



*Promoting choice and
value to customers*

Open Letter
Gas Shippers, suppliers,
transporters and other interested
parties

Our Ref: NET TRN PCR 41
Direct Dial: 020 7901 7498
Email: robert.hull@ofgem.gov.uk

30 March 2007

Dear Sir,

Treatment of National Grid LNG Storage Services and Section 23(3) Notice to modify Special Condition C3.

1. In the SO December Document¹ and the TPCR Final Proposals Document² Ofgem indicated its intention to review the provision of LNG services by NGG.
2. On 21st March 2007 Ofgem published its SO consultation document³ which stated that it "will soon be publishing an open letter on proposed changes to the regulated prices at which National Grid Gas (NGG) procures gas reserve from LNG facilities"
3. This open letter meets that commitment and sets out Ofgem's preferred approach to the regulation of LNG storage services provided by NGG. It sets out proposals for an increase in the level of the restriction on LNG price set out in NGG's licence (to be reviewed after one year) during the transition to and development of competition in these services.

Background

4. At present NGG has a restriction in Special Condition C3 of its gas transporter licence to ensure the prices for the supply of LNG storage services are those set out in that condition ("the C3 Prices"). NGG has consent from the Authority (as provided for in the licence condition) to charge prices other than the C3 Prices in circumstances where the prices are determined by competitive auction.
5. One of the things for which LNG storage services are used is the provision of system reserve (Operating Margin (OM) gas) to the National Transmission System (NTS).

¹ "National Grid Electricity Transmission and national Grid Gas System Operator Incentives from 1 April 2007", Ofgem 208/06, December 2006

² "Transmission Price Control Review – Final Proposals", Ofgem 206/06, December 2006

³ "National Grid Gas System Operator Incentives from 1 April 2007", Ofgem 43/07, March 2007

Competition and price caps

Ofgem's initial view

6. In the SO December document Ofgem indicated that the introduction of competition for the provision of system reserve (OM gas) was a priority. Ofgem also recognised that the LNG price caps required review.

Views of respondents to the SO December Document

7. There were thirteen respondents to the SO December Document of which two were marked as confidential. Copies of the non-confidential responses have been placed on Ofgem's website. Three respondents agreed with our proposal to review the reference prices that apply to the gas reserve price incentive. One respondent raised concerns about locational market power (monopoly and monopsony) and one disagreed with any increase in price. Four respondents agreed with the introduction of competition and linking reserve prices to market price, two respondents disagreed with this proposal. One respondent suggested that allowing historic LNG expenditure into the NTS TO asset base creates a risk of NGG recovering this cost twice. One respondent expressed concerns about the proposed treatment of the Scottish Independent Undertakings.
8. NGG considered that more enduring arrangements than the current ones was desirable, particularly to allow new investment in LNG storage facilities. NGG considered that the present arrangements allowed it neither to recover efficient costs nor to compete freely in the market. NGG considered that Ofgem has a duty to enable NGG to finance the provision of OM gas and that the funding level should be set so as to enable the LNG Storage business to make long term investment decisions with some regulatory certainty. NGG considered that once contestability is established all regulation should be removed and thereupon closure costs associated with the LNG storage facilities should be recovered from consumers as these liabilities become due.

Ofgem's updated view

9. Given the number and range of industry developments and reforms to commercial and regulatory arrangements, Ofgem considers that OM gas can in future be provided by a range of service providers that may include both new gas storage facilities and demand management. Ofgem continue to consider that competition in this market is feasible and that competitive provision is in the interest of consumers. Ofgem also considers that it would be possible in the long term to source LNG road tanker loading services competitively and that this would result in more efficient provision of LNG storage services.
10. Until effective competition has developed however it is appropriate to retain price caps to protect customers because NGG is the sole monopoly provider. In setting the C3 Prices it is important to allow the company to earn sufficient revenues to cover at least its efficient forward looking costs.
11. The sites providing the services covered by the C3 Prices also provide a number of services that have different sources of revenue (through competitive auctions). Ofgem has therefore set price caps that in its judgement will, when taken in conjunction with the auction revenues, at least cover their forward looking capital and operating expenditure. The returns the assets earn will be largely determined by

market demand. If market demand is strong the auction prices will remain high and the price that NGG NTS pays for these services will be set by the market price and not the C3 price cap. In these circumstances NGG NTS will earn higher returns but this will reflect market demand and hence the value of the services the facilities provide rather than any exercise of market power. If market demand is lower and the prices from the auctions are below the regulated prices, NGG NTS will earn lower returns but will still be able to earn enough revenue to cover forward looking costs. Ofgem does not therefore consider that NGG will be remunerated twice for these activities.

Ofgem's proposals

12. Ofgem propose to insert a new condition in NGG NTS's Gas Transporter Licence requiring NGG to introduce competitive tendering for operating margins services. It is Ofgem's intention to introduce this obligation with the measures introducing the TPCR proposals.
13. In the interim however it is necessary to retain price caps to protect customers from potential abuse of market power. Ofgem has analysed the cost of providing the LNG services and proposes increasing the C3 Prices to the higher of a 25% increase in the current price⁴ or the market price⁵. Ofgem proposes limiting the application of the C3 Prices to the provision of services to NGG NTS and to the Scottish Independent Undertakings. These price caps will be reviewed after one year.

Future review of pricing arrangements

14. It is Ofgem's intention to consult on this review of the C3 Prices prior to the end of formula year 2007/08 and to either set revised price caps or introduce alternative arrangements for future years until such time as competition is established.
15. NGG considers that historic investment costs and the future costs of decommissioning the LNG storage facilities should be taken into account in establishing the regulatory framework going forward.
16. The framework established in the light of the 1997 Monopolies and Mergers Commission ('MMC') report set a revenue cap for the storage business but, in so doing, was clear that the commercial risk that BG⁶ failed to recover up to that cap due to commercial pressures was to be borne by BG. It also stipulated that the risk that future development of competition impacted (positively or negatively) on the value of the BG's storage assets (at that time comprising Rough, Hornesa and the LNG sites) - the 'stranded asset' risk - also resided with British Gas given the 'unfocused' basis on which the combined regulated business was valued for regulatory purposes. Ofgem views this as a definitive statement that decommissioning (or closure) costs are a cost for National Grid to manage and, ultimately, bear.
17. Ofgem therefore considers that the issue of historic costs and decommissioning costs was determined by the MMC. Subsequent regulatory decisions (for example when Isle of Grain was converted to an import terminal) were taken on a consistent basis with this determination.

⁴ 25% reflects an uprating of the current C3 costs (set in 1997) for inflation.

⁵ Market price will be determined by the volume weighted average for the ten percent of storage capacity for which the highest prices paid by shippers.

⁶ The relevant licence holder at the time and the equivalent of what is now NGG for these purposes.

18. Ofgem is therefore strongly minded in any subsequent review not to allow for the costs of decommissioning of these facilities. Ofgem is, as always, willing to consider any *new* evidence that NGG may provide justifying consideration of historic and decommissioning costs.

Next steps

19. Published along side this letter is a notice under section 23 (3) of the Gas Act 1986 proposing modifications to NGG's gas transporter licence to implement the changes proposed in this letter.

Responses to consultation

20. This letter is issued in support of the section 23 notice referred to in paragraph 16 above and interested parties are invited to respond to that consultation during the period set out in that notice.

Robert Hull

A handwritten signature in black ink, appearing to read 'Robert Hull', with a horizontal line underneath.

Director, Networks