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*Promoting choice and value for  
all gas and electricity customers*

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Date: 6 May 2011

Dear Paul,

### **Fleetwood Entry Point: Income Adjusting Event for National Grid Gas NTS**

I am writing to inform you of the Authority's decision concerning the Income Adjusting Event (IAE) notice that you submitted to Ofgem on 7 February 2011<sup>1</sup>, in accordance with Special Condition C8C 3(b)(iii). In forming our conclusions on the notice we have given careful consideration to the views from all the responses that we received to our March consultation<sup>2</sup>, including those from Centrica Energy and National Grid Gas (NGG)<sup>3</sup>. I will place a copy of this letter on our website in order to notify all market participants and interested parties of the Authority's decision and the reasons for that decision.

We have assessed the issues that you raise in your notice and have concluded that the events described in your notice do not constitute an IAE. Without fettering the discretion of the Authority, we had previously discussed the use of an IAE with the industry as a potential means of providing an opportunity to review the revenue entitlement associated with the Fleetwood project. We therefore realise that our determination against there being an IAE will be unexpected in some quarters. But, having considered the legal arguments carefully, we have concluded that the circumstances in this instance do not satisfy the criteria for an IAE. The reasons for this are set out below.

We recognise that issues regarding capacity at Fleetwood and its remuneration remain unresolved. We are particularly concerned that Canatxx has, in effect, been able to secure a free option on gas transmission capacity, which undermines the principle of user commitment. We are also concerned that the liabilities associated with the Fleetwood signal are currently being socialised and are ultimately likely to be passed on to consumers.

We are committed to ensuring that consumers receive value for money from their gas and electricity network companies. We have therefore examined a number of routes to address the underlying issues you raise in your notice.

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<sup>1</sup> Letter from P Hallas to S Cook, 7 February 2011, Income Adjusting Event against National Grid NTS

<sup>2</sup> All non-confidential responses have been published on Ofgem's website.

<sup>3</sup> 7 March 2011, Consultation Letter - Fleetwood Income Adjusting Event (Reference 28/11)

## Background

In the September 2006 gas entry capacity auctions, NGG received a signal for 650GWh of capacity at a new entry point in Fleetwood<sup>4</sup>. This was to meet the needs of a potential new gas storage project. The storage project was refused planning permission at an appeal to the Secretary of State in 2007 and a revised application was also rejected by Lancashire County Council in 2010. The shipper that gave the signal (Canatxx) subsequently defaulted on the provision of credit to cover its capacity commitments. However, the credit arrangements under the Uniform Network Code (UNC) mean that even though Canatxx defaulted on its credit obligations, it still retained rights to future capacity for which credit is not yet due. This means that Canatxx has been able to avoid any adverse commercial consequences from its decision to default.

The Fleetwood signal triggered a target development cost up to £200m (in 2006/07 prices) for NGG to fund the development. At NGG's request, because of the perceived scale and complexity of the work, we approved a 48 month lead time for delivery of capacity. This meant that the first release of capacity at Fleetwood by NGG was scheduled for October 2010. By October 2007, when Canatxx's project planning appeal was rejected, NGG had spent £10.5m on the initial stages of network reinforcement. The network reinforcement project was subsequently deferred by NGG and they have incurred no further expenditure on it.

Annex 1 shows the actual investment costs as well as the System Operator (SO) and Transmission Owner (TO) revenue associated with the Fleetwood signal. Under the terms of the Transco Price Control Review (2002 – 2007), Transco (now NGG) was given an ex ante target cost for the Fleetwood project. The actual costs incurred are subject to an ex post efficiency assessment. Therefore, only the actual efficient cost of the investment is added to the RAV (Regulatory Asset Value). However, under the arrangements put in place as part of the price control, NGG is allowed to earn additional SO revenues as part of the incentive arrangements for accepting the risks and obligations associated with the release of increased capacity. Where the actual efficient level of investment is less than the target cost, as in this instance, there is a negative TO RAV adjustment. For the incentive period 1 April 2010–30 March 2015, NGG earns a total of £46m from these arrangements.

NGG's decision not to continue with the Fleetwood project appears efficient. It would not be in the interests of consumers for NGG to complete the £200m capacity investment in the absence of a committed user.

However, the unique nature of the Fleetwood entry point means that the capacity that NGG is obliged to make available is unlikely to be utilised to any significant extent by another party within the incentive period<sup>5</sup>. As a consequence, it is arguable that NGG potentially earns £46m without having to provide the capacity or bear the buyback risk<sup>6</sup> since the investment has not taken place.

