance to Gas Distribution Network Operators (GDNs). This allowance is to provide funds for GDNs to replace the gas lost from the network through leakage, theft and gas used in transportation. The Shrinkage Allowance is calculated by multiplying the unit price of gas by the licensees' Allowed Shrinkage Volume. The Allowed Shrinkage Volume and the Shrinkage Allowance, are intended to incentivise GDNs to reduce the volume of gas lost through shrinkage.

GDNs use an engineering model to report the volume of gas lost to shrinkage. The modelled results are compared to the Allowed Shrinkage Volume set for the GDNs in RIIO-GD1. GDNs are financially penalised or rewarded according to performance against the outputs and incentives. GDNs are obliged to review the model annually and to propose changes to improve the accuracy of the model. When the model is changed, we can also amend the Shrinkage Allowance and the Allowed Shrinkage Volume to reflect that the future reporting will be on a different basis to when those outputs and incentives were set.

Summary

On 17 December 2014 we published two consultations. The purpose of the first² consultation was to understand stakeholders' views regarding correcting an error in our original decision³ on Modification Number Four to the Shrinkage and Leakage Model. The second⁴ consulted on our 'minded to' position regarding a proposal to amend the gas price used to calculate the Shrinkage Allowance for National Grid Gas Plc (in respect of its gas distribution networks) (referred to in this letter as NGGD) . This letter contains our decisions on both of these matters.

¹ The terms "the Authority", "we", "us" and "our" are used interchangeably in this letter. The Authority is the gas and electricity markets authority. Ofgem is the Office of the Authority.

² <https://www.ofgem.gov.uk/publications-and-updates/modification-number-four-shrinkage-and-leakage-model-%E2%80%93-proposed-amendment>

³ <https://www.ofgem.gov.uk/publications-and-updates/decision-letter-regarding-modification-number-four-shrinkage-and-leakage-mode>

⁴ <https://www.ofgem.gov.uk/publications-and-updates/national-grid-gas-distribution-nggd-modification-gas-price-used-calculate-shrinkage-allowance>

Decision on Modification Number Four to the Shrinkage and Leakage Model

On 17 December 2014 we published a consultation on our 'minded to' position to amend the direction so that it reflected our decision, ie to amend the published Shrinkage Allowance by amending the gas price used to calculate the Shrinkage Allowance so that it is calculated correctly. We have decided to implement our 'minded to' position. Annex 1⁵ of this letter sets out the amended Shrinkage Allowance using the same unit price of gas as was used to calculate the original allowance in Special Condition 1F.

We received three formal responses from GDNs; all support this proposed change. These responses are published alongside the December 2014 consultation. We have made this decision because the Shrinkage Allowance in our original decision did not accurately reflect the changes to the Allowed Shrinkage Volume.

NGGD modification to the gas price used to calculate Shrinkage Allowance

NGGD requested that we amend its Shrinkage Allowance to reflect the forecast price of gas between now and the end of the price control period. We have approved NGGD's request to use an alternative gas price to calculate the Shrinkage Allowance for its networks. The amended allowance and how it was calculated appear in Annex 2 of this letter. The proposed unit price proposed by NGGD meets the requirements of Special Condition 1F.

Annex 3 of this letter shows the final Shrinkage Allowance for all licensees taking both decisions into account: on Modification Number Four and on NGGD's request to use an alternative gas price. The only difference between the numbers in Annex 1 and Annex 3 is the Shrinkage Allowance for the NGGD licensees from the fourth year of the RIIO-GD1 price control.

We received four responses to our consultation on NGGD's request, which did not raise any concerns with the new proposed unit rate for NGGD.

SGN (responding on behalf of Scotland Gas Networks Plc and Southern Gas Networks Plc) also noted that the worked example in our consultation showed the unit price £20,591/GWh in 2014/15 prices,⁶ but the Shrinkage Allowance in 2009/10 prices. In the worked example in Annex 1, we show the extra calculation step of converting the 2014/15 unit price into 2009/10 prices before multiplying by the volume to reach the Shrinkage Allowance. The unit rate in 2009/10 prices is £16,167/GWh. The final Shrinkage Allowance amounts have not changed since the consultation was published.

The amended gas price will be incorporated in to the Price Control Financial Model. It will result in savings for gas customers in the years before the end of the price control rather than waiting for a true-up at the end of the period. Annex 1 of this letter sets out the amended Allowed Shrinkage Volume for all licensees taking in to account our decision on NGGD's proposal.

Unit price used to calculate the Shrinkage Allowance for other licensees

In our consultation on NGGD's proposal we noted that there may be merit in using a common unit price to calculate the Shrinkage Allowances of all GDN licensees. However, all respondents noted that there may be issues with amending the gas price used to calculate the allowance for all GDNs. In their opinion it would be better to wait before making

⁵ This does not take in to account NGGD's request where we use an updated unit price of gas to calculate the Shrinkage Allowance of its licensees. This is discussed in the next section of this letter. Annex three and the Direction we have published alongside this letter incorporates our decision on NGGD's request.

