



This letter is addressed to gas transporters, gas shippers, gas suppliers and other interested parties

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Dear Colleague

NTS Exit capacity and interruption incentive for Gas Distribution Networks 2010/11

1. Gas Distribution Network (GDN) operators are incentivised to minimise NTS exit capacity bookings and interruption payments to customers on their own networks. The current incentive was set in November 2005¹ and covers the transitional gas offtake period running 2008/09 to 2009/10². This consultation letter sets out Ofgem's initial proposals on the incentives which should apply to the GDNs when purchasing NTS exit capacity and interruption for the gas year 2010/11. We propose to retain the scope and form of the incentive which applies to the transitional offtake period, and intend to update the capacity volume targets to cover the 2010/11 gas year. We intend to consult on the incentives which will apply to the 2011/12 gas year, when UNC modification 90³ (DN Interruption reform) and UNC modification 116V⁴ (Reform of NTS offtake arrangements) come into effect⁵, as part of the ongoing price control review.

¹ 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 When Ofgem gave its consent to DN sales in January 2005, it included the introduction of reformed NTS offtake arrangements from September 2005 as a condition of its consent. In June 2005, in response to concerns about the practicality of the timetable, Ofgem concluded that it would be appropriate to delay the introduction of the arrangements to allow for further consultation and to allow the new arrangements to be developed in parallel with the transmission price control review. This delay to the introduction of the NTS offtake arrangements necessitated the creation of a transitional regulatory framework, known as the 'transitional offtake arrangements'. The transitional arrangements were introduced to cover the GDNs offtake bookings for the period October 2008 to September 2010 after which it was anticipated that enduring offtake reform proposals would take effect.

³ UNC090 'Revised DN interruption arrangements', Ofgem decision letter, 15 March 2007

⁴ UNC 'Reform of the NTS offtake arrangements (0116V, 0116BV, 0116CVV, 0116VD, 0116A)', Ofgem decision letter, 5 April 2007

⁵ On 30 April 2007 the Competition Commission received an application to appeal the Authority's decision to implement UNC 116V. Implementation of UNC 116V will be contingent on the outcome of this process.

Background

Exit capacity and interruption incentive for the transitional offtake period

2. The GDNs' exit capacity and interruption incentive for the transitional period covers GDNs' bookings of flat and flexibility offtake capacity⁶ as well as any interruptible payments the GDNs make to customers on their networks. It is designed to incentivise the GDNs to contract efficiently, and to make tradeoffs between their capacity management options to the extent that any of them are substitutable.
3. The incentive provides GDNs with separate daily flat and flexibility capacity volume targets. These were set in 2005 based on a combination of NTS forecasts for LDZ demand growth and GDN forecasts for their exit capacity requirements. To obtain the cost allowance, the volume targets are multiplied by outturn NTS exit capacity charges and converted into an overall cost target. The GDNs are not fully exposed to any cost overruns. They have an incentive cap which is the minimum of 7.5% of the cost target or £5m, as well as an incentive collar set as a maximum of 7.5% of the cost target or £5m. Within these parameters there is a 100% sharing factor of any gains or losses, but as additional protection the GDNs also have a £1m threshold for Income Adjusting Events.
4. The interruption component of the incentive is set as a cash allowance for each GDN, but from 1 October 2008 onwards (beginning of the transitional offtake arrangements) this value has been set to zero for each network. Under the existing interruption arrangements a GDN is only required to pay a site if it interrupts it for more than 15 days, but in recent years levels of interruption have been very low and no single supply point has been interrupted for greater than 15 days in any one year. At the time that the transitional offtake incentive arrangements were introduced Ofgem decided that it was no longer appropriate to allow the GDNs a separate allowance for interruption costs, and indicated that a longer term view on an interruption incentive should be taken as part of the interruption reform process.
5. Full detail on the Distribution Network Exit Capacity incentive revenue formula for each GDN is published in Special Condition E2B: Restriction of revenue in respect of the Distribution Network transportation activity, Part 1 b, Paragraph 8 (5) of each GDN's gas transporter licence.

NTS Enduring Offtake and GDN interruption reform

6. In April 2007 the Authority approved UNC Modification Proposal 116V 'Reform of NTS offtake arrangements' with effect from 1 April 2008. Because GDNs book NTS offtake capacity with three year lead times, the Authority's decision to implement offtake reform with a one year delay means that the offtake bookings GDNs and shippers make in July 2008 will be for the gas year commencing 1 October 2011. The transitional offtake arrangements run from 1 October 2008 to 30 September 2010. This creates a gap in the regulatory NTS offtake framework between the end of the transitional offtake arrangements and the start of the reformed enduring offtake arrangements the following year. On 17 April 2007 National Grid Transmission raised UNC Modification Proposal 142 'Extension of the current sunset clauses for registration of capacity at NTS exit points'. This proposal intends to extend the transitional offtake arrangements to cover this period.
7. In July 2006 NGG Distribution raised UNC Modification Proposal 90 'Revised DN interruption arrangements'. The proposal was originally intended for

