# Minutes of Review Group 0221
# Monday 10 November 2008
# held at
# Elexon, 350, Euston Road, London NW1 3AW

**Attendees**

| | | |
|---|---|---|
| John Bradley (Chair) | (JB) | Joint Office of Gas Transporters |
| Lorna Dupont (Secretary) | (LD) | Joint Office of Gas Transporters |
| Alison Chamberlain | (AC) | National Grid Distribution |
| Andrew Pearce | (AP) | BP Gas |
| Chris Wright | (CW) | Centrica |
| Craig Purdie | (CP) | Centrica Storage Ltd |
| Jeff Chandler* | (JC) | Scottish and Southern Energy |
| John Baldwin | (JB1) | Canatxx Shipping |
| Paul O'Donovan | (POD) | Ofgem |
| Rekha Patel | (RP) | Waters Wye Associates |
| Richard Fairholme | (RF) | E.ON |
| Ritchard Hewitt | (RH) | National Grid NTS |
| Roddy Monroe | (RM) | Centrica Storage Ltd |
| Shelley Rouse | (SR) | Statoil |
| Tim Bradley | (TB) | National Grid NTS |

* by teleconference

## 1. Introduction

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

## 2. Review of Minutes and Actions from the previous meetings

### 2.1 Minutes (28 October 2008)

The minutes of the previous meeting were approved.

### 2.2 Actions from previous sessions 1 - 4

**Action RG0221/007:** National Grid NTS to report on the outcome of novation discussions to this Review Group.

**Update:** JB reported that a presentation and update had been given at the Transmission Workstream meeting (06 November 2008) and it had been suggested that further discussion should take place following an appropriate meeting of this Review Group. **Action carried forward.**

**Action RG0221/009:** National Grid NTS (TB) and Ofgem (POD) to investigate and report on the background and circumstances supporting the decisions made in respect of Milford Haven.

**Update:** POD reported that most of the Ofgem personnel who had been involved with this project had left the organisation. As far as he was in a position to ascertain, the Revenue Drivers calculated at the outset were recognised to have become inadequate as construction progressed; there were no special circumstances relating to the auctions; subsequent shortfall was discussed with the industry and was likely to have been added into the RAV; this was still being addressed.

TB reported that Special Condition 4b laid an obligation on National Grid (2005) which was reviewed each year, and this covered the high level principles of how it should be done. POD added that Shippers were given the option to state where the Entry Point would be. RH added that this was not a single service – there were two Entry Points close together (two customers upstream) and there was opportunity for the customers to stipulate where they wanted the Entry Point to be. JB1 pointed out that there was a different risk profile associated with each User.

The following link has been provided to enable access to the document "The Statement and Methodology for Gas Transmission Connection Charging – effective from 01 April 2008". The document can be found under the heading of Connection Charges – Transmission at the following location on National Grid's website: www.nationalgrid.com/uk/Gas/Charges/statements/

**Action closed.**

**RG0221/010:** National Grid NTS (TB) to create a comparison table setting out the advantages and disadvantages of options (ii) and (iii) and include a discussion on other aspects associated with the choice.

**Update:** See 3, below. **Action closed.**

## 3. Questions discussed in Session 4: outstanding issues

In response to Action RG0221/010, TB presented comparison tables setting out the advantages and disadvantages of options (ii) and (iii) and including other aspects associated with the choice. Copies were provided to the meeting, the content explained, and discussion ensued.

### Question 4.1

The document was reviewed and amended onscreen as the debate progressed.

TB explained the User/Entry Point scenarios considered and described the advantages and disadvantages identified with each.

*Scenario 1: New Single Point User/Existing Entry Point*

In response to a question from CW, RH said that National Grid NTS was looking at instances where there was an ability to provide an incremental signal, and in his view there was a issue only with QSEC. JB1 conceded there may be less of an issue with AMSEC but felt this would still need discussion at another meeting.

