

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

10th January 2011

Dear Paul,

Re: National Grid LNG Facilities Price Control – Initial Proposals

This non-confidential response is on behalf of the Centrica group of companies excluding Centrica Storage.

Scope of the control:

Centrica agrees that this control should only address short term issues in line with the Adapted Rollover for TPCR4 until 1st April 2013 and that the longer term issues should be addressed as part of RIIO-T1. In line with the principles adopted for the rollover, we believe that Ofgem should address only those issues which are essential in the intervening period. In particular, it is essential that the balance of cost and risk faced by users is not materially changed by the proposals. We also agreed that given the above, it is reasonable that Ofgem should not seek to apply the full set of RIIO principles in the initial or final proposals.

We are sympathetic to the point that NG is experiencing a different environment to that which prevailed when the current PCR arrangements were formulated, but it is important to ensure that a balanced approach is taken. In our view the current arrangements operate more as a price floor than a price cap, namely NG receives the higher of the price “cap” and the commercial revenues it is able to secure for the capacity. This is an extremely unusual position for a (semi) commercial company and has meant that over the last years, NG has been protected. The risk faced by NG has been minimal and will clearly have flowed through to revenues. Now, the proposal is to increase substantially the price floor and to extend further protection to NG. We note and applaud Ofgem’s approach in reducing the revenues sought by the amounts it believes NG elected not to secure, and the generally challenging approach taken towards NG’s request for an increase.

Scale of the increase:

We still have concerns that the scale of the increase is extremely difficult to justify in the context of a commercial company which is permitted considerable upside where it is able to secure additional

revenues and no downside due to the operation of the price floor. Increases of 85-250% for no additional service provision (and with no downside) are significant, and in our view any such award should take account of previous additional commercial revenues secured over and above the price floor.

We note the point made in 4.15 “...This is greater than the cost of capital used in DPCR5, but we consider this is justified given that the LNG business faces more risky and volatile revenues than the typical network monopoly.” However, we are of the view that the additional risk faced is not large and that the price cap (taken together with the ability to request a price control review), operates to minimise downside risk for NG LNG while allowing scope for considerable upside as a result of commercial activities. While NG LNG does face slightly more risk than a normal network monopoly, we contend that the scope for significant upside (which is not generally available to a network monopoly due to the rules around over-recovery) counterbalances this more than adequately.

Treatment of costs and revenues:

A substantial amount of the requested increase appears to be attributable to depreciation charges brought forward. Given the assets, it would seem reasonable that the economic value of the assets would have been substantially depreciated by this point and hence that the apparent acceleration may be hard to justify. If increases on this scale are to be considered in the short term (albeit supported by expected changes to asset lives), we believe that NG should provide a clear report setting out the depreciation policies over the life of the asset, the sums depreciated to date against the original economic value, any subsequent revaluations and all assumptions made. In addition, the report should include the historical commercial revenues to allow comparison against historical depreciation. While an unusual approach, we feel that this would be justified due to the position of NG in this instance where it is protected from downside by a price floor, but still has an upside available to it.

We note Ofgem’s approach to treatment of central costs apportioned to assets which are being run down with a view to closure. We agree that this is a reason for concern and that proper apportionment of costs would generally include distribution across the life of assets that would benefit from the expenditure.

As noted above, we believe that given the short term nature of the proposals, it is better to follow the “minimal change” approach. In terms of treatment of historical vs. future capex, we agree that it will be appropriate to consider the future use of the asset and the regulatory treatment. This is particularly important in the case of Glenmavis (vis-à-vis “regulated” services to Scottish Independent Networks) and the somewhat different position on Avonmouth. However, given the current consultation and request from NG for such enormous increases in the cap, including seeking to cover “commercial” revenues foregone, we have considerable reservations about allowing depreciation and return on asset base increases in line with the NG projected ratio of regulated : commercial volume output. While it would be reasonable to allow for some margin of forecasting error, if further revenues are to be allowed based on forecasts, some kind of true up mechanism would be appropriate at the start of the next price control.

Future questions to consider:

In looking to the longer term under RII0, we believe that there are a number of key questions (below) to be considered as part of the provision of LNG storage services and the degree to which these are supported by effectively regulated revenues.

- What level of LNG storage support does the system need and where does it need to be located
- What price NG is allowed to charge for the services

- How does NG determine the most economic and efficient method of service provision, e.g. by use of (semi) regulated assets or commercial contracts
- How NG is held accountable
- Based on risk faced, what level of return should NG be permitted/guaranteed for these services
- What future uses may be possible for the assets as maintained/improved – e.g. potential conversion to LNG import terminals - and what regulatory treatment might be required

Improvements to Transparency:

While for the most part, these longer term questions should fall to be considered as part of RIIO-T1, essential improvements to transparency could easily be made much sooner. We believe these changes would be beneficial in the short term and provide additional evidence for the RIIO deliberations.

NG has a licence requirement to publish an OM report in the summer of each year, this should promote competition and provide transparency on NG's activities in terms of meeting the OM requirements. In our view the current report does not deliver against these criteria and is a missed opportunity.

The selection criteria used by NG as part of the OM tender process lack transparency and hence parties' ability to compete effectively in the tender is compromised. The bid selection criteria should be published before the auction and audited afterwards to ensure consistency of approach. This would lead to a more efficient and competitive auction – for example, the current delivery to space ratio required is not published, but critical to tender selection. Bid selection should be open to industry scrutiny (not simply closed audit after the event) and where NG services have been selected in preference to competitive bids, this should be justified. We would like consideration to be given to independent oversight of the bid selection process.

In addition, NG can deliver OM by means of a number of commercial arrangements, which may or may not include service provision by the LNG storage assets. The terms of these arrangements are not transparent, NG asserts confidentiality as a reason for non-inclusion in the report, which again hampers effective competition. In our view, given that the services provided do not need to be transparent - only the volumes, deliverability, location and pricing need to be available to the same extent as in the tenders – we do not see that this should be an issue. NG's position as both buyer and seller (albeit in different parts of the group) means that it is essential to ensure that all these transactions are fully transparent and carefully scrutinised.

If there are any of the points raised in this response that you would like to discuss in more detail, I would be happy to help and can best be contacted on 07789 570046 or Alison.russell@centrica.com.

Yours sincerely,

By e-mail

Alison Russell
Senior Regulation Manager, Upstream Energy