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Dear Bob

Re: "LNG Storage price control – Initial thoughts" consultation

National Grid LNG Storage welcomes the opportunity to comment on the above consultation.

As Ofgem outlines in its document, National Grid owns and operates four Liquefied Natural Gas facilities located at Avonmouth, Dynevor Arms, Glenmavis and Partington. In keeping with their original purpose, these sites continue to play a critical role in ensuring both the safe and efficient operation of the gas transportation network and the security of gas supplies to consumers. This is achieved through the provision of system support services to National Grid NTS System Operator (NGG NTS SO) and storage services to gas Shippers and in respect of the Scottish Independent Undertakings.

Going forward, whilst Ofgem anticipate that there will be a transition to a fully contestable market in the provision of Operating Margins (OM) services, the existence or otherwise of viable, alternative service providers to the LNG storage facilities remains to be proven. Until such time as it is, there is a need to ensure that the LNG storage facilities attract sufficient levels of funding so as to enable essential investment to be undertaken to ensure their continued safe and efficient operation. Due to the fact that the revenues which the LNG Storage business derives from the sale of storage services to shippers is highly volatile, being characterised to date by extended periods of low returns followed by short periods of high returns, it is difficult to rely on such revenue streams to underpin investment in long-term assets to support the provision of a regulated service. We therefore believe that any form of control implemented by Ofgem needs to provide the required level of certainty of funding to enable National Grid to carry out significant, long-term investment in these facilities.

Whilst we appreciate that Ofgem may not wish to implement such arrangements in advance of NGG NTS SO issuing any tender for long-term OM services, we believe that Ofgem should be prepared to consider the need for such arrangements in the event contestability is not proven.

Objectives of the review

Within the consultation document, Ofgem state that the objective of the review is the protection of consumers in respect of the provision of LNG storage services. In our view, this potentially has two facets. Firstly, there is the need to ensure that customers, through their transportation charges, only pay for the efficient level of costs (including a return on investment) associated with the provision of non-contestable system support services by the LNG Storage business. Secondly, and of equal importance, is the need to ensure that customers continue to have access to such services for so long as they are required. This requires that National Grid is able to finance necessary investment to ensure the continued, safe operation of the LNG storage facilities.

We therefore believe that a further objective of the review should be to ensure that any regulatory arrangements are designed to ensure that National Grid is able to finance the activities of the LNG Storage business for so long as there is no competition (and hence an effective obligation) in the provision of system reserve services to NGG NTS SO and services to the Scottish Independent Undertakings. This would be consistent with Ofgem's further duties under the Gas Act 1986 (as amended). In this regard, we believe that Ofgem should give consideration not only to the level of revenue required to finance the business but also to the certainty that such revenue will be realised in order to fund the ongoing safe operations of the LNG Storage business and enable it to make necessary investments.

In terms of the factors that should be taken into consideration when determining the funding requirement of the LNG Storage business, within the consultation document Ofgem re-iterates its view that any closure costs of the LNG storage facilities are for National Grid (and its shareholders) to bear. We understand that Ofgem's view is based on its interpretation of the wording within the 1997 Monopolies and Mergers Commission (MMC) report[1] concerning the risk of stranding of BG plc's storage assets (which at the time included, Rough, Hornsea and the LNG storage facilities).

As we have previously indicated, National Grid's interpretation of what the MMC intended in relation to the funding arrangements that should apply to LNG storage and the obligations and risks the business should take on alongside any funding arrangement is different to Ofgem's. In particular, we believe that there is at least a significant degree of ambiguity as to whether the MMC ruled out making an allowance for stranding as a point of principle given that a large part of its consideration of the issue centred on whether any stranding was likely to arise (which it concluded was unlikely, and which we now find not to be the case). We propose to set out our detailed comments on this matter in a separate letter to Ofgem. In light of our views, we continue to believe that the issue of asset stranding should be considered as an integral part of the funding requirements and hence is relevant to previous, current and future regulatory arrangements.

