



Ofgem Consultation – User Commitment for NTS Quarterly Entry Capacity – Initial Impact Assessment on Modification Proposals - AEP¹ Response

The Association welcomes the opportunity to comment on this Initial Impact Assessment. We also appreciate Ofgem’s responsiveness to industry views that the impact assessment should consider this issue holistically and explore alternative approaches that are beyond the scope of the shipper community to progress.

CHAPTER: Two

Question 1: *Do you have any additional views on the merits/disadvantages of the options for securitization of capacity to add to those of the review group?*

The Association considers that the issues and advantages are presented in a balanced way in this chapter. We would however like to emphasise the potential annual cost to customers of any of the proposals and whether this is a proportionate and cost effective means of mitigating the risk of default. In particular if security is not provided then only 10% of the revenues might be recovered, leaving customers still exposed to the remaining costs.

Question 2: *Do you have views on the ability for NGG to cover the potential of shipper default through commercial insurance instruments?*

The Association is not in a position to comment on this issue

CHAPTER: Three

Question 1: *Do you agree with the analysis of the risks involved? Are there any quantifiable risks that have been omitted?*

We broadly agree with the risks identified

Question 2: *Is the level of securitization being proposed appropriate? If not, why?*

¹The Association of Electricity Producers (AEP) represents large, medium and small companies accounting for more than 95 per cent of the UK generating capacity, together with a number of businesses that provide equipment and services to the generating industry. Between them, the members embrace all of the generating technologies used commercially in the UK, from coal, gas and nuclear power, to a wide range of renewable energies.

The level of securitisation was subject to much discussion by the review group, although there is no right answer to this question. This level seeks to strike a balance between full securitisation, which would be too costly and a level that provides an appropriate incentive to avoid default.

We are unclear as to why the NPV for the costs of securitising capacity are only calculated over five years, particularly since proposals 246 and 246A require existing capacity holdings to be securitised and current bookings extend well beyond five years. It also appears that the costs of defaulting from current capacity bookings are calculated across the full duration of bookings i.e. up to Y+17. This does not appear to be consistent?

Question 3: *Do you agree with the benefits as presented here? Are there any other ways in which the quantitative benefits could be presented?*

The Association acknowledges that undertaking this kind of benefit analysis is challenging, particularly where outcomes are uncertain. We consider this to be a reasonable methodology, but it is difficult to judge whether or not these required reductions in risk of default are likely to occur in practice.

Section 3.30 notes that the main potential benefit of the proposals is that they might prevent the consumer from having to pick up the cost of a credit default. Yet it remains a matter of judgement whether the ongoing annual cost is worth the reduction in risk that may be seen or whether such defaults will occur even with revised security arrangements in place.

Question 4: *How do the risk ranges presented for each of the proposals rank against your perceived risk of default for future capacity bookings?*

It is difficult to comment on the absolute risk ranges given the assumptions made, but the ordering of the risk reductions required for break –even seems about right.

Question 5: *Do you have any preference amongst the proposals on the basis of the quantitative analysis?*

If these proposals were the only options available then the Association would favour the lowest cost option, 246B. However we are not convinced this is the best way to manage the risk of default.

CHAPTER: Four

Question 1: *Do you think that the implementation of any of these proposals would have an adverse effect on competition? Please give reasons for your answer.*

We acknowledge that the timing of the provision of security was discussed extensively at the review group, and that requiring security in advance of bidding in the allocation process was considered to be the most secure manner of proceeding. However we have concerns that this may create additional challenges to smaller players that may impact on the viability of a project and in extreme may impact on competition. We note that in the exit regime developers looking to secure exit capacity for a power station development only have to place security once the ARCA is signed, so can at least present something tangible to project financiers.

Question 2: *Do you think any of these proposals are unduly discriminatory?*

The issues of undue discrimination are always difficult to address objectively, but it does not seem unreasonable to treat existing capacity and future capacity holdings differently. To 'change the rules' regarding existing holdings, such that parties' past decisions may well have been different, would be seen to be creating regulatory risk, that may deter parties from investing in the UK at a time when significant investment is required to secure future energy supplies. Any decision that may have this effect would not be in the best interests of consumers, both current and future.

