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Date: 21 January 2009

Dear Colleague

**Operating Margins (OM) Contestability
Notice under section 23 Gas Act 1986 to modify Special Condition C3 of the NGG
NTS licence**

National Grid Gas (NGG) National Transmission System (NTS) is currently engaged in a tendering process for the procurement of Operating Margins (OM) gas. In view of the fact that much of this gas is currently procured from National Grid's Liquefied Natural Gas (LNG) storage facilities at regulated prices, NGG asked Ofgem¹ to clarify whether tender submissions by interested parties should be constrained by these regulated prices. The prices are regulated by special condition C3 of the NGG NTS licence (referred to in this letter as the "C3 prices").

We issued a letter on 15 January 2009² setting out our view that we are minded to suspend the application of C3 prices for the relevant period of OM provision provided that we judge the tender process to have been effective. That letter also proposed legal text to amend special condition C3, which would be necessary in order to enable us to suspend the application of C3 prices.

This letter constitutes our formal consultation on changes to special licence condition C3. We also give further detail on the criteria we propose to use to assess the competitiveness of the tender process and invite comments on the tender process itself. The statutory consultation period ends on 18 February 2009 but we would welcome early comments ahead of that date, particularly in respect of the tender process itself and our proposed criteria.

Background to OM services

System reserve or Operating Margins (OM) gas is the term for gas that is used to maintain system pressures under certain operational circumstances, eg a sudden loss of supply or a sharp increase in demand. There are three groups of OM services, defined as follows:

- Group 1 - includes those events that, although unlikely to occur during a 1-in-50 winter, would have a major impact on the safe operation of the NTS. This group includes a loss of supply or a loss of infrastructure.

¹ Letter from Mark Ripley (National Grid) to Ian Marlee, 23 December 2008

² "Operating margins (OM) Contestability", Ofgem, 15 January 2009

- Group 2- includes those events that could reasonably be expected to happen during any winter, but potentially more so in a severe winter as alternative supplies are expected to be less available and occurrences of such events could escalate due to higher demands. This group includes analysis for compressor failure, routine forecasting errors and significant supply losses.
- Group 3 - is orderly rundown, which is to ensure safe rundown of the system in the event of a Network Gas Supply Emergency while firm load shedding takes place. This is the major use for OM gas.

OM gas allows time for National Grid Gas (NGG) to reconfigure the National Transmission System (NTS) or for the market to deliver additional supply in response to any of the above operational issues. This protects against the need to declare emergency conditions so that normal commercial market operation can be maintained where possible. The requirement to hold OM is set out in NGG's safety case and in the Uniform Network Code (UNC).

In the past, the majority of this OM gas was procured from National Grid's Liquefied Natural Gas (LNG) storage facilities, which comprise the four plants at Avonmouth, Dynevor Arms, Glenmavis and Partington. These sites provide the OM service to NGG NTS at C3 prices. Note that the prices for the provision of LNG to the Scottish Independent Units are also contained in special condition C3. It is not the intention of this consultation to affect these arrangements other than to give us the power to suspend these prices should the need arise, although at this time we do not foresee the need to do so.

In recent times, the proportion of the OM service that has been supplied by NG's LNG storage facilities has been in decline, partly due to the emergence of alternative sources (eg Isle of Grain) and partly due to the reduction in the locational element of the requirement (eg the development of the Milford Haven pipeline has removed the location requirement at Dynevor Arms³).

Competition in the provision of OM services

As part of the Transmission Price Control Review (TPCR), NGG NTS accepted special licence condition C25 which requires it to use reasonable endeavours to promote competition in the provision of OM services by 1 April 2009. To this end, NGG has issued two consultations⁴ on the subject and held a workshop, along with having meetings with a number of potential providers of OM services. On 23 December 2008, it issued a tender for the procurement of OM services⁵.

NGG NTS is concerned that the continued application of C3 prices may influence the tender process currently under way. Potential bidders for the provision of OM services might be dissuaded from participating in the process, as the C3 prices might be interpreted as being a cap on the price at which participants can tender. Ofgem recognises that the existence of C3 prices may not be consistent with the operation of a competitive procurement framework.

