

Final proposals on transitional incentive schemes and formal licence consultation under section 23 of the Gas Act 1986 and paragraph 3(a) of Standard Special Condition A2

November 2005

Summary

This document:

- ◆ sets out Ofgem's final proposals on the scope, form and duration of the incentive schemes necessary to support the offtake arrangements proposed for National Transmission System (NTS) exit capacity in the period from October 2008 to September 2010 (the "transitional" period); and
- ◆ includes formal consultations on the licence modifications necessary to implement these final proposals and provide some definitional clarification.

This follows the decision of the Gas and Electricity Markets Authority (the Authority), in June 2005, to delay to September 2007 the implementation of the enduring offtake arrangements for the release of NTS offtake rights from 1 October 2010¹, and the publication, in September 2005, of Ofgem's Initial Proposals for transitional incentives (the "Initial Proposals consultation")².

Proposed transitional offtake arrangements

In August 2005, National Grid NTS raised Uniform Network Code (UNC) Modification Proposal 0046 (and an associated consultation on changes to relevant supporting documents³), outlining details of a proposed process through which firm capacity (held by NTS DCs) and NTS offtake capacity (held by Distribution Networks (DNs)) could be allocated for the period 1 October 2008 to 30 September 2010⁴. Furthermore, on 25 November 2005, following the withdrawal of its earlier consultation report in this regard, National Grid NTS re-released a consultation on its IExCR given further consideration of the implications of the transitional arrangements. It is important to note that the contents of these consultations should not be interpreted in any way as fettering

¹ 151/05, Ofgem open letter on enduring offtake arrangements, June 2005

² 204/05 - *Initial proposals on transitional incentive schemes supporting the offtake arrangements*, Ofgem, 21 September 2005.

³ Consultation on the Incremental Exit Capacity Release (IExCR) Methodology Statement and SC4B Licence Statements to support the Transitional Gas Exit Capacity Arrangements proposed in UNC Modification Proposal 0046

⁴ *UNC Modification Proposal 0046, Extension of the sunset clauses for registration of capacity at NTS exit points*, August 2005.

the discretion of the Authority to accept or reject this modification proposal or approve the proposed changes to the IExCR.

Under the proposals, DNs will be required to request their requirements for NTS exit rights for the gas year 2008/09 (i.e. for the first year of the transitional period) two weeks after the implementation of the modification proposal and for gas year 2009/10 (i.e. the second year of the transitional period) in June / July 2006. The arrangements for DCs would remain unchanged.

In the event that these requests require National Grid NTS to undertake any investment to deliver the level of NTS exit rights requested by a DN at any NTS offtake point (or group of NTS offtake points), then DNs will be required to enter into a contractual agreement with the NTS. This will outline the volume of NTS exit rights the DN requests from the NTS, the date at which these rights are required, and also outline the financial implications of either party defaulting on the terms of the agreement.

Proposed transitional incentive schemes

Ofgem does not consider it appropriate to extend all of the incentive schemes currently applying to National Grid NTS and the DNs into the transitional period at this time:

- ◆ the “greater than 15 day interruptions” DN incentive will be reviewed as part of the DN interruptions reform project; and
- ◆ the scope, form and duration of the NTS exit incentives will be defined at the time of the next Transmission Price Control Review (TPCR) (to come into effect on 1 April 2007).

However, Ofgem considers it necessary to specify incentives for the DNs for the duration of the transitional period to mitigate a tendency for DNs to overbook NTS exit rights. Ofgem proposes a single “sliding scale” incentive mechanism for each DN for the duration of the transitional offtake arrangements, with the specification of a single cost performance measure and target (for each DN) covering both NTS offtake (flat) capacity and NTS offtake (flexibility) capacity, as well as a defined cap, collar and sharing factors. Ofgem proposes that cost performance targets are specified for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity for each DN (for the formula years 2009/10 and 2010/11), with both products priced at the prevailing (out-turn) price of NTS exit capacity.

Caps and collars for DN cost performance measures should continue to be calculated as a fixed percentage of each DN's cost performance target reflecting the locational nature of both exit charges and demand and ensuring that incentive schemes are accurately targeted across the network. However, given respondents' concerns regarding the level of absolute exposure they may face under the DN incentives as a result of uncertainty over future levels of exit capacity prices, Ofgem proposes to impose an absolute limit of plus or minus £5 million on potential DN financial exposure.

Furthermore, the sharing factors that currently apply to the DN's will be extended to cover the two years of the transitional period.

The incentive parameters proposed are presented in Table 1 below.

Table 1 Parameters for DN incentive schemes

	Cap and Collar		Sharing factors	
	Cap	Collar	Upside	Downside
Proposed incentive parameters	Minimum of 7.5% of DN target and £5m	Maximum of -7.5% of DN target and -£5m.	100%	100%

Ofgem notes that a number of DN respondents raised concerns with the current Income Adjusting Event (IAE) threshold of £2m. Ofgem continues to consider that the IAE threshold needs to strike an appropriate balance between materiality and the regulatory resources required to manage IAE claims. However, following consideration of respondents' views, Ofgem believes that it is appropriate to consult further on the appropriate IAE threshold, and proposes to issue a consultation in this regard in the coming weeks. One of the options considered in this consultation will be the reduction of the IAE threshold to £1m.

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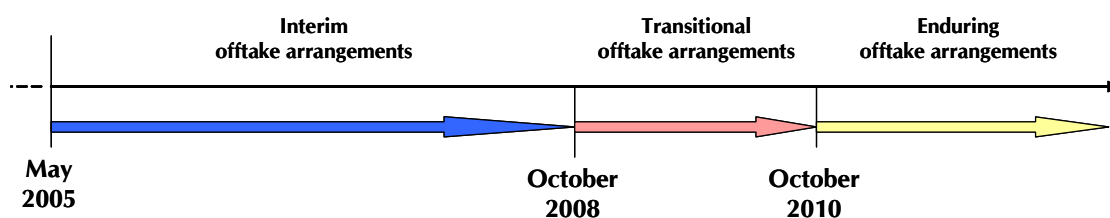
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1. Introduction

Overview

- 1.1. Given the Authority's decision, in June 2005, to delay the implementation of the long term "enduring" offtake arrangements by two years, it has been necessary to consider the arrangements for the allocation of NTS offtake rights to NTS connectees (that is the Distribution Networks (DNs) and customers directly connected to the NTS), for the period between 1 October 2008 (the time at which the interim arrangements end) and 1 October 2010 (the time at which the enduring arrangements begin).
- 1.2. References to the "transitional" arrangements within this document are references to the arrangements proposed for this two year period. The incentives associated with these "transitional" arrangements are the subject of this consultation. The sequencing of these alternative offtake arrangements is illustrated in Figure 1.1 below.

Figure 1.1: Offtake arrangements going forward



- 1.3. Ofgem considers that the proposed incentive schemes to support the transitional offtake arrangements should primarily be designed to protect the interests of customers (who ultimately pay the costs of system operation) and provide the network businesses with an appropriate balance of risk and reward. For example, the incentive schemes will, among other things, need to ensure that the DN's book an efficient level of NTS exit rights.

- 1.4. In September 2005, Ofgem published its initial proposals on incentives for the transitional period (the “Initial Proposals consultation”)⁵.
- 1.5. In total Ofgem received eleven responses to the Initial Proposals consultation. These respondents included the six relevant GT licensees (i.e. National Grid NTS, National Grid Gas Distribution, Northern Gas Networks, Scotia Gas Networks plc (on behalf of Scotland Gas Networks Limited and Southern Gas Networks Limited), and Wales & West Utilities Limited), shippers/suppliers, the Association of Electricity Producers (AEP), the Chemical Industries Association (CIA) and energywatch. Two responses had confidential annexes, however, otherwise, no other responses were marked as confidential.
- 1.6. All non-confidential responses can be found on the Ofgem website (www.ofgem.gov.uk).
- 1.7. This document considers the views expressed by respondents to the Initial Proposals consultation and:
 - ◆ presents Ofgem’s final proposals on the scope, form and duration of the incentive schemes necessary to support the offtake arrangements proposed for National Transmission System (NTS) exit capacity in the period from October 2008 to September 2010; and
 - ◆ formally consults upon the licence modifications necessary to implement these final proposals and provides some definitional clarification to the relevant GT licences under:
 - ◆ paragraph 3(a) of Standard Special Condition A2 (Private Collective Licence Modification procedure in respect of Standard Special Conditions applicable to both NTS and DN licensees) with respect to the proposed modification of Standard Special Condition A3 (Definitions and Interpretation); and

⁵ 204/05 - *Initial proposals on transitional incentive schemes supporting the offtake arrangements*, Ofgem, 21 September 2005.

- ◆ section 23 of the Gas Act 1986 with respect to changes to Special Conditions in Part C and Part E of the NTS and DN GT licences respectively.

In issuing this document there can be no expectation on the part of any NTS or DN-GT, shipper, supplier or other interested party as to any further decision which the Authority may be required to take in relation to the transitional offtake arrangements or any future enduring regime. Information in this document is not binding on the Authority. Nothing in this document is to be construed as granting rights or imposing any obligations on the Authority. The Authority's discretion will not be fettered by any statements made in this document.

Structure of document

1.8. This document has three further chapters:

- ◆ Chapter 2 describes the proposed transitional offtake arrangements and provides an overview of a number of aspects of the arrangements directly related to NTS and DN incentive schemes;
- ◆ Chapter 3 describes Ofgem's final proposals on the proposed transitional incentive schemes given respondents' views to the Initial Proposals consultation; and
- ◆ Chapter 4 describes the proposed way forward.

1.9. This document also has a number of appendices:

- ◆ Appendix 1: List of respondents to the Initial Proposals consultation;
- ◆ Appendix 2: Summary of proposed targets;
- ◆ Appendix 3: List of licence conditions proposed for modification;
- ◆ Appendix 4: Explanatory note regarding licence modifications proposed;
- ◆ Appendix 5: Notice under paragraph 3(a) of Standard Special Condition A2 (Private Collective Licence Modification procedure in respect of Standard Special Conditions applicable to both NTS and DN licensees)

of Ofgem's proposal to modify the six relevant GT licences as described in this document;

- ◆ Appendix 6: Notice under Section 23 of the Gas Act of Ofgem's proposal to modify the six relevant GT licences as described in this document;
- ◆ Appendix 7: Proposed licence modifications:
 - ◆ Appendix 7A: Proposed licence modifications to Standard Special Condition A3 (Definitions and Interpretation);
 - ◆ Appendix 7B: Proposed licence modifications to Part C (Special Conditions applicable to the Licensee (NTS));
 - ◆ Appendix 7C: Proposed licence modifications to Part E (Special Conditions applicable to the Licensee (DN)).

1.10. The regulatory background relevant to the development of the proposed transitional incentive schemes is set out in Ofgem's Initial Proposals consultation.

Views invited

1.11. Ofgem welcomes views on all aspects of this consultation, to be received by close of business on 23 December 2005. Respondents are asked to provide views in a timely manner. Responses should be addressed to:

Mark Feather

Associate Director, Networks

Office of Gas and Electricity Markets

9 Millbank

London SW1P 3GE

(Telephone: 020 7901 7412)

1.12. Electronic responses may be sent to matteo.guarnerio@ofgem.gov.uk

1.13. Respondents are free to mark their reply as confidential, although we would prefer, as far as possible, open responses that can be placed in the Ofgem

library. Ofgem would also prefer that non-confidential responses are sent electronically so that they can be placed on the Ofgem website.

- 1.14. If you wish to discuss any aspect of this paper, Matteo Guarnerio (telephone 020 7901 7493) or Mark Feather (telephone 020 7901 7437) would be pleased to help.

Consultation code of practice

- 1.15. If respondents have comments or complaints about the way this consultation has been conducted these should be sent to:

Michael Fews

Head of Licensing

Office of Gas and Electricity Markets

9 Millbank

London SW1P 3GE

(Telephone: 020 7901 7085)

michael.fews@ofgem.gov.uk

Related consultation documents

- 1.16. The following consultations are related to this consultation, and discussed further in Chapter 2:
- ◆ UNC Modification Proposal number 0046: *Extension of the Sunset Clauses for Registration of Capacity at NTS Exit Points* – this modification proposal is currently with Ofgem for decision; and
 - ◆ Consultation on the Incremental Exit Capacity Release (IExCR) Methodology Statement to support the Transitional Gas Exit Capacity Arrangements proposed in UNC Modification Proposal 0046 – this consultation is due to close on 23 December 2005.

Way forward

- 1.17. Subject to consideration of respondents' views, Ofgem anticipates that the Authority will direct the introduction of the proposed modifications set out in this document to the NTS and DN GT licences in January 2006 such that they take immediate effect but reserves its discretion to revise this date.

2. Proposed transitional offtake arrangements

- 2.1. In this chapter, we describe the offtake arrangements currently proposed for the transitional period.
- 2.2. On 10 August 2005, National Grid NTS raised Uniform Network Code (UNC) Modification Proposal 0046 (*Extension of the Sunset Clauses for Registration of Capacity at NTS Exit Points*), outlining details of a proposed process through which firm capacity (held by NTS direct connects (DCs)) and NTS offtake capacity (held by DNs) could be allocated for the period 1 October 2008 to 30 September 2010. The consultation relating to this Modification Proposal closed in mid September and a decision on this proposal is expected to be released early in the new year.
- 2.3. Related to Modification Proposal 0046, changes are proposed to a number of supporting documents as part of the transitional arrangements.
- 2.4. Accordingly, National Grid NTS has released consultations on proposed changes relating to:
 - ◆ the Incremental Exit Capacity Release (IExCR) Methodology Statement which currently only applies to the interim period, i.e. gas year ending 30 September 2008;
 - ◆ Standard Condition 4B statement of “Principles and Methods to be used to Determine Charges for National Transmission System Connection Services” to introduce the concept of an Advanced Reservation of Capacity Agreement (ARCA) for DNs; and
 - ◆ a proposed generic form of ARCAs applicable to DNs, based upon that which is currently applicable in respect of NTS DCs.
- 2.5. The consultation on these supporting documents closed on 22 September 2005. However, on 25 November 2005, National Grid NTS released a further consultation on proposed changes to the IExCR. This, later, consultation is due to close on 23 December 2005.
- 2.6. It is important to note that, although the contents of this modification proposal and the associated changes to relevant supporting documents are outlined in this

chapter, nothing in this consultation document should be viewed as fettering the discretion of the Authority in relation to these separate consultations.

