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Date: 06 January 2012

Dear Colleague

Decision on Glenmavis Liquefied Natural Gas facility

The purpose of this letter is to set out our policy decision on funding the Glenmavis Liquefied Natural Gas (LNG) facility following on from our consultation[1] issued earlier this year.

We sought responses on our proposal to modify Table 1 in Special Condition C26 of National Grid Gas' (NGG) Gas Transporter (GT) Licence to reflect the increased costs incurred by Scotland Gas Networks (SGN) as a result of the early closure of Glenmavis LNG facility. The increased costs arise from the additional transportation costs in sourcing LNG from Avonmouth (£1.1m), the cost of booking LNG storage at Avonmouth (£3.5m) and the cost for maintaining the Glenmavis site as a storage buffer during 2011/12 (£7m[2]). The total funding increase required at that time was therefore £11.6m (all in 2011/12 prices).

We had also proposed to amend the definition of "independent system" within C26, to more correctly reflect both the policy intent and current implementation of the condition[3]. We are further of the view that in the interests of completeness and consistency, a corresponding amendment should be made to SGN's licence in order to dovetail with the amended definition of "independent system" in the NGG licence.

One respondent to the August consultation indicated that recovering costs in 2011/12 would have a significant impact on exit capacity prices at some exit points (ranging from zero changes at some exit points to an increase of up to 1700% at other exit points). It was suggested that recovering costs in 2012/13 would minimise charging volatility and the impact of higher charges upon shippers would not be as significant.

[1] Glenmavis Liquefied Natural Gas (LNG) facility and supply to the Scottish Independent Undertakings (SIUs), Aug 2011, Ref 107/11.
http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/110812_GM_public_consultation_letter.pdf
[2] This figure is based on the recent average efficient running costs for the Glenmavis site, excluding long term capex investments. We believe this is a proportionate approach to the cost assessment given the nature of the situation and timing involved.
[3] The Final Proposals for the current Gas Distribution Price Control specifically remove the costs for running the independent systems from SGN's allowance, on the basis that it is to be recovered through Special Licence Condition C26.

The Authority has considered responses received to the consultation and undertaken further analysis of the position faced by SGN, the Scottish Independent Undertakings[4] (SIUs) it serves and consumers. The Authority's decision, in the interests of ensuring the security of supply to the SIUs and consumers, and in accordance with the Secretary of State's Direction of 19 March 2008, is as follows:

1. to allow for the additional costs incurred by SGN in the 2011/12 formula year to be payable by NGG to SGN;
2. to allow for NGG to pay these additional 2011/12 formula year costs to SGN over the 2012/13 formula year, with an appropriate adjustment to keep SGN net present value neutral to the timing gap between their expenditure and the revenue recovery;
3. to allow for NGG to recover these additional 2011/12 formula year costs from shippers in the 2012/13 formula year; and
4. to amend the definition of "independent system" within Special Condition C26 of the GT Licence to reflect both the policy intent and current implementation of the condition by specifically providing for LNG costs as well as LPG costs.

All figures that are to be included in NGG's Licence will have a 2009/10 price base as per the Authority's decision[5] to implement a change in the methodology of RPI indexation. There are further minor changes to reflect the intent of the RPI indexation methodology. This is consistent with our approach in the TPCR4 rollover price control.

Background

National Grid LNG (NG LNG) owns the Glenmavis LNG facility. Historically, this facility has provided a combination of commercial storage services to gas shippers and price regulated services to both NGG and SGN.

In December 2010, the Glenmavis facility developed a suspected leak in the cold box and had to suspend its liquefaction process. Whilst Glenmavis was able to meet its supply obligations to the end of the 2010/11 storage year[6], its capability in the next couple of years is subject to a number of uncertainties. As a result it was excluded from the scope of the LNG Price Control Final Proposals[7] which the Authority[8] has approved.

The prices charged by NGG to SGN for liquefaction, storage space and tanker loading are also restricted to those specified in Special Condition C3 of NGG NTS's licence. The switch to sourcing LNG from Glenmavis to Avonmouth, along with the revised regulated prices as a result of the recent NGG LNG price control, has resulted in a change to SGN's costs in providing services to the SIUs. In the Gas Distribution Price Control Final Proposals we said that consumers should underwrite any such costs arising from changes to the regulated prices in Special Condition C3[9] of the Gas Transmission licence. Avonmouth C3 prices have increased; the Avonmouth booking costs incurred by SGN are £3.5m (in 2011/12 prices).

We had previously assessed that these costs were in line with historical levels that have been subject to cost assessment through two previous price controls. We recognise that there were a limited number of short-term solutions available to SGN that would not have compromised the SIUs' security of supply.

