



Gas and electricity licensees,
consumer groups, and
any other interested parties

Ofgem
Value for Money

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Date: 30 October 2008

Dear colleague

Decision on National Grid's proposal to commence generating electricity at Gas Distribution pressure reduction sites

On 3 April 2008, Ofgem published an Open Letter seeking views on National Grid Gas's (NGG's) proposal to commence generating electricity at gas distribution sites.

This letter sets out the conclusions that Ofgem has drawn from the responses to the consultation and the actions it has decided to take.

Background to Ofgem's April Consultation

In April 2008, Ofgem published its consultation titled "Open letter consultation on National Grid proposal to commence generating electricity at Gas Distribution pressure reduction sites"¹. The consultation discussed three main issues:

- Whether the trial project referred to as the Electricity Generation Project, proposed by NGG, should be allowed to go ahead;
- Whether the Authority should give NGG the requested consents under NGG's Gas Transporter licence; and

Whether the expected project benefits outweigh the potential risks and costs to customers.

The consultation sought responses to the following questions:

- Do respondents agree with NGG's proposed environmental benefits associated with this technology?

Are there any potential benefits, costs or risks to consumers that have not been considered in this letter?
- Are there any other licence conditions that could be affected by NGG's proposal?
- Should this kind of arrangement be ruled out as it has the potential to dilute the incentive on NGG to operate either the transmission or distribution networks efficiently?

¹ http://www.ofgem.gov.uk/Networks/GasDistr/otherwork/Documents1/NGG_Blueng_Open_letter.pdf

- Should NGG be looking at the opportunities to reduce pressures on the National Transmission System to prevent the need for excessive pressure reduction at these sites?
- Given that National Grid plc (NG) also owns National Grid Electricity Transmission plc and is therefore not allowed to generate electricity itself, are there any concerns regarding this proposal from this perspective?
- Are there any other issues Ofgem should be considering in reviewing NGG's proposal?
- Should Ofgem be considering the proposal to reduce own use gas for pre-heat using biomass generators separately from the proposal to convert the energy lost in depressurisation into electricity using turbo-expanders?
- Are there any modifications to NGG's gas transportation licences that would be appropriate to safeguard consumers if the Authority grants the relevant consents?

Views of Respondents to April Consultation

We received responses from 16 industry stakeholders in response to the April Open Letter. A copy of each non-confidential response has been placed on the Ofgem website². Set out below are the main points raised by respondents in respect of the proposal by NGG.

Whether the trial should go ahead

- The majority of respondents to Ofgem's April 2008 Consultation supported the development of innovative projects which have the potential to satisfy or reduce energy demand with the minimum impact on the environment.
- A number of respondents questioned the particular technology itself in terms of the environmental benefits of combining both the turbo expander and CHP engine.
- Some respondents requested further consultation on the proposal requesting additional technical and commercial details on the proposed scheme.

Whether the Authority should consent to derogations from NGG's GT licence

- A number of respondents stated it may be appropriate to review elements of the incentives for NGG in light of the proposal.
- Some respondents highlighted the proposed 3rd Electricity Directive, which if implemented as currently drafted clearly prohibits Transmission System Operator's (TSO's) being involved in generation activities either directly or indirectly.
- A number of respondents questioned whether consent was required under SS27 (Disposal of Assets).

Whether the projected benefits outweigh the potential risks and costs to customers

- A number of respondents highlighted the storing of biomass on network distribution sites as a potential safety hazard.

Ofgem's Views

This consultation was designed to elicit responses to inform our decision as to whether the Authority should grant the consents required to allow NGG to enter into a proposed commercial arrangement with blue-ng to commence generating electricity and if so, what conditions we should attach to such consents.

² <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=1288&refer=Networks/GasDistr/otherwork>

We consider NGG's proposal to commence generating electricity at Gas Distribution pressure reduction sites has the potential to provide both environmental and financial benefits to consumers. However, at this stage, the magnitude of these benefits is unknown.

The reduction in use of natural gas for pre-heat (own-use gas) has the potential to lower the carbon footprint created by the operation of the distribution network, depending on the efficiency and environmental benefits of the proposed alternative. As a separate matter Ofgem has been asked by blue-ng to consider the case for accreditation of the electricity generated by the project under the Renewables Obligation (RO), which we administer on behalf of the government. In order for a generating station to receive support under the RO Order, it has to be accredited as being capable of generating electricity from eligible renewable sources. Ofgem will consider any application for accreditation to determine whether or not a technology meets the requirements of the legislation. All applications for accreditation are treated on a case-by-case basis and are treated entirely independently from other issues such as those considered by this decision letter.

