This letter is addressed to consumers and their representatives, gas distribution networks (GDNs), independent gas transporters (IGTs), gas shippers and suppliers and any other interested parties

Promoting choice and value for all customers

Your Ref:
Our Ref: NTWK/GDPC/70
Direct Dial: 020 7901 7021
Email: joanna.whittington@ofgem.gov.uk

Date: 23 October 2007

Dear Colleague

Capacity outputs incentive for GDPCR – October Update Consultation

Introduction

1. GDNs have a licence obligation to develop and maintain their pipeline system to enable them to meet gas demand on their networks in the event of a 1 in 20 peak demand day(s). GDNs meet this standard through a combination of investment in their own pipeline network, procuring interruption services on their own network, and booking flat and flexibility exit capacity from the NTS. Exit capacity from the NTS is booked by the GDNs but paid for directly by shippers, so absent any specific mechanism the GDNs would have no financial incentive not to overbook it. The capacity outputs incentive is intended to incentivise GDNs to make efficient use of the capacity management outputs available to them, including making efficiency trade-offs between the options where possible.

2. The capacity outputs incentive for the transitional offtake period expires on 30 September 2011. As part of GDPCR final proposals it will be necessary for Ofgem to implement a capacity outputs incentive covering the period 1 October 2011 – 31 March 2013. In updated proposals[1] we consulted on the scope, form and structure of the capacity outputs incentive to apply to the GDNs in this period. The consultation did not include proposed values for the incentive parameters, but we indicated that following completion of the NTS Offtake Capacity Statement (OCS) process at the end of September, we would use a separate consultation in October to publish data on incentive values. Having reviewed this information, this consultation letter provides indicative values for the 1 October 2011 – 31 October March 2013 capacity outputs incentive; provides further detail on the capex reopener criteria referred to in updated proposals; and consults further on the way in which certain of the incentive parameters are set.

Interruptions

3. In updated proposals we indicated our intention to set the interruptible capacity incentive at a level which incentivises the GDNs to contract for interruption with Network Sensitive Loads (NSLs) up to the point at which it becomes more efficient to reinforce the network to make them firm. We explained that this would equate to the discounted cost of the reinforcement projects necessary to remove locational

[1] Gas Distribution Price Control Review Updated Proposals Document, Ofgem, 24 September 2007

constraints on the GDNs. We continue to consider that this would constitute an appropriate treatment of NSLs, but have undertaken further analysis to review whether this would be sufficient on its own to incentivise efficient interruption outcomes across the whole of the gas distribution networks.

4. Our analysis at the time of updated proposals was based on the view that the GDNs tend to require interruptible capacity for two specific reasons: to manage the capacity needs of specific locational constraints or, at the margin, to manage the overall level of peak day demand. We took the view that the generic interruptible capacity that the GDNs may need to manage peak day demand can be traded to some extent with NTS flat capacity, while trade-offs at location specific constraints are more directly between pipeline reinforcement and interruption. At a high level we continue to consider that this analysis is sound, but we are now aware that the discrete trade-offs between NTS flat capacity and interruption are not infinite and, for some GDNs, only exist assuming a certain minimum level of interruptible capacity is available. We are also aware that a shortfall of interruptible capacity and NTS storage combined could result in GDNs having to invest in distribution network flexibility. For some GDNs, if they are unable to contract for any generic interruptible capacity, then incremental NTS flat capacity on its own would be an insufficient substitute, and distribution network investment would be necessary.

5. For GDNs for whom investment would be necessary if they are unable to procure the volume of interruptible capacity they require, an interruption incentive which only promotes trade-offs between NTS flat capacity and interruption will not be sufficient to promote efficient capex outcomes. The price of NTS exit capacity may well be less costly than procuring interruptible capacity, but if distribution network reinforcement would also be required to support the increased capacity, the price of NTS exit capacity on its own will not be the relevant point of reference in evaluating the value of interruption.

6. Ahead of the first interruptible capacity auctions, we consider that unnecessary capex triggered as a consequence of the way the interruption incentive is set would be among the least desirable outcomes. In looking at the issue of investment costs, we further note that in some cases the relationship between NSL investment costs and the network investment required to support increased transportation capacity or incremental linepack is not mutually exclusive; that is to say in some cases the effect of a large LTS investment could have the effect of reducing the scale of certain locational constraints. Taking these factors into account we now consider that in determining the efficient level of interruption incentive for each GDN, it would be appropriate to calculate the discounted reinforcement cost of the network investment required to support all interruptible customers as firm, not just the discounted reinforcement cost of the projects necessary to remove locational constraints.