⁶ Offtake capacity can be divided into two distinct components - one relating to the volume of gas that can be taken at a consistent rate over the 24 hour period of the gas day (known as 'flat capacity') and one relating to the ability to vary the rate of offtake over short periods of time (known as 'flexibility capacity'). Most users require both access to a specified volume of flat capacity and the ability to vary the actual level of offtake relative to this capacity.

implementation in April 2007, but in order to provide more time for participants to prepare for the significant changes that the reform entails, in March 2007 Ofgem directed implementation of the proposal with effect from 1 April 2008. GDN interruption reform requires GDNs to contract interruptible capacity with three year lead times, which means that in June 2008 customers will participate in tenders for interruptible capacity for the gas year beginning October 2011. Until October 2011 the existing interruption arrangements will prevail.

2010/11 NTS exit capacity and interruption incentive proposals

8. Ofgem considers that it would be appropriate to extend the GDNs existing exit capacity and interruption incentive by one year to cover the extended transitional offtake period covering the gas year 2010/11. We propose to retain the same incentive scope and form as the current incentive, but intend to update the incentive target values with exit capacity volume forecasts for the 2010/11 gas year. We provide full details of these volumes in Table 1.1 of this letter.
9. We have reached this view for the following reasons:
 - Consistency – The extension of the transitional offtake arrangements means a continuation of the existing offtake arrangements for the twelve month period leading up to the enduring offtake arrangements taking effect in October 2011. The exit and interruption incentive scheme which accompanies the transitional arrangements has been accepted and is understood by the GDNs. For Ofgem to implement a different set of incentives, to govern continuation of the same industry arrangements, would lack consistency.
 - Proportionality – As previously noted, from 1 October 2011 significant changes to the gas industry capacity management arrangements will be implemented in the form of UNC Modifications 90 and 116. To undertake a significant review of the transitional incentive arrangements would not seem appropriate when any changes implemented would only apply to the 12 month extended transitional offtake period.
 - Timescale – The GDNs will book their NTS offtake requirements for the gas year 2010/11 in July 2007 and it will be necessary for Ofgem to finalise the incentive structure and target volumes for this period in advance of this date. The timelines for achieving this (including the need for licence modifications) would be very tight if significant changes to the form or scope of the incentive were required.
10. The responses to Ofgem's September 2005 initial proposals on transitional incentive schemes⁷ indicated broad support for the idea of incentive schemes covering the acquisition of NTS exit rights by the GDNs. However, concern was expressed by some respondents regarding Ofgem's proposals for setting the exit capacity target volumes. One respondent in particular highlighted that there were factors potentially outwith the GDNs' control which could lead to exit capacity bookings exceeding targets and GDNs paying a financial penalty. Ofgem did not consider that this risk was significant enough to merit changing the proposed volume target methodology, but in order to provide additional protection against unforeseen circumstances Ofgem decided to reduce the threshold for considering an Income Adjusted Event (IAE) from £2m to £1m. For the 2010/11 exit capacity and interruption incentive we continue to consider that £1m is an appropriate IAE threshold.
11. A summary of the responses to the September 2005 initial proposals document was published in the November 2005 Final proposals document on transitional incentive

⁷ Initial proposals on transitional incentive schemes supporting the offtake arrangements, Ofgem, September 2005

schemes. The responses in full, and both of these documents, can be viewed under the 'Networks – Gas Distribution' section of Ofgem's website (www.ofgem.gov.uk).

