

Representation - Draft Modification Report 0550

Project Nexus: Incentivising Central Project Delivery

Responses invited by: **10 March 2016**

To: enquiries@gasgovernance.co.uk

Representative:	Hilary Chapman
Organisation:	Scotland Gas Networks and Southern Gas Networks
Date of Representation:	10 th March 2016
Support or oppose implementation?	Oppose
Relevant Objective:	f) Negative

Reason for support/opposition: Please summarise (in one paragraph) the key reason(s)

The Uniform Network Code is not the appropriate legal and contractual framework to utilise for the purpose intended by the proposer. Its use in this respect should not be deemed acceptable by the authority.

Notwithstanding the above we set out below the underlying issues and flaws in this proposal.

Joint Industry Governance and Responsibility for Project Nexus

Since the conception of Project Nexus in 2008, although it has been a Transporter obligation to replace UK Link systems through Xoserve, it has been driven jointly by all industry participants. The system requirements and details of the changes to the settlement processes driving the project have been developed jointly by Gas Shippers and Gas Transporters, and overseen by independent Programme Management from PwC. Furthermore, the introduction of the Project Nexus Steering Group (PNSG), which includes representation from Ofgem, Gas Transporter and Gas Shippers, means the industry as a whole is collectively responsible for making key decisions impacting on programme delivery. We therefore consider that it is unreasonable to introduce a modification at such a late stage in the project lifecycle that will penalise one specific group of parties for delays to the delivery, without looking back across the whole project and considering the joint nature of decisions at certain milestones, in addition to assessing the performance of all parties.

The industry parties concerned are fully committed to a timely delivery of the project and a financial penalty on one set of parties will not drive positive behaviours and will not encourage all parties to ensure delivery by October 2016.

Nature of the 'Incentive' Payment

The proposer, after many iterations, has settled on calling the proposed payment by Transporters an “incentive” to deliver Project Nexus and likening this to the incentives in place under the Transporter Price Control (RIIO). We do not consider the payment, which will be enforced through this modification, an incentive as it is one-sided and so acts purely as a penalty for non-delivery by Transporters. Whilst Shippers have argued that this incentive is akin to a traditional service provider contract where incentives to deliver on time are commonplace, we consider that:

- a) this project is not a traditional contract as it is delivering code requirements for the benefit of the industry and is not a commercial agreement, and therefore the margins do not include the appropriate risk premia which would ordinarily be used to mitigate any incentive charges as a result of non-delivery;
- b) it is not normal to add incentives to a contract or delivery just months from delivering a project that spans years in the making. It could be argued that the inclusion of an incentive, if undertaken at the commencement of the contract, would change the subsequent behaviour under said contract, and therefore the addition of incentives at this point is retrospective in nature. At the very least, the inclusion of an incentive regime should have been considered upon nomination of the revised October 2016 delivery date through UNC modification 0548¹; and
- c) the nature of an incentive payment is typically reciprocal, and can be both a charge for non-delivery, or a payment for timely or early delivery. The latter is not proposed in this modification. Furthermore, for a payment to be an incentive, rather than a penalty, there is typically a test of whether the payment reflects the loss caused - “the true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.”² When considering the payment proposed under this modification against this test, the conclusion can be drawn that the payment is punitive in nature.

Transporters are not able to fully control delivery due to the level of industry involvement, including Shipper dependencies, and therefore cannot guarantee the outcome of the project alone, hence the charge cannot be considered an incentive.

Impacts upon Funding, Governance and Ownership Review, the Cooperative Model and Future Industry Costs

Through the current Funding, Governance and Ownership Review (FGO) there is an increased focus upon the industry working in a collaborative manner – a modification of this nature does not seem to further this objective.

