National Grid Transco – Potential sale of gas distribution network businesses

Initial proposals on interim incentive schemes supporting the offtake arrangements

March 2005 79/05

Summary

This document sets out Ofgem's initial proposals on the scope, form and duration of interim incentive schemes that will be necessary in the event that National Grid Transco plc's (NGT) proposed sale of one or more of its gas distribution network (DN) businesses proceeds. This proposed sale necessitates significant changes to industry arrangements, as more fully described in Ofgem's four Regulatory Impact Assessments (RIAs) issued during 2004 and its Final Impact Assessment (Final IA), published in November 2004.[1]

The publication of this document follows the Gas and Electricity Markets Authority's (the Authority's) recent conditional grant of consent regarding four applications from Transco plc (Transco) under Amended Standard Condition (ASC) 29 of its original Gas Transporter (GT) licence to dispose of four of its gas distribution networks to four wholly owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers.[2]

Background

In August 2004, the Authority decided that "Option 2" was the most appropriate model for the enduring offtake arrangements, in the event of DN sales proceeding. This view was subsequently endorsed by the Authority at its January 2005 meeting in which it granted its conditional consent to DN sales proceeding. Under this approach, appropriately incentivised DNs will book National Transmission System (NTS) exit capacity in the same way as shippers that arrange for the offtake of gas in respect of sites directly connected to the NTS. It is currently envisaged that the NTS will undertake the first long term allocation of exit capacity and flow flexibility under the proposed

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[1] *National Grid Transco – Potential sale of network distribution businesses, Agency and Governance Regulatory Impact Assessment,* Ofgem, April 2004; *National Grid Transco – Potential sale of network distribution businesses, Allocation of roles and responsibilities between transmission and distribution networks Regulatory Impact Assessment,* Ofgem, April 2004; *National Grid Transco – Potential sale of gas distribution network businesses, Offtake arrangements Regulatory Impact Assessment,* Ofgem, June 2004 *National Grid Transco – Potential sale of gas distribution network businesses, Interruption arrangements Regulatory Impact Assessment,* Ofgem, June 2004; *National Grid Transco – Potential sale of gas distribution network businesses Final Impact Assessment,* Ofgem, November 2004.

[2] See *National Grid Transco – Sale of gas distribution networks, Authority decision, Transco plc applications to dispose of four gas distribution networks,* Ofgem, February 2005. Ofgem also noted that Transco also applied for consents under Paragraph 3 of Schedule 3 to the Gas Act 1986 (the Gas Act) to permit it to dispose of land (relating to the four relevant gas networks) that it has acquired compulsorily, to the four relevant wholly owned subsidiary companies. The Authority consented to these applications at its meeting on 20 January 2005.

enduring offtake arrangements in September 2005. Under the current proposals, rights allocated through this process would relate to the gas year commencing 1 October 2008. Therefore, it is envisaged that for the period from hive-down of the four relevant DNs from Transco to its four relevant wholly owned subsidiary companies (1 May 2005) through to the start of the enduring arrangements (30 September 2008), interim offtake arrangements will apply to both the NTS and DNs, as described in the Final Impact Assessment (Final IA).[3]

The proposed interim offtake arrangements are different in many respects from the proposed enduring arrangements and yet still reflect a divested industry structure. As such, the implementation of these arrangements will require the specification of interim incentive arrangements.

Objectives

In addition to Ofgem's statutory objectives and the statutory duties of gas transporters (GTs)[4], there are a number of objectives that are specific to the interim incentive schemes that apply to the proposed interim offtake arrangements.

Ofgem's considers these to be:

- to ensure that the NTS has incentives to make available to users the full physical capacity of the network;
- to ensure that the NTS has an incentive to buy back NTS exit capacity[5] in order to relieve network constraints in an economic and efficient manner; and
- to provide incentives for the DNs to make efficient trade offs between requests for incremental NTS offtake capacity[6] and the use of DN demand management tools (including use of interruption).

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[3] *National Grid Transco – Potential sale of gas distribution network businesses Final Impact Assessment,* Ofgem, November 2004.
[4] As outlined in Appendix 1.
[5] For the purposes of this paper, the "bundled" product offered to NTS direct connects in the interim is referred to as "NTS exit capacity". The separate capacity and flexibility products offered to the DNs are named "NTS offtake (flat) capacity" and "NTS offtake (flexibility) capacity". This is consistent with the terminology adopted in the current drafting of the Uniform Network Code (UNC). In addition, for the purposes of this document, all the products described above will be generally termed "NTS exit rights".
[6] NTS offtake rights include NTS offtake (flat) rights and NTS offtake (flexibility) rights.

NTS interim incentives

For the NTS, Ofgem proposes to retain most aspects of the current exit incentive scheme in the interim, but also to establish a "buy-back" facility, recognising that in the interim arrangements, NTS connectees (i.e. both DNs and shippers representing other NTS direct connects) will have unconstrained access to NTS exit capacity (subject to statutory and licence obligations on Transco). The proposed NTS interim incentive scheme therefore has the following key elements:

- ♦ a combined buy back and interruption greater than 15 days incentive;
- ♦ a constrained LNG incentive; and
- ♦ a charges foregone and exit investment incentive.

DN interim incentives

As part of the process of amending Transco's GT licences[7] to facilitate the proposed sale of the DNs, Ofgem proposes that the current DN incentives (defined for the target level of the cost of curtailing DN offtakes for greater than 15 days) are removed, and instead replaced by a new interim incentive scheme taking into account the value of incremental requests for NTS offtake (flat) rights and NTS offtake (flexibility) rights and costs of interruption greater than 15 days. Each DN should be subject to individual targets, caps and collars, for the duration of the interim period.

Way forward

Ofgem welcomes views on all aspects of this consultation, to be received by close of business on 5 April 2005.

Following consideration of respondents' views to this document, Ofgem intends to publish Final Proposals for these interim incentive arrangements in April 2005. This

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[7] Prior to DN sales, Transco held only one GT licence and all gas transportation assets owned by Transco were operated pursuant to this licence. In November 2004, in connection with DN sales, the Authority granted five additional GT licences to Transco. The new licences were largely identical to the original Transco GT licence. On 1 February 2005, the Authority issued a direction modifying each of Transco's six GT licences so that the original Transco GT licence relates to the NTS only; four of the new additional GT licences relate respectively to the four DNs to be disposed of and one of the new additional GT licences relates only to the four DNs to be retained by Transco.

document will include a final consultation on proposed licence amendments necessary to implement these proposals.

Table of contents

1. Introduction

Purpose of this document

1.1. This document sets out Ofgem's initial proposals on the scope, form and duration of the incentive schemes necessary to support the interim offtake arrangements in the event that the proposed sale of one or more of Transco's distribution networks (DNs) proceeds. This follows the Gas and Electricity Markets Authority's (Authority's) decision on 20 January 2005 to grant its conditional consent to Transco plc's (Transco) applications to dispose of certain DN assets to four wholly owned subsidiary companies, currently intended to take place on 1 May.

1.2. As noted in the November 2004 Final Impact Assessment (Final IA)[8], offtake arrangements have been proposed for both the long term (i.e. "enduring" arrangements from 1 October 2008 onwards) and the short term, "interim" period (i.e. arrangements proposed for adoption from the date of hive down, currently planned for 1 May 2005) until 30 September 2008.

1.3. This document outlines Ofgem's initial proposals on the incentives that should be applied to Transco's National Transmission System (NTS) and the DNs (both Transco's Retained DNs (RDNs) and the Independent DNs (IDNs)) to support the interim offtake arrangements.

1.4. As noted in the Final IA, Ofgem has proposed that the interim offtake arrangements should, to a large extent, be based upon existing arrangements. Ofgem therefore proposes retaining the scope and form of the existing NTS incentives for the interim period, to the extent that they remain appropriate in the context of interim offtake arrangements.

1.5. This document is structured as follows:

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[8] *National Grid Transco – Potential sale of gas distribution network businesses, Final Impact Assessment,* Ofgem, November 2004.

- Chapter 2 provides background to the proposed NTS and DN interim incentive schemes, including an outline of the DN sales process to date, and a summary of Transco's current exit incentives;
- Chapter 3 describes the proposed offtake arrangements (interim and enduring) that would be implemented, in the event that DN sales proceed;
- Chapter 4 describes Ofgem's initial proposals for the interim incentive schemes for the NTS and the DNs; and
- Chapter 5 describes the proposed way forward, including a summary of views invited, and next steps.

Views invited

1.6. Ofgem welcomes views on all aspects of this consultation, to be received by close of business on 5 April 2005. Respondents are asked to provide views in a timely manner. Responses should be addressed to:

Sonia Brown

Director, Transportation

Office of Gas and Electricity Markets

9 Millbank

London SW1P 3GE

(Telephone: 020 7901 7412)

1.7. Electronic responses may be sent to **matteo.guarnerio@ofgem.gov.uk** Respondents are free to mark their reply as confidential, although Ofgem would prefer, as far as possible, open responses that can be placed in the Ofgem library. Ofgem would also prefer that non-confidential responses are sent electronically so that they can be placed on the Ofgem website.

1.8. If you wish to discuss any aspect of this paper, Matteo Guarnerio (telephone 020 7901 7493) or Mark Feather (telephone 020 7901 7437) would be pleased to help.

Consultation code of practice

1.9. If respondents have comments or complaints about the way this consultation has been conducted these should be sent to:

Michael Fews

Head of Licensing

Office of Gas and Electricity Markets

9 Millbank

London SW1P 3GE

(Telephone: 020 7901 7085)

Michael.fews@ofgem.gov.uk

Related consultation documents

1.10. On 10 February 2005, Ofgem issued a consultation document[9], which outlined its Initial Thoughts on the incentive schemes to support the enduring offtake arrangements, to apply from 1 October 2008. Following consideration of respondents' views to this document (and consistent with the Authority's decision to give its conditional consent), Ofgem intends to publish initial proposals for the incentive schemes (including proposed incentive parameters) in Spring 2005.

Way forward

1.11. Following consideration of respondents' views to this document (and consistent with the Authority's recent decision to grant its conditional consent to Transco's application to dispose of four of its DNs), Ofgem intends to publish Final Proposals for the interim incentive schemes (including a formal consultation under section 23 of the Gas Act on the proposed licence modifications necessary to implement these proposals) in April 2005.

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[9] *National Grid Transco - Potential sale of gas distribution network businesses. Initial thoughts on enduring incentive schemes supporting the offtake arrangements*, Ofgem, February 2005.

1.12. In issuing this document it is important to make clear that after the Authority's decision in relation to DN sales on 20 January 2005, there can be no expectation on the part of NGT, Transco, potential shippers, suppliers, DN purchasers or any other interested parties as to any further decisions which the Authority may be required to take or any further consents which the Authority may be required to grant (including for the avoidance of doubt any decisions or consents which may be necessary pursuant to a condition precedent or a condition subsequent attached to the consents granted by the Authority on 20 January 2005) in relation to DN sales. The information in this document is not binding on the Authority. Nothing in this document is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion will not be fettered by any statements made in this document.

2. Background

2.1. This Chapter sets out the regulatory background relevant to the development of the proposed incentive schemes. It presents an overview of:

- the regulatory process to date associated with Transco's proposed sale of DNs[10]; and
- Transco's current incentives, particularly those relating to exit arrangements.

DN sales process

2.2. In May 2003, Transco publicly announced that it would consider the sale of one or more DNs, were this to maximise shareholder value. Any such sale would require the consent of the Authority, the Health and Safety Executive (HSE) and the Secretary of State for Trade and Industry).

