



Gas Transporters, shippers and interested parties

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Dear Colleague

Retaining the Transitional Interruption Incentive

Summary

1. As part of our June 2007 decision¹ to extend the transitional Gas Distribution Network (GDN) exit capacity incentive arrangements to 30 September 2011, we agreed to separately consult on the interruption incentive arrangements for the entire transitional period commencing 1 October 2008.
2. Having reviewed the incentive value, we propose that the zero value which will take effect from 1 October 2008 should be maintained throughout the transitional period until 30 September 2011.
3. This letter sets out the rationale behind our proposal and invites views on whether or not it is appropriate. Responses to this letter should be sent in electronic format to indra.thillainathan@ofgem.gov.uk to be received no later than 5.00pm on **15 August 2008**.

Background

4. The interruption incentive, introduced in October 2002 is set as a cash allowance to cover the costs of payments made to individual supply points for instances of interruption in excess of 15 days during any one year. For the 2007/08 period the allowance across all GDNs was set at £1.73m. In deriving the allowance for this incentive as part of the Transco Price Control Review 2002-07², Ofgem recognised the high degree of uncertainty regarding the actual volume of interruption required due to it being largely dependent on the weather.
5. Following DN Sales in 2005, the decision³ was taken to set the value of the GDN interruption incentive to zero with effect from 1 October 2008 on the basis that it would be reviewed following the outcome of the decision to progress reform of the

¹ *Final proposals on extended transitional NTS Exit capacity and interruption incentive and formal licence consultation under section 23 of the Gas Act 1986, 18 June 2007.*

² *'Transco's National Transmission System Operator Incentives – Final proposals'*, Ofgem, December 2001.

³ Published in *'Final proposals on transitional incentive schemes and formal licence consultation under section 23 of the Gas Act 1986 and paragraph 3(a) of Standard Special Condition A2'*. November 2005

interruption arrangements. This decision was given effect through paragraph 5(b) of Special Condition E2B⁴ of the Gas Transporter licence. Subsequently in March 2007 we directed implementation of UNC Modification 90, Revised DN Interruption Arrangements, with effect from 1 April 2008. While the first round of interruption tenders took place in June 2008, lead times associated with any necessary capital investment in the network means that the new regime will not become fully operational until 1 October 2011.

6. As part of GPCR final proposals, incentive arrangements were put in place for the period commencing 1 October 2011. These have been given effect through Special Condition E6 (Distribution Network Exit Capacity costs and incentive revenue) of the GT licence. Interruption incentive arrangements for the period 1 October 2008 to 30 September 2011 will therefore remain at the default position established in 2005 as set out in Special Condition E2B.
7. As part of a separate consultation in May 2007 on the extension of transitional exit capacity incentive arrangements⁵ - which apply to GDNs when purchasing NTS exit capacity, we proposed that the default value of the interruption incentive should be maintained throughout the transitional period from 1 October 2008 to 30 September 2011. The majority of respondents agreed with this proposal, although two GDNs did not. They argued that it only provided a downward risk as a GDN would have no allowance to cover the cost of making payments to any one supply point that had been interrupted for more than 15 days in any one year, with no possibility of the GDN outperforming the incentive should they avoid interruption of this kind. One of these respondents also considered that the default value of zero was originally intended as a temporary measure and should be reviewed fully in a separate consultation.
8. In light of responses received last year, we are now consulting on what value the transitional interruption incentive should take. Our view remains that the default zero value should apply for the entire transitional period.

Analysis & Rationale

9. As the table on the next page shows, since the incentive was established levels of interruption have been low and no payments have been made to supply points as interruptions have not been in excess of 15 days for any one supply point during any one year. On this basis it would appear that the incentive provides the GDNs with a windfall gain rather than an incentive to operate their networks efficiently and effectively.

⁴ Under paragraph 8(5)(b) of Part 1 b

⁵ Incentive provides GDNs with separate daily flat and flexibility capacity volume targets.

Number of supply points interrupted per GDN

GDN	2005/06	2006/07	2007/08
North West	19 (31)*	6 (14)*	0
East	0	0	0
West Midlands	0	0	0
London	0	0	0
Scotland	10 (13)*	6 (14)*	19 (79)*
Southern	0	0	0
Northern	2 (3)*	0	0
Wales & West	0	0	0

Note: *Figure in brackets is *no of supply points days* = no of supply points interrupted x duration of interruption for each supply point in days

10. We propose therefore, that the interruption incentive should take the value of zero for the entire transitional period for the following reasons:
- Over the three formula years between 2005/06 and 2007/08 the GDNs have made no payments to supply points under these incentive arrangements and have had a collective windfall gain of around £5m over the period;
 - Given the relatively small amount of monies involved and the time bound nature of the transitional arrangements, which will cease to exist on 1 October 2011, we consider that it would be a disproportionate regulatory response to formulate a more sophisticated scheme which relates to outturn events; and
 - If in the event that the GDNs do incur significant losses from having to make large interruption payments during the transitional period, they can have recourse to the Income Adjusting Event provisions of the GT licence⁶.

Next steps

11. If, after having considered responses received to this letter, we decide it is appropriate to retain the zero value transitional interruption incentive to 30 September 2011, a change to the licence will not be required. Special Condition E2B already stipulates that a zero value will prevail from 1 October 2008, or such date that the Authority otherwise directs in writing.
12. Please feel free to contact Indra Thillainathan on 020 7901 7294 if you would like to discuss this letter further.

Yours sincerely,



Rachel Fletcher
Director, Distribution

⁶ Under paragraph 8(6)(a) of Part 1 b of Special Condition E2B