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15 January 2009

Dear Colleague

### **Operating Margins (OM) Contestability**

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 Ofgem<sup>1</sup> to clarify whether tender submissions by interested parties should be constrained by these regulated prices.

This letter sets out our views on this issue and sets out our proposal to formally consult on changes to special licence condition C3 on 21 January 2009. Despite the short time until this consultation begins, we would be grateful for early comments on our approach to the licence changes and to assessing the competitiveness of the tender process.

### **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.
- 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

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

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 prices which are regulated by special licence condition C3 and are referred to in this letter as the "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 Arms<sup>2</sup>).

### **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 consultations<sup>3</sup> 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 services<sup>4</sup>.

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. Therefore, in order to facilitate effective competition, we are minded to suspend the application of C3 prices for the relevant period of OM provision<sup>5</sup> 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 attach our proposed modification to the current wording of special licence condition C3 as an Appendix to this letter. We would welcome any comments on the draft wording. 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 UNC240<sup>6</sup>, which anticipates the potential increase in type of OM service provider by proposing to remove the current restriction which limits OM service provision to storage facilities and LNG importation facilities. 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

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<sup>2</sup> "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.

<sup>3</sup> "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

<sup>4</sup> "Operating Margins ("OM") – Invitation To Tender", letter issued by NGG on 23 December 2008

<sup>5</sup> 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.

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**

We propose that our assessment of the success of this tender process will include consideration of:

- Pre-tender process;
- Tender process; and
- Responses to the tender

Note that we do not consider that the price of offers should be a consideration. Note also that Ofgem will not have a role in deciding which tender will be successful; that is the role of NGG NTS. Ofgem will consider only whether the tender process was sufficiently competitive to justify suspending C3 prices for OM service provision.

We would welcome any suggestions as to what further issues should form part of our considerations.

### **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 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 therefore propose to consult formally on this licence change on **Wednesday 21 January 2009**.

We would welcome any views or comments interested parties might have in relation to the proposed licence change or the contestability of the provision of OM services, in advance of us commencing the formal consultation. If you wish to make verbal comments, contact details can be found at the end of this letter. Any written comments should be sent to:

Lisa Martin  
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9 Millbank  
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[Lisa.Martin@ofgem.gov.uk](mailto:Lisa.Martin@ofgem.gov.uk)

If you reply to us in writing, your response may be published on Ofgem's website [www.ofgem.gov.uk](http://www.ofgem.gov.uk) and placed in its library unless you ask us to keep it confidential. Ofgem will 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.

If you do wish your response to remain confidential, please 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.

Concurrent with the formal licence change consultation, we propose commencing our assessment of the tender process. We anticipate this will include seeking views from industry parties as to the pre-tender and tender processes that NGG NTS has undertaken to date. We would conclude our assessment in the light of responses to the formal consultation. We would expect to make decisions on:

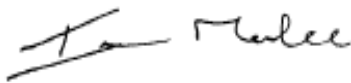
- whether or not to modify special licence condition C3;
- the criteria for assessing the effectiveness of the competition;
- the actual effectiveness of the competition; and
- whether to suspend C3 prices

by 19 February 2009.

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,



**Ian Marlee**  
**Director, Trading Arrangements**

## Appendix – Proposed new wording for Special Condition C3.

### All substantive changes from current licence text in bold

#### Restriction of Prices for Liquefied Natural Gas (LNG) Storage Services

1. (a) The licensee shall ensure that the charges made by the licensee for the provision of Operating Margins for the relevant year commencing on 1 May 2008 and each subsequent relevant year are the charges set out in Table 1 below.

(b) The Authority may direct in writing that the requirement set out in paragraph 1 (a) shall be suspended for such period of time as the Authority may specify.

TABLE 1

LNG storage facility	Reserved space (pence per kWh per annum)	Reserved deliverability (pence per peak day kWh per annum)	Storage injection (pence per kWh)	Storage withdrawal (pence per kWh)
Glenmavis	A	E	$0.349 * \text{LNGSPIT}_t$	$0.015 * \text{LNGSPIT}_t$
Dynevor Arms	B	F	$0.248 * \text{LNGSPIT}_t$	$0.021 * \text{LNGSPIT}_t$
Avonmouth	C	G	$0.238 * \text{LNGSPIT}_t$	$0.024 * \text{LNGSPIT}_t$
Partington	D	H	$0.323 * \text{LNGSPIT}_t$	$0.021 * \text{LNGSPIT}_t$

Where:

