

Modification proposal:	Uniform Network Code (UNC) 203V: Revision to DN Shrinkage Regime		
Decision:	The Authority ¹ directs that this proposal be made ²		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	20 June 2008	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Shrinkage is gas lost from the network through leakage, theft and own use gas, for example for purging the system. Currently shrinkage on the gas distribution networks (GDNs) is determined by calculation of a shrinkage factor which is based on throughput of gas on the network. Evidence analysed during the 2008-13 Gas Distribution Price Control shows that there is little correlation between shrinkage and throughput for the existing networks. Therefore Ofgem has determined that shrinkage should be determined via a fixed allowance.

In the Gas Distribution Price Control, Ofgem based shrinkage allowed revenue on shrinkage factors (percentages of throughput) for each LDZ for the first six month period and then based on fixed annual shrinkage allowances for each LDZ for the remainder of the price control. Earlier price controls had based the shrinkage allowances on shrinkage factors. We changed from factors to a fixed allowance because analysis shows that there is little correlation between shrinkage and throughput for the existing networks. Changing to a fixed allowance is more reflective of actual costs incurred and this should lead to more efficiency.

The current UNC arrangements are based on shrinkage being related to throughput. If the UNC arrangements are not modified GDNs will remain exposed to windfall gains and losses as the amount of shrinkage gas they are required to purchase changes with throughput whilst the revenue allowance for shrinkage remaining constant.

The modification proposal

UNC Modification Proposal 203V proposes the following changes to Section N of UNC:

- to update references to LDZ Shrinkage Factors to reflect LDZ Shrinkage Quantities;
- make appropriate amendments to the content of industry notification processes, namely current Initial and Final Proposals;
- effect minor change to the classification of LDZ vented gas, consistent with the operation of the approved³ Leakage model calculations (the proposer argues that vented gas is not burnt and therefore should be classed as unaccounted for gas, not own use gas), and;
- update the sources of information used in the assessment process to include all inputs to the leakage model.

¹ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

² This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

³ Note that the proposal does not indicate who approved the model .

The proposer is of the view that implementation of the changes would align the requirements of Special Condition E8 with those contained within UNC TPS Section N. Hence the modification will better facilitate the achievement of the relevant objective in standard special condition A11.1(c) "so far as is consistent with sub-paragraphs (a) to (b), the efficient discharge of the licensee's obligations under this licence".

UNC Panel⁴ recommendation

At the Modification panel meeting held on 15 May 2008, of the 8 Voting Members present, capable of casting 10 votes, 6 votes were cast in favour of implementing this Modification Proposal. Therefore the Panel recommended implementation of this Proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 15 May 2008. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR⁵. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC⁶; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties⁷.

Reasons for the Authority's decision

The UNC defines the volumes of gas that are required to be purchased by GDNs for Shrinkage purposes. Currently the volumes are based on shrinkage factors. Following the changes implemented in the GDPCR the GDNs are exposed to windfall gains or losses if the UNC is not changed because they are required to purchase quantities of gas proportional to throughput. Our analysis showed that there is no evidence of a link between shrinkage and throughput. This modification proposal is therefore expected to mitigate the GDNs' exposure to windfall gains and losses and thus lead to more effective allocation of costs, which in turn will lead to benefits to consumers through greater efficiency across the industry.

Eight (8) responses were received to the Joint Office consultation on this proposal. Three of the four shippers did not support the proposal. The main concerns were the associated financial implications to users. Essentially increased administrative and operational costs resulting from Shippers having to change their systems and processes to reflect the new shrinkage arrangements. Additionally, it is their belief that if an erroneous increase in shrinkage is allocated to Shippers then this will increase their costs and contractual risks. Further, during the development of this proposal National Grid changed the definition of 'Vented Gas'. Vented gas will be regarded as 'unaccounted for

⁴ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules

⁵ UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com

⁶ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547

⁷ The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

gas' as opposed to 'own use' and therefore increasing the volume of gas that falls within the classification of shrinkage.

Ofgem supports the reclassification of the vented gas element to align the UNC with actual analysis and calculations undertaken within the industry approved leakage model. This element of the proposal reclassifies how LDZ vented gas is accounted for, however it does not impact on the volume of Shrinkage gas being procured. The DNs will therefore face the same incentives to limit emissions of vented gas.

One respondent believes that implementation of this proposal would impact on the allocation of gas to Shippers. If there is a mis-allocation of gas as a result of this Proposal then this will increase the costs to gas Shippers and so be seen to be detrimental to competition.

However a second respondent believes that implementation of this Proposal would allow for a more accurate allocation of Shrinkage gas throughout the year and therefore better allocation of costs. They therefore believe that implementation would help to secure effective competition between Shippers/Suppliers.

As explained above, Ofgem's analysis shows no correlation between shrinkage and demand and that a fixed quantity better reflects the actual amount of shrinkage. Ofgem therefore considers the existing shrinkage factor itself causes mis-allocation and that this Proposal will reduce the effect.

National Grid NTS notes that this change proposes to introduce a volumetric based LDZ Shrinkage allowance, which differs from the NTS Shrinkage allowance that is based on throughput. They believe that this may demonstrate fragmentation in respect of accounting for Shrinkage across the system.

The components of shrinkage are different for the transmission and distribution systems, with compressor usage being the largest component of shrinkage on the NTS and leakage being the main component of Shrinkage on the distribution systems. We believe that fuel used by NTS compressors is related to throughput, which is not the case for GDN shrinkage. We consider that any fragmentation is justifiable as it will improve cost allocation and hence the modification will better facilitate the achievement of the relevant objective in standard special condition A11.1(a) "the efficient and economic operation of the pipe-line system to which this licence relates;".

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC 203V: *Revision to DN Shrinkage Regime* be made.



**Rachel Fletcher,
Director, Distribution.**

Signed on behalf of the Authority and authorised for that purpose.