In line with the provisions of NGG's gas transporter licence and the Uniform Network Code, as a consequence of Canatxx defaulting on its credit, NGG has been collecting these revenues from the generality of shippers. In the formula year 2010/11 it collected £11m commencing in October 2010, with another £22m due in 2011/12.

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<sup>4</sup> Auction revenue from the sale of NTS entry capacity falls into the TO revenue stream. Any revenue associated with incremental entry capacity falls into the SO revenue stream during the five-year incentive period and the period remaining until the next price control period. Following this time it will be treated as existing capacity and remunerated in the TO revenue stream. (see New entry terminals to Transco's National Transmission System-Ofgem's views, Appendix 2 Transco's revenue treatment (30/06/2003)).

<sup>5</sup> A successor project has been launched by Halite Energy Limited and a public consultation is underway.

<sup>6</sup> Buyback is the process of compensating users if NGG is unable to deliver entry capacity, which is sold on a financially firm basis, and users wish to flow gas against the capacity holding.

### *Details of the IAE notice*

In your notice, you suggest that the refusal of planning permission for the Canatxx gas storage facility at Fleetwood has resulted in there being no foreseeable requirement for the entry capacity that had previously been signalled for at the entry point. You note that NGG is entitled to recover SO revenues due to it as a result of Canatxx's Fleetwood entry capacity bid for the five-year period starting October 2010. These are in the order of £40 million and a significant proportion of these charges would fall on British Gas Trading (BGT). The trigger date for the IAE is identified as 1 October 2010, being the date that NGG was due to begin collecting Canatxx revenues through the SO commodity charge.

Your letter suggests that it is wrong for a price control mechanism to allow a low risk, regulated monopoly to be entitled to collect the full amount of Fleetwood revenues owed to it from shippers other than Canatxx. The notice suggests that NGG should recover revenues for costs incurred to date. But it suggests that any other amounts recovered amount to "unearned revenue", providing NGG with a windfall gain. You note that it is likely that these costs will ultimately fall on consumers.

Your notice suggests that NGG be allowed to collect no more than £1 million in the year commencing 1 October 2010 for the Fleetwood signal instead of the currently allowed SO revenue of £11m. Because of the recurring nature of NGG's revenue entitlement, it is suggested that an IAE will need to be raised for every year in which NGG stands to benefit from a windfall revenue gain.

### *IAE criteria*

An IAE is intended to provide protection for both NGG and consumers when events occur that result in a significant increase or decrease in SO costs against those assumed at the time the SO parameters were defined.

The IAE provisions of the Licence allow the Authority to determine whether there should be an adjustment made to NGG's allowed revenue on the basis of evidence of "...costs and/or expenses that have been incurred or saved by an income adjusting event"<sup>7</sup>.

The Authority's first task is to determine whether all or any of the costs referred to in Centrica's notice were incurred or saved as result of an IAE. The Authority has some discretion to decide what constitutes an IAE but the event must have increased or decreased the relevant SO costs by at least £2m in the relevant formula year<sup>8</sup> before any revenue adjustment can be made.

### **March 2011 Consultation**

On 7 March we issued a consultation on your IAE notice. Amongst other things, this consultation provided further details of the background to the Fleetwood situation, a copy of the notice and subsequent correspondence, details of the relevant provisions of the Gas Transporter's Licence (Special Licence Condition C8C 3 (b)) and a description of the treatment of Fleetwood allowed revenues. A subsequent addendum provided further details of NGG's costs.

We received 12 responses to the consultation.

Two shippers considered that, on balance, the IAE process was not designed to cope with such eventualities. One of these considered that NGG was simply acting in a way that the incentives are designed to engender, and so should not be penalised for this.

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<sup>7</sup> Special Licence Condition C8C 3 (b) (iii) and (v)

<sup>8</sup> Special Licence Condition C8C 3(b)(i) (D) and (aa)

NGG considers that there has not been an IAE in because the licence states the event itself must have increased or decreased the value of "relevant system operation costs" in 2010/11 ("the relevant formula year"). They conclude that the collection of revenues is not relevant to this, so that the trigger point is not an IAE.