7. In Appendix One of this letter we have published a table listing, for the purposes of calculating an incentive, estimates of the investment costs necessary to support all customers as firm by GDN. This data is based on information provided to Ofgem by PB Power in their October Capex/Repex update report. The estimates of investment costs are to some extent dependent on the GDNs capex allowances determined as part of GDPCR updated proposals and these costs may need to be updated in light of any changes to the capex allowances determined as part of GDPCR final proposals. Discounted over a forty five year period using the cost of capital modelling assumption published in updated proposals (4.84% vanilla WACC), we have also calculated what the annuitised value of each of these estimated costs would be. Using this methodology the value of the incentive across all GDNs would be approximately £25.3m per annum. This compares to an equivalent value for the capacity charges discount received by interruptible customers under the existing

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

interruption arrangements of approximately £39m[2]. This value is dependent on the level of transportation charges levied, but at a conservative estimate we would be expect that, all other things being equal, the effect of this methodology would be to reduce the overall level of transportation charges paid by distribution network customers.

8. Setting the interruption incentive using this methodology relative to the methodology proposed in updated proposals results in some GDNs having a larger interruption target value than they would otherwise have had. As indicated above, we consider that this relatively cautious approach to setting the incentive is the one most likely to promote efficient capex outcomes, but we recognise that this change could make outperforming the incentive easier for some GDNs. To protect customers against any windfall gains, we propose 50% sharing factors on performance against target and propose that caps and collars should not apply. We recognise that this represents a change from the incentive consulted on in updated proposals, but we consider that this is justified in view of the other changes explained above.

Flat Capacity

9. In our updated proposals document we indicated our intention to set the flat capacity volume target based on forecasts of the flat capacity needs of each distribution network assuming all supply points on their networks, other than customers currently nominated as NSLs, are firm. We continue to consider that this is an appropriate basis for setting the NTS flat capacity target. If the GDNs consider that they will gain under the flat capacity incentive by paying for interruptible capacity, which will allow them to decrease their NTS flat capacity bookings then we would expect them to trade these gains off against the interruptible capacity incentive. We consider that the effect of changing the methodology used for determining the size of the interruption incentive will improve the efficiency of this trade off.

10. In updated proposals we also noted that it was important where possible for the interruption incentive and NTS flat capacity incentive to have equally powered sharing factors. In view of the decision to change the proposed methodology for setting the size of the interruption incentive, and the proposal to apply 50% sharing factors on performance against target, we consider that it would also be appropriate for 50% sharing factors to apply to the GDNs' flat capacity incentive. Given the total value of the NTS flat capacity target, we do consider that this incentive should have caps and collars. We indicated in updated proposals that we do not necessarily think that the caps and collars should continue to be set at 7.5% and could potentially be wider at say 15%, but we will take the opportunity to review respondents submissions on this issue before reaching a firm view. In Appendix One table 2 we have published the flat capacity volumes that we intend to apply to the last six months of the formula year 2011/12, and the full twelve months of the formula year 2012/13.

Flex Capacity

11. In the context of the industry dialogue on NTS flex capacity associated with the enduring offtake reform proposals, in updated proposals we sought views on whether industry parties considered that there was a need to incentivise GDNs' bookings of flex within the forthcoming price control period. The closing date for responses to updated proposals was 22 October 2007 and in the short time since we have not had the opportunity to review in full respondents' submissions on this issue. We do not wish to comment conclusively on the appropriateness of not

[2] Based on 1 October 2007 distribution network charges and assuming interruptible customers pay LDZ capacity charges based on bottom stop SOQ

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

incentivising flex at this stage, but we do note that in the period since updated proposals we are not aware that any new analysis on the subject of NTS flex constraints has been conducted.

12. The case for not incentivising flex is based on the clear view expressed by industry during the consultation on the offtake proposals (and in the subsequent appeal) that there is no shortage of flex capacity and that demand for the product is not anticipated to increase significantly. In the absence of a scarcity of flex we consider that, providing the service is auctioned at zero price, the only danger to participants of not incentivising the GDNs to book it might be that it would remove the incentive on the GDNs to book it efficiently. We consider that concerns of this nature could be overcome through other regulatory options such as subjecting GDNs bookings of flex to explicit scrutiny in the event that they increased year on year by more than 10 per cent say. We do not propose to consult on flex capacity incentive values at this stage.

Capex reopener

13. Our proposals for the capacity outputs incentive reflect a preference to ensure that where interruptible capacity is available on terms which make it economic for the GDNs to contract for it, the properties of the incentive make it financially efficient for them to do so. In updated proposals we listed the reasons why we consider customers will find it attractive to participate in the interruptible capacity auctions as follows: the potential for an increase in interruptible payment; more flexible contracting options; and the risk of losing out on any interruptible payments in the future if they are made firm. All other things being equal, we consider that these reasons, combined with the strong incentive on the GDNs to book interruptible capacity where it is economic for them to do so, should result in optimal levels of interruptible capacity being booked. Nevertheless, ahead of the first interruptible capacity auctions it is not possible to be certain that the GDNs will be able to contract for all of the interruptible capacity they require in all of the locations they require it. As a result in some cases network investment may be necessary.

14. In proposing to set the interruption incentive at the discounted cost of the level of investment required to support all existing interruptible customers as firm, we consider that in the event that investment is required as a substitute for interruption, there will be significant scope for the GDNs to fund additional capex in the years before the next price control period through savings made against the capacity outputs incentive. However, given that differing sharing factors in the interruption incentive and the capex roller incentive could be viewed as obscuring efficiency trade-offs slightly, we consider that it would be appropriate to consult on the criteria that would apply in principle should a capex reopener be required.