- 2.7. The focus of this consultation is to outline final proposals for the most appropriate scope, form and duration of the incentive schemes necessary to support the offtake arrangements for NTS offtake capacity in the period from 1 October 2008 to 30 September 2010. As such, it is necessary to make some high-level assumptions as to the nature of the offtake arrangements in place for this period without fettering Authority discretion.
- 2.8. Modification proposal 0046 describes a process through which NTS exit rights may be allocated to NTS connectees (i.e. both DNs and NTS DCs). This process relates to the allocation of rights for the duration of the transitional period (i.e. for NTS exit rights relating to the period 1 October 2008 to 30 September 2010).
- 2.9. The offtake arrangements proposed by National Grid NTS for the transitional period differ from those currently defined in the UNC (the interim offtake arrangements) in that they are designed to relate to periods for which investment by National Grid NTS may be undertaken to satisfy requests for NTS capacity that might otherwise not be capable of being satisfied. Consequently, the proposal is designed to provide National Grid NTS with sufficient confidence that requests for NTS exit rights relating to future periods will be backed by firm bookings in the future, and hence that it would be in the interests of customers to invest to meet this demand. In contrast, the interim offtake arrangements are designed for the period May 2005 to October 2008 - a period in which National Grid NTS will have insufficient time to invest to meet requests for additional NTS exit rights.
- 2.10. Fundamentally, the proposed transitional offtake arrangements are similar to those already implemented for the duration of the interim period. In particular, under the proposed transitional offtake arrangements, DNs continue to determine the level of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity required at each NTS/DN offtake point. Therefore, consistent with the existing offtake arrangements, each DN is responsible for requesting a sufficient level of NTS offtake rights at each NTS/DN offtake point to meet its 1 in 20 licence obligation (rather than, for example, shippers representing DN connectees determining their own NTS offtake requirements). In addition, aside

from payments made through any incentive arrangements, DNs do not bear any of the cost of NTS exit rights requested. Instead, any such costs would be borne, under the current charging arrangements, entirely by customers connected to the DNs. It is also proposed that there are no changes to the way in which shippers representing customers directly connected to the NTS request increases in NTS exit capacity.

- 2.11. The key difference between the transitional offtake arrangements and the existing (interim) offtake arrangements relates to the period over which NTS exit rights may be requested, and the process through which these requests are made. Under the current UNC provisions, DNs are able to request changes to their “initial allocations” of NTS exit rights up to the end of the interim period (i.e. gas year ending 30 September 2008).
- 2.12. In contrast, under the new proposals, DNs will not be assigned an initial allocation of NTS exit rights for the transitional period. Instead, DNs will be required to request their *total* requirements for NTS exit rights for the gas year 2008/09 (i.e. for the first year of the transitional period) two weeks after the implementation of the modification proposal and for gas year 2009/10 (i.e. the second year of the transitional period) in June / July 2006.
- 2.13. In the event that these requests require National Grid NTS to undertake any specific reinforcement of the network to deliver the level of NTS exit rights requested by a DN at any NTS offtake point (or group of NTS offtake points) then DNs will be required to enter into a contractual agreement with the NTS. This “DN ARCA” (which will be required given the proposed changes to National Grid NTS’s IExCR and Standard Condition 4B statement) will outline the volume of NTS exit rights the DN requests from National Grid NTS, the date at which these rights are required, and also outline the financial implications of either party defaulting on the terms of the agreement.
- 2.14. DNs will then have the ability to request amendments to their capacity allocations within the three year investment lead time. For example, in June / July 2008, DNs will be able to request amendments to their allocated capacity for gas years 2008/9 and 2009/10.

2.15. National Grid NTS considers these arrangements are comparable to those that are already in place for customers directly connected to the NTS, hence are desirable to ensure there is no undue discrimination between the two classes of NTS connectees.

3. Proposed transitional incentive schemes

3.1. This chapter summarises:

- ◆ Ofgem's initial proposals for the scope, form and duration of incentive schemes supporting the transitional offtake arrangements;
- ◆ respondents' views to Ofgem's Initial Proposals consultation; and
- ◆ Ofgem's final proposals for the scope, form and duration of incentive schemes supporting the transitional offtake arrangements.

DN transitional incentives

3.2. This section outlines Ofgem's proposals for the incentives that will relate to the DNs for the transitional period. It describes the proposals in terms of:

- ◆ scope;
- ◆ form; and
- ◆ duration.

Scope

Initial Proposals

3.3. The Initial Proposals consultation stated that, under the proposed transitional offtake arrangements, any DN requests for NTS exit capacity at the three year ahead stage that trigger NTS investment will require the DN in question to enter into a contractual agreement with the NTS. The Initial Proposals consultation anticipated that such contractual agreements would financially commit the DN to remunerating National Grid NTS for the NTS exit capacity requested with some form of penalty payment being payable should the DN amend its capacity request at a later date to a lower volume of capacity.

3.4. The Initial Proposals consultation noted that, if the costs incurred as a result of such penalty payments could be passed through, by the DN, to its shippers, and

ultimately customers, then the DNs might still be incentivised to over-request capacity at the three year ahead stage leading, in turn, to an inefficiently high level of NTS investment and the potential for stranded assets. As such, Ofgem did not propose that any penalty payments made by the DNs to the NTS should be able to be passed through to customers, but instead, the DNs should be exposed to 100% of such costs.

- 3.5. The Initial Proposals consultation noted that, under current National Grid NTS proposals, each DN will be able to amend their initial capacity requests (which were made at the three year ahead stage) within investment lead times, and as late as three months before the commencement of the relevant gas year. However, given that the customers connected to the DN's network pay for the level of NTS capacity requested through network charges, there would exist, absent any incentive scheme, a potentially rational tendency for the DN to overbook NTS exit capacity.
- 3.6. Ofgem therefore stated that it was necessary to specify incentives for the DNs for the duration of the transitional period primarily to mitigate this potential tendency to overbook NTS exit rights when making amended capacity requests (within investment lead times). In order to deliver a relatively simple incentive scheme, Ofgem proposed a single incentive mechanism for each DN for the duration of the transitional offtake arrangements.
- 3.7. The Initial Proposals consultation stated that Ofgem did not consider it appropriate to extend the current greater than 15 day interruptions DN incentive for the duration of the transitional period. Instead, Ofgem proposed to review this element of DN incentives at the time of the next gas distribution price control review (GDPCR) at which time a broader review of DN incentives (in the context of DN interruption reform) would be undertaken.

Respondents' views

DN respondents

- 3.8. One DN respondent stated that it supported the Ofgem initial proposals for the transitional incentive schemes.

- 3.9. Another DN respondent stated that it supported the concept of incentive schemes covering the acquisition of exit rights by the DNs under the transitional arrangements. However, this DN respondent stated that the initial proposals do not appear to include any incentive for a DN to return capacity that has been booked, but is subsequently not required. This DN respondent stated that the incentives should encourage both the submission of accurate bookings in the first place and also the return of any capacity that is subsequently not required so that it can be made available to another user of the NTS. This DN respondent stated that if the DN has no incentive to return surplus capacity, this would lead to a risk of higher capacity bookings than would have otherwise been the case and potentially inefficient investment by the NTS.
- 3.10. This DN respondent stated that DNs should be credited under the incentive scheme for returning capacity to the NTS and that this should outweigh any contractual penalty payment for cancelling the booking. This DN respondent also noted that if the NTS investment is not required at the target time, it will typically be used in the following year or two and hence the cost of such inefficiency is the time value of the investment for the period of non-use. This DN respondent stated that an alternative approach would be to credit the DN for returned capacity to the extent that the NTS is able to avoid the associated investment expenditure, and / or is able to re-sell the capacity to another party. However, this DN respondent noted that the value to the DN of returning the capacity would be unknown at the time of making the decision, so making it difficult for the DN to optimise its position.
- 3.11. One DN respondent stated that where parties are investing to meet their own licence / statutory obligations, the equitable solution is for both parties to be allowed to recover the associated costs via their own charging mechanisms. This DN respondent accepted that DNs should have exposure when requesting capacity over and above the growth rates used by the NTS to compile the Transporting Britain's Energy (TBE) report, and that this could be achieved by a DN being obliged to enter into an ARCA style contract with the NTS.
- 3.12. DN respondents also raised concerns with the proposed DN ARCA arrangements:

- ◆ One DN respondent stated that more consideration on how the DN ARCA arrangements will work in practice is required before they are implemented and stated that it was unclear why these arrangements are needed given that the NTS has been provided with a revenue allowance consistent with substantive investment for reinforcement. This DN respondent stated that the ARCA arrangements are only viable if the DNs can fully back-off the risk to the customer and that ARCAs can only be used for specific new DN connection requirements that trigger the need for a specific offtake capacity requirement and are not appropriate for general increases in offtake capacity as a result of general demand growth within the DN. This DN respondent stated its belief that the ARCA commitment would be based upon NTS exit capacity (for which shippers pay) resulting in a potential mismatch of requirements and concluded that ARCAs should not be required for transitional arrangements but should only be considered during discussions on the enduring exit arrangements.
- ◆ One DN respondent noted that a detailed methodology would need to be worked out to define the rules for when an ARCA would be required, and covering the arrangements at sites with multiple users.
- ◆ One DN respondent stated that it would regard any aspect of the scheme that simply penalised the DN for requesting extra capacity as unacceptable and, as a consequence, it is firmly opposed to Ofgem's proposal that any penalty under the ARCA should not be capable of being recovered. This DN respondent stated that it would be extremely concerned if a situation could arise whereby a DN could potentially be exposed to a double penalty for its offtake capacity requirements, once under the licence incentive arrangements and once under the DN ARCA and furthermore stated that the overall incentive package (including the caps/collars) will need to include any payments under the ARCA.

3.13. One DN respondent acknowledged the linkage between the transitional incentives and modification proposal 0046 and noted that the current absence of this modification proposal's implementation precludes DNs from actually

booking its 2005 capacity requests (thus eroding the typically required 3 year investment lead time).

- 3.14. Two DN respondents supported the Ofgem proposal to review the interruptions incentive as part of the DN interruption reform process / GDPCR. However, one of these DN respondents stated that it was important that this review takes place in a timely manner to ensure that the transmission and distribution arrangements are aligned and deliver equitable treatment of interruptible customers across the gas supply system. Another DN respondent recognised that the timescales associated with the introduction of the transitional exit arrangements effectively precluded the possibility of aligning exit and interruption incentives at this point, but stated that such alignment would be necessary to achieve all the potential benefits of DNs optimising between investment in incremental capacity and contracting with customers to interrupt demand.
- 3.15. Another DN respondent stated that one of the key principles underpinning the incentives is the ability for transporters to manage their capacity by a combination of investment and demand side management. Whilst recognising that a new interruption regime may be forthcoming, this DN respondent stated that this should not preclude the inclusion of the current interim measures for interruption which form a component part of the complete DN capacity management picture and recommended that this component is included within the transitional scheme so that capacity booking is not distorted by the absence of this element of the scheme.

National Grid NTS

- 3.16. National Grid NTS stated that the proposed scope of the DN incentives is broadly correct and that it is appropriate for Ofgem to set the DN incentives now in view of the investment lead times involved for the NTS. National Grid NTS stated its support, as a matter of principle, for a regime that provides an incentive on the DNs not to over-book NTS flat or flexibility offtake capacity.
- 3.17. National Grid NTS stated that it continued to support the need for an ARCA on DNs in order to provide a level of financial commitment to underpin any specific reinforcement that the NTS would need to undertake to deliver the requested incremental capacity. Furthermore, National Grid NTS agreed that

DNs should not be able to pass through the costs of penalty payments made under any ARCA commitment to their customers.

- 3.18. In relation to the scope of the DN incentives, National Grid NTS stated that it could see the logic in Ofgem's view that the incentive around payments made for greater than 15-day interruption should form part of the reform of interruption arrangements on the DNs.

Shippers/suppliers

- 3.19. A shipper/supplier stated that it generally agreed with Ofgem's initial proposals for DN access to NTS exit capacity. Another shipper/supplier stated that, in general, it supported the approach proposed by Ofgem, stating that implementing transitional arrangements for the period will provide additional clarity and aid investment planning, although this shipper/supplier accepted that both the DNs and NTS face some uncertainty in certain areas. Overall, this shipper/supplier stated that the detailed arrangements are pragmatic, minimise changes and make use of existing processes.
- 3.20. Another shipper/supplier recognised the need to ensure the most efficient and economic trade-off is made in incentivising investment in the NTS and the DNs to provide transportation services. However, this shipper/supplier stated that it was not convinced that the approach set out achieves this aim. This shipper/supplier considered that it would be preferable to set the DNs' incentives in line with the NTS incentives and would recommend that only minimal changes are made at this time given that the DNs and the NTS have Gas Act and licence obligations regarding efficiency and meeting reasonable demands of customers.
- 3.21. One shipper/supplier stated that the current ARCA regime for NTS DCs, which has been generically applied to DNs, is the most economic, transparent and non-discriminatory way for NTS offtakes to signal and request extra NTS exit capacity, but that National Grid NTS's option to defer the date on which capacity is made available needs to be addressed as there are no claims procedures to compensate affected parties. Furthermore, this shipper/supplier noted that incentives on National Grid NTS may be needed to ensure that capacity is provided in the timescales agreed under the ARCAs.

- 3.22. Another shipper/supplier stated that UNC modification proposal 0046 should be implemented and it should not depend on decisions about licence changes.
- 3.23. Two shippers/suppliers stated that it was sensible to review the 15-day interruption incentive at the time of the next distribution price control.

Other respondents

- 3.24. The CIA recognised the need to ensure that DNs do not overbook capacity but stated that it also required secure gas supplies (in terms of there being enough capacity).
- 3.25. Energywatch noted that 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. Energywatch noted that the disaggregation of the UK gas market, following the sale of the DN businesses by National Grid, 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, energywatch stated that it was critical that all networks owners are financially exposed to any repercussions, caused by their decisions, on other networks. In principle, therefore, energywatch stated that it supported 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.
- 3.26. However, energywatch emphasised 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 and urged Ofgem to consider this principle when considering the transitional arrangements in their entirety.
- 3.27. Energywatch noted that the current incentives package underpinning the period June 2005 to September 2008 (the interim period) appeared to operate in the manner intended with DNs 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 stated 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.

3.28. However, some respondents expressed concern over the ARCA arrangements proposed by National Grid NTS:

- ◆ the CIA stated it would like to see further information on standard ARCA terms; and
- ◆ the AEP also expressed concerns that the proposed ARCA arrangements may increase the risk faced by parties seeking to secure incremental capacity and that this risk may need to be mitigated by incentives on National Grid NTS to ensure capacity is provided in a timely manner. In particular, the AEP noted that the proposed ARCA arrangements gave National Grid NTS a unilateral option to defer the date on which capacity was made available with no compensation for the affected parties and that it would like to see this option for deferral removed from the ARCA.

3.29. In relation to the 'greater than 15 day interruptions' incentive, energywatch stated that it was appropriate to revisit this element of the package in 2007 and therefore, supported the proposal not to extend the current arrangements in the short term. The AEP agreed that this incentive should be reviewed at the time of the next distribution price control review.

Final Proposals

3.30. Following consideration of the views expressed by respondents, Ofgem continues to believe that:

- ◆ DNs should face 100% exposure to any penalty payments incurred by a DN as a result of contractual agreements entered into with National Grid NTS for NTS exit capacity at the three year ahead stage;

- ◆ it is necessary to specify incentives for the DNs for the duration of the transitional period to mitigate a potential tendency to overbook NTS exit rights through a single incentive mechanism; and
- ◆ it is not appropriate to extend the current greater than 15 day interruptions DN incentive for the duration of the transitional period at this time, but rather it should be reviewed as part of the DN interruptions reform project.

