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LNG Storage price control - Initial thoughts

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Target audience: LNG storage facilities, gas shippers, National Grid Gas NTS and any other interested parties

Overview:

National Grid Gas (NGG) owns four Liquefied Natural Gas (LNG) storage facilities. Currently, they are price controlled in their provision of services to the Transmission System Operator (TSO) and Scottish Independent Units (SIUs), but also provide storage to gas shippers through the deregulated market. Ofgem's aim is to get NGG to establish effective competition in the provision of services to the TSO, so that the LNG facilities can become fully deregulated. Until competition has been established, we will to price regulate these services to protect consumers.

This document is the first in a series of three regarding the price control of LNG storage facilities. It sets out the current framework for price regulation of LNG and asks for views on the appropriateness of these conditions going forward.

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Context

National Grid Gas' Liquefied Natural Gas (LNG) Storage facilities are hybrids - part price controlled providers of services to the Transmission System Operator, and part commercial providers of storage to the market. Ofgem aims to get National Grid Gas to establish effective competition in the provision of reserve so that the LNG storage facilities can become fully deregulated. This is in keeping with Ofgem's aim of protecting consumers' interests through the promotion of competition where appropriate.

Until competition is established, Ofgem will price (or revenue) regulate these services. This document is the first in a planned series of three which will consult on the regulatory arrangements for NGG's LNG Storage facilities.

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Summary

National Grid Gas (NGG) owns four Liquefied Natural Gas (LNG) storage facilities; these are situated at Avonmouth, Dynevor Arms, Glenmavis and Partington. When these facilities were built in the 1970's, they were designed to deliver gas during a few days of high demand, ensuring that NGG could meet firm demand in line with its network planning requirements. This role developed such that they provided additional services to the Transmission System Operator (TSO) to maintain system pressures and resolve locational constraints on the network.

Historically, these assets formed part of Transco's Regulatory Asset Base (RAB). They were removed from the RAB and a separate price control was put into place with effect from 1 April 1997. The rationale for their removal from the RAB was in part to promote competition in what we viewed as contestable services. In 2000 we partially deregulated the LNG storage facilities by introducing auctions for their provision of commercial storage and granting derogation for NGG to charge in excess of the regulated price caps in providing this service. The drive to introduce competition in the provision of the other services was put on hold, but we are now fully committed to renewing this drive. We would expect to see competition introduced within two years at which point we would expect to be able to remove any remaining price controls.

In the interim period, the LNG storage facilities remain a monopoly provider of services to both the TSO and Scotia Gas Networks. In order to protect consumers' interests, Ofgem will have to price regulate the provision of these services. We recognise that in order to keep the LNG facilities operational, some capital expenditure will be required. A key issue will be the treatment of such capex, since this will bring long-term benefits to both the commercial services and the current regulated services (once these become deregulated).

Ofgem considers that the decommissioning (or closure) costs of LNG storage facilities are for National Grid to manage and bear. The 1997 Monopolies and Mergers Commission report stipulated that the risk that future development of competition impacted (positively or negatively) on the value of BG's storage assets resided with British Gas, given the manner in which the business was valued for regulatory purposes. Subsequent regulatory decisions (for example when Isle of Grain was converted to an import terminal) were taken on a consistent basis with this determination.

The current price control for NGG's LNG storage facilities expires in April 2008. This document is the first in a series of three relating to the setting of a new price control for NGG LNG. As such, it describes the current regulatory regime applied to the LNG storage facilities, outlines alternatives that could be adopted and seeks views from interested parties on the appropriate way forward.

Ofgem intends to publish a set of Initial Proposals for this price control in October 2007, with Final Proposals following in December 2007. To inform these Proposals, we are seeking views on a number of issues and will also be requesting operational and costs information from NGG LNG and NGG NTS, as appropriate.

1. Introduction

Chapter Summary

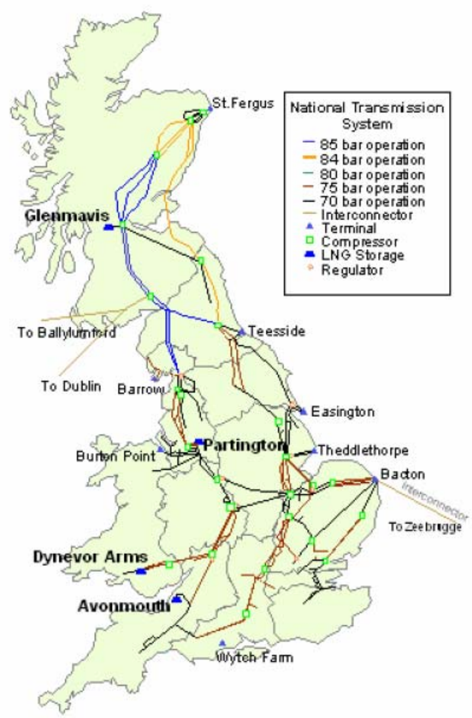
This Chapter gives an overview of the role of Liquefied Natural Gas storage facilities and the services they provide to the National Transmission System. It also outlines the regulatory regime currently applied to these facilities.