While Project Nexus is currently scheduled for implementation in October 2016, and therefore the penalty regime proposed by 0550 would be effective in advance of the full FGO co-operative funding arrangements going live in April 17, consideration should be

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http://www.gasgovernance.co.uk/sites/default/files/Final%20Modification%20Report%200548%20Urgent%20v2.0_0.pdf

² *Cavendish Square Holding BV v El Makdessi and ParkingEye Ltd v Beavis [2015] UKSC 67*

given to the effect of 550 in relation to Xoserve's proposed not-for-profit status going forwards. It is likely that any future penalty payment would be at least in part funded by the community to pay a certain constituency. The consequence would be that Xoserve costs are no longer charged in the current efficient, cost-recovery basis, and any recipient of a penalty payment would have, in essence, contributed to that payment in the first place. Inclusion of risk premia would lead to an increased cost of industry change purely to enable the redistribution of funds, which is not in the best interests of customers.

The inclusion of penalty payments in the UNC would lead to an increase in the costs of making future industry changes as parties would need to take such costs into account when they undertake their obligations to adhere to the UNC. The inclusion of penalty costs may ultimately impact on end users as parties seek to reclaim such costs therefore this would prove to be counter-productive. Furthermore, any increase in operating costs under the UNC may serve as a barrier to entry to any new organisations wishing to enter the market, as a higher financial threshold would need to be met.

Definition and Demonstration of Transporter Failure

We are also concerned that the modification fails to set out the mechanism and criteria that the authority would use to come to a determination should a date change be approved or the date not be met. Typically, any assessment of performance would have the methodology and criteria for pass and failure set out in advance, in order to clearly set out the decision process, timescales and escalation/dispute procedures. This modification does not offer any further detail than to assert that Ofgem will describe "the specific transporter failure that led to the deferral of the Project Nexus Implementation Date³" within their decision of any consequent date deferral modification. The fault of Transporters will need to be established beyond any reasonable doubt and given the length of the project and the dependencies and deliverables of other industry parties, this may not be immediately obvious or objectively demonstrable. With this in mind, due to the lack of detail within the modification, it is possible that should the modification be approved and the incentive regime called into force, then a judicial review of any decision would be required.

Best Endeavours Delivery of Project Nexus

The legal text for related modification 0548 places a best endeavours obligation on all parties, including Transporters, to deliver Project Nexus in the timescales set out within the modification. There is therefore a shared obligation for all parties to work towards the same goal. However, the penalty regime proposed under modification 0550 only applies to Transporters, and is therefore not a fair two-way regime.

Relevant Objectives

The modification currently states that Relevant Objective f) only is positively impacted. We strongly believe that the impact on this objective is negative rather than positive. The obligation to deliver the project on a reasonable endeavours basis is already in the UNC and the proposed financial penalty is therefore an additional, and unnecessary, layer on top of this.

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http://www.gasgovernance.co.uk/sites/default/files/Draft%20Modification%20Report%200550%20v1.0_0.pdf

Precedence

We believe that approval of this modification could set a future precedence for penalty payments to become an embedded part of the UNC, which would detrimentally change the future nature of the Code. Furthermore, as a penalty regime must be reciprocal, we are concerned that approval of this modification would lead to similar modifications being raised to impose “incentive” arrangements onto other regulated parties.

Implementation: *What lead-time do you wish to see prior to implementation and why?*

We would like to see an authority decision made at the earliest opportunity in order to eliminate any uncertainty from the Project Nexus program.

Impacts and Costs: *What analysis, development and ongoing costs would you face?*

If this modification is implemented then Transporters will be liable for payments up to £10m collectively. This cost is in addition to our own project Nexus delivery development costs, in addition to Xoserve costs, that we will experience throughout the duration of this project.

Legal Text: *Are you satisfied that the legal text will deliver the intent of the Solution?*

Yes

Are there any errors or omissions in this Modification Report that you think should be taken into account? *Include details of any impacts/costs to your organisation that are directly related to this.*

There is a statement in the solution section of the modification that says “For the avoidance of doubt the modification proposes that the Gas Transporters meet the costs of any incentives from shareholders and not through transportation allowances” This statement is not in the business rules and has therefore not been taken into account in the legal text.

Please provide below any additional analysis or information to support your representation

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