



Gas transporters, gas shippers,  
industry participants and  
consumer representatives

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*Promoting choice and  
value for all customers*

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Dear Colleague

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

On 21 January 2009 we issued a letter constituting our formal consultation on possible changes to Special Condition C3<sup>1</sup> of National Grid Gas (NGG) National Transmission System's (NTS) Gas Transporter Licence. This licence condition sets out the regulated prices (referred to in this letter as "C3 prices") at which NGG NTS currently procures its Operating Margins (OM) gas from National Grid's Liquefied Natural Gas (NG LNG) storage facilities and the price at which LNG storage services are provided to Distribution Network Operators (DNs).

The proposed change to Special Condition C3 would allow for Ofgem to suspend the application of C3 prices. In our 21 January letter we set out that we would consider suspending the application of C3 prices in respect of the provision of OM services for the relevant period of OM provision. We explained that this would be dependent upon whether we judged competition in the provision of OM services to have been effective. In order to inform our view on this, we also set out a number of criteria we believed to be appropriate to consider in order to reach our decision.

As part of our consultation, we welcomed comments from the industry on the proposed changes to special condition C3, the proposed criteria and whether there were any additional considerations that may be appropriate to assist in our assessment. We also welcomed views from parties that had been involved in the tender process in respect of their views on the effectiveness of this process.

Having regard to the responses received, this letter now sets out our decisions on the following:

- whether to modify Special Condition C3; and
- if so, whether to suspend C3 prices in respect of the provision of OM services.

### **Respondents' views to the consultation**

We received six responses to our consultation in respect of the proposed change to the licence condition, the proposed criteria and the effectiveness of the competition.<sup>2</sup> In addition we also received consent from NGG NTS to modify its licence.

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<sup>1</sup> Restriction of Prices for Liquefied Natural Gas (LNG) Storage Services.

<sup>2</sup> Responses are available on the Ofgem website: [www.ofgem.gov.uk](http://www.ofgem.gov.uk)

### *Licence modification*

Three respondents specifically offered a view on the proposed changes to the licence condition. One respondent offered its full support to the modification to allow Ofgem to suspend C3 prices. Another respondent stated that it had concerns regarding the proposed licence drafting. This respondent noted that while Ofgem had clarified that it had no intention to suspend C3 prices in relation to LNG service provision to DNs at this point in time, the proposed drafting would still facilitate this at some point in the future. Due to this, the respondent considered that the drafting should be restricted and not extended to include DNs. The third respondent questioned why a licence change was required this year given that only an incremental volume of OM gas would be procured by new service providers due to limits resulting from NGG NTS's Safety Case.

### *Proposed criteria for the assessment of effective competition*

While the majority of respondents were comfortable with the criteria we proposed to assess the effectiveness of competition in the provision of OM services, two respondents suggested that our assessment should incorporate additional considerations. One of these respondents was of the view that an assessment of the barriers to entry for new providers, as well as whether there had been a sufficient pool of potential providers to compete, should be considered; the other respondent expressed concern over Ofgem's stance that prices of offers should not be a consideration in the assessment of whether the tender process had been a success. On this latter point, one respondent stated that it agreed with Ofgem that the price of offers should not be a consideration in the assessment of contestability.

### *Effectiveness of competition*

All six respondents to the consultation considered that NGG NTS had performed well throughout the pre-invitation to tender and invitation to tender stages. One respondent stated that NGG NTS had made good efforts to engage participants in the tender, while two others noted that NGG NTS had effectively managed the pre-tender and tender process, and had made a reasonable attempt to promote competition in OM service provision.

One respondent was concerned that there was a lack of clarity around what constitutes "effective competition" and expressed concern that this may take some time to emerge. This respondent also considered there to be more significant issues surrounding the contractual and commercial framework, liabilities and obligations and that these were likely to have a significant impact on competition. Until these issues were addressed, this respondent considered that competition would be unlikely to develop.

Further, a number of respondents were concerned about the lack of alternative new providers of OM services. One respondent stated that they had concerns related to NG LNG's current share of the OM market. Another considered that competition in actual OM provision this year would be unchanged from last year due to the fact that OM provision was not yet open to a wider range of providers.

