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Mr. Paul O'Donovan
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Ofgem
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Dear Paul,

**RE: Consultation Letter: Income Adjusting Event claim for the Canatxx incremental entry capacity signal at Fleetwood**

Thank you for providing the opportunity for interested parties to represent their views on this extremely important issue. This non-confidential response is provided on behalf of the Centrica group excluding Centrica Storage Limited, and may be placed in the Ofgem Research and Information centre.

As the originating party, we fully support the aims of this Income Adjusting Event (IAE). By initiating this IAE, we are seeking to protect our customers from rewarding National Grid Gas (NGG) and its shareholders with a windfall gain.

**Summary of main points**

The situation at Fleetwood is evidence of a flaw in the prevailing user commitment regime; specifically the timing mismatch between the placing of auction bids and the requirement to place credit to underpin those bids. While the removal of a shipper's outstanding entry capacity for a relevant quarter may deter non-payment of credit where other entry capacity is held, it is evident from this case involving Canatxx that this deterrent is ineffectual where a shipper holds no other entry capacity.

It is an NGG responsibility to have in place adequate credit arrangements, yet it is clear from this case that prevailing arrangements are deficient. We are concerned that where NGG can be held neutral or even benefit financially from this deficiency, its incentives to take remedial action and implement appropriate credit arrangements are severely diminished.

Canatxx was required to bid for incremental capacity a year earlier than would normally have been the case in order to satisfy NGG's requirement for a 48 month – as opposed to the (then) standard 36 month – investment lead time. This was necessary, it claimed, due to the extent and complexity of the Fleetwood engineering solution. At the time Centrica opposed granting NGG an extended lead time. Had the standard 36 month investment lead time prevailed, Canatxx would have been clearer about the acceptability of its planning application before, rather than after, it bid for entry capacity and this would no doubt have altered its bidding behaviour.

We therefore believe that Canatxx would not have bid at the time or to the extent that it did, if normal lead times had applied and were it to be faced with a firm and enduring liability rather than the “free option” provided for under current arrangements.

Given the difficulties in attaining planning consents and Canatxx’s sale of its interests in the Fleetwood development, it is also apparent to us that NTS entry capacity is no longer required on the scale or to the timescales originally planned. We believe that this is how NGG also views the situation, hence its decision at an early stage of the process to suspend all further work – and in particular prior to the commencement of any physical network development.

In light of these circumstances, we believe that there is a commonly held view amongst the majority, or even all, stakeholders that the original auction signal was misleading and should now be disregarded. We consider that where the original bidder cannot be held financially liable, a properly functioning regime should have the facility to recognise this, and consequently the ability to amend, suspend or annul the terms of NGG’s licence which require delivery of the capacity and also permit recovery of the associated revenue.

By contrast, we consider it wholly inappropriate for these terms to remain unchanged and for shippers and their customers to be asked to pay in place of the original bidder, whilst the original bidder continues to retain rights over future capacity at the same ASEP for uptake at a time of its choosing. In these circumstances, revenues collected by NGG in excess of its actual costs can only be considered a windfall gain to NGG.

**Buyback risk**

The question has been raised about NGG’s ongoing exposure to capacity buyback risk at the Fleetwood entry point. As set out above, in a properly functioning regime this question would not arise as either the original bidder would remain liable for their commitment, or post-auction liabilities would be adjusted accordingly. Notwithstanding this, even under current arrangements we believe any such discussion to be spurious as set out below.

Given the timeframe of this IAE claim – 1 October 2010 to 31 March 2011 – we are in a position whereby the Authority has the full benefit of hindsight when making decisions about financial allowances for all of NGG’s buyback costs actually incurred at Fleetwood over the relevant period. In this case, of course, that figure is zero.

Notwithstanding this actual cost, it could be argued that NGG did not know at the start of this period that it would not be required to buy back any capacity and it therefore faced an unknown financial risk over these six months, for which it should now be rewarded. Fortunately, an extremely accurate assessment of NGG’s actual risk over this period can be made.

Capacity buyback action is only required when gas tendered for delivery with associated firm capacity cannot be accepted by NGG. For this to occur there must first be gas available at the entry point. In this case it is patently obvious, even to the most uninitiated, that the likelihood of Canatxx or any other party having gas available for delivery at Fleetwood at anytime within the period 1 October 2010 to 31 March 2011 would have been non-existent. As evidence of this we would point to the known opposition by planning authorities, the length of time needed to commission and undertake new reports and studies to address environmental and engineering planning concerns, undertaking new planning consultations following a revised application, and the lead time for planning decisions. Then, once all planning hurdles have been cleared, there remains the obvious task of engaging contractors and commencing the physical construction of the facility; in itself an extensive undertaking.