2.3. In July 2003, Ofgem issued a consultation document on the regulatory, commercial and operational changes that would be required in order to protect the interests of customers in a divested industry structure.[11] Following this consultation, in December 2003, Ofgem issued a Next Steps document.[12] This provided an overview of the responses received in relation to the July consultation, and set out Ofgem's views following consideration of the responses and a proposed way forward for considering Transco's proposals including the establishment of workgroups to take forward the development of a commercial and regulatory framework (including the development of appropriate offtake arrangements).

2.4. The remainder of this section provides an overview of the key elements of this process, including:

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[10] Full details of the regulatory process associated with Transco's DN sales and copies of all documents published by Ofgem can be found in the gas distribution networks sale area of work on Ofgem's website (http://www.ofgem.gov.uk).
[11] *National Grid Transco – Potential sale of network distribution businesses, A Consultation Document.* Ofgem, July 2003.
[12] *National Grid Transco – Potential sale of network distribution businesses 70/03. Next steps.* Ofgem, December 2003.

- role of workgroups;
- Regulatory Impact Assessments (RIAs);
- conditional agreements between National Grid Transco plc (NGT) and purchasers in respect of the DNs proposed to be sold[13]; and
- recent developments, including the Authority's decision to grant conditional consent to DN sales.

Workgroup processes

2.5. In January 2004, Ofgem established a number of workgroups as part of the consultation process for DN sales. These included a Development and Implementation Steering Group, a Commercial Interfaces Workgroup, a Regulatory Architecture Workgroup and an Agency Workgroup.

2.6. These groups, which have been chaired by Ofgem (and conducted on a non-binding informal basis without in any way fettering the Authority's discretion), are composed of a diverse representation of interested parties including shippers, customers, potential buyers of the DNs and NGT. The groups have made considerable progress in clarifying the way in which a divested industry model could operate were sales to proceed (and subject to any necessary licence modifications). In particular, the groups have provided a significant contribution to the development of the proposed offtake arrangements.

2.7. These workgroup discussions have highlighted, amongst other issues, the importance of developing effective and well targeted financial incentive schemes on the NTS and DNs as part of the development of the commercial and regulatory framework necessary to protect the interests of customers in a divested industry structure.

[13] Note that in this document, references to NGT and Transco have been used interchangeably.

Regulatory Impact Assessments

2.8. Between April and June 2004, through a series of RIAs, Ofgem consulted upon the regulatory, commercial and operational arrangements necessary to protect customers within a divested industry structure. These included:

- Agency and Governance Arrangements RIA, published in April 2004;
- Allocation of Roles and Responsibilities between Transmission and Distribution Networks RIA, published in April 2004;
- Offtake Arrangements RIA, published in June 2004; and
- Interruption Arrangements RIA, published in June 2004.

2.9. Following consideration of the responses from industry participants, and other interested parties, decision documents detailing the Authority's conclusions with respect to these issues were published. The conclusions regarding the "Agency and Governance" and "Roles and Responsibilities" RIAs were issued in May 2004[14], and those relating to the Interruption and Offtake arrangements in August 2004[15]. It was made clear that, in reaching these conclusions, there could be no expectation on the part of any interested party (including without limitation, NGT, Transco, potential purchasers, shippers, suppliers and other interested parties) either as to the Authority's final decision in relation to the proposed sale of DNs, or as to the regulatory, commercial and operational framework which may be implemented if the Authority consents to the proposed sale of DNs.

2.10. Ofgem has also published a number of (non-binding) open letters and preliminary position papers relating to various aspects of the proposed regulatory arrangements[16]. In September 2004, Ofgem published a position paper outlining

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[14] *National Grid Transco – Potential sale of gas distribution network business, Allocation of roles and responsibilities between transmission and distribution networks,* Ofgem, May 2004, 119/04 and *National Grid Transco – Potential sale of gas distribution network business, Agency and governance arrangements,* Ofgem, May 2004 120/04.

[15] *National Grid Transco – Potential sale of gas distribution network business, Offtake arrangements, Conclusions document on framework,* Ofgem, August 2004, 199/04 and *National Grid Transco – Potential sale of gas distribution network business, Interruptions arrangements, Conclusions document on framework,* Ofgem, August 2004 198/04.

[16] Copies of all open letters published by Ofgem relating to the DN sales process can be found in the gas

an initial view that any incentive scheme that will apply to the DNs will, at the commencement of the scheme, have a duration of one year. In that document, it was noted that this would provide Ofgem, the new DN owners and interested parties with the opportunity to reconsider the target levels of costs of the schemes at a relatively early stage and in light of further information arising from the first year of operation of the scheme.

Conditional agreements between NGT and purchasers

2.11. On 31 August 2004, NGT announced that it had reached agreement on the sale of four DNs[17], and informed Ofgem that it had entered into conditional agreements of sale, with the following prospective purchasers:

- a consortium led by Cheung Kong Infrastructure Holdings Ltd including United Utilities plc which agreed to purchase the North of England DN;
- a consortium led by the Macquarie European Infrastructure Fund which agreed to purchase the Wales & West DN; and
- a consortium comprising Scottish and Southern Energy plc, Borealis Infrastructure Management Inc and Ontario Teachers Pension Plan which agreed to purchase the South of England and Scotland DNs.

2.12. In its statement, NGT indicated that these transactions were subject to certain regulatory consents and approvals including those required from the Authority, the Secretary of State of Trade and Industry (Secretary of State) and the Health and Safety Executive (HSE). In addition, the statement highlighted that the proposed transactions would raise a potential £5.8 billion for NGT.

Recent developments

2.13. Following the release of the Authority's conclusions document regarding the offtake arrangements RIA and the interruptions arrangements RIA, NGT, Ofgem

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distribution networks sale area of work on Ofgem's website (http://www.ofgem.gov.uk).
[17] National Grid Transco statement, *Sale of four gas distribution networks and proposed £2 billion one off return of capital to shareholders,* 31 August 2004.

and other interested parties began to develop the detail of the proposed reform. Among other things, this programme has involved:

- the establishment of a Uniform Network Code (UNC) Workgroup (chaired by NGT), which considered the potential changes required in relation to Transco's network code and the development of a UNC; and
- the establishment of an Exit Reform Forum (chaired by NGT), with the objective of further developing the details of potential reforms to the exit arrangements.

2.14. The remainder of this section describes a number of additional important recent developments. These include:

- the publication of a Final IA in November 2004;
- the Authority's decision regarding grant of conditional consent in January 2005;
- the publication of a document outlining Ofgem's initial thoughts on the NTS and DN incentive schemes required to support the enduring offtake arrangements in February 2005;
- the publication of an Initial Thoughts document on the proposed restructuring of Transco's original GT licence and its five additional GT licences in November 2004; and
- the publication of a formal Section 8AA and associated Section 23 consultation in February 2005.

Final Impact Assessment

2.15. In November 2004, Ofgem published a Final IA[18], which set out:

- a proposed alternative regulatory, commercial and operational framework to the status quo, which would be necessary to protect the

[18] *National Grid Transco, Potential sale of gas distribution network businesses, Final Impact Assessment.* Ofgem, November 2004, 255/04a.

interest of consumers were the sale of DNs to proceed. This framework built upon each of the decisions set out in previous RIAs; and

- Ofgem's analysis of the estimated potential costs and benefits that customers are likely to accrue in the event that the proposed sale of the DNs proceeds.

2.16. Ofgem invited views from interested parties on all aspects of the Final IA. Summaries and full copies of responses to the Final IA were provided to the Authority in order to inform their decision on DN sales.

Licensing documents

November 2004 licensing document

2.17. In November 2004[19], Ofgem issued a licensing document setting out Ofgem's initial thoughts on the restructuring of Transco's original GT licence and five additional GT licences (granted to Transco as part of the proposed sale of its DNs[20]). This document included a formal consultation under Section 23 of the Gas Act to modify Transco's GT licences, and a Section 8AA informal consultation.

2.18. The modifications under Section 23 were limited to conditions relating to Transco's price control, and were designed to separate the price control between Transco's six GT licences.

2.19. The document also consulted (on an informal basis) on some of the substantive licence changes that would be required to support Transco's proposed divestment of its DN businesses so that customers' interests are protected within a divested industry structure.

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[19] *National Grid Transco, Potential sale of gas distribution network business, Initial thoughts on restructuring of Transco plc's gas transporter licences*, Ofgem, September 2004 215/04.
[20] In November 2004 (pursuant to applications from Transco in connection with DN sales), without fettering the Authority's discretion in relation to DN sales, five additional GT licences were granted to Transco. As a result, Transco currently holds six GT licences. On 1 February 2005, the Authority issued a direction modifying each of Transco's six GT licences so that the original GT licences relates to the NTS only; four of the new additional GT licences relate respectively to the four DNs to be disposed of and one of the new additional GT licences relates only to the four DNs to be retained by Transco.

February 2005 licensing document

2.20. On 12 January 2005, the Authority received an application from Transco under Special Condition 25A of each of four of six gas transporter (GT) licences currently held by Transco and under section 8AA of the Gas Act 1986 (the Act). This application sought consent from the Authority to transfer (in connection with NGT's proposal to sell four of Transco's local gas DNs) the four relevant DN GTs licences.

2.21. On 14 February 2005 Ofgem issued a document formally consulting on the Authority's proposal to grant such consent to Transco and on the changes proposed as part of the:

- **section 8AA** process for the four relevant DN GT licences that NGT is proposing (as part of DN sales) to transfer from Transco to the four relevant wholly owned Transco subsidiary companies; and
- **associated section 23** process to modify the two NTS and RDN GT licences, which will continue to be held by Transco after DN sales.

2.22. Some of the changes consulted upon through the Section 23 and Section 8AA process were modifications to Transco's existing licence conditions in order to ensure that these conditions are suitable to protect the interests of customers within a divested industry structure. In addition, the Authority proposed to introduce a number of new licence conditions into each of Transco's six GT licences to reflect the need for the creation of new obligations that are not currently covered, and which are necessary to protect the interests of customers in a divested industry structure.

Grant of Authority consent

2.23. On 20 January 2005, the Authority met to consider Transco's application to dispose of DN assets to four wholly owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers.

2.24. At its meeting of 20 January 2005 the Authority:

- granted its conditional consent to Transco's applications under Amended Standard Condition (ASC) 29 of its original GT licence and Paragraph 3 Schedule 3 to the Gas Act;

- endorsed the previous decisions that it had reached in 2004 regarding the regulatory, commercial and operational framework that would be necessary to protect the interests of customers in the event that the sale of one or more DNs proceeds; and

- concluded that its consent should be granted subject to certain conditions.

2.25. The Authority's decision on Transco's requests was arrived at having had due regard to its statutory objective and duties as well as its public law duties. In addition, the Authority took into account the statutory and licence obligations of gas transporters.

2.26. In considering the regulatory, commercial and operational framework, the Authority endorsed the continued development of the enduring offtake arrangements for the allocation of NTS exit capacity and NTS exit flow flexibility through the DN sales process and concluded that the proposed arrangements were reasonable and proportionate to protect the interest of customers. However, the Authority also concluded that the implementation of the enduring offtake arrangements[21] need not occur prior to the completion of the DN sales transaction. Instead, the Authority decided that customer interests would be protected so long as the enduring offtake arrangements were implemented by September 2005.

2.27. In order to achieve the implementation of the enduring offtake arrangements by September 2005, the Authority has imposed certain conditions to its consent that must be met before Transco can be permitted to hive down its DN assets to its wholly owned subsidiary companies, scheduled to occur on 1 May 2005.

[21] Chapter 3 provides a more detailed description of the proposed enduring offtake arrangements.

2.28. For the period following hive down and share sale the Authority intends to propose a number of licence conditions on Transco and DNs relating to the implementation of the enduring offtake arrangements.

