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 gas and electricity customers

Your Ref:
Our Ref:
Direct Dial: 020 7901 7194
Email: rachel.fletcher@ofgem.gov.uk

Date: 19 August 2010

Dear Colleague

Minded to position on Gas Distribution Network capacity outputs incentive 2013/14 and 2014/15

Under Special Condition E6 Part C of the Gas Transporters Licence (The Licence) Gas Distribution Network operators (GDNs) are subject to a capacity outputs revenue incentive. The mechanism incentivises the GDNs to make efficient bookings of National Transmission System (NTS) exit capacity and to contract efficiently for GDN interruptible capacity, including making efficiency tradeoffs between the two where appropriate.

The incentive was set as part of the Gas Distribution Price Control Review[1] (GDPCR) to cover formula years 2011/12 (t=4) and 2012/13 (t=5) in coordination with implementation of the revised GDN interruption arrangements[2] in October 2011, but the licence contains no values for formula year 2013/14 or beyond. Under the revised interruption arrangements GDNs contract for interruptible capacity with three year lead times[3], and from 2012/13, under the revised exit capacity arrangements[4], will commit to incremental exit capacity with three year lead times. We had previously set out our intention to re-set the capacity outputs revenue incentive to cover formula years 2013/14 and 2014/15 in this year.[5]

This consultation letter sets out our minded to position not to set the incentive values for 2013/13 and 2014/15 at this time. Instead we are minded to set allowances for expenditure on interruptible and exit capacity as part of the forthcoming gas distribution price control review (GDPCR2).[6] We have reached this minded to position following

[1] GDPCR Final Proposals, Ofgem, 3 December 2007 http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/final%20proposals.pdf
[2] Uniform Network Code (UNC) 90: Revised DN Interruption Arrangements, Ofgem decision, 15 March 2007 http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC090D.pdf
[3] Under the revised interruption arrangements GDNs hold annual tenders for interruptible contracts with three year lead times but where longer term contracting makes economic sense, the arrangements permit GDNs to enter contracts with longer than three year lead times and, via the ad-hoc tender option, GDNs can contract for interruptible capacity at shorter than three years notice.
[4] Uniform Network Code (UNC): Reform of the NTS offtake arrangements (UNC 0116V, 0116BV, 0116CVV, 0116VD, 0116A) and Introduction of Enduring NTS Exit capacity Arrangements (UNC 0195 and 0195AV), Ofgem decision, 19 January 2009 http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC195AVD.pdf
[5] Consultation on Gas Distribution Networks capacity outputs incentive Ofgem 17 December 2009: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=211&refer=Networks/GasDistr/GasDistrPol
[6] The process of this review has already started. On 30 July we published an open consultation letter on the way forward for GDPCR2: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=211&refer=Networks/GasDistr/GasDistrPol

consideration of the responses to our December consultation and discussions with the GDNs.

Background

GDNs are required to provide network capacity to meet peak customer demand. Where they think peak demand might outstrip capacity they have three main options. These are: reinforcing their own network assets; purchasing rights to take gas from the national transmission system (exit capacity); and purchasing rights to interrupt gas supplies to customers connected to their networks (so called interruptible capacity contracts which provide the customer with a discount from transportation charges in return for interrupting when requested by the distributor).

At the first gas distribution price control review in 2008 (GDPCR1) a suite of allowances were put in place to ensure that the distribution GDN achieve (and customers only pay for) the appropriate balance between network expenditure, expenditure on interruptible and on exit capacity. The GDNs were given a separate allowance for expenditure on interruptible and exit capacity and new arrangements were introduced for how they contract for interruptible capacity.

Given the lead times required to put in place investment alternatives to interruptible and exit capacity we had set out our intention at GDPCR1 to review the capacity outputs incentive this year.[7] In December 2009 we consulted on a high level approach for the incentive. In the consultation we set out our intention not to change the form and scope of the incentive and to set expenditure allowances for 2013/14 and 2014/15 this year. As part of the consultation process we asked for the GDNs to submit their requests for allowances.

Following our review of the consultation responses and the GDNs' submissions we came to the minded to position that it would be more appropriate that these allowances were not set at this time and instead considered as part of GDPCR2.

Rationale for our minded position

We came to our minded to position taking into account the consultation responses and considering the emerging thinking from our RPI-X@20 review of network regulation.[8] We also took into account the likely impact on the GDNs businesses and on gas customers.

