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| Network Innovation Competition 2020 Supplementary Answer form | | |

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| Project Name | H100 Fife | | |
| Question number | #25 | Pro forma section | 7 |
| Question date | 10/09/20 | Answer date | 14/09/20 |
| Question summary | In the event of seeking derogations under Option 2 or 3 presented in the bid, can you provide further information (with specific reference to legislation and/or licence conditions) on the obligations that SGN believe they would be unable to fulfil as part of the project and justifications on how these conclusions have been reached? In this instance we will waiver the 2 page requirement on SQs. | | |

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## Answer (please retain document formatting and do not exceed 2 pages unless otherwise agreed with Ofgem)

As detailed in Section 7 of our submission we have engaged Addleshaw Goddard

LLP to carry out a review of the relevant regulations, consider possible issues and identify a resolution which minimises the requirement to deviate from the existing the regulatory arrangements where possible. Further detail on this regulatory analysis was provided in Appendix O, however due to the page limit allowed for the submission some of the analysis for Options 2 and 3 was not included in the final draft to ensure the analysis of our preferred Option 1 was detailed in the submission. We have provided this full analysis below which covers the key points for consideration as requested.

Further to this, if we were to move to Option 2 or 3, we would also require Ofgem to provide us with the derogation for the purposes of our complying with our Financing Documents as at present we have similar restrictions around “permitted purpose” and “indebtedness ” within our Financing Documents which the lenders would expect us to obtain Ofgem derogations for if we were to move away from this.

Option 1 has been designed to complement our debt structure and Financing Documents which ScGN is a party to and should we move to an Option 2 (or 3) then we would need evidence to show that Ofgem had consented to this.

**Regulatory Issues**

**7.1 Anticipated changes to regulatory arrangements**

SGN believe that a solution for H100 Fife Phase 1 can be implemented that requires **no derogation, licence consent, licence exemption or changes to regulatory arrangements**. The only likely requirement would be **a letter of comfort** from Ofgem addressing the fit of the project into The Gas (Calculation of Thermal Energy) Regulations 1996 (as amended) (please see row 1 of the table in section 7.3).

**7.2 Options and objectives**

Despite the regulatory and licensing intricacies and challenges of this project, SGN recognises that protection of the participating customers is sacrosanct and that a solution must be sought that allows customer participation to be simple, without disadvantage and with minimal disruption.

With that in mind, SGN's preferred approach to the project ('Option 1') involves maintaining the current regulatory structure, with only the letter of comfort required. Under Option 1, SGN Futures would deliver system activities related to the electrolyser, predominantly hydrogen gas generation from electricity, and appoint a third-party shipper to take on ownership of the gas beyond the electrolyser, allowing Scotland Gas Networks plc (**ScGN**) to deliver and operate the regulated network components of H100 Fife Phase 1 without the need for derogation or exemption from their gas transporter licence. The Meter Asset Manager (MAM) can also be appointed by the third-party shipper. Option 1 offers the opportunity to demonstrate that hydrogen gas can operate under the current industry arrangements (including the Uniform Network Code (noting our comments below on possible amendments) and Xoserve central systems) with minimal modifications. It would also allow gas consumers to remain with their current gas supplier and/or change supplier if they so desired.

Alternative models explored by SGN were:

(a) 'Option 2': SGN Futures and ScGN carry out the project activities, but with licence requirements/ derogations (in particular, one of them would have to act as shipper);

(b) 'Option 3': ScGN would undertake the entirety of the project via a full derogation of its licence.

***For the purposes of the analysis below, we have assumed that SGN's preferred Option 1 is to be effected. We have commented on the specific differences below where relevant for Option 2. We have not expanded further on this for Option 3, however would note that the same derogations would apply for option 2, and would need to understand further analysis to confirm what over and above this would be required for Option 3.***

**7.3 Regulatory analysis**

In reaching the conclusion at paragraph 7.1, SGN has worked with Addleshaw Goddard LLP to review the relevant regulations, consider possible issues and identify a resolution which minimises the risk of any changes to the regulatory arrangements. SGN intends to keep the regulatory issues listed below under review as its solution for H100 develops.