Given that we administer the RO on behalf of the Department for Business Enterprise and Regulatory Reform (BERR) and we are bound by the requirements of the legislation, the two issues of consents in respect of NGG's licence and the RO eligibility application by blue-ng are being treated as distinct and separate issues.

The reduction in own use gas has the potential to deliver financial benefits to consumers through a lower shrinkage purchase requirement for NGG, which is currently funded by consumers through the price control. However, further benefits to consumers may be available through a share of the net income derived by NGG from such use of the sites, whether through joint ventures such as blue-ng, from operating similar projects themselves, or by charging third parties for access to their facilities. The potential scale of this financial benefit will not be known until the proposed trial has been undertaken and the sharing mechanism for any premiums between the licensee and gas consumers would then need to be agreed at this stage.

Ofgem believes that the existing network price controls provide strong incentives on NGG to operate both the transmission and distribution networks efficiently. These incentives along with the requirement under the licence to operate an efficient network provide adequate safeguards for consumers to ensure the operation of the NTS and GDN are not affected by the proposed project. Furthermore, NGG has informed Ofgem that the agreement with Blue-NG is constructed such that Blue-NG bears all the costs of construction, maintenance and operation of its plant. This includes the costs of the resources engaged by NGG in developing and negotiating the current proposal. Therefore NGG, and hence consumers, will not incur any costs as a consequence of this venture. Ofgem will be monitoring the costs of the project and NGG's cost reporting and revenue reporting RIGS to track related expenditure.

With regard to the additional network risks associated with the project we have accepted NGG's representations that the nature of the plant design ensures that NGG can continue to operate its networks unaffected by the proposal at all times. The equipment proposed for the sites is in addition to the existing equipment and can be operated and removed without interfering with existing gas flows. With regards to any additional risks associated with the storing of biomass on operational sites NGG will need to satisfy the Health and Safety Executive (HSE) that the operation of the sites will not negatively impact the safety, reliability and security of the distribution system.

As part of the consent for the trials we have requested details on operational experience, costs and environmental benefits that will aid our review of the benefits of the trials and assist the future development of any full regulatory impact assessment.

A number of respondents highlighted in their responses the impact of the proposed 3rd Electricity Directive, which if implemented as currently drafted clearly prohibit Transmission System Operators (TSOs) from being involved in generation activities either directly or indirectly. With regards to the way National Grid Electricity Transmission's licence is currently worded there is no prohibition on the proposed arrangement, however, this may be superseded if a European directive is passed which is subsequently passed into UK law.

Ofgem considers NGG's proposal requires consent under SCA27 (Disposal of Assets). Although NGG's proposal does not directly involve a relinquishment of operational control, it does envisage the grant of an encumbrance in allowing blue-ng access to the rotating shaft of the turbine embedded in NGG's pipe-line system which, technically, constitutes a "disposal" of that shaft for the purposes of SCA27. NGG therefore requires consent from the Gas and Electricity Markets Authority.

Ofgem's Decision

We have decided that it is appropriate to provide consent to NGG pursuant to Standard Special Condition A27 Disposal of Assets and Standard Special Condition A39 Indebtedness for the purpose of the trial, in the light of the potential benefits to consumers outlined above. Following the trial, if NGG indicates that it wishes to roll-out similar projects on larger scale, we will carry out a full regulatory impact assessment to examine in more detail the costs and benefits to consumers. We are requesting information from NGG on completion of each phase of the trial which will facilitate further quantification of the costs and benefits of the Electricity Generation Project.

The consents are included in appendix A and B to this letter.

If you wish to discuss any aspect of this decision please contact Paul Branston (paul.branston@ofgem.gov.uk) on 020 7901 7105.

Yours faithfully



Rachel Fletcher
Director – Distribution

Signed on behalf of the Authority and authorised for that purpose by the Authority

APPENDIX A – Consent pursuant to SSC A27 (Disposal of Assets)

To the Company Secretary:

National Grid Gas plc
Company No. 2006000
1-3 The Strand
London
WC2N 5EH

GAS TRANSPORTERS LICENCE

Consent issued by the Gas and Electricity Markets Authority pursuant to Standard Special Condition A27 (Disposal of Assets)

WHEREAS:

