All GDNs, Shippers, Suppliers and
other interested parties

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Open letter regarding Modification to the Leakage Model under special condition E9 of the Gas Transporters Licence

This letter is to inform you of our position on changes to the Leakage Model common to all Gas Distribution Network Companies.

Background

On 20 April 2012, National Grid Gas Distribution (NGGD) and Southern Gas Networks (SGN) submitted to us a request to modify the gas Leakage Model[1] for their respective Local Distribution Zones (LDZ).

Leakage, together with gas lost to theft (in transportation) and some gas used by Gas Distribution Networks (GDNs) for their own purposes[2] is collectively called "shrinkage". Under the uniform network code (UNC) GDNs are responsible for replacing the gas lost to shrinkage to ensure that shippers are not exposed to the relevant costs. Under the 2008-2013 Gas Distribution Price Control Review (GDPCR) we set two incentives in this area to encourage GDNs to reduce leakage[3] and shrinkage: the Shrinkage Allowance and the Environmental Emissions Incentive (EEI), which are underpinned by special licence conditions E8 (SCE8) and E9 (SCE9) respectively. Both of these incentives require GDNs to report using the Leakage Model which is common to all GDNs.

NGGD and SGN proposed to modify the current Leakage Model by establishing a better estimate of the current low pressure service population for each LDZ and taking into account the leakage reduction associated with service transfers. NGGD informed us that its proposed changes to the Leakage Model had been discussed with industry at the Shrinkage Forum[4] in January 2012 and independently through bilateral meetings with all of the GDNs. Full details of the modification were made publicly available on the Shrinkage Forum's website.[5] NGGD's proposed changes gained support from SGN, which put forward an identical modification proposal. Both NGGD and SGN consulted on changes to the model and commissioned a report by an independent expert (as required under the terms of the licence), who supported the case for the modification.

[1] This is an input based model which uses known system parameters and historical test data to estimate and assess shrinkage volumes. A virtually identical model is used to assess the EEI volumes.
[2] This is mainly for heating gas in winter and stopping pipes from freezing.
[3] They can do this primarily through replacing iron mains with plastic ones and also investing in pressure management systems.
[4] A cross industry group (including shippers and suppliers) to discuss shrinkage issues. http://www.gasgovernance.co.uk/SF/060112
[5] http://www.gasgovernance.co.uk/SF/060112

Under SCE9, GDNs must establish a Leakage Model which facilitates the achievement of the objectives of accuracy, consistency and commonality among other distribution networks. Therefore, on 6 July 2012 we wrote to Northern Gas Networks (NGN) and Wales and West Utilities (WWU) asking for their views on this modification proposal. Both companies informed us that they supported the proposed changes to the Leakage Model put forward by NGGD and SGN. However, one of the network companies did not support the timing of the implementation of the proposed modification given the proximity to the re-setting of the shrinkage and leakage baselines as part of the RIIO-GD1 process.

In August 2012 we engaged with the network companies to explore options in relation to their requested modification. The challenge we faced at the time involved deciding whether to support a modification which would improve the accuracy of the model, but which lacked the support of all the networks in respect to its implementation. The section below sets out our views on this issue.

Key Issues

The main aim of the shrinkage and leakage incentives introduced under GDPCR was to reduce shrinkage and natural gas emissions across the industry through the Shrinkage Allowance (SCE8) and the EEI (SCE9). Any changes to the Leakage Model should be reflected in the calculation of baselines for the EEI and the leakage baseline under the Shrinkage Allowance. This approach is consistent with our proposals under GDPCR where we set out our intention to introduce governance arrangements to modify the baselines (where there has been a modelling change) in order to avoid potentially significant windfall gains or losses for the GDNs in relation to the EEI and the Shrinkage Allowance. Hence, any significant changes on the Leakage Model under SCE9(13) should be undertaken on the condition that they only take effect once the modifications to the baselines in SCE8 and SCE9 have been implemented.

In order to modify the baselines under SCE8 and SCE9 we would have to follow the licence modification process which includes a statutory consultation under section 23 of the Gas Act of not less than 28 days. The modification takes effect not less than 56 days from the publication of our decision as a result of this consultation. Hence, it would take almost five months to implement the necessary changes and the proposed modification would only come into effect for the last reporting year of GDPCR.

In principle we support NGGD’s modification to the current Leakage Model since it establishes a better estimate of the current service population for each LDZ and improves the accuracy of the model. However, notwithstanding the improvement in the model, we do not consider that it is in consumers’ best interests to have a situation where different leakage models are used by companies as a basis for setting allowances for RIIO-GD1.

We conveyed these concerns about the timing of implementation and the need for a consistent approach to setting RIIO allowances to the Shrinkage Forum on 26 September 2012 and also to NGGD bi-laterally. On the back of these discussions, NGGD has written to us to confirm that it will withdraw its modification and re-submit its RIIO-GD1 baselines using the current, approved Leakage Model.

Our view

We believe that any modification to the GDNs’ Leakage Models that results in its output being more closely aligned with the likely actual leakage from the system should be encouraged. We are committed to encouraging innovation in this area and are proposing changes to the current framework within RIIO-GD1. The extent of our proposal has been set out in the latest licence consultation for RIIO-GD1[6] and consists of the following elements.

[6]

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We are proposing new licence conditions by which GDNs have the ability to submit modifications which do not carry the support of all GDNs to us for decision. We will review the proposals and assess them on their individual merits. If we consider the proposed modification better facilitates the objectives as set out in the licence and is consistent with our principal objectives and statutory duties then the approved model will apply to all GDNs.

Additionally, we are proposing a mechanism in the RIIO-GD1 licence to provide us with the power to direct changes to both the leakage and shrinkage baselines without the need to undertake a lengthy licence modification process. This power will only be effective when a modification to the Leakage Model has been approved and we will only be able to direct the changes to the baselines in line with the modification proposed by GDNs and consulted upon with industry. We consider that this will improve the efficiency of the modification process and avoid some of the implementation issues highlighted by the recent modification proposals.

We are concerned that GDNs regard the potential of windfall gains under the Shrinkage Allowance and EEI as the main incentive driving changes to the Leakage Model. This interpretation is inconsistent with our proposals under GDPCR where we stated that the purpose of the incentive was to deliver social benefits by reducing the amount of leakage across networks and enable its accurate calculation by having an up to date model in place.

SCE9(7) requires all GDNs annually to review the Leakage Model to ensure it facilitates the accurate calculation and reporting of gas leakage. Having attended recent discussions at the Shrinkage Forum, we remain concerned that not enough has been done by the industry to develop the existing model. This was evidenced by the number of incomplete actions from the previous meeting which was held in January. To help us understand GDNs' work in this area, we propose in RIIO-GD1 that GDNs submit a brief annual report demonstrating the activities they have undertaken to demonstrate compliance with their licence obligation annually to review the model. We would expect GDNs to work together on this and use the Shrinkage Forum to feed their views into this report.

Yours faithfully

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