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[4] These constitute four remote towns in Scotland which are not on the main gas grid. They are supplied with LNG which is delivered by road tanker.
[5] http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RPI%20Issue%20-%20Decision%20Letter.pdf
[6] A storage year is a 12 month period from 1 May in any year to the following 30 April.
[7] LNG Storage C3 price control – Final Proposals", Ofgem ref A11/18, 21 February 2011
[8] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms "Ofgem", "the Authority", and "we" are used interchangeably in this document.
[9] Gas Distribution Price Control Review Final Proposals Document (8.25)– Ofgem Ref 285/07, 3 December 2007

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We issued a consultation in August 2011 that detailed the proposal for Glenmavis to be used as a buffer tank for the 2011/12 storage year for the purposes of serving the needs of the Scottish Independent Undertakings[10] (SIUs), in order to secure supply to these vulnerable communities.

Responses

We received three responses to our consultation from SGN, NGG and NG LNG. The three respondents supported the principle of passing the extra costs SGN incur from supplying the SIUs via Special Condition C26. They also support the proposed wider definition of "independent systems" to include LNG.

However, NGG raised an issue with respect to the timing of passing costs via the C26 mechanism. In our consultation we indicated that the costs should be recovered in the current formula year (2011/12), however NGG state that shippers are likely to incur significant costs in their entry and exit charges but particularly in relation to exit charges.

NGG pointed out that if the costs were to be recovered in the current formula year, exit charges are likely to change and be applicable from February so that the revenue could only be recovered over the two months of the formula year (February and March 2012). The same would apply for entry charges.

NGG are able to amend entry charges in April and October. This is not the case for exit charges. Exit charges set from February 2012 (in formula year 2011/12) will apply until October 2012 (in formula year 2012/13). NGG argued that there is a risk that the change to exit charges to apply from February 2012 would be greater than they would otherwise have been.

In relation to exit charges NGG would over recover in the first part of 2012/13 and have to adjust the exit charges downwards, in order to ensure that for the remaining portion of the year they recover only the revenue allowance in order to avoid over recovery. NGG argued that shippers would not welcome the introduction of recovery in 2011/12, due to the volatility it would introduce both within 2011/12 (with limited notice) and within 2012/13.

In addition, the effect of the 0.0018 p/kWh exit charge increase differs across exit points. NGG identified that there would be a median increase in exit charges of 13%. Some exit points would not be significantly affected by the increase however other exit points could see an exit charge increase of 1700%

In response to NGG's suggestion SGN have indicated that to recover the additional costs in 2012/13 would mean a significant short-term under recovery of £11.6m for SGN. SGN pointed out that they have no control over theses costs and had expected to be able to recover them in the year incurred i.e. 2011/12.

The Authority's decision

After careful consideration, we have decided to allow the recovery of the additional costs incurred by SGN for supplying the SIUs. NGG's Gas Transporter Licence will be amended in Table 1 of Special Condition C26 and will reflect the increased costs of £11.09m (2009/10 prices) imposed on SGN.

Whilst SGN bore the costs in 2011/12, the costs will be recovered in 2012/13 and will be reflected as such in the Gas Transporter's Licence on a 2009/10 price base to reflect the new RPI indexation methodology.

[10] These constitute four remote towns in Scotland which are not on the main gas grid. They are supplied with LNG which is delivered by road tanker.

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We recognise the concerns that SGN have raised. The cost adjustments have been calculated to keep SGN net present value neutral to the delay in cost recovery to 2012/13, which accounts for the uplift of the cost adjustment (in 2011/12 prices) from £11.6m originally expected to £12.17m.

The table below details the breakdown in costs incurred by SGN that they will be entitled to recover. As indicated earlier, NGG's Licence will have a 2009/10 price base as per the Authority's decision[11] to implement a change in the methodology of RPI indexation. The total additional costs to be recovered is shaded in blue and will be added into NGG's Licence[12].

	SGN NPV neutral (2009/10 price base)	**SGN NPV neutral (2011/12 price base)**	**August 2010 consultation (2011/12 price base)**
Additional transport costs	£1.05m	£1.15m	£1.1m
Additional Avonmouth booking costs	£3.35m	£3.67m	£3.5m
Glenmavis Storage Buffer	£6.69m	£7.35m	£7m
Additional costs to be recovered	**£11.09m**	**£12.17m**	**£11.6m**

We will amend the definition of "independent system" within C26, to more correctly reflect both the policy intent and current implementation of the condition[13]. The method to allow the recovery of the additional costs incurred by SGN for supplying the SIUs is via NGG's licence.

This decision relates to resolving costs in the 2011/12 storage year. We will work with SGN to agree the solution for future storage years including reviewing the proposals set out in their business plan which is available on their website[14].