Question box

Question 1: Are there any objectives for this price control that have not been listed in this Chapter?

Background

1.1. National Grid Gas (NGG) owns four Liquefied Natural Gas (LNG) storage facilities which are connected to the National Transmission System (NTS). These facilities are sited at Glenmavis, Dynevor Arms, Partington and Avonmouth, as shown below.



National Transmission System

1.2. LNG storage facilities have particular characteristics that make them both useful and expensive. They are much more expensive to run than other forms of storage due to the liquefaction process. They are also relatively slow to fill and have limited storage capacity. However, they can regasify large quantities of gas very quickly. As such, they are a very flexible source of gas.

1.3. When these facilities were built in the 1970's, they were designed to deliver gas during a few days of high demand, ensuring that NGG could meet firm demand in line with its network planning requirements. Nowadays, there are four main services provided by these facilities:

- commercial storage
- resolution of locational transmission constraints
- provision of operating margins gas
- transportation services provided to Scotia Gas Networks (SGN) in respect of Scottish Independent Undertakings (SIUs)

Commercial storage

1.4. The commercial storage service allows for the provision of storage to shippers, with capacity being allocated through UNC allocation processes.

Resolution of locational constraints

1.5. The resolution of locational transmission constraints is a geographic service to support the transmission system. The Transmission System Operator (TSO) uses this service instead of building additional pipeline capacity. The Avonmouth facility is currently used in this role, and the TSO provides discounts to gas shippers prepared to book such LNG. Revenues received in relation to this service are subject to NGG NTS's Constrained LNG incentive scheme.

Provision of operating margins gas

1.6. Operating Margins (OM) gas is the term for gas that is used to maintain system pressures under certain operational circumstances, eg a sudden loss of supply or a sharp increase in demand. There are three groups of OM services, defined as follows:

- Group 1 - includes those events that, although unlikely to occur co-incident with a 1-in-50 winter, would have a major impact on the safe operation of the NTS. This group includes a loss of supply or a loss of infrastructure.
- Group 2- includes those events that could reasonably be expected to happen during any winter, but potentially more so in a severe winter as alternative supplies are expected to be less available and occurrences of such events could escalate due to higher demands. This group includes analysis for compressor failure, routine forecasting errors and significant supply losses.
- Group 3 - is orderly rundown, which is to ensure safe rundown of the system in the event of a Network Gas Supply Emergency while firm load shedding takes place. This is the major use for OM gas.

1.7. The income from the provision of operating margins is price regulated - with the regulated prices set out in the NGG NTS licence. NGG NTS is also subject to an incentive scheme in respect of its procurement of OM services.

Services in respect of Scottish Independent Undertakings (SIUs)

1.8. NGG uses the tanker loading facility at the Glenmavis site to load road tankers which transport gas to four remote towns in Scotland known as the Scottish Independent Undertakings. They total around 91km of pipes, which are owned by Scotia Gas Networks Ltd, and supply around 6,500 consumers with regasified LNG.

1.9. This service is provided pursuant to a bilateral contract between NGG NTS and SGN that formed part of the distribution network sales package. The prices charged under this contract are restricted to those specified in Special Condition C3 of NGG NTS's licence, which is included as Appendix 2 of this document.

Regulation of LNG storage facilities

1.10. Historically, the LNG storage facilities formed part of Transco's Regulatory Asset Base (RAB). These assets (which at that time also included the Isle of Grain site) were removed from the RAB and a separate price control was put in place with effect from 1 April 1997. The rationale for the removal of these assets from Transco's RAB was in part to promote competition in what we viewed as contestable services. Our decision to unbundle these assets was supported by the Monopolies and Mergers Commission in 1997 and by a subsequent Fair Trading Act investigation in 1999.