TB pointed out that a reduction in risk may be greater for one option than another. JB1 observed that, perversely, some scenarios could force a default and therefore would increase the risk. RH agreed that there was a risk that a party may not underwrite its existing position once a proposed implementation took place, and this could create a problem. CW pointed out that, if this was an existing User, capacity could be remarketed, and the chances of reselling capacity may also need to be factored in.

RH commented that, in the current regime, costs were socialised and not specifically identified; asking parties to provide security at the outset presumed quantification and identification, and was in effect raising the entry qualifications for new parties.

*Scenario 2: New Single Point User/New Entry Point and Multiple Point User/New Entry Point*

JB1 thought that the regime would be easier for an existing User because there was more risk associated with a new User at a new Entry Point. It was recognised that there may be issues of due and undue discrimination. The community was likely to be more secure in this scenario than with the new User/new Entry Point because a party with existing market share was provided the ability to raise security.

Other scenarios were discussed and associated risks were briefly assessed. CW was concerned that new difficulties should not be inadvertently created, such as the freedom for unscrupulous companies to set up numerous individual companies as a way of avoiding their business risks and liabilities. RH reiterated that the community's risk needed to be removed/reduced by devising an appropriate way to collect the money at a logical point(s) during the process and also acceptable credit tools that supported and mitigated the levels of exposure.

*Scenario 3: Multiple Point User/Existing Entry Point*

Responding to a question from RP, RH said that, at the point of default, if you can call upon the money you have effectively been paid for the capacity that the party holds; the capacity stays with the individual because it has paid for it. It can then dispose of that capacity; ie the liability has not transferred to others.

RM said that if a party had put credit arrangements in place this would not of itself be a reason for National Grid NTS to invest. RH said that this was a product of how the Licence was currently constructed; a party has to be in default for the capacity to be taken away. In this instance no invoice would be sent in respect of this capacity and no invoice would be sent subsequently as the User would not flow gas into the NTS.

RH then asked the question: do you treat the existing User the same as a new User? If so, it would require the same commitment and parties would need to be very mindful of the impact. RM pointed out that an existing User's financial relationship would have built up over time and be construed as lower risk. A new User could demonstrate no payment history and was therefore higher risk. There was also a risk of new companies, with limited assets that met requirements for release of capacity, being set up solely for new entry. The Revenue Driver is set at the point Ofgem approves the new capacity, but if the party withdraws – the Revenue Driver would still be invoked and be paid to National Grid NTS by Users in general. RM added that most companies had demand risk thresholds and asked how much risk should be borne by National Grid NTS and was this going to be discussed? RM then asked how much of this risk did Ofgem believe should be borne by National Grid NTS. RH responded that this Revenue Driver principle was built into National Grid NTS's incentives and the UNC smears the risk to Users. National Grid NTS has been funded in light of these rules under the Price Control; if the position changed a review of the Price Control would be indicated.

JB1 recapped: if the situation arose where a new User/new Entry Point did not have to pay and continued to defer, but an existing User/new Entry Point did have to pay; this would be inequitable and needs to be addressed so that both pay. A new User would have to put up more security and this may count as a higher hurdle; an existing User would have to put up incrementally more but this would not make a significant difference to its commercial position. It would help to have examples of real Users in this scenario, eg at Caythorpe. RH added that credit assessments may generate a different solution. RH observed that an existing User is incentivised to pay because its capacity could be removed; the same rules applied to a single Entry Point new User would have a different effect. It would be useful to define the combinations and effects to clarify examples.

TB referred to the TO Auction Revenue, figure included – we need to get a feel for what we are underwriting. JB1 said that the target was 50% of TO Revenue that would be expected to be recovered, ie £250 million, the maximum in any one year. RF pointed out concerns regarding the bid price and the reserve price at some ASEPs could attract more onerous credit requirements than at others, and this could influence bidding strategies. JB1 observed that charges were only meaningful if you could get someone to pay them – the community needed to avoid creating perverse incentives with unintended consequences.

