



Gas Transporters, shippers and interested parties

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Dear Colleague

Decision letter on retaining the Transitional Interruption Incentive

Background

On 18 July 2008 Ofgem published a consultation letter¹ setting out our proposal that the zero value Gas Distribution Network (GDN) interruption incentive, which will take effect from 1 October 2008 be maintained at zero throughout the transitional period between 1 October 2008 until 30 September 2011. The letter set out the rationale behind our proposal and invited views on whether or not it is appropriate.

This letter summarises the views of respondents to the consultation letter and sets out our decision and reasons for our decision.

Respondents' and Ofgem's views

Ofgem received three responses to the consultation letter, two which were submitted by GDNs and the remaining one by a shipper. All responses are non-confidential and can be found on the Ofgem website www.ofgem.gov.uk under the Gas Distribution Policy area of work. A summary of their views and our response is given below.

One of the three respondents, a shipper, supported the proposal. They considered that anything other than a zero value interruption incentive for the transitional period would be likely to result in GDNs receiving windfall gains under the incentive. They also concurred with our view that GDNs would have recourse to the Income Adjusting Event (IAE) if they were exposed to material levels of interruption payments.

The two GDN respondents considered the proposal of retaining a zero value interruption incentive for the transitional period to be inappropriate on the basis that they would be exposed to the cost of any payments. As such they considered that the incentive should take a value greater than zero for the reasons given below.

They pointed out that since the provisions² of the IAE have a threshold of £1.5m in years 1³ and 4 and £1m in years 2 and 3, GDNs would be exposed to the costs of interruption up to the threshold. Therefore, they would only be able to apply for funding to cover interruption

¹ *Retaining the Transitional Interruption Incentive*

² Set out in Special Condition E7

³ Year 1 = FY 2008/9, year 2 = FY 2009/10, year 3 = FY 2010/11, year 4 = FY 2011/12.

costs in excess of the threshold. As such, they considered that recourse to the IAE would be of no use unless a significant amount of interruption costs were incurred.

While Ofgem recognises that the threshold set by the IAE will not protect GDNs from all instances where an interruption payment is made, it will cover them from significant losses incurred from large interruption payments if the amount breaches the IAE threshold. Given that GDNs have not interrupted any single supply point for more than 15 days (the event that triggers payments) during any year since the incentive was established, we consider the likelihood of GDNs having to incur the cost of such interruption in the transitional period to be low. However, in the event that it does occur, we would expect the GDNs to incur the costs of some level of interruption up to a point, after which they will be recompensed by the IAE.

One respondent disputed our assertion that GDNs had received a windfall gain equivalent to £5m under the incentive arrangement between 2005/06 and 2007/08. They considered that in 2005/06 and 2006/07, under their interpretation, the licence only allowed the GDN to recover the incentive allowance when interruption payments had been made. Therefore as no such interruption payment had been made no money from the allowance would have been received during this period. The same respondent continued that only in 2007/08 with the interpretation of the licence agreed had GDNs been able to receive the allowance irrespective of whether any payments had been made or not.

Having looked at the revenue returns submitted by GDNs for 2005/06 and 2006/7, we recognise that a difference in licence interpretation amongst the GDNs did result in one GDN receiving an allowance even though no interruption payment had been made, while others did not. Taking this into account we have revised the collective windfall gain received between 2005/06 and 2007/08 to £3.7m.

Notwithstanding this, given that the agreed licence interpretation for 2007/08 did allow for GDNs to claim the allowance even if no payments had been incurred, we consider that the scope for GDNs to make windfall gains would persist should we set an incentive allowance with a value that is greater than zero.

Between them the two respondents set out three options in preference to the zero value incentive for the duration of the transitional period:

Both respondents suggested:

- An incentive allowance that is greater than zero in line with targets that have applied since DN sales.

One of the respondents suggested two further options:

- Allow a pass-through of the costs of interruption payments for the transition period; or
- Retention of the historical allowance but to include a sharing factor of savings made from the allowance or any expense incurred above the allowance.

Since the incentive was established levels of interruption have been low and no payments have been made to supply points as interruptions have not been in excess of 15 days for any one supply point during any one year. On this basis we consider that setting an interruption incentive with a value other than zero would not be appropriate. As we have already stated, GDNs will have recourse to the IAE in the event of incurring significant levels of interruption payment.

Ofgem's decision

Whilst we have taken on board the concerns by the respondents opposed to the proposal set out in our consultation letter of 18 July 2008, we have decided to retain the zero value transitional interruption incentive for the duration of the transitional period until 30 September 2011 for the reasons given above. It will not be necessary to change the licence to reflect our decision as Special Condition E2B already stipulates that a zero value will prevail from 1 October 2008, or such date that the Authority otherwise directs in writing

If you have any questions to the points covered in this letter, please contact Indra Thillainathan on 020 7901 7294.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is placed over a light grey rectangular background.

Rachel Fletcher
Director of Distribution