1.11. The 1997 price control for LNG storage facilities set price caps for the provision of services by these facilities. In 2000, Ofgem granted a derogation for NGG to charge in excess of the regulated price caps in providing services to shippers (but not in providing services to itself) in parallel with the introduction of auctions of capacity at these facilities. The 2002 Transco price control review renewed the regulated price cap in respect of services supplied by the LNG storage facilities to NGG.

1.12. In the Transmission Price Control Review (TPCR4) 2007-12, Ofgem sought views on amendments to the price regulation framework. We decided to amend the existing price caps such that when considered in conjunction with auction revenues, they were likely to cover the forward looking capital and operating expenditure of the LNG storage facilities. These amended price caps are linked to a reference market price for commercial storage service sold at the LNG storage facilities if these market prices are higher than the default levels of the price caps.

1.13. The TPCR4 also considered whether it was appropriate to reincorporate the LNG storage facilities into the NGG NTS RAB. Although one element of capital expenditure in relation to the Glenmavis facility was allowed for in calculating the 2007-12 RAB, we concluded that it was not appropriate for consumers to underwrite the long-term cost of facilities which might not be needed. We also confirmed our view that decommissioning costs should not be paid for by consumers.

1.14. Additionally, the TPCR introduced a new licence obligation on NGG NTS (Special Condition C25) to establish a transparent and robust process for the competitive provision of the operating margins services currently being supplied by the LNG storage facilities. The purpose of this condition is to provide a framework for NGG NTS to contract on a longer-term basis for the services it needs, thereby allowing competition to develop. This Condition is included as Appendix 3 of this document.

1.15. It is intended that if the terms of this new licence condition are met, then NGG LNG storage facilities should be able to tender on the same basis as other potential storage providers. This would imply the disapplication of the current regulated prices for the provision of OM services as specified in Special Condition C3 of NGG's proposed licence.

1.16. In an open letter of 30 March 2007[1] (see Appendix 4), Ofgem reiterated the views it expressed during the TPCR. It also undertook to review the price caps set as part of the TPCR after one year. This document constitutes the start of that formal review process.

Objective of this review

1.17. The objective of this review, in line with Ofgem's primary duties, is the protection of consumers in respect of the provision of LNG storage services. NGG has a new licence obligation to facilitate the introduction of competition in the provision of operating margins services and Ofgem has an expectation that competition will be established within 2 years of the start of the TPCR4 price control.

[1] "Treatment of National Grid LNG Storage Services and Section 23(3) Notice to modify Special Condition C3", Ofgem open letter, 30 March 2007

2. Form, scope & duration of control

Chapter Summary

This Chapter raises issues on the form, scope and duration of the control, and asks for respondents views.

Question box

Question 1: Do you agree that it is feasible for competition to be introduced in this sector in the medium term? What obstacles are there (if any) to introducing competition?
Question 2: Do you agree that in the short term, price cap regulation is the most appropriate form of price regulation for LNG storage facilities? Please give reasons for your answer.
Question 3: Are there any other issues that should be deemed to be within the scope of the control eg, is an Impact Assessment required?
Question 4: What would be the most appropriate duration for the control? Please give reasons for your answer.

Form of control

2.1. Ofgem has put in place a set of price caps for the provision of services by the LNG storage facilities to either NGG or the Scottish Independent Undertakings. These price caps are valid until 30 April 2008. The provision of storage services to shippers are not price capped as they are provided on a competitive basis, with prices being determined through UNC allocation processes.

2.2. Ofgem considers that the required services can be provided by competitive third parties. We consider that the establishment of contestable services will bring long-term benefits to consumers. However, until effective competition has developed, it is appropriate to retain regulatory price controls to protect consumers because NGG is the monopoly provider of these services. Once competition is established we expect that the price paid by NGG NTS for these services would be determined by the market and we would not anticipate setting price caps which could potentially distort competition in this sector.

2.3. Ofgem set price caps for 07/08 price regulation of LNG storage facilities. The basis of this decision, as distinct from adopting other forms of control, is that it maintains the volume and decommissioning risks and benefits with NGG, since they are best placed to manage the associated risks and benefits. In recent years, NGG has benefited from the management of these risks and benefits; it has profited from the Isle of Grain site and revenues from the provision of commercial storage services have strengthened in line with a general tightening of supply.

2.4. For the forthcoming control, we can continue with price caps or could introduce some other form of control; one option would be to provide a revenue allowance. If a revenue allowance were to be adopted, consumers would take on the risk that if actual revenue is less than forecast, they would make up the shortfall. Conversely, if actual revenues exceed forecasts, consumers benefit through rebates in subsequent years. This form of control would also give NGG greater flexibility in determining prices, as individual prices would not be regulated.