Proposed licence modification

Our letter of 15 January 2009 stated that, in order to facilitate effective competition, we are minded to suspend the application of C3 prices in respect of the provision of OM services

³ " National Grid completes review of its UK Liquefied Natural Gas Storage business", National Grid press release, 4 November 2008. The removal of the obligation for Dynevor Arms to be available for OM provision is now the subject of modification proposal UNC237.

⁴ " Operating Margins Contestability: Initial Consultation", 10 March 2008 and "Conclusions on Operating Margins Contestability And Initial Thoughts for Associated SO Incentive Arrangements", 2 September 2008, both available on NGG's website

⁵ "Operating Margins ("OM") – Invitation To Tender", letter issued by NGG on 23 December 2008

for the relevant period of OM provision⁶ provided that we judge the tender process to have been effective. However, the NTS licence conditions do not allow for suspension of the C3 prices and a licence modification is needed to achieve this flexibility.

We received two responses to our letter, both of which commented that the revised drafting did not reflect that the information contained in Tables 1 and 2 in C3 referred to the prices for both OM provision and the supply of LNG storage services to DN Operators. One of these respondents suggested alternative wording for the licence change (the substance of which we have adopted in our latest drafting). The other respondent also commented on the short advance warning for the consultation. We acknowledge the timescales are tight, but in this instance we have been constrained by the timetable of externally driven events, namely the NGG OM tender process. It is because of this timeline issue that we thought it important to engage in an informal pre-consultation process, albeit very short, and this has brought forward constructive input for this formal licence consultation. The second respondent also requested confirmation that Ofgem is currently only considering the suspension of C3 prices in respect of the provision of OM services. We can confirm that this is the case and that, should we consider that it is appropriate to consider suspending the C3 prices in respect of the provision of services to DN operators, we will consult further at that time.

We attach a Notice under section 23 Gas Act 1986 proposing modification of special licence condition C3 as an Appendix to this letter. Note that it is not intended to delete the C3 prices for OM provision altogether, only to suspend their application.

Allied to NGG NTS's C25 obligation to promote competition, NGG NTS has proposed modification proposal UNC240⁷, which anticipates the potential increase in type of OM service provider by proposing to remove the current restriction which limits OM service provision from gas in storage. This proposal also looks to resolve issues around the different timing of the gas year and the gas storage year. This proposal has not yet been submitted to Ofgem and our intent to progress with this consultation should not be considered to fetter the discretion of the Authority with regards to UNC240. The fact that a decision has not been made on UNC240 should not deter non-storage parties from participating in the tender process, but if the proposal were to be rejected then that would have implications for the outcome of our competitiveness assessment.

Assessment of the competitiveness of the current tender process

As outlined in our 15 January letter, prior to issuing any direction to suspend the C3 prices in respect of the provision of OM services, we will need to assess the effectiveness of the competition resulting from the tender process. Below we provide further details of the areas that we propose to consider in order to reach such a decision. We would welcome comments on these areas as soon as possible and any additional considerations that may be appropriate. In order to assist us in considering the tender process itself, we would also welcome comments as early as possible from all parties that have had any involvement in the tender process in respect of their views on the effectiveness of the process.

The following sections identify what we consider to be the key criteria for assessing the tender process.

Overall

Our assessment will include consideration of the extent to which the complete tender process has:

- been a fair and transparent process
- given Ofgem sufficient confidence that there has been competition for the tender

⁶ This would of course be subject to any other processes required to allow the result of the tender process to be realised, e.g. the modifications mentioned above.

