Minutes of Review Group 0221
Friday 6 March 2009
held at
ELEXON, 350 Euston Road, London NW1 3AW

Attendees

John Bradley (Chair)	(JB)	Joint Office
Tim Davis	(TD)	Joint Office
Charles Ruffell (by phone)	(CR)	RWE npower
Chris Shanley	(CS)	National Grid NTS
Chris Wright	(CW)	British Gas
David Linden	(DL)	BP Gas
Graham Thorne	(GT)	Canatxx Shipping
John Baldwin	(JB2)	Canatxx Shipping
Jeff Chandler (by phone)	(JC)	SSE
Nick Wye	(NW)	Waters Wye Associates
Paul O’Donovan	(POD)	Ofgem
Richard Fairholme	(RF)	EON UK
Ritchard Hewitt	(RH)	National Grid NTS
Roddy Monroe	(RM)	Centrica Storage Ltd

1. Introduction

JB welcomed attendees to the twelfth meeting of Review Group 0221.

2. Review of Minutes and Actions from the previous meetings

2.1 Minutes (26 February 2009)

The minutes were approved.

2.2 Actions from previous sessions

None.

3. Further Consideration of the Draft Modification Proposal

CS gave a presentation setting out difficulties with Option 3 (providing security after a QSEC auction). In light of the difficulties envisaged, National Grid NTS had amended the draft Modification Proposal such that security would be provided prior to allocation within a QSEC auction (Option 1). Whilst not supporting Option 3 (providing security after close of the auction), National Grid NTS had identified a potential approach which, were security not provided, may allow capacity allocations to be cancelled and the revenue driver impact to be set aside without the need for a licence modification.

CS continued that, under Option 3, assuming there were three bidders at a new ASEP, if one User failed to provide security, the allocations of the other Users would also fall away – such that no incremental capacity would be released. This was because the release of incremental capacity was based on an economic test of the bids in aggregate and the User commitment from the remaining two bidders alone would not have subject to an economic test. JB2 was not convinced this made the Option 3 approach unworkable, and alternatives were debated.

NW suggested that having a subsequent ad-hoc auction would be acceptable if National Grid NTS confirmed that the consequent delay would not impact National Grid NTS’s investment delivery time. RH said this could only be achieved if the QSEC auctions were brought forward since the signal to invest would otherwise be delayed, and potentially substantially delayed if, for example, the failure to provide credit was repeated following any ad-hoc auction.

TD questioned whether Option 3 represented a potential improvement over the present position as opposed to a solution to every possible set of circumstances. DL argued that Option 3 would not improve the situation since the revenue driver would still apply and the underlying licence problem remained to be addressed.

Moving to the example of an existing ASEP with multiple Users that bid for baseline and incremental capacity, the process would not work effectively if one failed to provide security and the bids of others were cancelled – especially if the baseline capacity were substituted elsewhere. RF asked whether failing to provide security would lead to termination, and RH explained the process which could lead to this under the draft National Grid NTS Modification Proposal. This was recognised as providing a significant incentive to provide suitable security.

JB asked if there was consensus that the issues raised were a showstopper for Option 3. RM asked whether the problem was the shape of the curve against which QSEC bids were placed and whether bids could be reallocated such that other Users still received the capacity they had bid for. RH said that generally the curve meant that unit prices drop as the volume requested increases. CW suggested that it would be possible to look at the actual bids and repeat the allocation process for the remaining Users based solely on assessing these bids against the IECR criteria. RH said this would both increase the timetable and potentially allocate Users a different level of capacity to that which would they were seeking to obtain.

Under Option 1, JB2 asked how bids would be excluded from the auction if security levels were exceeded. RH confirmed the intention was that bids would not be accepted and would not appear on screens such that other bidders would continue to see the true position. RH felt that this was the most economic and efficient approach to allocating capacity and that Option 3, as National Grid NTS envisaged it, was probably worse than the status quo.

RM asked whether a Modification Proposal which solely implemented the element which made all capacity fall away in the light of a failure to provide credit was viable. RH said he would be more than happy to debate this if the Group concluded this was the right way forward and that the key question remained the balance between the risk to other Shippers from default and the cost of reducing that risk. RM said this should look at barriers to entry and security of supply implications rather than simply financial risk to Users.

DL remained concerned about the cost to industry of deferral, which could be, say £20m. He asked if the balance of risk could be changed such that National Grid NTS would chase down any outstanding money, or an income adjusting event could be triggered. RH said that this would be a fundamental change to risk profiles which would need to be factored into future price controls.

JB2 summarised that Option 3 had problems if bids were reopened, and Option 1 was effective if the aim was to exclude all parties who do not have strong credit positions. However, this was a barrier to entry especially for new players and independents which could effectively be excluded form the market. Finding a solution probably needed a look beyond the UNC and in particular to adjust licence revenue drivers to match reality.

JB returned to the question as to whether the Option 3 issues were a showstopper if all bids stood other than those of the defaulting party. RF felt that it could be better than the status quo in terms of the Relevant Objectives, but RH did not. JB2 felt it would be better than now if capacity allocations for those who had provided credit were not impacted – compared to now, at least the capacity of those who fail to provide credit could be offered for sale to others and hence this was an improvement. NW agreed the approach could be expected to facilitate the Relevant Objectives as you would be securitising earlier than now. RM suggested that this revised Option 3 plus a tweak to the licence was the proposal the Group had discussed previously and, with the Licence tweak to adjust the revenue driver, would be an improvement on the existing position. RH was concerned that National Grid NTS would need certainty about its revenue before committing to investment, and if there was a process for this to be clarified, investment timetables would inevitably be put at risk.

