

12 July 2005

## **REFORM OF DISTRIBUTION NETWORK INTERRUPTION ARRANGEMENTS**

1. On 24 June 2005, the Authority of Gas and Electricity Markets (Authority) announced that it was delaying implementation of the National Transmission System (NTS) enduring offtake arrangements until September 2007. A letter from Alistair Buchanan explaining the reasons for this decision is available on Ofgem's website<sup>1</sup>. Following this decision, Ofgem has considered its implications on the timetable for reforming interruption arrangements on the distribution networks (DNs).
2. This letter sets out the background to DN interruptions reform and outlines Ofgem's decision about the most appropriate way forward.

### **Background**

3. In March 2001, Ofgem published a review of Transco's NTS exit capacity, interruption and LNG arrangements.<sup>2</sup> This paper identified a number of perceived weaknesses in Transco's interruptions arrangements and set out proposals for reform. Ofgem subsequently consulted upon these proposals in the context of the review of Transco's system operator (SO) incentives.<sup>3</sup> This resulted in the adoption of a transitional exit capacity incentive and in a new licence condition requiring Transco to use all reasonable endeavours to introduce universal firm registration of NTS exit rights by 1 April 2004.
4. Following discussions with the industry, which highlighted the interactions between NTS and DN interruptions arrangements, in May 2003 Ofgem published an open letter setting

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<sup>1</sup> *Enduring Offtake Arrangements*, Ofgem, 24 June 2005.

<sup>2</sup> *The New Gas Trading Arrangements – Review of Transco's exit capacity, interruption and LNG arrangements*, Consultation Document, Ofgem, March 2001.

<sup>3</sup> *Transco's National Transmission System – System Operator incentives 2002-7, Final Proposals*, Ofgem, December 2001.

out its view that the interruptions reform programme should be re-scoped to include DN interruptions reform.<sup>4</sup>

5. In July 2003, Ofgem identified interruptions reform as one of the 'gateway' requirements for National Grid Transco (NGT) to obtain approval by the Authority of its proposed sale of up to four gas DNs.<sup>5</sup> Thereafter, interruptions reform was pursued as part of the DN sales process. However, in August 2004<sup>6</sup> the Authority considered the prevailing industry view that, although there were important interactions between the NTS and DN interruption regimes, it was neither appropriate nor necessary to undertake the substantial work required for implementing DN interruptions reforms within the strict timetable dictated by the DN sale process. The Authority therefore decided that DN interruptions reform could be developed over a more extended period and be de-coupled from the DN sale process.
6. At that time, the Authority also considered that the existing DN interruption regime was not appropriate post April 2006 when it was envisaged that DNs would have needed to take decisions regarding investments on their networks. This was due to on-going concerns relating to the potential for the existing interruption regime to give rise to undue discrimination. In particular, it was recognised that different arrangements across the NTS and DNs could distort future decisions on where to locate a new load as well as pipeline and storage investment decisions. Further, continued administered arrangements on the DNs could have led Transco NTS to favour DNs over NTS direct connects in contracting for interruption.
7. For these reasons, a new licence condition requiring each DN licensee to use reasonable endeavours to implement revised interruptions arrangements by April 2006 was introduced as part of the licence changes that came into effect on 1 May 2005.

### **Ofgem's views**

8. As with the NTS enduring offtake arrangements, Ofgem considers that DN interruptions reform is an important aspect of the regulatory, commercial and operational framework necessary to protect consumers' interests in a divested industry structure.
9. However, Ofgem is also aware of the close interactions between the NTS offtake arrangements and the DN interruptions regime. At present, the arrangements for interruptions on the NTS and DNs follow the same approach. Further, the NTS SO has an additional transitional exit incentive. As stated in Ofgem's August 2004 document, to the extent that the NTS and DNs start adopting different approaches to the treatment of interruptions, there is a risk of discrimination between DN supply points and NTS direct

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<sup>4</sup> *Universal firm registration of NTS exit capacity: update*, Ofgem, 8 May 2003.

<sup>5</sup> *National Grid Transco – Potential sale of network distribution businesses, A Consultation Document*. Ofgem, July 2003.

<sup>6</sup> *National Grid Transco – Potential sale of distribution network businesses, Interruptions arrangements, Conclusions document on framework*, Ofgem, August 2004.

connects. This may lead to economically inefficient decisions being made by customers deciding where to connect on the gas network.

10. Under the NTS enduring offtake arrangements, DNs will decide how much NTS exit capacity they require to meet their contractual and licence obligations. In doing so, they will take a view on the amount of capacity they require on the NTS given the relative cost of interrupting customers on their network, booking storage or investing in additional capacity. Diverging approaches for the NTS and DNs could distort these decisions.
11. Furthermore, Ofgem is conscious of the substantial amount of work involved in developing revised DN interruptions arrangements. The deadline of 1 April 2006 has always been considered to entail a challenging timetable, which was deemed necessary largely in the light of the expected implementation of NTS enduring offtake arrangements by September 2005.

#### *Review of DN interruption timetable*

12. For the reasons outlined above, Ofgem considers that it would be beneficial to undertake the reform of DN interruptions arrangements in coordination with the development of NTS enduring offtake arrangements. On this basis, the development of the revised DN interruptions regime should be finalised by April 2007, in time for implementing any associated changes to gas distribution charges from 1 October 2007.

#### *Standard Special Condition D8 (Reform of the Distribution Network interruption arrangements)*

13. Under standard special condition D8, paragraph 1, of their GT licences, each DN has a reasonable endeavours obligation to bring forward reforms of the arrangements for the interruption of supply points by 1 April 2006. Paragraph 2 of this licence condition determines that if a DN is not in compliance with the obligation in paragraph 1, it should ensure that new interruption arrangements are implemented as soon as practicable thereafter.
14. On the basis of Ofgem's decision to realign the development of DN interruptions reform and NTS enduring offtake arrangements, Ofgem does not intend to enforce compliance with paragraph 1 of standard special condition D8.

#### *Interactions with the price control review*

15. Both NTS enduring arrangements and DN interruptions reform could have substantial policy implications on the development of the review of the DN price controls. Postponing these reforms would allow full consideration of their effects as part of the DN price control review.

*Interactions with the review of the structure of gas distribution charges*

16. Ofgem has also considered the interactions between the timetable for implementing DN interruptions reform and the review of the structure of gas distribution charges. A document setting out Ofgem's initial proposals for reform of the existing structure of gas distribution charges has been further delayed for this reason. Following this letter, Ofgem intends to publish its initial proposal document on the structure of gas distribution charges in July.
17. If it would be helpful to discuss these matters further, please do not hesitate to contact myself or Samanta Padalino, Head of Gas Distribution Policy, on 020 7901 7033.

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