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17 September 2010

UKLNG.064

Dear Stuart

National Grid Liquefied Natural Gas facilities price control

National Grid LNG Storage (NG LNGS) welcomes the opportunity to work with Ofgem towards developing a price control which protects the interests of consumers whilst at the same time ensures that adequate funding is made available to maintain safe and reliable operations at the facilities for so long as they continue to be required to provide regulated services (in keeping with Ofgem's duties under Section 4AA(2)(b) of the Gas Act). This response presents the views of NG LNGS on the main issues highlighted by Ofgem in their open letter of 17 August 2010.

The LNG storage facilities concerned within this price review provide three different regulated services. All three sites provide Operating Margins (OM) services to National Grid Gas (NGG) as the NTS System Operator. In addition to this, Glenmavis provides an LNG tankering service to meet the requirements of the Scottish Independent Undertakings (SIUs) and Avonmouth offers a Constrained LNG service[1].

NG LNGS has requested a price control review because the supply of LNG to the SIUs fulfils an obligation for Scotia Gas Networks (SGN) under the Gas Act 1986 (as amended) whilst the provision of OM services forms part of the Safety Case for National Grid Gas (NGG). As such, the facilities are obliged to remain operational even though current levels of revenue are not sufficient to cover their efficiently incurred costs. This is because the previous price control was based on assumptions which have since proved incorrect.

The purpose of this review must be to allow adequate funding to maintain options at each site either until long term arrangements are put in place at GDPCR2 / TPCR5, or until such time as it can be established which of the services currently provided will continue to be required and which will not. However, given the age of the assets in question, it is vital that engagement between the main stakeholders in the provision of these services; namely SGN, NGG and NG LNGS, takes place now to ensure that the most economic long term solutions can be delivered in the timescales required.

[1] This is a service provided to the System Operator (NGG) to aid the resolution of local system constraints by supporting pressures at times of high demand.

This line of thinking is supported in the 'RPI-X@20 Emerging Thinking' document where Ofgem recognise that "*The proposed new regulatory framework would encourage network companies to focus on the longer term and: … [amongst other things] … Manage uncertainty, taking on risk where appropriate and* ***keeping options open*** *where cost effective; and* ***Engage more effectively*** *with all stakeholders, responding to* ***existing and anticipated needs*** *of consumers of network services*"[2] .

By way of background, it is necessary to consider each of the LNG storage facilities separately as the issues involved are generally site specific. However, in the case of all the facilities, it must be stressed that these are aging assets which require continuous safety improvements to be made to extend their operating lives. Safety is the foremost concern of NG LNGS and under no circumstances can any facility be permitted to operate if any doubt exists as to the integrity of the plant.

At Partington, commercial services are no longer being offered in order to preserve the aging assets for use in the provision of regulated OM services. As the site is situated in an area of the NTS where there are a number of alternative storage providers, it is anticipated that there will not be a requirement in the medium / long term for the provision of OM services from the facility. In addition, given the topography of the site, there are safety-based constraints on operating beyond the short term. For these reasons, Partington requires adequate funding for the period up to and including 2013 when, once the plant has been purged of gas and disconnected from the NTS, it can then be safely and permanently decommissioned.

Avonmouth is the newest of the three sites (although still more than 30 years old) and currently offers commercial, as well as regulated, services. It is situated in an area of the NTS where there is no sign of contestability emerging in the provision of 'locational' OM services and, as such, there appears to be an ongoing requirement for the site in the short / medium term. Therefore funding is needed to ensure that service levels can be maintained for as long as a requirement for the facility exists. The site will also be the only provider of a back-up tankering service to Glenmavis from May 2011.

While it is envisaged that commercial services will continue to be made available from Avonmouth for the duration of this review period, in the longer term a decision may need to be made which balances the relative value of commercial revenues against the ongoing cost of regulated OM provision. NG LNGS believes that continuing to offer commercial services at Avonmouth beyond 2013 could necessitate the replacement of the 'cold box' (£30m-£40m) within perhaps 5 years. However, restricting the site to OM service only may significantly extend the life of this asset given that liquefaction would only be necessary to replace boil-off gas and following the calling of OM services. Work is ongoing in order to find the most suitable approach and the views of the industry and Ofgem are welcome on the subject.