3.31. Ofgem notes that respondents have raised concerns in a number of areas, and considers these below under the following headings:

- ◆ the need for DN incentives;
- ◆ incentives to return capacity not required;
- ◆ the proposed ARCA arrangements;
- ◆ linkage between transitional incentives and modification proposal 0046; and
- ◆ the greater than 15 day interruptions incentive.

The need for DN incentives

3.32. Ofgem notes the views expressed by a shipper/supplier that only minimal changes should be made to DN incentives at this time given that the DNs and the NTS have Gas Act and licence obligations regarding efficiency and meeting the reasonable demands of customers. However, Ofgem continues to consider that an incentive upon DNs is necessary to ensure that DNs are exposed to the costs of their purchases and can make efficient trade-offs between such purchases and investment i.e. to address the rational tendency to over-book NTS exit capacity.

Incentives to return capacity not required

3.33. Ofgem notes the comments from a DN respondent with regards to the operation of the proposed incentive under the scenario where the DN books more capacity than is required at the three year ahead stage. Ofgem recognises that,

in the circumstances where the contractual arrangement entered into by the DN at the three year ahead stage requires the DN to pay for the capacity booked at the three year ahead stage irrespective of whether this is used, there will be no explicit financial incentive upon the DN to release the capacity, which is not in the event required, for use by another user. For example, if the contractual arrangements require a one year commitment, and if the DN books 120 units of either NTS exit flat capacity or NTS exit flexibility capacity at the three year ahead stage and subsequently decides that it only requires 110 units in the first year of delivery, it will, if it amends its capacity request to 110, pay for the 10 units of capacity booked and unused under its contractual arrangements. However, if the DN, instead, retains its capacity request at a level of 120 units, then it will, to the extent that it remains within its cap and collar, face the cost of 10 additional units under its incentive scheme. Therefore, under this example, the DN would bear the cost of 10 units whether it reduces its capacity request or not.

3.34. However, Ofgem would note that this scenario only occurs under the specific circumstances where a DN capacity request at the three year ahead stage triggers NTS investment that requires the DN to enter into contractual arrangements with the NTS and, subsequent to making the request, the DN decides that it no longer requires the full amount of the capacity it booked at the three year ahead stage. Furthermore, this effect is only an issue to the extent that a third party could benefit from this surplus capacity and will only endure for the duration of the commitment entered into under the contractual arrangements.

3.35. Given that the relevant circumstances are quite specific, and the duration of the effect on incentives is finite, Ofgem does not consider that an adjustment to the proposed incentive scheme is necessary or appropriate at this time. Ofgem would note that the introduction of explicit anti-hoarding products could be considered in the context of the proposed enduring offtake arrangements to address such issues.

3.36. It is noted that, in the transitional period, DNs are free to agree appropriate clauses with National Grid NTS within the contractual agreements they enter into such that, should National Grid NTS be able to sell any released capacity to a third party, the DN receives some remuneration. However, without fettering

the Authority's discretion in relation to licence enforcement, to the extent that a DN does not reduce its capacity request in such circumstances, and this prevents another party from accessing the capacity, then Ofgem would need to consider carefully this against the DN's licence obligations to ensure the coordinated, efficient and economic operation of the combined GB pipe-line system so far as is consistent with the efficient and economic operation of their own pipe-line system⁶.

The proposed ARCA arrangements

Ofgem role

- 3.37. Ofgem notes that a number of respondents have raised concerns with the DN ARCA arrangements proposed by National Grid NTS.
- 3.38. There is no express power of the Authority to review or approve these documents. Furthermore, it is Ofgem's view that there should not be *ex ante* intervention in what should be commercially negotiated arrangements within the transitional regime⁷. However, Ofgem notes that, if parties have an issue regarding the ARCA which cannot be resolved commercially, such disputes could be referred to the Authority for determination provided that such disputes fall within the Authority's powers, for example, in relation to section 21 or section 27A of the Gas Act 1986. This is reflected in the latest IExCR consultation issued by National Grid NTS on 25 November 2005.
- 3.39. Given that the DN ARCA arrangements are not subject to Authority approval, Ofgem notes that, in proposing ARCA terms and conditions, National Grid NTS remains subject to its statutory and licence obligations. For example, section 9 of the Gas Act 1986, obliges National Grid NTS to:
- ◆ ensure the efficient development and maintenance of its pipe-line system;

⁶ Standard Special Condition A11 (Network Code and Uniform Network Code)

⁷ subject to the Authority's role under the Competition Act 1998

- ◆ comply, so far as it is economical to do so, with any reasonable request for it to connect any premises to its system and convey gas by means of that system to the premises; and
 - ◆ avoid undue discrimination in connections or the terms under which it undertakes the conveyance of gas through its systems.
- 3.40. However, given the concerns expressed by respondents and the perception by some that the DN ARCAs are Authority approved documents, Ofgem intends to publish an open letter, for the attention of all interested parties, clarifying its role in relation to both DN and NTS DC ARCAs.

Definition of incremental exit capacity

- 3.41. Ofgem would note the concerns raised by one DN respondent regarding the definition of incremental exit capacity for ARCA purposes and that DNs should have exposure when requesting capacity over and above agreed growth rates.
- 3.42. The term “incremental exit capacity” is defined in Special Condition C18 (Licensee’s methodology for determining incremental exit capacity volumes) of the NTS-GT licence in order to define the scope of the IExCR, and hence the ARCAs, which are referenced in this statement. Ofgem is proposing to amend the provisions of Special Condition C18 to clarify the meaning of the term “incremental exit capacity” for the transitional arrangements such that it references a series of “initial volume allocation” numbers which would be set out in National Grid NTS’s IExCR. Ofgem’s proposed licence amendments are discussed further in Appendix 4.
- 3.43. Related to this, National Grid NTS is currently consulting on changes to its IExCR which provide that “incremental exit capacity” for DNs should be defined in relation to “initial volume allocation” numbers which are consistent with the DN volume targets determined for their incentives.

Interaction of ARCAs with DN incentives

- 3.44. Ofgem notes the concern raised by one DN respondent that they may be exposed to a “double penalty” under both the incentive regime and the DN ARCA. Ofgem would note that this will not be the case as:

- ◆ the DN ARCA payments will only be required in the event that the DN does not ultimately book some or all of the capacity requested at the three year ahead stage; and
- ◆ a DN will only make payments under the incentive regime within its licence in the event that capacity is booked (and that booked capacity exceeds the volumetric target set).

3.45. As stated above, Ofgem does not anticipate that the contractual (ARCA) arrangements entered into would do anything more than ensure that the DN actually pays for the capacity it requests at the three year ahead stage (and which is subsequently built on its behalf) for a defined period. As such, to the extent to which a DN triggers NTS investment and then subsequently does not book and pay for the capacity requested, Ofgem continues to believe that DNs should face 100% exposure to the value of the unused capacity, as agreed under the contract they enter into. This level of exposure should minimise inefficient NTS investment, reduce the risk of stranded assets and encourage effective demand forecasting. Furthermore, DNs could enter into contractual arrangements with large connecting parties such that, if the connecting party does not require the capacity that it has requested, the DN is able to back off any resulting liability incurred under the DN ARCA.

Linkage between transitional incentives and modification proposal 0046

3.46. Ofgem notes the view expressed by respondents that Ofgem should approve modification proposal 0046. However, Ofgem believes that it would not be in the interests of customers for modification proposal 0046 to be approved in advance of the publication of these Final Proposals as DNs need some certainty with respect to the incentive targets that they are likely to face, and therefore their cost exposure, in advance of submitting their capacity requests. Furthermore, Ofgem would note that modification proposal 0046 and the proposed changes to the IExCR are intrinsically linked as the IExCR outlines the process by which incremental capacity will be released in the transitional period and, therefore, it would be inappropriate to approve modification proposal 0046 until National Grid NTS has submitted its final consultation report to the Authority with respect to the IExCR.

The greater than 15 day interruptions incentive

- 3.47. Ofgem notes respondents' views in relation to the greater than 15 day incentive that emphasised the need for its timely consideration as part of the DN interruption reform debate. Ofgem's initial thoughts on the timetable for DN interruption reform were outlined in an open letter published in July 2005⁸.
- 3.48. Ofgem notes the views of one DN respondent that interim measures for DN interruption should be included at this stage so that capacity booking is not distorted by the absence of this element of the scheme. Ofgem acknowledges the concern raised, but considers that a delay would make available a better quality data set against which to determine an incentive. As such, and given the forthcoming DN interruptions reform, Ofgem considers that the deferral of this element of the scheme until that time is appropriate.

Form

Initial Proposals

- 3.49. The Initial Proposals consultation proposed that the DN incentive schemes continue to be structured following a standard "sliding scale" form, with a defined incentive cost target and a cap and collar. Deviations from this target level of incurred cost would then be shared between DNs and customers, and therefore be subject to a defined sharing factor.
- 3.50. Ofgem proposed cost performance targets for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity for each DN (for formula years 2009/10 and 2010/11⁹) derived as follows:
- ◆ expected volume of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity required by each DN (by offtake zone) in each year; multiplied by
 - ◆ a reference price for both NTS offtake (flat) capacity and NTS offtake (flexibility).

⁸ 168/05 - [Reform of Distribution Network interruption arrangements](#), Ofgem

⁹ Targets for 2008/9 are already specified within the licence.

Expected volume of NTS exit rights

- 3.51. In order to inform its decision on the value of the cost performance targets, Ofgem invited each individual DN to provide their view of appropriate capacity targets for the transitional period. However, it was recognised that the DNs may have a rational tendency to overstate the required targets. Therefore Ofgem performed an independent analysis of the data provided and determined a methodology for the derivation of the DN targets, which was detailed in the Initial Proposals consultation document.
- 3.52. In the Initial Proposals consultation, Ofgem emphasised that the methodology applied to calculate proposed incentive targets for capacity would not necessarily be applied in the calculation of incentive targets in the future. In particular, it should not be assumed that, in the future, past behaviour will be used for the derivation of DN incentive targets, as this may, in the long term, cause distortions in the behaviour of DNs.

Expected price of NTS exit rights

- 3.53. In the Initial Proposals consultation, Ofgem considered that the most appropriate reference price for NTS offtake (flat) capacity remained the prevailing (out-turn) price of NTS exit capacity as set out in National Grid NTS's charging statement. Furthermore, Ofgem considered that the prevailing (out-turn) price of NTS exit capacity continued to be the most appropriate reference price for NTS offtake (flexibility) capacity, ensuring that both DNs and customers directly connected to the NTS are able to access NTS offtake flexibility on a not unduly discriminatory basis.
- 3.54. In the Initial Proposals consultation, Ofgem noted that using the prevailing (out-turn) price of NTS exit capacity for NTS exit rights would mean that DNs would be exposed to an amount of price risk to the extent that the volumes of NTS exit rights they request differ from those volumes included in the calculation of the incentive target. Ofgem also noted that the methodology used to calculate the price of NTS exit capacity is likely to be reviewed in the context of the forthcoming transmission price control review (TPCR).

Definition of caps, collars and sharing factors

- 3.55. In the Initial Proposals consultation, Ofgem proposed that the incentive parameters should remain the same as those set for the interim incentives, as shown in Table 4.1 below.

Table 3.1 Parameters for DN incentive schemes

	Cap and Collar (% of each DN target)		Sharing factors	
	Cap	Collar	Upside	Downside
Proposed incentive parameters	7.5%	-7.5%	100%	100%

- 3.56. Ofgem stated that 100% sharing factors were appropriate to ensure that DNs bear, within the limits of the cap and collar, the opportunity cost of over-requesting capacity and to ensure consistency with the proposed 100% pass-through of any ARCA penalty payments incurred as a result of a shortfall in amended capacity requests relative to initial capacity requests.

Duration

- 3.57. In the Initial Proposals consultation, Ofgem considered that the transitional incentive schemes should be defined for the entire transitional period (i.e. from 1 October 2008 to 30 September 2010). Ofgem stated that it intended to consider the interaction between the transitional incentive scheme and the DN price controls as part of the GDPCR. In particular, Ofgem stated that it would wish to understand better the existing capacity of the DN and the relationship between capex allowances under the price control settlement and the future capacity of the DN.

Respondents' views

- 3.58. One DN respondent supported the proposal to retain the structure of the existing incentive scheme as all parties will have become used to the operation of the scheme and have set up internal reporting mechanisms.

Expected volume of NTS exit rights

DN respondents

- 3.59. One DN respondent agreed with Ofgem's proposal to use the volumes consistent with its 1 in 20 obligation to derive the DN volume targets.
- 3.60. Another DN respondent expressed concern at the general premise within the Initial Proposals consultation that there is a tendency for DNs to overbook NTS exit rights. This DN respondent stated that it has requested capacity based on its legal 1 in 20 obligation and that it is inappropriate that the request has been adjusted downwards. This DN respondent stated that, if it were to request exit rights in line with the allowance given in the consultation document, there would be a risk of non-compliance with its legal obligation. This DN respondent stated that it was unclear how Ofgem had derived capacity targets and stated that data presented as "DN requests from NTS" were in fact the amounts allocated by the NTS. Furthermore, this DN respondent stated that if requests for capacity across DNs are reduced then this will lead to DNs requesting more than is actually required in the future.
- 3.61. One DN respondent noted that Ofgem's methodology for setting targets for flat capacity results in a target that is equal to the 1 in 20 demand for gas in the LDZ and that this is the correct level given that GTs have a legal obligation to provide sufficient capacity to meet 1 in 20 demands and it would be perverse to penalise or reward them for meeting this obligation.
- 3.62. One DN respondent stated that there is not a linear relationship between demand growth and flexibility requirements and therefore stated that the flow flexibility product should be removed from the incentive scheme and reviewed as part of the main price control. This DN respondent also questioned the application of Ofgem's methodology where previous flexibility requirements have been zero, stating that the methodology applied was demonstrably flawed. Another DN respondent stated that the assumption that flow flexibility requirements vary in proportion with the level of demand does not allow for the fact that, as the volume of gas supplied grows, the total amount of diurnal storage required increases in proportion, but that, as the amount of gas transported increases, transmission losses increase, reducing the ability of the

network to provide line-pack storage and increasing the requirement for flow flexibility to meet the greater diurnal storage requirements. As such, this DN respondent stated that the requirement for flow flexibility increases at a much faster rate than demand and the methodology for determining flow flexibility targets should be reviewed and a more complex approach, consistent with the above rationale should be adopted.