2.5. Ofgem is seeking views as to the most appropriate form of control prior to the establishment of competition in this sector. We are also seeking views from prospective entrants to the market regarding the steps required for the development of competition in this area and what they consider to be the main barriers to establishing competition. We would expect responses on this issue to inform the efforts of NGG to promote competition in the provision of operating margins services.

Scope of control

2.6. The purpose of the control is to deal with the regulation of the LNG storage facilities sited at Glenmavis, Dynevor Arms, Partington and Avonmouth, until it has been demonstrated that effective competition has been established. The TPCR4 and subsequent open letter laid out Ofgem's current position on a number of related policy issues. These are discussed below.

2.7. The LNG storage facilities will not be included in the NGG NTS RAB. Depending on the form of control adopted (see previous section), the value of the existing assets (however determined) could be used to derive depreciation and return allowances as part of a price cap or overall revenue allowance. However, Ofgem is currently minded adopt price caps based on forward looking costs, rather than a revenue allowance. Ofgem considers that it is meeting its duties by ensuring that the LNG storage facilities will be able to earn enough revenue to cover at least their efficient forward looking costs. However in establishing the level of efficient forward looking costs we do not intend to allow revenue to provide facilities that may be utilised to provide services in the future competitive market.

2.8. In considering the efficient forward looking costs, Ofgem would expect to review operating expenditure (Opex) and short-term capital expenditure (Capex) requirements for the coming period. Longer-term capex will not be included, as this relates to the period in which services should be competitive and so the level of such investment is a commercial issue for NGG and its shareholders to decide upon.

2.9. TPCR4 established a new licence obligation on NGG to facilitate competition in the provision of those monopoly services currently being provided by LNG storage facilities. Price regulation will only be removed from those services supplied to NGG and SIUs once a competitive market is established.

2.10. We stated in our open letter that we considered decommissioning costs to be closed unless NGG provided new evidence. Any new evidence that NGG might wish to present in this regard will be dealt with outside of this control.

Duration of the control

2.11. The current control lapses on 30 April 2008. Whereas Ofgem has made it clear that price (or revenue) regulation will continue as long as is necessary to protect consumers, it has not specified the duration of such regulation. We have a clear expectation that in line with NGG NTS's proposed licence condition to establish competition in the provision of operating margins services, a competitive environment should be established within two years. However, we would welcome views on what would be an appropriate timescale for competition to be established.

2.12. We would expect to conduct a consultation on the removal of price (or revenue) regulation for the provision of all LNG storage services, prior to the actual deregulation of prices. We anticipate that this will involve requesting information from interested parties to asses the degree of competition in the market for these services in order to inform our decision.

3. Assessing costs

Chapter Summary

This Chapter outlines Ofgem's approach to cost analysis which will be used to inform the price caps (or revenue allowances as appropriate) for the Initial Proposals document.

Question box

Question 1: What other approaches should Ofgem consider for the determination of NGG LNG's costs?
Question 2: How should Ofgem deal with the potential double counting of capex at Glenmavis?

3.1. The estimation of the costs likely to be incurred by the LNG storage facilities in providing services to NGG and the SIUs is an important part of the price control. These estimates will form the basis of price caps or revenue allowances, dependent on the form of control adopted (see previous Chapter).

3.2. For the purposes of determining the most recent price caps, Ofgem commissioned TPA Solutions to conduct an analysis of the opex and capex requirements of the LNG storage facilities[2]. This analysis covered the next five years and we would therefore not envisage replicating the analysis for this price review, but intend to use Ofgem internal resource to update the work.

3.3. In the March open letter, we considered that we are fulfilling our duties by allowing the company to earn sufficient revenues to cover at least its efficient forward looking costs. This would involve making allowance for ongoing operating costs and short term capital expenditure to maintain the facilities as an ongoing concern, while considering likely revenues from commercial storage activities. Ofgem would welcome views on the appropriateness of this approach.

3.4. Ofgem will be sending information requests to NGG NTS and NGG LNG to initiate the process of data collection. We would expect this to happen within a week of the publication of this consultation document. The analysis of this data will form the basis of the subsequent Initial Proposals document.

3.5. Ofgem is mindful of the interactions between the SIU costs and the allowances that need to be made for Scotia Gas Networks in their gas distribution price control

[2] "Review of the National Grid Storage Business", TPA Solutions, 17 October 2006

review. The actual allowances to be made for SGN will be dealt with under the gas distribution price control review process.

