



Indra Thillainathan
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Scotia Gas Networks
c/o Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Our Reference:
Your Reference:

Telephone: 01738 456400
Facsimile: 01738 456415
email:

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Dear Indra

Retaining the Transitional Interruption Incentive

I am writing in response to Rachel Fletcher's consultation letter dated 18 July 2008 regarding the above.

As the above referenced letter identifies, the target allowance associated with the interruption incentive for the transition period from 1st October 2008 to 30th September 2011 is currently set at zero. However, under the interruption arrangements that apply to the same period, GDNs are exposed to making payments in the event that an interruptible supply point is interrupted on fifteen or more days in any one year. Pre-October 2008, the exposure of GDNs to this expenditure has been/is limited by the inclusion of the interruptible incentive allowance but thereafter, unless the zero incentive allowance is changed, the GDNs are fully exposed to the cost of any payments which we do not believe is appropriate.

The interruption arrangements are part of the GDNs' set of "tools" available to them to manage the efficient and economic operation of their system. Until October 2011, these arrangements give them access to interruption to avoid investment and therefore we firmly believe that the associated expenditure/risk should be appropriately financed. Whilst we recognise that, recently, no such payments have been made there is clearly no guarantee that they will not be required in the intervening period from now until the new interruption arrangements take effect in October 2011. Indeed, Scotland Gas Distribution Network only narrowly avoided making such payments in 2007/08 and given the nature and location of that particular network it is likely that these payments will be required going forward. We therefore do not believe that it is

correct for Ofgem to base their removal of the allowance on the incidence of payments in recent years.

We also note that Ofgem is concerned that over the three formula years between 2005/06 and 2007/08 the GDNs have received a windfall gain under this incentive arrangement. We do not believe this to be the case. Certainly, Scotia Gas Network's interpretation of the incentive arrangement for the period 2005/06 and 2006/07 has been that the allowance was only triggered where interruption payments had been made. It is only the agreed interpretation of the incentive arrangement that has been applied to 2007/08 that has enabled the GDN to recover the incentive allowance if no payments have been made. We therefore believe the £5m figure presented in the letter is incorrect.

Ofgem has suggested that if the incentive allowance is retained at zero, a GDN would have recourse to the Income Adjusting Event (IAE) provisions of the licence should they incur significant losses. While this may theoretically be true, the applicable IAE provision set out in Special Condition E7 has an exposure threshold of between £1.5m and £1m (depending on the year in question) before a GDN could apply for additional funding. We therefore do not believe that Ofgem's suggestion in this respect is likely to be of any use to the GDNs other than in extreme conditions.

Given the above, and based on the regulatory principle that the GDNs should be funded to carry out all legitimate operations, we believe that Ofgem should set an incentive allowance that is greater than zero and that it should be in line with the targets that have applied since the DN sales. Alternatively, Ofgem should allow as a pass-through the cost of these interruption payments for the transition period. Either of these options would be consistent with regulatory precedent for this aspect of the regime and also address Ofgem's concern that it would be disproportionate to design a more sophisticated incentive arrangement. A third option, which we believe would be relatively simple to set up and operate would be to retain the historical allowance but include a sharing factor of any savings that are made from that allowance or any expenditure that is incurred above the allowance.

I hope that you will find these comments helpful.

Yours sincerely

Rob McDonald

Director of Regulation.