Many of the stages set out above are public and extremely high profile, allowing any interested party to form a credible view of the progress of any Fleetwood project. In addition, we believe it highly likely that any developer at Fleetwood would seek to engage actively with NGG to ensure NTS entry capacity was available when needed. As an interested party with extensive experience of the entire planning and engineering cycle, and a large financial stake in the game, NGG would have been best, and possibly uniquely, positioned to assess for itself the risk of capacity buyback. Indeed, NGG will have factored in its buyback exposure when it took the decision at a very early stage of the process to suspend all further work on the Fleetwood connection.

Based on what we know from publically available sources, and without the benefit of having had conversations with any developer at Fleetwood as NGG no doubt will have done, our best estimate would be that the very earliest that gas would be available for delivery at Fleetwood would be 4-5 years away i.e. 2015-16. Further, given both the planning and geological constraints identified throughout the process, any eventual development will be much smaller than originally anticipated. Therefore, NGG still has plenty of time to undertake the remaining work necessary to build the Fleetwood entry capacity; assuming it has already used 6 months of its original 4 year lead time, it has a further three and a half years of work in order to complete this. As set out above, therefore, NGG could complete the NTS reinforcement and connection work faster than a storage facility could actually be consented and built.

So, to address the original question of the extent to which NGG faced buyback risk for the period 1 October 2010-31 March 2011, we consider that risk to have been to all intents and purposes non-existent. This logic is absolutely supported by the buyback out-turn figure which, as set out above, is zero. We therefore consider that while NGG acted in an economic and efficient manner in suspending further work on the entry point, it must not be rewarded for a buyback risk which in reality it did not take.

A further question has been made about buyback risk which may arise from an incremental signal and associated substitution obligation received at another ASEP between 2017 (when the current incremental signal expires and capacity is treated as baseline) and 2022 (which is the limit of current Fleetwood capacity booking). Barrow has been used as an example. The first thing we would note is that any buyback risk will arise as a result of the incremental capacity becoming baseline capacity in 2017 (the expiry of the incremental signal period). We believe that there is still plenty of time, with opportunity provided by the RIIO-T1 price control, to take steps to prevent that incremental capacity becoming baseline and therefore giving rise to buyback risk resulting from substitution. Alternatively, the substitution obligation could be amended to prevent this risk from materialising.

At the start of the current price control period, extensive revisions were made to NGG's capacity obligations at certain ASEPs. Barrow was one of the terminals affected, with baseline capacity reducing from the previous level of 712GWh/d to 309 GWh/d. The terminals feeding through the Barrow ASEP have historically delivered close to the previous 712GWh/d baseline, demonstrating that this is a reasonable assessment of physical capability of the assets in that area.

Crucially, no change was made to the physical infrastructure anywhere in the vicinity of the Barrow ASEP in order to enact this reduction; as far as we are aware this was purely a commercial change agreed between NGG and Ofgem. It seems logical to us that whether intended or not, the baseline reduction at Barrow would facilitate the new entry point which had been signalled at Fleetwood; a lower capacity obligation at Barrow could serve to reduce the extent of the network reinforcement needed to accommodate the anticipated volumes at that new entry point.

A number of developments continue to be discussed in the Barrow area, with some showing real potential. We also note that existing Barrow capacity is close to being sold out for some periods between 2017 and 2022. This indicates that an incremental signal at Barrow is entirely plausible.

Whether or not network investment is required to satisfy an incremental signal, the cost to the bidding shipper(s) will remain the same, however we see no reason why the Barrow baseline could not simply return to its pre-2007 level with no additional investment whatsoever. The result of this would be that NGG would be paid significant SO revenues for doing no network development for Fleetwood, then would receive significant addition SO revenues for simply reinstating the original Barrow baseline – all without actually touching the physical network and with very little or no additional buyback risk. This simply cannot be right.

When considering buyback risk, it must of course be remembered that it is not only NGG which faces this exposure. Under its current SO Incentives, shippers are exposed to 50% of all buyback losses up to £11.82m and 100% of losses greater than this. Therefore, to the extent that buyback risk may arise in future, NGG's decision not to invest also increases shippers' risk, and potentially further cost to consumers.

