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Dear Bob

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

The four Liquefied Natural Gas (LNG) storage facilities that are owned and operated by National Grid play a critical role in ensuring the safe and efficient operation of the gas transportation network and security of gas supplies to consumers. This is achieved through the provision of system support and reserve services to National Grid Gas System Operator (NGG SO) and the provision of gas supplies to Scotia Gas Networks in respect of the Scottish Independent Undertakings (SIUs) and commercial storage services to shippers. Due to the quantity of hazardous material stored at the LNG storage facilities and, in a number of cases, their close vicinity to centres of population, they have been categorised as top-tier COMAH sites and, as such, attract considerable attention from the Health and Safety Executive (HSE) . Accordingly, in view of the nature of the LNG storage facilities and the essential services they provide, it is in the interest of gas consumers and the wider public that they attract sufficient funding to enable the required levels of investment to be undertaken to ensure their continued safe and efficient operation.

In our opinion, when taken together with forecast levels of shipper income, the proposed 29 per cent reduction in the current level of prices set out in Special Condition C3 of National Grid Gas's NTS licence (the C3 prices) would not provide sufficient revenue to finance the ongoing activities of the LNG storage business in the period up to the establishment of competition in Operating Margins (OM) services. Fundamentally, we believe that Ofgem have under-estimated the required amount of forward looking capital expenditure to maintain the safe and efficient operation of the LNG storage facilities in the period up to 30th April 2011 (the assumed date for the introduction of competition under Ofgem's "2011 contestability" scenario).

Furthermore, we believe that Ofgem's approach to determining the required levels of capital expenditure fails to take proper account of the uncertainty regarding the timing of the introduction of competition in OM services. In particular, we understand that Ofgem have based their forecast of capex requirements up to 30th April 2011 on the assumption that competition in OM services will be established by that date and that, therefore, investment to be funded by consumers can effectively be "run-down" in expectation of that event. We consider that this is an over-simplistic assumption that drives an inefficient level of investment in the event that competition is delayed beyond the 30th April 2011. In such circumstances, National Grid LNG Storage would be left trying to play “catch-up” in order to put in place additional investment to ensure the provision of non-contestable storage services for a further, unquantifiable, period of time.

In its Initial thoughts consultation, Ofgem stated that, in line with its primary duties, the objective of the LNG storage price review is the protection of consumers in respect of the provision of LNG storage services. In our opinion, Ofgem’s Initial proposals would fail to meet this objective in that they would not provide sufficient funding to ensure that we can invest to maintain the safe and efficient operation of the LNG storage facilities; thereby jeopardising the provision of essential services in support of the delivery of reliable and secure supplies of gas to consumers. Furthermore, any under-estimation of the costs of providing such services will inevitably discourage the development of competition in OM services to the longer-term detriment of consumers.

In the period since the publication of the Initial proposals, we have held discussions with Ofgem in relation to our forecasts of operating costs and capital expenditure. We will continue to seek to engage with Ofgem in the period up to the publication of the final proposals in order to better inform their view of the required levels of forward looking costs and to further discuss our views on other aspects of Ofgem’s Initial proposals.

Our further comments on Ofgem’s Initial proposals are set out below.

Scope of control

We are disappointed that Ofgem continues to refuse to have regard to both stranding risks and the need to provide an allowance to cover return and depreciation on historic assets when determining the revenue requirements for the LNG storage business. As indicated in the Initial proposals document, National Grid LNG Storage has written to Ofgem setting out its arguments in support of its case on the treatment of stranding risk and historic investment. We do not believe that the points raised by National Grid LNG Storage have been adequately addressed in the Initial Proposals document and we continue to look forward to receiving a detailed response to our separate letter to Ofgem.

Form of control

As highlighted in our response to the Initial thoughts consultation, we believe that when fulfilling their duty to ensure that National Grid Gas is able to finance the activities of the LNG storage business, Ofgem should have regard not only to the level of revenue required to finance the business but also the certainty that such revenue will be realised. In their summary of the Initial proposals (page 2 of the Initial proposals document), Ofgem state that “we propose continuing with a price cap on the provision of regulated services with **guaranteed** remuneration through the regulated services for efficient forward looking costs only” *[emphasis added]*. From this statement, it would appear that Ofgem have accepted the principle that National Grid Gas should have certainty over remuneration in order to finance the LNG storage business. However, we disagree with Ofgem’s view that the application of a price cap on regulated services will “guarantee” such remuneration.