It was agreed that Option 3 was not a plausible option if the allocations of Users other than a defaulting party were reopened, but it may be if all other allocations were untouched. In addition, a licence change to allow capacity cancellation and revenue driver adjustments could be recommended. POD said that the licence already allows for National Grid NTS to seek to have capacity cancelled as part of the incoming adjusting event process, although National Grid NTS is not incentivised to follow this route. Whilst most Shippers felt that this adjusted Option 3 could be preferable or neutral relative to the status quo, DL felt it could be worse than the status quo since the cost of providing credit had not been assessed against the risk of default and the benefit provided by increased credit requirements – which JC supported, although he felt that Option 3 could nonetheless offer a small improvement on the status quo.

National Grid NTS remained of the view that credit provision 28 days ahead of the QSEC was the best way forward, but with some flexibility to increase security prior to the auction closing and capacity allocations being finalised. The draft Modification Proposal had been written on this basis. GT, NW, RM and JB2 felt that this option was worse than the status quo particularly since it excluded project financed developments from the market and hence was detrimental to competition. CW was marginally in favour of Option 1, and RF agreed that it would work for larger players such as E.ON and Centrica but felt it was hard to justify on competition grounds. DL remained largely neutral, for the same reason ie needing to assess the balance of risk and cost. JC felt it would be a marginal improvement on the status quo provided top-up within the auction period was possible.

RH confirmed that he saw Option 3 as worse than the current arrangements because of the additional risk and complexity which would be bad for competition. JB2 suggested that there might be no problems in 90% of the cases and so the difficulties with Option 3 were being overstated by National Grid NTS. RH emphasised that he was looking at the issue from the perspective of the Relevant Objectives and could not see that Option 3 was consistent with furthering the Relevant Objectives with respect to economic and efficient system development (under National Grid NTS' Licence) and competition because of the effect on other Users, who had to pick up the cost impacts in the event of default.

CW questioned what costs were likely to be involved in Option 1 and how these compared to other project costs. GT said that Canatxx had invested more equity than other projects might, but that a standard project financed deal would be precluded by Option 1 since obtaining credit of the amounts suggested, possibly of the order of £15m to £20m, would be at best extremely difficult but probably impossible. For any project, having guaranteed rights to get gas onto the grid was a condition precedent for the bank to release credit – the project would have to be at financial close and so providing credit in advance of acquiring capacity was simply not feasible.

RM questioned whether security of supply would be harmed by any of the options and how this should be reflected in consideration of the Relevant Objectives – if the proposals discouraged independents, this could damage security of supply. CW questioned whether the projects, if viable, would be picked up by others such that, in reality, security of supply would be neutral. NW suggested that the existence of varied players with different perspectives meant that more projects would go ahead with small players active in the market. RM agreed that, in practice, independents bring finance to projects and take them forward whereas the majors may not see them as worthwhile, although they may "adopt" them once developed beyond a certain stage.

JB2 asked if an alternative was a long term credit check on a once a year basis, as now, but looking further ahead than 12 months. DL said that this left the revenue driver issue unresolved, so was no better than the status quo. JB2 agreed that a licence change was also needed but felt this may have to wait for the next price control.

DL suggested that any proposal would need a full impact assessment to understand the financial implications and it was perhaps appropriate for the adjusted Option 3 to go forward as a Modification Proposal and be further developed and assessed. RH emphasised that under this option the revenue driver would be unaffected and National Grid NTS would invest on the basis of the signal and the incentives it faced – if the revenue allowance were to be reconsidered, National Grid NTS would want the option to reconsider its agreement to release capacity and invest to meet that. He would not want to accept a risk that the revenue allowance would be adjusted after capacity allocation had been completed and investment decisions taken. By contrast, RM felt it was appropriate to follow a logging up process with Ofgem assessment at each price control as to whether or not investment had been efficiently incurred by National Grid NTS.

4. Review Group Report to Panel

JB asked if the Group's final Report should be written on the basis that no agreement had been reached on an appropriate Modification Proposal to be taken forward.

CW asked if there would be merit in a further meeting to try and reach agreement. RH cautioned that if there was no report to the March Panel there would be little prospect of getting a Proposal in place in time for the next QSEC auction. RF asked whether there was a need for the process to be completed quickly or whether some delay would be acceptable. RH said he had no idea who would be bidding in the next auctions or who might default, and therefore concluded that the best time to implement was as soon as possible.

DL suggested that a further discussion was merited to go through the drafting of the Modification Proposal which had been developed by National Grid NTS but, understandably, only circulated immediately prior to the meeting. RH suggested that an alternative was to rely on the standard modification process once a Proposal had been raised in order to allow consideration of the details. To assist this, National Grid NTS would welcome comments on the Proposal as drafted. CW suggested, that given the complexity and sums involved, more than one pass through a Workstream would be needed once the Proposal was raised such that a wider audience could understand and consider the various options.

RM asked if the Ofgem Impact Assessment would be based on several options or a single proposal. POD said that Ofgem could look at several options, but needed to receive a Modification Proposal in order to trigger the formal process which would then necessarily look at all Proposals on the table.

It was agreed that a Review Group Report should be drafted looking at the two main timing options, listing the pros and cons of each and recording the analysis undertaken. In addition, the Report should include a recommendation that Ofgem undertake a full impact assessment of the range of options and consider modifying the licence to address a number of issues. The JO had provided a draft Report including a possible recommendation to Ofgem, and the wording of this and the other recommendations was discussed and agreed.

The JO agreed to circulate a revised Report for comment, with responses requested as soon as possible such that the Report could potentially be sent to the March Modification Panel meeting.

6. Any Other Business

JB thanked all Members for their contribution to the Group's work on what had proved to be a difficult topic. While no clear consensus had been reached on the appropriate way forward, the work of the Group should provide a valuable contribution to the development and consideration of any subsequent Modification Proposals raised regarding this issue.