Enduring offtake arrangements – conditions to consent

2.29. The first of the conditions to consent relating to the enduring offtake arrangements is that Transco must procure an undertaking addressed to the Authority from NGT, specifying that NGT will, prior to the proposed section 8AA (and related section 23) licence modifications to the six Transco GT licences becoming effective, use its best endeavours to ensure that steps are taken to implement the enduring offtake arrangements by 1 September 2005. [22]

2.30. The second of these conditions is that Transco must secure undertakings addressed to the Authority from each proposed third party purchaser, specifying that, prior to the completion of the sale of shares to the new purchaser, such purchaser will use its best endeavours to ensure that steps that are taken to implement the enduring offtake arrangements by 1 September 2005.

Enduring offtake arrangements - proposed licence conditions

2.31. In order to cover the period following hive down and the subsequent sale of shares in the DNs to the new purchasers, the Authority has proposed a number of licence conditions on Transco and each DN regarding the implementation of the enduring offtake arrangements

2.32. These proposed licence conditions, if implemented, would be binding upon Transco and each of the DNs and require them to use their best endeavours to implement the enduring offtake arrangements by 1 September 2005.

2.33. The Authority has also proposed, as part of the licence condition binding upon Transco, an obligation upon it to procure from NGT an undertaking to the Authority that it will use its best endeavours to ensure that Transco implements the enduring offtake arrangements by 1 September 2005.

[22] The enduring offtake arrangements are described in chapter 5 of Ofgem's Final IA.

2.34. Further, the Authority has proposed, as part of the licence conditions binding upon each independent DN, an obligation requiring it to procure an undertaking addressed to the Authority from its ultimate controller that it will use its best endeavours to ensure that the relevant independent DN implements the enduring offtake arrangements by 1 September 2005.

2.35. The proposed licence modifications are being consulted upon as part of the Section 8AA and associated Section 23 licence modification proposals to Transco's six GT licences.[23]

2.36. It is important to note that there can be no expectation on the part of NGT, Transco, DN purchasers, potential shippers, suppliers or any other interested parties as to any further decisions which the Authority may be required to take or any further consents which the Authority may be required to grant in relation to the proposed transaction and nothing in this document in any way fetters the discretion of the Authority in respect of this or any other matter.

Separate interim incentives schemes – application of conditions of consent

2.37. As part of the conditions to consent, the Authority imposed a series of conditions, which provide that Transco cannot sell the shares in its four wholly owned subsidiary companies without the Authority's prior consent. In addition, the conditions provide that Transco shall consent to any licence modifications and implement any other regulatory, commercial or operational changes following hive down that the Authority considers are necessary in order to ensure that the proposed sales transactions are implemented in a manner that ensures that the interests of customers are protected.

2.38. These conditions are considered necessary given that Ofgem intends to issue a Section 23 notice in May 2005 to modify the NTS and DN licences to, amongst other things, incorporate interim incentive schemes following the scheduled hive down date. Further, it is necessary for the Authority to retain control over the share sale given that other issues may arise through the detailed development of

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[23] *National Grid Transco – Potential sale of gas distribution network businesses. Formal consultation under section 23 and section 8AA of the Gas Act 1986*, Ofgem, February 2005

the regulatory, commercial and operational arrangements that have not yet been anticipated and addressed.

Initial thoughts on enduring incentives

2.39. In February 2005, Ofgem published an Initial Thoughts document on the form, scope and duration of the enduring incentive schemes for the NTS and DNs (i.e. those that will apply from 1 October 2008).[24]

2.40. This document outlined Ofgem's initial thoughts on a range of issues in relation to these incentives. In particular, the document presented:

- a range of options for the determination of baselines for both NTS exit capacity and exit flow flexibility;
- a description of NTS enduring incentives relating to the provision of incremental capacity in the long run (including the description of incentives that could apply in the event that incremental capacity is delivered through investment or through substitution);
- medium and short term NTS incentives (relating to the allocation of NTS exit capacity and NTS exit flow flexibility in constrained allocations), designed to provide the NTS with incentives to release additional NTS exit capacity and NTS exit flow flexibility which becomes available and to buy back NTS offtake rights in an efficient manner; and
- enduring DN incentive schemes, designed to mitigate a potentially rational tendency for the DNs to overbook NTS exit capacity and NTS exit flow flexibility.

Consultation on network code arrangements

2.41. Ofgem has recently issued an open letter giving interested parties the opportunity to comment on the detailed industry code proposals to support a divested industry structure with multiple gas transporters. This consultation brought together three key streams of work, namely:

- Transco plc's (Transco) Modification Proposal 0745, which proposes to modify Transco's Network Code into an individual ("short form") network code that incorporates by reference the UNC;[25]

- The UNC itself, which has been prepared by Transco in consultation with shippers and potential purchasers of the gas distribution networks (DNs); and

- The proposed GT licence conditions which support this, namely Standard Special Conditions A11, A12 and A15.[26]

2.42. As part of this consultation, Ofgem has provided for comment a copy of Transco's draft UNC.

Transco's current incentives

2.43. Since 1 April 2002, Transco has been subject to a set of System Operator (SO) incentives that encourage Transco to reduce the costs associated with the day-to-day management of its gas transportation system. In addition, Transco has been subject to a set of NTS SO capacity investment incentives which provide Transco with financial incentives to invest in the NTS, where it is efficient to do so, and in response to its customers' changing needs.

2.44. Targets and parameters for the current incentives have been defined up to and including 2006/07. In order to ensure consistency with the duration of the interim offtake arrangements (up to 30 September 2008), new targets and parameters for the existing incentive schemes that will be retained will need to be defined for the remaining two formula years which are not included in the current incentive schemes (2007/08 and 2008/09).

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[24] *National Grid Transco – Potential sale of gas distribution network businesses: Initial thoughts on enduring incentive schemes supporting the offtake arrangements*, Ofgem, February 2005.
[25] Transco submitted Urgent Modification proposal 0745 to Ofgem on 23 February 2005. Ofgem granted urgency status on 25 February 2005. Urgent Modification proposal 0745 is currently being progressed in accordance with Transco's Network Code modification rules, using a parallel but separate process to this consultation process.
[26] National Grid Transco – Potential sale of gas distribution network businesses, Formal consultation under section 23 and section 8AA of the Gas Act 1986, Ofgem, February 2005, 45/05.

2.45. As the proposed incentive schemes supporting the interim offtake arrangements retain most aspects of the current exit incentive scheme, this section provides an overview of the current NTS exit SO incentives. In addition, it provides a brief description of the NTS entry capacity buy-back incentive, which is of relevance for the proposed buy-back interim incentive scheme on the NTS.

Exit incentive

2.46. The exit incentive schemes, as described in Transco's original GT licence, are designed to ensure that Transco operates its NTS and DN networks in a manner consistent with its statutory duties and licence obligations. These obligations include the requirement to develop and maintain an efficient and economical pipeline system and the obligation to operate the NTS in an economic, efficient and coordinated manner.

2.47. Under the current exit arrangements Transco is incentivised in four key areas:

- a foregone charges incentive;
- an interruptible incentive;
- a Liquefied Natural Gas (LNG) - related incentive; and
- an exit investment incentive.

2.48. Table 2.1 outlines the targets and parameters of the current exit incentive scheme specified in Transco's original GT licence.

Table 2.1 Incentive targets (2005/06 – 2006/07), £m

Component	2005/06	2006/07
Foregone charges	37.2	37.9
15 day interruption	1.59	1.68
Constrained LNG	6.6	6.6

2.49. With the exception of the cost of constrained LNG, all of the components of the exit incentive arrangements are currently subject to a single cap and collar and to common sharing factors.

2.50. In February 2004, Ofgem reviewed Transco's exit incentive regime parameters, and made a number of proposals relating to the level of parameters that should apply to the exit incentive scheme for the period 2004/05 to 2006/07. As a result of the review, the parameters of the scheme were amended. Table 2.2 sets out these parameters.[27]

Table 2.2 Incentive parameters (2004/05 – 2006/07)

Cap and collar (£m)		Sharing factors	
Cap	**Collar**	**Upside**	**Downside**
1	-1	50%	25%

Foregone charges

2.51. This element of the current exit incentive scheme is based upon the revenues foregone by Transco as a result of its existing interruption discounts. In exchange for agreeing to be interrupted by Transco up to 45 days per year, shippers serving interruptible supply points do not pay exit capacity charges in respect to those supply points. Ofgem refers to these foregone charges as the "interruptible discount".

2.52. There is a target set within Transco's original GT licence for the level of these "foregone charges". Transco is then exposed to a proportion of the difference between this target level and actual foregone charges across the NTS (including the NTS charges foregone in respect of interruptible customers on the LDZs).

Interruptions incentive

2.53. Transco may call an interruption in the event of network capacity constraints, supply demand balancing on high demand days, in an emergency or for testing purposes. Where Transco nominates a supply point to be interrupted for more than 15 days in a particular year (up to the maximum permitted which is usually 45 days), there is a transportation charge credit.

[27] Note that the LNG-related incentive was defined separately to these incentives, with Transco facing a 100% sharing factor (both upside and downside) and with no caps and collars specified.

2.54. Under the second element of the current exit incentive schemes, Transco is set a target cost related to interruption, based on the expectation of the costs it will be deemed to have incurred in procuring interruption of interruptible sites in excess of 15 days in a given year.

2.55. Under this incentive, Transco is exposed to a proportion of the difference between actual level of costs incurred and the target level, giving Transco an incentive to use interruption efficiently.

LNG-related incentive

2.56. The third element of the current exit incentive schemes relates to the use of LNG facilities. Transco is set a target for the cost of using constrained LNG storage, and is exposed to the difference between actual costs and this target, thereby incentivising the efficient use of LNG.

2.57. When originally developing the exit incentive schemes, Ofgem considered that Transco's incentives could be distorted by its ownership of LNG storage facilities that can function as an alternative to interruption[28]. In particular, increases in the price and/or volume of its use of LNG over forecast levels, as an alternative to using interruption, could result in increased revenues to Transco LNG.

2.58. If the sharing factors and caps and collars outlined above were also applied to LNG costs, Transco SO would only bear a proportion of such higher costs. The remainder would be then recovered in whole (or in part) by higher transportation charges levied on shippers and eventually borne by customers.

2.59. In order to avoid such a perverse outcome, no cap or collar was specified with regard to the cost of Transco procuring transmission support from the LNG facilities (with Transco therefore facing a 100% exposure to the LNG costs incurred).

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[28] *Transco's National Transmission System Review of System operator incentives 2002-7, Proposals Document,* February 2004.

Exit investment incentive

2.60. The final aspect of the exit incentive schemes rewards Transco for investing efficiently to meet its customer requirements. Under its exit capacity investment incentive Transco is allowed additional revenues associated with delivering network capacity in excess of the baseline firm and interruptible output measures.

2.61. Where Transco provides additional exit capacity above the baseline measure, it is allowed additional revenue equal to the volume of additional capacity provided multiplied by the exit unit cost multiplier. The exit unit cost multiplier is comprised of the exit capacity UCA (0.322£m/GWh day) multiplied by the exit capacity adjustment factor (0.10772) and adjusted for inflation. If Transco provides a lower level of capacity than the baseline measure, no additional revenue is allowed. Note that this incentive, since February 2004, is also subject to the caps, collars and sharing factors outlined for the overall exit incentives, as described in Table 2.2.

3. Proposed offtake arrangements

3.1. This Chapter describes the NTS offtake arrangements that have been proposed for implementation in the event of DN sales proceeding. In doing this, arrangements are considered for both:

- the short term, "interim" period (i.e. arrangements proposed for adoption from 1 May 2005 until 30 September 2008); and
- the long term (i.e. "enduring" arrangements).