2010/11 NTS exit capacity target volumes

12. Under the current industry arrangements, the gas year runs 1 October to 30 September each year, whereas the GDNs price control formula year is consistent with the financial year and runs 1 April to 31 March. Extending the transitional offtake arrangements by one year to cover the 2010/11 gas year therefore has implications for two price control formula periods: the second six months of the formula year beginning 1 April 2010, and the first six months of the formula year beginning 1 April 2011. For the purposes of the exit capacity incentive it is therefore necessary for Ofgem to publish daily flat and flexibility capacity target volumes for the two formula year periods.
13. For the formula year beginning 1 April 2010, daily flat and flexibility capacity target volumes have already been determined. These were published in each GDN's licence in January 2006 when the transitional incentive was put in place, and since formula year volume targets are set to accommodate future gas year requirements, were set to take account of 2010/11 gas year exit capacity requirements. The licence currently states that for all days from 1 October 2010 the 2010/11 target volumes should be set to zero. This decision was taken in anticipation that the enduring offtake reform proposals would be implemented on this date. Since enduring offtake reform will not be implemented until 1 October 2011, we intend to modify the GDNs licences to allow the 2010/11 formula year target volumes to apply for the full formula year running 1 April 2010 to 31 March 2011. The 2010/11 flat and flexibility capacity target volumes can be found in Table 1.1.
14. We propose to set the flat and flexibility volume targets for the first six months of the formula year beginning 1 April 2011 based on the exit capacity forecasts for 2011/12 submitted to Ofgem by the GDNs as part of the GDP CR BPO process. We have reviewed this data internally and for the purposes of this exit capacity incentive are content with its integrity. We have also sense checked the data against NTS LDZ growth forecasts published in National Grid Transmission's 2006 Ten Year Development Statement. The GDN forecasts are not significantly different from the forecasts derived by applying NTS LDZ growth forecasts to GDNs 2009/10 capacity bookings. For flat capacity the GDN forecasts are lower than the comparable NTS generated forecasts. For flex capacity the picture is more variable. At an aggregate level, taking flat and flex together, the GDNs forecasts provide the lower target capacity volumes. The proposed 2011/12 flat and flexibility capacity target volumes can be found in Table 1.1. From 1 October 2011 we consider it appropriate to set these values to zero.
15. When the transitional offtake incentive arrangements were implemented in January 2006 the allowance for GDNs interruption payments to customers was set to zero. In light of the continued low volumes of interruption across the distribution networks, we consider that it is appropriate for this value to remain at zero. We note that this decision should be considered within the overall incentive framework, where if an exceptionally cold winter caused the GDNs to incur greater interruption costs than expected, their exposure to these costs would still be limited by the 7.5% or £5m overall incentive target cap.

Next Steps

16. Views on this consultation are invited. Any responses or queries should be addressed to lewis.hodgart@ofgem.gov.uk (phone 0207 9017021) by 31 May 2007.
17. Having considered responses to this consultation, in early June 2007 we intend to publish Final Proposals on the 2010/11 gas year exit capacity and interruption

incentive. At the same time, we also intend to publish a statutory licence modification proposal notice, making the necessary changes to the GDNs exit capacity incentive volume targets for the formula years 2010/11 and 2011/12 which the 2010/11 gas year affects. It is anticipated that the statutory consultation period for this licence modification will end in early July 2007 in time for the GDNs July bookings of 2010/11 NTS exit capacity.

Yours sincerely

Joanna Whittington
Director, Gas Distribution

Table 1.1: Proposed incentive targets for the extended transitional period⁸ (GWh / day)

DN	LDZ Exit Zone	Flat Capacity			Flexibility Capacity		
		2009/10	2010/11	2011/12	2009/10	2010/11	2011/12
Scotland	SC1	55.53	56.08	54.33	6.17	6.23	3.62
	SC2	75.97	77.04	63.88	8.31	8.39	8.66
	SC4	245.95	248.9	242.74	13.94	14.08	5.79
North of England	NO1	249.74	252.23	250.88	-2.36	-2.33	0.66
	NO2	28.08	28.45	30.08	2.61	2.64	2.96
	NE1	242.52	245.72	246.05	20.3	20.56	20.42
North West	NE2	66.7	67.58	69.33	1.08	1.1	4.45
	NW1	233.83	235.58	294.34	22.82	23.61	15.15
East of England	NW2	344.73	347.16	285.32	15.08	15.11	25.76
	EA1	40.78	41.58	43.57	5.52	5.61	6.46
	EA2	46.29	47.08	45.79	6.06	6.16	6.79
	EA3	76.66	71.16	49.04	0.75	0.76	0
	EA4	230.17	241.5	260.35	0.29	0.3	-3.16
	EM1	113.88	115.35	80.53	0.12	0.13	6.84
	EM2	107.31	108.69	118.33	6.7	6.78	0.61
	EM3	277.06	280.63	309.67	2.15	2.18	17.34
London	EM4	21	21.27	16.52	1.29	1.31	0.98
	NT1	21.23	21.5	18.00	0	0	0
	NT2	188.29	190.65	185.86	-5.57	-4.48	-6.28
West Midlands	NT3	322.6	326.65	315.24	-9.48	-9.03	0
	WM1	114.18	115.63	128.07	-0.48	-0.48	-10.18
	WM2	240.55	243.62	226.23	2.76	2.79	11.01
Wales & West	WM3	122.53	123.56	111.37	-2.65	-2.62	2.66
	SW1	39.12	39.76	39.49	2.13	2.23	2.29
	SW2	168.96	171.76	173.07	5.38	5.62	5.98
	SW3	97.69	99.31	99.34	3.69	4	4.11
	WA1	53.78	54.55	54.06	0	0	0
South of England	WA2	198.25	200.05	242.30	0	0	0.98
	SE1	454.73	460.09	472.83	0	0	-8
	SE2	102.46	103.67	95.69	0	0	0
	SO1	120.72	121.88	124.64	5.22	5.3	4.55
	SO2	308.34	313.89	320.16	7.54	7.66	2.87
Total		5009.62	5072.56	5067.08	119.36	123.61	133.33

⁸ Figures expressed are with respect to formula years.