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Dear Mr Feather

## **Initial proposals on transitional incentive schemes supporting the offtake arrangements**

### **Introduction**

energywatch welcomes the opportunity to comment on Ofgem's initial proposals supporting the offtake arrangements for the period October 2008 to September 2010.

The incentive schemes are important to consumers insofar as they promote efficiency in operation and investment between connecting systems and, therefore, reduce overall transportation costs. The disaggregation of the UK gas market, following the sale of the DN businesses by Transco, has meant that there is a danger that the network owners will view their networks in isolation, with little regard to the impacts their operating and investment decisions may have on the wider gas market. In order to redress this, it is critical that all networks owners are financially exposed to any repercussions, caused by their decisions, on other networks. In principle, therefore, energywatch supports the introduction and extension of incentive schemes which internalise external costs and, as an overall package, deliver a cost effective and robust transportation service to customers.

energywatch is keen to reinforce the view, however, that all arrangements must be non-discriminatory between all system offtakes, i.e. the arrangements put in place to support DN connections must be consistent with those put in place to support direct customer NTS offtakes. We understand that the market rules establishing these arrangements do not directly form part of this consultation. However, we urge Ofgem to consider this principle when considering the transitional arrangements in their entirety.

### **The transitional incentive scheme**

The current incentives package underpinning the period June 2005 to September 2008 (the interim period), in our view, appears to operate in the manner it was

intended. Distribution Network Operators are able to plan and operate their systems in accordance with their Licences, whilst facing some financial exposure to the economic impacts of relying on the upstream NTS network for the provision of capacity and within day flexibility. For this reason, energywatch believes that the current approach to planning and incentives should be extended during the transitional period, subject to the UNC and IExCR changes needed to integrate the longer time horizon.

In relation to the 'greater than 15 day interruptions' incentive, energywatch understands that the interruptible arrangements are to be reformed in 2007. Given that the transitional period commences in October 2008, we believe that it is appropriate to revisit this element of the package in 2007 and therefore, support the proposal not to extend the current arrangements in the short term.

The targets, reference prices, caps/collars and sharing factors proposed by Ofgem for the DN incentive scheme are entirely consistent with those currently in operation during the interim period. energywatch sees no reason to modify these parameters at this current time as they appear to have encouraged the DNs to reduce their offtake capacity requirements whilst continuing to meet their planning and operations related Licence conditions. It should be understood; however, that the interim incentive scheme has only been in operation for a few months and energywatch recommends that the performance of the DNs and Transco NTS should be continually reviewed to ensure that the parameters are appropriate and no one party is receiving windfall gains.

In light of this, energywatch supports the proposal to defer setting the NTS incentives until the TPCR in 2007. As highlighted by Ofgem, this would permit a fuller review of the interim scheme and allow the industry to set targets which will better serve the UK gas market. energywatch agrees that the medium/longer term benefits of this approach would outweigh the potential short term costs resulting from a lack of certainty regarding the cost-recovery and treatment of investment for the transitional period. We do not believe, however, that the "lack of certainty" should absolve Transco NTS from employing the most cost effective measures to meet additional demands. Transco's GT Licence requires that it operates the system in an economic and efficient manner and we expect Transco NTS to adhere to this obligation, or face the regulatory consequences.

energywatch proposes that during the transitional period, and in order to assist Ofgem and the industry in reviewing Transco NTS operational and investment performance, it is worth considering the application of a "shadow NTS Offtake incentive scheme." This scheme would be based on the interim scheme and, although no monies would flow during its operation, it might provide a reasonable benchmark against which Transco NTS' performance could be measured. This would assist in influencing the longer term scope of the scheme and in setting the general Price Control allowances over the next Control period.

### **Longer term arrangements**

Finally, energywatch fully supported the Authority's decision to defer the implementation of the enduring arrangements. However, we remain unconvinced that a radical overhaul of the exit arrangements is actually necessary. If the interim and transitional arrangements prove to be effective, assuming that the Authority approves Modification Proposal 0046, then we believe that they should be considered in the longer term. The approach is straightforward and transparent and, assuming that all offtakes are treated equally, it is non-discriminatory. energywatch urges Ofgem to seriously consider the long-term extension of the current arrangements before embarking on a potentially disruptive and resource intensive drive to introduce unnecessary reform.

If you do wish to discuss any of the points in this paper in more detail please do not hesitate to contact me on 0191 221 2072 or email [regulatory.affairs@energywatch.org.uk](mailto:regulatory.affairs@energywatch.org.uk).

Yours sincerely

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