Nine respondents considered that there had been an IAE and were supportive of the proposed adjustment to NGG's income. They highlighted that NGG would be receiving a windfall gain from the increased revenue over and above any costs or risks that they had taken on. None of these responses specified a cost related trigger for the IAE. However, 7 respondents considered that all costs saved by NGG should be associated with the IAE.

### **Ofgem's determination**

Your submission has identified the collection of SO revenues as the trigger event. This first occurred in the formula year 2010/11. However, the collection of revenue did not have an effect on the relevant SO costs and therefore could not constitute an IAE. We concur with NGG in that respect.

Further, as no relevant SO costs were expected to be incurred or saved by NGG in the year 2010/11, it would be unlikely that an IAE could be identified in that year.

We have considered whether there is a cost related event that could constitute an IAE within 2010/11, including an assessment of whether an anticipated change in buyback risk could be construed as a relevant cost. In terms of the potential triggers for the IAE a number of events could be considered. In our view, the most obvious events are either the refusal of planning permission to Canatxx in October 2007 or NGG's decision not to proceed with construction in 2008. However, the licence provisions require the IAE notice to be submitted within three months of the formula year in which the event happened. Neither of these events would permit consideration of this event under the IAE approach. We also concluded that buyback risk was not a relevant cost in this instance because it is concerned with the possibility of a future event resulting in a cost rather than an actual cost incurred (or saved).

Additionally, it is not clear to us that the IAE provision was intended to address this situation. An IAE is normally associated with significant cost over-runs or savings in a specific formula year. Whereas, an entry point project will typically have cost variations spread over several years, depending on project progress, without these being considered as IAE events. Furthermore, we consider that the obligation on NGG to provide capacity at Fleetwood goes hand in hand with the allowed revenue. It would not be appropriate to remove one without removing the other. This is not taken into account in the current licence drafting.

### *Licence issues*

In December 2010 we rectified apparent drafting errors in the gas transporter licence<sup>9</sup> which had previously prevented shippers from exercising their intended right to submit to the Authority a notice of an IAE. We did not go further than rectifying obvious drafting errors as this would likely have been regarded as changing the effect of the provision rather than giving effect to the original intention of the clause, which would have amounted to a re-opening of the price control settlement. However, in carrying out the analysis of the IAE provisions and the revenue driver in the light of your IAE notice, it has become apparent that the existing licence provisions do not offer a robust means of dealing with potential costs saving. For example, shippers would have been unable to raise an IAE without an insight into the cost implications of these triggers on NGG.

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<sup>9</sup> Modification of Special Condition C8A and C8C 3 (b) of National Grid Gas PLC's Gas Transporter Licence in respect of its National Transmission System under Section 23 (1) (a) of The Gas Act (1986). 10 December 2010.

## Next steps

We consider that although an IAE has not occurred in this case, the passing on of Canatxx's liabilities to the industry and ultimately to consumers is a serious matter. We also have concerns over the way that NGG has dealt with the Canatxx capacity issue at Fleetwood.

However, the current gas transmission entry regime was not designed with such a situation in mind. Ofgem has always recognised the importance of regulatory certainty and the benefits this brings to both licensees and consumers. The special licence conditions in the NTS licence put in place at the price control review were the subject of consultation with the industry and were accepted by NGG and Ofgem as part of the price control package. No one anticipated the Fleetwood situation arising. Seeking to make licence modifications to remove NGG's obligation to provide capacity at Fleetwood without the consent of the parties concerned could be considered to be undermining the regulatory regime, which would ultimately be to the detriment of consumers. NGG has indicated that it wishes to keep the obligation to provide capacity at Fleetwood. This means that the capacity will ultimately become available to other shippers through the entry regime by capacity substitution, trade and transfer<sup>10</sup>.

We will, however, seek to ensure that the regime is reviewed to minimise the risk that an issue of this type arises again and to ensure the cost to consumers is minimised. In particular, we are actively considering the following steps:-

### *UNC Mod 350*

We received the Uniform Network Code (UNC) 350 modification "Combining the NTS entry capacity credit checks" on 26 April 2011. This modification would replace the separate credit checks on entry and exit capacity with a single credit check. Our expectation is that this modification would, amongst other things, remove the ability of a user to allow their entry capacity to lapse. It would also clarify that should a user have insufficient credit in place or fail to pay their capacity invoices they may ultimately face termination<sup>11</sup> in accordance with UNC Transportation Principal Document Section V. If approved, this may clarify the risks and obligations on both NGG and Canatxx and potentially break the current cycle of deferment of capacity obligations.