15. Additional capex triggered as a consequence of interruption reform is likely to be driven by one of two sources: the need to remove particular locational constraints, or the need to build increased transportation or storage capacity on the GDNs. Taking steps to remove a particular locational constraint is likely to require a one-off investment which, if NSL customers had contracted for interruption, would not have been required. The need to provide increased transportation or storage capacity is likely to require bringing forward, or in some cases upsizing, capex projects already identified through the GDPCR process. As a result of the bilateral meetings Ofgem has held with the GDNs, the GDNs' BPQ responses, and PB Power's analysis of capex, we have a clear idea of the materiality of these projects. In the event that investment is required we would expect the size and nature of the project to be known to us already.

16. We consider that any capex which the GDNs would like to submit for consideration under a capex reopener should require to meet the following criteria:

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

- Efficiency – The GDNs must be able to demonstrate that, taking the discounted cost of an investment over a forty five year period together with the reasonably foreseeable costs of any incremental NTS flat capacity necessary to support an increased load, interruptible offers which would have removed the need for the investment were not available in sufficient numbers or at sufficiently competitive prices to avoid the need for reinforcement. In reviewing the outcome of an interruptible auction we would be likely to consider the extent to which a GDN had effectively marketed the interruptible product in determining whether investment had been necessary. We would also review interruptible bids the GDNs received for a particular interruptible auction.

- Materiality – Any application for a capex reopener utilises time and resources from the GDNs and from Ofgem. For this reason we consider that any application should be for recovery of costs greater than £1million per GDN. We would also expect the GDNs to take account of the effect the decision to invest would have on their performance against target in the capacity outputs incentive when reaching a decision over whether to apply for a capex reopener. In the event that an application for a capex reopener was permitted we would expect to make a proportionate adjustment to the size of the interruption and flat capacity incentive targets.

Income Adjusting Event

17. Under the transitional exit capacity incentive the Income Adjusting Event (IAE) threshold was reduced to £1m per formula year for each GDN, but from formula year 2012/13 it is scheduled under licence to return to a value of £2m. Given the level of risk to which we consider the GDNs are exposed under this incentive proposal, we do not propose to reduce the IAE threshold to £1m in the forthcoming price control period. We do recognise that in applying the same absolute value to each GDN, the existing IAE threshold does not reflect the differing size of each of the GDN businesses. Taking this into consideration we seek views on whether it would be more appropriate for the IAE threshold associated with the capacity outputs incentive in the period 1 October 2011 – 31 March 2013 to take an annual value equivalent to 0.5% of allowed revenue for each GDN. This would result in a range of IAE thresholds of between £1m and £2m.

Next Steps

18. This consultation letter represents Ofgem's view of the most appropriate way to incentivise the GDNs to make efficient use of the capacity management outputs available to them in complying with their licence obligation to meet gas demand on their networks in the event of a 1 in 20 peak demand day(s). The letter can be read in conjunction with the chapter on incentives published in updated proposals but, for the avoidance of doubt, where the proposals differ materially, the incentive proposals consulted on in this letter should be read as Ofgem's latest thinking on the subject. We will take account of responses to this consultation and updated proposals in preparing final proposals on GDPCR.

19. Responses to this consultation are invited and should be addressed in writing to gdpcr@ofgem.gov.uk by 9 November 2007. If you would like to discuss any part of this consultation please contact Lewis Hodgart by phone on 02079017021 or by e-mail at lewis.hodgart@ofgem.gov.uk.

Yours sincerely

Joanna Whittington
Director
Gas Distribution

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

Appendix One

Table One

GDN	Estimated cost in £m of all interruptibles as firm	Annuitised value £m over 45 years at 4.84%
Scotland	47	2.5
North of England	48	2.6
North West	60	3.2
East of England	90	4.8
London	2.5	0.13
West Midlands	0.9	0.05
Wales and the West	161	8.6
South of England	64	3.4
Total	473.4	25.3

* For the 1 October 2011 – 31 March 2012 period of the 2011/12 formula year, and for the full 2012/13 formula year, we consider that the interruption incentive for each GDN should take the value proposed in the right hand column of table one. The eighteen month period in question will cover two winters and in our view it is during the winter that GDNs are most likely to require interruptible capacity.

Table Two

	Flat Capacity (Gwh)	
LDZ	11/12 proposal	12/13 proposal
SC	413.64	418.51
NO	289.43	294.51
NE	332.18	337.98
NW	596.69	604.27
EA	404.99	414.28
EM	561.37	568.17
NT	516.53	521.19
WM	461.10	466.01
SW	319.14	323.52
WA	327.09	330.35
SE	605.30	615.32
SO	481.48	490.23
	5308.94	5384.37

*The first six months of the 2011/12 formula year are covered by the transitional offtake exit capacity incentive and the GDNs already have flat capacity volume targets for this period. We propose to set new volume targets to apply to the second six months of the 2011/12 formula year as detailed above. The volumes proposed for 2012/13 would apply to the full formula year.

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**