Representation - Draft Modification Report 0550

Project Nexus: Incentivising Central Project Delivery

Responses invited by: 10 March 2016

To: enquiries@gasgovernance.co.uk

Representative:	Richard Pomroy
Organisation:	Wales & West Utilities Ltd
Date of Representation:	10th March 2016
Support or oppose implementation?	Oppose
Relevant Objective:	**f)** Negative

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

WWU has three key areas of concern with this modification.

1) Issues of principle, precedence and impact on the customer bill;
2) Legal issues with proposal and process; and
3) Imposition of obligations on GTs which were not priced into Xoserve service provider contracts or RIIO GD1 allowances

1) Issues of principle, precedence and impact on the customer

a) Principle

Ofgem already has sufficient remedies to take action against transporters should it have grounds to do so based on the facts at the relevant time. Licence Condition A15 (3) requires that Xoserve services "*shall be established, operated and developed on an economic and efficient basis*". This gives sufficient scope for Ofgem to take action against transporters should it decide that such action is appropriate. Such enforcement action is a licence issue and should not be subject to dual governance under the UNC as well. This would lead to "double jeopardy" for GTs and may fetter Ofgem's scope to take actions under the GTs' licences.

In addition, this modification proposal will not better facilitate the delivery of Project Nexus. Modification 0548, which moved the Project Nexus Implementation Date to 1st October 2016, imposed a "best endeavours" obligation **on both** Shippers and Transporters.

The term best endeavour is deemed to mean "what the words say; they do not mean second-best endeavours" (Sheffield District Railway Co v Great Central Railway Co [1911] 27 TLR 451). This has been further refined by the Court of

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Appeal to require the obligors "to take all those steps in their power which are capable of producing the desired results … being steps which a prudent, determined and reasonable [obligee], acting in his own interests and desiring to achieve that result, would take" (IBM United Kingdom Limited v Rockware Glass Limited [1980] FSR 335).

Transporters are therefore already committed to delivering the core functionality on the 1st October 2016, taking all those steps in their power which are capable of producing the desired results. Project Nexus is receiving significant focus, including from the Chief Executives of gas transporters who are taking the "best endeavours" obligation very seriously.

We do not believe that imposing additional obligations on transporters will make the delivery any more certain than the existing best endeavours basis being undertaken.

We note that none of the representations to modification 0548 from Shippers, including that from the proposer of this modification proposal, made any reference to the need to impose any additional regime to ensure the 1st October date was met. Apart from some metering obligations in UNC TPD section M, this is the only "best endeavours" UNC obligation on parties and therefore should be the priority for all parties.

b) Precedent

The implementation of this modification would set an inappropriate precedent that where there is a one off development then it is possible to have liabilities on some or all code parties. We are concerned that this will over time turn the UNC from a contract where all parties are encouraged to work in the wider interests of the industry to one where parties increasingly focus on their own interests. In the long term we believe that this will be detrimental to customers (with potential increases in risk premium within the Network Weighted Average Cost of Capital (WACC).

c) Customer Bill Impact

Funding costs. The inclusion of additional liabilities linked to one off projects within the UNC would result in an increase in the risk premium for DNs. Increases the WACC from an increased risk premium and increased insurance premiums in future price controls will result increases in customer bills The UNC was developed on the basis that there would be limited liabilities on all parties, contributing to lowering existing risk for DNs and lower costs for customers. This low risk premium benefits the consumer through a lower WACC being applied during price controls. If this modification is implemented this will need to be notified to future lenders and may change their view of risk and hence impact future DN funding and ultimately increased customer bills. Furthermore, insurance premiums would be likely to increase in future price controls resulting in increased TOTEX which the customer would fund as efficiently incurred.

Totex Sharing mechanism. Despite the intent of the Modification, we believe that any penalty could be considered as TOTEX, and could be presented as efficiently incurred if they exceeded the incremental cost of achieving delivery. As such the

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sharing mechanism would result in the consumer paying for approximately 40% of the cost.

We believe that these costs on current and future consumers significantly outweigh any benefit to Shippers of being paid under this regime.

2) Legal issues with the proposal and process

a) Legal issues with the proposal

WWU's view is that the payment proposed is, in legal terms, an unlawful penalty and therefore a court would find that this is unenforceable. Where a contract imposes a payment that bears no relationship to any possible losses then it is a penalty and unlawful. That is, if the contractual function of the provision is deterrent rather than compensatory. We believe that this is the case for this modification proposal and provide further details in the Additional Information section of this response.