NG LNGS has previously announced that it will be withdrawing commercial services at Glenmavis with effect from the end of the current Storage Year (i.e. 30th April 2011). The facility will then only provide regulated OM services to NGG and tankering services to the SIUs. There appear to be no alternative providers of either service in the short / medium term and, as such, there is a requirement to keep the site operational until a permanent solution to both services can be developed. NG LNGS consider that under current operating conditions, and assuming necessary funding is provided now, the life of the site could be extended without major investment to 2015. This would have the effect of allowing time to develop a long term solution at the existing Glenmavis site or for an alternative third-party solution to be developed and implemented, ensuring an orderly transition of the service and maintaining security of supply throughout the process.

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[2] Paragraph 6 of Executive Summary [Regulating energy networks for the future: RPI-X@20 Emerging Thinking (20th January 2010)]

However it should be recognised that there is a very real danger that if no economic investment is facilitated in these sites, and no long term signals are given to encourage alternative solutions, a situation may arise whereby the existing assets become unavailable (e.g. for technical or safety reasons) before replacement providers or facilities have been established, something which all interested parties must work together on to prevent.

Scope of Control

NG LNGS is of the view that, because the emphasis of their use has had to shift to providing regulated services, the most appropriate method of treatment for the LNG storage assets is to bring them under the scope of the main Transmission or, potentially in the case of Glenmavis, Gas Distribution Price Control. However, the timescales required to incorporate price changes into the next OM tender exercise in February 2011 are challenging and there does not appear to be time to carry out the necessary analysis required to devise the long term funding arrangements for each site. In light of this, Ofgem's decision not to address the issue of bringing the LNG storage assets at Avonmouth and Glenmavis under the remit of the main price controls at this stage appears appropriate.

Notwithstanding this, treatment of historic CAPEX should continue to be made a priority of the upcoming price control. In the Final Proposals of the last review, Ofgem determined that an allowance would be made for depreciation and return on one third of the total LNG storage historic asset base on the assumption that this was the proportion that was related to the provision of regulated activities[3]. The majority of the capacity of the sites is currently being used to deliver regulated services linked to declining market appetite for commercial services. NG LNGS therefore considers that upward revision of the historic RAB percentage allocated to regulated activities would be in keeping with Ofgem's desired approach whilst better reflecting the present operating conditions as well as the original design basis of the facilities.

In terms of how CAPEX in general (whether historic or new) should be treated in this review, NG LNGS favours an approach whereby costs are recovered over the remaining economic lives of the facilities. Therefore, taking Partington as an example, an efficient capital investment required to maintain safe operation of the facility for a period of two years should be recovered in full over those two years. The same applies to Glenmavis out to 2015 and to Avonmouth for as long as the site can be expected to be required to remain operational. This would have the effect of mitigating the volatility in annual prices that would transpire if this CAPEX were to be treated purely as OPEX whilst also allowing the costs of the investments to be recovered from the consumers who benefit from them.

There are two further issues which NG LNGS considers relevant to the scope of this price control. The first is that there is reason to believe that any conclusions coming out of the review should take effect from the date upon which the reasonable endeavours obligation placed on NGG by Standard Special Condition C25 were judged by the Authority to have been met. NG LNGS considers that Ofgem's open letter dated 18 February 2010[4] and NGG's open letter dated 10 March 2010[5] support the case that these reasonable endeavours were met before 1 May 2010 and therefore that the review should allow costs efficiently incurred during this year (2010-11) to be recovered in addition to those forecast for the period 2011-13. The second issue is that, despite the stance taken by Ofgem in previous controls, NG LNGS continue to consider that costs associated with making a site safe should be funded as a regulated activity. This should not necessarily extend to complete site remediation but should instead apply to efficiently incurred costs relating to a 'purge and make safe' operation. This is in line with the condition that the site must be in to allow the consent to be returned to the HSE following cessation of operations.