This view was supported in part by another respondent who considered that, due to Safety Case restrictions, the lack of non-storage non-LNG alternatives was cause for concern if C3 prices were removed and NG LNG was able to bid above regulated prices, in the knowledge that the bids would be accepted.

### *Suspension of C3 prices*

In terms of whether Ofgem should suspend the application of C3 prices, provided it had the power to do so, four of the six respondents did not believe that Ofgem should do so for the

2009/10 storage year, one other respondent considered that the existence of the C3 prices was not consistent with the aim of developing OM contestability, and one respondent did not provide a specific view.

Of the respondents opposed to the suspension of C3 prices, one considered that this approach would not be consistent with Ofgem's statutory duty to protect customers or in line with NGG NTS's licence condition A11.1 – the efficient and economic operation of the pipeline system. This respondent noted that while it supported an incentive mechanism to ensure costs to customers did not increase, and the most efficient, least cost OM service was procured, they did not believe suspending C3 prices would achieve this.

Another respondent considered that suspending C3 prices would likely lead to an increase in costs being passed through to shippers and in turn, consumers. A further respondent opposed to the suspension of C3 prices this year nonetheless considered that it was reasonable to consider the option again next year, but only once the Safety Case issues had been resolved and the outcome of the current tender was known.

A further respondent was of the view that because C3 prices had not affected the competitive prices offered by market participants in the current tender, any attempt to amend C3 prices was now unnecessary.

#### *Other issues*

One respondent expressed concerns over the merits of the tender process which has been borne from particularly tight timescales at the end of the consultation period. This respondent also considered that the process had not been transparent to industry and that they assumed an arrangement of the pass through of costs would be made between NGG NTS and Ofgem.

Two respondents welcomed information on the tender, being made available post-tender, believing this would give the industry more comfort about the process in future. One of these respondents believed that publication of information relating to the outcome of the tender would be the most effective way to encourage participation in the future.

#### **Ofgem's view**

Ofgem considers that significant progress has been made towards contestability in the provision of OM services and that effective competition is likely to be possible in the future in most areas of OM provision. However, in relation to the provision of some locational services the possibility of effective competition is still not apparent at this stage.

We agree with the comments made by respondents to our consultation in respect of the process that NGG NTS has undertaken and believe that this has facilitated the move towards the development of competition. We recognise the significant work that NGG NTS has undertaken to date in this area.

#### *Licence Modification*

Given the potential for effective competition in the future, having considered the views of respondents to the consultation, and following receipt of consent from NGG NTS to the proposed licence amendment, we consider that it remains appropriate to implement the licence modification allowing us the power to suspend C3 prices. We recognise the concerns raised by one respondent in relation to the Authority having the power to suspend C3 prices in respect of LNG service provision to DNs. We would note that we have previously had this power in the licence and we consider that it is appropriate for the Authority to have this flexibility reinstated. However, we would reiterate that we currently are not considering utilising this power and were we to consider doing so in the future, we would expect to consult prior to using the power. We attach a Direction under section 23 of

the Gas Act 1986 to modify Special Condition C3 of the Gas Transporter licence of NGG NTS with effect from 23 February 2009 as an Appendix to this letter.

*Decision in relation to the suspension of C3 prices*

We welcome the views and suggestions provided by respondents to our consultation. In this case, our concerns in relation to contestability of OM services for 2009/10 are based upon the overall effectiveness of the competition resulting from the tender process. For the reasons set out below, we do not consider there has been effective competition in the provision of OM services.

We recognise that the lack of Safety Case approval for new types of OM service providers has limited the number of potential providers able to participate in the tender for the provision of the OM service for 2009/10. Further, we are aware that a number of potential storage and LNG importation providers who may be interested in providing the service in the future were also unlikely to have been in a position to take part in this year's tender process (particularly as a result of delays in the commissioning of new facilities).