3.2. Given that this consultation document describes Initial Proposals for the incentive schemes supporting the *interim* offtake arrangements for the NTS and the DNs, this Chapter focuses on outlining the proposed *interim* offtake arrangements. In order to provide additional background, this Chapter also provides a brief description of the proposed enduring offtake arrangements (and the associated proposed incentive schemes). Note that these are described in more detail in the February 2005 enduring incentives document.

Interim arrangements

3.3. As outlined in the Final IA, in the event that DN sales proceeds, Transco plans to hold the initial long term (unconstrained) allocation of NTS offtake rights later this year. It is planned that this auction will sell annual strips of offtake rights for the period from 1 October 2008 onwards.[29]

3.4. As such, it is proposed that the "enduring arrangements" for the allocation of offtake rights will not apply to the period from 1 May 2005 up to 30 September 2008. In these timescales, it will generally not be possible for the NTS to undertake physical investment to increase the available level of offtake rights. Accordingly, "interim arrangements" have been developed that will determine how exit rights from the NTS will be allocated to NTS connectees in this period.

3.5. The interim arrangements outlined in this section relate to:

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[29] The length of investment lead times may be reconsidered by Ofgem before or during the NGT price control review, and may evolve over time.

- NTS exit capacity and NTS offtake (flat) capacity;
- NTS offtake (flexibility) capacity;[30] and
- interruptible access to the NTS;

NTS exit capacity and NTS offtake (flat) capacity

3.6. The Final IA describes the underlying principles for the allocation of offtake capacity during the interim arrangements. Consistent with these principles, the current Uniform Network Code (UNC) drafting outlines in more detail the current proposals for the interim offtake arrangements.

3.7. For each of the years in the interim period (1 May 2005 – 30 September 2008), the DNs have been allocated an amount of NTS offtake (flat) capacity for each offtake point consistent with each DN's 1 in 20 obligation. These allocations are provided in Appendix 2, for reference.

3.8. In order to ensure that Transco makes maximum use of exit capacity without introducing artificial constraints, Transco proposed making capacity available, annually, to DNs and NTS direct connects on an **unconstrained** basis (subject to consistency with its statutory and licence obligations).

3.9. For DNs, Transco will facilitate an annual release of additional offtake rights. Through this process, the DNs will be able to request changes to their level of offtake rights. To the extent that the request for additional offtake rights cannot be delivered through the existing network, the NTS will establish whether this can be facilitated economically and efficiently through the use of (or contracting for) additional demand management tools including with other NTS connectees (e.g. tendering for the buy back of exit capacity, according to agreed procurement guidelines).[31]

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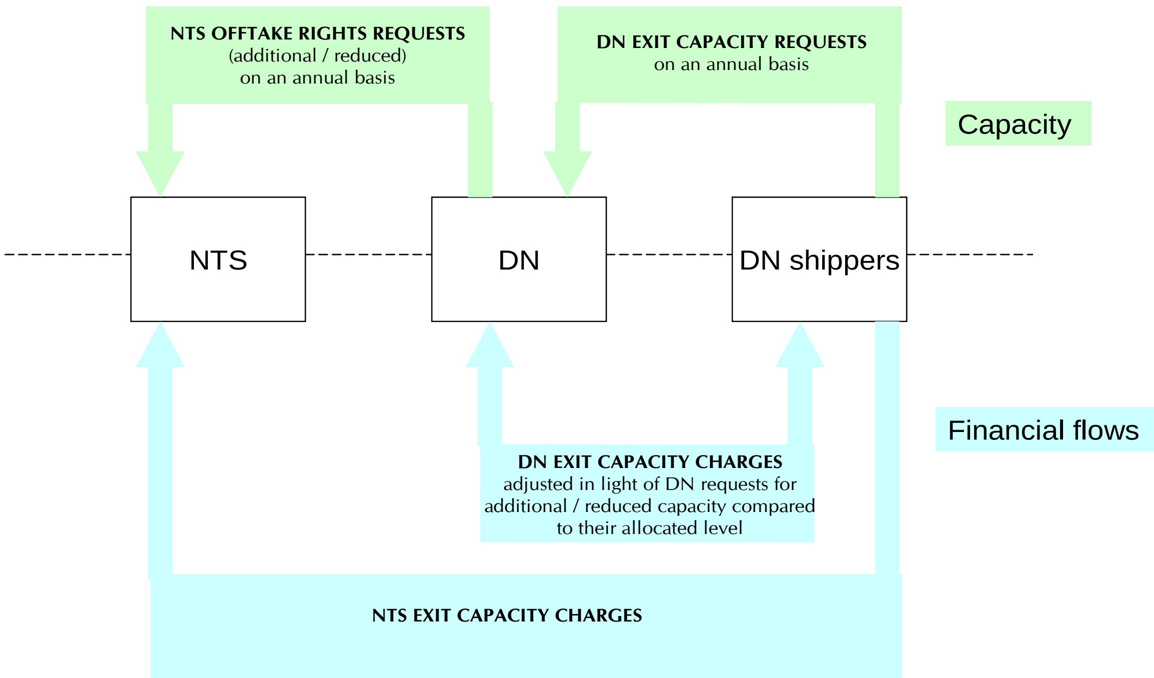
[30] For the purposes of this paper, the "bundled" product offered to NTS direct connects in the interim is referred to as "NTS exit capacity". The separate capacity and flexibility products offered to the DNs are named NTS offtake (flat) capacity" and "NTS offtake (flexibility) capacity". This is consistent with the terminology adopted in the current drafting of the Uniform Network Code (UNC). In addition, for the purposes of this document, all the products described above will be generally termed "NTS exit rights".
[31] Note that the process followed for the release of additional offtake rights is described in the Incremental Exit Capacity Release (IExCR) Statement.

3.10. The key difference for directly connected NTS customers will be that the NTS will be required to meet all requests for additional NTS exit capacity (subject to statutory and licence obligations). This includes requests by customers that are currently interruptible to hold firm rights.

3.11. Payment flows will effectively remain as now for the duration of the interim period. This means that DNs will not make any payments directly to the NTS, either for the initial allocation of capacity rights, or for the release of additional capacity rights. Instead, shippers representing DN connected customers will make payments directly to the NTS. Shippers conveying gas over DNs will continue to pay DN exit capacity charges to the DN. In addition, incentive payments to (from) the DN will be made through adjustments to DN exit capacity charges.[32]

3.12. Figure 3.1 describes the payment flows outlined above with respect to DNs and the process of requesting exit capacity in the interim period.

Figure 3.1 Interim DN payment flows and exit capacity requests



[32] Chapter 4 outlines in more detail the interaction between payment flows and interim DN incentive schemes.

Flow flexibility

3.13. For the duration of the interim period, it is proposed that DNs will be allocated an amount of NTS offtake (flexibility) capacity (for each offtake point,) consistent with each DN's 1 in 20 obligation. This holding of NTS offtake (flexibility) capacity will allow each DN to profile their offtake of gas from the NTS over the day (rather than requiring DNs to offtake gas from the NTS at the flat offtake rate implied by their holding of NTS offtake (flat) capacity).

3.14. As is the case with NTS offtake (flat) capacity, DNs will be able to request increases (or decreases) in their allocation of NTS offtake (flexibility) capacity on an annual basis. This will enable DNs to trade off the use of NTS offtake (flexibility) with the use of demand management tools and, to an extent limited by lead times, with additional DN investment.

3.15. For shippers serving directly connected customers, access to flow flexibility from the NTS will remain substantially as now (i.e. be bundled with firm offtake rights), with the key change being that offtake rights will be available for shippers serving directly connected NTS sites on an unconstrained basis subject to statutory and licence obligations.

Interruptible access to the NTS

3.16. In the interim, current shippers' interruption arrangements will be largely maintained, apart from that (as described above) all NTS directly connected interruptible sites will have the right to apply for the sites to become firm should they so wish in the interim period. This is consistent with the requirement for the NTS to release capacity on an unconstrained basis in the interim, subject to statutory and licence obligations.

3.17. It is proposed that the NTS will therefore retain the right to interrupt those NTS interruptible sites that choose to retain interruptible status, consistent with the terms of their current contracts. The NTS will also be able to request DNs to "turn down" offtake at NTS/DN offtake points, up to the level of volume of interruptible offtake the DN makes available at each NTS/DN offtake point.

Enduring arrangements

3.18. This section briefly describes the enduring arrangements that have been proposed for implementation in the event that DN sales proceed. These are consistent with those initially proposed in the Offtake Arrangements and Interruptions arrangements RIAs published in June 2004, the Offtake Arrangements and Interruptions conclusions documents published in August 2004, the Final IA (published in November 2004), and most recently presented in the initial thoughts document on enduring incentive schemes.

3.19. As part of this process, Transco held a number of industry meetings and also issued a consultation document.[33] This consultation process was undertaken, among other things, to invite views on the drafting of the business rules relating to the enduring offtake arrangements

3.20. As outlined in the Final IA[34], the proposed offtake arrangements would be required to ensure that the previously internalised interface between the NTS and the DNs is externalised in a manner consistent with GT statutory duties and licence obligations, including providing access to all network users on a basis which is not unduly discriminatory.

3.21. The arrangements outlined in this section relate to:

- NTS exit capacity;
- Interruptions arrangements; and
- NTS flow flexibility.

NTS exit capacity

3.22. As described in more detail in Ofgem's Initial Thoughts document on enduring incentive schemes, the Authority considered "Option 2" to be the most appropriate approach to defining the interface between the NTS and parties connected to the NTS.

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[33] *Towards a new industry framework*, Transco, December 2004
[34] Chapter 5, page 65.

3.23. As explained in the Final IA, the key features of the "Option 2" approach are:

- DNs estimate the level of NTS exit capacity they believe necessary to meet their (DN specific) 1 in 20 obligation;
- shippers serving NTS direct connects (i.e. sites connected to the NTS other than DNs) estimate the level of NTS exit capacity they require at NTS offtake points of the customers to whom they convey gas;
- DNs and shippers serving other NTS direct connects use these estimates as the basis for the NTS exit capacity requests they submit to the NTS;
- NTS exit capacity requests, by both DNs and shippers of other NTS direct connects, are submitted to the NTS in investment planning timescales (i.e. relating to three years ahead and beyond);
- the NTS is required to deliver the level of NTS exit capacity requested at each NTS offtake point by DNs and NTS direct connect shippers;
- shippers that have customers connected to DNs submit DN exit capacity requests to DNs (by daily metered site and non daily metered zone) similar to the current arrangements at the DN level; and
- DNs deliver the level of DN exit capacity requested by DN shippers.

3.24. In terms of payment flows, Ofgem considers that an "Option 2A" approach, as described in the Offtake Arrangements RIA is the most appropriate option. Under this approach, DNs have a central role in the payments process, effectively acting as an intermediary for all NTS-related payments from DN shippers who convey gas to customers offtaking from the DNs. This approach was considered most appropriate as, under this model, payment flows are relatively simple, minimising the number of payment interfaces between shippers and network owners.

3.25. Two additional elements which are key to the definition of the NTS offtake rights under the new arrangements are the locational scope and duration of these arrangements. Following discussion of these issues at industry workgroup meetings, it was concluded that NTS offtake rights:

- should be defined by individual offtake point (i.e. follow a nodal approach). Under this approach, trading of offtake rights between participants would also be possible, facilitated by the NTS; and

- should be grouped into annual strips. It is anticipated that by bundling rights by year, the initial allocation of rights should deliver investment signals to the NTS regarding the level of peak offtake users require in any year. Furthermore, bundling the rights into "annual strips" is expected to make the initial allocation process more simple and transparent than less aggregated product "bundles".