- (a) National Grid Gas plc, a company registered in England and Wales with company number 2006000 and registered office at 1-3 Strand, London WC2N 5EH (the "Licensee"), is the holder of two gas transporter licences ("the licences") one of which is treated as granted by the Gas and Electricity Markets Authority (the "Authority") under section 7 of the Gas Act 1986 (the "Act") and was amended and restated by a licensing scheme made by the Secretary of State for Trade and Industry pursuant to paragraph 19 of Schedule 7 to the Utilities Act 2000 on 28 September 2001 and relates to the National Transmission System (the "NTS licence") and the other of which was granted by the Authority under section 7 of the Act on 5 November 2004 and relates to the four gas distribution networks retained and operated by the Licensee (the "RDN licence").
- (b) blue-ng Limited is a company incorporated and registered in England with company number 6300207 whose registered office is at 1-3 Strand, London WC2N 5EH
- (c) By Standard Special Condition A27 (Disposal of Assets) ("SSCA27"), the Licensee is required to give to the Authority not less than two months notice of its intention to dispose of or relinquish operational control over any transportation asset and may dispose of or relinquish such operational control in specified circumstances, including where under SSC A27(4)(a) the Authority confirms in writing that it consents to such disposal or relinquishment.
- (d) On 11 January 2008 the Licensee informed the Authority in writing that it had entered into negotiations with blue-ng to agree terms under which it will permit blue-ng, in two trial phases, access to the Licensee's transportation assets at certain sites and pressure reduction stations to install and maintain environmentally sustainable electricity generation plant; and permit blue-ng to generate electricity using such plant (the "project").
- (e) The Licensee requested the Authority's consent to the Licensee making a disposal pursuant to SSC A27 by granting access to the said transportation assets to blue-ng with effect from 1 September 2007 to enable blue-ng to realise the project.
- (f) The Authority believes that in principle, the proposal has the potential to provide environmental and financial benefits for consumers, the magnitude of which will not be clear until completion of the proposed trials.

- (g) The Authority is minded to grant consent, having carefully considered the Licensee's application.

NOW THE AUTHORITY HEREBY CONSENTS AS FOLLOWS:-

Having regard to the Licensee's 11 January 2008 request the Authority hereby consents to the Licensee making a disposal by granting access to specific transportation assets to blue-ng Limited at the Licensee's sites at Beckton (Beckton PRS, Station Number 384, Armada Way, Royal Docks Road, Beckton, E6 7FB) and Southall (Southall PRS, Station Number 192, White Street, Southall, UB2 5AT), both sites comprising phase one of the project; and six additional distribution sites which comprise phase two, and each of the six sites at which phase two of the project will be conducted will be notified in writing to the Authority at least three months prior to the intended construction start date of the trial site.

2. The Licensee shall provide in writing the following details to the Authority for each of the proposed sites within two months of the completion of the first twelve months of operation of the trials of phases one and two of the project:
 - (a) capital costs;
 - (b) operating costs;
 - (c) maintenance costs;
 - (d) expected asset life;
 - (e) operational experience (including risks to gas supply);
 - (f) environmental benefits from the substitution of the licensees gas pre-heaters;
 - (g) environmental costs associated with noise and emissions;
 - (h) critical issues that must be overcome for the technology to deliver environment and economic benefits.
3. This consent is deemed to have taken effect on and from 1 September 2007 and shall continue until the plant is decommissioned and removed from all of the Licensee's said sites by or on behalf of blue ng, unless this consent is revoked, amended or replaced by the Authority following consultation with the Licensee on giving six months prior written notice to the Licensee or such other period as may be agreed in writing between the Authority and the Licensee.
4. For the avoidance of doubt, this consent is issued pursuant to SSC A27 only and its effect is restricted to that condition and unless otherwise stated:
 - (a) nothing in this consent shall fetter the Authority's discretion in relation to the interpretation or enforcement of any other provision of the licence, including, without limitation, any other paragraph of SSC A27 even if such interpretation or enforcement relates to the activities covered by this consent;
 - (b) any reference in this consent to compliance with any specific provision of the licence or the absence of such references in this consent or any other consent, acceptance, approval, direction, indication, agreement or other similar licence related instrument issued by the Authority, shall in no way be construed as meaning that the licensee is not required to comply with any condition which is not specifically referred to in this consent and no adverse inference shall be drawn by any inconsistencies in approach; and
 - (c) notwithstanding paragraph 4, in the event that the Authority determines that the licensee has breached this consent, this consent shall be revocable immediately upon written notification at the sole discretion of the Authority.

NOTICE

This document also constitutes notice under section 38A of the Act of the reasons for the Authority's decision to grant consent.

Dated 27 August 2008

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is written over a light grey rectangular background.