This letter shall constitute sufficient notice in respect of the licence modifications for the purposes of s38A of the Gas Act 1986.

If you have any comments or questions on this letter, please contact Natasha Ranatunga on +44 20 7901 7183 or gas.transmissionresponse@ofgem.gov.uk in the first instance.

Yours faithfully

Rachel Fletcher,
Acting Senior Partner – Smarter Grids & Governance: Distribution

[11] http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RPI%20Issue%20-%20Decision%20Letter.pdf

[12] The £11.09 figure will be added to the existing subsidised charge of £6.03m (£5.4m in 2005/06 prices) which covers the cost of booking capacity at Glenmavis, the cost of LNG tanker filling and the cost of transporting the LNG to the SIUs from Glenmavis.

[13] The Final Proposals for the current Gas Distribution Price Control specifically remove the costs for running the independent systems from SGN's allowance, on the basis that it is to be recovered through Special Licence Condition C26.

[14] http://www.sgn.co.uk/index.aspx?id=6557&rightColHeader=87&rightColContent=15&rightColFooter=237&TierSlicer1_TSMenuTargetID=565&TierSlicer1_TSMenuTargetType=4&TierSlicer1_TSMenuID=6

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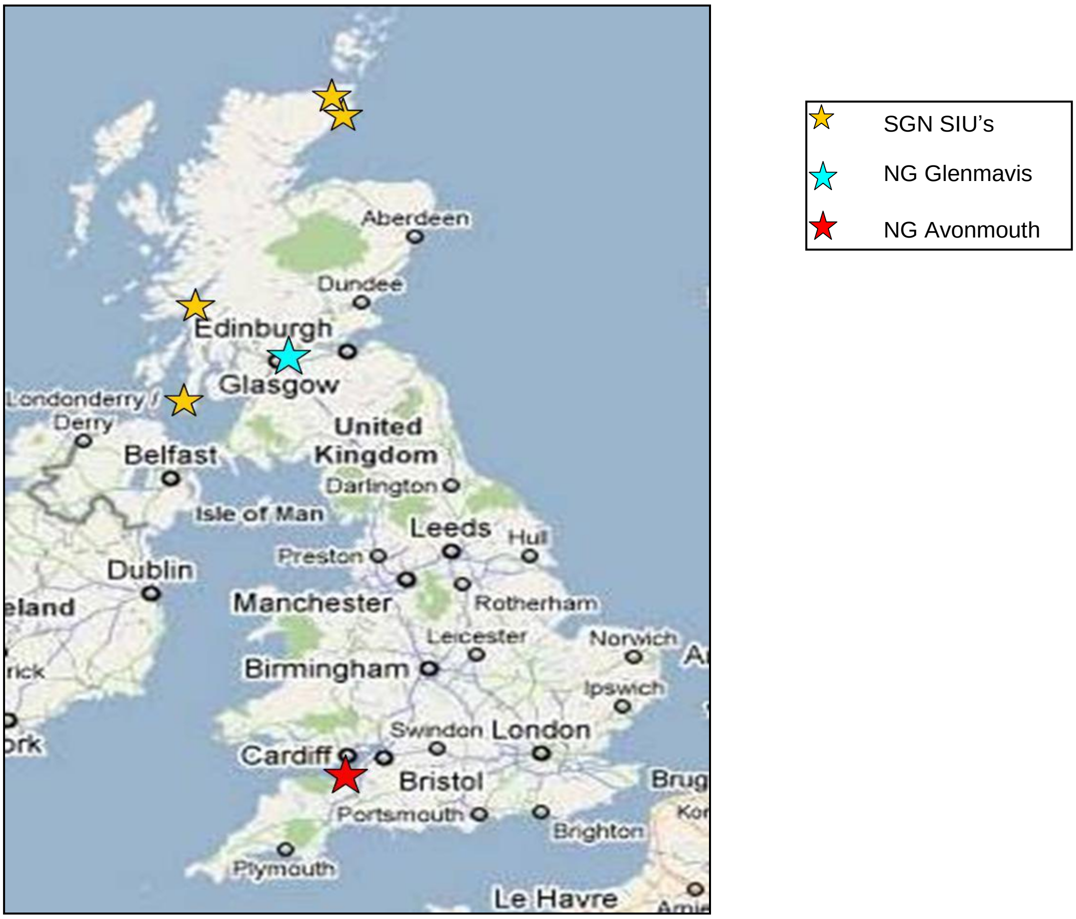
Appendix One - Map of SIUs and LNG facilities



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Appendix Two
Background to regulated service at Glenmavis

NG LNG facilities

Glenmavis is one of five LNG facilities[15] that were sited at strategic points in the transmission network in the mid 1970s, as an economic alternative to network reinforcement. These facilities were separated out from the regulated operations of NGG in the late 1990s[16], in order to promote contestability in the provision of operating margins (OM)[17]. The Glenmavis facility is owned and operated by National Grid LNG ("NG LNG"). We have continued to price regulate the provision of OM services by NG LNG to NGG and shall continue to do so until Ofgem is in a position to remove the current price cap for the provision of OM services as specified in Special Condition C3 of NGG NTS' licence[18].