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[1] BG Plc: A report under the Gas Act 1986 on the restrictions of prices for gas transportation and storage services

Form of Control

Under the current price control arrangements, National Grid LNG Storage is permitted to charge NGG NTS SO for OM services at the higher of either the price cap set out in Special Condition C3 of the National Grid Gas Transporter Licence (Transmission) or a weighted average of the highest 10% by volume of prices paid for services by shippers at each of the LNG storage facilities. This approach could deliver the required level of funding for the LNG Storage business. However, it exposes the LNG Storage business to the risk that: (i) NGG NTS SO does not book the volume of OM services Ofgem assumes will be booked at "C3" prices when setting the price caps; and (ii) revenues from shipper sales are less than that assumed by Ofgem in calculating the "C3" price caps.

To overcome such uncertainty, we continue to believe that for the period until contestability in OM services is confirmed, the LNG Storage business should be afforded the financial protection provided by a revenue target. Whereby, if total revenue to the LNG Storage business is less than a target revenue for that business then any shortfall would be funded by all shippers. This would most simply be achieved through the creation of an uplift to the NTS SO maximum allowed revenue, and consequently the resulting NTS SO Commodity charge, equal to the revenue deficit of the LNG Storage business. This approach would ensure that, as a group, NGG recovers adequate revenue to fund its effective obligations.

To the extent that total income from shipper, OM and Scottish Independent Undertakings sales exceeds the target revenue, it is proposed that a proportion of this should be passed back to consumers through a lowering of all shippers' NTS SO commodity charges and the NTS SO maximum allowed revenue. This would ensure that the incentive for the LNG Storage business to continue to make available as much capacity as economically possible beyond that required for OM purposes is maintained.

In our opinion, a revenue cap approach, set for an appropriate duration and incorporating a profit sharing mechanism, represents the best means of ensuring certainty of funding for the LNG Storage business, whilst, crucially, protecting the interests of consumers by maintaining security of supply and safe operation of the networks.

Scope and duration of control

In terms of the scope of the price control, we would agree that regulation should apply to those LNG storage facilities where there are no practical substitute providers of OM services and should continue to apply for so long as this remains the case. In a report commissioned by Ofgem as part of the recent Transmission Price Control Review (TPCR), Ofgem's consultants saw little competition for services at the Glenmavis and Avonmouth facilities and only saw significant competition for services at the Partington facility materialising by 2010 at the earliest. On this basis, we believe that there is a sound argument for setting a price control (along the lines described above) with a longer-term duration for these specific facilities. Amongst other things, this would represent a significant improvement over the current arrangements in that it would go some way to providing the requisite certainty over future revenues to underpin necessary investment at these important facilities.

However, it is recognised that Ofgem may not consider it appropriate to set a long-term regulatory arrangement in advance of NGG NTS SO issuing a tender in respect of longer-term OM services (consistent with NGG's obligations under Special Condition C25 of its Gas Transporter Licence (Transmission)). As such, it is acknowledged that the most pragmatic solution may be to establish a regulatory arrangement for one year in order to provide sufficient time for the OM tender to be carried out and the results to be properly considered. However, to be acceptable to National Grid, we believe that the arrangement should be such as to provide a reasonable expectation of earning a reasonable rate of return for each of the LNG storage facilities. Furthermore, there should be a commitment on the part of Ofgem to establish a longer-term set of regulatory arrangements in the event that the tender process demonstrates that there is no viable alternative provider of OM services to one or more of the LNG storage facilities.

Within the consultation document, Ofgem state that it considers that it will be meeting its duties by ensuring that the LNG Storage business will be able to earn enough revenue to cover at least its efficient forward looking costs. In our opinion, any approach should provide an expectation of covering operating costs and depreciation costs and also earning a reasonable rate of return for the LNG Storage facilities on historic investment.

Based on its open letter[2] of 30th March 2007, we understand that Ofgem may not be including return on historic investment as part of what is including in 'efficient forward looking costs'. Ofgem's reason for not recognising historic investment is based on its interpretation of the wording within the MMC's 1997 report regarding asset stranding. In our opinion, this is an incorrect interpretation of the MMC's views regarding what would constitute an appropriate level of funding for the LNG Storage business.