Following the discussions, RH questioned if there was any closer movement now to either Option 2 or Option 3. POD interjected that Ofgem would not want to see Option 3 eliminated from the debate at this stage. RF believed that the community needed to see the potential financial impacts before any decisions could be made, eg on what time period, etc.

JB noted that there seemed to be the suggestion that Option 3 might be pursued, whilst addressing anomalies. JB1 pointed out that there is a concern at St Fergus under this option, which RH noted. 'St Fergus only' Shippers may feel disenchanted especially the smaller or individual ones.

JC questioned what happened to funds placed on credit and the interest that accrued. RH thought that it would need to be decided whether it would be returned to the party or neutrality or somewhere else. Security instruments also needed to be decided and set to be appropriately accessible so that any monies owing at default could be easily recovered.

**Action RG0221/011: National Grid NTS (TB) to investigate what happens to the interest on monies lodged as security (Energy and Transportation) and report to the meeting.**

**Question 4.3**

Discussion moved on to the second comparison table. TB explained the advantages and disadvantages under Options A, B and C. RH asked members what baseline amount that you need the credit cover against. Is this what Users paid or agreed to pay in the auction. The regime is expecting a certain recoverable amount needs to access this to avoid Users funding the shortfall. The base figure needs to be set then an agreement reached on how to best securitise it. JB believed there may be objections to retrospective application, ie auctions that have yet to be delivered on.

A short discussion followed and CW asked if there were any parallels that could be looked at in other industries; possibilities to consider may be Heathrow Terminal 5 and the water industry but this would need further enquiry.

RH then asked what entry capacity the arrangements should apply to. It was thought there would be a need to revisit AMSEC and QSEC at some point. Ofgem was asked for its view on the Options and POD believed that the main concern would be consumer exposure under Option C. Others thought that Option A did not address the current risk. Raising a Modification Proposal on the basis of Options A and/or B ran the risk of being rejected because of the element of retrospective application; any agreed arrangements could ultimately be tested in court by a third party.

Application of the new rules retrospectively could force a party into default, and end with no money and no change to the actual risk to community. This risk of default would depend on *when* the rule was applied, and different effects may be apparent due to timing. JB1 believed that forcing a party into liquidation was worse for the community than the status quo.

The suggestion was made that Option C be adopted but with a phased implementation. It was pointed out that this may undermine Ofgem's User Commitment model, however Ofgem has a duty to customers that may take precedence. For new auction purchases going forward it was suggested that standard credit arrangements would apply ie 28 days after allocation. For existing Users there might need to be a lead in period to allow for extra credit facilities to be organised, or a right to defer liability over a period of years, as this would be a change to their existing contract. It was questioned what would happen to the Revenue Driver if the capacity was put back, and it was suggested that it would be up to Ofgem and National Grid NTS to consider whether the Licence would require modifying to accommodate this. JB1 thought this was only an option if the Revenue Driver could be changed otherwise it made no sense; in his view the only ways to reduce risk on consumers were either to give National Grid NTS some of the risk, or negotiate a deferral to put it back.

CW asked how would it be ascertained that a party was in genuine financial difficulty, as opposed to just not wanting to meet their obligations; or would it just be delaying the inevitable? There had to be a stop point. RF thought that a committee of Users, similar to the Energy Balancing Committee, might be necessary to undertake these decisions.

It would be easier to address the new auctions; for the old ones it may be appropriate to negotiate transitional arrangements.

Distilling the various comments and views JB concluded that the meeting had demonstrated an inclination towards Option C, with an interim arrangement to allow existing Users to match new security requirements. There was no dissent from this conclusion.

**Action RG0221/012: National Grid NTS (TB) to focus on Option C and devise appropriate interim arrangements.**

## 4. Work Plan: Session 5

RH clarified the questions and these were considered and discussed.