3.6. As already mentioned in paragraph 1.13, capex relating to the continuance of the tanker loading facility to the SIUs is incorporated in the NGG NTS RAB, and thereby earns a depreciation and return allowance for NGG NTS. Including this cost in the establishment of price caps (or revenue allowance as appropriate) would make the charges more cost reflective and facilitate the development of competitor services, but would also mean that NGG are being remunerated twice for this investment (albeit only for a limited time). Ofgem would welcome views on the appropriate manner of dealing with this issue.

4. Next steps and timeline

Chapter summary

This Chapter outlines the next steps and the timeline for the price control.

4.1. This document is the first in a planned series of three on the LNG price control. Following on from this consultation, the next document in the series will be the Initial Proposals in October 2007, and then the Final Proposals in December 2007. If NGG LNG agrees with the Final Proposals, licence drafting will be done in January/February 2008, with a view to issuing a Section 23 notice in March 2008.

4.2. In order to facilitate the necessary analysis prior to the Initial Proposals document, Ofgem will be requesting relevant business forecasts of volumes from NGG NTS and NGG LNG. We may also request updates to the most recent opex and capex forecasts supplied last year.

4.3. Ofgem is asking for responses to this consultation by 17 September 2007. Given the tightness of the timelines, early responses would be appreciated in order to allow the maximum time for consideration of any issues raised.

Appendices

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Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 17 September 2007 and should be sent to:

- Robert Hull
- Director of Transmission
- Ofgem, 9 Millbank, London SW1P 3GE
- 020 7901 7050
- Robert.Hull@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish an Initial Proposals consultation document in October 2007. Any questions on this document should, in the first instance, be directed to:

- Paul O'Donovan
- Transmission Directorate
- Ofgem, 9 Millbank, London SW1P 3GE
- 020 7901 7414
- Paul.ODonovan@ofgem.gov.uk

CHAPTER: One

Question 1: Are there any objectives for this price control that have not been listed in this Chapter?

CHAPTER: Two

Question1: Do you agree that it is feasible for competition to be introduced in this sector in the medium term? What obstacles are there (if any) to introducing competition?

Question2: Do you agree that in the short term, price cap regulation is the most appropriate form of price regulation for LNG storage facilities? Please give reasons for your answer.

Question 3: Are there any other issues that should be deemed to be within the scope of the control eg, is an Impact Assessment required?

Question 4: What would be the most appropriate duration for the control? Please give reasons for your answer.

CHAPTER: Three

Question1: What other approaches should Ofgem consider for the determination of NGG LNG's costs?

Question2: How should Ofgem deal with the potential double counting of capex at Glenmavis?

Appendix 2 – Special Condition C3

Special Condition C3: Restriction of Prices for LNG Storage Services

1. The licensee shall ensure that the charges made by the licensee for the:

a) provision of Operating Margins; and
b) supply of LNG storage services to any DN Operator whose transportation system includes independent systems which are operated using LNG

in the period of 12 months commencing on 1 May 2007 and finishing on 30 April 2008 are the charges set out in Tables 1 and 2 below.

TABLE 1

LNG storage facility	Reserved space (pence per kWh per annum)	Reserved deliverability (pence per peak day kWh per annum)	Storage injection (pence per kWh)	Storage withdrawal (pence per kWh)
Glenmavis	A	E	0.349	0.015
Dynevor Arms	B	F	0.248	0.021
Avonmouth	C	G	0.238	0.024
Partington	D	H	0.323	0.021

Where:

A Equals a price in pence per kWh per annum which is the higher of 1.706 or 0.85 * WAHGPSSt.

B Equals a price in pence per kWh per annum which is the higher of 2.840 or 0.85 * WAHDAPSSt.

C Equals a price in pence per kWh per annum which is the higher of 1.463 or 0.85 * WAHAPSSt.

D Equals a price in pence per kWh per annum which is the higher of 1.086 or 0.85*WAHPPSSt

E Equals a price in pence per kWh per annum which is the higher of 1.233 or 0.15*WAHGPSSt

F Equals a price in pence per kWh per annum which is the higher of 1.815 or 0.15*WAHDAPSSt

G Equals a price in pence per kWh per annum which is the higher of 1.345 or 0.15*WAHAPSSt

H Equals a price in pence per kWh per annum which is the higher of 0.994 or 0.15*WAHPPSSt