- 3.63. One DN respondent expressed concern that the way in which the targets for the transitional incentive scheme had been set disadvantaged those parties that responded quickly to the incentive scheme. This DN respondent noted that a company responding immediately is allowed to retain the benefits until October 2009, a period of four years, whilst a company that delayed responding to the scheme by a year would receive benefits until the end of the transitional period, a period of five years. This DN respondent stated that companies should achieve the maximum benefit by responding to an incentive scheme immediately and not delaying, and that this could be addressed by setting all targets for 2009/10 by scaling offtake quantities in line with the growth rates in the TBE report.
- 3.64. Another DN respondent also noted that some DNs may be advantaged due to a greater ability to substitute offtake flat or flex either across exit zones or, in the case of the four retained DNs, across DN boundaries.
- 3.65. One DN respondent stated that, to the extent that DN targets have to be set, they should be based upon the DN's assessment of its network requirements, not that of the NTS as this could create an incentive regime that, from the outset, exposed the DN to a penalty.
- 3.66. One DN respondent stated that it was vital that any future incentive regime includes a mechanism for adjusting the target offtake parameters in response to changes in demand as a result of:
- ◆ genuine demand growth, for example as a result of large loads and interruptible loads switching from interruptible to firm;

- ◆ regulatory reform of the DN exit and interruption regime, which may lead to a step change in the likelihood that some sites will opt to become firm; and
- ◆ variation in calorific value (CV) over which the DN has no control, for example, a lowering of the CV could mean that any diurnal storage capacity within the network itself would no longer be sufficient to meet the requirements expected of it.

3.67. This DN respondent stated that without a mechanism to adjust the *ex ante* targets where variation is at least attributable to one or more of the above factors, Ofgem's incentive scheme would appear to be based upon a DN's demand forecasting capability/accuracy, rather than offtake capacity booking behaviour and associated network management. This DN respondent stated that a term should be included in the incentive formula that would "automatically" adjust the target offtake capacities, for example, the calculation used to derive the targets could be inserted into the licence which would allow an adjustment term to be included where actual demand growth rates differ from Ofgem's pre-determined rates.

3.68. Alternatively, this DN respondent stated that an amendment could be made to the existing income adjusting event (IAE) provision set out in paragraph 8(6)(a) of Special Licence condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) to mitigate a DN's exposure under the incentive mechanism if the exposure was as a result of a change in demand growth rates outwith its direct control. This DN respondent stated that this would require an amendment to the £2m threshold that is currently within the licence as well as amendments to the paragraphs within the licence that define an IAE. This DN respondent noted that the IAE mechanism only obliges Ofgem to *consider* changing targets in relation to uncontrolled events and therefore requested comfort from Ofgem from the outset that the incentive scheme is not intended to expose DNs to unanticipated demand growth, changes to the regulatory regime or CV changes and, therefore, that a claim for such items under the IAE provision would in principle be acceptable.

3.69. One DN respondent also noted that for the transitional year 2008/09, the target offtake capacity targets already within the licence were proposed to be used,

although, the original intent was that such figures should only apply to the months April to September 2008.

National Grid NTS

- 3.70. National Grid NTS stated that it was important that the DNs should be appropriately remunerated for booking their 1 in 20 requirements.

Shippers/suppliers

- 3.71. A shipper/supplier expressed concern that Ofgem's proposed review of 1 in 20 obligation figures could result in an under-investment in gas pipeline infrastructure. This shipper/supplier recognised the requirement to avoid "gold-plating" through over-investment in assets, but noted that customers' interests are better protected by ensuring sufficient capacity and the risks associated with under-investment outweigh those associated with over-investment. This shipper/supplier stated that it was not clear that this trade-off has been properly assessed and would expect it to be more clearly brought out in Ofgem's forthcoming discussions on the GDPCR.
- 3.72. Another shipper/supplier stated that it was not entirely clear that Ofgem should impose its calculation of the 1 in 20 level of capacity bookings, when the licence obligation sits with the DN. This shipper/supplier accepted that there is uncertainty but the DNs should be free to determine their own requirements providing that any subsequent costs are not passed through.

Other respondents

- 3.73. The AEP expressed concern that the licence requirements concerning 1 in 20 demand and the proposed incentives judged against targets set several years in advance may not be consistent since the licence conditions regarding capacity planning are judged on out-turn network use rather than against forecast. The AEP stated that it was appropriate that DNs should be encouraged to provide as accurate forecasts of capacity requirements as possible whilst not over requesting capacity so that charges to DN connected customers do not rise unnecessarily.

- 3.74. The AEP also noted the possibility that events outside DN influence or control (such as significant one off connections or interruptible to firm switching) could cause the actual capacity required to be at variance with the forecast target level causing the DN to be penalised for not forecasting these events. The AEP stated that it was not clear how this might reflect on consumers and whether capacity might be withheld or lead times imposed.
- 3.75. The AEP also questioned why targets are being set for each exit zone which may inhibit capacity optimisation across exit zones when a target for each LDZ would permit this to occur and may allow a more efficient outcome.

Expected price of NTS exit rights

DN respondents

- 3.76. One DN respondent agreed that it is appropriate to set one price for the determination of NTS flat and flexibility prices as per the interim arrangements. This DN respondent recognised that by setting this out-turn price at the actual NTS exit price (some three years hence) a level of unknown risk exists in terms of the financial exposure to which a DN is exposed, but, on balance, that this price setting was appropriate. This DN respondent noted that, using the out-turn price results in any incentive reward or payment being crystallised some years (3 or 4) after the initial booking of capacity, which could lessen the focus of DN's when requesting capacity and that a more immediate impact on allowed revenue may prove more robust in fully promoting the DN behaviour sought by an incentive scheme.
- 3.77. One DN respondent agreed with Ofgem that both DN out-turn performance and the target should be based on the prevailing prices in the year in question (and hence the DN would not be exposed per se to change in Transco's pricing methodology).
- 3.78. One DN respondent stated that the main mechanism to lower costs is to concentrate usage on the exit zones with the cheapest capacity rights. This DN respondent stated that DN's could concentrate their offtake rights in a zone where they were predicted to be cheap, only to find that subsequently, the price moved against them, and that perversely, this very focus will tend to increase

prices in that zone and hence the risk of the DN being financially exposed. This DN respondent noted that participants will not have price certainty when entering into a commitment and prices will be updated at periodic intervals rather than immediately responding to supply and demand. This DN respondent therefore stated that basing the incentive scheme upon prices at the time when most of the capacity is likely to be booked i.e. three years prior to capacity usage, could reduce this risk.

- 3.79. Two DN respondents noted that changes to NTS exit pricing as a result of the TPCR may be significant and that Ofgem has confirmed that this could be treated as an IAE subject to the appropriate requirements being met. One of these DN respondents noted that the financial threshold for such an event is set at £2m and stated that there was merit in setting a DN related threshold at a percentage of notional NTS exit right charges or, if setting a limit was too arbitrary, it may be more appropriate to signal that IAE events would be considered based on individual DN events, where the relative cost of any loss (versus notional revenue) could be weighed. This DN respondent stated that there would be merit in extending the provisions of any IAE to the potential costs within a DN ARCA.
- 3.80. This DN respondent stated that the DN and NTS DC regimes are quite different with respect to flow flexibility in that NTS DCs who are not obliged to buy the flow flexibility product can, for their size, impose a much greater level of flow variation on the NTS than DNs who must pay for all flexibility, undermining the logic that the two products must be the same price to avoid undue discrimination between users. This DN respondent noted that the pricing for flow flexibility should be cost reflective otherwise inefficient investment decisions were likely.
- 3.81. This DN respondent noted that Ofgem has proposed an extension of the existing incentive regime in terms of the reference price that would be used in relation to flow flexibility for the transitional incentive scheme. This DN respondent stated that, whilst it recognised that this approach has been adopted for convenience, in practice, to the extent that a DN responds to the incentive scheme, investment decisions associated with meeting diurnal storage requirements would be based on completely arbitrary economics.

3.82. One DN respondent agreed in principle with the Ofgem proposal that the reference price should be the NTS exit charge. However, this DN respondent noted that, in comparing NTS DCs and DNs, no consideration is taken of the difference in timescales applied to these two categories of connectees i.e. NTS DC customers tend to finalise their booking commitments closer to the time when the capacity is required, therefore the price is more transparent to them whereas DNs are making capacity commitments more than 3 years in advance and are exposed to more risk of exit charge variations. The introduction of a market for secondary trading would ensure that this risk is manageable.

National Grid NTS

3.83. National Grid NTS agreed that the most appropriate reference price for NTS offtake (flat) capacity remains the prevailing (out-turn) price of NTS exit capacity as set out in its charging statement. However, National Grid NTS stated that it continued to have some concerns over the potential perverse incentives associated with a reference price for NTS offtake (flexibility) being based on the flat exit capacity charge. As such, National Grid NTS stated that it therefore supported Ofgem statements that the methodology used to calculate the price of the NTS exit capacity is likely to be reviewed in the context of the forthcoming TPCR. National Grid NTS also supported Ofgem's view that it would be appropriate to include the resulting revised NTS offtake (flat) capacity and NTS offtake (flexibility) capacity charges in the calculation of the cost performance targets for the transitional incentive schemes rather than the current prices.

Shippers/suppliers

3.84. A shipper/supplier agreed that the prevailing (out-turn) price of NTS exit capacity continues to be the most appropriate reference price for NTS flexibility capacity in the transitional period. Another shipper/supplier stated that, in the absence of a separately defined price for exit (flexibility) capacity, then it is appropriate to align the treatment of the DNs and NTS DCs. However, this shipper/supplier expressed its concern that if flexibility capacity is unbundled in the future it will be priced on different basis and stated that it would like to understand better how the targets and incentives might be affected.

- 3.85. However, under the enduring offtake arrangements, this shipper/supplier disagreed that DNs should be purchasing NTS flexibility rights at the same price as NTS DCs because of the fundamental differences between DNs and smaller customers requesting NTS exit rights whereby DNs can substitute NTS Offtake capacity (flat) and NTS offtake (flexibility) capacity between their different exit zones where NTS shippers, most with only one offtake point, cannot. This shipper/supplier concluded that applying a single price or uniform arrangements would promote far more discrimination between different NTS offtake point types than the level of discrimination that currently exists and that Ofgem's enduring offtake arrangements should be amended to take this into account.
- 3.86. A shipper/supplier noted that a particular concern for shippers and suppliers to business customers is the risk that the arrangements Ofgem is proposing could result in volatile transportation prices. This shipper/supplier recognised that Ofgem had introduced licence requirements to minimise the number of transportation pricing changes, and considered that the value that stability of transportation prices contributes to the competitive supply market must be considered when developing these arrangements.
- 3.87. This shipper/supplier stated that it was not clear how the incentive arrangement will work or how the DNs would be best able to meet their targets given that it will be based on an out-turn price using a methodology that will be reviewed in future and its level will be affected by the outcome of the GDPCR.

Other respondents

- 3.88. The AEP agreed that the out-turn price would seem to be the most appropriate price to use in that it relieves the DNs from carrying price risk which they cannot readily offset at a time when there may be substantial rebalancing of charges. However, the AEP stated that it was unclear how the DNs are supposed to plan to manage their capacity requirements across their exit zones when the price which may drive this will be uncertain.

Definition of caps, collars and sharing factors

DN respondents

- 3.89. Two DN respondents agreed that the Ofgem proposal to continue with the current definition of caps, collars and sharing factors was appropriate.
- 3.90. One DN respondent stated that, only once NTS exit charges are known, will it be able to make an informed response in relation to the definition of caps, collars and sharing factors. This DN respondent stated that it is not unreasonable for the incentivised party to be able to make an assessment of the potential risk/reward to which it might be exposed. This DN respondent noted that, given the role of the NTS exit capacity charge within the incentive mechanism, expected future charge changes will have a direct impact on the risk faced by a DN under the transitional incentive regime. This DN respondent stated that, although the proposed cap and collar would, to some extent, limit a DN's relative exposure under the proposed regime, it does not provide any protection against a DN's absolute exposure. As such, this DN respondent suggested that the caps/collars should be adjusted to a fixed £m amount.

National Grid NTS

- 3.91. National Grid NTS stated that it is for the DNs to decide whether the transitional incentive parameters provide the correct risk and reward balance and therefore made no comments on the parameters themselves.

Shippers/suppliers

- 3.92. One shipper/supplier agreed that the proposed definitions provide the sharpest incentives on the DNs to book NTS exit capacity appropriately and to consider trade-offs between alternatives, such as increased interruption on their networks and stated that the performance measures should be set as fixed percentages.

Other respondents

- 3.93. Energywatch noted that 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 and that it saw 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. However, energywatch noted that the interim incentive scheme has only been in operation for a few months and recommended that the performance of the DNs and National Grid NTS should be continually reviewed to ensure that the parameters are appropriate and no one party is receiving windfall gains.

Duration

DN respondents

- 3.94. One DN respondent stated that it supported the proposal to set the incentive schemes for the duration of the transitional arrangements.
- 3.95. Another DN respondent agreed in principle with the Ofgem proposal to introduce an incentive scheme for the whole transitional period. This DN respondent stated that a scheme of any shorter duration would lead to further uncertainty and would potentially introduce a third scheme between network sales and the GDPCR. This DN respondent stated that DNs need clarity about their operational framework to allow the efficient and economic development and management of the distribution networks. However this DN respondent stated that it would be desirable to reassess the impact and desirability of these incentives following the GDPCR.

Shippers/suppliers

- 3.96. A shipper/supplier stated that its primary concern is that the proposals appear to pre-empt the consultation process it expects Ofgem to follow in setting the next distribution price controls and welcomed Ofgem's assurance that no decision it makes at this time in relation to incentives will fetter the Authority's discretion regarding the future approach, framework, and associated incentive arrangements which will be developed as part of the GDPCR.
- 3.97. Another shipper/supplier noted that the implication of "transitional arrangements" is that there is a need for further change. This shipper/supplier noted that, while modest changes may be required, it had yet to see a compelling case for the fundamental regime changes proposed for the enduring arrangements in the Authority's Final Impact Assessment regarding NTS exit

capacity and offtake reform. This shipper/supplier stated that there are no clear reasons to move away from an approach based upon licence and other statutory investment obligations allied with a centralised planning model. Furthermore, this shipper/supplier stated that if Ofgem remains wedded to the objective of requiring financial commitment for incremental capacity requests, then this could be achieved through ARCAs, rather than capacity auctions and that this would ensure that NTS DCs and DNs are treated equally, although the ARCA would need to balance the risk between the buyer's commitment to pay and the seller's obligation to deliver the requested capacity on time.

Other respondents

- 3.98. The CIA stated that its main issues lie with the reform to DN interruption arrangements and that it awaited the commencement of these discussions.
- 3.99. Energywatch stated that it fully supported the Authority's decision to defer the implementation of the enduring arrangements but stated that it remained 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 energywatch stated that they should be considered in the longer term as the approach is straightforward and transparent and, assuming that all offtakes are treated equally, it is non-discriminatory. Energywatch urged 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.