In this context we are also mindful that the Commission has opened infringement proceedings against Belgium concerning its gas transit system and one element of this seems to be a distinction between existing and future installations. This will require further consideration to see if it is relevant.

There is also the question of whether a company's credit rating should be taken into account when determining the level and type of credit that is required. It would seem appropriate to consider the risk of default when determining what security is required. We note in the exit regime the security required in connection with an ARCA does take account of the credit rating of the company. Simply treating all companies the same does not in itself guarantee the arrangements are not unduly discriminatory and it could be argued that failing to take into account relevant differences between companies is in fact discriminatory.

Question 3: *Do you think the proposals are sufficiently simple and transparent?*

The proposals themselves are readily understood. However the application of the principles may be more complex in practice since parties will have to estimate in advance the outcome of the QSEC process to determine the security that would be required. If this is not judged correctly then parties may fail to secure the capacity they need.

Question 4: *What is your preference on the basis of the qualitative issues?*

Given that a balance needs to be struck between risk of default and the costs to consumers of any 'insurance mechanism' we continue to believe that, of these three proposals, 246B is the preferred option. However we are not convinced that any of these proposals provide the best way forward when a more holistic approach is taken and other alternative measures considered.

CHAPTER: Five

Question 1: *Do you think that shipper termination is a tool that should be more widely used to deal with credit default issues?*

Shipper termination creates a significant deterrent for shippers who may make speculative capacity bookings, this may therefore discourage such bookings and protect consumers from incurring additional costs if revenue drivers are not triggered.

Question 2: *Do you agree that the Income Adjusting Event clause in the gas transporter licence should be reviewed? If so, what manner of changes would you recommend?*

There seems to be scope for improvement to the IAE process to contemplate changes in revenue as well as costs and to allow shippers and potentially other industry parties such as consumer organisations to raise an IAE. A materiality threshold would seem to be appropriate.

Question 3: *Do you agree that the revenue driver mechanism for gas entry capacity could be improved? If so, how?*

The Association considers there is scope for improvement to the automatic triggering of a revenue stream for NG when an application for incremental capacity passes the NPV test. Ideally the triggering of a revenue stream and capacity delivery should be more flexible and responsive to shipper / developer needs and reflect the reality of project development, so that the revenue driver is not triggered until there is greater certainty that the project is actually going ahead and that NG will actually need to deliver the requested capacity either through investment or other means.

The situation regarding the Fleetwood entry point arose because the capacity lead time was longer than the project lead time. A similar situation exists at exit where a CCGT can be built in a shorter timescale than the time required to deliver the associated exit capacity. However during the NTS exit regime development it was recognised that the early stages of both the CCGT project and exit capacity project involved time consuming but relatively inexpensive activities, with the point at which a commitment to significant capital expenditure was being made by both the developer and NG being a similar time from first gas. This was contemplated in 116B and more fully developed in the 195 proposals to provide in the ad hoc process a requirement for demonstration information to be provided, this could include consents, planning permission etc. If the information is not provided at a certain point in time then NG may defer delivery of the capacity. There are elements of this principle that could be developed further but could usefully be applied for projects relating to entry capacity.

Question 4: *Do you have a view as to whether the Authority's role in the approval of NGG NTS proposals to release incremental capacity is no longer required?*

So far as we are aware Ofgem has never intervened to prevent the release of capacity at this stage. However It could at some point in the future provide a useful review step. It therefore may be helpful if Ofgem were to provide some guidance on the assessment criteria they use to help to mitigate any potential concerns parties may have that this step increases regulatory and project risk.

Question 5: *Are there any other options, outside of the UNC, that could be considered for making the entry capacity credit arrangements more robust?*

Ofgem has previously expressed a view that NG should carry some of the risk of default. We support this view, else NG's rate of return should be set at the risk free rate which clearly it is not.

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