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Date: 24 February 2012

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 providers¹. 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")².

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 homogenous³. 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 types⁴.

Based on the criterion set out in a letter to the industry in December 2009⁵, we directed the suspension of the application of the C3 prices for Locational North, Orderly Rundown and Non-locational services in February 2010 with effect from 06:00 1 May 2010 to 06:00 1 May 2011⁶.

¹ 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.

² In April 2011 Ofgem directed the modification of Special Condition C3 setting out the new regulated prices from 1 May 2011.

<http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/Decision%20under%20Section%2023%20C3%20LNG%20prices.pdf>

³ The individual requirement types are Supply Loss, Orderly Rundown, Locational North, Locational Scotland, Locational West, Locational Wales, Locational South and Non-locational.

⁴ [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)

⁵ http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/OM%20Contestability_2_11209_FINAL.pdf

⁶ See our decision letter of 18 February 2010

[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)

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.

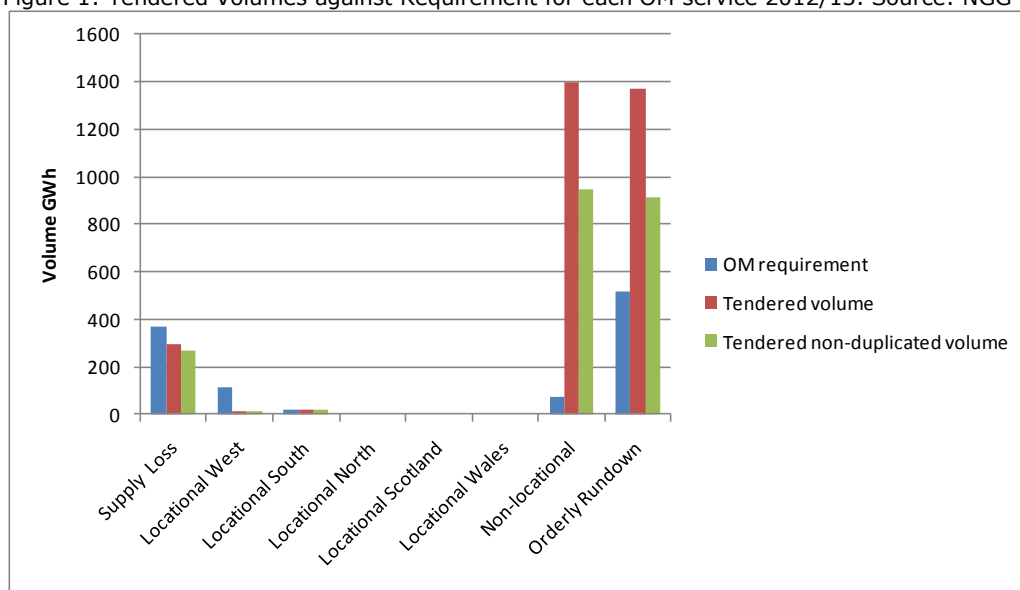
In November 2010 we issued a letter to the industry⁷ setting out that we were minded to suspend the C3 prices for the relevant period of OM provision provided that we judged the tender process to have been effective for the OM requirement type and setting out the criterion on which we would make this judgment. Based on this criterion, in February 2011 we directed the suspension of the application of the C3 prices for Orderly Rundown and Non-locational services with effect from 06:00 1 May 2011 to 06:00 1 May 2012⁸.

Assessment of OM Tender for 2012/13

We have assessed the effectiveness of the competition resulting from the OM tender process for 2012/13. As set out in our February 2011 decision, our key criterion for assessing the effectiveness of competition is whether NGG NTS could purchase the complete volume of each of the OM requirements from providers other than NG LNG. The open letter also set out that in cases where only a small number of non NG LNG tenders are received we shall also need to consider factors beyond our key criterion, for example the range of tenders received and the level of prices offered.

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 2012/13. Source: NGG



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.

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

⁸ See our decision letter of 24 February 2011

<http://www.ofgem.gov.uk/NETWORKS/TRANS/GASTRANSPOLICY/LNGPRICECONTROL/Documents1/OM%20decision%202011.pdf>

The results of the tender as set out in Figure 1 indicate the complete volume of the Orderly Rundown, Non-locational OM and Locational South requirements can be met without any requirement for services from NG LNG storage facilities. We note that in the case of Orderly Rundown and Non-locational OM requirements a range of tenders were received. We have analysed the results of these tenders, including undertaking "pivotality tests"⁹. Having considered this analysis we are satisfied that competition is effective for the provision of Orderly Rundown and Non-locational OM requirements.

For the reasons set out above, the Authority intends to direct the suspension of the application of C3 prices for the following services¹⁰:

- Orderly Rundown; and
- Non-locational.

The suspension of the application of these C3 prices will take effect from 06:00 1 May 2012 to 06:00 1 May 2013 i.e. the duration of the 2012/13 gas storage year associated with the 2012/13 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 Mathieu Pearson (020 7901 7294) in the first instance.

Yours sincerely

Martin Crouch
Partner, European Wholesale

⁹ 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.

¹⁰ For further details see the attached direction.