

POTENTIAL GAS DISTRIBUTION NETWORK SALE
OFGEM PRELIMINARY POSITION ON DURATION OF INCENTIVES

The Offtake Arrangements conclusions document explains the Gas and Electricity Markets Authority's (the Authority's) decision in relation to the allocation of transmission exit capacity and diurnal storage.¹ The Interruptions Arrangements conclusions document explains the Authority's decision in relation to the interruptions framework.

Following these decisions, it is necessary for Ofgem to consider the form, scope and duration of any incentive schemes to apply to distribution network (DN) businesses in order to give effect to the proposed commercial and regulatory framework. Ofgem intends to consult on all aspects of the incentive scheme in due course. However, we have been asked by potential purchasers for an initial view regarding the duration of the incentive schemes.

In issuing this preliminary position paper, it is important to make clear that there can be no expectation on the part of Transco, potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed DN sales may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposal. This preliminary position paper is provided on an informal basis and should not be treated as binding on the Authority. Nothing in this position paper is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statement made in this paper.

Ofgem considers that there is likely to be considerable uncertainty surrounding the appropriate target cost levels in any incentive scheme on DNs. Previously, other network owner incentive schemes have exhibited levels of uncertainty as to the appropriate target level of costs for the scheme, particularly in the early years of such schemes. Therefore, in common with previous incentive schemes, Ofgem's initial view is that any incentive scheme that would apply to the DNs would, at the commencement of the scheme, have a duration of one year. This provides Ofgem and network owners with the opportunity to reconsider the target levels of costs of the schemes at a relatively

¹ *National Grid Transco – Potential sale of gas distribution network businesses, Offtake Arrangements Conclusions document on framework*, Ofgem August 2004.

early stage and in light of further information arising from the first year of operation of the scheme.

In the longer term, as more information regarding the appropriate target level of costs becomes available through ongoing operation of the schemes, Ofgem considers that it will, most likely, be appropriate to extend the duration of such incentive schemes.

Furthermore, in the longer term, it will be appropriate to review the incentive arrangements applying to the DNs in light of the reform of the interruption arrangements, planned for implementation in April 2006.

Ofgem considers that these initial views are appropriate as customer interests are protected through striking a balance between the requirement for network owners to be appropriately incentivised to invest efficiently in the networks they own and the inherent uncertainty regarding the appropriate target levels of costs in the early years of network owner incentive schemes.

This proposal will be considered in the context of Ofgem's consultation on the potential licence changes that could be introduced to support the sale of one or more DNs.