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|  | **Regulatory issue** | **Proposed resolution** |
| 2. | ***Gas Act.***  Whether a licence will be required by SGN Futures, or a licence derogation by ScGN, for carrying out the project. | If 'Option 1' of SGN's proposal is adopted as planned, no activity of SGN Futures should require a licence, nor should ScGN need to obtain any additional licence or a derogation from its transporter licence.  If the intended approach changes and SGN Futures or ScGN is carrying out any (additional) licensable activities (e.g. the role of a shipper) (Option 2), SGN will re-evaluate whether any licence or derogation is required.  ***Detail:***  "Licensable Activities" under the Gas Act are:  (a) conveying gas through pipes to any premises or to a pipeline system operated by a gas transporter;  (b) participating in the operation of a gas interconnector;  (c) supplying to any premises gas which has been conveyed to those premises through pipes;  (d) arranging with any gas transporter for gas to be introduced or taken out of the transporter's pipeline system.[[1]](#footnote-1)  *Option 1*  We have considered the potential for SGN Futures or ScGN to engage in any Licensable Activities under Option 1. The proposal assumes that activities (c) and (d) above will be undertaken by third parties with appropriate licences in place. Activity (a) will be undertaken by ScGN (under its current licence). Activity (b) will not be relevant. Consequently, SGN Futures will not be engaging in any Licensable Activities and ScGN will not require any derogation from its licence.  *Option 2*  Under Option 2, either SGN Futures or ScGN may take on the role of shipper, requiring a licence or derogation unless an exemption applies.  No exemptions under the Gas (Exemptions) Order 2011 apply (as the activities do not concern large consumers, a licensed supplier or a gas related emergency)[[2]](#footnote-2).  Turning to the exemptions specific to shipping, we do not consider that either party would be conveying as a landlord, supplying propane or butane or conveying/ supplying to a very large consumer. If SGN Futures was acting as shipper, it might seem that the exemption of conveying the gas to an 'associated company' would assist. However, although ScGN is intended to be an affiliate of SGN Futures, the exemption will not apply, as the gas is not being conveyed to 'premises' (but to ScGN's transporter pipeline)[[3]](#footnote-3).  In short, Option 2 is more complex under the Gas Act, as a licensable activity will be taking place and there are no apparent exemptions. Option 1 in contrast appears relatively straightforward to carry out without performing a licensable activity and this is in any case SGN's preferred option. |
|  | ***Licence requirements***  The restrictions/ requirements placed on ScGN under its licence, in particular in relation to: (a) restrictions on its activities and investment; (b) restrictions on its acquisition of gas or related rights and derivatives; and (c) avoiding providing cross-subsidies or an unfair commercial advantage to related entities. | SGN is satisfied that it would be able to comply with its licence conditions under Option 1.  The proposed structure under Option 1 has been designed to support this. Pursuant to this SGN Futures will be an affiliate company to ScGN (and thereby not directly owned by ScGN). Further, as with all intra group agreements, an arm's length contract will be in place between ScGN and SGN Futures for the services procured by ScGN of SGN Futures and to govern the funding between the two entities.  Given the innovative nature of hydrogen supply, SGN will work with Ofgem if any licence amendments become necessary as the project develops.  ***Detail:***  Looking at each licence restriction in turn:  (a) ScGN can only carry out the activities of a gas transporter and may only directly hold shares in a body corporate if that body only carries out business for a 'permitted purpose'[[4]](#footnote-4) .  *Application*: under Option 1, ScGN would only be acting as transporter, so would be compliant with standard special conditionA32. If a form of Option 2 was ultimately adopted which required ScGN to act as shipper, SGN is aware that it would need to consider a derogation for this [pursuant to the definition of “permitted purpose” standard special conditionA32 and the definition of Licensed Activities under the Gas Act] . It is not proposed that ScGN will hold shares in SGN Futures, to avoid directly holding shares in a company which will be, among other things, producing gas[[5]](#footnote-5);  (b) ScGN and its affiliates cannot purchase or acquire capacity rights, gas or gas derivatives with the intention of disposing of these to a third party[[6]](#footnote-6).  *Application*: under Option 1, SGN Futures (which we are assuming for these purposes would be an 'affiliate' of ScGN, as they would share an ultimate parent) would not be purchasing or acquiring gas, but producing it. ScGN would not be carrying out any of these activities. This restriction would only require further consideration if a version of 'Option 2' were adopted where either ScGN or SGN Futures was acting as shipper, where they would be purchasing gas/ acquiring capacity rights.  (c) ScGN is prohibited from providing cross-subsidies to, or receiving any cross-subsidy from, an 'affiliate or related undertaking'[[7]](#footnote-7) .  *Application*: since the NIC funding would be payable to ScGN, but an element of will be paid to SGN Futures for services provided to ScGN under the NIC project, a contract will be put in place between the two to facilitate this. This contract will be on arm's length terms; will protect against any cross-subsidy and to reflect the requirements of the NIC;  (d) ScGN is required to conduct its business so that neither it nor any affiliate/ related undertaking (among others) obtains an unfair commercial advantage[[8]](#footnote-8) .  *Application*: as noted above, the agreement between SGN Futures and ScGN will be on arm's length terms. Contracts with other parties, in particular the third party shipper, will be on industry standard/ market terms.  (e) ScGN is prohibited from, amongst other things (c), entering into an agreement or incur a commitment incorporating a cross-default obligation[[9]](#footnote-9).  *Application*: as noted above, under Option 1 SGN Futures will contract with various third parties to produce and deliver hydrogen for injection into the network which will ensure any risk of cross default is ring fenced away from ScGN. Under Option 2 ScGN would undertake this contracting role and therefore would require a derogation from Ofgem. Until contracts are placed it would be difficult to be specific on the exact detail of what this derogation would need to cover so instead would need to be more high level.  As is clear from the above, Option 1 (which is SGN's favoured approach) would be simpler to carry out in light of the licence requirements than Option 2. |

1. Section 5 of the Gas Act 1986. [↑](#footnote-ref-1)
2. Part 4 (sections 19-21) of the Gas Exemptions Order 2011. [↑](#footnote-ref-2)
3. [↑](#footnote-ref-3)
4. Schedule 2A of the Gas Act 1986. Standard special condition A32, 36 and standard condition 43. [↑](#footnote-ref-4)
5. Standard special condition A36 [↑](#footnote-ref-5)
6. D4 (prohibited procurement activities) of the standard special licence conditions. [↑](#footnote-ref-6)
7. Standard special condition A35. [↑](#footnote-ref-7)
8. Standard special condition A6. [↑](#footnote-ref-8)
9. 1. Standard Special Condition A39: Indebtedness

   [↑](#footnote-ref-9)