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Date: 24 February 2011

Dear Colleague,

### **Operating Margins (OM) Contestability**

As part of the 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. The purpose of this condition was to provide a framework for NGG NTS to hold tenders for contracts for the services it needs, thereby allowing competition to develop. It was intended that if the terms of this licence condition were met, then NG LNG storage facilities should be able to tender on the same basis as other potential OM providers<sup>1</sup>. 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").

During the course of its consultations on its SO incentive scheme for 2010/11, National Grid raised concerns that the market for OM provision was not homogenous<sup>2</sup>. As a result of these concerns, a modification to Special Condition C3 was made on 18 February 2010 to clarify that Ofgem's power to direct the suspension of the C3 prices could be used for individual OM requirement types<sup>3</sup>.

Based on the criterion set out in a letter to the industry in December 2009<sup>4</sup>, in February 2010 we directed the suspension of the application of the C3 prices for Locational North, Orderly Rundown and Non-locational services with effect from 06:00 1 May 2010 to 06:00 1 May 2011<sup>5</sup>.

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<sup>1</sup> At present, the prices that non NG LNG OM providers offer into the tender are constrained to competitive levels by NG LNG in its role as the OM supplier of last resort. Therefore, in order for NG LNG to be able to "tender on the same basis" as other potential OM providers, NG LNG should face effective competitive constraints from non NG LNG OM providers such that the prices it offers into the tender are also constrained to competitive levels.

<sup>2</sup> The individual requirement types are Supply Loss, Orderly Rundown, Locational North, Locational Scotland, Locational West, Locational Wales, Locational South and Non-locational.

<sup>3</sup> [http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/Direction%20to%20Modify%20Special%20Condition%20C3\\_170210\(1\).pdf](http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/Direction%20to%20Modify%20Special%20Condition%20C3_170210(1).pdf)

<sup>4</sup> [http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/OM%20Contestability\\_211209\\_FINAL.pdf](http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/OM%20Contestability_211209_FINAL.pdf)

<sup>5</sup> See our decision letter of 18 February (hereafter the "February 2010 decision letter")

[http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/OM\\_Contestability\\_18\\_February\\_2010%20\(sig\).pdf](http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/OM_Contestability_18_February_2010%20(sig).pdf)

In November 2010 we issued a letter to the industry<sup>6</sup> (referred to in this letter as the “November 2010 open letter”) setting out that we were minded to suspend the C3 prices for the relevant period of OM provision provided that we judged the tender process to have been effective for the OM requirement type and setting out the criterion on which we would make this judgment.

There was one response to the open letter in relation to the proposed key criterion for assessing effective competition which was supportive of Ofgem’s proposed approach.

Ofgem has considered this response. In light of this supportive response, our view remains that set out in the open letter.

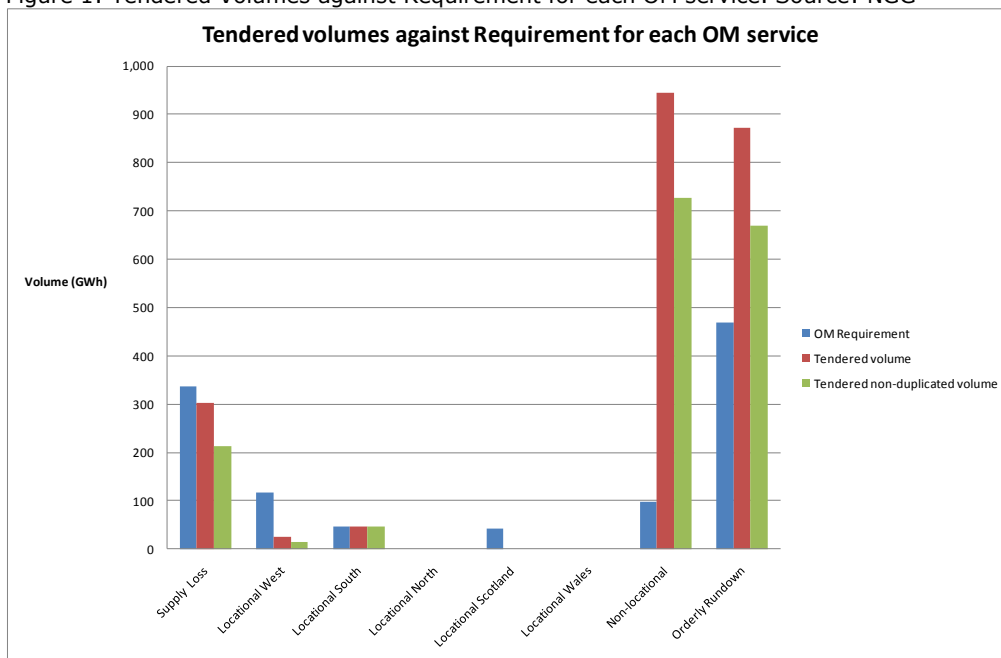
It is also worth noting that the provision of Operating Margins by reducing demand from the NTS and/or increasing supply on to the NTS was subject to a successful revision of the National Grid Transmission Safety Case that was deemed satisfactory by the HSE in February 2010. Therefore the provision of OM services to NGG NTS is open to a full range of facilities.

The current C3 prices were set during the LNG price control of 2008 and were set to endure until the earlier of 2012 or the establishment of contestability. Following an approach by NG LNG, and the suspension of the C3 prices for some requirements in 2010/11, Ofgem is currently reviewing C3 prices and has recently published its Final Proposals<sup>7</sup>.

### Assessment of OM Tender for 2011/12

The OM tender for 2011/12 has been completed and NGG NTS intends to announce the results on 25 February 2011. 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



<sup>6</sup>

<http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/OM%20contestability%20letter.pdf>

<sup>7</sup> <http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/LNGPC%202011%20Final%20Proposals.pdf>

The blue bar in Figure 1 represents the volume requirement of each OM service and the red and green bars represent the volume of offers received in the tender from non-NG LNG providers. We note that potential double counting of capabilities arising from different tenderers offering OM services at the same facility has been taken into account in the green bar.

The results of the tender as set out in Figure 1 indicate the complete volume of the Orderly Rundown and Non-locational OM requirements can be met without any requirement for services from NG LNG storage facilities. We note that across these two OM requirements a range of tenders were received. We have analysed the results of these tenders, including by undertaking "pivotality tests"<sup>8</sup>. 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 two 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 services<sup>9</sup>:

- Orderly Rundown; and
- Non-locational.

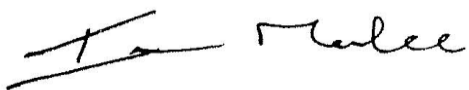
The suspension of the application of these C3 prices will take effect from 06:00 1 May 2011 to 06:00 1 May 2012 i.e. the duration of the 2011/12 gas storage year associated with the 2011/12 OM tender process.

For the avoidance of doubt, on the basis of the tender results, NGG's assessment of each OM requirement and our assessment criteria, we do not consider that competition has been effective in the provision of the Supply Loss, or any Locational Service.

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.

If you have any queries or comments on this letter, please contact Philippa Pickford (07786 197346) or Timothy Wyndham (020 7901 7146) in the first instance.

Yours sincerely



Ian Marlee  
Partner, GB Markets

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<sup>8</sup> 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.

<sup>9</sup> For further details see the attached direction.