



Gas transporters, gas shippers,
industry participants and
consumer representatives

*Promoting choice and value for
all gas and electricity customers*

Direct Dial: 020 7901 7487
Email: Ian.Marlee@ofgem.gov.uk

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Dear Colleague

Operating Margins (OM) Contestability

As part of the Transmission Price Control Review TPCR4, National Grid Gas (NGG) National Transmission System (NTS) accepted Special Condition C25 which required it to use reasonable endeavours to promote competition in the provision of Operating Margins (OM) services by 1 April 2009. The purpose of this condition was to provide a framework for NGG NTS to hold tenders for contracts for the services it needs, thereby allowing competition to develop. It was intended that if the terms of this licence condition were met, then NGG LNG storage facilities should be able to tender on the same basis as other potential OM providers¹. Further, it was intended that once competition was established, Ofgem should be in a position to remove the current price cap for the provision of OM services as specified in Special Condition C3 of NGG NTS's licence (referred to in this letter as the "C3 prices").

Currently, NGG NTS is engaged in the tendering process for the procurement of gas to meet the 2010/11 OM requirement. This letter is intended to provide clarification to interested parties of the circumstances under which we will consider suspending the application of the C3 prices for the provision of OM services in 2010/11. It also sets out that we are minded to modify Special Condition C3 of the gas transporter licence to make it clear that Ofgem's power to direct the suspension of C3 prices can be used flexibly.

OM Contestability 2009/10

Last year, NGG NTS was concerned that the continued application of C3 prices could influence the tender process that was underway at the time. It considered that 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 could tender. We recognised that the existence of C3 prices may not be consistent with the operation of a competitive procurement framework. In order to facilitate effective competition, we therefore issued a letter² to the industry setting out that we were minded to suspend C3 prices for the relevant period of OM provision

¹ At present, the prices that non NGG LNG OM providers offer into the tender are constrained to competitive levels by NGG LNG in its role as the OM supplier of last resort. Therefore, in order for NGG LNG to be able to "tender on the same basis" as other potential OM providers, NGG LNG should face effective competitive constraints from non NGG LNG OM providers such that the prices it offers into the tender are also constrained to competitive levels.

² See Ofgem's consultation letter: Operating Margins (OM) Contestability, 21 January 2009, www.ofgem.gov.uk.

provided that we judged the tender process to have been effective. In order to achieve that flexibility, we also amended the NTS licence conditions to allow for the suspension of the C3 prices. We also consulted on the criteria we would use to consider whether NGG NTS had met its obligations under C25.

However, following our assessment of the 2009/10 tender process, Ofgem was unable to conclude that there had been effective competition for the provision of OM services and consequently we did not direct the suspension of C3 prices in respect of the provision of OM services³. In reaching this decision, we recognised that a number of circumstances resulted in a situation where an insufficient volume of OM provision made itself available through the tender process to ensure that the process was competitive. Specifically, this was the result of lack of Safety Case approval for new types of OM service providers and delays in the commissioning of new storage and LNG importation facilities which, collectively, limited the number of potential providers able to participate in the tender for the provision of the OM service. Further, we were also aware that an insufficient volume had been made available to NGG NTS to meet each of its various types of OM requirement for 2009/10.

Notwithstanding this decision, we noted that we considered that competition in the provision of OM services remained a very real possibility in the near future and that we expected NGG NTS to continue to work towards achieving effective competition in the provision of OM services.

OM Contestability 2010/11

NGG NTS is currently engaged in the tendering process for the procurement of OM gas to meet the requirement for OM provision for 2010/11. In line with our previous view, we continue to recognise that the existence of C3 prices may not be consistent with the operation of a competitive procurement framework. Therefore, in order to assist in the facilitation of effective competition for the 2010/11 tender, we are minded to suspend C3 prices for the relevant period of OM provision provided that we judge competition in the provision of OM services to have been effective.

We will therefore need to assess the effectiveness of the competition resulting from the tender process. In doing so, a key criteria we propose for our assessment is whether NGG NTS can purchase the complete volume of each of the OM requirement types⁴ from providers other than NGG LNG. Where it cannot, we consider that the price at which NGG NTS procures volumes from the NGG LNG storage facilities will still need to be regulated given that these costs are passed directly through to shippers.

In its third summer consultation document on Operating Margins published in September 2009, NGG noted that as a result of facility, network and supply and demand characteristics, the requirement and market for OM provision is not homogeneous. As a result, the provision of OM is subject to a number of constraints and a varied level of competition for each requirement type. Given this, it may be the case that our assessment concludes that effective competition has been achieved for certain OM requirement types and not for others. Were this situation to occur, we propose to use our powers under Special Condition C3 to direct the suspension of C3 prices for those OM requirement types where we judge that effective competition has been realised, and retain C3 prices for those OM requirement types where we judge effective competition is still not evident.

Whilst the terms of Special Condition C3 do not specifically prohibit Ofgem from suspending the C3 prices in some cases and not others, it does not specifically give Ofgem the discretion to do so. Therefore, in the interests of clarity, we are minded to

³ See Ofgem's decision letter: Operating Margins (OM) Contestability, 20 February 2009, www.ofgem.gov.uk

⁴ The OM requirement types include: Supply Loss, Orderly Rundown, Non-locational, Locational – West, Locational – North, Locational – South and Locational – Scotland.

modify the licence condition to make it clear that Ofgem has the flexibility to suspend the application of C3 prices in respect of the provision of OM services in some cases and not in others, provided that we judge competition to have been effective in the provision of the respective OM requirement types. We would welcome comments from the industry on our proposal to amend the licence condition to make it clear that Ofgem has this flexibility.

Timeline going forward

NGG NTS issued its invitation to tender documents on 4 December 2009 with a closing date of 29 January 2010. It then has until 19 February 2010 to decide on the outcome of this tender. Were Ofgem to decide to make a licence amendment to the wording of Special Condition C3 to allow flexibility in the suspension of C3 prices, this would need to be done ahead of Ofgem's decision on whether effective competition has been achieved in the provision of OM services, that is, by 18 February 2010. To issue a direction to suspend the application of C3 prices in some cases only, if required, we would therefore need to formally start the consultation on this licence change by 18 January 2010⁵.

We would welcome views or comments from interested parties in respect of how we consider whether competition has been effective. We would also welcome views or comments on undertaking a licence modification to change the wording of Special Condition C3 for the reasons set out above. 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:

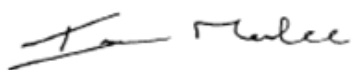
Claire Rozyn
Ofgem
9 Millbank
London
SW1P 3GE
Claire.Rozyn@ofgem.gov.uk

If you reply to us in writing, your response may be published on Ofgem's website 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. We would welcome responses by **Tuesday 12 January 2010.**

If you have any queries or comments on this letter, please contact Claire Rozyn (Claire.Rozyn@ofgem.gov.uk, 020 7901 7216) in the first instance.

Yours sincerely



Ian Marlee
Partner, Trading Arrangements

⁵ Formally commencing a consultation on 18 January 2010 would allow Ofgem at least two full days to consider responses ahead of making our decision.