nationalgrid

National Grid LNG Storage
National Grid House
Warwick Technology Park
Gallows Hill, Warwick
CV34 6DA

Paul O'Donovan
Gas Transmission Policy
Ofgem
9 Millbank
London
SW1P 3GE

Peter Boreham
Director UK LNG

Peter.j.boreham@uk.ngrid.com
Direct tel +44 (0)1926 656970
Direct fax +44 (0)1926 656587

www.nationalgrid.com

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Dear Paul,

Response to the Initial Proposals for the National Grid LNG facilities price control

National Grid LNG Storage (NG LNGS) welcomes the opportunity to respond to the Initial Proposals that were published by Ofgem on 22 November 2010.

The Initial Proposals recognise the concerns that NG LNGS have raised in requesting a re-opening of the price control and in our previous correspondence on this matter. There are still significant areas of concern, outlined in this response together with answers to each of the specific questions raised.

Chapter 2 question 1: "*Do you agree with our Initial Proposals on the scope, form and duration of the control?*"

NG LNGS is broadly in agreement that the scope of the control should cover the funding required for the continued provision of regulated services over the period 2010/11 up to and including 2012/13. NG LNGS agree that funding for Avonmouth and Glenmavis post-2013 can be addressed as part of the prices controls that will come into effect in April 2013, provided that sufficient funding is available in the interim to keep all necessary options open.

NG LNGS does not agree that a price cap is the most appropriate form of control for the LNG Storage facilities. Both regulated and commercial volumes are reducing as a result of competition. If Operating Margins bookings fall further in 2011/12 or it becomes necessary to shut one or more of the sites earlier, a unit price cap will not allow all regulated costs to be recovered.

Price cap regulation relies on accurate forecasts of regulated volumes required. With the market success of contestability NG LNGS considers that, as it has no control over these volumes, it is heavily subjected to windfall gains or losses based on variable OM requirements from NGG. Whilst best endeavours are always employed to make forecasts as accurate as possible these are constrained by the ring-fencing arrangements in place between NG LNGS and NGG-NTS and, if actual volumes in a year are below forecast, substantial efficiently incurred costs are permanently written off. This has been a major factor in the previous price control being reopened and needs to be rectified to adequately fund the business. Therefore a mechanism needs to be incorporated to ensure that NG LNGS can recover its costs without volume risk that is beyond its control.

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NG LNGS notes Ofgem's proposal not to employ the RIIO principles but looks for assurance that the protection of Regulatory Asset Value (RAV) implied under RIIO will be reflected in any Final Proposals.

In section 2.15, the Initial Proposals state that *"Ofgem is minded to introduce an incentive to facilitate decommissioning in a sustainable manner"*. NG LNGS in principle supports the introduction of environmental incentives and believes that an incentive to encourage early site remediation to improve the visual amenity of any closed LNG Storage facility and bring forward surrender of their Pollution, Prevention, and Control (PPC) licence should be investigated.

Chapter 3 question 1: *"Do you agree with our Proposals on the differing treatment of depreciation and return between historical and future capex?"*

Returns for any company needs to reflect the risks that they face. Any independent business would not be able to accept the returns outlined in the Initial Proposals based at a regulated level without removal of wider commercial risks. For example, no independent business would make an investment if it knew in advance that, for every £1 spent, it could only recover at best 27 pence of its costs as would be the case at Avonmouth under these Initial Proposals. As described above, recovery of the 27 pence is itself dependent on outturn volumes being equal to those assumed when setting the regulated C3 price. Where investments have been made in the past on the basis that returns will be provided in future years, then these must be honoured otherwise it undermines the whole basis of regulatory asset values. The future investments that have been identified for each of the sites are all necessary to maintain safe operation of the regulated services and therefore NG LNGS believe that the same proportion (100%) should be used when determining the allowance for future investments at all the facilities.