Interruptions arrangements

3.26. The proposals for interruptions arrangements, in the event of DN sales proceeding, are that:

- current arrangements for interruption of NTS directly connected sites will be reformed (amongst other things, giving Transco and NTS connectees greater flexibility in contracting for demand management);

- the NTS will offer an interruptible product on a day-ahead basis. Any user of the NTS will be able to apply to purchase this product should they so wish. This will give Transco the right, but not the obligation, to provide capacity to that user on the day; and

- interruptions arrangements at the DN level will not be reformed as part of the DN sales process.[35]

NTS exit flow flexibility

3.27. Under the proposed enduring offtake arrangements, consistent with the Authority's view described in the Final IA, NTS exit flow flexibility would be allocated on a commercial basis, and would be a product sold by the NTS to DNs and shippers on behalf of directly connected NTS customers.

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[35] It is noted that a review of DN interruption arrangements is currently planned for 2006, outside of the DN sales timetable.

3.28. Under the proposed arrangements, NTS exit flow flexibility:

- is defined in terms of usage over the period 06:00 to 22:00;
- is independent of holding of NTS exit capacity; and
- is defined as being used whenever offtake of gas deviates from a flat 1/24th profile over the day.

3.29. In addition, under the proposed offtake arrangements, operational flow requirements will be managed by the NTS through the purchase and sale of NTS exit capacity and NTS exit flow flexibility products. The NTS will therefore (for example) be required to buy back NTS exit flow flexibility rights if it wishes to curtail the use of exit flow flexibility in the course of operating its network.

Proposed enduring incentive arrangements

3.30. This section provides a brief description of Ofgem's initial thoughts on enduring incentives (to be implemented at the same time as the enduring offtake arrangements, i.e. applying from 1 October 2008).[36] Enduring incentive arrangements will be defined for the:

- NTS; and
- DNs (both RDNs and IDNs)

NTS enduring incentives

3.31. In the February 2005 consultation on enduring incentive schemes supporting the enduring offtake arrangements, Ofgem considered that the high level objectives of the NTS incentive schemes should be:

- to ensure that the NTS has incentives to deliver the full physical capability of the network;

[36] For more details, see *National Grid Transco – Potential sale of gas distribution network businesses. Initial thoughts on enduring incentive schemes supporting the offtake arrangements.* Ofgem, February 2005.

- to ensure that the NTS has sufficient funds within the price control period to undertake appropriate incremental investment (in response to enduring demand signals); and

- to ensure that the NTS has an incentive to buy back NTS offtake rights in order to relieve network constraints in an efficient and economic manner.

3.32. Ofgem's initial thoughts for the proposed scope, form and duration of incentive schemes were set out for:

- the long term;

- the medium term; and

- the short term.

3.33. The long term incentive schemes relate to the sale of NTS offtake rights three years ahead and beyond. Consistent with the arrangements at entry, Ofgem proposed that revenue from the sale of rights up to baseline[37] levels is treated as transmission asset owner (TO) revenue (with requests for NTS exit capacity and NTS exit flow flexibility above baseline being termed requests for "incremental NTS exit capacity" and "incremental NTS exit flow flexibility").

3.34. Ofgem's initial view was that, for the long term, the NTS incentive schemes should have two distinct revenue streams:

- **incremental NTS exit capacity and NTS exit flow flexibility provided by investment**. Ofgem considered that, should the NTS decide to meet demand for incremental capacity and/or flow flexibility, then it should retain incremental SO auction revenue for a five year (rolling) period based on a fixed rate of return (set at the relevant cost of capital – i.e. currently 6.25%) on the nodal Unit Cost Allowance (UCA). Meeting demand for incremental NTS exit capacity and/or NTS exit flow

[37] Note that the document outlining Ofgem's initial thoughts on enduring incentive schemes consulted on the most appropriate approach to adopt in calculating NTS exit capacity and NTS exit flow flexibility baselines and also provided indicative baseline data for NTS exit capacity under a range of different calculation methodologies.

flexibility in this manner will eventually result in a (permanent) increase in baselines at the relevant offtake point. In addition, Ofgem's initial view was that, similar to the entry arrangements, a test of "sustained demand" is incorporated into the arrangements (this is proposed to be a simplified version of the test in place at entry), and should be a check of whether requests for incremental demand exist for at least three years; and

♦ **incremental NTS exit capacity and NTS exit flow flexibility release provided by substitution**. Ofgem's initial view was that, should the NTS decide to meet requests for incremental capacity at any given offtake point through substituting spare capacity from other offtake points, the NTS should be allowed to retain a proportion of the resulting auction revenue. Ofgem considered that changes to baselines resulting from substitution should only occur following the long term allocation process (and not following medium or short term allocations). In addition, Ofgem's initial view was that the NTS should retain incentive revenue for only one year, and that the incentive revenue received by Transco through this mechanism should be a percentage (50%) of the auction revenue received for the sale of incremental NTS exit capacity and/or NTS exit flow flexibility. At least initially, Ofgem considered it appropriate to place a cap on the maximum level of incentive payments that may be earned by the provision of incremental NTS offtake rights through substitution.

3.35. In the February 2005 Initial Thoughts document, Ofgem proposed that parameters for offtake rights incentives should be specified for five years (from the start of the enduring arrangements), consistent with NTS entry incentives.

3.36. Medium and short term incentives (i.e. those that relate to the allocation of NTS exit capacity and NTS exit flow flexibility in constrained allocations) were also proposed for the NTS.

3.37. Under the proposed arrangements, the NTS would be allowed to retain a percentage of the receipts of all sales of offtake rights sold above baseline subsequent to the three year ahead auction process. Revenue from the sale of rights up to baseline would be treated as TO revenue (consistent with arrangements at entry). The cost of any NTS offtake right buy-backs should be included within the scope of this incentive scheme. In terms of the form of the medium/short term NTS incentive scheme, Ofgem's initial preference was for a sliding scale set of incentives, with a cap and collar set around a target (set with reference to expected costs of buy backs) and symmetric sharing factors.

DN enduring incentives

3.38. Unlike the NTS enduring incentive schemes, the DN incentives are primarily designed to remove a potentially rational tendency for the DNs to overbook NTS exit capacity and NTS exit flow flexibility.

3.39. Ofgem has proposed a single incentive mechanism for the enduring DN incentive schemes. Ofgem considered that the structure of the enduring DN incentives should follow a standard "sliding scale" form, with a defined incentive cost target and a cap and collar. Under these proposals, the incentive payment / charge made to the DNs through these incentive schemes would be the difference between the "target" and "actual" level of charges for NTS offtake rights, subject to a sharing factor.

3.40. Ofgem's initial view therefore was that the cost performance targets defined for NTS exit capacity and NTS exit flow flexibility should be calculated as follows, for each DN (over the period 2008/09 to 2012/13):

- expected volume of NTS offtake rights; multiplied by
- expected price of these rights (which will vary by offtake point for the DN); plus
- the expected cost of greater than 15 day interruption of DN connectees.

3.41. The initial thoughts document on enduring incentive schemes, also outlined Ofgem's initial views, and invited consultation responses on:

- the most appropriate way of ensuring consistency between the enduring DN incentive schemes and the DN price control review;

- whether DN cost performance targets should be expressed in fixed monetary values, or whether the exit price and volume elements should be permitted to vary in line with actual exit prices, and demand growth respectively;
- whether it is appropriate to express DN caps and collars in terms of a percentage of the cost performance target; and
- the proposed duration of the enduring DN incentive schemes.

4. Proposed interim incentive schemes

4.1. As described in the previous Chapter, under the current proposals, it is envisaged that the NTS will undertake the first long term allocation of exit capacity and flow flexibility under the proposed "enduring" offtake arrangements in September 2005. The rights allocated through this process will relate to gas year commencing 1 October 2008. Therefore, for the period from hive-down of the four relevant DNs from Transco to four wholly owned Transco subsidiary companies (currently planned for 1 May 2005) through to the start of the enduring arrangements (1 October 2008), interim offtake arrangements (described in detail in Chapter 3) will apply to both the NTS and DNs.

4.2. The interim offtake arrangements differ in many respects to the proposed enduring arrangements, yet still reflect a divested industry structure. As a consequence, a different set of incentive schemes to those developed for the enduring arrangements will be required for the interim period.

4.3. This chapter defines Ofgem's initial proposals on the scope, form and duration of these interim incentive schemes for both:

- the NTS; and
- the DNs.

NTS interim incentives

4.4. As more fully described in Chapter 3, Ofgem has proposed that the interim offtake arrangements should, to a large extent, be based upon existing arrangements. Ofgem therefore considers it most appropriate for the proposed interim NTS incentive schemes to be based upon those which are currently in place.

4.5. The remainder of this section describes:

- the scope of the current NTS exit incentive schemes; and
- the scope of the proposed NTS interim exit incentive schemes.

Scope of the current NTS exit incentive schemes

4.6. The current NTS exit incentive schemes are designed to ensure that Transco operates its network in a manner consistent with its statutory duties and licence obligations. In particular, these obligations include the requirement to develop and maintain an efficient and economical pipeline system. The schemes provide Transco with an incentive to operate its network over the short and long term in a manner consistent with the interests of customers.

4.7. As described more fully in Chapter 2, the current schemes provide incentives for the NTS in four key areas. These are:

- a **foregone charges incentive**, designed to give Transco NTS an incentive to reduce the charges foregone as a result of the interruptible "discount" applied to shippers agreeing to have interruptible sites interrupted by the NTS for up to 45 days per year;
- an **interruptions incentive** on Transco NTS under which it is required to make additional payments in respect of supply points that it interrupts in excess of 15 days per year;
- an **LNG-related incentive**, designed to give Transco NTS an incentive to efficiently trade-off interruption and/or investment with its use of constrained storage facilities; and
- an **exit investment incentive**, which allows Transco NTS additional revenues associated with exceeding the baseline output measures set out within its GT licence.

Scope of the proposed NTS interim exit incentive schemes

4.8. To ensure consistency with the current price control, Ofgem proposes retaining the scope and form of the existing NTS incentives for the interim period, to the extent that they remain appropriate in the context of the interim offtake arrangements. Ofgem considers this will continue to provide Transco with incentives both to operate the NTS in a manner consistent with the interests of customers while also facilitating a smooth transition to a divested industry structure.

4.9. However, Ofgem does consider that some changes to the current scope of NTS incentives will be required in order to accommodate the proposed changes to the industry structure as a result of DN sales. The key addition to the current incentives is that of a facility through which the NTS will have an incentive to buy back firm capacity rights as efficiently as possible.

4.10. This recognises that, under the proposed interim offtake arrangements, the NTS will be required to make NTS offtake rights available to both DNs and shippers representing other NTS direct connects on an unconstrained basis (subject to statutory and licence obligations). Ofgem considers that a buy-back facility is therefore required that will define both the expected level of the cost of any buy-backs, and the extent to which the NTS and customers bear the risk that the actual level of the cost of buy-backs to the NTS differs from that expected.

4.11. Ofgem therefore proposes that in the interim period, three separately specified incentive schemes will apply to the NTS:

- a buy back and greater than 15 day interruption incentive;
- a constrained LNG incentive; and
- a foregone charges and exit investment incentive.

4.12. This set of incentives is designed to encourage Transco NTS to manage efficiently and trade off between tools at its disposal to manage the use of the system and mitigate constraints.

