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Dear Bob

LNG Storage price control – Initial thoughts

We welcome the publication of Ofgem's initial thoughts on the potential future price control of LNG storage and we hope that the comments we have made in the following paragraphs are helpful.

As Ofgem has identified, Scotia Gas Networks (SGN) has a particular interest in the cost of services at the Glenmavis LNG storage facility owing to its use of the facility in meeting its Scottish Independent Systems (SIU) obligations. At this time, the Glenmavis facility provides a monopoly service to SGN and, therefore, consistent with other monopoly services, we agree with Ofgem's initial thoughts that the associated charges should be regulated. We also firmly believe that SGN's own allowed revenue calculation should include a pass through term for these LNG costs over which it has no control.

We have provided more detail in response to the specific questions Ofgem has raised below.

<u>Form, scope and duration of control</u>

Qu.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?

In considering the regulation of LNG, we think that it is important to consider the differences between the LNG services that are provided to NGG NTS for operating margins (OM) gas and those services that are provided to SGN for SIU purposes. The former are services that are required by the NTS in order to overcome short term, operational constraints caused by infrastructure and/or supply/demand issues. These scenarios are more likely to occur in peak day/high demand situations and could, we believe, be met by alternatives to LNG such as use of gas from other storage facilities and/or the exercise of demand-side response contracts. In other words, the source of gas that is required to meet the OM gas requirements is not limited to that provided by the LNG services. We therefore agree with Ofgem that it is feasible for competition to be introduced for the provision of OM gas in the short to medium term. We are not aware of any particular or potential obstacles to the NTS pursuing such options.

However, the source of gas that is required to meet the SIU commitments is dependent upon LNG, which in turn relies on those services provided by NGG's LNG facilities. That is, currently, there are no alternative sources of LNG available to meet SGN's requirements. This does not mean to say that they could not develop in future. However, the capital investment requirements associated with developing potential alternative sources of LNG may form an obstacle to their development. Furthermore, there are a number of technical issues that would have to be addressed including gas quality issues (if LNG were to be sourced from outside the UK network), tanker compatibility, LNG storage and loading facilities. There would also be significant implications for the shipper commercial and balancing arrangements. Accordingly, while we do believe that there is future potential for alternative sources of LNG to meet the SIU requirements, we do not believe that these will materialise in the same timescales that we would expect competition to develop for OM gas purposes and possibly not in the medium term.

Qu.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 answers.

Yes, we agree that in the short term price cap regulation is the most appropriate form of price regulation for LNG storage facilities. As Ofgem has indicated, in adopting this approach minimum risk is passed on to users of the facility. We also believe that the use of price cap regulation is a more proportionate form of regulation when compared with the potential complexities associated with adopting a revenue allowance.

However, in setting the price cap that applies to the LNG services for SIU purposes we are firmly of the view that they should not be linked to the competitive, shipper market price that is determined through the auction process. As we explained in our letter to you dated 26 April 2007, SGN's use of the facility represents an "enduring base load", whereas NGG NTS and shippers use and, in the case of shippers, value LNG as a "peak day" service. As we have identified, it is clear that the SO and shippers have alternatives to this service; SGN does not. Therefore, we continue to believe that it is not appropriate to introduce a market related charge/cap particularly when, we understand, the regulated charge/cap is designed to recover all appropriate costs. In any event, as we have mentioned earlier, we firmly believe that SGN should be given an effective pass through of these costs.

Qu.3. Are there any other issues that should be deemed to be within the scope of the control e.g., is an Impact Assessment required?

Other than the issue of how to treat the capex relating to the continuance of the tanker loading facility to the SIUs that has been incorporated in the NTS RAB (and which Ofgem has acknowledged needs to be addressed), we are not aware of any other issue that should be deemed to be within the scope of the control. We do not believe that an Impact Assessment is required based upon the current monopoly position enjoyed by the LNG facilities to which the proposed control would apply.

Qu.4. what would be the most appropriate duration for the control? Please give reasons for your answer.

Special Condition C25 of the NGG's NTS licence requires NGG to promote competition in the provision of OM services by 1 April 2009. However, as we have explained, we do not believe that potential competition for the provision of LNG services for SIU purposes will emerge in the same timescale. Therefore, given the interaction with SGN's own price control, we believe that it would be appropriate for the proposed control of the LNG services to coincide with the Gas Distribution price control i.e. for 5 years. However, to the extent that LNG costs to service the SIUs are treated as a cost pass through, it may be appropriate to reduce the duration of the LNG control.

<u>Assessing Costs</u>

Qu.1. what other approaches should Ofgem consider for the determination of NGG LNG's costs?

We believe that the approach Ofgem proposes to adopt to determine NGG LNG's costs is appropriate. In order to set the current price caps Ofgem, via its consultants, has conducted an analysis of the opex and capex requirements of the LNG storage facilities over the next 5 years. It would therefore seem appropriate to adopt an approach that seeks to update these figures. However, in doing so, we also believe that it would be appropriate to ensure that the operation of the facilities for the provision of these "regulated" services is the most efficient. For example, we believe alternative storage liquefaction patterns for SGN's LNG requirements could reduce costs.

Qu.2. how should Ofgem deal with the potential double counting of capex at Glenmavis?

Ofgem has identified that the capex costs associated with the continuance of the tanker loading facility to the SIUs is incorporated in the NTS RAB. As we have highlighted in previous correspondence, we agree with Ofgem that the concurrent inclusion of these costs in the LNG price caps (or revenue allowance as appropriate) will mean that NGG are being remunerated twice for this investment which is clearly wrong. Therefore, it appears to us that there either needs to be an adjustment to the NTS RAB to remove the LNG component, or, alternatively, the price caps (allowed revenue) will need to be based on capex that excludes that which has been allowed within the NTS RAB. Irrespective of which mechanism is adopted going forward, it is apparent that a corrective mechanism will also need to be applied retrospectively to the 07/08 regulated LNG charges to remove the double recovery associated with this year.

I hope that you will find these comments useful.

Yours sincerely

Rob McDonald
Director of Regulation