⁶ The gas price NGGD proposed comes from the 23 July 2014 Heren National Balancing Point (NBP) Price Assessment Offer prices for the Summer 2016 and Winter 2016.

changes for other licensees. GDNs' concerns include the varying cash flows of the different businesses and different views regarding what will happen with the gas price in future.

While we consider that a single unit price may be more transparent for customers, we recognise the arguments made by respondents against using a single unit price. We encourage all GDN licensees to consider on an ongoing basis whether they should propose an alternative unit price. Where licensees consider amendments should be made to the Shrinkage Allowance we encourage the licensees to discuss which unit price may be appropriate and whether a common unit price can be used across all GDN licensees. Finally, we note that there will be a true up at the end of the period where the Shrinkage Allowance will be calculated using actual gas prices. Where GDN licensees have received a Shrinkage Allowance based on forecast prices that is higher than they would have received based on actual gas prices, the difference will be returned to customers. The ability of licensees to amend the unit price used to calculate their Shrinkage Allowance should lead to more consistent network charges for customers.

Should you wish to discuss the issues raised in this document, please contact Neil Copeland at neil.copeland@ofgem.gov.uk or on 020 7901 7193.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Paul Branston', written over a light grey rectangular background.

Paul Branston,
Associate Partner, Gas Networks

Annex 1

Corrected Shrinkage Allowance based on Modification Number Four

Distribution Network	Correct Allowance (£m 2009/10 prices)							
	t=1	t=2	t=3	t=4	t=5	t=6	t=7	t=8
NGGD EoE	11.80	10.80	10.67	10.44	10.24	10.01	9.88	9.68
NGGD Lon	6.10	5.46	5.35	5.23	5.13	5.02	4.83	4.72
NGGD NW	9.00	8.38	8.27	8.05	7.85	7.62	7.42	7.22
NGGD WM	7.00	6.79	6.79	6.59	6.47	6.37	6.27	6.15
Northern Gas Networks Ltd	10.00	9.61	9.39	8.99	8.87	8.77	8.55	8.35
Scotland Gas Networks plc	5.20	4.80	4.70	4.60	4.47	4.37	4.25	4.14
Southern Gas Networks plc	13.30	13.10	13.00	12.68	12.48	12.28	12.06	11.56
Wales & West Utilities Ltd	8.80	8.62	8.62	8.42	8.32	8.22	8.02	7.82

Annex 2

Proposed revision to the shrinkage cost allowance

Distribution Network	Shrinkage allowance (£m 2009/10 prices)							
	t=1	t=2	t=3	t=4	t=5	t=6	t=7	t=8
NGGD East of England	11.8	10.8	10.7	7.92	7.74	7.55	7.36	7.18
NGGD London	6.1	5.5	5.4	4.30	4.19	4.07	3.96	3.85
NGGD North West	9.0	8.4	8.3	5.76	5.59	5.40	5.24	5.08
NGGD West Midlands	7.0	6.8	6.8	5.01	4.88	4.77	4.67	4.54

The Shrinkage Allowances from year t=4 onwards was calculated by multiplying the corresponding shrinkage volume (duplicated below for your information) by the unit price of £16,167/GWh. This is the 2014/15 unit price (£20,591/GWh) deflated to 2009/10 prices (by dividing by the RPIA_t Factor of 1.2736).

By way of an example, the Shrinkage Allowance for East of England in year t=5:

$$= 479\text{GWh} \times \text{£}16,167/\text{GWh}$$

$$=\text{£}7.74\text{m}$$

Distribution Network	Shrinkage volume (GWh) (Based on Shrinkage and Leakage Model v1.4, from t=2 onwards)							
	t=1	t=2	t=3	t=4	t=5	t=6	t=7	t=8
NGGD East of England	569	515	503	490	479	467	455	444
NGGD London	317	282	274	266	259	252	245	238
NGGD North West	407	378	367	356	346	334	324	314
NGGD West Midlands	335	323	316	310	302	295	289	281

Annex 3

Final Shrinkage Allowance taking both decisions in to account

Distribution Network	Correct Allowance (£m 2009/10 prices)							
	t=1	t=2	t=3	t=4	t=5	t=6	t=7	t=8
NGGD EoE	11.80	10.80	10.67	7.92	7.74	7.55	7.36	7.18
NGGD Lon	6.10	5.46	5.35	4.30	4.19	4.07	3.96	3.85
NGGD NW	9.00	8.38	8.27	5.76	5.59	5.40	5.24	5.08
NGGD WM	7.00	6.79	6.79	5.01	4.88	4.77	4.67	4.54
Northern Gas Networks Ltd	10.00	9.61	9.39	8.99	8.87	8.77	8.55	8.35
Scotland Gas Networks plc	5.20	4.80	4.70	4.60	4.47	4.37	4.25	4.14
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Wales & West Utilities Ltd	8.80	8.62	8.62	8.42	8.32	8.22	8.02	7.82