- A equals a price in pence per kWh per annum which is the higher of  $1.706 * \text{LNGSPIT}_t$  or  $0.85 * \text{WAHGPSS}_t$ .
- B equals a price in pence per kWh per annum which is the higher of  $2.840 * \text{LNGSPIT}_t$  or  $0.85 * \text{WAHDAPSS}_t$ .
- C equals a price in pence per kWh per annum which is the higher of  $1.463 * \text{LNGSPIT}_t$  or  $0.85 * \text{WAHAPSS}_t$ .
- D equals a price in pence per kWh per annum which is the higher of  $1.086 * \text{LNGSPIT}_t$  or  $0.85 * \text{WAHPPSS}_t$ .
- E equals a price in pence per peak day kWh per annum which is the higher of  $1.233 * \text{LNGSPIT}_t$  or  $0.15 * \text{WAHGPSS}_t$ .
- F equals a price in pence per peak day kWh per annum which is the higher of  $1.815 * \text{LNGSPIT}_t$  or  $0.15 * \text{WAHDAPSS}_t$ .
- G equals a price in pence per peak day kWh per annum which is the higher of  $1.345 * \text{LNGSPIT}_t$  or  $0.15 * \text{WAHAPSS}_t$ .
- H equals a price in pence per peak day kWh per annum which is the higher of  $0.994 * \text{LNGSPIT}_t$  or  $0.15 * \text{WAHPPSS}_t$ .

$\text{WAHGPSS}_t$  equals, in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage services provided to shippers by the licensee at the licensee's LNG

storage facility at Glenmavis, the average price (weighted by volume) payable by shippers in respect of that ten percent of all such Storage Capacity purchased for which the highest prices were payable by any shipper purchasing such Storage Capacity for the relevant year

WAHDAPSS<sub>t</sub> equals, in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage services provided to shippers by the licensee at the licensee's LNG storage facility at Dynevor Arms, the average price (weighted by volume) payable by shippers in respect of that ten percent of all such Storage Capacity purchased for which the highest prices were payable by any shipper purchasing such Storage Capacity for the relevant year by

WAHAPSS<sub>t</sub> equals, in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage services provided to shippers by the licensee at the licensee's LNG storage facility at Avonmouth, the average price (weighted by volume) payable by shippers in respect of that ten percent of all such Storage Capacity purchased for which the highest prices were payable by any shipper purchasing such Storage Capacity for the relevant year

WAHPPSS<sub>t</sub> equals, in respect of the amounts payable by shippers to the licensee in respect of Storage Capacity as part of the supply of LNG storage services provided to shippers by the licensee at the licensee's LNG storage facility at Partington, the average price (weighted by volume) payable by shippers in respect of that ten percent of all such Storage Capacity purchased for which the highest prices were payable by any shipper purchasing such Storage Capacity for the relevant year

**2. (a) The licensee shall ensure that the charges made by the licensee for the supply of LNG storage services to any DN Operator whose transportation system includes independent systems which are operated using LNG for the relevant year commencing on 1 May 2008 and each subsequent relevant year are the charges set out in Table 2 below.**

**(b) The Authority may direct in writing that the requirement set out in paragraph 2 (a) shall be suspended for such period of time as the Authority may specify.**

TABLE 2

TANKER CHARGES	
Glenmavis tanker filling slots	£3437.50 * LNGSPIT <sub>t</sub> per annum
Glenmavis tanker filling charge	£250 * LNGSPIT <sub>t</sub> per tanker filled or partially filled

3. LNGSPIT<sub>t</sub> is the price indexation adjustment term, which shall be calculated using the following formula:

$$LNGSPIT_t = \left(1 + \frac{RPI_t}{100}\right) \times LNGSPIT_{t-1}$$

where LNGSPIT shall take the value 1 in respect of the relevant year commencing 1 May 2007 only and RPI<sub>t</sub> shall be as follows:

RPI<sub>t</sub> means the percentage change (whether of a positive or a negative value) in the arithmetic average of the retail prices index published or determined with respect to each of the six

months from July to December (both inclusive) in relevant year t-1 and the arithmetic average of the retail prices index numbers published or determined with respect to the same months in relevant year t-2

4. For each relevant year for which, and to the extent to which, the licensee charges for the supply of LNG storage services in accordance with **paragraphs 1 and 2** of this condition the licensee, so far as concerns LNG storage arrangements, shall be deemed to have complied for that relevant year with the provisions of Standard Special Conditions A4 (Charging – General) and A5 (Obligations as Regard Charging Methodology).

5. The licensee shall provide a report in writing to the Authority stating the volume and price of all Storage Capacity sold in respect of each relevant year. This report shall be provided to the Authority as soon as reasonably practicable and in all circumstances by no later than 31 August following the end of the relevant year to which it relates.

6. In this condition "Operating Margins" and "Storage Capacity" shall bear the meaning given to those terms in the licensee's network code as at 16 March 2007.

7. For the purposes of this condition only "relevant year" means a period of twelve months commencing on 1 May at 06:00 hours.