The GDNs' requests for allowances were based on forecasts of future peak demand for gas on their networks and the investment that would be required to support all customers who currently have interruptible contracts as firm capacity (firm capacity cannot be interrupted for the purpose of capacity management).

In our review of the GDNs' submissions we found that their demand forecasts had varied significantly year on year over the period since GDPCR1. We also noted that for some of the GDNs their demand forecasts were significantly different from those produced by National Grid in its forecasts of offtake from the NTS produced in its ten year statement.[9] Consequently, without a more comprehensive review of the demand forecasts, we are not confident that we are able to set allowances with sufficient accuracy. We think it is more

---

[7] Given the same issue would occur next year and given the synergies available in setting allowances it was considered sensible to set the allowances for the 2013/14 and 2014/15 at the same time. Allowances for subsequent years could be set as part of GDPCR2.

[8] Since we undertook our review of the capacity outputs incentive the final recommendations of the review have been published. They and the emerging thinking documents can be found on our website: http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Pages/ConsultDocs.aspx

[9] Special Condition C2 of National Grid's Gas Transporters licence requires that the Ten Year Statement, published annually, shall provide a ten-year forecast of transportation system usage and likely system developments that can be used by companies, who are contemplating connecting to our system or entering into transport arrangements, to identify and evaluate opportunities.

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

appropriate to set these allowances as part of GDPCR2, during which we would expect a robust justification by the GDNs of their demand forecasting methodologies.

In coming to our minded to position we have thought about our approach to setting expenditure allowances at a high level. In particular we have considered how developments in our thinking on setting expenditure allowances since GDPCR1 should be taken into account.

Our thinking on the setting of allowances has moved on significantly. DPCR5 signalled a movement away from allowances for specific types of expenditure, with the approach being instead to set an overall expenditure allowance in combination with a requirement to deliver a clear set of outputs over the price control period. This approach provides companies with the flexibility to determine the optimal expenditure solutions to deliver a defined set of outputs. It also involves ensuring that the rewards for outperforming the price control settlement are equalised across all types of expenditure. One of the recommendations of the RPI-X@20 review is to adopt and further develop this approach for future price controls.

To set allowances for specific types of expenditure at this time would limit our flexibility to implement the DCPR5/RPI-X@20 principles as part of GDPCR2 should we decide this is appropriate.

We consider that any impact on GDNs and/or gas customers' will be limited because the GDNs will retain the incentive to efficiently contract for interruptible and exit capacity for 2013/14 and 2014/15 in the absence of explicit expenditure allowances. The incentive is preserved because allowances for expenditure on capacity set during GDPCR2 will provide the GDNs with the incentive to make efficient investment decisions. We also note that, due in part to the downturn in gas demand, likely expenditure by the GDNs on reinforcement and on interruptible contracts is relatively low and therefore to the extent there is any uncertainty this can be easily managed.

Any efficiently incurred expenditure will be accommodated within the expenditure allowances set at GDPCR2. Further, the GDNs will be able to contract for an efficient level of capacity during the 2010 and 2011 auction processes as they have access to all the information that they need to be able to balance the cost of interruptible discounts against network reinforcement costs. It is also the case that not setting allowances for expenditure on interruptible and exit capacity will place decisions made regarding these on an equivalent footing to other types of capacity investment which, given the lead time for investment, GDNs will be required to commit to prior to the setting of investment allowances.

Next Steps

Shortly following conclusion of this consultation we intend to publish a direction implementing our decision not to set allowances under the capacity outputs incentive at this time.

We seek industry views on the issues highlighted in this consultation and in particular on the following questions:

- Do you agree that implementation of our minded to position will have a minimal impact on GDNs and gas customers?

- Do you agree that GDNs will retain the incentive to efficiently book interruptible and exit capacity for 2013/14 and 2014/15 without explicit expenditure allowances being set now (but considered as part of GDPCR2)?

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

- Do you agree with our minded to position not to set interruptible and exit capacity allowances for 2013/14 and 2014/15 at this time but instead to consider these allowances as part of GDPCR2?

Consultation responses are invited and should be submitted to Mathieu Pearson (**mathieu.pearson@ofgem.gov.uk**) by 30 September 2010.

Yours sincerely

Rachel Fletcher
Partner, Distribution