A price cap form of control will only ensure that sufficient revenues are recovered in the event that the outturn level of OM services booked by NGG SO equals the level assumed when setting the price cap. Since NGG SO is directly incentivised to minimise the amount of OM services it books, there is a risk that the LNG storage business will under-recover against the level of revenue assumed when setting the price caps. Any such under-recovery would have a direct impact on the ability of the LNG storage business to finance its activities due to the fact that avoided costs do not match the associated reduction in revenue.

In view of the above, we continue to believe that a revenue cap form of control (in line with the form of control that applies in respect of certain of the assets at the Glenmavis facility), with a mechanism to share any over or under-recovery of revenues with customers, remains the most appropriate way to ensure certainty of funding for the LNG storage business whilst, at the same time, protecting the interests of consumers by maintaining security of supply and safe operation of the facilities. A more detailed description of our proposal was set out in our response to the Initial thoughts consultation.

Notwithstanding our view that a revenue cap form of control remains the most appropriate means of ensuring funding of the LNG storage business, our comments in the further sections of this response are related to the price cap form of control proposed by Ofgem.

Duration of control

As a consequence of the uncertainty surrounding the timing of the development of competition in OM services, we note that Ofgem have performed their revenue and cost analysis over a three year timeframe with a view to setting C3 prices that could continue to apply beyond April 2009. Specifically, within the Initial proposals consultation document, Ofgem state that "the prices would endure either until competition is established or until the Authority sees fit to revise them some time after 2009".

Whilst we agree that it would be sensible to establish prices that could continue to apply beyond April 2009, we would be concerned to ensure that such prices align with movements in the costs of the business over time. As a result, we believe that prices should be increased year-on-year by the Retail Price Index. Furthermore, rather than the duration of the price caps being entirely at Ofgem's discretion, we believe that National Grid Gas should have the right to disapply the prices on giving, say, 6 months notice. This would enable National Grid Gas to seek the resetting of prices in the event of any material misalignment of costs and revenues.

Capex

Within the Initial Proposals document, Ofgem re-iterate their view that consumers should only be funding capex that is necessary to continue the operation of the LNG storage facilities until competition is introduced for the provision of OM gas. Whilst we would not disagree with the broad thrust of this principle (as it applies to forward looking capex), we believe that it is an important point of clarification that consumers should be funding the efficient levels of capex necessary to ensure the "safe and efficient" operation of the facilities up to the introduction of competition in OM services. In this context, National Grid LNG Storage considers that the uncertainty over the timing of the introduction of competition in OM services has a direct bearing on what would constitute an efficient level of investment under the various scenarios proposed by Ofgem.

For their part, we understand that Ofgem have based their forecast of capex requirements up to 30th April 2011 on the assumption that competition in OM services **will** be established by that date and that therefore investment to be funded by consumers can effectively be "run-down" in expectation of that event. In our opinion, this is an over-simplistic assumption that drives a sub-optimal level of investment in the event that competition in OM services is delayed beyond the 30th April 2011. This is because National Grid LNG Storage (if it were simply to invest in the facilities according to Ofgem's proposed allowance) would be left trying to play "catch-up" in order to put in place additional investment to ensure the safe and reliable operation of the facilities for a further, unquantifiable, period of time. Since such investment would, in all likelihood, be required in relatively short timescales (by virtue of the fact that any decision concerning the state of contestability in OM services is unlikely to be forthcoming until near to the time), it is unlikely to result in the most efficient levels of expenditure.

In contrast, National Grid LNG Storage's forecast of capex requirements to 30th April 2011 is intended to reflect the practical reality around lead-times for investment and the timing of any decision in relation to the state of competition in OM services. As such, we believe that it represents a reasonable and prudent view of what constitutes an efficient level of expenditure that should be funded by consumers in order to ensure the safe and efficient operation of the LNG storage facilities up to 30th April 2011, whilst allowing for the fact that the facilities could be required to continue to provide non-contestable services for an indeterminate period beyond that date.

