Potential sale of gas distribution networks - Section 23 licence changes required for implementation of proposed interim NTS and DN incentives

Development & Implementation Steering Group

22 March 2005

Outline of presentation

- Overview
- Interim NTS incentives:
  - Overview of proposed incentives
  - Implications for licence
- Interim DN incentives:
  - Overview of proposed incentives
  - Implications for licence
- Additional changes

Background

- Initial Proposals consultation on interim incentives for NTS and DNs published 8 March, responses due 5 April 2005
- Final Proposals to be published late April 2005, including formal Section 23 consultation
- Modifications to GT licences required to implement proposed changes included Section 23
- Therefore:
  - purpose of today is to give an overview of interim incentive proposals and proposed licence modifications; and
  - we will hold a subsequent session to discuss comments.

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Interim NTS incentives: current

- Current NTS incentives are defined up to 2006/07
- Scope and form of the current incentives are:

• Charges foregone • Exit investment • Interruption > 15 days	• Common cap and collar (£1m) • Common sharing factors (50% upside / 25% downside)
• CLNG incentive	• No caps and collars • 100% sharing factor

Interim NTS incentives: proposed

Parameters set up to 2008/9

- Charges foregone
- Exit investment
- Interruption > 15 days
- **Buyback**

- Common cap and collar (+/- 1m)
- Common sharing factors (50% up / 25% down)
- **Single incentive scheme (common targets, cap and collar)**

CLNG incentive

- No caps and collars
- 100% sharing factor

Only two changes from current regime

Interim NTS incentives: buy-back

A new buy-back incentive is required because:

- In the interim, NTS connectees will have unconstrained access to NTS exit capacity
- Transco may be required to undertake buy-backs to satisfy these requests
- However, Transco have indicated that they expect no buybacks in the interim
- The target of the buy back element is therefore set at zero

Interim NTS incentives: buy-back

Incentive: Buy-back and interruption greater than 15 day

- Standard sliding scale incentive for costs of buy-backs and interruption cost to 2008/09
- Two options presented in consultation for key parameters

	Year			
	05/06	06/07	07/08	08/09
Buy back target (£m)	0	0	0	0
>15 day interruption target (£m)	1.59	1.68	1.73	1.68
Target total (£m)	**1.59**	**1.68**	**1.73**	**1.68**

Applicable to 2005/06 to 2008/09	Cap and Collar (£/million)		Sharing factors	
	Cap	Collar	Upside	Downside
Option 1	Exp. cost of interruption	-5	80%	75%
Option 2	Exp. cost of interruption	-7	75%	50%

Interim NTS incentives: buy-back

Incentive: Buy-back and interruption greater than 15 day

Proposed licence modifications

- Addition of new $ExCBBIIR_t$ revenue and equivalent cost term in Special Condition 8B (Pages 32/33)
- New target and measure, and proposed parameters activated 1 June 2005 (Pages 124 – 130)
- Existing interruptions incentive turned off from 1 June 2005 (Page 80 - target; Page 88 - measure)
- Both consultation options included in licence drafting

Interim NTS incentives: CLNG

Incentive: Constrained LNG

Incentive proposal

- Retain existing incentive form
- New target parameters for 2007 – 2009
- Retain existing cap, collar and sharing factors

Proposed licence modifications

- Extend targets for $ExCIT_t$ term for final two years of interim period
- Proposed parameters on Page 76

Interim NTS incentives: foregone charges

Incentive: Foregone charges & exit investment

Incentive proposal	▪ Retain existing incentive form ▪ New target parameters for 2007/08 and 2008/09 ▪ Retain existing cap, collar and sharing factors
Proposed licence modifications	▪ Extend targets for $ExNTSSIT_t$ charges foregone term for final two years of interim period ▪ Proposed parameters on Page 81 ▪ Two options in Initial Proposals included in drafting ▪ Incremental exit capacity term ($IExR_t$) unchanged (Page 83)

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Interim DN incentives: background

- Incentives are based around interim offtake arrangements:
  - For the interim (until September 2008) DNs have been allocated a level of flat capacity and flexibility consistent with their 1 in 20 obligation
  - DNs will be able to request (on an annual basis) changes in their allocation of exit capacity and flexibility
  - Potential rational tendency for a DN to overbook capacity and flexibility
  - Without an appropriate incentive, shippers would eventually pay for the additional capacity requested

DN interim incentives: objective

ADDITIONAL CAPACITY REQUEST

INITIAL ALLOCATION

An increase in capacity generates incentive payments from the DN

If the DN does not request changes in its allocation, no incentive payment/charge is made*

A reduction in capacity generates incentive payments to the DN

*Note that this slide assumes no incentive payments for interruption > 15 days.

Interim DN incentives: objective

DN interim incentives are designed:

- to incentivise the DNs to meet their 1 in 20 obligation in an efficient manner, given the nature of the interim offtake arrangements; and
- to allow a smooth transition to the proposed enduring DN incentive scheme.

Incentive structured as standard "sliding scale" form, with incentive cost target, cap collar and upside / downside sharing factors

Interim DN incentives: licence mods

- Key Licence modifications made to Special Condition E2B
- New term “$DNExCIR_t$“ defined for interim incentive payments (Page 17):

$DNExCIR_t$

- Formula described on page 24
- Target is cost of “base” allocation of flat and flexibility capacity, and cost of interruption
- Measure is cost of “actual” allocation of flat and flexibility capacity, and cost of interruption
- Incentive payments based on difference between target and measure
- Incentive subject to cap, collar and sharing factors (page 25/26)

Interim DN incentives

Based on deemed cost of "base allocation" of offtake rights

Based on expected cost of greater than 15 day interruptions

Incentive target = Target cost for flat and flexibility capacity + Target cost for interruptions

Performance measure = Actual cost for flat and flexibility capacity + Actual cost for interruptions

Based on deemed cost of offtake rights actually allocated

Actual cost of greater than 15 day interruptions

Interim DN incentives: targets

Target cost for flat capacity ($DNExCTC_t$)	▪ Base allocation of flat capacity, multiplied by relevant LDZ exit charge, summed across exit zones (Page 28)
Target cost for flexibility ($DNExFFTC_t$)	▪ Base allocation of flexibility in each LDZ exit zone, multiplied by a reference price, summed across exit zones (Page 29) ▪ Reference price currently set at relevant LDZ exit charge
Target cost for interruptions ($DNExIIT_t$)	▪ Parameters set for duration of interim period, consistent with Initial Proposals (Page 30)

Interim DN incentives: measure

Actual cost for flat capacity ($DNExCDC_t$)	▪ Actual allocation of flat capacity, multiplied by relevant LDZ exit charge, summed across exit zones (Page 32)
Actual cost for flexibility ($DNExFFDC_t$)	▪ Actual allocation of flexibility in each LDZ exit zone, multiplied by a reference price, summed across exit zones (Page 33) ▪ Same reference price used as in calculation of target
Actual cost for interruptions ($DNExIIC_t$)	▪ Actual cost of interruptions incurred by DNs (Page 33)

Interim DN incentives: other changes

Other changes to Special Condition E2B:

- **Statement of interruption (page 36)**. Retention of requirement on DNs to provide a daily statement of interruptions (movement from Part 2 of E2B)
- **Determination of adjustment (page 37)**. Defines how an Income Adjusting Event may be called. Level of materiality to be determined (subject to ongoing analysis)

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Additional changes

- Over to Suzie…

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