In particular, we would highlight that when considering whether its proposals in respect of BG's Storage business (namely, the establishment of a revenue cap of £160m) would be sufficient to finance the carrying on of that business, the MMC had specific regard as to whether such revenues would be sufficient to provide a return on the regulatory value of the storage assets. Since the regulatory value of the storage business was determined by the MMC having regard to historic investment (including the MAR adjustment of pre-1992 assets), it seems reasonable to conclude that the MMC considered that the storage business should have an expectation of realising sufficient revenues to provide a reasonable rate of return on historic investment. Indeed, it was this revenue expectation that Ofgem used to determine the maximum prices in NGG's Gas Transporter Licence (Transmission), the exact form of which existed for the 7 years immediately prior to 2007 when prices were last reviewed and where no return on historic assets was first proposed as a short term deal. Consistent with the MMC's approach, we consider that any price control arrangements should include an allowance to provide a return on historic investment.

In addition to the matters referenced above, we believe that the Price Review should concentrate on the parameters that underlie the required revenue for the LNG Storage business. The relevant areas are as follows:

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

i) *the level of expected shipper income over the regulatory period under consideration*

When forecasting shipper income National Grid believes that the most important factor is the forecast summer/winter price differential taken from forward price curves. Current forward price curves suggest a forecast summer/winter price differential no higher than we saw at the time of last year's storage auction.

Going forward, whilst we believe that the forecast summer/winter price differential will continue to be a key determinant of shipper income, there is an issue as to whether the reduction of NTS entry capacity baselines (set by Ofgem as part of the recent TPCR) at a number of the LNG storage facilities will have an adverse impact on the levels of revenue derived from sales of storage services to shippers.

ii) the expected OM volume LNG Storage will be obligated to provide

We understand that NGG NTS SO will be providing a forecast of its OM requirements as part of the review of SO incentives and would expect this to inform discussions on the LNG Storage price review. As one would expect where contestability for services exists, which it does at the margin in particular for non locational services, NGG NTS SO will contract for its OM requirements with the provider of least cost. Any reduction in bookings by NGG NTS SO will lead to reduced income for the LNG Storage business. Because operating costs are largely fixed and not variable the effect of the existing C3 price capping mechanism will result in insufficient income for the LNG Storage business to finance its functions.

iii) the efficient levels of operating costs and capital expenditure

We note that Ofgem is currently minded to allow only efficiently incurred operating costs and short-term capital expenditure. Whilst we accept that Ofgem should only allow efficiently incurred costs and expenditure, we would expect Ofgem to allow efficiently incurred capex that is required to ensure the safe operation of the LNG storage facilities both in the short and longer-term.

iv) the asset value of the business on which a return should be earned

We have outlined above our views on the need to include within the LNG storage price control an allowance for return on historic assets. There is, however, an issue as to the value against which such rate of return should be allowed. Two obvious reference values are the current net book value and the regulatory value of the LNG Storage business rolled forward from 1996. Given our views regarding who should bear the stranding risk in relation to the LNG storage facilities, we believe that the return should be based on the rolled forward regulatory value less the rolled forward regulatory value of the Isle of Grain at the time of disposal.

v) the appropriate rate of return applicable

When assessing what would constitute a reasonable rate of return for the LNG Storage business, we consider that it would be appropriate to use the return on capital that Ofgem allowed for the Transmission business under the TPCR as a benchmark. To the extent that the relative risk of the LNG Storage business differs from that of the Transmission businesses, then this risk differential should be reflected in the allowed return on capital for the LNG Storage business in addition to the relevant movement in capital markets over the last year.

Summary

In summary, we believe that, alongside Ofgem's duty to protect the interest of consumers, Ofgem has a duty to finance the activities of the LNG Storage business for the period it believes such activity should be regulated. Furthermore, we believe that such duty should take account of both level of revenue required to finance the business and need for certainty that such revenue will be realised in order to fund the ongoing operations of the LNG Storage business and enable it to make necessary investments. We believe that this is best achieved by setting a revenue allowance rather than a price cap for the period in which Ofgem believes that the provision of OM services will remain a non-contestable activity.

For the reasons set out in this response, we believe that Ofgem should have regard to both stranding risks and return on historic investments when assessing the required level of funding for the LNG Storage business. Finally, to the extent that contestability in the provision of OM takes place then we believe that all regulatory encumbrances (not just price regulation) should be removed to enable the LNG Storage business to compete freely in such a market.

Yours sincerely

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