[3] Paragraph 2.33 LNG Storage Price Control - Final Proposals (19 December 2007)
[4] Operating Margins (OM) Contestability 2010: Decision Letter
[5] Operating Margins (OM) - Further Update on Safety Case Demonstration to the Health & Safety Executive

Form of Control

Once the appropriate level of funding for the period up to 2013 has been agreed, it will be necessary to put in place a regulatory framework which ensures that this funding is actually recovered by NG LNGS whilst minimising market impact. There is a risk that if the current price-cap regulation (C3 prices) remains in place, it would leave the ability of NG LNGS to finance its activities outside of its control given that it cannot influence the volume of services required by its regulated customers. This could potentially lead to a further re-opening of the control being necessary if volume requirements were not as forecast. However, site specific fixed revenue allowances would ensure that each facility has available the financing necessary for its specific requirements irrespective of the OM, constrained LNG or SIU volumes likely to be booked over the duration of the control period.

NG LNGS notes that, in the previous review, Ofgem took the view that this type of revenue control was inappropriate for the LNG storage businesses because "*NGG's shareholders have benefited from strong commercial revenues over the last few years*"[6]. However, since then, the situation has reverted with National Grid's shareholders effectively subsidising a business whose revenues have fallen far short of its efficiently incurred costs as a result of price-cap regulation being applied in a period which has seen substantially lower OM capacity bookings than forecast. Indeed, the strong commercial revenues quoted above were only evident in two of the years since commercial services were first offered at the sites and, when the last ten years are considered, the picture changes considerably.

NG LNGS also appreciates that it may have been easier to justify the use of a price cap in a market where volume bookings were (or were forecast to be at the time of the price review) at a more or less constant level. However, given the growth of contestability in OM provision and the changes in the pattern of flows across the NTS, this is no longer the case and the sites are being kept fully operational despite minimal volumes being booked. This means that the requirement on each facility (at least in terms of OM provision to NGG) increasingly appears to resemble an "availability" service. As a result, this strengthens the belief held by NG LNGS that the site specific fixed revenue allowances mentioned above would be more appropriate than price caps in ensuring that each facility is adequately funded – at least until longer term decisions can be made regarding their future.

In order to address the concern that such revenue targets might lead to volatile prices and therefore issues in cost-forecasting and financial planning for customers, it is important to note that the primary customers of the service in question are SGN and NGG – both large regulated companies. Therefore, price volatility is not likely to be an issue in the same way as it might be for smaller businesses. This concern could be further addressed by applying the revenue target over the duration of the price control period rather than on an annual basis. Appropriate arms-length contracts could be put in place for each facility which would set out both the volumes required and the prices charged for both years of the control at the same time (i.e. ex ante).

Finally, whilst appreciating that the thrust of this price review is regarding regulated services, NG LNGS consider it appropriate to clarify how commercial services at Avonmouth, assuming they can be economically justified, would fit into a revenue-control framework. The most appropriate method of addressing this issue would be to offset any related revenues against the Avonmouth fixed revenue allowance. This would have the effect of reducing the proportion of the allowance to be recovered from NGG in respect of OM services thereby reducing costs to consumers. NG LNGS should be allowed to keep a proportion of this revenue as this would act as an incentive to actively pursue commercial services.

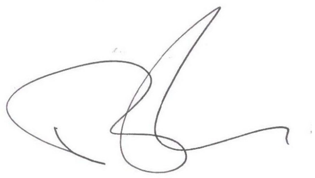
[6] Paragraph 2.12 LNG Storage Price Control - Final Proposals (19 December 2007)

Duration of Control

NG LNGS supports the approach suggested by Ofgem that the review should last until 2013. This aligns with the planned closure date for Partington and there are clear benefits in developing any new review concurrently with GDPCR2 and TPCR5. This is because any incentives on NG LNGS would be applied in parallel to those on SGN and NGG. These would be longer term incentives which have the potential to deliver increased levels of efficiency and cost saving as they would allow SGN and NGG to tender out to the market for new solutions based on long term contracts. These solutions cannot be approached under the current rolling one-year incentives because neither NG LNGS nor any other prospective service provider would invest on the basis of only one year's guaranteed revenue.

I hope that this response has been helpful. If you need any clarification on the points made or have any questions please contact Paul Hernaman 01926 65 6351 or paul.hernaman@uk.ngrid,com in the first instance.

Yours sincerely,



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