Final Proposals

- 3.100. Following consideration of respondents' views to the Initial Proposals consultation, Ofgem continues to consider that:
- ◆ the DN incentive schemes should follow a standard "sliding scale" structure, with a defined incentive cost target and a cap and collar;

- ◆ the cost performance targets for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity (for formula years 2009/10 and 2010/11¹⁰) should be calculated by multiplying the expected volume of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity required by each DN (by offtake zone) in each year by a reference price for both NTS offtake (flat) capacity and NTS offtake (flexibility);
- ◆ the methodology applied by Ofgem in deriving the expected volumes is appropriate;
- ◆ the most appropriate reference price for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity remains the prevailing (out-turn) price of NTS exit capacity as set out in National Grid Gas's charging statement; and
- ◆ the incentive parameters should remain the same as those set for the interim incentives.

3.101. However, Ofgem notes the concern of respondents' with regard to the uncertainty faced in relation to the magnitude of their potential financial exposure under the proposed incentive, particularly in relation to future changes in NTS exit charges. Given these concerns, Ofgem believes that it is appropriate to impose an absolute limit of plus or minus £5 million on the potential financial exposure. The decision to implement this absolute cap/collar is discussed further later in this chapter.

¹⁰ Targets for 2008/9 are already specified within the licence.

3.102. The proposed DN incentive parameters are as shown in Table 4.2 below.

Table 3.2 Parameters for DN incentive schemes

	Cap and Collar		Sharing factors	
	Cap	Collar	Upside	Downside
Proposed incentive parameters	Minimum of 7.5% of DN target and £5m	Maximum of -7.5% of DN target and -£5m.	100%	100%

3.103. This document formally consults upon the licence modifications necessary to implement these final proposals and provide some definitional clarification to the relevant GT licences under:

- ◆ paragraph 3(a) of Standard Special Condition A2 (Private Collective Licence Modification procedure in respect of Standard Special Conditions applicable to both NTS and DN licensees) with respect to the proposed modification of Standard Special Condition A3 (Definitions and Interpretation)¹¹; and
- ◆ section 23 of the Gas Act 1986 with respect to changes to Special Conditions in Part C and Part E of the NTS and DN GT licences respectively¹².

3.104. The licence modifications proposed are explained in Appendix 4, and the licence modifications themselves are provided in Appendix 7.

3.105. Ofgem notes that respondents have raised concerns in a number of areas, and considers these below under the following headings:

- ◆ expected volume of NTS exit rights;
- ◆ expected price of NTS exit rights;

¹¹ The relevant Notice is provided in Appendix 5.

¹² The relevant Notice is provided in Appendix 6.

- ◆ definitions of caps, collars and sharing factors; and
- ◆ duration.

Expected volume of NTS exit rights

Modification of targets proposed

- 3.106. Ofgem notes the concerns raised by one DN respondent in relation to the proposed targets for the transitional incentives and its statement that the “DN requests from the NTS” data presented actually represented the amounts allocated by the NTS. Ofgem sought clarification from National Grid NTS on this matter and, as a result, National Grid NTS discovered an error in the conversion to GWh/day applied within both the data provided to Ofgem for use in the target calculations, and in the Offtake Capacity Statements issued with respect to capacity in the period up to and including the 2007/8 gas year.
- 3.107. As a result of this error, National Grid NTS issued revised Offtake Capacity Statements on 21 October 2005 and provided a revised data set to Ofgem to correct the 2007/8 data used as a basis for Ofgem’s target calculations. Following use of this revised data set, a number of the targets for flat and flexible capacity have been revised for some of the DNs. As a result, the Northern DN has seen a material increase in its targets for both flat and flexible capacity and there have been marginal changes to some other targets. The targets now proposed are included in Appendix 2 and codified within the licence drafting within Appendix 7.

Interaction of targets with 1 in 20 obligation

- 3.108. Ofgem notes that a number of respondents have raised concerns with regards to the interaction of the determination of targets for the expected volume of NTS exit rights, and the 1 in 20 obligations of the DNs. Ofgem, however, considers that the determination of such targets does not, in any way, relieve either the DNs or the NTS of their 1 in 20 licence obligations. **It is for each GT licensee to form its own view of the 1 in 20 level of peak aggregate daily demand and to manage its network accordingly.** The determination of incentive targets merely provides a mechanism to ensure that DNs are exposed to the costs of purchasing NTS exit capacity and have financial incentives to trade-off these

costs with the costs of network investment. Should the relevant DN need to book a level of NTS offtake rights in excess of its incentive target in order to meet its 1 in 20 obligation, then the DN must book the additional amount to ensure such compliance.

- 3.109. It is noted that Ofgem will consider capacity investment decisions as well as NTS capacity purchasing decisions that individual DNs may wish to take for the next gas distribution price control period on the basis of information available to Ofgem at the time of setting this control. Ofgem has previously issued an open letter providing guidance on the treatment of capital expenditure incurred during the current control period at the forthcoming GDPCR.¹³
- 3.110. Furthermore, it is open to DNs to apply to the Authority for an IAE when an event has had an adverse impact on the DN's financial position and performance.

Determination of flow flexibility targets

- 3.111. Ofgem has considered the view expressed by two DN respondents that the need for NTS exit flow flexibility does not vary in proportion with the level of demand and the statement by one DN respondent that it increases at a much faster rate.
- 3.112. Ofgem agrees that the total amount of diurnal storage required increases in proportion with demand and that a DN's ability to provide line-pack storage within its network decreases if demand is increasing and the capacity of the physical network remains fixed. However, Ofgem does not believe that the assumption that the capacity of the network remains fixed is a valid one. Ofgem would note that network investment will increase the physical capacity of the network broadly in line with demand. As such, Ofgem would expect a proportion of this investment to be used to increase diurnal storage capacity within the DN, unless it is more efficient to procure such storage from the NTS. Ofgem therefore considers that long term increases in flow flexibility requirements should therefore be broadly consistent with demand growth.

¹³ *Gas Distribution Price Controls*, Ofgem open letter, March 2004.

- 3.113. Ofgem acknowledges the lumpy nature of investment and therefore that there may be deviations from this trend. However, in Ofgem's view, applying forecast demand growth to derive appropriate incentive targets is appropriate and will encourage DNs to make an appropriate trade-off between the purchase of NTS exit flow flexibility and investment in its own network.
- 3.114. In setting targets for flow flexibility, Ofgem has sought to maintain the same proportions of sources of diurnal storage, including the retention of a zero percentage contribution of flow flexibility to diurnal storage requirements, where this has historically been the case.

Relative treatment of DNs in target setting

- 3.115. Ofgem notes the concern raised by one DN respondent that the mechanism for target setting disadvantages those parties that responded quickly to the interim DN incentive scheme. Ofgem agrees that DNs should not be disincentivised from responding early to pricing and investment signals. However, Ofgem would also note that applying the mechanism suggested by this DN respondent would mean granting DN respondents targets in excess of those that they originally requested from Ofgem and therefore represent a windfall gain for the DN involved at the expense of customers. As such, Ofgem does not believe that such an approach would be consistent with its principal objective to protect the interests of customers.
- 3.116. In the Initial Proposals consultation, Ofgem noted that, in the future, past behaviour will not necessarily be used for the derivation of DN incentive targets, as this may, in the long term, cause perverse behaviour by DNs when making capacity booking decisions. Ofgem would re-emphasise this, given the issues raised by this DN respondent.
- 3.117. Ofgem would further note the issue raised by a DN respondent that some DNs may be advantaged due to a greater ability to substitute offtake flat or flexible capacity either across exit zones or, in the case of the four retained DNs, across DN boundaries. Ofgem would note that the ability to substitute across zones is likely to vary across DNs as a result of the inherent characteristics of the networks that they have inherited. To the extent that some DNs have already

exhibited an ability to substitute between zones, this has been reflected in their targets, given that they are based on DN requests from the NTS for 2007/8.

- 3.118. Ofgem notes the comment made by the AEP that LDZ targets may encourage DNs to make efficient trade-offs going forward. However, an exit zone based approach has been retained to maintain consistency with the interim incentives and the current level of granularity of transportation charges.

Incentive targets and changes in demand

- 3.119. Ofgem notes the comment from one DN respondent that DN targets should be based upon a DN's assessment of its network requirements, not that of the NTS. Ofgem would note that the growth rates assumed by National Grid NTS in its forthcoming Ten Year Statement for 2005 and provided to DNs in accordance with the Uniform Network Code (section H of the Offtake Arrangements Document) have been applied to determine targets to ensure consistency in target setting across DNs.
- 3.120. Ofgem would note that, in general, out-turn demand growth may be different to that assumed in the determination of targets. Ofgem notes the request, from one DN respondent, that any future incentive should include a mechanism for adjusting the target offtake parameters in response to changes in demand as a result of demand growth, regulatory reform of the DN exit regime and variations in CV over which the DN has no control.
- 3.121. Ofgem agrees that, in the event that reform of the DN interruption regime leads to a step change in DN capacity requirements, it will be necessary to consider re-opening the DN incentives to ensure that DNs are not unduly disadvantaged.
- 3.122. However, Ofgem is of the view that the IAE provisions and the incentive caps and collars are in place to limit DNs' financial exposure in the event of any material issues caused by unexpected demand growth or variations in CV.
- 3.123. Ofgem acknowledges that the DN is unlikely to have control over variations in CV, and that if the actual CV falls below that assumed by the DN when planning its network investment, then additional NTS firm or flexible capacity may need to be acquired. However, Ofgem expects DNs to take into account the potential range of CVs in planning their networks and determining the level of firm or

flexible capacity required, consistent with their 1 in 20 licence obligations. As such, Ofgem has assumed that DNs have adopted an appropriately conservative approach consistent with the lower bound of this range. Furthermore, given that significant reductions in CV are not anticipated within the transitional period¹⁴, Ofgem does not view a reduction in CVs as a material risk to DNs.

- 3.124. Ofgem continues to consider that the IAE threshold needs to strike an appropriate balance between materiality and the regulatory resources required to manage IAE claims. However, following consideration of respondents' views, Ofgem believes that it is appropriate to consult further on the appropriate IAE threshold, and proposes to issue a consultation in this regard in the coming weeks. One of the options considered in this proposed consultation will be the reduction of the IAE threshold to £1m.
- 3.125. Ofgem would note that, under the terms of Special Condition E2B(8)(6)(i), it can only approve an IAE as such following consultation with the relevant parties. However, without fettering the Authority's discretion to consider IAE applications on a case-by-case basis, Ofgem acknowledges that any changes that are beyond a DN's control, that cause them to be at a financial disadvantage, could form an acceptable basis for a claim under the existing IAE provisions.

Determination of targets for 2008/09

- 3.126. One DN respondent noted that the targets for 2008/09 are already present within the DN-GT licences, although the original intent was that such figures should only apply to the months April to September 2008. However, Ofgem would note that the original licence drafting for the interim incentive arrangements envisaged the introduction of enduring arrangements on 1 October 2008 and the need to set DN incentives for these arrangements. In this respect it is noted that the 2008/9 figures established for the last six months of the interim incentives (April to September 2008) included load growth for the 2008/9 winter and therefore it is not inconsistent to apply these targets to the full 2008/9 formula year.

¹⁴ *Importing Gas into the UK – Gas Quality Issues, a report to Department of Trade and Industry, Ofgem and the Health and Safety Executive, Ilex Energy Consulting, November 2003.*

3.127. On this basis, and given that DN incentives remain necessary for the transitional arrangements which commence from 1 October 2008, Ofgem does not believe that it is appropriate to change these targets. Indeed, Ofgem considers that if it were to change the targets for 2008/9 this may require a re-opening of the interim incentives for the final six months of the interim incentive period in order to re-set the targets for this period. Ofgem does not consider that such a re-opening would be desirable as it would undermine incentives that have already been set.

Expected price of NTS exit rights

3.128. Following consideration of the views expressed by respondents, Ofgem continues to consider that the reference prices for the DN incentive should be out-turn prices.

DN exposure to price risk

3.129. Ofgem recognises the concerns expressed by a number of respondents in relation to the price risk faced by DNs as a result of the use of out-turn prices. Given these concerns, Ofgem believes that it is appropriate to impose an absolute limit of plus or minus £5 million on the potential financial exposure that may be faced by DNs. As a result:

- ◆ the cap proposed is the lower of:
 - ◆ the cap based on 7.5% of the exit incentive target; and
 - ◆ £5 million, and
- ◆ the collar proposed is the greater of:
 - ◆ the collar based on -7.5% of the exit incentive target; and
 - ◆ - £5 million.

3.130. Ofgem would note that an absolute cap / collar, applicable across all DNs, is proposed to provide some absolute protection over and above the protection offered by the proportional caps/collars and IAE provisions already in place. As such, the inclusion of this absolute cap and collar, and the determination of its

level of £5 million, has no bearing on Authority decisions in relation to any IAE applications that may be made in the future by a DN. A relatively high value of £5 million was chosen in order to provide this additional assurance to DNs whilst protecting the interests of customers as, on the basis of current NTS exit charges, no individual DN would be exposed to losses of as much of £5 million given the proportional collar in place. Indeed, for many DNs, the potential financial exposure is significantly less than this amount. As such, the absolute collar will only be the limiting condition should there be a material change in NTS exit capacity charges.

- 3.131. Ofgem would also note that, by imposing an absolute cap of £5 million, the potential for the DNs to benefit under the DN incentive scheme has also been limited.
- 3.132. It is important to emphasise that regardless of whether any caps or collars imposed as part of the DN incentive scheme have been reached, DNs will continue to have licence obligations to operate their pipe-line systems in an efficient and economic manner¹⁵ as well as statutory obligations regarding efficient development and maintenance of its pipe-line system¹⁶.
- 3.133. Furthermore, it should be noted that the introduction of the absolute cap / collar is for the transitional arrangements only, and should not be viewed as setting a precedent for the enduring offtake arrangements.
- 3.134. Furthermore, Ofgem would note that, in relation to DNs' concerns over price risk:
- ◆ DNs will only face price risk to the extent to which their out-turn performance deviates from their incentive targets;
 - ◆ DNs are in a position to be able to understand and manage price risk, and for this reason, sharing a small proportion of the price risk is appropriate to incentivise correct behaviour;

¹⁵ For example in Standard Special Condition A11 (Network Code and Uniform Network Code)

¹⁶ Section 9 of the Gas Act 1986

- ◆ the DN incentives will have caps and collars in place to limit a DN's exposure to price risk; and
- ◆ IAE provisions could provide additional protection to DNs from price changes that have a material impact where the relevant criteria are met.

3.135. Ofgem notes that one DN respondent requested that the IAE threshold should be set at a percentage of notional NTS exit charges. However, Ofgem would note that the caps/collars proposed are on a proportional basis, and therefore, for the IAE threshold to be meaningful, it would need to represent a smaller proportion than that represented by the caps/collars. As such, any IAE threshold that is set on this basis would be very small in absolute terms and therefore would be unlikely to reflect the materiality of the costs of managing IAE claims. Ofgem therefore continues to consider that an absolute IAE threshold is appropriate. However, Ofgem would welcome views on this matter in response to the forthcoming consultation on IAE thresholds outlined above.

3.136. Ofgem does not believe that it is appropriate to extend the IAE provisions to ARCA incurred costs, as this would weaken the incentives placed upon DNs at the three year ahead stage and it should be the responsibility of the contracting parties to manage their contractual risk in this regard.