Chapter 3 question 2: *"Is it appropriate that NGG and SGN should be more exposed to the capex costs associated with the provision of regulated services at Glenmavis?"*

NG LNGS is required to make long term investments to provide regulated LNG Storage services while customer requirements can be refreshed each year, making it difficult to justify investments when there is no guarantee that the costs will be recovered. NG LNGS believes that it is a good idea for the customers at Glenmavis to be more exposed to the investment costs associated with continuing to provide regulated services. This should provide an incentive for those customers to confirm their requirements over the lifetime of the proposed investments. In turn it provides NG LNGS with greater clarity about what investments are required and a contractual mechanism for NG LNGS to recover their investment costs without any stranding risk. There is significant investment required at Glenmavis to keep it operating beyond 2011, and so it may be appropriate for the regulated customers to be exposed to all of the costs of operating Glenmavis by means of a long term contract instead of using the C3 price mechanism. This risk has been highlighted by further failure of the plant at Glenmavis since our original submission.

Chapter 3 question 3: "Do you think it is appropriate to include commercial revenue foregone in the consideration of price caps?"

Paragraph 3.16 makes the assertion that *"NG LNG withdrew volume from the market because of commercial issues, rather than there being a fall in market demand."* However, paragraph 1.19 recognises that *"there has been a significant tailing-off of demand for the annual commercial storage product."* There were a number of factors that led to the decision to withdraw commercial services from Glenmavis and Partington including reducing prices, fall off in market demand, and lack of interest in long-term contracts. However, the primary reason for withdrawing commercial services at Glenmavis and

Partington was to prolong the provision of regulated services from those sites. Therefore NG LNGS believe that it is completely inappropriate to include the foregone commercial revenue in setting the allowed regulated revenues.

Table 4.1 of the Initial Proposals summarises the cost components of the NG LNGS Submission and compares these with Ofgem's Initial Proposals. The big variances are in the proposed allowances for future capital investment and for depreciation / return on RAV, but it is also important to consider the other variances.

NG LNGS has provided detailed information to Ofgem on each of the projects (capex and opex) included in the submission and also made it clear that all of these projects are necessary for the safe continuance of regulated services. Notwithstanding our response to the question regarding customer exposure to capex costs at Glenmavis, NG LNGS believes that all of the capex made within our submission should be allowed within the Final Proposals.

NG LNGS notes Ofgem's proposal to move to a site-by-site split of the Regulatory Asset Base (RAB) in determining the allowance for depreciation based on historical volume bookings since 2006/7. Whilst NG LNGS appreciates that taking a site-by-site approach to this issue is more in keeping with how the rest of the price control is being conducted, we are concerned that it provides no mechanism to recover the residual share of RAV at Dynevor and does not reflect the future use of the sites. National Grid shareholders have already borne the loss of Dynevor shutting, and it is not appropriate for an independent business efficiently incurring costs to be exposed to further losses at the remaining sites. A more equitable solution for determining the depreciation for historical investment would be to include future years up to the end of the anticipated life as well as the recent years in the calculation of the site-specific ratios.

The other significant area of costs is the day-to-day operating expenditure both at the sites and for central support. In paragraph 3.4 of the Initial Proposals, Ofgem note that their cost consultant at the previous review indicated that the operation of the facilities was generally efficient and there was limited opportunity for cost reduction but Ofgem have then proposed applying an apparently arbitrary 10% operating expenditure challenge. The application of such a challenge seems to be inappropriate, especially retrospectively for 2010/11. There is little justification behind Ofgem's proposal to reduce the allowance for central costs by 24% given these costs include central engineering support for the capex programme and refresh of unsupported IT systems. The majority of these costs relate to LNG Storage specific activities where it is more cost effective to undertake them across all three sites rather than have a team at each site separately. There is already significant financial risk from allocating these costs equally across the three sites when, as Ofgem recognise, one site is already been run down with a view to closure. One way to mitigate this financial risk would be to allocate all of the central support costs to the enduring site, Avonmouth, in which case an efficiency challenge may then be appropriate.

NG LNGS looks forward to providing any further clarification needed on the points raised in this response and to the publication of the Final Proposals in January. For clarification or further information please contact Paul Hernaman on 01926 656351, or paul.hernaman@uk.ngrid.com, in the first instance.

Yours sincerely

Peter Boreham
Director UK LNG
National Grid