4.13. It is important to note, however, that current incentive schemes are only specified through to the end of the current price control period (i.e. up to 2006/07). As a consequence, there is a need to specify targets for 2007/08 and 2008/09 (i.e. the first two years of the next price control period). Ofgem considers this necessary in order to give the NTS a degree of certainty as to the form of incentives it will face for the duration of the interim period. It is noted, however, that all NTS incentives may be reviewed at the time of the setting of the next price control.

Form of the interim NTS incentive schemes

4.14. As described in the previous section, Ofgem proposes that in the interim period, three distinct incentives will apply to the NTS:

- a buy back and greater than 15 day interruption incentive;
- a constrained LNG incentive; and
- a foregone charges and exit investment incentive.

Buy back and greater than 15 day interruption incentive

4.15. As outlined above, interim incentive schemes are required to give the NTS an incentive both to interrupt NTS connectees and buy back firm capacity rights as efficiently as possible. Ofgem proposes that these incentives are defined in a single (combined) mechanism. In addition, Ofgem proposes that this incentive is specified in a standard "sliding scale" form. Under this approach, a target will be defined equal to the expected level of Transco's expenditure on the buy back of firm capacity rights and the cost of interrupting customers for more than 15 days. Deviations from this target level of incurred cost would then be shared between Transco NTS and customers, subject to a defined sharing factor, a cap and a collar.

Definition of incentive target

4.16. Transco has stated that the 1 in 20 firm capacity requirements for the NTS in the interim period, including anticipated growth, can be satisfied without any need for the buy back of capacity. In addition, Transco has stated that, other than for a small number of cases, it would anticipate that the NTS would have sufficient spare capacity to accommodate all requests from NTS direct connects moving from being interruptible to firm. Transco has also stated that this would not require a corresponding increase in the interruption of customers connected to the DNs.

4.17. As a consequence, Ofgem proposes that the target for the buy back element of this incentive is set at **zero** for each year of the interim arrangements. This implies that Ofgem does not anticipate Transco being required to undertake any buy back of capacity rights in the interim period (despite the NTS being required to meet requests for incremental exit capacity on an unconstrained basis in the interim period, subject to its statutory and licence obligations).

4.18. Consistent with the current NTS incentive arrangements Ofgem proposes that the target for the 15 day interruption element of the incentive is based upon current predictions of the costs associated with interrupting customers for more than 15 days per year (under their current interruptible contracts). The target for this cost for 2005/06 and 2006/07 is already contained within Transco's current licence. The cost targets defined for the remaining two years of the interim period have been calculated to be consistent with the methodology followed for defining growth forecasts in Transco's 10 year statement.[38] The proposed targets for the buy-back and interruption incentive over the interim period are presented in Table 4.1 below.

Table 4.1 Proposed targets for the buy-back and interruption incentive

	Year			
	05/06	**06/07**	**07/08**	**08/09**
Buy back target (£m)	0	0	0	0
Greater than 15 day interruption target (£m)	1.59	1.68	1.73	1.68
Target total (£m)	**1.59**	**1.68**	**1.73**	**1.68**

Definition of cap, collar and sharing factors

4.19. In discussions regarding the setting of cap, collar and sharing factor for this incentive, Transco has stated that buy back costs would only be incurred if a limited number of (currently interruptible) directly connected sites were to request firm exit capacity. Transco has estimated that the maximum cost of buy backs that could result from these customers switching to firm would be approximately £16 million per annum. Ofgem analysis of the customers who

[38] Note that this is based on a forecast increase in the level of interruption between 2006/07 and 2007/08 of 2.7%, and a forecast decrease in the level of interruption between 2007/08 and 2008/09 of 2.5%.

may choose to become firm and who are currently interruptible, suggests a figure between £5 million and £7 million for potential buy backs. Therefore, it is these figures that have been proposed for the collars on this incentive.

4.20. It is proposed that the cap for this incentive is set equal to the greater than 15 day interruption target. Accordingly, this target will set the limit on the level of potential upside that Transco will face.

4.21. Ofgem proposes including two options for caps, collars and sharing factors in the Initial Proposals consultation document. These are:

- ♦ **Option 1**. Under this alternative, the cap reflects expected interruptible costs (i.e. £1.59m in 2005/06) and the collar is based upon the potential costs of buy-backs. Under this option, sharing factors are relatively high.
- ♦ **Option 2**. In this alternative, the cap is the same as in Option 1, but is combined with a relatively deeper collar, and relatively lower sharing factors (compared to Option 1).

4.22. These options are described in Table 4.2 below:

Table 4.2 Parameters for buy back and interruption incentive

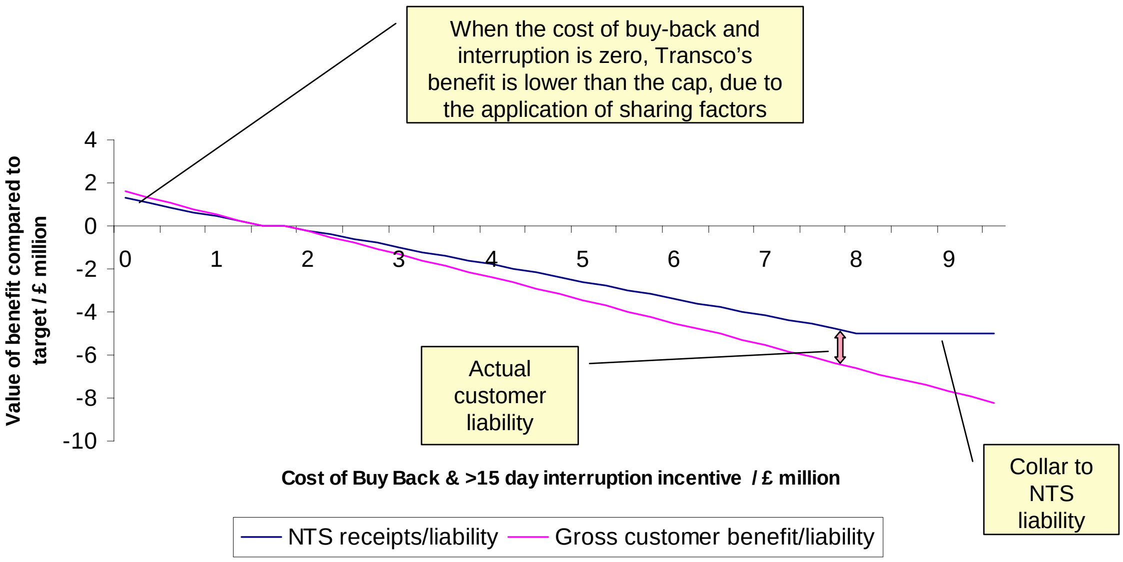
Applicable to 2005/06 to 2008/09	**Cap and Collar (£m)**		**Sharing factors**	
	Cap[39]	Collar	Upside	Downside
Option 1	1.59	-5	80%	75%
Option 2	1.59	-7	75%	50%

4.23. Ofgem considers that both of these options will give an appropriate balance of risk and reward for customers and for Transco's shareholders. Respondents' views are invited on the scope and form of the proposed buy back and 15 days interruption incentive. In particular, views are invited on the most appropriate combination of caps, collars and sharing factors that should apply to the NTS.

[39] It is proposed that the cap is set equal to the target level of interruptible cost in each year of the incentive.

4.24. For illustration, Figure 4.1 below represents the proposed structure of the buyback and interruption greater than 15 days under the parameters defined for option 1 above for the year 2005/06.

Figure 4.1 Illustration of the buyback and Interruption greater than 15 days incentive (under Option 1 for year 2005/06)



4.25. As illustrated in Figure 4.1, if Transco incurs zero interruption and buy back costs in 2005/06, then it will retain £1.27m in incentive payments under Option 1 (i.e. 80% of the specified cap of £1.59m). In the event that the combined cost of interruption and buy back is at the target level of £1.59m, then no incentive payments will be made or received by Transco. Should these costs exceed £1.59m, then Transco will bear 75% of these, up to the "collar" level of £5m. Customers will therefore bear 25% of the costs incurred over target level (up to the collar level), and 100% of the incremental costs incurred by Transco once the collar has been reached.

4.26. Respondents' views are invited on the proposed scope, form and duration of the buy back and interruption greater than 15 days incentive. In particular, views are welcomed on whether the Option 1 or Option 2 combination of parameters would be most appropriate for this incentive.

This means that the cap will differ for each year of the incentive, consistent with the "Target Total" data

Constrained LNG incentive

4.27. Ofgem proposes that the form of the existing incentive for constrained LNG (CLNG) is retained in the interim period. Targets and incentive parameters for this incentive have already been defined for the duration of the current price control period, hence only new targets for 2007/08 and 2008/09 are proposed to be defined as part of the interim incentives.

4.28. The proposed CLNG incentive targets for 2007/08 and 2008/09 are set out in Table 4.3 below. Ofgem proposes that the final targets for the CLNG incentive are set at a level equal to the expected level of cost Transco will incur in its use of LNG for constraint management purposes. At this stage, our analysis has indicated that this cost will lie within a range, as set out in Table 4.3. The principle driver behind the range concerns the uncertainty of expected deliveries from storage facilities into the system on the 1 in 20 peak day in constrained locations. The lower bound assumes that storage facilities at these constrained locations, other than LNG storage facilities, capable of relieving a constraint will deliver gas from store at their published maximum rate on the 1 in 20 peak day. The higher figure assumes no deliveries onto the NTS are expected from such storage facilities on the 1 in 20 peak day.

4.29. Ofgem is carrying out further analysis before presenting Final Proposals, but would like to take into account views from respondents on whether storage facilities other than LNG should be expected to be delivering gas onto the NTS at their published maximum rate on the 1 in 20 peak day in the absence of a contract with Transco to deliver at such rates on the day in question.

Table 4.3 Targets for CLNG incentive

	05/06	06/07	07/08	08/09
Target (£m)	6.6	6.6	1.57 – 2.6	1.03 – 2.1

presented in Table 4.1.

4.30. Ofgem proposes retaining the current parameters for the CLNG incentive[40], which are contained in the following table.

Table 4.4 Parameters for CLNG incentive

	Cap and Collar (£m)		Sharing factors	
	Cap	Collar	Upside	Downside
Applicable to 2005/06 to 2008/09	N/A	N/A	100%	100%

4.31. Respondents' views are invited on the proposed scope and form of the CLNG incentive.

Charges foregone incentive and exit investment incentive

4.32. As described above, this incentive is a feature of the current price control, and it is proposed to extend the duration of this incentive to the end of the interim period. As a consequence, there is a need to specify targets for 2007/08 and 2008/09 (i.e. the first two years of the next price control period).

4.33. Two alternatives for the specification of targets for these two years are proposed in this Initial Proposals consultation document, as outlined in Table 4.5:

♦ **Option 1**, the "rollover" of existing licence targets through to the end of the interim arrangements; and

♦ **Option 2**, a "revision" approach, which is a continuation of the current targets through to 2006/07, with an increase in targets for the remainder of the interim period reflecting the rise in NTS exit capacity charges of 8.9% planned for April 2005. The revised targets under this option

[40] It is noted that when developing the incentive schemes, Ofgem considered that Transco's incentives could be distorted by its ownership of LNG storage facilities that can function as an alternative to interruption. In particular, increases in the price and/or volume of its use of LNG over forecast levels, as an alternative to using interruption, could result in increased revenues to Transco LNG. If the sharing factors and caps and collars outlined above were also applied to LNG costs, then Transco SO would only bear a proportion of such higher costs. The remainder would be recovered in whole (or in part) by higher transportation charges levied on shippers and eventually borne by customers. In order to avoid such a perverse outcome, no cap and collar was specified with regard to the costs of Transco procuring transmission support from the LNG facilities (with Transco therefore facing a 100% exposure to the LNG costs incurred).

include a forecast increase in interruptible load of 2.7% from 2006/07 to 2007/08 and a forecast 2.5% decrease in interruptible load from 2007/08 to 2008/09.[41]

Table 4.5 Targets for charges foregone incentive

	Year			
	05/06	**06/07**	**07/08**	**08/09**
Option 1 "Rollover" (£m)	37.2	37.9	37.9	37.9
Option 2 "Revision" (£m)	37.2	37.9	42.3	41.2

4.34. As with the current arrangements, any appropriate additional revenue accruing through the exit investment incentive revenue driver will be added to the charges foregone target.

