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22 July 2010

Dear Ikbal

Application Regulations and Revocation Schedules of Future Licences (74/10)

National Grid Gas plc (NGG) and National Grid Electricity Transmission plc (NGET) welcome the opportunity to respond to Ofgem's consultation on revisions to Licence Application Regulations and Revocation Schedules of Future Licences.

NGG owns and operates the National Gas Transmission System (NTS) and also owns and operates four of the gas distribution networks. In association with the Gas Distribution Network Operators NGG also jointly provides for the administration of the Uniform Network Code (UNC) Governance arrangements through the Joint Office of Gas Transporters.

NGET owns the electricity transmission system in England and Wales and is the National Electricity Transmission System Operator.

This response is on behalf of NGG and NGET (National Grid) and is non-confidential.

Overview

Having considered the existing arrangements in place between parties to OTC-type trades for use of cleared markets, we consider that the requirement to hold a gas shipper licence is not required as a condition of becoming a party to the UNC in relation to parties solely engaged in NBP gas trading activities.

The proposed revisions to the applications process may add value to the licences themselves by providing more thorough validation of the VAT details of the applicant and while we recognise that there is a limit to the ability of any document to prevent fraud, any improvement in the information available to parties through a licence which has the effect of increasing surety is to be welcomed.

In tandem with changing the requirements to hold a shipper licence, National Grid and the wider industry will need to consider consequential modifications to the UNC contract in order to recognise the restricted activities of a "Trader Party". Please see Section 2, Question 3 response – UNC Changes for further detail.

Ofgem's proposals make no reference to potential developments in the European markets, such as a European Regulation that could require market movement towards central clearing instead of bilateral contracts, or attempts to ward off VAT fraud via EEX reverse charging law proposals¹. The

¹ As per Heren Report news dated 28 Jun 2010.

former could have an impact on Trader behaviour and the application (via clearing houses) of common credit arrangements, while the latter specifically addresses the stated aim of the proposals of responding to fears over VAT fraud. As such, Ofgem may wish to consider these proposals in the wider context of potential European developments.

Electricity Licences

In principle the proposal to introduce a tiered system to risk score new entrants into the market is welcomed by National Grid. Vetting of a company's credentials, including its previous Director's trading history, and previously refused licence applications, will send a message to the market that those companies wishing to enter the market need to do so as credible companies that intend to undertake activities specifically within the scope of their licence. The proposal further affords a degree of comfort to National Grid that licensed companies will adhere to code and charging rules whilst participating in the market.

The governance of the tiered application process needs to be clear, predictable, and designed for consistent application, without the requirement for a third party assessment of events of default under the terms of the licence on a case by case basis. This is particularly pertinent in the cases where a licensee is unable to pay its debts to National Grid, is subject to administrative receivership, or is subject to a winding up order. NGET currently has no sanctions available to it in order to prevent insolvent or bad debtor companies from continuing to post nominations in the electricity market systems, and therefore should a licensed company enter into default, National Grid would expect the Authority to allow the remedial actions set out in this proposal to be fully implemented without recourse and without delay so as to protect consumers.

Whilst the process for new entrants into the market would be made transparent under these proposals there remains a concern that established companies, which may have been risk assessed under this process, may be purchased by a third party that has not undergone any risk assessment by the Authority. Thus, this third party would acquire a company which has a licence and become active in the market with no checks. National Grid would welcome clarification that in these circumstances the new 'owner' would be subject to the principles of the proposal in terms of the tiered system of risk profiling and revocation.

Detailed responses to the questions within the consultation follow below.

Section 2 Questions

Question 1: Do you agree with the proposed changes to the Current Application Regulations and the Current Guidance Document?

The proposed changes appear to address the concerns over potential fraud as described in the summary of the proposal document. There appears to be a risk of fraudulent use of a shipper / supplier licence potentially leading to costs being incurred by the rest of the industry and, while National Grid broadly supports the changes proposed to the licence application process, we note that the changes proposed will require material work in relation to UNC modification (see below). It is important that the cost of this work is considered against the probability and possible costs arising from fraudulent activity and we would welcome more information regarding the potential cost / benefit position.

An indication as to the viability of a specific licence applicant (provided as a result of the proposed revised applications process based, for example, on the level of tier of application governance applied) might provide a benefit to xoserve's customer lifecycle process.

Question 2: Are there any additional questions which you consider could be included in the New Regulations?

