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Dear Colleague,

Open letter on Income Adjusting Events thresholds for gas distribution networks

As part of its recent consultation on final proposals for gas Distribution Network (DN) incentives in the transitional offtake period, Ofgem indicated that it would consult on potential changes to the thresholds for Income Adjusting Events (IAEs) for DNs. The purpose of this letter is to initiate consultation on a number of options for setting this threshold.

Background

Under the current price control, National Grid NTS¹ (NG NTS) can apply for an event to be designated an IAE if it meets certain criteria. These provisions allow NG NTS to apply for an adjustment to its price control as a result of events that were unexpected at the time of the price control and over which NG NTS has no control. In the scheme, NG NTS can only apply for an adjustment to its allowed revenues if the event causes a cost greater than an agreed threshold. Currently, for NG NTS, this threshold is set at £2 million. As part of the arrangements that were developed following the sale of four of National Grid Gas' (NGG) DNs, IAE provisions were extended to DNs.²

The threshold for each DN was also set at £ 2million for the interim period.³ When proposing this measure⁴, Ofgem noted that this would have implications for some of the DNs to the extent that their exposure to any event through the DN incentives may be lower than this threshold.

¹ Transco plc changed its name to National Grid Gas plc on 10 October 2005. This document uses the name National Grid Gas (NGG), throughout the document including where referring to NGG's predecessor organisations. It is noted that National Grid Gas plc is the holder of a licence in respect of its National Transmission System as granted under the Gas Act 1986. For the purposes of this letter, references to National Grid NTS are references to National Grid Gas plc as the holder of the NTS licence.

² The IAE provisions for DNs are included in Special Condition E2B 8(6) of each DN's licence.

³ The 'interim' period is the period until 30 September 2008, when the long term "enduring" offtake arrangements were originally envisaged to start.

⁴ See *National Grid Transco – Potential Sale of Gas Distribution Network Businesses. Final proposals for interim incentives and formal consultation under Section 23 of the Gas Act 1986*, Ofgem, April 2005.

However, as the administration involved in the Authority approving an IAE is not costless, Ofgem considered that a threshold of £2 million was reasonable for the interim period.

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 DNs and customers directly connected to the NTS (DCs)), 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) (the "transitional period").

On 21 September 2005 Ofgem issued initial proposals for the incentive schemes supporting the offtake arrangements in the transitional period⁵. In this document, Ofgem stated that it did 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. However, Ofgem considered it necessary to specify incentives for the DNs for the duration of the transitional period to mitigate a potentially rational tendency for DNs to overbook NTS exit rights.

A number of respondents to Ofgem's initial proposals suggested modifications to the IAE provisions for DNs. In particular, one DN respondent requested that the IAE threshold should be set as a percentage of notional NTS charges. Another DN respondent requested a downwards adjustment to the £2m threshold that is currently within the licence in order to mitigate a DN's exposure under the incentive mechanism.

As noted in the 'final proposals' document outlining the proposed incentives for the transitional period⁶, 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 considers that it is appropriate to consult further on the appropriate IAE thresholds.

Options

Ofgem has identified three potential options for setting the IAE thresholds for DNs, which are outlined in more detail below. The three options that have been identified are:

1. Status quo
2. £1 million threshold
3. Proportional threshold

It is important to note that the proposed changes refer only to the IAE provisions for DNs. Ofgem does not intend to propose any change to the IAE provisions for the NTS or any other regulated businesses.

It should be noted that Ofgem considers that any chosen option should apply for the transitional period only, since the concerns raised by respondents highlighted specific concerns in relation

⁵ *Initial proposals on transitional incentive schemes supporting the offtake arrangements*, Ofgem, September 2005.

⁶ *Final proposals on transitional incentive schemes supporting the offtake arrangements and formal licence consultation under Section 23 of the Gas Act 1986 and paragraph 3 (a) of Standard Special Condition A2*, Ofgem, November 2005.

to the transitional period, in particular in relation to potential price risk.⁷ However, Ofgem would welcome views on the appropriate time frame under which the revised IAE threshold would apply. Without fettering the discretion of the Authority, it is expected that the appropriateness of the relevant IAE provisions would be reviewed as part of the development of the enduring offtake arrangements.

Option 1 – status quo

The first option is to retain the current £2 million IAE threshold for each DN. This approach would be consistent with the NTS scheme. In addition, a single threshold across all licensees would be consistent with the treatment of IAEs in the electricity transmission regime. However, under this approach it is possible that the exposure of some of the DNs under their respective incentive schemes may be smaller than the threshold and so the threshold would offer no protection.

Option 2 - £1 million threshold

Under this option the IAE threshold for DNs would be reduced to £1 million for each DN. Ofgem considers this threshold would be reasonable for the transitional period and would provide some protection for all DNs and so address some of the concerns raised by some of the DNs in the consultation on incentives for the transitional period. A threshold of this scale would also continue to take into account the fact that the administration involved in the Authority approving an IAE is not costless.

Option 3 – proportional threshold

Another option would be to set the IAE threshold relative to the size of the DNs exposure, for example, as a fixed percentage of the DN cost performance targets set for the transitional period. 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. In some cases, the IAE threshold set on this basis could be very small in absolute terms and therefore would be unlikely to reflect the materiality of the costs of managing IAE claims. It may be possible to introduce this approach together with a minimum threshold (eg £500 000). We would welcome views on the potential role of this option as a way forward and on the appropriate percentage level at which the IAE threshold should be set.

Views invited

Ofgem would welcome views on all aspects of this letter. Responses to this letter should be sent in electronic form to Mark Feather (mark.feather@ofgem.gov.uk) by 24 January 2006.

⁷ Under the proposed DN incentives, the reference price was the prevailing (out-turn) price of NTS exit capacity as set out in National Grid NTS's charging statement. Therefore, DNs would be exposed to an amount of price risk to the extent that the volumes of NTS exit rights they request differ from their volumetric target.

Way forward

Following consideration of respondents' views, Ofgem intends to publish an open letter outlining its proposed way forward on IAEs early next year. In the event that the current threshold is changed, this letter would include a formal consultation under Section 23 of the Gas Act 1986 proposing the relevant changes to the drafting of each DN licence.

If you wish to discuss any aspect of this letter, Mark Feather (telephone 0207 901 7437) would be pleased to assist.

Yours sincerely

David Gray
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