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Date: 18 February 2010

Dear Colleague

Operating Margins (OM) Contestability

As part of the last 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. It was intended that if the terms of this licence condition were met, then National Grid Liquified Natural Gas (NG 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").

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 services². However, 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

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 issued an Open Letter in December 2009³ setting out our view that we were minded to suspend the application of C3 prices for the relevant period of OM provision, provided that we judged competition in the tender to have been effective.

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 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.

³ See Ofgem's Open Letter: Operating Margins (OM) Contestability, 21 December 2009, <http://www.ofgem.gov.uk>

In support of this aim, on 17 February 2010, we directed a licence modification⁴ to enable the Authority to direct the suspension of the application of C3 prices in respect of one or more LNG storage facilities and/or one or more OM requirements.

In our December Open Letter we consulted on the proposal that the key criterion for our assessment of the effectiveness of competition should be whether NGG NTS can purchase the complete volume of each of the OM requirements from providers other than NG LNG. Four responses were received to the consultation which closed on 12 January 2010. Written responses were received from SSE, E.ON and NGG NTS and a verbal response was received from AEP. The written responses are available on our website⁵.

Three of the respondents expressed concerns about the proposed criterion for assessing whether competition had been effective. The fourth respondent expressed no view on our proposed criterion. One respondent considered that the test was loosely defined and potentially too simplistic compared to the detailed analysis Ofgem would typically carry out when assessing competition in other markets. Another respondent, who did not consider effective competition to be present in this market, considered that just having sufficient volume offered by non NG LNG providers to meet the requirements did not demonstrate a competitive market – for example, a single tender could provide all the volume for an OM type at a very high price. This respondent also stated that the same approach Ofgem had used in the past to assess competition for TPA exemption for storage projects including detailed HHI studies, should be used here. The third response, provided verbally, also raised concerns that considering the volume of OM provided by non NG LNG providers might not be an adequate test of the extent of effective competition.

While we acknowledge each of these concerns, we would reiterate that the purpose of our assessment is to understand whether competition in OM has been effective, based on whether the NG LNG storage facilities are able to tender on the same basis as other potential providers. It is our view that the relevant consideration in this context is whether NGG NTS can purchase its requirements without purchasing from NG LNG. If NGG NTS cannot, it is our view that the price at which NGG NTS procures volumes from the NG LNG storage facilities will need to remain regulated. However we accept that there would be concerns if any party were able to exercise market power. We have therefore also taken this into consideration.

In addition, we note that our December Open Letter left open the possibility that we would consider other factors in our assessment where there remained a question around whether effective competition had been achieved. In cases where only a small number of non NG LNG providers were available to meet an OM requirement, we agree that we would need to consider factors beyond our key criterion, for example, the range of tenders received and the level of prices offered.

In previous years OM services have been provided by storage facilities. In order to allow for OM to be provided from sources other than gas held in store, a Safety Case amendment has been required. NGG NTS submitted its case to the Health and Safety Executive (HSE) in November 2009. We note that NGG NTS has indicated to us that the HSE is minded to accept its Safety Case Demonstration thereby allowing non-storage providers to provide OM services. Therefore, NGG NTS plans to consider the offers of non-storage tenderers in coming to a view on its final bookings for the 2010/11 gas storage year.