Pricing of the flow flexibility product

3.137. Ofgem agrees that the pricing for the flow flexibility product should be cost reflective to encourage efficient investment decisions and that the flow flexibility product should be available to both NTS DCs and DNs. However, in the absence of this Ofgem continues to consider that NTS exit capacity charges represent the most appropriate reference price for NTS exit flow flexibility within the DN transitional incentive regime to allow consistency with the charges faced by NTS DCs and ensure non-discrimination between these classes of users. Both of these areas will be considered as part of the implementation of the enduring offtake arrangements in the context of the forthcoming TPCR.

3.138. To the extent to which a future review of charges results in separate charges for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity, it will be appropriate to include the resulting revised charges in the calculation of the

transitional incentive scheme, such that the reference price for the DN incentive scheme in relation to flexible capacity will be the equivalent out-turn charge for NTS exit flow flexibility.

Pricing volatility

- 3.139. Ofgem notes the concerns raised by a shipper/supplier with regards to volatility of transportation charges. Ofgem acknowledges the impact of frequent price changes upon shippers/suppliers and would note the licence obligations in place to limit the frequency of such changes. However, Ofgem does not believe that the arrangements proposed should materially affect the volatility of transportation charges.

Definition of caps, collars and sharing factors

- 3.140. Following consideration of the views expressed by respondents on the appropriate definition of caps, collars and sharing factors within the transitional DN incentives, Ofgem continues to consider that its initial proposals in this regard are appropriate.
- 3.141. Ofgem notes the comments made by a DN respondent that the caps/collars should be adjusted to a fixed £m amount to limit a DN's absolute exposure. Given such concerns, Ofgem is proposing to super-impose an absolute cap / collar of £5 million in addition to the proportional cap / collar proposed.

Duration

- 3.142. Following consideration of respondents' views, Ofgem continues to consider that the proposed transitional incentive should be determined for the whole transitional period. However, Ofgem would acknowledge that it will be necessary to consider re-opening the DN incentives to ensure that DNs are not unduly disadvantaged should introduction of the DN interruptions regime lead to a step change in DN capacity requirements.
- 3.143. Furthermore, to the extent to which a future review of charges results in separate charges for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity, it would be necessary to modify the DN-GT licences to ensure that the reference prices are defined appropriately.

- 3.144. Ofgem would further state that no decision made at this time in relation to incentives will fetter the Authority's discretion regarding the future approach, framework and associated incentive arrangements which will be developed for the GDPCR.
- 3.145. Finally, Ofgem continues to consider that there is a compelling case for the introduction of enduring offtake arrangements. However, any future policy proposals in this regard will be subject to further consultation and impact assessment.

NTS transitional incentives

Initial Proposals

- 3.146. In the Initial Proposals consultation, Ofgem stated that it did not propose to specify NTS incentives for the transitional period at this time as it considered that the potential benefits of addressing the most appropriate scope and form of NTS incentives at the time of the TPCR outweigh the potential costs resulting from a lack of certainty regarding the cost-recovery and treatment of investment for the transitional period.
- 3.147. Ofgem stated that this would enable incentives to be set following the operation of the interim incentives, and provide an opportunity for incentives to be set in the context of wider price control agreement as well as enabling Ofgem to consider more fully all interactions between entry and exit.

Respondents' views

DN respondentss

- 3.148. One DN respondent stated that deferral of the setting of the NTS incentives for the transitional period to the forthcoming TPCR was unduly discriminatory against the DNs because, closer to real time, forecasts would become more accurate and therefore NTS incentive targets for the transitional years would be based upon more accurate forecast information when compared to the forecast information used to set the DN incentive for the same years.

3.149. This DN respondent also noted that, in adopting this approach, the NTS incentive for the transitional years would not be set until after any investment decisions for those years would have been made. This DN respondent noted that it would seem that Ofgem is content for the NTS to rely on planning processes and licence obligations and therefore cannot understand why this approach could not be adopted for DNs until the enduring arrangements are introduced.

National Grid NTS

3.150. In its response, National Grid NTS agreed that the NTS transitional incentives should be considered as part of the next price control review, to allow consideration of the interactions between entry and exit, incentives to be set in the context of the wider price control agreement and the most appropriate methodology to setting output measures and Unit Cost Allowances to be determined. National Grid NTS stated that it was particularly keen to ensure that the process of setting baselines and revenue drivers leads to any costs that they may incur for providing increased entry, exit, flat or flexibility capacity being appropriately remunerated.

3.151. National Grid NTS noted that Ofgem had stated that one risk from not setting the NTS incentives at this time would be that “the NTS makes inefficient decisions”. However, National Grid NTS stated that this should not be the case given their wider licence obligations such as those within Standard Special Condition A11 (relating to efficient and economic operation of the system), which would still apply.

3.152. Finally, National Grid NTS stated that it would welcome a discussion with Ofgem on the proposed timescales associated with developing the NTS transitional incentive arrangements as part of the TPCR.

Shippers/suppliers

3.153. A shipper/supplier agreed that it was appropriate to consider the NTS incentives within the wider TPCR process.

Other respondents

- 3.154. The CIA stated that it agreed with not setting the NTS transitional incentives until the price control review which will allow for a more consistent review.
- 3.155. The AEP stated that it was broadly happy with the arrangements for securing NTS exit capacity in the transitional period, and to the extent that the current ARCA regime meets the needs of NTS DCs, both existing and new, consider that incentives are not required in the transitional period. The AEP agreed that it would be more appropriate to consider incentives, output measures and unit cost allowances for both exit and entry at the time of the price control review to allow for a more coherent holistic approach.
- 3.156. Energywatch supported the proposal to defer setting the NTS incentives until the TPCR in 2007 to permit a fuller review of the interim scheme and allow the industry to set targets which will better serve the UK gas market. energywatch agreed 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. However, energywatch stated that the “lack of certainty” should not absolve National Grid NTS from employing the most cost effective measures to meet additional demands and noted National Grid NTS’s licence obligation to operate the system in an economic and efficient manner.
- 3.157. Energywatch proposed that during the transitional period, and in order to assist Ofgem and the industry in reviewing National Grid NTS’s operational and investment performance, the application of a “shadow NTS offtake incentive scheme” should be considered, which would be based on the interim scheme and, although no monies would flow during its operation, might provide a reasonable benchmark against which National Grid NTS’s performance could be measured. Energywatch stated that this could assist in influencing the longer term scope of the scheme and in setting the general price control allowances over the next control period.

Final Proposals

- 3.158. Ofgem has taken into account the views expressed by respondents and continues to consider that the potential benefits of considering the most appropriate scope and form of NTS incentives at the time of the TPCR outweigh the potential costs resulting from a lack of certainty regarding the cost-recovery and treatment of investment for the transitional period.
- 3.159. Ofgem notes the concerns expressed by one DN respondent that deferring consideration of the NTS incentives would mean that these incentives will be based on more accurate planning information and therefore be discriminatory against DNs. Ofgem also notes the comments made by the same DN respondent that Ofgem seems to be content to rely on planning processes and licence obligations with respect to NTS investment and should do the same for DN investment. However, Ofgem considers that an incentive upon DNs is necessary to ensure that DNs are exposed to the costs of their purchases and can make efficient trade-offs between such purchases and investment i.e. to address the rational tendency to over-book NTS exit capacity. Furthermore, as stated above, Ofgem continues to consider that the potential benefits of considering the most appropriate scope and form of NTS incentives at the time of the TPCR outweigh the potential costs resulting from a lack of certainty regarding the cost-recovery and treatment of investment for the transitional period.
- 3.160. Ofgem notes the suggestion, by energywatch, of a “shadow NTS offtake incentive scheme” whereby no monies would flow during the operation of such a scheme. However, Ofgem is concerned that, in the absence of any financial incentive, such a shadow scheme may generate a perverse outcome. As such, Ofgem does not propose to implement such a scheme.

Views invited

- 3.161. Views are invited on:
- ◆ all aspects of the transitional incentive schemes outlined in this chapter for the DNs and the NTS; and

- ◆ the licence modifications outlined in Appendix 7, which are explained in Appendix 4, and to which the Notices in Appendices 5 and 6 relate.

3.162. Ofgem would particularly wish to draw Appendix 5 to the attention of NTS and DN GTs, as this represents a formal consultation under the private collective licence modification procedure, and, as such, licensees are requested to formally register any objections to the proposals contained within this Notice.

4. Way forward

- 4.1. Once National Grid NTS has submitted its consultation report on the IExCR to Ofgem for consideration, the Authority will consider whether to approve Modification Proposal 0046.
- 4.2. If Modification Proposal 0046 has been approved, following consideration of respondents' views to this Final Proposals consultation, and subject to receiving the consent of the relevant licensees, Ofgem envisages the Authority directing the proposed licence modifications in January 2006.
- 4.3. Once the necessary licence modifications are in place, Ofgem intends that the Authority will consider whether to approve the modifications to the IExCR proposed by National Grid NTS.

Appendix 1: Respondents to the Initial Proposals consultation

- ◆ Association of Electricity Producers
- ◆ Chemical Industries Association
- ◆ EDF Energy
- ◆ energywatch
- ◆ National Grid Gas Distribution
- ◆ National Grid NTS
- ◆ Northern Gas Networks Limited
- ◆ RWE npower / RWE Trading GmbH
- ◆ Scotia Gas Networks plc
- ◆ Shell Gas Distribution Limited
- ◆ Wales & West Utilities Limited

Appendix 2: Summary of proposed targets

Table A2.1: LDZ growth rates assumed

LDZ	2007/8 to 2008/9	2008/9 to 2009/10	2009/10 to 2010/11
Scotland	1.45%	1.23%	1.06%
Northern	1.61%	1.15%	1.04%
North West	1.57%	2.32%	0.93%
North East	1.77%	1.48%	1.32%
East Midlands	1.71%	1.45%	1.29%
West Midlands	1.63%	1.96%	1.23%
Wales North	1.97%	1.67%	1.42%
Wales South	1.28%	1.01%	0.91%
Eastern	2.26%	1.72%	1.56%
North Thames	1.66%	1.44%	1.25%
South East	1.44%	1.27%	1.18%
Southern	1.92%	2.47%	1.57%
South West	2.34%	1.92%	1.66%

Table A2.2: Comparison of incentive targets and DN requests from NTS for 2007/8¹⁷
(GWh / day)

DN	LDZ Exit Zone	Flat capacity		Flexible capacity	
		incentive target	DN requests from NTS	incentive target	DN requests from NTS
Scotland	SC1	59.73	59.73	6.00	6.00
	SC2	72.71	72.71	8.09	8.09
	SC4	245.32	245.32	13.57	13.57
North of England	NO1	250.04	242.99	-0.03	-2.42
	NO2	26.97	27.32	2.64	2.54
	NE1	226.29	234.81	9.86	19.65
	NE2	61.94	64.58	0.31	1.05
North West	NW1	347.80	228.91	8.71	25.04
	NW2	216.63	330.96	8.74	14.96
East of England	EA1	39.70	39.39	5.36	5.31
	EA2	43.32	43.28	5.86	5.83
	EA3	65.16	71.36	-0.14	0.72
	EA4	233.68	226.02	0.02	0.28
	EM1	92.09	110.37	1.33	0.12
	EM2	97.03	104.00	0.78	6.49
	EM3	294.18	268.51	5.74	2.09
	EM4	19.50	20.35	1.26	1.25
London	NT1	12.86	20.59	0.00	0.00
	NT2	197.34	182.59	0.00	-3.93
	NT3	284.71	312.84	0.00	-7.35
West Midlands	WM1	77.52	109.86	1.81	-0.50
	WM2	254.96	232.21	5.92	2.66
	WM3	134.14	119.14	-4.56	-2.75
Wales & West	SW1	38.26	37.50	2.09	1.89
	SW2	164.62	161.98	4.73	4.80
	SW3	95.24	93.66	4.96	4.68
	WA1	53.94	51.87	0.00	0.00
	WA2	193.68	193.77	0.00	0.00
South of England	SE1	419.01	442.67	0.00	0.00
	SE2	109.67	99.74	0.00	0.00
	SO1	116.54	116.46	5.66	5.00
	SO2	297.99	296.13	6.45	7.22
Total		4842.57	4861.61	105.16	122.29

¹⁷ Note that the incentive targets relate to the formula year 2007/8, and the DN requests from the NTS relate

Table A2.3: Proposed incentive targets for the transitional period¹⁸ (GWh / day)

DN	LDZ Exit Zone	Flat capacity		Flexible capacity	
		2009/10	2010/11	2009/10	2010/11
Scotland	SC1	55.53	56.08	6.17	6.23
	SC2	75.97	77.04	8.31	8.39
	SC4	245.95	248.90	13.94	14.08
North of England	NO1	249.74	252.23	-2.36	-2.33
	NO2	28.08	28.45	2.61	2.64
	NE1	242.52	245.72	20.30	20.56
	NE2	66.70	67.58	1.08	1.10
North West	NW1	233.83	235.58	22.82	23.61
	NW2	344.73	347.16	15.08	15.11
East of England	EA1	40.78	41.58	5.52	5.61
	EA2	46.29	47.08	6.06	6.16
	EA3	76.66	71.16	0.75	0.76
	EA4	230.17	241.50	0.29	0.30
	EM1	113.88	115.35	0.12	0.13
	EM2	107.31	108.69	6.70	6.78
	EM3	277.06	280.63	2.15	2.18
	EM4	21.00	21.27	1.29	1.31
London	NT1	21.23	21.50	0.00	0.00
	NT2	188.29	190.65	-5.57	-4.48
	NT3	322.60	326.65	-9.48	-9.03
West Midlands	WM1	114.18	115.63	-0.48	-0.48
	WM2	240.55	243.62	2.76	2.79
	WM3	122.53	123.56	-2.65	-2.62
Wales & West	SW1	39.12	39.76	2.13	2.23
	SW2	168.96	171.76	5.38	5.62
	SW3	97.69	99.31	3.69	4.00
	WA1	53.78	54.55	0.00	0.00
	WA2	198.25	200.05	0.00	0.00
South of England	SE1	454.73	460.09	0.00	0.00
	SE2	102.46	103.67	0.00	0.00
	SO1	120.72	121.88	5.22	5.30
	SO2	308.34	313.89	7.54	7.66
Total		5009.62	5072.56	119.36	123.61

to the gas year 2007/8. However, these capacities are compared within this table on the basis that both are driven by the 2007/8 winter and are therefore comparable.

¹⁸ Figures expressed are with respect to formula years.