### 4.1 Question: "What level of security is needed post capacity release obligation (eg flat, tapered, enduring, etc)?"

**and**

### 4.2 Question: "How would this be applied to existing capacity holdings?"

RH said that so far the group has looked at capacity yet to achieve its first gas flow day, and the security to cover this. At 06:00 the gas flows and the requirement for 4 years falls away and the UNC requirement of 12 months in advance is triggered. Should this be changed so that there is still a commitment to utilise the pipe for eg 4 years; should this be underwritten? He pointed out that there could potentially be a situation where a build programme is ongoing while a party ifs aware all the time that the capacity will not be required 4 years later.

**Recap on Security Levels Prior to Release**

JB addressed the issue of flat vs tapered capacity prior to release and suggested that this had not been resolved.

For incremental capacity projects, fifty per cent of its NPV is the hurdle for the economic test. Where this hurdle was just met, Users would put up 50% of the risk even if the auction parties were required to raise security to cover the entire auction bid value. The questions arising where whether there should there be a period of time for credit provision to be put in place and should this be stepped over a period of time?

Shippers were concerned whether someone is going to pay; the assumption should be that everyone will pay and there should be incentives to pay on time. The Revenue Driver is allowed at the point Ofgem does not disallow, and commitment to revenue is then made. Should this be underwritten at this point, or a stepped up commitment (over 4 years) applied? If anyone defaults, the community will recover a percentage of the 50% that represents the auction value. The stepped periods would provide a reduction in smearing risk to Users over time.

JB1 observed that the contract between Ofgem and National Grid NTS was essentially vertical – the full revenue driver applied from the Ofgem decision date, but a contract on the ground may be stepped over 4 years. Currently all the Revenue Driver risks were smeared to Users and none specifically to the applicant User. A single step movement to 50% for the applicant User would present a new hurdle.

Different scenarios were discussed with various figures, including 5%, being suggested as perhaps sufficient to prevent frivolous actions. RH then asked what was acceptable to the community as a whole.  JB1 commented that the Storage Operator Group may not accept 50%, but there was a need to establish something; others may of course prefer 100%, because they favoured no risk.

JB responded that previous meeting had concluded that the difference between the Revenue Driver and the auction income would be smeared to Users.  CW commented that with even with no investment in the ground the community might be hit with higher smeared charges. In his view no investment should mean no charge.  JB1 asked whether in the event of a Shipper default this should automatically trigger a reopening of the Licence parameters if no investment were made.

JB1 asked what was the equivalent under Exit?  JB responded that, under most of the Modifications currently proposed, there was no economic test based on NPV but a four year commitment was required.  National Grid NTS had provided figures that showed a four year commitment represented much less than 50% NPV.

CW asked whether the same rules should apply both to incremental and baseline.  RH responded that it should apply to both, to treat all capacity holders the same; it could be new incremental or a new User purchasing baseline.

JB canvassed the views of the meeting and it was established there was support for a phased or staged commitment. Also there was some support for the principle of a reopener under the Licence**.**  In response to a question from CW regarding the potential for reopening of the Licence, POD said that it would have to be discussed with National Grid first but should not be entirely discounted.  JB1 added that Shippers would want reopening to minimise the ongoing liability.  JB questioned whether the meeting would still be in favour of a staged, or lower than 50% commitment, if a reopener were not possible. JB1 responded that the 50% NPV test was entirely arbitrary and nearer the gas day further capacity allocation might lead to a recovery of greater than 50%. More scenarios were discussed and JB1 believed that enough rigidity was required to stop high risk projects from going ahead; a move away from the current 100% socialisation, but not to the full auction value.

Without the reopener the choice might be of full auction value on Day 1 or stepped, but if reopening the Licence and the Economic Test meant that there were more possibilities and variables to consider. This could lead to numerous Modification Proposals. Nevertheless, POD suggested that the group needed to consider options with and without the reopener.