The potential legal issue therefore reflects greater uncertainty and complexity than the existing measures available to Ofgem through Licence condition A15.

The payment envisaged in this modification proposal has been variously described as an incentive, liquidated damages and liability which we comment on individually below:

i. **Incentives.** These are generally symmetrical and reward early delivery as well as penalise late delivery. This modification proposal does not have this characteristic. Incentives are appropriate when the presence of the incentive will encourage earlier implementation which delivers additional value. In this case there is no option for earlier delivery so a balanced incentive is not appropriate. For the reasons given above we do not believe that the proposed payment will result in encouraging more focus on delivery to the Project Nexus Implementation Date.

ii. **Liquidated damages.** These are a genuine pre-estimate of the loss parties will experience. The Draft Modification report makes it clear that the value of the payment is not based on a pre-assessment of potential losses.

iii. **Liability.** Contracts typically have liability clauses that say if x happens then one party is liable but in these cases the value of any claim has to be assessed after the event. The modification proposal does not adopt this approach. We note that SPAA adopts this approach in relation to non-provision of data for Theft Risk Assessment Service in SPAA Schedule 34, TRAS Risk Assessment Arrangements, Clause 2.3

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b) Legal issues with the process

The modification proposal proposes that, if the scheme is triggered, then the Authority (Ofgem) will be the arbiter on whether the transporters are found to be at fault. This raises two issues:

i. The level of resource and expertise to undertake the analysis for Ofgem. Again this would be adding cost that will feed through to customer bills

ii. What process will be used to conduct analysis, noting that this could be subject to judicial review by either Transporters or Shippers? Should the modification be implemented and subsequently triggered and given the values involved it seems likely that the Ofgem process will be subject to significant scrutiny by one or more of parties involved. Consequently, there is the clear potential for significant legal costs which again will ultimately feed through to customer bills.

3. Imposition of penalties which were not priced into service provider contracts or RIIO GD1 allowances

Shippers may argue that that commercial service provider contracts generally contain either liquidated damages or liability clauses for non-delivery. This is correct however this point fails to consider three key points:

a) That such arrangements are known in advance before sub-contracts are let and this allows such clauses to be backed off down the contractual chain

b) The consequence of such arrangements is an increase in price for the service as the price will reflect the increased risk to the service provider, given that this modification has been raised so late in the Project Nexus time line this pricing in risk option is not available

c) More fundamentally project delivery in the regulated gas industry has always been based on keeping costs low by minimising risks. It is entirely unreasonable for Shippers to seek both to continue to benefit from this cost minimisation approach and to seek payment should the Project Nexus Implementation Date be put back.

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

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

WWU could face direct costs of up to £1M from the penalty. It should be noted that WWU will also incur costs of any delay to Project Nexus implementation both from

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extension of its own internal programme and from any additional cost incurred by Xoserve.

Furthermore, as stated in our response there is a likelihood that risk premiums would increase resulting in increases to the WACC used during price control and insurance payments in undertaking our business. Both of these would result in increases in customer bills.

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.*

None noted.

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

The leading case of Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Limited [1915] AC 79 sets out tests to help distinguish penalties from liquidated damages:

- A clause will be a penalty clause if the sum specified is "extravagant and unconscionable" in comparison with the greatest loss that could possibly have been proved as a result of the breach.
- It is likely to be a penalty if the breach of contract consists of not paying a sum of money and the sum stipulated as damages is greater than the sum which ought to have been paid.
- There is a presumption that if the same sum is stated to apply to different types of breach of contract, some of which are serious and others not, it is likely to be a penalty clause.
- It is not a bar to the operation of a liquidated damages clause that a precise pre-estimation is impossible.

In our view the first point is the key issue in respect of this modification proposal. As Shippers have not demonstrated the loss that they may suffer from any delay there is a good argument that the payment exceeds any likely loss. The draft modification report makes it clear that the modification does not attempt to estimate any loss making it clear that the payments were intended to be based on the cost of the project to Xoserve but when this was not possible it was based on an entirely arbitrary figure. The following is an extract from the Draft modification report Section 3 Solution:

"To provide industry with assurance that the scheme is set at a relevant level, the amount of these payments was intended to be defined by the UNC Governance Workgroup. There is little information available and Xoserve have been unable to provide either their cost liabilities (due to commercial reasons) or an accurate

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assessment of the cost of Project Nexus. Due to this the proposer has chosen a value of £5m per month to place on the incentive scheme."

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