4.35. It is proposed to retain the current, relatively limited, cap and collar parameters, presented in Table 4.6 below.

Table 4.6 Parameters for charges foregone and exit investment incentive

	Cap and Collar (£m)		**Sharing factors**	
	Cap	Collar	Upside	Downside
Applicable to 2005/06 to 2008/09	1	-1	50%	25%

4.36. Respondents' views are invited on the proposed scope and form of the charges foregone and exit investment incentive. In particular, views are invited on the most appropriate option ("rollover" or "revision") for the calculation of the charges foregone targets for 2007/08 and 2008/09.

[41] Note that this is consistent with the proposed targets for the cost of NTS interruptions for greater than 15 days, presented in Table 4.1.

Duration of the interim NTS incentive schemes

4.37. The incentive schemes supporting the interim offtake arrangements relate to the period 1 May 2005 to 30 September 2008. As noted before, the parameters for the current incentive schemes have been specified until 2006/07.

4.38. Consistent with the objective of retaining the current incentive schemes as far as is practical and with the period in which the interim offtake arrangements are due to operate, Ofgem proposes that the incentive scheme and parameters described above remain in place until 30 September 2008.

4.39. Respondents' views are invited on the proposed duration of the interim NTS incentive schemes.

Views invited

4.40. Views are invited on all aspects of the NTS interim incentive schemes outlined in this section, and in particular, regarding Ofgem's initial proposals on:

- ♦ the proposed options for the parameters of the buy back and 15 day interruption incentive;
- ♦ the proposed options for the parameters of the charges foregone and exit investment incentive;
- ♦ the proposed parameters for the CLNG incentive; and
- ♦ the proposed scope, form and duration of the NTS interim incentives.

DN interim incentives

4.41. This section outlines Ofgem's proposals for the incentives that will relate to the DNs for the interim period.

4.42. Accordingly, the remainder of this chapter describes the:

- ♦ objectives of the interim DN incentive arrangements; and
- ♦ scope, form and duration of the proposed arrangements.

Objectives

4.43. It is important that the proposed interim DN incentive scheme ensures that the interface between the NTS and DNs is operated in a manner consistent with GT statutory duties and licence obligations. In particular, these obligations include, without limitation, the requirements to provide non-discriminatory access to the pipeline system and to develop and maintain it in an efficient and economical manner. The arrangements should therefore provide the DNs with an incentive to operate in a manner consistent with customers' interests.

4.44. In the context of the proposed interim offtake arrangements, it is also of key importance that the proposed interim incentive schemes for the DNs are designed to mitigate a potentially rational tendency for the DNs to overbook NTS offtake (flat) capacity and NTS offtake (flexibility) capacity in the interim period, as without appropriate incentives, DN shippers would bear the full cost of all additional NTS offtake rights requested by the DNs.

4.45. Ofgem considers that the objectives of the DN interim arrangements should be:

- **to incentivise the DNs to meet their 1 in 20 obligation in an efficient manner, given the nature of the interim offtake arrangements**: during the interim period, the DNs will be able to amend their allocation of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity through an annual process. The incentive arrangements should therefore allow the DNs to meet their 1 in 20 obligation through an efficient balance of contracting for NTS offtake rights and interruption on their own networks; and

- **to allow a smooth transition to the proposed enduring DN incentive scheme**: as far as is possible, Ofgem considers that the interim DN incentive schemes should be consistent with the proposed enduring DN incentives. By drawing on the proposed enduring DN incentive regime when designing the interim DN incentives, Ofgem considers that this should help to minimise disruption which may be felt by the DNs in moving onto the enduring incentive arrangements from 2008 onwards.

Scope, form and duration of the proposed schemes

4.46. The proposals for interim DN incentive schemes are described below in terms of:

- scope;
- form; and
- duration.

Scope

4.47. As part of the process of amending Transco's GT licences to facilitate the proposed sale of the DNs and ensure that customers' interests are protected, DN incentives were removed from Transco's GT licence as part of the Section 23 process in February 2005.[42] Ofgem has proposed that these incentives be replaced by a set of new incentives that will apply to each DN, for the duration of the interim period (i.e. until 30 September 2008).[43]

4.48. As noted above, from the start of the proposed interim offtake arrangements (1 May 2005) until the start of the enduring offtake arrangements (1 October 2008), DNs have been allocated a level of both NTS offtake (flat) capacity and NTS offtake (flexibility) capacity consistent with their 1 in 20 obligation. These allocated levels of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity, proposed for inclusion in the cost performance targets, are included in Appendix 2. As described in Chapter 3, DNs will also be able to request (on an annual basis) additional exit capacity and flexibility (which they may wish to do, for example, in order to satisfy unexpected growth in DN offtakes).

4.49. As such, Ofgem considers that DNs should face an incentive that enables them to trade-off the cost of additional NTS exit capacity (and flexibility) with the cost of increased interruption of DN connectees. Ofgem would therefore expect that, to satisfy increases in DN offtake, DNs will select the least cost alternative, be

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[42] *Section 23 Direction: Modification of the price control conditions in each of Transco plc's six gas transporter licences*, Ofgem, February 2005

[43] *National Grid Transco, Licensing: Next Steps.* Ofgem, November 2004, 263/04

this through the use of demand management tools, or the booking of additional NTS exit capacity and/or flexibility.

4.50. The scope of the interim DN incentive arrangements will therefore differ from that of the enduring regime for two key reasons:

- firstly, given investment lead times, there will only be limited scope for DNs to trade-off the cost of investment in their own networks with the cost of securing NTS offtake rights and/or DN demand management contracts; and

- secondly, under the proposed interim arrangements, DNs will already have an allocation of NTS exit capacity and offtake flexibility for the interim period (agreed between the DNs and the NTS as being consistent with the DNs' 1 in 20 obligation).

4.51. In order to deliver a scheme capable of incentivising DNs to trade-off efficiently requests for additional NTS offtake (flat) capacity and NTS offtake (flexibility) capacity and contracting for interruption in the interim period, Ofgem proposes designing a single incentive mechanism for each DN for the duration of interim offtake arrangements. This requires the specification of a single cost performance measure and target (for each DN) covering NTS offtake (flat) capacity, NTS offtake (flexibility) capacity and cost of interruption.

Form

4.52. Ofgem proposes that the DN incentive schemes are structured following a standard "sliding scale" form, with a defined incentive cost target and a cap and collar (similar to those proposed for the NTS incentive schemes). Deviations from this target level of incurred cost would then be shared between DNs and customers, and therefore subject to a defined sharing factor.

4.53. Ofgem proposes that cost performance targets are defined for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity for each DN (over the period 2005/06 to 2008/09) as follows:

- allocated volume of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity in each year; multiplied by

- prevailing (outturn) price for NTS offtake (flat) capacity and NTS offtake (flexibility); plus

- the expected cost of greater than 15 day interruption of DN connectees.

4.54. The volume component of these targets has therefore already been determined, having been agreed between NTS and DNs in the context of DN sales. The allocated levels of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity proposed for inclusion in the cost performance targets are included in Appendix 2.

4.55. A significant issue to be resolved through this consultation process is the most appropriate reference price to use in the definition of the cost performance target (and actual cost performance measure). As described previously in the context of the interim offtake arrangements, DNs will not make any payments to the NTS in the interim period. Accordingly, no prices will be defined for either NTS offtake (flat) capacity or NTS offtake (flexibility). However, prices for both of these forms of capacity will be necessary in order to translate the volumetric requests for incremental offtake capacity into incentive payments to/from the DNs.

4.56. For NTS offtake (flat) capacity, Ofgem proposes that annual NTS exit charges (defined on an LDZ charging zone basis in the interim period) are used as the most appropriate price element for calculating the cost performance target. This is because this price will be defined on an ongoing basis throughout the interim period (for the purpose of charging shippers who convey gas across the DNs).

4.57. However, the choice of reference price for NTS offtake (flexibility) capacity is more complicated. This is because, in the interim period, offtake flexibility will not be separately priced by the NTS. There are three main options for setting a price for flexibility for the purposes of specifying the DN incentive targets:

- **NTS exit charges**. Following this approach would mean assuming that the price for NTS offtake (flexibility) capacity is the same as for NTS offtake (flat) capacity. This would result in prices for flexibility varying significantly between DNs (given that charges for offtake of gas from the NTS are locational). A consequence of this may be that, where exit charge prices are low (e.g. Scotland), DNs may have an incentive to increase their use of flexibility and reduce directly substitutable activities, such as within DN gas storage facilities.

- **Incremental price of providing an additional unit of flow flexibility**. Transco has proposed that this could be derived from the additional cost of a new piece of pipeline.

- **Incremental price of providing storage in the DN network**. An alternative would be to specify a reference price directly linked to the cost of providing gas storage in the DN network.

4.58. Our initial proposal is that NTS offtake (flexibility) capacity should be priced at the same level as NTS offtake (flat) capacity (given that, in the interim period, directly connected customers will only be able to access additional flexibility of offtake through purchasing additional NTS exit capacity). However, it is noted that alternative approaches to pricing of flexibility may be adopted for the Final Proposals. Respondents' views are invited on the most appropriate reference price for offtake (flexibility) capacity.

4.59. Appendix 3 presents indicative targets for each DN based upon the methodology outlined above. Targets specified in this appendix are based upon forecast quantities (included in Appendix 2) and 2005/06 exit charges. NTS offtake (flexibility) capacity has been priced at the same level as NTS offtake (flat) capacity. Note that the level of actual annual targets would be adjusted each year in line with changes in actual NTS exit charges.

Definition of caps, collars and sharing factors

4.60. Ofgem's initial view is that caps and collars for DN cost performance measures should be calculated as a fixed percentage of each DN's cost performance target. This will mean that the absolute level of DN caps and collars will vary significantly across each network (for example being lower in Scotland than in the South West). Ofgem considers that this approach will reflect the locational nature of both exit charges and demand and would ensure that incentive schemes are accurately targeted across the network. Ofgem's initial view is that these caps and collars should be symmetric around defined targets.

4.61. Ofgem considers that the caps and collars defined for the DNs should be sufficiently broad so that the expectation is that they are not breached. The caps and collars included in these options have been set with reference to the potential for DN connected sites that are currently interruptible to switch to firm.

4.62. Sharing factors will also need to be defined when setting the incentive parameters for the interim DN incentives schemes. DNs will be trading off the cost of additional (or reduced) requests for offtake capacity with the cost of demand management tools (and, to a limited extent, investment in their own networks). Ofgem therefore proposes that relatively high sharing factors are specified in these schemes, given that DNs will face the full cost of the use of demand management tools and/or any investment in their own networks.

4.63. Ofgem proposes presenting two alternative options for incentive parameters, applicable to each DN in the interim period. These are presented in Table 4.7.

Table 4.7 Parameters for DN incentive schemes

	Cap and Collar (% of each DN target)		Sharing factors	
	Cap	Collar	Upside	Downside
Option 1	7.5%	-7.5%	100%	100%
Option 2	10%	-10%	75%	75%

4.64. Ofgem considers that both of these options will give an appropriate balance of risk and reward for customers and for the DNs. Respondents' views are invited on the most appropriate option for caps, collars and sharing factors in the interim DN incentive scheme.

