

Sonia Brown  
Director, Transportation  
Office of Gas and Electricity Markets  
9 Millbank  
London  
SW1P 3GE

Head Office  
Inveralmond House  
200 Dunkeld Road  
Perth  
PH1 3AQ

Telephone: 01738 456400

Facsimile: 01738 456415

email:

Our Reference:  
Your Reference:

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Dear Sonia

**NGT – Potential Sale of Gas Distribution Network Businesses  
Final Proposals for Interim Incentives and Formal Consultation under Section 23 of  
the Gas Act 1986**

Thank you for the opportunity to respond to the above consultation which sets out Ofgem's final proposals for the interim incentives scheme that are anticipated to be in place in respect of the NTS and DNs for the period 1 June 2005 to 30 September 2008. The document also consults on further licence changes to address respondents' views and issues identified following Ofgem's licence consultation published on 14 February 2005.

Final Incentive Scheme

Following the publication of Ofgem's initial proposals on the interim incentive scheme, Ofgem presented at various DISG meetings licence drafting which, if implemented, would introduce the proposed scheme. We found this approach very useful in helping us to understand the detail of the DN scheme and provided us with opportunities to comment on the drafting at various stages. Nevertheless, during the above drafting process it was acknowledged that the final incentive parameters would be set out in the current consultation.

We are disappointed that Ofgem has not proposed an *ex post* adjustment mechanism to avoid a DN being "penalised" for genuine, unforeseen additional demand growth including the impact of interruptible customers requesting to become firm. This is particularly relevant given the expected reform of DN exit arrangements. We are also concerned that Ofgem has stated that it does not expect to modify the Regulatory Asset Values of the DNs at the next price control review to take account of NTS offtake related investment. We disagree with this conclusion and believe that Ofgem's view on this issue potentially undermines the intent of the incentive scheme, which is to encourage the DN to invest in its own system if it were more efficient to do so than to seek incremental NTS capacity. We would urge Ofgem to revisit both of these conclusions in the review after the first year of the incentive scheme.

Ofgem has set out its final view of the targets, caps, collars and sharing factors. This is a new incentive scheme, the targets for which have been set against *NGT's* planning assumptions and have therefore been outwith the control or influence of the new DN owners. This further underlines why it will be important to ensure that a review of the scheme is initiated after one year. Furthermore, we firmly believe that the introduction of DN exit reform should be preceded by a review of the DN incentive scheme to ensure that the two are compatible. In any event, a review after one year would be consistent with Ofgem's position paper on the duration of the incentives presented to DISG 17.

Notwithstanding the above comments, we believe that the drafting contained in the S23 formal consultation that would introduce the interim incentive scheme is consistent with Ofgem's final proposals.

#### Income adjusting event

We are disappointed that Ofgem has proceeded with its proposals to introduce a single income adjusting event threshold across all networks, the impact of which would, in all likelihood, exclude certain DNs from claiming such an event. Nevertheless, we welcome Ofgem's commitment to revisit the threshold in the context of the enduring offtake incentive scheme.

#### Other licence changes

A number of licence modification proposals are contained in this S23 consultation to address respondents' views and issues identified following Ofgem's licence consultation published on 14 February. In our view, this drafting reflects the outcome of discussions and comments Ofgem has received to earlier drafts that have been tabled at recent DISG meetings. We do not have any further comments.

#### Next Steps

We note that it is envisaged that the licence modifications set out in this formal consultation will be directed for implementation on 27<sup>th</sup> May 2005 such that they take effect on 1 June 2005. However, to the extent that Ofgem is in a position to do so, an earlier direction in this respect would be welcome in terms of the share sale process given that Monday 30 May is a public holiday.

I hope that you will find the above comments helpful.

Yours sincerely

Rob McDonald  
**Director of Regulation**