We do not consider that there are any additional questions which could be included in the New Regulations.

Question 3: Do you have any additional comments on the content and format of the Revised Guidance Document?

We have no additional comments on the proposed Revised Guidance Document.

Question 4: Do you have any views on the proposed introduction of a tiered application process, based on risk profiling?

National Grid broadly supports the introduction of a tiered application process (however we would welcome more information regarding the potential scope and scale of fraudulent activity so that this can be balanced against the costs that will be incurred by the changes proposed).

We agree with Ofgem's concern that changes to the licensing requirements and applications process should not, of themselves, unnecessarily restrict access to the market.

Section 3 Questions

We agree with Ofgem's reasoning in Section 3.2 for their view that inactive licences should be revoked after an appropriate period.

Question 1: Do you have any views as to why such a high number of gas shipper licences are not being used for their intended purpose?

National Grid supports Ofgem's view that many gas shipper licences are held solely by trading companies. Some licences are held prospectively by entities with delayed prospects of entering the market, while others remain held by entities that have ceased market activity, but have not sought to have their licence revoked. The cost of obtaining a gas shipper licence (£350) and retaining such a licence (£0) provides little deterrent to obtaining one, or incentive to seek to have the licence revoked if it is subsequently found to be unnecessary. Additionally, we agree that the requirements of trading platforms and power exchanges and the UNC (as set out in 3.12 to 3.14) to hold a gas shipper licence are relevant. The reason for these requirements is unclear to us – it might be to act as a proxy for an independent risk assessment regarding the acceptability of the party wishing to trade using their systems.

Question 2: Do you think further action is necessary or proportionate given the issues raised in the chapter in relation to gas shipper licences?

Yes; we would support the withdrawal of gas shipper licences from those parties who have not undertaken the activities for which such a licence is required. We consider that the current approach used by Ofgem to review and where appropriate revoke inactive licences is proportionate and adequate.

Question 3: Do you agree that parties should not be required to obtain a gas shipper licence prior to being able to carry out non-physical trades of gas?

We would like to respond to the following aspects of the proposals:

- Removal of a level of governance (The Gas Shipper Licence) on trading parties;
- Potential changes to the UNC required to recognise the roles and responsibilities of both licensed and non-licensed parties;
- Potential impact on the transporter's systems and processes, including UK-Link systems

The lack of requirement to hold a gas shipper licence would not, in itself, change the commercial relationships between trading parties. For example, any trader wishing to participate in the On-the-day Commodity Market (OCM) via APX-Endex's systems would continue to need to accede to APX's Credit Requirements² and its Users are required to accede to the UNC. In addition, National

² As defined in APX Market Rules v10.0, section 17 on page 72.

Balancing Point (NBP) gas trading between parties is notified to xoserve's systems (input into UK-Link systems) and as a result contributes to the daily energy imbalance position of both parties to the trade. The Energy Balancing Credit Committee (EBCC) oversees the energy balancing credit rules in the UNC that exist on behalf of all UNC Users in order to protect the Gas Shipping Community from the risk represented by non-payment of energy balancing charges in respect of trades actioned³. Finally, all transacted NBP gas trades have two counter-parties (buyer and seller) and gas shippers have their own credit policies and bilateral contract arrangements (for example, the generic bilateral "NBP '97" gas trading contract that governs NBP gas trading) so ultimately gas shippers can decide whom they wish to trade with.

All parties (including traders) are subject to assessment in terms of financial stability by:

- EBCC rules in the UNC;
- the market rules related to the OCM; and
- the credit relationship they have in place with other parties to OTC trades.

The current arrangements for trading on the Electricity markets do not require a trader to hold a licence; such trades rely solely on the bilateral contractual arrangements between the counter-parties to a trade, which is individual to each trading relationship. Therefore, the proposed changes to remove the requirement for traders to have a gas shipper licence are a move towards Ofgem's stated goal of introducing consistency across all gas and electricity licences.

There is a concern that removal of a level of governance (the requirement to hold a gas shipper licence) on traders reduces control and increases the risk of potential fraud. However, on review of the current shipper Licence Application process National Grid is of the view that the current licence arrangements do not bring any additional benefit to the industry beyond the existing commercial market mechanisms. We believe that there would be no increase in risk as a result of dropping the requirement for gas traders to hold a gas shipper licence in order to access the xoserve UK-Link (energy balancing) system.