**Qualification as an IAE**

As Ofgem will be well aware from our previous conversations and correspondence, we have been concerned for some time that attempt might be made to obfuscate the matters of whether these events constitute an IAE, and the associated trigger event date; it is a requirement that any IAE is raised within six months of the end of the formula year in which that trigger event falls. Centrica is not directly involved at the Fleetwood entry point, however we will face a significant element of any SO revenue smear which will arise from Canatxx's non-payment of its liabilities to NGG, subject to the Authority's decision under this IAE. We are clear, therefore, that the trigger event under this IAE is 1 October 2010, that being the date from which socialised liabilities started to accrue.

While we recognise that October 2009 was a key date in this unfolding situation – that being the date when Canatxx declined to provide the required credit to NGG - we note that there is no formal process for advising shippers of such credit non-provision. While some shippers may have noticed that Fleetwood capacity was being offered for re-sale as primary capacity, again there was no formal notification of the reasons for this. We therefore consider that there would be a significant number of shippers who would have remained oblivious to the situation at Fleetwood until such time as they started receiving neutrality invoices which contained their proportion of the revenue under-recovery smear – this being post October 2010. Crucially, we also note that the ability for any shipper to raise an IAE only commenced on 10 December 2010, therefore making shipper-raised IAE action in respect of previous formula years impossible.

In summary this issue has occurred as a result of deficiencies in the entry credit regime – which is an NGG responsibility – and the regime which governs the way in which NGG can collect revenues, in particular permitting revenue collection under inappropriate circumstances. We believe that a solution for this problem must be sought through the ongoing RIIO-T1 discussion, however in the intervening period this IAE action is the only option available to seek a satisfactory resolution.

We have made every possible effort to seek an acceptable resolution to this problem since it first came to our attention in 2008. We now believe that this IAE provides the Authority with the opportunity to take robust action to protect gas consumers from inappropriate and unacceptable costs and we most strongly encourage the Authority seize this opportunity.

Yours sincerely

Chris Wright
**Commercial Manager**

Appendix 1

**Q1 a) Do you consider that an IAE has occurred?**

Yes we do.

**b) What is the basis of your conclusion?**

Special Licence Condition C8C 3 (b) establishes at (i) (A), (B) and (C) respectively three specific circumstances in which an IAE may arise. Additionally, Special Licence Condition C8C3(b)(i)(D) provides discretion for the Authority to be able to conclude that an event or circumstance other than those listed at (A), (B), or (C) constitutes an IAE. We are in no doubt that the events surrounding the collection of SO revenues by NGG arising from the Fleetwood investment signal – which is now known to be spurious - constitutes an IAE under Special Licence Condition C8C3(b)(i)(D).

Aside from the technical grounds for an IAE described above, we do not accept that the current situation could in any way be considered as either an intended or an appropriate outcome of a well functioning regulatory regime. Left unchecked, the effect would be to reward a low risk, regulated monopoly network provider with millions of pounds of unearned, windfall revenues, paid for by consumers. This will come at a time when these funds are desperately needed for essential and worthwhile investments in secure gas supplies and our low carbon electricity future.

This revenue would not only far exceed our estimation of NGG's actual expenditure on this (now suspended) project, but also infinitely exceeds NGG's capacity buyback risk from not delivering the capacity. This is because, over the 2010-11 period, there is not even the remotest possibility that the signalled capacity could have been required or utilised. Beyond this timeframe we believe that the risks of buybacks, while theoretically possible, is extremely remote and should not be rewarded.

**Q2 Do you consider that any or all the costs saved by NGG are associated with the IAE?**

Yes. Cost savings in this respect are realised by NGG not undertaking the infrastructure investment necessary to deliver the capacity signalled for Fleetwood with no real associated liabilities.

We are told that NGG suspended work on this project once it became clear that planning permission was not forthcoming, and to the best of our understanding, no actual physical work has been carried out to enhance the NTS as a result of the investment signal.

**Q3 Has the IAE increased or decreased the relevant system operation costs by more than the £2m threshold?**

Yes. Special Licence Condition C8C 3 (b) (i) (aa) establishes a materiality threshold of >£2m. Figures provided within the consultation document show that SO revenue recovery relating to Fleetwood for the period 2010-11 is £11m, and indeed comfortably exceed this threshold in future years.

**Q4 If the Authority concludes that an IAE has occurred, how should we calculate an adjustment figure that ensures that the financial position and performance of NGG is, so far as reasonably practical, the same as if the IAE had not occurred?**

NGG must be allowed to recover only that expenditure legitimately and reasonably incurred in its work to date on the Fleetwood project, plus the applicable rate of return. Figures provided as an addendum to the consultation document indicate that NGG expenditure to date is about £9.9m. This equates to £1.98m per year across a five year recovery period. Therefore, only where this figure is verified, we propose that this figure plus the applicable rate of return, is collected by NGG for the 2010-11 formula year.