JB1 argued against securitising the full auction value. If we be set out to protect Users against all risks we would end up securitising everything?

RH concluded that there were two variables: the percentage of Revenue Driver (which needed to be fixed before a debate could occur on credit arrangements), and stepping or no stepping.  JB1 believed that all capacity should be treated the same and asked: do you need to underwrite all that has been bid?

RH asked members

- do they  want to:

  Securitise all the bids value; or

  Securitise on the basis a number of years; for a fixed timescale after which you can do various swaps; after 42 months you can make it available for re-auction and substitution (still potentially a liability).

- what is the level of risk the community is prepared to bear (and then develop the credit arrangements to suit).

Members made reference to Ofgem's *"Best practice guidelines for gas and electricity network operator credit cover" 58/05* and whether this still represented Ofgem policy. The following action was therefore agreed:

**Action RG0221/013: Ofgem (POD) to establish whether there has been any change in its policy since the release of its document 58/05.**

RH concluded that progress had been made and that Option 3 was the agreed choice; Option C had gained support over the other Options A and B.

**5. Allocation of actions for Session 6 (27 November 2008)**

JB read out the items included for discussion in Session 6. (Please refer to the Work Programme for further details).

**6. Any Other Business**

**6.1 Novation**

There had been genuine interest and a general consensus at the Transmission Workstream in favour of partial and whole capacity but that is should only apply to capacity released in the QSEC Auctions.

RH would decide when to phase in the novation elements and will speak to the relevant National Grid NTS team so that he can report back to the Transmission Workstream and this Review Group.

**Action RG0221/014: National Grid NTS (RH) to suggest date where novation might be discussed.**

**7. Diary Planning for Review Group**

The next meeting of the Review Group (Session 6) will be held from 13:00 – 16:30 (in the Green Room) on Thursday 27 November 2008, at Elexon, 4th Floor, 350 Euston Road, London NW1 3AW.

Future meetings have been arranged as follows (all at Elexon, 350 Euston Road, London NW1 3AW):

Session 7: Wednesday 10th December - 10.00 – 13:00

Subsequent meetings (Sessions 8, 9, 10, 11, and 12) will be arranged as the progress of the work of the group dictates.

For further details of the content of each Session please refer to the Work Programme.

**ACTION LOG – Review Group 0221**

| **Action Ref** | **Meeting Date** | **Minute Ref** | **Action** | **Owner*** | **Status Update** |
|---|---|---|---|---|---|
| RG0221 007 | 13/10/08 | 2.1 | Report on the outcome of novation discussions to this Review Group. | National Grid NTS (RH) | Replaced by Action RG0221 014<br>**Closed** |
| RG0221 009 | 28/10/08 | 4.2 | Investigate and report on the background and circumstances supporting the decisions made in respect of Milford Haven. | National Grid NTS (TB) and Ofgem (POD) | **Closed** |
| RG0221 010 | 28/10/08 | 4.1 and 4.3 | Create a comparison table setting out the advantages and disadvantages of options (ii) and (iii) and include a discussion on other aspects associated with the choice. | National Grid NTS (TB) | **Closed** |
| RG0221 011 | 10/11/08 | 3.0 | Investigate what happens to the interest on monies lodged as security (Energy and Transportation) and report to the meeting. | National Grid NTS (TB) | |
| RG0221 012 | 10/11/08 | 3.0 | National Grid NTS to focus on Option C and devise appropriate interim arrangements. | National Grid NTS (TB) | |
| RG0221 013 | 10/11/08 | 4 | Establish whether there has been any change in its policy since the release of its document 58/05 | Ofgem (POD) | |
| RG0221 014 | 10/11/08 | 6.1 | Suggest date where novation might be discussed. | National Grid NTS (RH) | |

* Key to action owners

RH – Ritchard Hewitt

TB – Tim Bradley

POD- Paul O'Donovan