Glenmavis LNG regulated services

The Glenmavis facility has been used to supply OM services to NGG and supply LNG to SGN to serve the needs of the SIUs. The SIUs comprise four independent gas networks that serve about 7,600 consumers that are located in remote regions of Scotland; namely, at Wick, Thurso, Oban and Campbeltown. They total around 91km of pipes, which are supplied with re-gasified LNG. Whilst these SIUs are not physically connected to SGN's main distribution network, SGN are responsible for maintaining and supplying the SIUs.

The LNG for SIUs has primarily been sourced from the Glenmavis LNG site, and then transported by road tanker to smaller local storage sites. Avonmouth and Partington have acted as back-up sources whenever Glenmavis has been unable to provide LNG.

NG LNG closed Dynevor Arms in 2008 and announced the withdrawal of commercial storage services from the Partington and Glenmavis facilities in 2010. Glenmavis facility suspended its liquefaction process in December 2010. NG LNG confirmed that it would withdraw regulated services from Glenmavis from May 2011. Consequently Avonmouth is the single source of liquefaction in GB as Isle of Grain was converted into a LNG importation terminal in 2005. Accordingly, since May 2011, SGN have been sourcing the LNG required to supply its SIU customers from Avonmouth. Sourcing from Avonmouth increases the distance to the SIU consumers by up to three times and also raises security of supply issues. See Appendix One for a map of the relevant SIUs and LNG facilities.

SIU funding arrangements

The cost of supplying LNG from the Glenmavis facility to these four networks is subsidised through a charge levied by NGG on all shippers, so these costs are no higher than the average GB gas transportation charges. The subsidised charge covers the cost of booking capacity at a LNG storage facility, the cost of LNG tanker filling and the cost of transporting the LNG to the SIUs.

This subsidy is in accordance with a Direction from the Secretary of State issued on 19 March 2008. The arrangement will lapse with the end of the current gas distribution price controls[19] on 31 March 2013.

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[15] Glenmavis, Partington, Avonmouth, Dynevor Arms and Isle of Grain LNG facilities.
[16] The Isle of Grain site was subsequently converted to an import terminal
[17] OM gas is used to maintain system pressures when the system has been put under stress until other system management actions become effective. There are several providers of these services to NGG, other than the NG LNG sites.
[18] For further details on this issue, see Operating Margins (OM) Contestability 2010/11 – Open Letter, 21 December 2009
[19] We understand that the Department for Energy and Climate Change will be consulting on the future options around these subsidy arrangements later in this year.

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This charge, which has historically amounted to £5.4m pa (in 05/06 prices), is then passed from NGG to SGN (through the operation of Special Condition C26 of the Gas Transporter Licence[20]) to fund the LNG tanker filling and transportation costs. The cost for operating and maintaining these SIU networks is funded separately through SGN's price control.

Current Situation

The Glenmavis facility had an expected operational life until 2015. The sudden failure of Glenmavis requires SGN to bring forward plans for an enduring supply solution for the SIUs. Arrangements also need to be put in place to maintain the supply to these networks until the long-term solution can be implemented.

Maintaining supplies in the short term

SGN considers that there would be significant risks to the security of supply for the SIUs in winter 2011/12 if it were to rely on the regular tankering of gas from Avonmouth. Since the local LNG storage capacities of the SIUs are limited and are not readily capable of expansion, SGN has considered a range of supply options that can be implemented in time for the 2011/12 winter.

SGN is proposing to use one of the Glenmavis storage tanks as a buffer store. Under this proposal, SGN will use tankers from Avonmouth to fill Glenmavis during the summer, such that travel distance to the SIUs in winter would be consistent with the current arrangements. These arrangements have been put in place since the start of the storage year 2011/12.

The enduring supply situation

SGN are evaluating a range of options for the longer-term supply of these networks, including lower carbon alternatives and have presented these in their business plan submission. In this regard, it is worth noting that the Department for Energy and Climate Change (DECC) intends to consult on whether the existing cross-subsidy arrangements for SIUs should extend beyond the current 2013 cessation. We expect this consultation to take place soon.

[20] This condition also covers certain subsidies in relation to independent networks that are supplied with Liquefied Petroleum Gas

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