Whereas the consultation document draws attention to NGG's capacity buyback exposure – and therefore financial risk - were it to fail to deliver capacity which is subsequently required, we strongly contend that for the 2010-11 period there is absolutely no possibility whatsoever that any capacity could be required at the Fleetwood entry point. There is no valid planning permission for development of the site, but even if there were there is not even the remotest possibility of construction taking place such that NTS entry capacity would to be required over the timeframe of this IAE.

There therefore exists absolutely no justification to inflate the above figure of £1.98m by way of recognition of buy-back risk since, as set out above, buy-back risk is zero.

We also consider buyback risk over the longer term to be negligible. As an industry participant relying on public information, for some considerable time we have been firmly of the view that a storage development in the location and of the scale originally proposed was always highly tentative, at best.

We accept that suspending work on the Fleetwood connection was the efficient course of action for NGG to have taken, but this being the case we do then consider it to be efficient to then charge shippers (therefore consumers) the full amount of the allowed revenue. We would also highlight two further points. First, in order to suspend work NGG must have been certain, even at that time, that the likelihood of the capacity not being required outweighed any risk it faced from capacity buybacks were that capacity to be required but be unavailable. We highlight this as evidence that even in NGG's view, the buyback risk over the life of the SO revenue signal is minimal. Second, while we accept that NGG may have acted reasonably and prudently in suspending work (and therefore limiting expenditure), it is required under its licence to act as a reasonable and prudent operator, and as such is already rewarded through its price control settlement for such behaviour.

**Q5 Are there additional factors or evidence which you think Ofgem should take into account to inform the Authority's decision?**

In our opinion, earlier actions by NGG unwittingly conspired to drive the Fleetwood investment signal, which is now recognised to be spurious and from which NGG now stands to benefit financially. Specifically, NGG instigated an extended lead time for delivery of the network reinforcement applicable to this project, from the prevailing standard 36 months, to 48 months. Because of this extended investment lead time, in order for its project to remain on track Canatxx was required to bid for capacity in the 2006 QSEC auction, this coming ahead of Canatxx learning the outcome of its planning application (which was subsequently rejected). On 2 August 2006, Centrica wrote opposing NGG's request for an extended lead time.

We are now in a position to surmise that, had NGG not sought (and been granted) an extended investment lead time, Canatxx would not have had to bid for its capacity as early as 2006, and therefore would have had a much clearer view on the planning acceptability of its project. It therefore seems likely that had standard lead times applied as we requested, Canatxx would initially have targeted the 2007 QSEC, but crucially would have received its first planning rejection before then. This, we believe, would have led to Canatxx delaying the placing of the investment signal pending planning certainty – which has still not been granted.

We therefore conclude that it would be wholly unacceptable if early action by NGG to limit its risk of capacity non-delivery, through the seeking of an extended investment lead time which drove the spurious investment signal, were to now be rewarded with a windfall revenue gain now that the capacity is no longer required.

Therefore, our view remains that NGG must be allowed to recover all reasonably incurred expenses plus the appropriate rate of return, there exists absolutely no justification for any amount in excess of this, since buy-back risk is zero.

While we welcome the newly reinstated ability to raise an IAE as a shipper, we consider it disappointing that we have had to do so for two reasons. First, NGG has a responsibility to have in place appropriate credit arrangements for the transportation services it offers. It is clear from the situation arising at the Fleetwood entry point that prevailing credit arrangements are, and have been for a number of years, deficient.

Second, the IAE clause is intended to be symmetrical; that is, to be used to recover a revenue shortfall experienced, for example, as a result of a "cost shock" extraneous to the price control settlement, as well as to give back excess revenues recovered. The situation we now find ourselves in has not resulted through of skilled management by NGG, but rather as a result of little more than the regulated entity's good fortune. Excessive rewards should not apply in such cases.

Failure to seize this opportunity to do the right thing will result in inappropriate windfall gains being realised by a low risk, regulated monopoly – and its shareholders - at the expense of gas consumers. As we have highlighted on many previous occasions, these circumstances would be inappropriate at any point in an economic and industrial cycle. However, they come at a time of hardship for many consumers, who are facing the fallout from the economic downturn. They also coincide with the requirement for unprecedented levels of investment in infrastructure in order to better secure gas supplies in to this country and to deliver the low carbon electricity future demanded by government and the broader population.

We believe that the Authority should remain mindful of the potential for serious reputational damage to the industry and the prevailing regulatory regime if NGG unduly benefits from this accident of fate.