UNC Changes

Traders would still be required to accede to the UNC to enable them to use the relevant UNC systems and be bound by the UNC including security provisions. We consider that the removal of the requirement for gas traders to hold a Shipper Licence would require changes to be made to the UNC and the relevant UNC modification proposal would need to:

- Define a Trader User solely engaged in NBP gas trading activities, as distinct from other categories of Users who engage in physical activities (as referenced under Section 5 (1)(c) of the Gas Act);
- Remove the requirement for a Trader User to obtain a shipper Licence as a pre-requisite to acceding to UNC (a Shipper User engaged in physical activities would continue to be required to hold a shipper licence).

Due to the extensive references to Shipper Users throughout each section of the UNC this would require careful legal consideration to ensure application in respect of the appropriate User category. This is expected to be an extensive exercise and so we would urge that this is taken into consideration in respect of any proposed timescales for changing existing Gas Shipper Licence processes.

The lack of requirement for traders to hold a shipper licence potentially reduces the administration of accession to the UNC by removing the requirement to validate the holding of a licence. All other Code accession requirements should continue to apply.

The UNC Accession Document does not currently make reference to the applicant needing a shipper licence to accede to the UNC, and therefore would not strictly need to be amended to enable the

³ As defined in UNC Principle Document Section X.

proposals. However, there may be benefit in amending the agreement to recognise the different types of UNC signatory – namely Shipper Users and Trader Users.

An additional benefit may be realised from the proposal to have separate classification for Traders and Shippers. Specifically, NBP trade positions `close-out` at 6pm on D+1, where Shipper energy imbalance positions do not close out until M+15. If Trader data could be used this would be beneficial in enabling more accurate and timely credit exposure monitoring.⁴

In conclusion (and subject to the qualifications detailed above) National Grid is supportive of the proposal to remove the requirement for `Trader Users` to hold Gas Shipping Licences.

Section 4 Questions

Question 1: Do you agree with our proposed changes to the Revocation Schedule of future licences?

In both the current and proposed versions of the Revocations Schedules a licensee can have its licence revoked following the cessation of licensable activity. The proposals seek to reduce the period of inactivity prior to which a licence may be revoked in these circumstances. This proposal may reduce the number of gas shipper licences in circulation and so might reduce the administrative burden associated with monitoring these dormant accounts. We therefore broadly support this proposal insofar as it addresses Ofgem's aims and potentially reduces industry costs, though we anticipate that such costs are not material.

However, we do have one area of concern on which we would welcome clarification from Ofgem. This relates to activities that require construction of physical assets prior to undertaking the licensed activity concerned. Generation, transmission, distribution, and interconnector licensees all need to construct relevant assets before they can undertake licensable activities. However, the developer's possession of a licence provides them with access to use certain statutory powers (e.g. in relation to installation of cables in public highways, compulsory purchase powers etc). While in many cases these powers may not need to be exercised (e.g. because voluntary agreements with land owners are preferred) their availability is important. Financing of projects may be dependent on the lending bodies being content that the scope to use statutory powers will remain available during the development / construction phase of a project. Only once the project has been constructed (which could take 5 or more years) would the licensee then commence the licensable activity. The proposal for the licence revocation time limit to be reduced to 1 year for all forms of licence may therefore adversely impact on the financing of new generation or other developments such as interconnectors, or offshore transmission networks.

The question to be clarified is what precisely does "...non-commencement of the relevant licensable activity..." mean? Does undertaking of design, development, and construction activities in respect of a generator, transmission, distribution, or interconnector project constitute a licensable activity, and if not then clarity from Ofgem on this point would be useful in reassuring developers that their licence would not be revoked.

Question 2: Do you agree we should align the Revocation Schedule between the gas and electricity sectors?

Yes, we agree that ideally there should be alignment of the Revocation Schedules between the gas and electricity sectors (subject to our comments above regarding the building of generation or network infrastructure).

⁴ This would have the same benefit as the implementation of the `Closed-out Data` part of Mod0233 (see page 2 of the Final Modification Report).

Question 3: Do you agree that we should reduce the time period to 1 year before a licence can be revoked in cases where parties have not commenced the licensable activity?

Yes, we agree that (subject to resolving the above issue regarding the building of generation or network infrastructure) the time period for revocation should be reduced to 1 year where parties have not commenced the licensable activity.

If you have any questions in relation to the above please do not hesitate to contact me.

Yours sincerely

[by e-mail]

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