WAHGPSSt Equals, in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage services provided to shippers by the licensee's LNG storage facility at Glenmavis, at the average price (weighted by volume) payable by shippers in respect of that ten percent of all such Storage Capacity purchased for which the highest price were payable by any shipper purchasing such Storage Capacity for the period of 12 months commencing on 1 May 2007 and finishing on 30 April 2008

WAHDAPSSt Equals in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage provided to shippers by the licensee at the licensee's LNG storage facility at Dynevor Arms, the average price (weighted by volume) payable to shippers in respect of that ten percent of all such Storage Capacity for the period of f 12 months commencing on 1 May 2007 and finishing on 30 April 2008

WAHAPSSt Equals in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage provided to shippers by the licensee at the licensee's LNG storage facility at Avonmouth, the average price (weighted by volume) payable to shippers in respect of that ten percent of all such Storage Capacity for the period of f 12 months commencing on 1 May 2007 and finishing on 30 April 2008

WAHDPPSSt Equals in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage provided to shippers by the licensee at the licensee's LNG storage facility at Partington, the average price (weighted by volume) payable to shippers in respect of that ten percent of all such Storage Capacity for the period of f 12 months commencing on 1 May 2007 and finishing on 30 April 2008

TABLE 2

TANKER CHARGES	
Glenmavis tanker filling slots	£3437.50 per annum
Glenmavis tanker filling charge	£250 per tanker filled or partially filled

2 For each formula year for which, and to extent to which, the licensee charges for the supply of LNG storage services in accordance with paragraph 1 of this condition the license, so far as concerns LNG storage arrangements, shall be deemed to have complied for that formula year with the provisions of Standard Special Conditions A4 (Charging – General) and A5 (Obligations as Regard Charging Methodology).

3 The licensee shall provide a report in writing to the Authority stating the volume and price of all Storage Capacity sold in respect of the period of 12 months commencing on 1st May 2007 and finishing on 30th April 2008. This report shall be provided to the Authority as soon as reasonably practicable and in all circumstances by no later than 31st August 2008.

4 In this condition Operating Margins and Storage Capacity shall bear the meaning given to those terms in the licensee's network code as at 16 March 2007.

Appendix 3 - Special Condition C25

Special Condition C25: Promoting competition in the provision to the licensee of operating margins services

1. The licensee shall use reasonable endeavours to promote competition in the provision of Operating Margins services to the licensee by 1 April 2009.

2. To meet its obligations pursuant to paragraph 1 of this condition, the licensee shall, wherever it is appropriate to do so, consult upon the actions it proposes to take to promote competition in the provision of Operating Margins services widely with interested parties.

3. The licensee shall from 31 October 2007 and thereafter, by 30 April and 31 October in each formula year until 30 April 2009 (unless the Authority otherwise directs in writing) provide the Authority with a written statement, in respect of the previous six months ending on 30 September and 31 March respectively, setting out:

(a) the actions the licensee has taken pursuant to its obligations under this condition; and

(b) the actions the licensee intends to take pursuant to its obligations under this condition in the six months immediately following the date the statement is submitted to the Authority pursuant to this paragraph.

4. Where the Authority considers that competition in the provision of Operating Margins services has been achieved before 1 April 2009, the Authority shall direct that all subsequent reporting obligations under paragraph 3 of this condition shall cease to have effect.

5. In this condition, “Operating Margins” shall have the same meaning as is given to that term in the licensee’s network code as at 16 March 2007.

Appendix 4 - March open letter

The following pages give the text of the open letter issued by Ofgem on 30 March 2007

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

Dear Sir,

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

1. In the SO December Document (Ref 1) and the TPCR Final Proposals Document (Ref 2) 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 reflects 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 price (Ref 4) or the market price (Ref 5). 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 BG (Ref 6) 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
Director, Networks

Appendix 5 – The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.[3]

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly[4].

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them[5]; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[6]

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

[3] entitled "Gas Supply" and "Electricity Supply" respectively.
[4] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.
[5] under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.
[6] The Authority may have regard to other descriptions of consumers.

- Promote efficiency and economy on the part of those licensed[7] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[8] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[7] or persons authorised by exemptions to carry on any activity.
[8] Council Regulation (EC) 1/2003

Appendix 6 - Glossary

L

LNG

Liquefied Natural Gas.

N

NGG

National Grid Gas

O

OM

Operating Margins gas

R

RAB

Regulated Asset Base

S

SGN

Scotia Gas Networks

SIU

Scottish Independent Undertakings

T

TPCR4

Transmission Price Control Review 4 (2007-12)

TSO

Transmission System Operator

U

UNC

Uniform Network Code

Appendix 7 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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