We believe that it is this difference in approach that drives the large difference between National Grid LNG Storage's view of capex requirements under the 2011 scenario compared to Ofgem's. It is worth pointing out however that the wording in paragraph 3.13 of the Initial proposals overstates the difference in that it includes expenditure for the current year (2007/08), which we understand is not within the scope of the current price review. We believe that it would have been more correct to compare the £22m (06/07 prices) of expenditure forecast by National Grid LNG Storage over the period 08/09 to 10/11 with the £6.9m (06/07 prices) forecast by Ofgem over the same period.

National Grid LNG Storage's projected capex requirement is built up from an understanding of the complex process plant that makes up an LNG storage facility and the position of the plant in its expected asset life (the sites were built between 1971 and 1983 and with component asset lives between 10 and 40 years many assets are past or approaching their expected asset life). Amongst other things, the projected spend addresses issues relating to removal of staff from hazardous environments, reduction in impact of any site incident, avoidance of failure leading to potential major incident and investment required for COMAH and environmental compliance.

In line with our interpretation of what constitutes efficient capital expenditure under the 2011 contestability scenario, we continue to believe that Ofgem should use our forecast of required capital expenditure in its calculation of the proposed C3 prices. Furthermore, in view of the fact that Ofgem are proposing to deregulate the assets within, possibly, a relatively short period of time, we believe that such investment should be fully expensed in the proposed year of spend.

Opex

Within the Initial proposals consultation Ofgem highlight that the latest forecasts of operating costs provided by the LNG storage business as part of the current price review are higher than the equivalent forecasts submitted to TPA Solutions during the recent Transmission Price Control Review (TPCR4). Ofgem also question whether TPA Solutions assessed central costs as part of their recent review of the business and raise a further concern as to what extent, if any, central costs and pension costs have already been allowed for in the TPCR4 settlement.

Since the publication of the Initial proposals consultation, National Grid LNG Storage has made further submissions to Ofgem to demonstrate that TPA Solutions did assess central costs as part of their review of the business and to explain and justify the variances between our latest forecast of operating costs and those submitted to TPA Solutions during TPCR4. On the issue of whether certain costs have already been allowed for in TPCR4, National Grid LNG Storage intends to provide evidence to Ofgem to show that there has been no "double-counting" of central costs and we therefore believe that such costs should be allowed in full.

As regards pension costs, whilst we believe that the relevant proportion of the pension deficit attributable to employees of the LNG storage business may have been allowed for as part of TPCR4 (and were not therefore included within our forecast of operating costs as part of the current LNG storage price review), we do not believe that ongoing pension costs were included as part of that settlement. Ultimately, however, we consider that it is for Ofgem to demonstrate to what extent, if any, LNG storage pension costs have been allowed for in TPCR4 given that they have access to the detailed calculations that underpinned the TPCR4 Final Proposals.

Finally, we would highlight that our forecast of operating costs has been developed in line with our proposed capital investment plan. Clearly, if lower levels of forward looking capex are assumed for the purposes of calculating the C3 price caps this should result in a consequential increase in assumed levels of operating costs to cover increased maintenance costs.

Shipper revenues

Within the Initial proposals consultation Ofgem invite further views and supporting evidence concerning the future level of revenues that are likely to be derived from the sale of commercial storage services. As we outlined in our response to the Initial thoughts consultation, National Grid LNG Storage believes that the most important factor affecting future levels of shipper income is the forecast summer/winter gas price differential. In deriving our current forecast of shipper income, we have had regard to the fact that the supply/demand position is not forecast to tighten significantly over the medium term and have therefore assumed that shippers will be prepared to pay for future LNG storage services in line with the results from the April 2007 LNG storage auctions. Specifically, we have assumed that shippers will value future services at a multiple of 1 x the forecast summer/winter price differential, which is consistent with the average price paid by shippers for capacity across both rounds of the April 2007 auction process.

In many respects this could be considered to represent an optimistic view of the price that shippers might pay for future LNG storage services. This is because in the second round of the April 2007 auctions, shippers were only prepared to pay (on average) a price that equated to a multiple of 0.7 x the forecast summer/winter price differential. Since shippers' bids in the second auction round are informed by information published in respect of the first, the results of the second round could be considered to provide a more accurate view of the market price for LNG storage services.

