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Friday, 23 November 2007

Robert Hull
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Ofgem
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London SW1P 3GE

By E-mail: robert.hull@ofgem.gov.uk

Dear Robert,

Re: LNG Storage Price Control – Initial Proposals

Thank you for the opportunity to comment on the above document, this non confidential response is on behalf of Centrica plc excluding Centrica Storage Ltd. We are happy that Ofgem place this response on their website and in the Ofgem library.

We are broadly supportive of the high level principle contained in the document, that if competition is to be introduced into the non competitive aspects of LNG storage, then it is necessary to continue a form of price regulation until competition is effective.

In our response to Ofgem's Initial Thoughts document, we set out our views (which have not changed) in terms of the appropriate steps to introduce competition in this area, providing the evidence was clearly that competition would generate customer benefits.

We agreed that subject to competition being fully effective, it would be appropriate for LNG price regulation to be dropped after a transitional period. We also noted that in terms of objectives, it would be appropriate to incentivise the efficient procurement by transporters of competitive services in future. Hence, we considered that Ofgem should consider in parallel whether a further incentive scheme may be required in this area under the SO control. This has not been reflected in the Initial Proposals, and we would like Ofgem to consider this area in advance of Final Proposals.

We support Ofgem's view that consumers should not bear decommissioning costs, these being properly a matter for NGG LNG shareholders and we are encouraged that Ofgem has continued this approach in the Initial Proposals.

In our previous response, we considered the two approaches and proposed a third option, namely a revenue target with a cap, collar and sharing factors. Given the challenging nature of an April 2009 implementation timetable, we continue to believe that this approach would be preferable and would better support a transitional period as mentioned above.

However, we had not fully appreciated the effect of the Initial Proposals. Ofgem clearly favours a Price Cap, noting that the overall level of return that NGG LNG earns will be determined by the revenues and prices commanded in the market for the commercial storage services. The document then sets out that if the price for commercial services exceeds the price cap, NGG LNG can charge the market price for these “capped” services. This is on the basis that “…it would be inefficient to force NGG LNG to sell these services to the TSO and SIUs at below the market rate if there were other shippers willing to pay more for the capacity.”

Centrica is concerned about this approach. Normally, the operation of a price cap is intended to protect customers’ interests pending competition being effective. Instead, in this scenario, it appears that the role of the price cap is, in fact, to operate as a price floor. The price floor clearly protects NGG LNG’s interests, rather than customers’, providing a guaranteed rate of return for the regulated services whilst allowing NGG LNG to earn windfall gains and a higher rate of return also on the regulated services.

We are also opposed to the asymmetrical nature of the drafting, namely that if the market rate is below the price cap, NGG LNG receives the price cap rate. Effectively, NGG LNG has all the benefits of a market approach with none of the risk and is clearly not incentivised to introduce a competitive market. Whilst Centrica does not support this way forward, if implemented, such a zero risk approach must result in NGG LNG being allowed only the most minimal rate of return in respect of the regulated services.

On the other hand, applying a true price cap and collar would protect the interests of all stakeholders, and act as an incentive on NGG LNG to move forward effective competition at the earliest opportunity.

In terms of the specific questions raised in the document, we are in agreement that it would be appropriate to use the TPA Solutions opex data. Clearly, it would be preferable to use more up to date information, but as Ofgem correctly highlights, the level of scrutiny applied to the TPA Solutions data is much more rigorous and hence that data is a better basis on which to make a price control decision.

Under opex, we note the inclusion of central costs, which Ofgem believes may not have been assessed by TPA. We believe that Ofgem should challenge these additional costs robustly before allowing them. We are concerned that Ofgem has based the Initial Proposals on two-thirds of these costs without further substantiation. We would have preferred that this category of costs be excluded unless fully evidenced.

Centrica is also concerned that NGG LNG has included pension costs in its submission which Ofgem believes to have been allowed for in TPCR. If this is the case it is clearly not appropriate and we support Ofgem’s approach of challenging their inclusion here.

With respect to capex proposals, whilst we wish to minimise costs to customers, Centrica is extremely concerned by the range of figures in the document. In chapter 3, based on the 2010/2011 contestability scenario, NGG LNG has submitted bids for capex of £42.9m (nominal), TPA Solutions recommends £2.2m in 2004/5 prices and based on desktop analysis, Ofgem considers £7.5m (nominal) to be a “more reasonable” total for the four years to 2011. Ofgem does not specify the basis of the desktop analysis, but does note that it is likely to change following further review.

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The information asymmetry between regulated parties and consultees is at least as prevalent under this control as under the GDPCR and TPCR and is unfortunate. On the basis of limited information and the wide range of figures above, Centrica has limited confidence in the capex figures provided, and requests that Ofgem provide further details of the desktop analysis undertaken and the scale of any likely further change.

On cost of capital, we note that Ofgem has used a pre tax rate of 6.25% as a modelling assumption, and states that the cost of capital from the GDPCR will inform the final proposals. Whilst we understand that Ofgem will wish to have regard to the GDPCR, we are disappointed that yet again, such a key part of the debate has been left until the final proposals when no further consultation is planned.

We do not have a particular view on the accuracy of the forecasts of reduced revenues from provision of services to shippers going forward.

Overall, whilst we would naturally wish to see a reduction in the Price Cap associated with the LNG Storage Price Control, in the context of NGG LNG being able to charge market related prices, we are not convinced of the likely benefit. In addition, the range of figures from a 29% reduction in the C3 prices, to a 166% increase in the C3 prices if NGG LNG's submission were to be permitted in full, is huge. On this basis, we are not confident enough in the numbers to be able to offer unqualified support to the proposals.

Should you wish to discuss any of the points raised above in more detail, I should be happy to help.

Yours sincerely,

By e-mail

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