Duration

4.65. Ofgem considers that the interim incentive schemes should be defined for the entire interim period (i.e. from 1 May 2005 to 30 September 2008). It may however be appropriate to review the incentive arrangements applying to the DNs in light of the reform of the interruption arrangements, planned for implementation in April 2006.

4.66. Ofgem would welcome views on the proposed duration of the DN interim incentive scheme.

Views invited

4.67. Views are invited on all aspects of the DN interim incentive schemes outlined in this section, and in particular regarding Ofgem's initial proposals on:

- the most appropriate reference price for offtake (flexibility) capacity;
- the most appropriate option for the definition of caps, collars and sharing factors in the DN interim incentive schemes; and
- the proposed scope, form and duration of the DN interim incentive schemes.

5. Way forward

5.1. This section outlines:

- ♦ a summary of views invited to this consultation; and
- ♦ next steps.

Summary of views invited

5.2. Ofgem invites views on all of the issues raised in this document, but in particular on:

- ♦ the proposed form, scope and duration of the NTS and DN interim incentive schemes;
- ♦ the proposed introduction of a buy-back element to the NTS interim incentive arrangements;
- ♦ the proposed options for parameters for the buy back and greater than 15 day interruption incentive;
- ♦ the proposed options for parameters for the charges foregone and exit investment incentive;
- ♦ the proposed form of the CLNG incentive;
- ♦ whether it is appropriate to express DN caps and collars in terms of a percentage of the cost performance target;
- ♦ the most appropriate reference price for NTS offtake (flexibility) capacity; and
- ♦ the most appropriate option for the definition of caps, collars and sharing factors in the DN interim incentive schemes.

Next steps

5.3. This document sets out Ofgem's initial proposals on the form, scope and duration of the NTS and DN incentive schemes supporting the interim offtake arrangements.

5.4. Following consideration of respondents' views to this document (and consistent with the Authority's recent decision to give its conditional consent to DN sales), Ofgem intends to publish Final Proposals for the interim incentive schemes (including a formal consultation under section 23 of the Gas Act on the proposed licence modifications necessary to implement these proposals) in April 2005.

Appendix 1 Objectives

1.1 This appendix sets out some of Ofgem's key statutory duties and policy requirements with respect to developing offtake, interruption and flexibility arrangements and the incentive schemes required to support a multi gas transporter environment. It is to be noted that these objectives are relevant to the definition of both interim and enduring incentive arrangements.

Objectives of the incentive schemes

1.2 Ofgem considers that both its principal objective and the general duties as set out in the Gas Act 1986 (the Act), as well as its general public administrative law duties, have direct relevance to the development of incentive schemes in a divested industry structure, as well as to the development of the form and content of the underlying offtake, interruptions and flexibility arrangements.

1.3 In addition to meeting Ofgem's statutory duties, the post-sale industry structure must also establish a relationship between the NTS, the RDNs and the IDNs that permits each network owner to fulfil its own statutory and licence obligations.

1.4 These include, without limitation:

- the duty of each GT to develop and maintain an efficient and economical pipeline system (Section 9(1)(a) of the Act);
- the duty of each GT to facilitate competition in the supply of gas (Section 9(1)(A) of the Act); and
- the duty of each GT to avoid any undue preference or undue discrimination in the terms on which it undertakes to convey gas (Section 9(2)(b) of the Act).

1.5 Further, and as set out in Amended Standard Condition 4D[44] of Transco's original GT licence, the GT has an obligation to ensure that it conducts its transportation business in a manner best calculated to secure that neither it nor

[44] If the modifications which are currently consulted upon will be approved, Amended Standard Condition 4D will become Standard Special Condition A6.

its affiliates or related undertakings, nor any gas shipper or supplier obtains any unfair commercial advantage, including, in particular, any advantage from a preferential or discriminatory arrangement.

1.6 A further licence condition relevant to this consultation document is the requirement for the GT to charge on a cost reflective basis. This is outlined in paragraph (5) (a) of Amended Standard Condition 4A[45] of Transco's original GT licence, which states that the GT must use a charging methodology that reflects the costs incurred by the licensee in its transportation business. In addition, the post-sale (divested) industry structure must be consistent with European law.

1.7 Finally, Special Condition 27[46] of Transco's original GT licence places an obligation on Transco to operate the NTS in an efficient, economic and coordinated manner. Without limitation, Ofgem considers this licence condition to be of direct relevance to the development of the incentive schemes. In particular, other than in exceptional circumstances, Ofgem would normally expect this obligation to be satisfied where Transco is responding to the commercial incentives in its incentive schemes. Nonetheless, this licence condition ensures that Transco's behaviour is appropriately constrained, for example:

- when its commercial incentives are not applicable such as when its revenues relating to one or more incentive schemes are either greater than the incentive cap or lower than the incentive collar; and
- where it is not subject to commercial incentives.

[45] If the modifications which are currently consulted upon will be approved, Amended Standard Condition 4D will become Standard Special Condition A5.
[46] If the modifications which are currently consulted upon will be approved, Amended Standard Condition 4D will become Standard Special Condition D5.

Appendix 2 Base allocations of (flat) capacity and (flexibility) capacity for interim period

		NTS Offtake (Flat) Capacity (GWh/d)			
DN	**LDZ Exit Zone**	**2005**	**2006**	**2007**	**2008**
SC	SC1	52.67	54.70	55.56	56.41
SC	SC2	65.36	68.38	71.83	73.26
SC	SC4	233.88	242.61	245.15	249.05
NofE	NO1	243.32	247.23	250.04	254.86
NofE	NO2	26.37	26.70	26.97	27.18
NofE	NE1	220.57	223.72	226.29	228.08
NofE	NE2	60.69	61.39	61.94	62.40
NW	NW1	335.28	340.13	347.80	348.01
NW	NW2	210.02	211.87	216.63	219.04
EofE	EA1	37.66	38.80	39.70	40.28
EofE	EA2	41.60	42.59	43.32	43.82
EofE	EA3	62.21	63.96	65.16	66.09
EofE	EA4	224.16	229.55	233.68	236.33
EofE	EM1	87.61	90.11	92.09	92.92
EofE	EM2	95.43	96.25	97.03	98.22
EofE	EM3	285.35	290.08	294.18	297.55
EofE	EM4	19.09	19.42	19.50	19.63
Lo	NT1	20.34	12.69	12.86	11.42
Lo	NT2	175.93	194.94	197.34	186.39
Lo	NT3	287.19	281.01	284.71	299.34
WM	WM1	74.90	76.17	77.52	80.48
WM	WM2	246.32	250.53	254.96	255.06
WM	WM3	129.59	131.79	134.14	134.67
W&W	SW1	36.49	37.69	38.26	38.72
W&W	SW2	157.03	162.17	164.62	166.65
W&W	SW3	90.86	93.83	95.24	96.72
W&W	WA1	51.71	52.92	53.94	54.81
W&W	WA2	187.30	190.82	193.68	195.98
SofE	SE1	412.86	416.30	419.01	421.10
SofE	SE2	107.71	108.81	109.67	110.19
SofE	SO1	114.77	116.37	116.54	121.22
SofE	SO2	280.67	286.44	297.99	298.56

		NTS Offtake (Flexibility) Capacity (GWh/d)			
DN	**LDZ Exit Zone**	**2005**	**2006**	**2007**	**2008**
SC	SC1	4.82	3.40	3.63	3.83
SC	SC2	7.26	7.60	7.97	8.12
SC	SC4	12.00	12.91	13.55	14.30
NofE	NO1	-1.04	-0.46	-0.03	0.69
NofE	NO2	2.57	2.61	2.64	2.65
NofE	NE1	7.64	5.58	9.86	10.59
NofE	NE2	0.61	0.22	0.31	0.37
NW	NW1	6.30	8.19	8.71	9.31
NW	NW2	8.32	8.45	8.74	8.79
EofE	EA1	5.08	5.25	5.36	5.45
EofE	EA2	5.62	5.76	5.86	5.92
EofE	EA3	-0.64	-0.36	-0.14	0.07
EofE	EA4	-1.00	-0.43	0.02	0.44
EofE	EM1	1.54	1.98	1.33	1.57
EofE	EM2	0.76	0.77	0.78	0.79
EofE	EM3	6.30	7.66	5.74	6.45
EofE	EM4	1.22	1.24	1.26	1.28
Lo	NT1	2.85	0.00	0.00	0.00
Lo	NT2	0.00	0.00	0.00	0.00
Lo	NT3	8.05	0.00	0.00	0.00
WM	WM1	1.44	1.61	1.81	1.74
WM	WM2	4.88	5.35	5.92	6.06
WM	WM3	-5.06	-4.86	-4.56	-4.13
W&W	SW1	1.76	1.99	2.09	2.18
W&W	SW2	4.13	4.54	4.73	4.92
W&W	SW3	3.87	4.62	4.96	2.81
W&W	WA1	0.00	0.00	0.00	0.00
W&W	WA2	0.00	0.00	0.00	-0.01
SofE	SE1	0.00	0.00	0.00	0.00
SofE	SE2	0.00	0.00	0.00	0.00
SofE	SO1	7.95	8.36	3.05	0.00
SofE	SO2	-1.21	-0.09	2.29	4.04

Appendix 3 Proposed indicative targets for interim DN incentives

DN	2005/06				2006/07				2007/08				2008/09			
	Offtake	Flex	Inter'tble. cost	Total target	Offtake	Flex	Inter'tble. cost	Total target	Offtake	Flex	Inter'tble. cost	Total target	Offtake	Flex	Inter'tble. cost	Total target
	(£m)				(£m)				(£m)				(£m)			
Scotland	*0.34*	*0.03*	*0.12*	**0.49**	*0.36*	*0.03*	*0.13*	**0.52**	*0.37*	*0.04*	*0.13*	**0.54**	*0.38*	*0.04*	*0.14*	**0.56**
North of England	*0.71*	*0.01*	*0.21*	**0.93**	*0.72*	*0.01*	*0.22*	**0.95**	*0.73*	*0.01*	*0.22*	**0.96**	*0.73*	*0.01*	*0.23*	**0.97**
North West	*15.95*	*0.42*	*0.07*	**16.44**	*16.15*	*0.48*	*0.08*	**16.71**	*16.51*	*0.5*	*0.08*	**17.09**	*16.59*	*0.52*	*0.08*	**17.19**
East of England	*21.63*	*0.44*	*0.81*	**22.88**	*22.09*	*0.52*	*0.84*	**23.45**	*22.46*	*0.49*	*0.86*	**23.81**	*22.71*	*0.53*	*0.93*	**24.17**
London	*25.94*	*0.66*	*0.05*	**26.65**	*25.95*	*0*	*0.05*	**26**	*26.29*	*0*	*0.06*	**26.35**	*26.44*	*0*	*0.06*	**26.5**
West Midlands	*11.92*	*0.02*	*0*	**11.94**	*12.13*	*0.04*	*0*	**12.17**	*12.34*	*0.07*	*0*	**12.41**	*12.43*	*0.08*	*0*	**12.51**
Wales and West	*34.81*	*0.72*	*0.18*	**35.71**	*35.75*	*0.83*	*0.19*	**36.77**	*36.3*	*0.88*	*0.2*	**37.38**	*36.78*	*0.65*	*0.2*	**37.63**
South of England	*51.11*	*0.33*	*0.11*	**51.55**	*51.84*	*0.44*	*0.12*	**52.4**	*52.85*	*0.33*	*0.12*	**53.3**	*53.27*	*0.29*	*0.12*	**53.68**