### *Capex adjustment at RIIO-T1*

NGG's decision to keep the revenue and associated capacity commitment at Fleetwood will have implications for NGG going forward. We would expect all future capacity modelling on the transmission network to be done on a base network that is capable of coping with the projected Fleetwood flows. This means that if entry capacity is needed at Fleetwood then NGG would be obliged to deliver it, without additional revenues being provided. In turn, this would imply that NGG would be fully exposed to any consequential buyback while the capacity is classed as incremental capacity. Further, if network reinforcement projects were needed it would mean that NGG would have to fund their development from the retained revenue (irrespective of the actual cost) without additional revenue drivers.

### *Changing the IAE provisions in the future*

We accept that NGG has acted in an efficient manner in taking the decision to halt the reinforcement of the NTS at Fleetwood and has acted in accordance with the terms of the

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<sup>10</sup> These mechanisms allow capacity to be moved from entry points where it is not valued to entry points where it is valued more. This applies both to unsold baseline capacity (i.e. capacity transfer) and sold baseline capacity (i.e. capacity trade). Substitution deals with a permanent movement of baseline capacity between entry points, whereas trade and transfer are for shorter periods, typically one month. Unbooked Fleetwood capacity will not be substitutable until 2017, when the capacity is reclassified as baseline capacity.

<sup>11</sup> Termination results in all the user's capacity rights being recalled. NGG will take appropriate action to recover any outstanding invoiced amounts and NGG will try to sell the capacity in order to minimise the amount of revenue that would otherwise be recovered from the shipping community.

licence. However, we also consider that NGG should have approached us with an IAE notice after their decision to defer the project. The fact that the licence is framed in terms of cost incurred or saved implies a symmetry in treatment. We plan to discuss this further with NGG, including as part of any review of the IAE provisions. The aim of such a review would be to ensure the IAE provisions are fit for purpose and are consistent with the new RIIO price control framework. While a review would not resolve the current situation it could prevent a recurrence.

## **Conclusions**

The Fleetwood situation is an exceptional circumstance which was not anticipated at the time the price control was set and the licence conditions were drafted. We have explored the legal issues carefully and have found no grounds to identify an IAE in this instance.

We are actively exploring next steps that will minimise the impact of the Fleetwood signal on the industry and on consumers. In our view, the way forward needs to recognise that the obligations on NGG to provide capacity go hand in hand with the remuneration they receive. We therefore aim to ensure that NGG is not remunerated twice for the same investments and explore ways of ensuring that the integrity of user commitment is preserved going forward.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Stuart Cook', is written over a solid black horizontal line.

**Stuart Cook**  
**Senior Partner, Smarter Grids and Governance**

cc. National Grid Gas

## Annex 1

*Actual Investment, Allowed System Operator (SO) and Transmission Owner (TO) revenue for Canatxx signal at Fleetwood (2010/11 terms)*

Formula Year commencing 1 April	Actual Investment	SO Allowed Revenue	TO Allowed Revenue	Total
	£ million			
2006	0.32			-0.32
2007	7.90			-7.90
2008	0.73			-0.73
2009	1.55			-1.55
2010		10.89		10.89
2011		21.84		21.84
2012		21.84	-12.59	9.24
2013		21.84	-20.17	1.67
2014		21.84	-19.80	2.04
2015		19.71	-19.43	0.28
2016		20.60	-19.05	1.54

This table is a simplified version of the more detailed costs and revenues presented in the Fleetwood IAE consultation (7 March 2011).

Actual investment costs relate to conceptual and detailed designs relating to three pipeline schemes. The bulk of expenditure prior to deferment was in the 2007 formula year.

SO allowed revenue is related to the amount of capacity sold subject to a cap and collar arrangement during the 5 year incentive period which follows contractual delivery of the entry capacity in October 2010. In this case it is the collar or minimum allowed SO that applies.

TO allowed revenues are zero until the start of the next price control period (2012). During the five year price control period which follows contractual delivery of the capacity, the TO Regulatory Asset Value (RAV) is adjusted by actual investment less deemed SO RAV. This provides for a TO allowed revenue via return, depreciation and opex components. As there is very little actual investment compared to the deemed SO investment, the effect is that the TO RAV is actually adjusted downwards by between £13m and £20m. In 2017, the capacity obligation drops in to the baseline obligation; the SO revenue stream stops, and NGG is remunerated for actual efficient investment through the RAV.