Appendix 3: Licence conditions proposed for modification

Modification under paragraph 3(a) of Standard Special Condition A2 (Private Collective Licence Modification procedure in respect of Standard Special Conditions applicable to both NTS and DN licensees)

- ◆ Standard Special Condition A3 (Definitions and Interruption)

Modification under Section 23 of the Gas Act 1986

- ◆ Part C (Special Conditions applicable to the Licensee (NTS)):
 - ◆ Special Condition C5 (Licensee's procurement and use of system management services);
 - ◆ Special Condition C7 (Charging obligations);
 - ◆ Special Condition C8A (Revenue restriction definitions in respect of the NTS transportation owner activity and NTS system operation activity);
 - ◆ Special Condition C8B (Restriction of revenue in respect of the NTS transportation owner activity and NTS system operation activity);
 - ◆ Special Condition C14 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the NTS transportation owner activity and NTS system operation activity);
 - ◆ Special Condition C18 (Licensee's methodology for determining incremental exit capacity volumes); and
 - ◆ Schedule A NTS output measures for the price control.
- ◆ Part E (Special Conditions applicable to the Licensee (DN)):

- ◆ Special Condition E2A (Revenue restriction definitions in respect of the Distribution network);
- ◆ Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity); and
- ◆ Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network).

Appendix 4: Explanatory note regarding licence modifications proposed

Overview

As explained in Chapter 1, this document formally consults upon the licence modifications necessary to:

- ◆ implement Ofgem’s final proposals for transitional incentives as set out in Chapter 3 of this document; and
- ◆ provide some definitional clarification to the relevant GT licences to clarify the applicability of the “NTS exit capacity” definition.

Without fettering the discretion of the Authority with regard to any future interpretation or enforcement of the relevant licence conditions, in the remainder of this appendix, we provide further explanation of the licence modifications proposed to implement Ofgem’s final proposals for transitional incentives and then explain the modifications proposed to clarify the applicability of the “NTS exit capacity” definition.

The licence modifications proposed are provided in Appendix 7.

Implementation of DN transitional incentives

In order to implement Ofgem’s final proposals with respect to the transitional incentives, it is necessary to modify Special Condition E2A, Special Condition E2B and Special Condition E6 of the DN-GT licences. Further, modifications are proposed to Special Condition C18 within the NTS-GT licence to clarify the definition of “incremental exit capacity” within the transitional period. All of these modifications are proposed under section 23 of the Gas Act 1986 and the relevant Section 23 Notice is provided in Appendix 6.

Ofgem’s final proposals for transitional incentives, as outlined in Chapter 3, are that, at this time, it is only necessary to implement an incentive for the transitional period upon DNs to counter a potentially rational tendency to over-book flat and flexible NTS exit capacity. As outlined in Chapter 3, the DN incentive proposed in this regard mirrors the

structure adopted by the equivalent incentive upon DNs for the interim period i.e. a sliding scale incentive mechanism with defined caps, collars and sharing factors. Indeed, Ofgem proposes to retain the caps, collars¹⁹ and sharing factors established for the equivalent interim incentive, and continues to consider that the out-turn price for NTS exit capacity forms an appropriate reference price. As such, the licence modifications required to implement Ofgem's final proposals for DN transitional incentives have been kept to a minimum and are described below for each affected licence condition.

Proposed modifications to DN Special Condition E2A

The only change proposed to Special Condition E2A within each of the DN-GT licences is the removal of the definition of "initial volume allocation". This term is defined to mean the initial quantity in GWh/day allocated to the relevant DN by the NTS operator as set out in the Offtake Capacity Statement on 1 May 2005 and is referenced in the definition of the volumetric targets within the DN incentive. However, whilst the volumetric targets for the interim incentive are consistent with the 1 May 2005 Offtake Capacity Statement, those proposed for the transitional period (in gas year 2010/11) are not.

Having considered the use of this term, Ofgem has reached the conclusion that it is not necessary to reference the source of the DN volumetric target numbers as the actual target volumes are specified within the body of the licence in Special Condition E2B and, as such, the term "initial volume allocation" is not required. Furthermore, it was felt that references to "initial volume allocation" may be misleading in the context of the transitional regime as this could, wrongly, be interpreted to relate to capacity requests made at the three year ahead stage.

As a result, the "initial volume allocation" term has been removed from Special Condition E2A, and references to "initial volume allocation" within Special Condition E2B have been changed to "target volume". This more generic term is consistent with both the interim and transitional regimes.

¹⁹ Subject to the imposition of an absolute cap / collar.

Proposed modifications to DN Special Condition E2B

In Special Condition E2B, the following changes are proposed:

- ◆ changing references to “initial volume allocation” to “target volume” as explained above;
- ◆ amendment of the formula for DNExCAP such that the cap applied to the DN incentive shall be the lower of:
 - ◆ the cap based on 7.5% of the exit incentive target; and
 - ◆ £5 million;
- ◆ amendment of the formula for DNExCOL such that the collar applied to the DN incentive shall be the greater of:
 - ◆ the collar based on -7.5% of the exit incentive target; and
 - ◆ - £5 million;
- ◆ the insertion of additional exit zone specific targets for NTS exit flat capacity (NTSBAExC) and NTS exit flow flexibility (NTSBAExFF) for the formula years $t=6$ and $t=7$ (i.e. 2009/10 and 2010/11), consistent with the numbers provided in Appendix 2;
- ◆ modification of the date upon which DNExCTC, DNExFFTC, DNExCDC and DNExFFDC become zero, from 1 October 2008 to 1 October 2010, to reflect extension of the relevant DN incentives to cover the transitional period; and
- ◆ minor modifications to clarify the drafting e.g. insertion of the word “calculated” in the definitions of DNExCTC, DNExFFTC and DNExIIT.

Ofgem would note that the NTS and DN-GT licences, as currently drafted, envisage that the mechanism for payment flows will move to an “Option 2A” approach²⁰ on 1

²⁰ This was explained in 255/04a – National Grid Transco – Potential sale of gas distribution network businesses Final Impact Assessment, November 2004.

October 2008 (or such date that the Authority shall otherwise direct in writing). As such, from this date, DNs will take a more central role in the payments process, with all NTS-related payments from DN shippers passing through DNs. Ofgem is not proposing to modify the licence to change this timing at the present time. However, Ofgem would note that the licence drafting gives the Authority the power to direct an alternative date, and, without fettering the discretion of the Authority, it is anticipated that the possibility of proposing a later date will be considered in due course. Furthermore, Ofgem would note that, if the date on which the Option 2A revenue flows is implemented remains at 1 October 2008 and the proposed changes to National Grid NTS's IExCR are implemented, it may be necessary to clarify the definitions of DNExCC and DNExFFC such that these terms reference the arrangements introduced by this IExCR and make it clear that any ARCA penalty payments incurred under such arrangements are explicitly excluded.

Proposed modifications to DN Special Condition E6

As a result of change to Special Conditions E2A and E2B, it is also necessary to modify Special Condition E6 to change references to "initial volume allocation" to "target volume". Furthermore, Ofgem proposes to insert the word "exit" within the licence definition for DNExFFC such that it refers to "NTS exit flow flexibility" for clarity.

Proposed modifications to NTS Special Condition C18

As a result of the introduction of transitional offtake arrangements, it is necessary to clarify the definition of "initial volume allocation" within Special Condition C18. This is because, as currently drafted, "initial volume allocation" numbers with respect to NTS/LDZ offtakes are defined in relation to the 1 May 2005 Offtake Capacity Statements. However, whilst appropriate for the interim period (as the Offtake Capacity Statements extend for this period, and the interim incentive targets are consistent with the 1 May 2005 Offtake Capacity Statements), this will no longer be appropriate for the transitional period. As such it has been necessary to distinguish between the interim and the transitional period within the definition of "initial volume allocation" in relation to NTS/LDZ offtakes. As such, for the period from 1 October 2008 to 30 September 2010, "initial volume allocation" is as approved by the Authority in writing and published in the IExCR published by National Grid NTS.

As part of the proposed modifications to Special Condition C18 in this regard, the applicability of the two parts of the original definition to NTS supply points or NTS connected system exit points in the first instance, and to NTS/LDZ offtakes in the second instance has been clarified. Furthermore, following further consideration, the definition of “initial volume allocation” applicable to NTS supply points or NTS connected system exit points, i.e. shippers, has been amended such that it is no longer tied to 1 May 2005, but rather is the aggregate registered quantity of NTS exit capacity that gas shippers are registered as holding at the time. This avoids the situation whereby incremental exit capacity for shippers increases over time, and is therefore more consistent with the potential comparison of required “incremental exit capacity” to a defined threshold as part of the ARCA process.

It is Ofgem’s view that the “initial volume allocation” numbers at NTS/LDZ offtakes for the transitional period should be consistent with the DN volume targets determined for the same period. As such, these numbers would implicitly incorporate anticipated demand growth. However, Ofgem would note that the “initial volume allocation” numbers need to be offtake point specific, whilst the DN targets have been defined on a zonal basis. National Grid NTS has submitted proposed “initial volume allocation” numbers to Ofgem, which have been calculated using a method consistent with that used for the DN incentive targets proposed in Appendix 2. Ofgem would note that these “initial volume allocation” numbers are referenced by the proposed IExCR upon which National Grid NTS is currently consulting and would welcome views on these numbers, which are provided in Annex 1. Ofgem will consider these views in determining whether to grant approval to National Grid NTS of its IExCR in this regard.

Clarification with respect to “NTS exit capacity” definition

It has become apparent that there is a lack of clarity with regards to the application of the definition of “NTS exit capacity” and certain related definitions within the NTS and DN-GT licences. As such, further modification of Special Condition E2B and Special Condition E6 of the DN-GT licences is proposed under section 23 of the Gas Act 1986. In addition, we also propose modifications to Special Condition C5, Special Condition C7, Special Condition C8A, Special Condition C8B, Special Condition C14 and further modification of Special Condition C18 under section 23 of the Gas Act 1986. Where modifications to special conditions are proposed, pursuant to section 23 of the Gas Act 1986, the relevant Section 23 Notice is provided in Appendix 6.

Further, a minor modification to Standard Special Condition A3 is proposed. As this is a standard special condition, this modification is proposed under the provisions of paragraph 3(a) of Standard Special Condition A2 (Private Collective Licence Modification procedure in respect of Standard Special Conditions applicable to both NTS and DN licensees). This represents a formal consultation under the private collective licence modification procedure (Private CLM), and, as such, licensees are invited to register formally any objections to the proposals. The Private CLM Notice associated with the proposed modification of Standard Special Condition A3 is provided in Appendix 5.

The lack of clarity with regards to the application of the definition of “NTS exit capacity” within the NTS and DN-GT licences is because “NTS exit capacity” is defined, within Standard Special Condition A3, with reference to the UNC terms:

- ◆ “NTS Exit Capacity”, which relates to NTS Exit Capacity offtaken by shipper users; and
- ◆ “NTS Offtake Capacity”, which constitutes NTS exit capacity that a DN is treated as utilising and comprises NTS Offtake (Flat) Capacity and NTS Offtake (Flexibility) Capacity.

However, there are occasions within the licence, where the term “NTS exit capacity” in the context of a DN, is used, but the intent is to refer only to NTS offtake (flat) capacity (as defined within the UNC).

The licence modifications required to provide the necessary clarity are described below by licence condition, first to Standard Special Condition A3 in the NTS and DN-GT licence, then within the DN-GT licences, and then within the NTS-GT licence.

Proposed modifications to Standard Special Condition A3

As stated above, there are occasions within the licence, where the term “NTS exit capacity” is used, but the intent is to refer only to NTS offtake (flat) capacity (as defined within the UNC). In order to allow the necessary clarifications to be made at appropriate points in the licence, it is necessary to introduce a defined term that is

consistent with the UNC term “NTS Offtake (Flat) Capacity”²¹. Ofgem therefore proposes to introduce a new definition for NTS exit flat capacity into Standard Special Condition A3. The definition of “NTS exit capacity” is left unchanged.

Proposed modifications to DN Special Condition E2B

Within Special Condition E2B, it has been necessary to change references to “NTS exit capacity” to “NTS exit flat capacity” as follows:

- ◆ in relation to the terms DNExC and DNExCC, which relate to the pass through of payments made by the licensee in respect of NTS exit flat capacity and take a value of zero before 1 October 2008, which is the date at which these new payment flows (associated with both NTS exit flat capacity and NTS exit flow flexibility) will come in²²; and
- ◆ within the DN incentive, in relation to:
 - ◆ DNExCTC and DNExCDC, which are the target cost and the deemed cost, respectively, of NTS exit flat capacity; and
 - ◆ NTSBAExC and NTSMAExC, which are the target volume and maximum actual allocation, respectively, of NTS exit flat capacity.

Proposed modifications to DN Special Condition E6

Within Special Condition E6 it has been necessary to change references to “NTS exit capacity” to “NTS exit flat capacity” in relation to the terms DNExCC, DNExCTC, DNExCDC and NTSMAExC consistent with the changes to Special Condition E2B above.

Proposed modifications to NTS Special Condition C5

Within paragraph 6(c)(iii) of Special Condition C5 it has been necessary to change “NTS exit capacity” to “NTS exit flat capacity” such that the licensee is required to consult DN

²¹ This is defined to be capacity which as DN is treated as utilising in causing or permitting gas to flow from the NTS at a rate which (for a given daily quantity) is even over the course of a day.

²² As discussed above, it is anticipated that the timing of the introduction of such “Option 2A” payment flows will be the subject of Authority consideration in due course.

operators before revising the system management services adjustment data methodology where there is a potential impact upon NTS exit flat capacity or NTS exit flow flexibility.

Proposed modifications to NTS Special Condition C7

Special Condition C7 specifies certain NTS specific amendments to Standard Special Condition A4 and Standard Special Condition A5. One such amendment is the introduction of a reasonable endeavours obligation that the NTS operator shall not make any changes to specified charges or reserve prices, or the charging methodology, in relation to specified capacity products, more frequently than once in each formula year and for such changes to take place on 1 October in each formula year or at such other time as the Authority may by notice in writing direct. Ofgem proposes to clarify the drafting of these provisions such that the specified charges or reserve prices and charging methodology are in relation to “NTS exit capacity (including NTS exit flat capacity and NTS exit flow flexibility)”, clarifying the previous reference to “NTS exit capacity and NTS exit flow flexibility”.

Furthermore, it is necessary to amend the definition of “as appropriate” such that it means that DN operators shall be consulted, in the specified context, if a modification to the charging methodology in relation to “NTS exit flat capacity and/or NTS exit flow flexibility” is proposed by the licensee. This is intended to clarify the previous reference to “NTS exit capacity and NTS exit flow flexibility”.

Proposed modifications to NTS Special Condition C8A & NTS Special Condition C8B

As discussed above, the NTS and DN-GT licences, as currently drafted, envisage that the mechanism for payment flows will move to an “Option 2A” approach on 1 October 2008 (or such date that the Authority shall otherwise direct in writing). From this date, DNs will take a more central role in the payments process, with all NTS-related payments from DN shippers passing through DNs. As such, the NTS licence is drafted such that, upon the introduction of the “Option 2A” payment flows, the NTS transportation owner (TO) and system operation (SO) actual revenue formulae reflect the change in the source of such payment flows.

