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Dear Paul

LNGS Price Control – NGG NTS Response Points

National Grid Gas welcomes the opportunity to respond to the above consultation. This response is on behalf of National Grid Gas in its capacity as the System Operator for the National Transmission System (NGG NTS). It is not confidential and NGG NTS has no objection to its being published.

Background

Operating Margins (OM) is a service required by the System Operator in order to reduce the likelihood of an emergency on the gas national transmission system or in the event of an emergency, to ensure the safety of users on the system. The availability of adequate volumes and deliverability of OM forms part of the NGG Gas Transporters Safety Case under the Gas Safety (Management) Regulations.

The largest providers of Operating Margins are currently storage facilities, followed by LNG importation facilities, demand reduction, and supply increase provision[1]. Non-storage OM provision has increased its market share in recent years following the development and promotion of different forms of OM provision through the OM contestability project. The development of contestability has led to more competition and options in the market for OM provision; this may lead to a reduced reliance on storage provision in future years.

NGLNG Storage currently provides approximately one third of Operating Margins provision under 'pre-emption rights', where Operating Margins services have priority over other bookings under the UNC. These facilities currently provide national and locational OM services at regulated prices[2]

The Avonmouth LNG storage facility also provides the Constrained LNG Storage service that is an alternative to building additional network capability. Shippers who book commercial services at this site are required to hold a level of gas within storage and deliver it if required in return for a credit based on the long term marginal price of investment in the pipeline system. This requirement has reduced in recent years, but is expected to increase in the next two years due to NGG NTS's increased obligation to provide exit capacity under enduring exit arrangements.

Timing and Appropriate Incentives

The timing of the outcome of the LNGS price control review is critical to the NGG NTS OM tender process. In parallel with the LNGS price control review, NGG NTS is undertaking consultations with the industry in relation to the Gas System Operator Incentive Scheme for 2011/12 and 2012/13. OM

[1] Supply increase provision is where a provider has the ability to increase flows from a gas field above the level expected.
[2] Regulated prices have been suspended as a result of the development of competition in delivery of these services for the Non-locational, Orderly Rundown and North locational requirements.

currently represents around 5% of the SO costs. Ofgem have expressed their initial views on the NGG NTS SO Incentive Initial Proposals[3]. They consider NGG NTS should be incentivised in relation to OM, and they favour a "bundled incentive" covering both holdings and utilisation is preferable.

Any delay in the outcome of the LNGS price control that results in a delay in making C3 prices known to the industry may have a number of implications:

- Alternative providers of OM services may wish to understand what regulated prices from LNGS will be set at in order to determine their own commercial offering to the NGG NTS OM tender.
- NGG NTS cannot optimise OM bookings to minimise costs for delivering the required service unless they know what level C3 prices will be set at as well as the form of the LNGS price control.
- In the absence of a clear and timely understanding (in January in advance of tender submissions for the 2011/12 OM tender) of the LNGS regulatory regime, due to the impact on tendering parties, NGG NTS believe there would be additional challenges in agreeing incentive schemes for the years 2011/12 and 2012/13.
- A defined price for regulated OM services enables ready assessment of LNGS OM services against other OM market offerings. The natural consequence of this is that where alternative OM offerings are competitive then NGG NTS will book these and as a consequence OM volumes booked with LNGS will reduce. This is of course the intention of the incentive scheme. It therefore seems perverse to give NGG NTS an incentive that may lead to lower OM bookings from LNGS while at the same time proposing the LNGS revenue (which is heavily influenced by fixed costs) should be volume dependent. As a general principle, National Grid considers that regulators should incentivise regulated companies to control those areas of expenditure over which they have influence to enable their functions to be adequately funded.
- Equally, a revenue cap might (depending on the level) address LNGS revenue requirements, but it will make determining the optimum provision of OM more problematic for NGG NTS. It might also have perverse incentives as we outline in our Gas System Operator Incentive Initial Proposals[4] (para 67 refers).

Impact on Customers and Consumers

A significant increase in the level of C3 prices will feed through to an increase in the cost of providing the necessary OM service. This in turn will feed through into the SO commodity charges. OM contributes to around 6% of the SO commodity charge and so a significant increase in C3 prices (the Ofgem initial proposals are for increases between 85% and 250%) will, depending on the volumes and deliverability of regulated OM purchased, lead to significant changes in the level of SO commodity charges. This will impact the shipping community. National Grid and shippers' ability to forecast the SO Commodity Charges will be limited due to the uncertainty over the treatment of C3 prices and OM volumes. This is likely to increase to cost of risk management for shippers and feed through to consumers in higher prices.

As a general principle, National Grid believe that it is appropriate that customers benefiting from particular assets should be the ones that pay for those assets. We believe the costs of assets should ideally be recovered over their economic lives. We also consider that where changes in regulatory treatment are proposed then appropriate notice should be provided so that affected stakeholders can take appropriate actions to mitigate the impact of the change.

Applying this principle of recovering costs over the remaining asset life in relation to the aging LNGS assets whose remaining life is (as a result of current circumstances) likely to be curtailed, appears arbitrary. It results in dramatic changes in the required LNGS revenues (and hence likely C3 prices) as set out in Ofgem's consultation (250% to 2001% change at Partington on the basis of Ofgem analysis). No adequate notice has been provided to the market, and so the market has not had the opportunity to react in a timely manner.