Pre-invitation to tender stage

Our assessment will include consideration of the extent to which the activities that took place ahead of the tender round (eg consultations, industry workshops and one-to-one meetings) have:

- not been unduly restrictive or presented information in such a way as to deter parties who could potentially provide these services
- enabled all interested parties to participate in the tender process
- enabled potential bidders to decide whether it would be appropriate for them to participate in the tender process
- given potential bidders sufficient information about the requirements of the service to be provided
- been considered by potential bidders that the information provided during the pre-invitation to tender stage of the process is full and complete
- allowed for questions and responses at the pre-invitation to tender stage of the process to be managed in a structured way

Invitation to tender stage

Our assessment will include consideration of the extent to which the invitation to tender process has:

- allowed potential bidders sufficient time to develop detailed responses to the questions set out in the tender, whilst at the same time ensuring that the process is not unnecessarily drawn out
- been structured to enable both existing market participants and potential new entrants to be able to express an interest
- allowed all potential bidders to understand:
 - the minimum criteria to bid
 - what minimum standards they would be required to meet
 - what they must provide to fulfil the requirements of the response
 - the rules of the competition going forward
 - an overview of the relevant regulatory and contractual framework
 - details of the key technical and commercial obligations
- allowed each bidder an opportunity to remedy any minor deficiencies in its tender within a short period of time

Post tender stage

Our assessment will include consideration of the extent to which the post tender process has:

- been a transparent process, taking decisions based upon the evidence submitted by bidders in their documented responses
- ensured that each tender is assessed against clear and objective criteria by a tender panel
- led to a decision based on assessment of the bidders' ability to manage and deliver the required services
- ensured that any area of bid negotiation has been undertaken in an open and transparent manner

Timeline going forward

NGG NTS issued the OM services tender on 23 December 2008, with a closing date of 30 January 2009. It will then have until 20 February to decide on the outcome of this tender and by 28 February NGG NTS needs to have informed NG LNG as to whether it intends to procure OM services from it, and if so what volume, so that NG LNG can then offer its remaining volumes to the market at commercial rates.

To facilitate this process, Ofgem would need to have a licence change to the wording of special licence condition C3 in place and have come to a view on the contestability of the tender process by 19 February 2009. This would then allow us to issue a Direction to temporarily suspend the application of the C3 prices, if required.

We would welcome the views of interested parties in respect of the proposed licence modification, the criteria proposed for assessing contestability of the provision of OM services and on their experience regarding the tender process itself. Responses should be received by 18 February 2009; however, we would welcome responses earlier, if at all possible. Responses should be sent to:

Ian Marlee
Director, Trading Arrangements
Ofgem
9 Millbank
London
SW1P 3GE
gbmarkets@ofgem.gov.uk

Unless marked confidential, all responses will be published on Ofgem's website www.ofgem.gov.uk and placed in its library. Respondents may request that their response is kept confidential. Ofgem shall respect your request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

Respondents who wish to have their responses remain confidential, should clearly mark the document/s to that effect and give the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Please put any confidential material in the appendices to your responses.

The statutory notice under section 23 of the Gas Act 1986 specifies a period of not less than 28 days during which interested parties can make representations or objections to the proposed licence modification, following which revisions to the proposed licence modification will be made if they are considered appropriate, except where the Secretary of State directs Ofgem not to make the modifications.

NGG must consent to the proposed licence modification before it can be implemented. If NGG consents, Ofgem intends, subject to any representations made during the consultation and any direction received from the Secretary of State, to direct the modification of NGG's NTS licence in line with the proposed modifications on 19 February 2009.

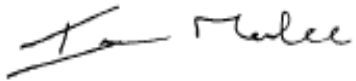
At the same time we would also expect, taking into account the views of respondents to this consultation, to make decisions on:

- the criteria for assessing the effectiveness of the competition;
- the actual effectiveness of the competition; and
- whether to suspend C3 prices.

As noted in our letter of 15 January, in terms of looking further ahead, once there is sufficient information to assess the degree of competition in the market we would expect to undertake a consultation on any enduring removal of the price cap for the provision of all OM services.

If you have any queries or comments on this letter, please contact Lisa Martin (020 7901 7123) or Paul O'Donovan (020 7901 7414) in the first instance.

Yours sincerely,

A handwritten signature in black ink that reads "Ian Marlee". The signature is written in a cursive style with a horizontal line underneath the name.

Ian Marlee
Director, Trading Arrangements