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Relevant Gas Transporters and
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Dear Colleague,

Open letter on Income Adjusting Events thresholds for gas distribution networks

As part of its consultation on final proposals for Gas Distribution Network (GDN) incentives in the transitional offtake period¹, Ofgem indicated that it would consult on potential changes to the thresholds for Income Adjusting Events (IAEs) for GDNs. On 14 December 2005, Ofgem published an open letter to initiate consultation on a number of options for setting this threshold².

Options presented in open letter

The Ofgem open letter outlined three potential options for GDN IAE thresholds during the transitional period:

1. **Status quo:** retain the current £2m 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.
2. **£1 million threshold:** reduce the IAE threshold to £1m for each GDN. Ofgem stated that this threshold would be reasonable for the transitional period and would provide some protection for all GDNs. 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.
3. **Proportional threshold:** set the IAE threshold relative to the size of the GDN's exposure, for example, as a fixed percentage of the GDN cost performance targets

¹ 252/05 - 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, Ofgem, November 2005

² 266/05 - Open letter on Income Adjusting Events thresholds for gas distribution networks, Ofgem, December 2005

set for the transitional period. However, Ofgem noted 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. Ofgem noted that, 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. However, in the open letter, Ofgem stated that it may be possible to introduce this approach together with a minimum threshold (eg £0.5m).

Respondents' views

Ofgem received eight responses to its consultation on GDN IAE thresholds, which have been posted on Ofgem's website³.

All of the GDNs responded to this consultation. Of the GDN respondents:

- ◆ one favoured Option 2 ie, a £1m IAE threshold
- ◆ one favoured an absolute threshold of £0.5m, and
- ◆ two favoured a variant of Option 3 ie, a proportional threshold subject to a minimum value, with that minimum value specified to be £0.25m and £0.5m respectively.

One GDN stated that, rather than setting a "cut-off" date or event such that the IAE provisions would end with the introduction of the enduring arrangements, they would support the IAE provisions being reviewed as part of the development of the enduring offtake arrangements. Another GDN stated that the IAE threshold should apply to the net present value of the event rather than the impact in a single formula year.

The three shippers that responded to the consultation expressed a preference for Option 1 ie, the status quo. One shipper expressed concern regarding the precedent that a reduced threshold could set for other network businesses. Another shipper stated that changing arrangements could increase the risk of transportation price volatility. Another shipper respondent noted that GDNs have less exposure and, as such, their need for protection is less.

energywatch responded to the consultation but did not state a preference between the options presented, instead stating that a level which minimises cost pass-through would be appropriate.

Ofgem's views

Following consideration of respondents' views, and having due regard to its statutory duties, Ofgem believes that an Option 2 approach is most appropriate, namely a reduction in the IAE threshold applicable to GDNs from £2m to £1m for the duration of the transitional period (ie, 1 October 2008 to 30 September 2010). It is expected that the appropriate IAE provisions would then be reviewed as part of the implementation of DN incentives for the period from 1 October 2010 onwards.

We note that, to modify the IAE provisions such that the threshold relates to the net present value of an event would, in many cases, be equivalent to a reduction in the threshold value. Ofgem believes that application of a threshold to an individual formula year remains appropriate to maintain consistency of approach across network businesses. Furthermore, we believe that a £1m threshold represents the most appropriate balance

³http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasdistpol&levelids=,1_12293#top12293

between offering some protection to GDNs and acknowledging the materiality of the costs of managing IAE claims during the transitional period.

In proposing the change outlined above, we would emphasise that Ofgem is not proposing any changes to the IAE provisions of any other network businesses and that proposals outlined in this letter relate solely to GDNs.

In order to implement the proposed change to the GDN IAE thresholds, it will be necessary to modify Special Condition E2B of the GT licences held in respect of each of the GDNs. To this end, we have attached to this letter a formal consultation under Section 23 of the Gas Act 1986 proposing the relevant changes to the drafting of each such licence. We would welcome views on these proposed licence modifications by 5 April 2006.

If you wish to discuss any aspect of this letter, Matteo Guarnerio (telephone 0207 901 7493) would be pleased to assist.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Robert Hull', written in a cursive style.

Robert Hull
Director, Transmission