Rachel Fletcher
Director of Distribution

Duly authorised by the Authority

APPENDIX B – Consent pursuant to SSC A39 (Indebtedness)

To the Company Secretary:

National Grid Gas plc
Company No. 2006000
1-3 The Strand
London
WC2N 5EH

GAS TRANSPORTERS LICENCE

Consent issued by the Gas and Electricity Markets Authority pursuant to Standard Special Condition A39 (Indebtedness)

WHEREAS:

- (h) National Grid Gas plc, a company registered in England and Wales with company number 2006000 and registered office at 1-3 Strand, London WC2N 5EH (the "Licensee"), is the holder of two gas transporter licences ("the licences") one of which is treated as granted by the Gas and Electricity Markets Authority (the "Authority") under section 7 of the Gas Act 1986 (the "Act") and was amended and restated by a licensing scheme made by the Secretary of State for Trade and Industry pursuant to paragraph 19 of Schedule 7 to the Utilities Act 2000 on 28 September 2001 and relates to the National Transmission System (the "NTS licence") and the other of which was granted by the Authority under section 7 of the Act on 5 November 2004 and relates to the four gas distribution networks retained and operated by the Licensee (the "RDN licence").
- (i) blue-ng Limited is a company registered in England with company number 6300207 whose registered office is at 1-3 Strand, London WC2N 5EH.
- (j) Pursuant to paragraph 1(c) of Standard Special Condition A39 (Indebtedness) (the "Condition"), the Licensee shall not without the prior written consent of the Authority (following disclosure by the Licensee of all material facts) enter into an agreement or incur a commitment incorporating a cross-default obligation.
- (k) The Condition also states that where the holder of the licence owns one or more relevant gas transporters, the licences for which are held in a single legal entity, references in the condition to the "Licensee" shall mean that legal entity.
- (l) The Licensee wrote to Ofgem, the office of the Authority on 11 January 2008 requesting the Authority's consent under paragraph 1(c) of the Condition to allow the Licensee under its RDN licence, to enter into agreements, or incur commitments, incorporating cross-default obligations in relation to blue-ng Limited.
- (m) On 11 January 2008 the Licensee informed the Authority in writing that it had entered into negotiations with blue-ng to agree terms under which it will permit blue-ng, in two trial phases, access to the Licensee's transportation assets at certain sites and pressure reduction stations to install and maintain environmentally sustainable electricity generation plant; and permit blue-ng to generate electricity using such plant (the "project").

- (n) A cross-default obligation may be regarded as arising as a result of the agreement because the Licensee could accrue liabilities through the activities of blue-ng. Amongst other things liability to the licensee could arise from:
- i. loss or damage caused by blue-ng (or its contractors) to transportation assets; or
 - ii. environmental liabilities to third parties arising from bio-fuel spillage.
- (o) Having carefully considered the licensee's application the Authority is minded to grant consent on the terms and conditions set out below.

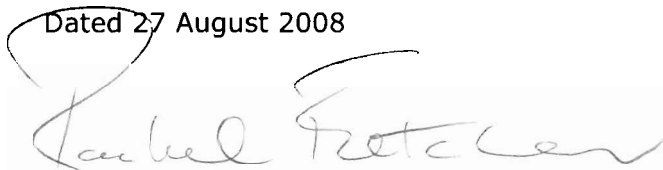
NOW THE AUTHORITY HEREBY CONSENTS AS FOLLOWS:-

5. Subject to paragraphs 2 and 3 below, for the reasons stated in the Licensee's requests, the Authority in accordance with the Condition hereby consents to the Licensee in relation to its RDN licence, entering into agreements or incurring commitments incorporating cross-default obligations in respect of blue-ng and the project, on condition that the Licensee will take appropriate steps to minimise its actual and potential liabilities that arise or have arisen or may arise as the case may be from any existing contracts, extension of such existing contracts, or new contracts.
6. This consent is deemed to have taken effect on and from 1 September 2007 and shall continue until the plant is decommissioned and removed from all of the Licensee's said sites at Beckton (Beckton PRS, Station Number 384, Armada Way, Royal Docks Road, Beckton, E6 7FB) and Southall (Southall PRS, Station Number 192, White Street, Southall, UB2 5AT), both sites comprising phase one of the project; and six additional distribution sites which comprise phase two; by or on behalf of blue ng, unless this consent is revoked, amended or replaced by the Authority following consultation with the Licensee on giving six months prior written notice to the Licensee or such other period as may be agreed in writing between the Authority and the Licensee.
7. For the avoidance of doubt, this consent is issued pursuant to the Condition only and its effect is restricted to the Condition and unless otherwise stated -
 - (a) nothing in this consent shall fetter the Authority's discretion in relation to the interpretation or enforcement of any other provision of the licence, including, without limitation, any other paragraph of Standard Special Condition A39 even if such interpretation or enforcement relates to the activities covered by this consent;
 - (b) any reference in this consent to compliance with any specific provision of the licence or the absence of such references in this consent or any other consent, acceptance, approval, direction, indication, agreement or other similar licence related instrument issued by the Authority, shall in no way be construed as meaning that the licensee is not required to comply with any condition which is not specifically referred to in this consent and no adverse inference shall be drawn by any inconsistencies in approach; and
 - (c) notwithstanding paragraph 2, in the event that the Authority determines that the licensee has breached this consent, this consent shall be revocable immediately upon written notification at the sole discretion of the Authority.

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