Furthermore, given that the April 2007 auctions were held against a background of uncertainty as to whether certain key supply projects, such as the Milford Haven LNG importation terminals, would be commissioned in time for winter 07/08, it is not unreasonable to assume that shippers might in future be prepared to pay even less for commercial LNG storage services as such projects come on line. Indeed, in their report on the LNG storage business commissioned by Ofgem, TPA Solutions commented that "in the medium term there is very likely to be very limited demand by shippers for LNG services. This will create a significant surplus of LNG capacity which will be exacerbated by the new LNG importation terminals coming on stream".

Finally, as we also highlighted in our response to the Initial proposals consultation, 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 (as set by Ofgem as part of TPCR4) at a number of LNG storage facilities will have an adverse impact on the levels of revenue derived from the sales of storage services to shippers.

Given the above, we do not agree with Ofgem's assessment that our forecasts of shipper income represent a pessimistic scenario. In fact, we believe that there is a significant risk that shipper revenues could be less than forecast thereby resulting in a potential under-funding of the LNG storage business.

Price control calculations

With regard to the price control calculations set out in Chapter 4, National Grid LNG Storage has highlighted to Ofgem a number of proposed amendments to the calculations and underlying data to improve their accuracy. These include:

- the need to include SIU revenues (in addition to OM revenues) when determining the required percentage change to C3 prices;
- the need to allow for full depreciation of investment in the proposed year of spend (currently, the total costs fail to take account of half the depreciation on the 2009/10 investment and none of the depreciation on the 2010/11 investment – this is contrary to Ofgem's view that National Grid needs to be remunerated for efficient forward looking capex in the period between investment and the establishment of contestability following the investment); and
- the need to reflect the latest OM forecasts provided to Ofgem by NGG SO.

National Grid LNG Storage notes that the current cost of capital used in the calculation is the pre-tax rate of 6.25% (as used in the TPCR) but that Ofgem expect the final rate used to be informed by the cost of capital used for the forthcoming Gas Distribution Price Control Review Final Proposals. In our opinion, this is not the most logical approach given the significant differences between the LNG storage business and the Gas Distribution business which, amongst other things, include:

- financial size and presence in the UK energy markets;
- the extent to which the two businesses are subject to regulation / have monopoly power;
- the difference in the markets in which respective companies operate, which impacts perceived risk profiles.

Given the predominantly fixed cost base exhibited by the LNG storage business, in conjunction with the volatile nature of the revenues it receives from year-to-year, the resulting EBIT figure is not one that would enable significant levels of debt to be secured by such a business. Hence, if the LNG storage business were to secure financing in its own right, this would need to be sourced predominantly from equity. As such, we believe that there are strong arguments in favour of the LNG storage business attracting a cost of capital significantly in excess of both National Grid Gas's Distribution and Transmission businesses.

As a final general comment, assuming that Ofgem have used the same methodology to calculate the proposed C3 prices as was used to set the current C3 prices, National Grid LNG Storage believes that the scale and direction of the proposed change in C3 prices is counter-intuitive. Specifically, it is difficult to reconcile the fact that Ofgem have proposed a 29 per cent reduction to the current C3 prices despite the fact that they have assumed higher total operating costs (opex and central costs) and a lower revenue forecast compared to that used to calculate the current price caps. Intuitively, these factors might have been expected to result in an increase in the level of C3 prices rather than a significant reduction.

It seems reasonable to conclude therefore that Ofgem have either changed the basis of the calculation of C3 prices or have significantly altered their view of efficient, forward looking capex i.e. they have assumed significantly lower capex in their latest calculations compared to that used to set the current C3 prices. We would welcome Ofgem's views on this point.

In summary, we continue to believe that if Ofgem continue to propose a price cap approach, given our arguments set out above, a significant increase in the C3 price levels will be required to ensure the safe and efficient operation of the LNG storage facilities (and thereby the continued delivery of safe and secure gas supplies to consumers) in the period up to the introduction of competition in OM services.

I look forward to further discussing the above points with you in due course.

Yours sincerely,

Richard Court
Commercial Planning Manager