We are concerned that, collectively, these circumstances have resulted in a situation where an insufficient volume of OM provision has made itself available through the tender process to ensure that the process has been competitive. We are also aware that an insufficient volume has been made available to NGG NTS to meet each of its various types of OM requirement for 2009/10. We are therefore unable to conclude that there has been effective competition for the provision of OM services.

In light of the above, we do not consider it appropriate to suspend C3 prices for the storage year 2009/10.

*Pass through of costs necessary to facilitate a change to the Safety Case*

Ofgem welcomes the response to the tender for the provision of OM, and in particular, the number of alternative providers that have expressed an interest in offering the service.

However, we recognise that this is currently limited by the potential number of providers who meet the Safety Case requirements that OM will be satisfied by gas held in store. In order for contestability to develop it is therefore important that NGG NTS uses reasonable endeavours to pursue proposals for a change to the Safety Case that can be considered by the Health and Safety Executive (HSE).

In its SO Incentives for 1 April 2009 Initial Proposals Consultation<sup>3</sup>, NGG NTS explained that there may be a requirement to over procure against its OM requirements until the capability of new providers of OM is demonstrated to the satisfaction of the industry and the HSE. It has proposed that this cost be treated as a pass through in respect of the SO External cost incentive revenue.

In its response to this consultation<sup>4</sup> NGG NTS provided an update on the requirements of the HSE in order to assess the necessary change to its Safety Case. NGG NTS explained that this would require it to procure additional OM services from new provider types in order to collate evidence to progress a change to the Safety Case. In its confidential response NGG NTS has provided Ofgem with a forecast of the costs of procuring the minimum additional service for this purpose, which is less than five per cent of the total cost of OM provision.

Ofgem recognises the commercial confidentiality of the information on this cost at present and also that, as part of the cost relates to the testing and hence a utilisation cost, NGG

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<sup>3</sup> National Grid Gas (NTS) SO Incentives for 1 April 2009, Initial Proposals Consultation, National Grid, 12 November 2008.

<sup>4</sup> NGG NTS also submitted a confidential response which provided additional information to Ofgem.

NTS can only currently provide a forecast. However, given NGG NTS's licence obligation to operate the system economically and efficiently, we would expect this cost to be kept to a minimum.

Given that in the longer term benefits to consumers should arise from contestability in the provision of OM services, we take the view that these additional costs as described to Ofgem may properly be recovered as Operating Margins costs in 2009/10 under the SO External cost incentive revenue.

## Going Forward

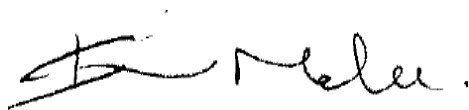
We are of the view that competition for the provision of OM services remains a very real possibility in the near future.<sup>5</sup> We consider that changes to NGG NTS's Safety Case to allow new provider types to participate in the market for OM provision could help in achieving this. We would therefore expect NGG NTS to progress the necessary process to make changes to its Safety Case as soon as possible in order to engage a wider range of new provider types into the market. We further expect NGG NTS to continue to work towards achieving effective competition in the provision of OM services.

We also note that two respondents requested information to be made available regarding the tender. We also consider that this would be an effective way to encourage further participation in the provision of OM in the future. We would therefore request NGG NTS to make available on its website such information as commercial confidentiality provisions will allow (e.g. the weighted average, maximum and minimum price of tenders and the number of tenders).

We consider that revealing such information to the market will enable both existing and potential OM providers to recognise the value of the service that they currently provide or may provide in the future. It will be for NG LNG to consider whether any of the information revealed in this way leads it to consider whether it wishes to put a case forward for revisiting the current C3 prices.

As a final point, as noted above we have decided that it is appropriate to make the licence modification so that we have the flexibility to suspend C3 prices for the provision of LNG storage services in the future. In respect of LNG storage services for the provision of OM we consider that this will be to facilitate competition when the circumstances are right in future. We would expect to consult before exercising the power conferred in relation to the provision of OM services and/or provision of services to DN operators.

Yours sincerely



Ian Marlee  
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<sup>5</sup> Note in this context the Authority's recent decision to approve UNC Modification 240 "Promoting Competition in Operating Margins Provision".