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[3] Ofgem's initial comments on NGG System Operator Incentives from April 2011 was published on 26 November 2010 at http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/Ofgem's%20initial%20comments%20on%20National%20Grid%20Gas%20System%20Operator%20Incentives%20from%20April%202011.pdf

[4] See the National Grid website: http://www.nationalgrid.com/NR/rdonlyres/E0A2DD71-7EFC-4B2A-95E0-52CDE2746420/43997/GasSOInitialProposals201112.pdf

Consumers have benefited from the LNGS over many years and ideally the cost of these facilities should have been spread evenly across the period of benefit. It does not seem appropriate to impose on the remaining LNGS customers the entire burden of recovering the remaining LNGS costs (principally in the form of remaining depreciation) over such an accelerated timescale. NGG NTS considers that for such long lived assets this approach is inappropriate should not set any precedent in relation to NTS assets more generally when or where these are retired early as a result of the changing use of the NTS. We consider that the cost of remaining depreciation and returns should continue to be spread over the remaining economic asset lives (irrespective of whether the assets concerned have been physically retired or not). Given the status of the LNGS asset base (part regulated / part "commercial"), this does imply that the regulated element of the asset base should be moved to the relevant Regulated Asset Base(s) (RAB). The effect of this approach would significantly reduce the size of any C3 price changes and consequential spikes in SO commodity charges falling on current gas customers.

NGG supports the principle of incentivisation of costs or services where a regulated party has the ability to influence those costs or services through efficient operation and innovation. We consider that in principle SGN should have an appropriate adjustment to their price control to reflect any significant change in C3 prices (the use of an updated C3 price for SGN has more merit than for other OM services given the greater certainty over the volumes involved).

Responses to Specific Questions

Chapter 2 Question 1: Do you agree with our Initial Proposals on the scope, form and duration of the control?
NGG NTS supports a temporary change to accommodate the immediate funding shortfall and change in circumstances so that the facilities can be retained in a reliable condition while NGG NTS is reliant on their services. We need to have clarity quickly so the NGG NTS OM tender process can be run in an efficient and orderly manner.

We are not supportive of the arbitrary allocation of costs proposed by Ofgem between regulated and commercial activities. Our understanding is that it is difficult to disaggregate costs between those required for regulated services and those required for commercial services and in many cases if certain Capex is not undertaken then neither regulated nor commercial services may be available. We are also concerned that Ofgem should not give LNGS an inappropriate incentive to offer commercial services in the short term that might prove to be detrimental to their ability to subsequently deliver essential regulated services.

<u>Form of control:</u> This is a difficult area. As a customer of LNGS NGG NTS seeks some certainty regarding the costs it will face for the services it requires. A C3 price cap is well suited to providing this, however we equally recognise that given the potentially large changes in C3 prices could have a significant impact on the OM booking revenues for LNGS and that this has implications for the overall funding of the activity. National Grid considers that the proposal to recover the remaining LNGS depreciation costs from Partington over its design life rather than its economic life is misplaced, and creates an unnecessary and inappropriate distortion of the costs associated with the site. Ofgem need to rethink their approach in this area.

NGG NTS would be extremely concerned if Ofgem were to seek to use this approach to NTS assets. It undermines the concept of the Regulated Asset Base (RAB) by in effect disallowing the remaining depreciation and return on investment where assets are retired early (though there is no commensurate upside where assets remain in service beyond their regulatory life). Much of the NTS was designed and built 30-40 years ago and it has subsequently evolved to meet the changing needs placed on the system. We are currently seeing substantially different network flows as a result of new sources of gas and this may lead to NGG NTS assets being retired early to reflect the changing network needs. NGG NTS should be allowed to recover the remaining depreciation and return in such cases – otherwise this would represent an asymmetric risk and create a perverse incentive to retain network in service after the need for it has passed and this might not be in the best interests of gas customers.

<u>Duration:</u> We agree that the duration proposed by Ofgem is appropriate in the circumstances. However, NGG NTS remains dependent on OM from LNGS for the medium term and so their continued operation is essential until other suppliers of OM come forward.

Chapter 3

Question 1: Do you agree with our Proposals on the differing treatment of depreciation and return between historic and future Capex?

We would be concerned if these proposals led to NGG LNGS failing to invest (on the grounds that such investment would not be remunerated) and this then led to OM services becoming unavailable. Ofgem makes reference to the behaviour of an independent company and it seems unlikely to us that an independent company would invest £100 knowing in advance that it would only recover a maximum of £27.

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

Ofgem's stated aim in this review is to address an immediate funding shortfall. The long term future of Glenmavis needs to be identified and NGG will play its part in identifying, so far as it is able given the uncertainties involved, our longer term requirements for OM in this part of the system. We consider that this work should form part of the RIIO-T1 process (and for SGN RIIO-GD1) which should identify the economic and efficient solutions and provide appropriate funding mechanisms. We also consider that the pricing signal from any proposed C3 prices should enable National Grid and other potential market providers to understand the cost of using services from the site and therefore make appropriate decisions without any further incentives.

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

It is not clear to NGG whether the withdrawal of commercial services was, as asserted by Ofgem for commercial reasons (especially given earlier comments regarding the weak market for commercial services), or whether it was because of plant capability or safety considerations.

Keeping all our stakeholders safe (through meeting of NGG's Safety Case) is of paramount importance. Delivery of commercial services will involve consequential wear and tear on aging plant with the consequential increase in risk that regulated services became unavailable. We consider it would be inappropriate for Ofgem to give an incentive to LNGS to value commercial services (of limited value so far as we can see) over the delivery of crucial safety related OM services and therefore urge caution in this area.

The commercial revenue assumption made is based on revenues from a number of years ago – these may not be reflective of the current market. If these were to be included, would it not be more appropriate to consider more recent market signals of potential revenues, such as through NGLNGS' recent request for interest?

I hope you find these comments helpful. Should you wish to discuss any of the points then please do not hesitate to contact Andy Balkwill (andy.balkwill@uk.ngrid.com 01926 65 5988) in the first instance.

Yours sincerely

BY E-MAIL

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