As stated above, Ofgem is not proposing to modify the licence to change the timing of the introduction of the “Option 2A” payment flows at the present time. However,

Ofgem would note that the licence drafting gives the Authority the power to direct an alternative date, and it is anticipated that the Authority will consider whether a later date is appropriate in due course.

Without fettering the Authority's discretion in relation to this matter, one option available to the Authority may be for the introduction of the "Option 2A" payment flows and the enduring offtake arrangements not to coincide, and as such, the relevant licence provisions have been clarified to be consistent with the capacity products available within the transitional period. However, the clarifications made are in order to ensure consistency in the application of definitional terms. As a result, these provisions may be subject to further modification should the nature and scope of the baselines determined for the transitional period differ from those assumed. These modifications do not, in any way, fetter the discretion of the Authority in relation to its decision on the timing of the introduction of the "Option 2A" payment flows or the determination of baselines in the transitional period. Ofgem would note further that, more substantial modification of the relevant conditions of the NTS and DN-GT licences will be required when the enduring offtake arrangements are implemented, to recognise the fact that the nature of the exit capacity products is expected to change, with flat and flexible capacity products expected to be offered to both shippers and DNs. As such, should the introduction of the "Option 2A" payment flows coincide with the introduction of the enduring offtake regime, the necessary clarification to these, and other, licence provisions can be made at that time.

If the "Option 2A" payment flows are implemented under the transitional arrangements, payments to the NTS for three distinct products will provide sources of actual revenue to the NTS:

- ◆ NTS exit capacity, as defined in the UNC i.e. NTS exit capacity offtaken by shipper users;
- ◆ NTS offtake (flat) capacity (as defined in the UNC), offtaken by DNs; and
- ◆ NTS offtake (flexibility) capacity (as defined in the UNC), offtaken by DNs.

Given that the drafting of the "Option 2A" payment flows splits the remuneration from these three sources into:

- ◆ “baseline” capacity (excluding the “on the day” sale of capacity), remunerated under the TO provisions; and
- ◆ “incremental” and “on the day” sales of capacity, remunerated under the SO provisions,

it has been necessary, not only to ensure that the three products listed above are defined, but to ensure that “baseline” and “incremental” sub-components of these products are also defined. As a result, the following definitions have been introduced into Special Condition C8A:

- ◆ “NTS exit shipper capacity”, which is defined to mean “NTS Exit Capacity” as defined in the network code;
- ◆ “NTS baseline exit flat capacity” and “NTS baseline exit shipper capacity”, which are defined in relation to new (but unpopulated) tables in Schedule A, which would, if necessary, specify the appropriate baseline value; and
- ◆ “NTS incremental exit flat capacity” and “NTS incremental exit shipper capacity”.

The necessary clarifications are then made to Special Condition C8B, and specifically with respect to the terms TOExR, TOREVBExC, REVBExC, DREVBExC and REVIExC.

Proposed modifications to NTS Special Condition C14

Within Special Condition C14 it has been necessary to clarify the definitions of the terms TOREVBExC, REVBExC, DREVBExC, and REVIExC consistent with the changes to Special Condition C8B above. Furthermore, modifications are proposed to the definitions for the terms DREVBFF and REVIFF to ensure that the definitions in Special Condition C14 reconcile to those in Special Condition C8B.

Proposed modifications to NTS Special Condition C18

In addition to the changes proposed to Special Condition C18 to implement the transitional offtake arrangements, further modifications are proposed as follows:

- ◆ to the definition of “incremental exit capacity” to simplify the definition such that it relates to “NTS exit capacity” and does not refer to “NTS exit capacity and NTS exit flow flexibility”; and
- ◆ such that, where references are in relation to incremental capacity at an NTS/LDZ offtake, references to “NTS exit capacity” are changed to “NTS exit flat capacity”.

Proposed modifications to Schedule A

As a result of the new definitions for “NTS baseline exit flat capacity” and “NTS baseline exit shipper capacity” introduced into Special Condition C8A, it has been necessary to introduce two new (but unpopulated) tables for NTS baseline exit flat capacity and NTS baseline exit shipper capacity, Table A6 and Table A7 respectively, consistent with Table A5 for NTS baseline exit flow flexibility, already within the NTS licence. These two new tables are necessary given that, at present, Tables A3 and A4 assume the bundled “NTS exit capacity” product.

In addition, the units within Table A5 have been clarified consistent with the other tables in this schedule and “flow flexibility” has been changed to “NTS exit flow flexibility” for clarity.

However, as stated above, the clarifications made are in order to ensure consistency in the application of definitional terms. As a result, these provisions may be subject to further modification should the nature and scope of the baselines determined for the transitional period differ from those assumed. These modifications do not, in any way, fetter the discretion of the Authority in relation to its decision on the determination of baselines in the transitional period.

Annex 1: National Grid NTS – proposed “initial volume allocation” numbers

LDZ	LDZ Code	NTS/LDZ Offtake	NTS Offtake (Flat) Capacity (GWh/d)		NTS (Flexibility) Offtake Capacity (GWh/d)	
			2008/9	2009/10	2008/9	2009/10
East Anglia	EA	Bacton	3.33	3.39	0.45	0.46
East Anglia	EA	Brisley	2.80	2.89	0.38	0.38
East Anglia	EA	Great Wilbraham	32.32	34.05	4.37	4.46
East Anglia	EA	Matching Green	89.12	82.23	0.07	0.00
East Anglia	EA	Peterborough Tee	23.72	25.62	3.21	3.47
East Anglia	EA	Roudham Heath	11.50	12.24	1.55	1.60
East Anglia	EA	Royston	2.21	2.19	0.30	0.29
East Anglia	EA	West Winch	10.43	8.88	1.41	1.21
East Anglia	EA	Whitwell	145.00	145.75	0.07	0.00
East Anglia	EA	Yelverton	66.09	76.66	0.07	0.75
East Midlands	EM	Alrewas EM	74.33	96.42	1.44	0.00
East Midlands	EM	Blaby	15.21	15.41	2.13	2.15
East Midlands	EM	Blyborough	76.27	84.98	0.00	5.89
East Midlands	EM	Caldecott	10.52	11.77	0.00	0.00
East Midlands	EM	Drointon	129.97	111.62	1.44	0.00
East Midlands	EM	Gosberton	16.29	16.60	0.00	0.00
East Midlands	EM	Kirkstead	1.16	1.18	0.16	0.17
East Midlands	EM	Market Harborough	9.11	9.22	1.28	1.29

LDZ	LDZ Code	NTS/LDZ Offtake	NTS Offtake (Flat) Capacity (GWh/d)		NTS (Flexibility) Offtake Capacity (GWh/d)	
			2008/9	2009/10	2008/9	2009/10
East Midlands	EM	Silk Willoughby	3.39	3.43	0.47	0.48
East Midlands	EM	Sutton Bridge	1.11	1.12	0.16	0.16
East Midlands	EM	Thornton Curtis	92.02	112.97	1.44	0.00
East Midlands	EM	Tur Langton	78.04	53.62	1.44	0.00
East Midlands	EM	Walesby	0.90	0.91	0.13	0.12
North London	NT	Horndon	39.25	38.76	0.00	0.00
North London	NT	Luxborough Lane	147.14	149.52	0.00	-5.57
North London	NT	Peters Green	134.45	156.46	0.00	0.00
North London	NT	Peters Green South Mimms	164.89	166.14	0.00	-9.48
North London	NT	Winkfield NT	11.42	21.23	0.00	0.00
North West	NW	Audley NW	7.61	7.87	1.12	1.07
North West	NW	Blackrod	201.69	99.80	7.09	10.46
North West	NW	Eccleston	25.22	20.08	2.73	0.00
North West	NW	Holmes Chapel	19.33	19.98	1.71	0.00
North West	NW	Lupton	15.08	15.27	2.22	1.91
North West	NW	Malpas	0.44	0.47	0.07	0.06
North West	NW	Mickle Trafford	27.06	28.56	2.56	2.00
North West	NW	Partington	18.95	93.31	0.00	4.79
North West	NW	Samlesbury	131.24	118.76	0.00	10.46
North West	NW	Warburton	116.36	144.96	0.00	3.16
North West	NW	Weston Point	4.07	29.50	0.60	4.00

LDZ	LDZ Code	NTS/LDZ Offtake	NTS Offtake (Flat) Capacity (GWh/d)		NTS (Flexibility) Offtake Capacity (GWh/d)	
			2008/9	2009/10	2008/9	2009/10
Northern	NO	Bishop Auckland	64.60	65.94	2.12	1.71
Northern	NO	Coldstream	2.05	1.84	0.33	0.28
Northern	NO	Corbridge	0.06	0.07	0.01	0.01
Northern	NO	Cowpen Bewley	51.17	51.46	-11.54	-11.89
Northern	NO	Elton	38.42	40.05	3.07	2.99
Northern	NO	Guyzance	2.00	1.91	0.32	0.29
Northern	NO	Humbleton	0.23	0.15	0.04	0.02
Northern	NO	Keld	1.98	1.63	0.32	0.25
Northern	NO	Little Burdon	17.60	8.05	1.95	0.34
Northern	NO	Melkinton	0.33	0.33	0.05	0.05
Northern	NO	Saltwick Pressure Controlled	8.59	8.81	1.38	1.34
Northern	NO	Saltwick Volumetrically Controlled	64.60	65.94	2.12	1.71
Northern	NO	Thrintoft	5.54	5.53	0.89	0.84
Northern	NO	Towlaw	0.55	0.53	0.09	0.08
Northern	NO	Wetheral	24.32	25.58	2.19	2.22
Scotland	SC	Aberdeen	21.98	20.08	2.10	2.08
Scotland	SC	Armadale	2.87	2.93	0.34	0.35
Scotland	SC	Balgray	11.87	10.86	0.96	0.97
Scotland	SC	Bathgate	22.88	22.81	-10.71	-8.43
Scotland	SC	Broxburn	61.71	63.18	6.78	6.83
Scotland	SC	Careston	3.17	2.90	0.41	0.42

LDZ	LDZ Code	NTS/LDZ Offtake	NTS Offtake (Flat) Capacity (GWh/d)		NTS (Flexibility) Offtake Capacity (GWh/d)	
			2008/9	2009/10	2008/9	2009/10
Scotland	SC	Drum	80.19	75.32	10.22	8.64
Scotland	SC	Glenmavis	139.54	141.30	14.07	12.97
Scotland	SC	Hume	1.15	1.18	0.15	0.15
Scotland	SC	Kinknockie	2.45	2.24	0.32	0.32
Scotland	SC	Langholm	0.15	0.14	0.02	0.02
Scotland	SC	Lockerbie	5.60	5.52	0.61	0.62
Scotland	SC	Nether Howcleugh	0.19	0.19	0.03	0.03
Scotland	SC	Pitcairngreen	1.66	1.52	0.25	0.25
Scotland	SC	Soutra	8.45	8.68	0.97	0.98
Scotland	SC	St. Fergus	0.91	0.84	0.13	0.13
Scotland	SC	Stranraer	0.68	0.66	0.08	0.08
Scotland	SC	Mosside	18.63	17.10	1.54	2.00
South	SO	Braishfield A	95.33	102.39	6.15	6.68
South	SO	Braishfield B	47.47	46.56	0.00	0.00
South	SO	Hardwick	121.22	120.72	3.17	5.22
South	SO	Ipsden 1	12.31	12.73	1.91	1.33
South	SO	Ipsden 2	15.13	14.56	-4.57	-4.45
South	SO	Mappowder	47.68	49.31	2.73	2.43
South	SO	Winkfield SO	80.64	82.78	1.37	1.54
South East	SE	Farningham	140.85	128.19	0.00	0.00
South East	SE	Shorne	72.59	63.86	0.00	0.00

LDZ	LDZ Code	NTS/LDZ Offtake	NTS Offtake (Flat) Capacity (GWh/d)		NTS (Flexibility) Offtake Capacity (GWh/d)	
			2008/9	2009/10	2008/9	2009/10
South East	SE	Tatsfield	207.66	262.69	0.00	0.00
South East	SE	Winkfield SE	110.19	102.46	0.00	0.00
South West	SW	Aylesbeare	23.45	23.73	2.81	2.16
South West	SW	Cirencester	9.39	9.58	0.17	0.20
South West	SW	Easton Grey	32.16	32.22	0.02	0.00
South West	SW	Evesham	6.77	6.86	1.00	1.10
South West	SW	Fiddington	27.55	27.79	0.53	0.32
South West	SW	Ilchester	33.48	34.49	2.31	2.53
South West	SW	Kenn	24.10	73.97	0.00	1.53
South West	SW	Lyneham	49.17	0.00	0.00	0.00
South West	SW	Littleton Drew	2.93	2.96	0.43	0.47
South West	SW	Pucklechurch	28.33	29.60	1.96	2.17
South West	SW	Ross on Wye SW	4.40	4.47	0.65	0.71
South West	SW	Seabank	60.36	60.11	0.03	0.00
Wales North	WAN	Maelor	54.81	53.78	0.00	0.00
Wales South	WAS	Dowlais	92.87	107.98	-3.50	0.00
Wales South	WAS	Dyffryn Clydach	42.03	45.72	2.15	0.00
Wales South	WAS	Gilwern	61.08	44.55	1.34	0.00
West Midlands	WM	Alrewas WM	144.50	121.39	7.08	3.84
West Midlands	WM	Aspley	39.30	72.04	-3.23	-5.40
West Midlands	WM	Audley WM	19.49	19.94	2.35	2.33

LDZ	LDZ Code	NTS/LDZ Offtake	NTS Offtake (Flat) Capacity (GWh/d)		NTS (Flexibility) Offtake Capacity (GWh/d)	
			2008/9	2009/10	2008/9	2009/10
West Midlands	WM	Austrey	70.78	78.40	-5.83	-5.89
West Midlands	WM	Leamington Spa	3.81	3.87	0.46	0.47
West Midlands	WM	Lower Quinton	28.57	27.45	0.00	0.00
West Midlands	WM	Milwich	21.69	22.20	2.62	2.59
West Midlands	WM	Ross on Wye WM	14.76	14.94	1.78	1.82
West Midlands	WM	Rugby	83.36	72.04	-6.87	-5.46
West Midlands	WM	Shustoke	39.78	40.76	4.81	4.81
West Midlands	WM	Stratford-upon-Avon	4.17	4.23	0.50	0.51
Yorkshire (North East)	NE	Asselby	2.96	3.14	0.49	0.53
Yorkshire (North East)	NE	Baldersby	1.19	1.26	0.20	0.21
Yorkshire (North East)	NE	Burley Bank	18.07	19.09	0.00	0.00
Yorkshire (North East)	NE	Ganstead	20.51	21.99	0.12	0.36
Yorkshire (North East)	NE	Pannal	141.86	140.18	9.61	19.21
Yorkshire (North East)	NE	Paull	33.82	36.03	0.20	0.59
Yorkshire (North East)	NE	Pickering	8.07	8.68	0.05	0.14
Yorkshire (North East)	NE	Rawcliffe	3.03	3.22	0.29	0.33
Yorkshire (North East)	NE	Towton	60.97	75.62	0.00	0.00