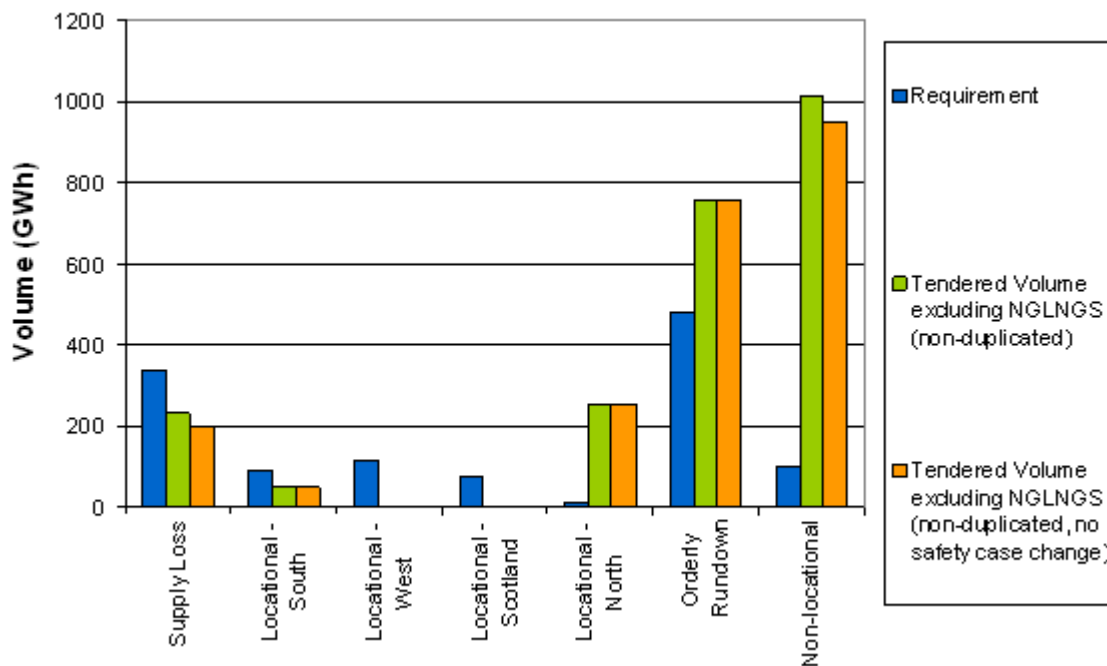
⁴ See Direction under Section 23 of the Gas Act 1986, 17 February 2010, <http://www.ofgem.gov.uk>

⁵ See Associated Documents: Operating Margins (OM) Contestability, 21 December 2009, <http://www.ofgem.gov.uk>

Assessment of OM Tender for 2010/11

The OM tender for 2010/11 has been completed and NGG NTS intends to announce the results on 19 February 2009. We have assessed the effectiveness of the competition resulting from the tender process as set out in our December letter and as discussed above. Figure 1 sets out the summary statistics for the offers received for each OM requirement.

Figure 1: Tendered Volumes against Requirement for each OM service. Source: NGG



The blue bar in Figure 1 represents the volume requirement of each OM service and the green and orange bars represent the volume of offers received in the tender from non-NG LNG providers both with and without the volumes provided by the Safety Case approved tendered. We note that potential double counting of capabilities arising from different tenderers offering OM services at the same facility or from a single tenderer available for different OM services has been taken into account.

The results of the tender as set out in Figure 1 indicate that when the offers from NG LNG are excluded, the complete volume of the Locational North, Orderly Rundown and Non-locational OM requirements can be met. We note that across these three OM requirements a range of tenders were received. We have analysed the results of these tenders, including by undertaking "pivotality tests"⁶. Having considered this analysis we are satisfied that no participant has been able to exercise market power and we therefore consider that competition is effective for the provision of the three OM requirements set out above.

For the reasons set out above, the Authority intends to direct the suspension of the application of C3 prices for the following services⁷:

- Locational North;
- Orderly Rundown; and
- Non-locational.

⁶ If, without the offer of a single tenderer, other tenderers are unable to meet the requirement then that single tenderer is deemed to be pivotal.

⁷ For further details see the attached direction.

The suspension of the application of these C3 prices will take effect from 06:00 1 May 2010 to 06:00 1 May 2011 i.e. the duration of the 2010/11 gas storage year associated with the 2010/11 OM tender process.

For the avoidance of doubt, on the basis of the tender results and our assessment criteria, we do not consider that competition has been effective in the provision of the Supply Loss, Locational South, Locational West and Locational Scotland OM requirements.

We welcome these developments in the provision of OM services. However we consider it prudent to keep the development of competition in the provision of OM under review and will therefore reassess the situation during the next OM tender process. Our expectation is that with the increased certainty of the Safety Case outcome the next tender will lead to a number of new providers offering services, including a number of those who participated in the previous tender but may not have participated in the 2010/11 tender.

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

A handwritten signature in black ink, appearing to read 'Stuart Cook', is written over a horizontal line.

Stuart Cook
Senior Partner, Transmission and Governance